July 14, 2022

Dear Friend of Valara Capital Management,

For the second quarter and six months ended, June 30, 2022, Valara Partners, LP. produced total returns, net of fees, of -19.55% and -10.85%, versus -16.10% and -19.96%, for the S&P 500 index, respectively. Value, as a style, outperformed growth and the S&P 500 for the quarter, while we did not. Although I found this performance frustrating, I am pleased that we remain well ahead for the year and confident that our portfolio is well positioned to achieve our long-term objectives – more below.

QUARTERLY REVIEW

The market focal points in the quarter remained: inflation, the Federal Reserve/interest rates, the war in Ukraine, Covid (in China), supply disruptions and shortages. Oil and gas continued to play a key role, particularly in Europe. As the quarter progressed, the economic fallout of the above added a new top concern to the list – imminent recession. A handful of economists, myself among them, believe a US recession may have already begun, despite the ongoing favorable job market results. You may recall that the first quarter of 2022 saw GDP contract by 1.4%. Mid-way through June, the Atlanta branch of the Federal Reserve updated its forecasting model (it has a particularly good record) to reflect another contraction in Q2. While the technical definition of recession is two sequential declines in GDP, the "spin machine" is fast to point out that the current dynamic is primarily a function of year ago comparisons – which included Covid support payments and pent-up demand at the end of lockdowns.

The war in Ukraine has already been longer, more expensive and vastly more disruptive to global trade than initially hoped. It wasn't bad enough that our global supply chains are being completely redrawn (geographically) and disrupted. Sanctions on Russian exports have made everything worse. In particular, the world is facing a severe energy crisis, with Europe at the epicenter. Having cut back dramatically on nuclear and allowing themselves to become heavily dependent on Russian oil and gas, the EU faces a choice between their principles and a long, cold, winter. Globally, coal has made a huge comeback because of the poor planning and delusional assumptions regarding how quickly alternative energy could step in for fossil fuels. Over the last ten years, the oil companies, their CEO's and their sources of capital have been chastened/vilified (for producing a product everyone desperately needs) to such an extent that they now question the wisdom of making the long-term investments required to increase supply of crude and refined product. President Biden, misunderstanding economics and capitalism, has threatened the oil industry with windfall profit taxes. High oil prices are exactly what is needed to incentivize conservation and increase supply – that's how markets work. We will reduce our carbon emissions, but it is going to be a very long road. Hope and virtue signaling will not bridge the gap. In the meantime, we rely on fossil fuels for transportation, industry, farming, health care, consumer products, packaging, and much more.

The rise in economic, geopolitical and social uncertainty has not been lost on markets. As inflation ramped up through the first half of the year, interest rates rose. Most starkly, mortgage rates have doubled. In April, when it became apparent that the Federal Reserve was going to get aggressive withdrawing stimulus, the yield curve briefly, and very slightly, inverted, suggesting economic weakness ahead. The inversion did not last long but as the third quarter gets underway it has returned and more definitively so. Asset prices, foreign exchange rates and credit spreads are warning that risk is on the rise, with emerging markets making headlines for currency weakness, faltering credit and social unrest. Most unusual has been the dramatic weakness in the Yen and the Euro. Both currencies are acting like there is something structurally wrong in these economies (a story for another day). The strength in the US dollar (fundamentally, the cleanest dirty shirt because of its reserve currency status) has been noteworthy.

PERFORMANCE COMMENTARY

Value outperformed Growth and the S&P 500 for the quarter. Our failure to keep pace was mostly a function of our sector weights. For the period, the top three sectors were Consumer Staples, Utilities and Health Care. We are underweight all three. The worst three sectors were Consumer Discretionary, Transportation and Communication Services. We are slightly overweight in Consumer Discretionary – not so bad. Gold mining is not a sector but, if it was, it would have been dead last and represented our largest sector overweight. A strong US dollar is frequently negative for gold and proved to be in this instance. While disappointed with this outcome, I believe that the intermediate term backdrop remains very favorable. There is an ongoing battle over the requisites for sound money and its gaining intensity. Russia and China have already moved to increase the ratio of gold in their reserves while digital gold – all the rage in recent years – has suffered massive credibility hits in the last few months. The monetary aspect of gold has been a secondary part of our thesis for the mining stocks, but it is becoming more tangible as the global central banks struggle.

It was a very quiet quarter with respect to trading. Early in the period we sold Mosaic and Archer Daniels into strength. We nearly eliminated both positions before they joined the sell off, with sales of MOS in the high $70s and ADM in the mid $90s. We have minimal residual positions in both. We also eliminated our position in GAP in an admission of error. We bought the stock when the flagship GAP brand was a "turn around" project but the Old Navy brand was doing well and Athleta was potential upside. The Gap brand continued to struggle, and we gave it some latitude but when Old Navy faltered, into a weak economic backdrop, it was time to move on. I continue to believe the present environment will punish operational and/or financial weakness. Proceeds of our sales were deployed into Warner Brothers Discovery and defending (small additions into weakness) our positions in Barrick Gold, Agnico Eagle Mines and Pan American Silver.

OUTLOOK

Hillary Clinton wrote "it takes a village" but the first half of 2022 suggests it may "take a crisis". For the last three decades the Federal Reserve has led global central banks down the path of playing God with markets. Over that period (since Paul Volker), when faced with unpalatable challenges, they have arrogantly and irresponsibly thrown free markets under the bus as if they could corrupt the rules and not undermine/destroy the system. Humans learn and adapt - when the rules change, they notice and adapt. Lack of enforcement, exceptions, mission creep and bailouts become the equivalent of case law. Without zero interest rates (for ten of the last fourteen years) thousands of companies would have failed but the economy would be stronger for it today. Failure is an essential part of capitalism – the refresh cycle. Most of those imperiled companies are still around, they have been joined by others, and have grown even more dependent on artificial support. Meanwhile they have prevented stronger, smarter and better managed companies from taking their place. This difficult adjustment is still in front of us and its why I believe that the Federal Reserve will have a very hard time raising interest rates without creating another crisis. It looks like that is what it is going to take to relearn the basic lesson – let markets clear.

That sounds pretty depressing and threatening, but it's not all woe. There is a common mistranslation of the Chinese word for crisis that I love despite the error. In Mandarin, the Chinese word for crisis is made up of two symbols: danger and critical juncture. The West, in its perpetual optimism, has commonly translated the second term as opportunity. Danger and Opportunity. It may be that my optimism takes time to bear out but our valuation model suggests that there are very good long term-investment opportunities in this market – we own a lot of them. If we do face a crisis, it too shall pass. We will get through whatever comes by following our discipline and I have confidence that it will serve us well – just as it did coming out of the Covid crisis in 2020 and the financial crisis of 2008. Thank you for your continued interest and support and feel free to call or email with any questions.

Sincerely,

Robert W. Simmons, CFA
Principal