April 13th, 2021

# Q1 2021

Dear investors,

Hanway Capital Fund returned **3.9%** for the quarter reaching a share price of **€133.1** net of fees and commissions. Good news has continued to set the tone during the first months of 2021, with economic indicators beating forecasts and Covid-19 vaccinations progressing at a good pace. Meanwhile, the market has continued to show us what the new rules of the game will be: we are heading towards a new inflation regime, and that will render obsolete the asset management models that have been followed for the past 40 years.

## An astronomical rally

The S&P 500, the American benchmark index, has had the best 12 months in its history with an increase of 76%. It is important to keep this fact in mind for all those who have started in the world of financial investments in recent months. The probability of something like this happening again is less than 0.0001% or, in other words, 1 in a million. This should not discourage anyone, but it should serve as a reference for developing good risk management policies.

The US stock market rally began on March 23rd, 2020, when 786 people were reported dead from the coronavirus in the US and the unemployment rate was at 3.5%. How is it possible that the stock market rose while unemployment soared to 14.8% and the death toll reached 562,000? It is not just that the stock market anticipated the good news that was coming, it even anticipated the bad news that were imminent.

The answer can be found in the efficient market theory (EMH). The market is a discounting mechanism that measures neither the current nor the future state of companies but is an indicator of the evolution of business expectations. Thus, in March, the outlook was so dire that it never materialized, no matter how bad the economic data that followed.

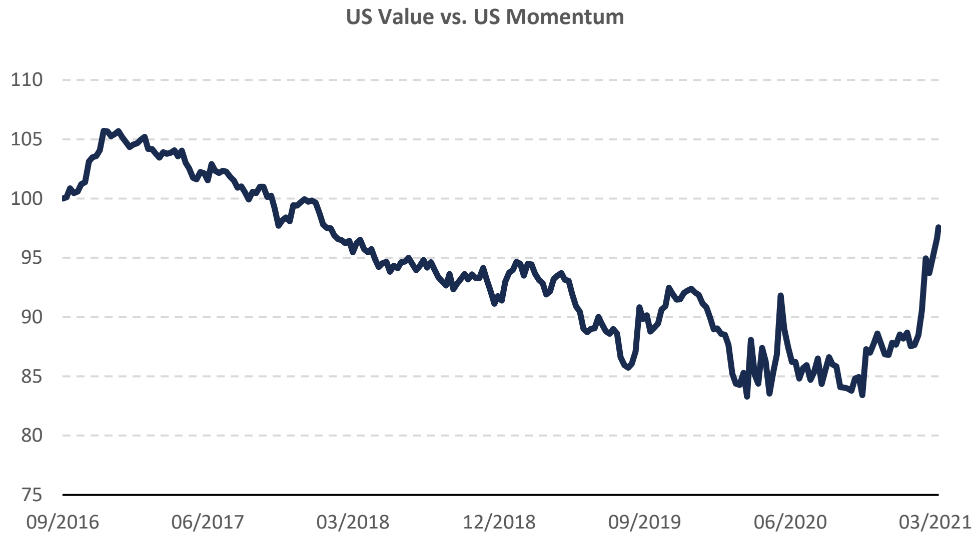
Now we are at the opposite swing of the pendulum: expectations could not be higher. An economic and business boom is expected to begin in the coming months as vaccination in the US crosses the herd immunity threshold, which experts put at 60%. However, it is in an excess of optimism that we should be the most cautious, as it is during these stages of exuberance that bubbles form and the greatest risks appear.

## The forgotten corners

This quarter the rotation that we pointed out in our last communication has persisted, with money moving out of technology, or growth companies, and into value companies. During this quarter we have seen several days of significant falls in the Nasdaq, the American technology index, accompanied by rises in the Dow Jones, the industrial index, something that has not happened for years.

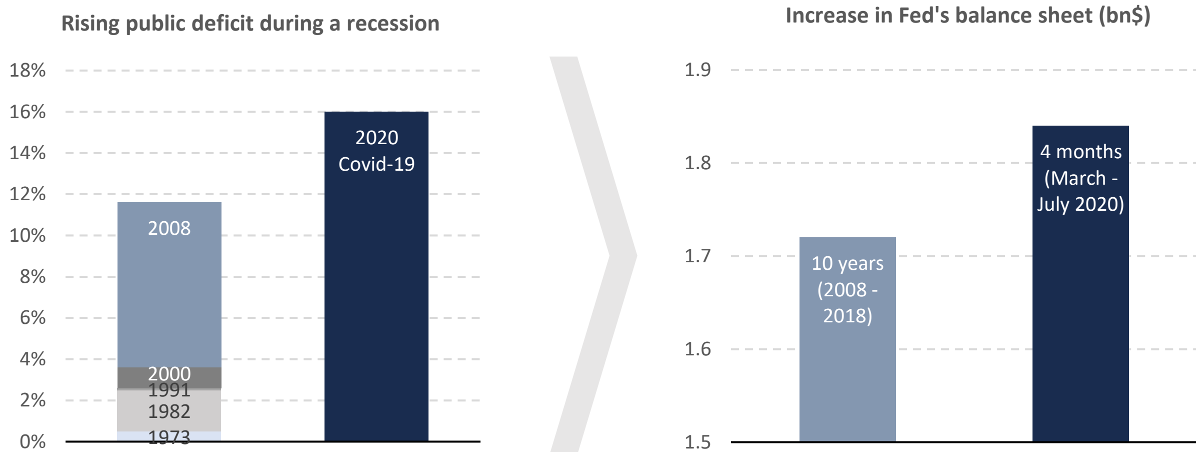
This huge rotation from assets that have performed so well in recent years (momentum and growth), towards companies that were marginalized by the market may be indicating a change of cycle, which

