Valara
Capital Management, LLC

January 12, 2023

Dear Friend of Valara Capital Management,

For the fourth quarter and twelve months ended December 31, 2022, Valara Partners, LP. produced returns, net of fees, of 23.25% and 1.17%, versus 7.56% and -18.11%, for the S&P 500, respectively. As added color, for the full year 2022, the Russell 1000 Value total return was -7.54% and the Russell 1000 Growth was -29.14%. It was a rough year for the US markets and I am pleased with our results.

QUARTERLY REVIEW

After hitting its low for the year in early October, the S&P 500 rallied 14% through November before giving half of it back by year end. Anticipation of Federal Reserve action played a dominant role in the narrative. The discussion has clearly shifted from inflation to an economic slowdown or recession – with ongoing speculation about if, or when, the Fed will blink. While Wall Street is obsessed with the Fed (has been for decades), I will venture to say that there are bigger geopolitical changes in the works – you can almost feel the plates shifting underfoot. The war in Ukraine has become entrenched and continues to ratchet up in its gravity. For Russia it is existential because it relates to the neutral zone that NATO (for decades) promised would be respected. Russia doesn't want NATO weapons in Ukraine any more than we wanted the Soviet Union's missiles in Cuba. It may be too big a generalization; but, for the US it's about maintaining the Hegemon/dollar – also existential. The entire world is hoping to see the situation defused. After the disastrous retreat from Afghanistan, a snubbing by Saudi Arabia and OPEC, freezing Russian dollar reserves and confiscating private property (makes the dollar less attractive as a reserve asset), the emerging trade of oil in Yuan, the digital currency settlement network being set up by the BRICS for trade away from the dollar, friction with Israel's new Netanyahu government..., one might worry that the US was losing global stature. The United States needs to reemphasize competence, principle and leadership in the basics. Unfortunately, this has been in short supply. Our recent election(s) is a case in point. It's not just that we are divided, it's the inability to reestablish bipartisan confidence in the system. There is no doubt it could be done, but there appears to be a lack of will to do it. Handling mission critical things correctly was something we used to be admired for. The world is watching and wondering whether our historic model, never perfect but the envy of all, is breaking down. "Liberty and Justice" aside – that's bad for business (long run).

Relations with China are not getting better either. In late October they held the 20th National Congress of the Chinese Communist Party and President Xi dramatically consolidated power. He publicly dismissed/humiliated his moderate predecessor and stacked his inner circle with hard liners. The fact that the country has made long term oil deals with Saudi Arabia in Yuan, has stockpiled commodities, diversified its reserves away from dollars and antagonized Taiwan, has the US military on edge. Whether it's out of true friendship or practicality, China and Russia have become two pillars (manufacturing and resources) of what looks like an emerging multipolar world. It's too soon to tell but 2022, and the fourth quarter in particular, offered some interesting data points.

In Europe, the UK Prime Minister did in fact lose her job (as speculated in our last letter) and the reappearance of the bond vigilantes should not be forgotten. There are many countries (all of the G7) that have fiscal/monetary backdrops that are similarly strained and the idea that the Central Banks/Treasuries of these countries are omnipotent will be increasingly questioned.

On the corporate front, S&P 500 third quarter earnings were better than feared, if still not great. Technology companies generally disappointed and Energy was the primary area of strength. Amazon, Google, Meta (Facebook), Microsoft and Hewlett Packard announced layoffs despite payroll numbers for the broader economy continuing to look reasonably good – albeit out the rear window. FTX (crypto currency exchange) failed spectacularly and the attorney that liquidated Enron was hired to oversee the bankruptcy. He noted that the situation (corporate controls and financial reporting) was “unprecedented” - the worst he has ever seen. These “revelations” tend to occur when the “tide is going out” and bad decisions become more challenging to obscure.

Credit markets traded sideways in the fourth quarter but with considerable volatility. The ten-year treasury yield peaked at 4.24% in October with the 30-year mortgage rate cresting over 7.30%. Both yields ultimately pulled back from these levels. The yield curve, which definitively inverted in late July, got incrementally more so into year-end and credit spreads peaked with interest rates and then narrowed.

