October 15th, 2021

Q3 2021

Dear Investors,

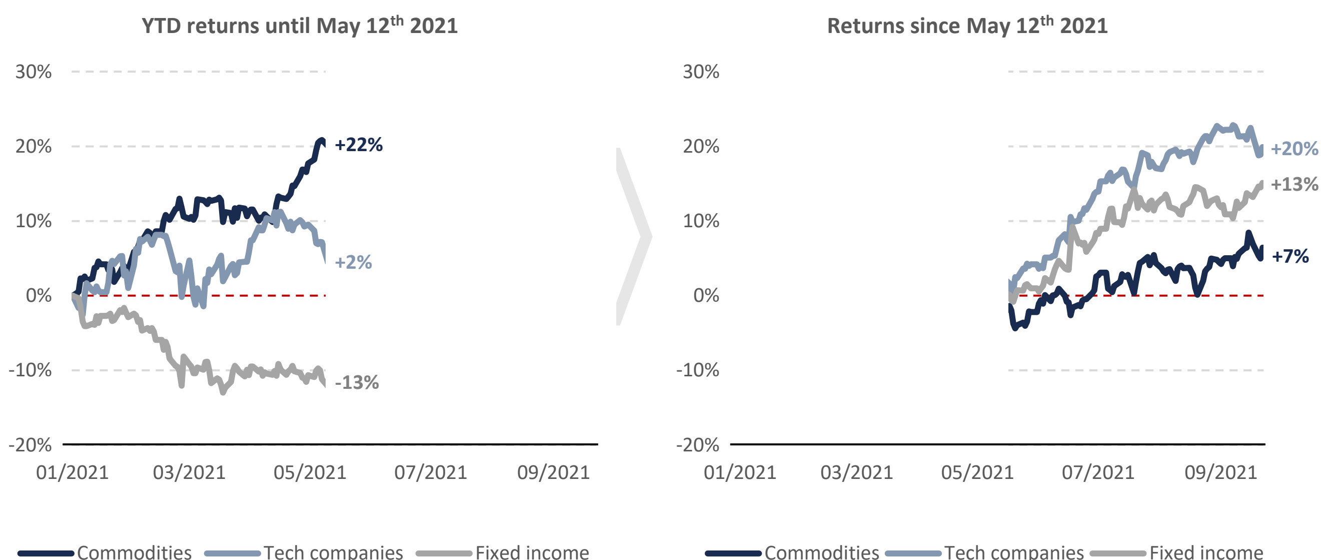
Hanway Capital Fund has **returned -0.4% this quarter** reaching a share price of **€136.7** net of fees and commissions. This brings the **year-to-date return to 6.4%.** Even though inflation data released this quarter were the highest in 30 years, the market has chosen to surrender to the official narrative that inflation will be transitory. Although our strategy has not worked over the past three months, our conviction remains intact, and we continue to believe that the biggest risk to the global economy is persistent inflation.

A year split into two

On May 12th, the Bureau of Labour Statistics revealed that the US CPI for April stood at 4.2% over the previous year, confirming that inflation was already with us. Since that date, successive published inflation data have not fallen below 5.0% in the US and in the Eurozone it stands at 3.4%.

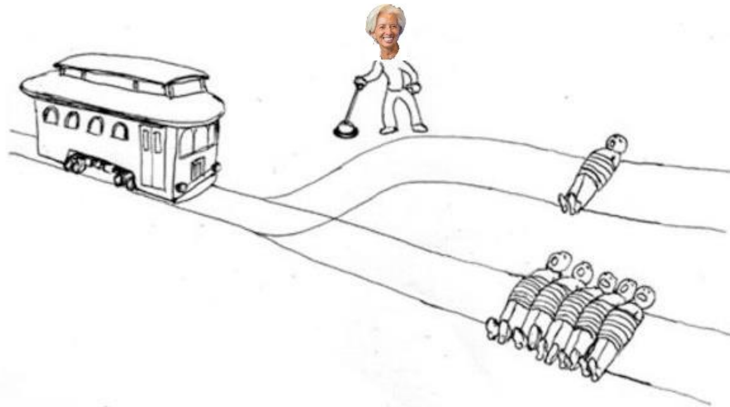
Why then has Hanway generated hardly any return since that day? Simply because the market has behaved as if these data would soon abate. Let's remember that stock markets are a discounting mechanism that measures neither the current state nor the future of the economy, but rather an indicator of the evolution of macroeconomic expectations.

Thus, while in the first half of the year the fear was that inflation would make its appearance, in the second half the narrative which gained adherents is that we will quickly return to moderate inflation. As a result, the assets we selected at the beginning of the year (mainly commodities, a short position in fixed income, and a preference for cyclical companies over technology companies) have undone the relative gains from the beginning of the year.