would lead us to a scenario where zero or negative interest rates come to an end and several decades later, inflation returns.




### Inflation - excessive money supply chasing fewer goods

It is indisputable that the stimulus packages to combat the crisis generated by Covid-19 are unprecedented. Taking the American economy as an example, the public deficit has soared more than in the previous five crises as a whole. All this was made possible by the massive injection of liquidity by the Federal Reserve, which introduced more money into the economy in four months than it did in the previous ten years of quantitative easing.




We will not dwell on why these measures did not create inflation in the previous crisis, but we believe that this time they will (*more information in the previous quarter's letter*). It is simply worth remembering that the wealthy class can hardly generate inflation by increasing their wealth via asset appreciation, while the working class can do so via direct transfers.

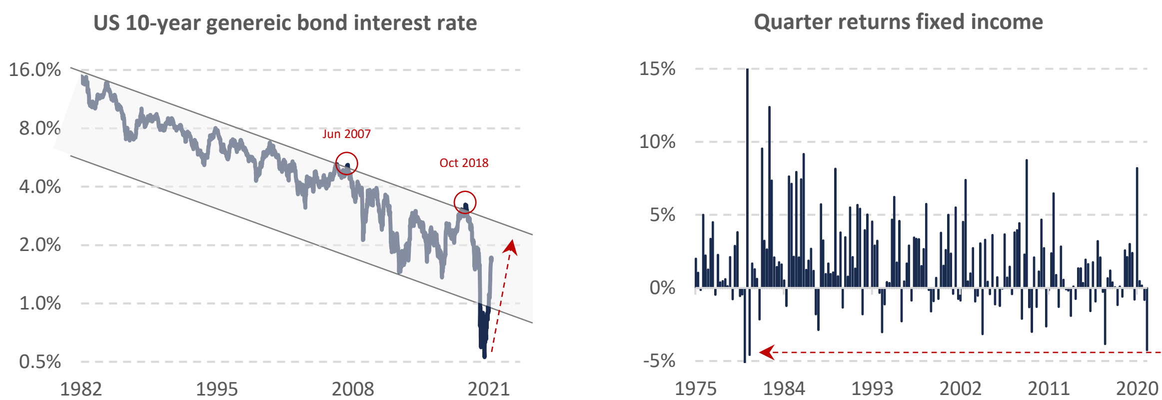
The deflationary forces of the last decades also seem to be exhausted. The **offshoring of production** in an increasingly globalized world has strained many supply chains during the pandemic. The Ever Given ship stranded in the Suez Canal for days has highlighted the fragility of global trade. Many

political leaders are increasingly interested in encouraging domestic production, whether for reasons of national security or to halt the deindustrialization that is causing so many problems for the Western middle class. Repatriating production will undoubtedly lead to an increase in production costs.

On the other hand, **the retirement of baby-boomers** will reduce the labor force, generating a shortage of workers who could negotiate better conditions in exchange for their labor. That could cause inflation wage.

Finally, the strong **corporate consolidation** of the last 20 years has drastically reduced competition in many sectors, especially technology. The US is in the midst of a war for global technological supremacy against China and is unable (or uninterested) in enforcing its antitrust laws.

All this is beginning to be felt in the capital markets, with the interest rate on the US 10-year bond being the main player this quarter. Its sharp increase from 0.9% at the beginning of the year to the current 1.7% has led to the worst quarter for fixed income in over 40 years. We have been warning for many months that long-term fixed income is a ticking time bomb ready to explode, as current conditions are a dreadful breeding ground. With interest rates very close to record lows, any sudden increase could trigger a stampede.




In macroeconomic terms, there are three possible scenarios from now on. In the first one, after recovering from Covid-19, the Western economy returns to its old normal, with minimal inflation, slow growth, and presumably even more inequality.

The second is the scenario the Fed is praying for, where after another two or three years with its foot firmly on the monetary accelerator, and this time with the help of fiscal policy, we finally head towards a world where inflation tends to be somewhat above 2% and interest rates are back in positive territory, while economic growth helps to level out some of the injustices that have taken hold over the past few decades.

The third scenario would be to enter a full-blown inflationary cycle. Just as inflation reached a point that could no longer be tolerated four decades ago, weak growth and inequality can no longer be tolerated now, and with increasingly exceptional measures of expansionary monetary and fiscal policy, we move decisively toward a world of inflation, partly also to be able to absorb the huge sovereign debt packages. The latter is the scenario we must guard against as it is the least expected, the most dangerous and the one for which the fewest investors are prepared.

