SORA
CAPITAL

Letter to Stakeholders

November 11, 2021

To our stakeholders,

The fourth quarter of the year is when we gather to produce our guidance towards the current macro landscape and outline conditions we may face in the following year. The ongoing environment is probably the most challenging we have faced in our careers, big scary headlines surface daily in the most prominent newsfeeds of the world.

The pandemic has been a harsh reckoning for many industries that were scarce in equity and/or their operations were not redundant or optimized. Current risk-headwinds on the economy embody almost all nightmares in economic policy: **inflation, overleveraging** and **stagflation.**

Is it all about Inflation?

We think yes, inflation so far will determine the course of general economic policy. To be blunt, we would not want to be in the shoes of any central banker now, because they face choosing between controlling **inflation** or fostering **growth**.

After almost two years of pandemic, we see important bottlenecks in the economy: labor, energy, semiconductors, commodities and goods markets, which are all leading to higher headline and core inflation. Certainly, this should have an effect on general economic growth (it is almost an unequivocal relationship, supply side disruptions lead to increase in prices and slowing growth).

The past economic crises were a demand induced recession with a catalyst derived from overleveraging. This time could be different, we are currently experiencing a supply side problem that if inflation proves not to be temporary, it could lead to the next recession (with the constant of an overleveraged economy). What worries us the most, is that governments and central banks are out of ammo, which could lead to experiments in economic policy (experiments that could prove costly).

Economic Scenarios

Our central thesis is that we are seeing two completely different songs in the ballroom, the main street tango and wall street waltz. Frothiness is everywhere, certainly markets are priced for perfection (or even beyond perfection). General economic views could be encompassed in two; inflation is temporary or permanent in a certain time range.

A general consensus in Wall Street banks is that core inflation will hover around 4% and 2% next year. Our view is that we coincide with the former, not with the latter. We think there is still a strong lagging force behind current inflation; thus, being closer to 3% than 2%.

There are very few pundits alleging deflation due to a massive technology change, however, we don't see that happening in the next 3-5 years which also eradicates the theory of "Japanization", nonetheless, deflation could happen in the longer run.

The big question is if inflation will produce Stagflation (low, mild or severe?). To offset whichever scenario, prudence is our strategy. Our view on the aforementioned tilts towards being cautious, rather than speculating on such abnormal market conditions. We are acting according to the "what if?" question. We will closely watch the underlying fundamentals of inflation, update our base with each data set and our view as deemed necessary.

The price of money and markets

There is a very low likelihood that long-term interest rates will go downward, if so, it will be very short lived. Even if there is a huge recession or depression, more money will be printed. We see monetary dynamics kicking in upward movements sooner or later. Depending on how the Fed reacts, real rates will be altered. If the Fed is behind the curve (not raising interest rates at a pace fast enough to keep up with inflation), only nominal rates will be higher, if the Fed is ahead of the curve, real rates will go upwards.

When can long-term interest rates go up? Difficult to know, nonetheless, we think this level of long-term rates is unsustainable. The rate level in junk bonds relative to the high leverage of the corporate and government bonds market, does not make sense to us. Based on the latter, our view considers a high likelihood that bond prices will fall in the next two years to compensate for risk-and-inflation-adjusted returns.

We think corporate profits peaked this year. Higher nominal and real rates will compress them. In terms of equity valuations, we don't foresee a multiple expansion in the short-run. If that was the case, it will be short-lived.

Investors and Investing

In Sora, we look for more than a fair return on investment (in fairness, we would just buy the S&P 500 and hold forever). Our view is that investors are being too complacent, historically the S&P 500 has returned on average about 11%. At current prices the net present value gives us a projected return of about 4% for the next ten years. Certainly financial markets are priced for perfection and things in our periscope are far from perfect.

If the price of money at the end of the curve (long-term 10-year and more) goes up, we expect a significant correction in markets which would put them in a more actuarially fair pricing. This resonates with the relative risk adjusted return of a 10-year treasury vs net present value of the S&P 500. When could this take place? Only God knows.

One thing we want to stress is that we speculate a lot of complacency in the markets is due to new-entry participants willing to incur more risk to bolster returns. We believe the use of reckless leverage will take its toll sooner or later.

Last but not least, we believe that the safe haven in stocks against inflation is overrated in the short to mid-term. Historically, when inflation is low, bond prices and stock prices are negatively correlated, while in high inflation, most of the times a positive correlation takes place.

What could derail the economy?

Towards the very short term, we think the biggest risk tilts towards commodities specially the energy market, oil and gas markets look very tight towards the year-end. An increase in volatility of inflation will lead to higher inflation expectations, higher yields and the possibility of higher taxes (alarming inequality statistics are arising from the pandemic).

What could go right?

The Fed has a perfect fine tuning towards making a smooth transition of inflation and interest rates, and continues gradually monetizing debt in a more controlled fashion. Supply side dislocations get back in their place and goldilocks economy (too rosy for us, but there is always a possibility).

Wrapping up

We think there is a lot of uncertainty about the progressive status of the economy. Country and corporate debt are at historic levels, but at the same time, we are very constructive about the future of the world economy, it is the medium term that looks challenging. The pandemic will bring windfall profits in many sectors. In particular, we believe healthcare to have similar growth prospects as Information Technology did in the 2000´s, the next GOOG, FB, and AMZN´s of the world we believe are going to be in healthcare (and some in energy and water).

Last but not least, if you received this letter means that you mean something to us, Sora´s team wishes you a great and healthy year-end and profitable 2022, where we think the most wise word for the following year is "prudence" (let's leave boldness for other years). Thank you for reading our view, it's just a sneak peek to a fire chat of really passionate people who love what they do.

Humble in our ideas but very proud of our people.

RM — PB.

Ricardo Montes de Oca — **Pablo Buch**

The citizens of Sora

P.S. If Warren and Charlie sometimes get it wrong don't expect more from us…

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