January 11th, 2021

Q4 2020

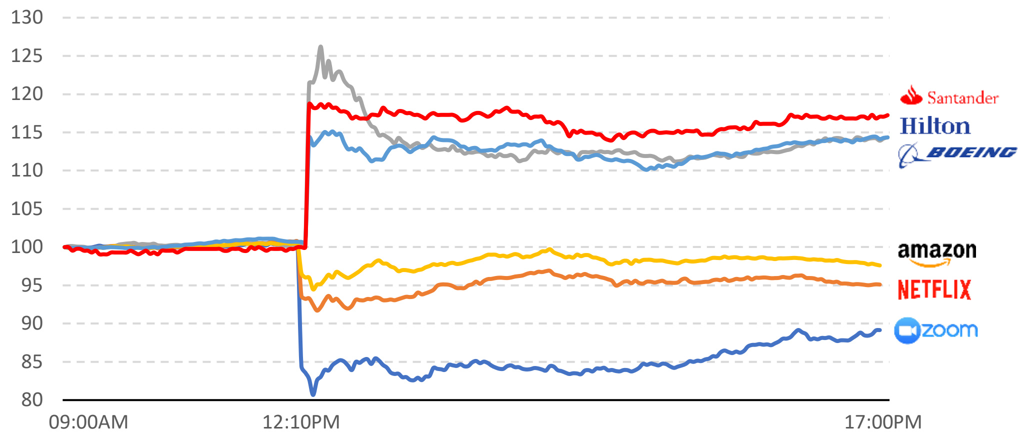
Dear investors,

Hanway Capital Fund returned **11.0%** for the quarter reaching a share price of **€128.1** net of fees and commissions. This brings the fund's first full year return to **27.0%.** The promising results obtained by the different vaccines against Covid-19 in clinical trials have finally triggered the much-expected rotation from defensive to cyclical assets. The fund’s positions opened in the third quarter have benefited from this trend, which may still last for a few more months until inflation makes its dreaded appearance in the second half of 2021.

Victory day

Perhaps in a few years, November 9th will become an event to celebrate. On that day in 2020, Pfizer and BioNTech announced the preliminary results of phase 3 for their Covid-19 vaccine: it was 90% effective. That day unleashed one of the largest rotations ever in the stock market. In a matter of minutes, the money left those companies that were considered beneficiaries of the lockdowns and entered the stocks that would better perform coming out of an eventual reopening. The two rivers we talked about in the third quarter report were finally mixing.

Despite several negative news at the beginning of 2021, the stock market continues to position for an eventual economic reopening. The market is always a reflection of the collective consensus of what the future will be like, not the present, and that is why despite new threats of restrictions and lockdowns around Europe, stocks that have suffered the most during the pandemic continue to rise. The focus continues to be the vaccine and herd immunity that will allow a return to normality in the mid-late 2021 in Western countries.

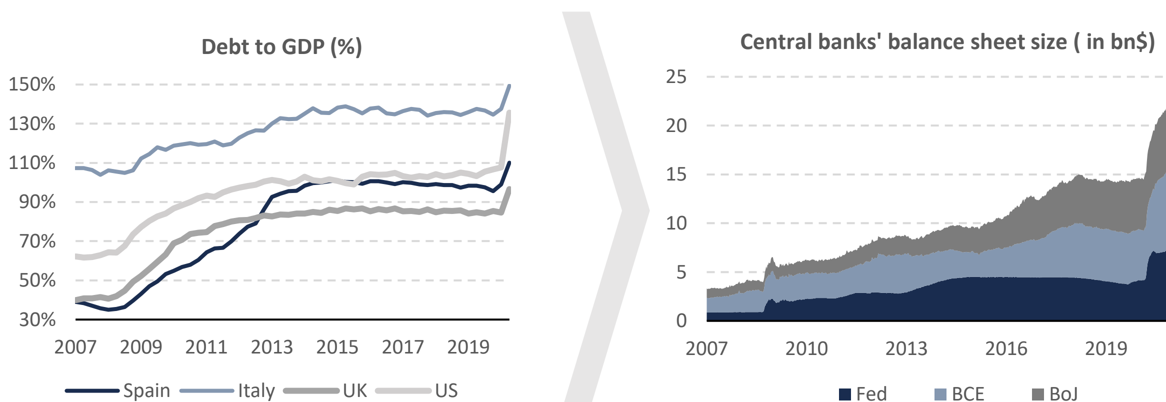


Christine Lagarde, the president of the European Central Bank, made several allusions during 2020 to the metaphor of building a bridge loan that would allow us to tiptoe through the economic devastation left by the pandemic, and walk out at the end of it as if nothing had happened. In essence, getting everything on pause and on assisted breathing thanks to liquidity injections from central banks and aid from governments.

