HANWAY CAPITAL

January 3rd, 2019

2019 outlook

Given the start of a new year, we did not want to miss the opportunity to address you and put into perspective the great movements of the markets this last quarter.

It is well known our macroeconomic analysis and our view on the consequences that a gradual normalization of interest rates and the end of Quantitative Easing could have. Since then, a strong correction has started led by the companies that have benefited most from the current economic cycle. From the historical high reached on September 20th to the bottom marked on December 24th, the S&P 500 crashed 19.78%. That said, the bull market was not broken, but it was very close. On the other hand, the volatility expected in the US for next year has gone from 17.22% to 22.17%, an increase of 29%. However, it is still far from the levels we expect.

To better understand what is going on in the markets, we will try to reflect on how we understand macroeconomics. The global economy is like a great machine composed of many gears that are constantly adjusting to any change under the cause-effect principle. It is therefore crucial to detect the gears that can cause the machine to malfunction.

Our economic system is governed fundamentally by two major forces, **productivity** and **debt**. The economy can only grow either by an increase in the units produced with the same resources (productivity) or by an increase in debt.

Productivity is the most important factor in the long term, but it is given little importance in the short term due to its low volatility. Productivity increases are very slow and can only be observable or significant when measured over a broad set of years. Productivity increases steadily year after year as we learn to do things more efficiently, producing more in less time and with the same resources.

Debt, however, does have a direct and more short-term impact on both the economy and the markets. It gravitates around the productivity curve and is what causes the famous cycles. Remember that this flow is controlled monopolistically by Central Banks, which are in charge of setting the interest rates and therefore encourage borrowing with low rates (as has been the case for the last 10 years) and discourage borrowing with higher rates. It works in a very simple way:

1. Provision of credit increases buying power that increases consumption of goods, services and investment assets
2. This generates an economic acceleration and an increase in the price of those goods
3. But let's not forget that credit also creates debt, which will have to be repaid later decreasing the consumption of goods, services and investment assets
4. That will lead to an economic slowdown and falling prices

Therefore, we can say that credit and debt drive growth first, to later depress it. Debt cycles usually last between 5 and 10 years and the current cycle has been exceptionally long because it started in 2008 at a very low point due to the strong recession. This cycle has also been particularly slow due to weaker growth in demand which in our opinion is due to the growing inequality caused by monetary policies of Central Banks.

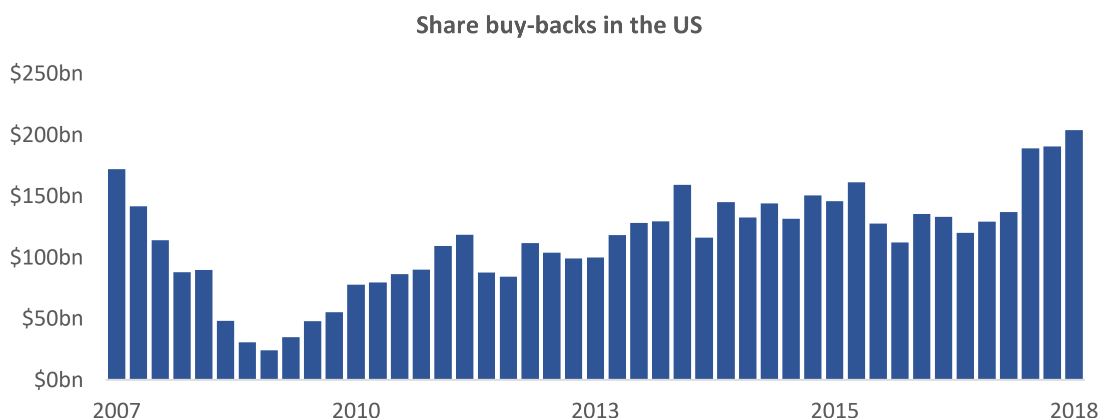
When demand exceeds production capacity, prices start to rise until Central Banks decide to restrict credit. We are currently in this situation: demand is strong, capacity limited and profit growth exceptional. But also, at the same time, demand for credit is abundant, inflation is emerging and eventually, Central Banks will be forced to raise interest rates to dampen growth, which causes share prices and other assets to fall. They fall because all investment assets are valued as the present value of their future cash flows, so a rise in interest rates reduces the current value of those assets. At the same time, a tighter monetary policy slows down the expectations for profit growth.