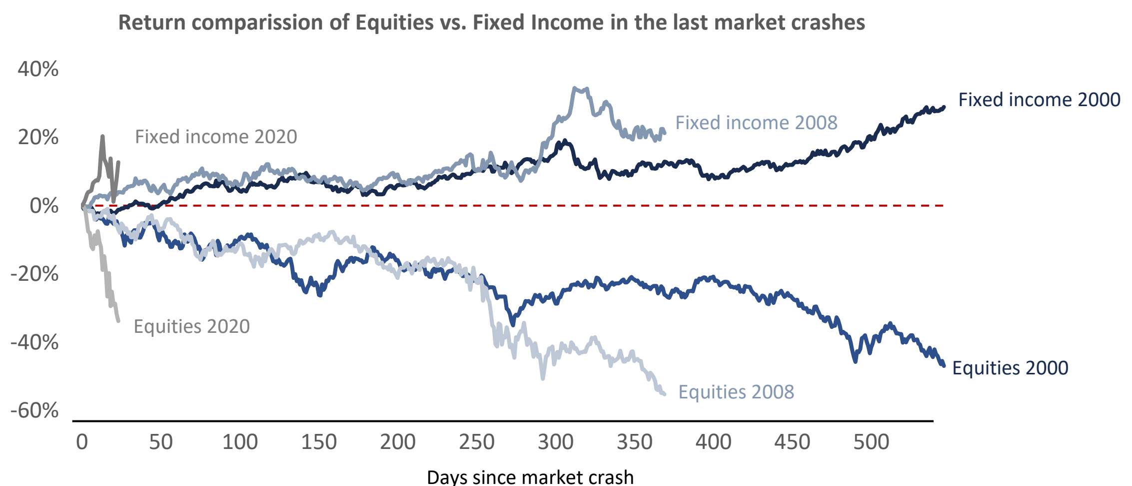
Central banks have a particular interest in convincing economic agents that inflation will be transitory. If that were not the case, they will be faced with the Trolley problem: either do nothing and allow inflation to rise, undermining people's savings and confidence in the financial system, or raise interest rates abruptly, slowing down the economy and pushing many indebted companies into bankruptcy.

Christine Lagarde @Lagarde · 6m
Many of the higher prices we are currently seeing are temporary, I explained in an interview with @AnnetteCNBC. We @ecb think prices will become much more stable in the year to come. Read the full interview ecb.europa.eu/press/inter/da...



La Ligne Maginot

Past experience helps us to generate behaviors that should help us if a situation repeats in the future. Thus, financial managers know that in the face of any market risk, protecting their clients' portfolios with a weighting in fixed income should be enough to abort any tragedy.



The past 30 years crisis' have shown that balanced funds (those with a portion in equities and another in bonds) weather the storms very well due to the negative correlation between the two assets. In other words, when the stock market goes down, bonds go up. But has this always been the case, and is it written anywhere that this way of protecting against the enemy will continue to work in the future?

André Maginot, French soldier and politician of the 20th century, fought on the Lorraine front during the First World War. In November 1914, at Verdun, he was wounded in the leg and limped for the rest of his life. But André Maginot is best known for naming and proposing the famous Maginot Line.

In 1929, Maginot was appointed France's Minister of War. The growing threat of Hitler's Third Reich and the fear that France would suffer a new bloodbath as in the previous war prompted Maginot, based on past experience, to draw what he would believe to be a brilliant idea.

The Maginot Line was a fortified wall of more than 500km that extended along the entire French border with Italy and Germany from the Mediterranean to the English Channel. It had 108 forts and was the largest line of military defense built in the modern world, and of great technological and military complexity. Based on the trench warfare of the First World War, the fortification would have all kinds of facilities to withstand a long siege: dining rooms, communication room, infirmary, operating rooms, and even comfortable bedrooms.

According to its promoter, the Maginot Line would greatly reduce casualties compared to the first great war. It would stop a possible German attack in time, protect the industrial basins and mines of Alsace and Lorraine, which in previous conflicts had been a tempting booty for the enemy, and would turn France into an impenetrable bastion.

Despite its detractors, such as the then General Charles de Gaulle who dismissed the project as old-fashioned and inflexible, Maginot obtained the support of Marshals Joseph Joffre and Phillipe Pétain, both of whom were almost octogenarians and clung to the archaic concept of rigid trench warfare. Construction began in 1929 and ended in 1938, but André Maginot died in office in 1932 and would never see the end of his long and ambitious dream, which ended in a bitter awakening.

When the war broke out, 25 years had already passed since the beginning of the First World War, and Nazi Germany inaugurated its novel and atrocious mechanism, the *Blitzkrieg* (lightning war). It was clear from the outset that this Second World War would have nothing to do with the first, and that trench warfare and static defense were a thing of the past.

In May 1940, Hitler's troops invaded Holland, Belgium and Luxembourg in just 18 days, and the impregnable Maginot Line fell in less than a month. The new techniques of warfare and mainly the airplanes proved how pointless was the outdated defense and turned it into the symbol of the French defeat in the Second World War.