## The *Green* New Deal

The commitment to the energy transition and compliance with the Paris Agreement are no longer mere rhetoric speeches but have become the cornerstone of supranational policies. Ursula von der Leyen, President of the European Commission, has set the fight against climate change as the main objective of her term in office, and the Biden administration in the US is working on a $2 trillion infrastructure plan to implement the energy transition.

We believe there is an interesting opportunity in the renewable energy sector beyond betting on the companies that make it up. The European Union Emissions Trading Scheme (EU ETS) is the world's largest multilateral greenhouse gas emissions trading scheme and a main pillar of EU climate policy. It consists of capping the carbon dioxide ($CO_2$) emitted by companies and creating a market and price for carbon emission allowances. The supply is reduced over time in order to reach the targets set by the EU. Within the limit, companies receive or buy emission allowances, which they can trade among themselves according to their needs.

The European Union aims to achieve carbon neutrality by 2050. To this end, it has set itself the target of reducing emissions by 20% by 2020 and 40% by 2030 compared to 1990 emissions. One of the key features of the current phase 4 (2021-2030) has been to strengthen the ETS program by reducing allowances by 2.2% per year. This summer, the European Commission plans to propose a more restrictive "Fit for 55" legislative package increasing the targets to a 55% reduction in emissions (vs. initial 40%) in 2030 compared to 1990.

This new, more ambitious target, in addition to the possibility of adding the road transport sector and heating systems to the program, could lead to a sharp rise in the price of carbon rights over the next few years. If companies fail to reduce their $CO_2$ emissions by investing in renewable energies, they will be forced to buy increasingly expensive emission allowances (EU ETS).

In recent months, we have already seen strong rises in preparation for the "Fit for 55", but we believe that the European Union will not increase its supply and will be intransigent in demanding that targets are met. There is therefore an interesting opportunity in this asset; moreover, investing means in practice forcing the most polluting companies to develop their energy transition plan and pollute less.

## Management report

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

1. **Equity positions:** The rotation that began on November 9th has strongly continued this quarter. Proof of this is that the Dow Jones Industrial index has led the gains with 12.1% while the Nasdaq lagged, growing by only 5.7%. The fund has closed some of the more speculative positions it held at the beginning of the year, slightly reducing its exposure to equities. During the period, this asset contributed 2.0% to performance.

2. **Dividends position:** The outlook for European dividends over the next few years continues its slow recovery. To the European dividend position, the fund has added a UK dividend position, the uncertainty of which should clear up after Brexit and while leading the Western world in vaccinations. This quarter, these positions added 0.2% to the fund's performance.

3. **Precious metals:** A side effect of interest rate hikes this quarter has been declines in gold and silver, which pay no coupon to the investor. In the last episode of severe inflation (1980), gold

did not work at first either, when inflation rose from 3.4% in 1972 to 12.3% in 1974. However, from 1977 onwards it staged an epic rise of over 500% when the Federal Reserve lost control and price variation soared to 14.8%. The weight of this asset in the fund remains at 10% and has subtracted 1.7% from the quarterly return.

4. **European banks:** Despite our doubts about the banking sector in the long term, in the short term there is no better protection against rising bond interest rates as we explained in our September 2019 report. The bet on European banks added 2.0% to the quarter's result.

5. **Commodities:** Commodities have continued their climb at the beginning of 2021 and are already at levels not seen since 2018 but are still 40% below the levels they reached in 2014. The next few months will be decisive in determining whether we are at the start of a super cycle or if this is simply a one-off rebound in anticipation of the grand reopening. In the meantime, these positions have contributed 1.0% to performance.

6. **Short position in fixed income:** Given the poor outlook for fixed income in the medium term, this quarter we added a short position that will benefit if the value of European bonds with long maturities falls (i.e., if interest rates rise). This quarter this has been the case, and this new position has added 0.2%.

7. **Short position in US technology companies':** We have also initiated a small bearish position in the US technology index this quarter, as we believe that all the tailwinds that have driven the sector in recent years (low interest rates, restrictions on mobility, globalization) are coming to an end. For the time being, it has neither added to nor detracted from the fund's performance.

8. **Emission rights position:** The last position of the fund, which we have already explained in detail in previous paragraphs, contributed 0.1% to performance.

The year 2021 has started as 2020 ended: with the assets most closely tied to the economic cycle rising strongly. While these moves make sense with the economic reopening ever closer, we believe they have perhaps gone too far in some corners of the market, which is why our positioning to start the second quarter is more cautious than it was at the beginning of the year.

*"Our goal is modest: we simply attempt to be fearful when others are greedy, and to be greedy only when others are fearful."*

- Warren Buffett

Un saludo,
Hanway Capital

## 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%** |
| **2021** | -1.9% | 2.8% | 3.0% | | | | | | | | | | **3.9%** |

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