For this reason, no one should be surprised to see strong economic growth paired with stock market declines. And in the same way, we do not agree with the argument that current falls are exaggerated *"because there continues to be a healthy economic environment"*. In fact, we find ourselves in the complete opposite situation to 2014, 2015 and 2016, when bad economic data was received with enthusiasm by the market because it indicated that Central Banks were going to continue with their expansive monetary policies.

This last debt cycle has also been accompanied by very low interest rates in historical terms, and a debt purchase program that has made borrowing attractive for many companies with the sole purpose of buying back their own shares and those of other companies. This has caused an increase in share prices and has left balance sheets much more indebted than at the beginning of the crisis. In addition, the recent tax reform of the American government reducing the corporate tax rate during a strong economic period, has boosted asset prices and has increased government deficit, which will be financed with even more debt.

However, despite the market declines we have witnessed, we believe that real volatility is still to come. It will not come until some of the triggers we are expecting, determine that the cycle has ended:

1. The American economy enters a recession: it's currently growing at 3.4%
2. Share buybacks are halted as a result of falls in corporate profits: 2018 has been a record year in terms of shares repurchased by American companies
3. Rate hikes trigger defaults in companies unable to manage higher financing costs: corporate and government leverage are at record highs



Psychology is the third relevant factor, not so much in the economy, but in market's behavior. We will quote Howard Marks (founder of Oaktree Capital) on his example of the pendulum to explain the effect of psychology on markets. When we swing a pendulum, it moves from one extreme to the other passing through the center (its balance) during an ephemeral moment. The market behaves the same way: its equilibrium would be the instant where asset prices match its value. But the market is controlled by all of us, humans with emotions, greed and fear, and that causes the market to rarely be in balance moving from periods of euphoria to periods of panic crossing the center at high speeds.

Nobody knows exactly what the trigger for the burst of the sub-prime bubble was, but somehow the euphoria vanished, and panic took over. *"Buy before it's too late"* was replaced by *"sell*

HANWAY CAPITAL

before it's worth nothing". We believe that we are at a critical point where negative headlines and recent falls will begin to have an impact on people, causing the pendulum to change direction sooner rather than later, and some financial assets that have been overvalued for many years, not only will return to their fair value, but will become undervalued.

With this explanation, we hope to have helped you better understand the current environment and draw your own conclusions which in the end are the ones that count. But we wanted to be clear on our firm conviction that the economy and the market interact through the cause-effect relationship as it has always been, and this time will not be different. The normalization of monetary policy after a long period of interest rates close to zero at the time of the greatest indebtedness in history will have a significant impact on asset prices.

These materials have been provided to you by Hanway Capital S.L. (Hanway Capital) and do not constitute under any circumstance investment advise nor commercialization and marketing of any fund. The purpose of these materials is solely to provide a general macroeconomic view and update of the financial markets. In addition, these materials may not be disclosed, in whole or in part, or summarized or otherwise referred to except as agreed in writing by Hanway Capital. No part of these materials may be used or reproduced or quoted in any manner whatsoever by the press. The information used in preparing these materials was obtained from public sources. Hanway Capital assumes no responsibility for independent verification of such information being complete and accurate in all material respects. To the extent such information includes estimates and forecasts of future financial performance, we have assumed those represent reasonable estimates. Nothing contained herein should be construed as tax, accounting or legal advice.

Readers of these materials are advised that any discussion, recommendation or other mention of any security is not a solicitation or offer to transact such securities. This document provides general information only, and neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other financial instrument or any derivative related to such securities or instruments (e.g. options, futures, warrants, and contracts for differences). This document is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of, and is not directed to, any specific person(s). Investors should seek financial advise regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed in this document and should understand that statements regarding future prospects may not be realized. Investments in general and, derivatives, in particular, involve numerous risks, including, among others, market risk, counterparty default risk and liquidity risk. No security, financial instrument or derivative is suitable for all investors. In some cases, securities and other financial instruments may be difficult to value or sell and reliable information about the value or risks related to the security or financial instrument may be difficult to obtain. Investors should note that income from such securities and other financial instruments, if any, may fluctuate and that price or value of such securities and instruments may rise or fall and, in some cases, investors may lose their entire principal investment. Past performance is not necessarily a guide to future performance.

This information may contain references or links to third-party websites. Hanway Capital is not responsible for the content of any third-party website or any linked content contained in a third-party website. Content contained on such third party websites is not part of this information and is not incorporated by reference. The inclusion of a link does not imply any endorsement by Hanway Capital. Access to any third-party website is at your own risk, and you should always review the terms and privacy policies at third-party websites before submitting any personal information to them. Hanway Capital is not responsible for such terms and privacy policies and expressly disclaims any liability for them.