

July 14, 2023

Dear Friend of Valara Capital Management,

For the second quarter and six months ended June 30, 2023, Valara Partners, LP. produced returns, net of fees, of -3.65%, and 0.71%, versus 8.74% and 16.89%, for the S&P 500, respectively. The market rally for 2023 has been extremely narrow, with a handful of stocks accounting for over half of the S&P 500's total return.

QUARTERLY REVIEW

In most respects, the second quarter of 2023 was one of de-escalation. After First Republic Bank was acquired by JP Morgan in late April, the recent banking crisis began to quiet down. The Federal Reserve's Bank Term Funding Program (BTFP), open to all federally insured depository institutions, allows the borrowing bank to receive par value of their loan collateral, regardless of how far underwater their pledged paper may be. In combination with reassuring FDIC actions, this seems to have worked. However, depending on the magnitude of the underlying asset/liability management mistakes, problems may yet prove unmanageable for small/weaker banks. The economy has held up better than expected in the face of higher interest rates, largely because of massive fiscal support, BTLP liquidity and generally accommodative markets. The increase in Federal borrowing in fiscal 2023 will be in the vicinity of \$1.7 trillion. In a period of economic growth that is remarkable and, long-term, worrisome. During periods of expansion, we should be paying down debt not increasing it. Needless-to-say, the Federal debt ceiling was raised and the issue kicked down the road again. As far as the market is concerned – "out of sight, out of mind." While artificial intelligence has been a hot theme for quite some time, it ramped into a frenzy in the first half. With the introduction of ChatGPT, late last year, the enthusiasm around AI has exploded. It is not an exaggeration to say that every earnings conference call I listened to in April touched on the topic. Much like the emergence of the internet in the late 1990's, everyone is trying to figure out who will benefit. As they do, they have bought Nvidia, Microsoft, Meta Platforms (Facebook), Apple, Amazon and Tesla. These six stocks which account for over 24% of the S&P 500 index, were individually up between 40% and 190% in the first half of the year. This type of concentration, at sky high valuations, exceeds my willingness to believe and/or ability to model. That does not make it incorrect - just unlikely.

Global stock markets were strong across the board with the single exception being China, which declined 10.6% as their reopening from Covid disappointed, and their real estate credit woes re-intensified. The US Treasury market, which rallied into early April, spent the rest of the second quarter selling off, as economic growth was better than expected dampening hopes that the Fed would restrain policy tightening. Corporate credit spreads bounced around but were largely unchanged. The US dollar, similarly, traded sideways in a fairly narrow range.

PERFORMANCE COMMENTARY

Given the above, it will surprise no one that growth significantly outperformed the S&P 500 and, to an even greater extent, value - in both the quarter and year to date. At this point in the cycle, Valara is concentrated in value and as a result we lagged both. This is unpleasant but not surprising after a year like we had in 2022. For the quarter, Technology, in particular mega-cap technology, was the clear leader. Runners up were Consumer Discretionary and Communications Services. Bringing up the rear were gold miners (technically not a sector), Utilities and Energy. With two of the worst performing sectors being our largest overweights, we struggled. Our stock selection was largely neutral. Ironically, two of our top three performers were Energy stocks: TechnipFMC +22% and Baker Hughes +10%. AIG +14% was also a material contributor. Our weakest stocks included Foot Locker, down 32% on disappointing earnings, Pan American Silver and Warner Brothers Discovery. Foot Locker's disappointment was not unique in the quarter for retailers and I continue to believe that the company's strategy, market position, valuation and balance sheet (staying power) are compelling.

Our recent trend of light trading persisted in the second quarter. This is not surprising given our already high level of portfolio concentration, and that value was underperforming. We continue to move capital out of names that have less anticipated return and into those with more, as would be expected at this point in the cycle. We reduced our exposure in Wheaton Precious Metals, Ralph Lauren and Omnicom into strength and rounded up our exposure in Fidelity National Information Services, Pan American Silver and Newmont.

OUTLOOK

Inflation has continued to moderate and the economy has been impressively resilient in the face of dramatically higher interest rates. As I write this, CPI for the month of June was released and was slightly below expectations. I have been surprised at how well the economy has fared and attribute it to the significant amount of fiscal support and the enthusiasm in the equity markets - particularly over AI. The stock market (S&P 500) now sits a mere 6% below its all-time high. Interestingly, the Chicago Fed's National Financial Conditions Index suggests that for the last few months, despite higher interest rates, financial conditions have been loosening.

At some point I think AI has the potential to be a dramatic lever for labor productivity. If it does not prove too disruptive to employment, it could be a net positive for GDP. That point may be now, which could be helpful for the United States in terms of its fiscal issues, or it may be later. As a value investor, my job is to weigh valuation against future opportunity. In this light, I do not see the leading AI purveyors as being attractive – quite the contrary, their valuations are stratospheric.

While fiscal spending has kept the economy supported, higher interest rates should be gradually doing their work of slowing things down. It takes time for interest rates to filter through the system. There are plenty of data points suggesting that the consumer is uncertain – while consumer confidence has rebounded from its Spring dip, economic confidence has not, neither have retail sales. Inventories and factory orders remain subdued, and retail promotional activity has notably increased. I suspect that corporate earnings are going to labor as the consumer remains reluctant and inflationary pressures persist. While the White House has taken the sting out of oil prices, with releases from the strategic petroleum reserve, it will soon have to abandon this largess and form a plan to refill it. We still have deep geopolitical divisions, a skills mismatch, a reluctant labor force and profound economic uncertainty – all of which are inflationary. My base case remains that the economy slows enough that the Fed chooses to reverse its tightening program. At that point we will see how the US dollar reacts: (A) with resilience, suggesting we (the US) can stumble forward as is, with the recent inflation being a flash in the pan, or (B) with weakness, suggesting our fiscal improprieties are coming home to roost.

In light of the recent rally, it is important to reiterate that the stock market is neither a uniform nor a static entity. The S&P 500 (for example) is more appropriately viewed as a varying distribution of opportunity. On the very expensive end are the mega-capitalization technology stocks that currently dominate the index in terms of weighting. On the very cheap end are the smaller (still large-cap), less thematic, slower growing value stocks. The distribution is particularly bar-belled at the present time. Valara Partners, LP. has picked a select list of the cheapest names, with strong financial prospects. I believe we are well positioned to outperform over the coming cycle. As always, I appreciate your confidence and welcome your questions or comments.

Sincerely,



Robert W. Simmons, CFA
Managing Member