Nonetheless, the global macroeconomic machinery is very complex and made up of various interconnected gears. It would be naive to think that the alteration of a component as relevant as money supply will not have consequences in the medium term.

War economy, post-war debt

The world already entered the pandemic with high debt levels. We came out of it at all-time highs only comparable to post-war periods such as after World War II. This time governments have not hesitated to turn on the aid tap, considering that an economic shock caused by exogenous causes could not fall only on citizens. Coordination between monetary and political institutions has been admirable. It is estimated that the US will close 2020 with an increase of 18% of debt over GDP, but conveniently the Federal Reserve has bought debt worth 16% of American GDP in the same period. In other words, the Fed has cushioned 89% of the blow.



Any economist would argue that a significant increase in debt issuance should trigger an interest rate increase. The more debt a country issues, the greater the supply of outstanding bonds and the greater the risk of default, so the lender should demand higher interest. But the market is always an equilibrium between buyers and sellers, and as long as there is a buyer willing to buy all the existing debt, it is difficult to see an increase in interest rates. Therein lies the role of central banks, which are creating a fictitious and unlimited demand in debt markets that artificially keeps interest rates at historic lows.

This is not only creating distortions in the bond market but is also disrupting the proper functioning of all capital markets. A glaring example can be found in some technology companies whose valuations are absurd. In the absence of a positive real interest rate, capital is forced to jump in search of any asset that can offer some yield. The entire risk-return curve has been shifted downwards, establishing a perception of risk that is contrary to reality.

Who is going to pay for all this?

When public debt reaches unsustainable levels, there are only four possible scenarios:

1. **Default or restructuring**: Debt service is impossible to achieve and it is therefore suspended. This starts a cascade of defaults since debt defaulted causes insolvency in the lender, which in turn will also stop paying its debts, leading to a depression like in the US after the crash of 1929. For this reason, in most cases a restructuring is accepted despite its harsh consequences, as in the Greek case of 2012.
2. **Austerity:** The most common recipe after the 2008 financial crisis. The European Union, led by strict German budget doctrine, decided to reduce public spending to balance the budget. Generally, these policies generate deflation and aggravate the economic situation, generating more unemployment and less activity. In many cases, this leads to less tax collection that prevents debt reduction even further.
3. **Tax hikes:** A politically unpopular and sometimes ineffective measure depending on which taxes are raised, as they can reduce economic growth. On the other hand, nowadays with strong inequality and large concentrations of wealth in the hands of few, this measure gains adherents. In a crisis that mainly impacts the working class, resentment towards the wealthy increases and can cause unrest or social disruption. That is why governments will raise taxes to facilitate redistribution of wealth. If the crisis persists, social unrest can spiral out of control and tension can manifest not only within a same country, but also between them. Especially between debtor and creditor countries. Last century during the 1930s in Europe is a clear example.
4. **Generating inflation:** Once there is no longer room to lower interest rates because they are at zero or even negative, a last resort is to print money. Ever since Nixon suspended convertibility of the dollar to gold in 1971, there is practically no limitation to the amount of money the Fed can introduce. If this measure generates inflation, it will help to absorb debt because it is not indexed to price increases. An economy with 100% debt to GDP, inflation at 5% for just five years and no real economic growth would reduce debt to 78%. At the end of the Second World War, strong inflation managed to reduce the colossal debt of countries.

Inflation is coming

Many inflation sceptics argue that the last time central banks lowered interest rates to zero and increased the size of their balance sheets, CPI did not actually increase, even though many predicted so. However, fundamental differences between 2020 and 2008 make us think that this time, inflation is ready to return and thus break a truce that has already lasted for 40 years.

