July 8th, 2021

Q2 2021

Dear Investors,

Hanway Capital Fund **returned 2.7% this quarter** reaching a share price of **€136.7** net of fees and commissions. This brings the **year-to-date return toto 6.7%.** Equities had another strong quarter to complete their second-best start of the year since 1999. Sharp rises in oil prices, the Federal Reserve's change of tone and high inflation data are just some of the obstacles that the market has had to overcome during these three months. For how long will it continue to avoid them?

John Law, fraudster or hero?

Which child has never dreamed of a money printing machine? To be able to buy anything you want, without limits. However, money is nothing more than a medium of exchange with no real value, so the more money there is in the economy, the more goods and services will cost. There is no point in doubling wages if the cost-of-living also doubles. John Law, a Scottish economist of the 18th century, is considered the inventor of paper money in Europe (in China it existed many centuries before) and brought France to the brink of bankruptcy. His story should be told to all those children, and those not that young, who have ever dreamed of the money printing machine.

At the death of Luis XIV in 1715, the situation of the French public finances was deplorable. The costly stridencies of the court together with foreign campaigns, such as the War of the Spanish Succession, had left the French state with a debt of 3,000 million francs with an income of only 142 million via taxes. In addition, the shortage of precious metals that France suffered caused constant devaluations of its currency and made it difficult to increase the money in circulation.

The Duke of Orleans, who had assumed the regency of France given Louis XV was only five years old, was a friend of John Law, who saw in the duke's rise to power a unique opportunity to put his most revolutionary ideas to practice. Law was of the opinion that economic activity should not be limited by the amount of precious metals in circulation, so he proposed to abandon the gold and silver coins used until the then and switch to paper money, i.e., fiat money with no intrinsic value whatsoever and mostly based on the trust of the community.

Said and done. In 1716, the regent authorized Law to create a private bank called *Banque Générale* through which paper money theoretically convertible into coins would be issued. Quantitative easing was born, and the French economy and international trade quickly took off. He managed to reduce the French public debt by paying the monarchy's creditors by giving them shares in the bank, so the *Banque Générale* was nationalized and transformed into the *Banque Royale* (the closest thing to a central bank today).

Thanks to the successful invention, Law was allowed to intervene in colonial trade by consolidating all French trading companies in the United States under the *Compagnie du Mississippi*. In 1719, Law began issuing shares in the new company while launching an overstated campaign about the potential wealth of Louisiana that unleashed an investment mania that quickly multiplied the value of the shares 36x. Law was appointed finance minister, becoming the second most powerful person in the country. He controlled everything, tax management, public debt, coinage, and international trade.

Confident in the success of a system in which he felt all-powerful (he famously has been quoted saying "*The economy is me*"), Law increased the issuance of this new paper money far beyond the bank's resources. Since any holder of those bills could go to the bank and convert them into gold or silver, issuing without the backing of those metals was in fact a scam. The return of several emigrants explaining that Louisiana was in fact a land of worthless swamps and marshes was enough to start an acute crisis of confidence.

To prevent the house of cards from collapsing, John Law decided to merge the company and the bank and to exchange the shares of the *Compagnie du Mississippi* for the famous paper money. To redeem the shares, he had to issue (without any backing) such a quantity of banknotes that the money supply abruptly doubled. The consequence was that inflation reached 23% per month in January 1720 and stocks fell to almost 0.

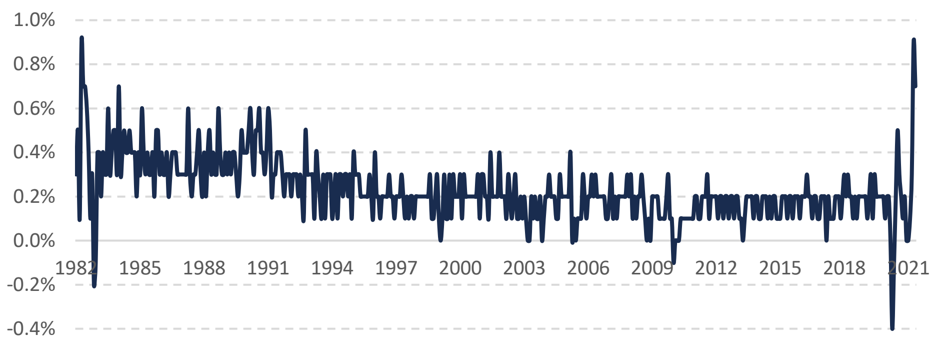
Many people queued from dawn outside the bank doors to exchange them, unsuccessfully, for gold. In July 1720 there was a riot and 15 people died. Law had to flee the country and died in poverty nine years later in Venice. France returned to the bankruptcy in which Luis XIV had left it, increased by the ruin of many private savers. It would take generations for France to recover from the collapse and the weakness of the French state finances helped trigger the revolution of 1789.

