Valara Capital Management, LLC

October 16, 2022

Dear Friend of Valara Capital Management,

For the third quarter and nine months ended September 30, 2022, Valara Partners, LP. produced returns, net of fees, of -7.92% and -17.91%, versus -4.88% and -23.87%, for the S&P 500, respectively. We are living in "interesting times" – more below.

QUARTERLY REVIEW

The abundance of intractable issues that have developed over the past few years seem to be diffusing into foreign exchange markets and sovereign bonds. Behind all of this is debt, and a lot of it. The recent (relatively speaking) rise of inflation has taken global central bank's favorite lever off the table and forced most of them to drain liquidity and raise interest rates – whether they wanted to or not. The coordinated policy of the past 14 years is over. Global tightening is hardest on those most vulnerable – be it emerging markets (EM) or countries with the weakest balance sheets. Emerging markets borrow in US dollars (USD) and, when rates rise rapidly in the US and the global economy slows, there is a scramble to hoard them. You may have noticed that the dollar has been soaring. The irony is, while the dollar is king in terms of global currencies, it is still losing value relative to goods and services at a near double-digit annual rate. The strong USD exchange rate is putting intense pressure on other countries – boosting the inflation that they experience in their local currency, driving local interest rates higher and pressuring their economies. This has gone far enough to prompt foreign financial ministers to plead the Federal Reserve to stop or slow its pace. Japan, in particular, scarred by past disinflation and stagnant growth, has been trying to keep domestic interest rates low and stimulative, only to see its currency rapidly depreciate. The Euro has also been extremely weak, slipping below one Euro to the USD for the first time in 20 years - when the currency was newly launched and just gaining credibility. Europe, faced with a hard landing driven by high energy prices, is also saddled with highly indebted members – Italy and Greece, in particular. Saving the most-stark for last, the Great British pound (GBP) stunned the world by falling almost 8% in two trading sessions in late September and requiring the BOE to step in and "calm" (buy Gilts) the markets. Understand that the GBP is a secondary reserve currency, not the South African rand (no disrespect). It is a, decidedly, "bad show."

Credit markets were historically volatile in the quarter – matching the peak of the Covid crisis. While sovereign bond rates generally rose, the ten-year Gilt rate (UK) doubled, from roughly 2% in early July to over 4% by September 30th. The US ten-year interest rate also increased significantly. Corporate bond spreads widened on higher perceived credit risk. Stocks were volatile as well, with the S&P 500 rallying 14% from June 30th through mid-August only to give it all back, and more, by quarter end. The S&P 500, down 5.3% (price only), was better than average for the quarter. The MSCI China index was down 23%, UK down 12%, EU down 11% and Japan down 9%.

While inflation remained a top concern, the specter of a global recession moved up the list of worries. The war in Ukraine seems to get incrementally more alarming by the week, with recent attacks on civilian targets in the Ukraine and Russia. The hope remains that there is some way to deescalate and find a diplomatic solution, but we are in hand-wringing territory. China, which has faded from the headlines, has financial problems of its own and is still pushing a strict zero-Covid policy, with lingering economic fallout.

PERFORMANCE COMMENTARY

Value versus growth was the inverse of the quarter for the S&P 500 - underperforming for the first 6 weeks then recouping all but 2.5%, thereafter. While that accounts for part of our weaker result, it's certainly not the whole story. Our sector weighting performance was bar belled. Consumer Discretionary, Energy, Financials and Industrials were the best performing groups, and we were overweight all but Financials, which were market weight. Energy was strong despite a 23% decline in oil prices. The gold miners were, again, our downfall, with materials, in general, lagging. A great deal of this poor performance can be attributed to the extreme strength of the US dollar. Our overweight in this area was a significant detractor. In terms of individual stocks our big contributors were TechnipFMC, Foot Locker, Murphy Oil, Archer Daniels, Kinross Gold (our gold outlier) and Fluor Corporation. Our detractors include Newmont, Baker Hughes, Mohawk, Pan American and Viatris. Baker Hughes and Pan American had weak quarters, but nothing thesis challenging. On balance, our stock selection was a minor negative.

Our trading in the quarter was driven by price changes relative to our targets and opportunism. We reduced our positions in Fluor, MetLife, Ralph Lauren and Textron. We sold our final piece of Archer Daniels Midland into strength, closing out a very successful investment. We invested the proceeds into, Warner Brothers Discovery, Gilead, and a handful of our existing holdings in mining.

OUTLOOK

In the last two global market crises, debt/exposure levels had reached a point that the only workable bailout was from the respective sovereigns. In both cases, sovereign issuance far exceeded GDP growth and was never paid down. The fact that capital market angst has moved into currency markets is troubling and suggests that this backstop may be nearing exhaustion. When the British Pound collapsed in late September, and Gilt interest rates rose, it was the first time in decades that a bond market had so chastened a major western government or central bank. In the 1980's there was a group of Wall Street banks and investors that were collectively referred to as bond market vigilantes. To quote the Clinton administration consultant James Carvil, "they intimidated everyone." All they did was demand basic fiscal/monetary discipline, a positive real rate of return plus an appropriate risk premium – investing 101 but the nemesis of politicians. After decades of watching the Fed manipulate the bond market at will, I was pleased, but a little alarmed, to see the bond vigilantes show up anew. The apparent take away is that the UK's proposed tax cuts and fiscal spending plan undermined financial credibility to the point of revulsion. That this happened in the UK is astounding. More astounding is that the current generation of central bankers/finance ministers appeared to believe that this day would never come. The UK Finance minister was just fired after six weeks on the job and the new Prime Minister may be next. This should be a wake-up call.

For economies to function, money and exchange rates need to be relatively stable. Currencies are not supposed to trade like stocks. If the UK is approaching its fiscal and monetary limit, there are a lot of other major players that are not far behind – you could argue that some are ahead (in a race you don't want to win). I don't pretend to know where this goes but its not what you want to see. It implies that bond holders are beginning to look at the fiscal issues and move to protect themselves. If they ever lose the ability to borrow with impunity, western governments are in for a shock.

Global economies have weakened; and, with rising rates, many are likely to fall into recession. At this point, rates have probably increased enough that even a pause would not change the outlook. One of our partners (a mentor, with tremendous experience and insight) remarked to me recently that no one knows what upcoming earnings are going to be. With all the existing cross currents, inflation, recession, supply chain disruption, war... that is undoubtedly correct, and it is an issue that I have been focused on. Despite the considerable thought/analysis that goes into our assessment of what each company will be able to earn over time, it is certain that I will make my fair share of mistakes. Recognizing this, our portfolio construction process attempts to build in a margin for analytical error and, as uncertainty has increased, I have emphasized credit metrics in our stock selection process and have lowered my tolerance for holdings that deviate from our investment thesis. I reiterate that, through whatever comes, we will stick to our discipline, and I have confidence that, over the cycle, it will serve us well. Please feel free to call or email me with any questions. As always, I appreciate your support and confidence.

Sincerely,

Robert W. Simmons, CFA
Principal