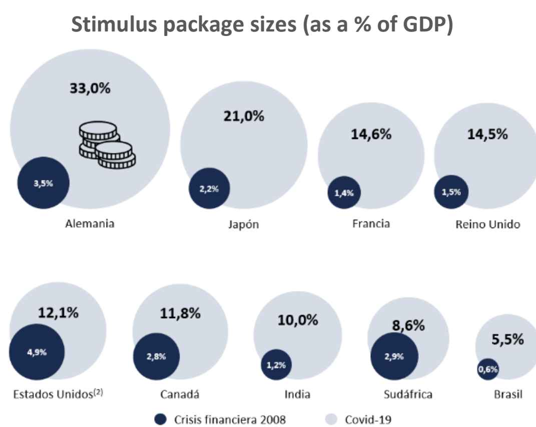
It is worth remembering how central banks introduce liquidity into the system and increase money supply. A central bank cannot, for now, print money and hand it over directly to governments, much less put it directly into citizens' bank accounts. The mechanism is much more subtle and through the purchase of bonds in the secondary market, they manage to introduce liquidity into the system.

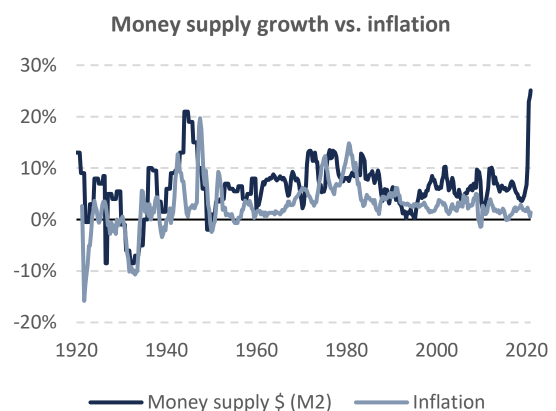
This is what central banks did during 2008 with their quantitative easing programs. The bought up to 30% of each member state's public debt in the Euro Zone, and even debt of companies with good rating. But this liquidity never reached ordinary citizens, given it was accompanied by austerity measures from governments. Liquidity was created to buy financial assets and stayed on the balance sheets of banks and enterprises.

If we realize that financial assets are mainly held by wealthy people, we will quickly realize why 2008 measures were not inflationary, but they did increase inequality. A high-net-worth individual will not change his consumption habits when doubling its wealth: the money supply was trapped at the top and did not flow as expected throughout the system.

Measures in response to Covid-19 pandemic are turning out to be very different. Not only are liquidity injections by central banks much larger, but governments are using that liquidity to create stimulus packages through loans, aids, guarantees and even money transfers directly to citizens. The US administration has directly transferred $1,200 and $600 checks per citizen and is already working on a third $2,000 check.

All these measures have increased money supply at a speed never seen before. Historical precedents show that inflation tends to appear after such events. Let us remember that inflation is a monetary phenomenon that must also be accompanied by consumption, if we increase the amount of money in circulation and not goods production, the price of them will increase.





Democrats achieve the Blue Wave in the US

We cannot finalize this chapter without making a brief mention to the US political situation. On January 5th, the state of Georgia carried out the runoff of the Senate elections in which both Democratic candidates won. As we explained in our previous letter, this implies a technical tie in the US Senate with 50 seats for each party. Kamala Harris, the new vice president of the United States, will also be the president of the Senate by law and will obtain the casting vote that will tip the balance in favor of the Democratic party.

This puts an end to the electoral period that began in November, which finalizes with Democratic control of all American institutions: The White House, Congress, and the Senate. This should allow Joe Biden to smoothly deploy his agenda on public spending and energy transition.

Linking this to inflation, let us remember that the Democratic Party is much more prone to public spending and direct transfers to citizens. Joe Biden addressed his audience at the last campaign rally in Georgia asking voters to cast their ballots for the two Democratic candidates, assuring that, *“if you send them to Washington, those $2,000 checks will go out immediately to restore the hope, decency and honor that so many people need".*

Alexander Tytler, an 18th century Scottish historian and professor at the University of Edinburgh, recalls the danger of appealing to voters by promising financial aid: *“A democracy is always temporary in nature; it simply cannot exist as a permanent form of government. A democracy will continue to exist up until the time that voters discover that they can vote themselves generous gifts from the public treasury. From that moment on, the majority always votes for the candidates who promise the most benefits from the public treasury, with the result that every democracy will finally collapse due to loose fiscal policy”.*

The day after the elections, a demonstration called by Donald Trump ended with an assault on the US Capitol cheered by the president himself after relentlessly and without foundation accusing the Democrats of electoral fraud. The images of an unprecedented day in US history that resulted in five deaths should remind us that despite Donald Trump has been defeated, his policies have not after being voted by more than 70 million Americans.