The idea of a fiat currency was synonymous with recklessness for two centuries and the link between money and gold was not completely abandoned until the 1970s, when the Bretton Woods system was ended. And what happened to Law and the legacy of the Duke of Orleans? Anyone strolling through the Louvre today can see in the Apollo Gallery one of the world's largest gems, *Le Régent*, a 140-carat diamond that the Duke acquired at the height of the money-printing euphoria, fascinated by the benefits of that policy. This diamond, which would later crown Luis XV and Napoleon would wear on the hilt of his sword, rests as a silent witness of that era of recklessness.

Transitory or persistent inflation

We have been warning for several quarters about the risk of a spike in inflation in the Western countries. The debate has finally landed in the minds of all economic agents: investors, politicians, central bankers and even ordinary citizens through the non-specialized press. Now it is no longer a warning, it is a fact. Inflation is already here.

U.S. month-over-month core inflation



U.S. inflation has soared to 5% year-on-year, a figure not seen since 2008. Most analysts agree that this data is not useful for any kind of rigorous analysis as it has "base effect distortion", i.e., since it is compared to the number from exactly one year ago at the height of the pandemic, the result is skewed. To avoid this criticism, the graph above shows core inflation measured month-over-month, i.e., it contains no distortion as it compares June prices to May prices of this same year. Still, we are looking at the highest data in four decades.

However, there is a surprising effort by the Federal Reserve in its communications to control and frame the inflation debate:

1. **It is misleading:** All data published during 2021 are distorted by the pandemic, and therefore should be taken with a grain of salt.
2. **It is transitory:** The sharp rises in inflation will end soon, and therefore should not worry us.
3. **It is controllable:** In the hypothetical case that it is prolonged in time, this inflation can be fought without problems by the central banks that have infinite resources to face it.

In our opinion, the debate on whether or not inflation is transitory is absurd: everything human is transitory by nature, and sooner or later it will come to an end. That is why we find it relevant to analyze how market dynamics will change and what opportunities will be left in its wake, rather than entering into the debate on its transitory nature.

So why so much effort to control the narrative? Like many other macroeconomic factors, inflation also tends to behave according to the expectations of economic agents. It is what we call common knowledge, or the narrative that we all accept. This is why monetary institutions are so concerned with controlling the inflation narrative: if they lose control over the inflation debate, they will also lose control over inflation itself. Or in other words, if citizens think that prices have gotten out of control, they will frontload their purchases and demand higher wage increases from their employers, thereby bringing inflation into the real world. Like John Law 300 years ago, Jerome Powell, chairman of the Federal Reserve, needs confidence in the system to maintain the bull market.

Arthur Burns' ghost

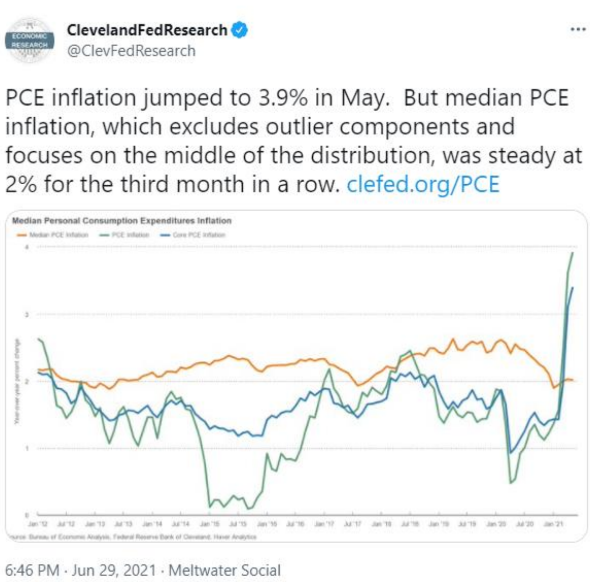
Arthur F. Burns was the chairman of the Federal Reserve from 1970 to 1978. He was a strong-minded man who believed that price changes were mostly caused by exogenous factors that had little to do with monetary policy and therefore price increases could be ignored if they were caused by singularities he could not control.