France fell into the hands of Hitler and his Third Reich until 1944. So brief was the life of the line that when British and American soldiers toured it, they were astonished to see that the guns looked brand new, never having been fired. The Maginot Line collapsed before shooting down a single enemy soldier. *Sic transit gloria mundi.*

Some asset managers may end up suffering the same fate as André Maginot and be unaware that combat techniques have changed. Buying fixed income to protect against possible market crashes means in practice fighting with the techniques of a bygone war.

The American Civil War (1861), the Russo-Japanese War (1904) and World War I (1914) were trench wars, and static defenses triumphed. The dotcom crisis (2000), the financial crisis (2008) and the covid crises (2020) were deflationary crises, and fixed income was the best defense. But we must ask ourselves, will our sovereign bond trench work just as well, if the enemy attacks us with lightning-speed price hikes?

Global energy crisis

Although health effects of the pandemic seem to be abating, COVID-19 continues to generate collateral damage. If the pandemic caused the price of a barrel of oil to go into negative territory in April last year due to lack of demand, this winter the pandemic threatens to generate a global energy crisis due to lack of supplies.

Since ancient times, civilizations have understood the arrival of cold weather as one of those times of the year when it is advisable to be prepared. This translates today into governments and large corporations trying to ensure that strategic energy reserves are full at the onset of winter. However, this year the International Energy Agency has warned that natural gas reserves in Europe are 20% below what is usual for this time of year.

The European Union is the world's third-largest energy consumer, but it is highly dependent on the outside world. We produce at least one fifth of our electricity with natural gas, 90% of which we import from Russia and Algeria. This leaves us very vulnerable to scenarios such as the current one, where the breakdown of supply chains has unleashed a global battle to try to accumulate as much gas as possible to face the winter.

This in turn has caused the price of gas in Europe to soar to record highs, dragging with it the price of electricity. Beyond the obvious social impact this will have on families, it is also causing the stoppage of industrial plants, which will end up translating into an economic slowdown.

The rising cost of gas is also increasing the economic attractiveness of generating energy using much more polluting sources, such as burning oil or coal. At Hanway Capital, we believe that the real solution to this problem lies in accelerating the transition to renewable energies in order to move away from dependence on polluting fossil fuels and the geopolitical strategies of authoritarian regimes.

Our position in CO_2 emission rights is the best way to express this belief. The price at which CO_2 emission rights are quoted indicates the price at which large companies and energy companies will have to pay for polluting. In the face of the press attacks against speculation in the emission rights market due to the impact on the electricity bill, we would like to highlight two facts:

1. The increase in the price of electricity in Europe during 2021 is 90% explained by the increase in the price of natural gas (394% this year) and only 10% by the increase in CO_2 emission rights (80% this year).
2. With the rise of ESG investing, we cannot think of a more sustainable investment than emission rights. By purchasing this asset, we encourage companies to make the necessary investments to stop emitting polluting gases.

Management report

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

1. **Equity position**: For the sixth consecutive quarter, US equities have appreciated, although their gains have been limited to 0.2%. In recent weeks, caution and pessimism seem to have taken hold of the market. On September 20th for example, the VIX volatility index reached 29 points while the S&P 500 was just 5% below its all-time highs. This behavior leads us to believe that equities could have a great last quarter this year, which has led the fund to timidly increase its exposure. During this period, equities subtracted -0.4% from performance.

2. **Precious metals:** The strength of the US dollar has weighed heavily on gold and silver prices, which are down 1% and 15% respectively. Historically, the negative correlation between precious metals and the dollar has been very strong, so many market players will be surprised if both are able to rise at the same time in an inflationary context. The fund's position in this asset has subtracted another -0.6% from the result.

3. **Commodities:** The energy crisis we are experiencing has its origin in the sharp rise of some commodities such as natural gas and oil. Governments will do everything in their power to try to curb their escalation before the cold weather arrives, but it will be the countries that export these commodities that will have the upper hand. In the meantime, this escalation has benefited the fund by +0.4% this quarter.

4. **Short position in fixed income:** Fixed income remains unperturbed by inflation data that continues to surprise on the upside. The US bond yield (1.5%) and US CPI (5.4%) have never been so far apart. It will be interesting to see whether this divergence ends up closing on the upside with rate hikes or the downside with a more controlled inflation. This quarter, profitability has been reduced by -0.3% due to this position.

5. **Emission rights position:** The CO_2 rally has continued this quarter, with prices rising from €56 to €62. The European Union has recommended this week to its member countries to take advantage of this rise and use the extraordinary profits they will obtain selling emission rights to subsidize the electricity bill for the most vulnerable communities. This very wise measure demonstrates the faith that Brussels has in this instrument, which this quarter has contributed +0.5% to the fund.

"No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future"

- Ian E. Wilson

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%	-0.8%	1.5%	-1.1%				**6.4%**

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