From an investment perspective, the diplomatic tension between the US and China started by Trump will persist and could escalate. An involution of the globalist movement has begun, and globalization is likely to scale back over the next decade. All these factors should not be underestimated when planning investment strategies.

Management report

Let us now analyze the fund’s individual positions for this quarter:

1. **Equity positions**: For the first time since the pandemic, it was the companies with the greatest exposure to the economic cycle that led the gains. Specifically, the factor that has dominated has been *antimomentum*: the more a stock had fallen in the first ten months of the year, the more it has risen in the last two. It is therefore not surprising that the Ibex 35 experienced the best month in its history. The cyclical positions that the fund bought in September have benefited from this trend, which we believe still has room to grow as the vaccination process advances. Exposure to equities, which contributed a 5.9% return to the fund, remains at 65%.

2. **Volatility positions:** When everyone has a date marked on their calendar, the price of volatility around that event is usually too high because all investors seek to protect themselves at the same time. Thus, even if the worst scenario ends up happening (which in the case of the American elections was that Trump would not accept the result), volatility goes down once the event has passed. This is what happened after the American elections on November 3rd, which benefited the volatility positions of the fund, adding 0.6% to the quarterly return.

3. **Dividends position:** The hope of a return to normality has greatly improved the dividend outlook for European companies. The prices of these dividends, for their part, still have room to reach the levels indicated by our estimates. Over the months, the uncertainty about these distributions should clear up, especially when the European Central Bank lifts the veto on bank dividends. During this quarter, these positions have added 1.8% to the fund's performance.

4. **European banks:** The sector that suffered the most at the beginning of the pandemic has also outperformed since the announcements of the results of the vaccines. However, we are sceptical about its immediate future. If our forecasts come true, central banks will push further into their negative real interest rate policies, greatly damaging the banking business. The fund has closed its position in this sector, which has added 2.6% to the result for the quarter.

5. **EUR vs. USD position:** With the confirmation of Joe Biden's victory in the elections and the approval of a new stimulus package in the US, the dollar has continued to decline. Unfortunately, the increases in the euro above $1.20 came in December after our currency position expired, which has not allowed us to participate in this movement. Currencies have detracted the fund's performance by 0.2% this quarter.

6. **Commodities:** Our conviction in inflation returning has increased the raw materials’ weight in the fund, reaching 10%. In the second half of the year, we expect a strong return in consumption as the 2020 savings are spent, which should push up the price of materials. In addition, the fund has also increased its presence in precious metals up to 15%, always as a protection against excessive money printing by central banks. During the quarter, these positions have rebounded slightly, contributing 0.3% to the fund's return.

We put an end to this first year very satisfied with the work done and the results obtained. Our competitive advantage, flexibility, has allowed us to successfully navigate the storm. Hanway Capital Fund has not suffered a drop of more than 10% from its highs at any point during the year demonstrating its resilience and risk management.

We face 2021 with the arrogance to act decisively when we find opportunities, but the humility of knowing that we could be wrong. The intellectual honesty of not confusing luck with skill, the integrity to admit mistakes and the strength to risk committing more. Ultimately, nothing we do will guarantee success, but with effort and discipline we can tip the balance significantly in our favour.

Finally, this quarter we received the worst of news with the death of one of our first investors and great supporter of our project, Luis Duffo. We want to dedicate this quarterly letter to Luis and his family, since without support like his, Hanway Capital would have never taken off.

Regards,
Hanway Capital

Luis Duffo Úbeda (1961 – 2020)

Appendix: Hanway Capital Fund historical returns:

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2019	-	-	-	-	-	-	-	-	-	-	-0.4%	1.2%	**0.8%**
2020	-2.9%	-3.0%	18.3%	4.6%	-0.4%	3.2%	-2.3%	0.5%	-2.7%	-1.9%	9.1%	3.8%	**27.0%**

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.

Carrer Balmes 188
08006 Barcelona
+34 93 152 10 28