When the 1973 oil crisis broke out and the price quadrupled, Burns decided that the energy cost (which accounted for 11% of the basket) should be removed from the CPI calculation. Despite multiple complaints from the Fed's staff, that did not deter Burns, who a few months later also removed food (25% of the basket) that had skyrocketed in price because of the El Niño weather phenomenon. Burns claimed that these events had little to do with the Fed's monetary policies.

To some extent, Burns may have been right, but the chairman was not done there. Over the next few years, he systematically removed from the calculation everything that was going up in price until the basket was left with only 35% of the original components, and even then, the index was rising at double digits. It was not until 1975 that Burns gave up and accepted that the United States had a serious problem with inflation, which had reached 12.3%. The lesson from Burns is clear: ignoring "transitory" factors carries great risk.

Returning to the present, the Fed insists that recent increases in the price of food, building materials, used cars, personal health products, gasoline and appliances reflect transitory factors that will quickly disappear with post-pandemic normalization. In case that does not rhyme enough with the above story, we all remember when last summer the Fed decided to abandon the goal of keeping inflation at 2% at bay and decided that 2% *average inflation* was better, considering that as the last few years had been well below, they will now allow it to be above for some time.

Well, here is the Fed's new idea, the "*median inflation*". The Cleveland Fed tweeted a few days ago that the calculation of inflation should eliminate those components of the CPI that they consider "extreme anomalies" because they have shot up too much. Sound familiar? It sure does to Arthur Burns.



Management report

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

1. **Equity positions:** U.S. equities regained the lead this quarter as technology stocks returned to all-time highs. The S&P 500, the American benchmark, rose by 8.2%, far outperforming the Eurostoxx, which rose by 3.7%. As we mentioned in the last report, the fund maintains a conservative equity bias in the face of the strong rallies we have witnessed. Thus, equities only contributed 0.4% to quarterly performance.

2. **Volatility positions:** Although there has not been a 5% correction in the major indices since the beginning of the year, the market has shown signs of fragility. To protect against potential declines, the fund bought a volatility position at the beginning of the quarter, which although it has not yet returned to pre-pandemic levels, is again approaching attractive levels. This quarter the protection has detracted the fund's performance by 1.1%.

3. **Dividends position:** European dividends have finally returned to their pre-pandemic level. When we recommended the investment in April 2020, our thesis was that dividends beyond 2021 were being affected by technical factors (excessive issuance of structured products) rather than fundamental reasons. Now, having participated in the recovery, the fund has exited the position, which this quarter contributed 0.7% to the yield.

4. **Precious metals:** With interest rates easing, gold and silver have recovered some of what they have lost this year. For now, inflation data has had no impact on the precious metals' price, as the market assumes that central banks have the situation under control, although this could change if the numbers continue to surprise on the upside. The fund's position in this asset remains intact, with metals adding 0.5% to the result over the period.

5. **Commodities:** Commodities have continued their upward path, with oil reaching levels of $75, not seen since 2018. These rises are starting to make some governments (China's in particular) uncomfortable as they fear that an increase in the cost of their imports will slow down their economy. It will be interesting to see if commodities are able to ignore this background noise and continue their climb, which has benefited the fund by 1.2% this quarter.

6. **Short position in fixed income:** Fixed income continued to fall until May 13th, when the US 10-year interest rate reached 1.7%. Since then, and despite the surprising inflation data published on May 12th, fixed income has recovered some of its losses and the interest rate has fallen to 1.4%. This round-trip has meant that this fund position has neither added to nor subtracted from performance.

7. **Short position in US technology companies’:** The technology sector has returned to its upward path, despite skeptical voices pointing to its excessive valuation and monopolistic position. Nothing seems to be able to stop the rises in the FAANGs (Facebook, Amazon, Apple, Netflix, Google), which have subtracted 0.6% from the fund's performance this quarter.

8. **Emission rights position:** The latest addition to the fund has had an exceptional quarter. Emissions allowances have risen from €43 per tonne of CO2 emitted to €56. Despite the impressive rise, prices still need to rise considerably more before forcing a real change in the

policies of the most polluting companies, as desired by the European Union. During the quarter, this position contributed 1.6% to the fund.

We do not necessarily believe that we are heading for a period of inflation as strong as the 70s and 80s for now. However, the situation is very similar to our volatility bet at the beginning of last year, when it had been marking record lows for far too long. Inflation expectations are coming off a 40-year super-cycle of negative expectations and falling interest rates. Sometimes it is precisely these abrupt trend changes that provide the best opportunities.

"Inflation is always and everywhere a monetary phenomenon. It's taxation without legislation"

- Milton Friedman

Regards,
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%	1.2%	0.6%	0.9%							**6.7%**

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