PERFORMANCE COMMENTARY

As noted above, Value outperformed Growth and the S&P 500. The US equity markets were middle of the road in terms of global performance. Europe bounced hard in the fourth quarter (+23%), with warmer than expected weather and related lower gas prices driving an improved economic outlook. The emerging markets lagged, which is typical in periods of heightened uncertainty.

With Value outperforming, the top four sectors were Energy, Industrials, Materials and Financials. Importantly for Valara, if gold mining was a sector, it would have ranked second best. The lagging sectors were Consumer Discretionary, Communications Services, Real Estate and Technology. Overall, sector weighting helped the partnership’s returns significantly.

Stock selection was also an important factor. Amazingly 24 of our 27 portfolio positions outperformed the S&P 500 – most by a very wide margin. Over half of our positions beat the best performing sector (Energy +21.5%) with seven of our top-ten positions rising over 28%. Our top five performances came from TechnipFMC +44%, Baker Hughes +41%, Fluor +39%, Gilead Sciences +33% and AIG +31%. We had two significant underperforming positions - Mosaic (-9%), which is no longer a sizable position for us, and Warner Brothers Discovery (-18%), which is a sizable position and I believe will be an important contributor in the future.

It was a very rewarding trading quarter, of selling into strength and redeploying capital. In the period we trimmed our positions in Fluor, Murphy Oil, Textron, NOV and MetLife. We invested the proceeds in Warner Brothers Discovery, Mohawk, a handful of our existing gold miners, Citigroup and Gilead Sciences. All of these trades were in response to price movements requiring rebalancing, according to our discipline, that significantly improved expected future returns.

OUTLOOK

Inflation has eased over the last few months as the global economy has slowed and I expect this trend to continue for a while. Despite increased optimism that the United States will enjoy a soft landing, I remain skeptical. The Fed has already tightened enough to create a disruptive headwind for growth and something systemic (liquidity or credit related) is likely to break. This has happened in each of the last two tightening cycles as the Federal Reserve attempted to reintroduce market discipline. I find it hard to believe that a decade of zero interest rates and complacency did not produce its share of malinvestment in need of correction. If it didn’t, it would be remarkable and clash with my experience of human nature.

While I expect inflation to ebb for a while, structural factors suggest that it is not gone for good. The reversal of globalization, in evidence for the past few years, is probably here for a while – in fact it is currently intensifying. Biden’s passage of the CHIPS Act last fall is indicative of the trend toward recapturing control of critical supply chains. Taiwan Semiconductor is now finding/warning that the total cost of ownership for its new Arizona plant is five times that of their plants in Taiwan. There will be an ongoing cost to reshoring. In addition, the US Government just posted the fourth annual deficit in a row at or above $1 Trillion, and Congress passed a new $1.7 Trillion spending bill for 2023. Fiscal discipline is gone and will not be coming back by choice. The poor Federal Reserve (I don’t really feel sorry for them) will have to manage as best they can. Finally, the easing of global inflation has occurred with China economically on its back foot. As “zero-Covid” eases, Chinese demand will pick up.

Corporate fundamentals are likely to be softer going forward as Fed tightening measures, and still-elevated inflation, erode income and discretionary spending. Recent earnings revisions have been to the downside and I expect to see profit margins contract, even without a recession. Robust government spending should be somewhat of an offset. The S&P 500 is trading at roughly 22x our estimated normalized earnings for 2023, which seems pretty richly valued.

In summary, the background remains uncertain (as usual), and the broader market not cheap. While uncertainty can be unpleasant, it also provides opportunity – that is my concluding message. Despite myriad issues, weak and volatile markets, 2022 was a positive year for Valara LP. Our portfolio of strong companies continues to trade at a weighted average 8x and median 9x estimated forward earnings (normalized) and is well positioned for future outperformance. By sticking to our discipline, I remain confident we will continue to produce superior results over the investment cycle. As always, please email or call with any questions you may have.

Sincerely,

Robert W. Simmons, CFA
Managing Member

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