April 6th, 2022

Q1 2022

Dear Investors,

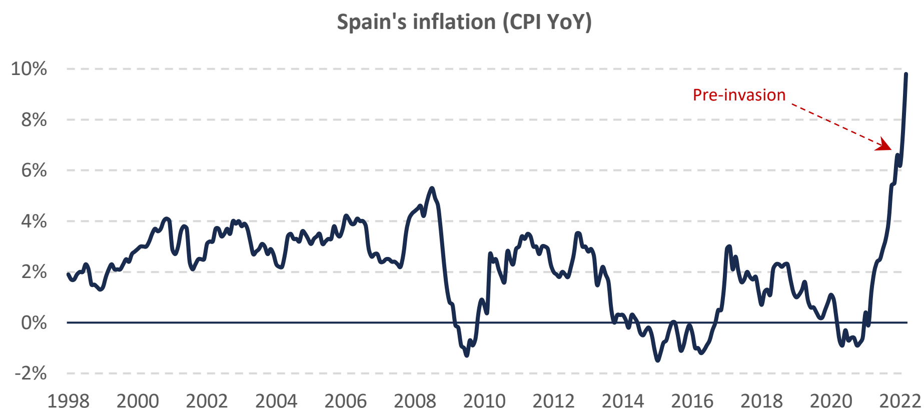
Hanway Capital Fund has **returned +0.3% this quarter** reaching a share price of **€146.2** net of fees and commissions. After almost two years of an uninterrupted rally, this quarter losses have been brutal. Our strong commitment to pro-inflation assets has enabled us to navigate this turbulent scenario without suffering like the European stock market, which has sustained losses of more than 10%. Even so, we believe that some of our positions have yet to wake up to this new reality and could thrive in the remainder of the year.

Policy makers have found their scapegoat

During the second quarter of 2020, in the wake of the historic liquidity injection undertaken so that the economy would be able to survive the pandemic, we warned of the imminent return of inflation. 2021 was the year in which central banks managed to sustain the narrative that inflation would be transitory and would rapidly decline. However, in 2022 price rises have slipped out of control. We are in the fourth month of 2022 and inflation in the United States stands at 7.9%, in the Eurozone at 7.5% and in Spain at 9.8%. These are the highest figures in 40 years.

Faced with the evidence that the problem they ignored for months has exploded, our leaders have been forced to choose between taking the blame or looking for a scapegoat. It is in this scenario that Vladimir Putin and his order to invade Ukraine on February 24th comes into play: the Kremlin has given our leaders the perfect excuse that allows them to dodge any hint of blame for the current inflation.

It's obvious that the invasion of Ukraine has had an immediate effect on inflation, making access to many raw materials, especially in the energy sector, more expensive for Europe. But the problems started much earlier, for as Milton Friedman reminds us, "inflation is always and everywhere a monetary phenomenon". It was absolutely naïve to think that all the quantitative easing programs from central banks, together with PPPs, furloughs and even direct checks to citizens would come free of charge.



Now we are beginning to feel the consequences, and it’s time to act surprised. Central bankers and policymakers alike will pretend to be very concerned and will deny having wished for this inflation. But how else could the spectacular mountain of debt accumulated over the last 20 years be repaid? Let us recall that debt is denominated in a fixed nominal amount. An economy with 100% debt over GDP with 5% inflation for only 5 years and no real economic growth would reduce debt to 78% without making any "apparent" effort.

But who is paying for all this spending? Mostly savers. A citizen with €10,000 saved in his bank account will lose during 2021-22 about €1,585, or 16% of his wealth. All those workers who are unable to negotiate a 10% wage increase in 2022 will also suffer. And finally, the last victims will be "conservative" investors in fixed income products, as they won’t be able to find bonds that pay them an interest that matches inflation.

That is why the appearance of Vladimir Putin has been so timely. US President Joe Biden refers to the increase of oil prices as "Putin's tax", and VP Kamala Harris reminded Americans that "there is a price to pay for democracy, and it means paying more for gas to punish Russia". Similarly, in Europe we are being asked to support our fellow Ukrainians by putting up with electricity and gas price increases.

One of the most influential newspapers in Spain, *La Vanguardia*, perfectly exemplifies this mentality in its editorial from March 31st. Titled "An increase to the war tax", the article ignores the fact that inflation in Spain was already at 6.5% before the invasion. Moreover, it also urges the European Central Bank to skip its price stability mandate and resume the same monetary stimulus that has brought us to this dreadful situation.

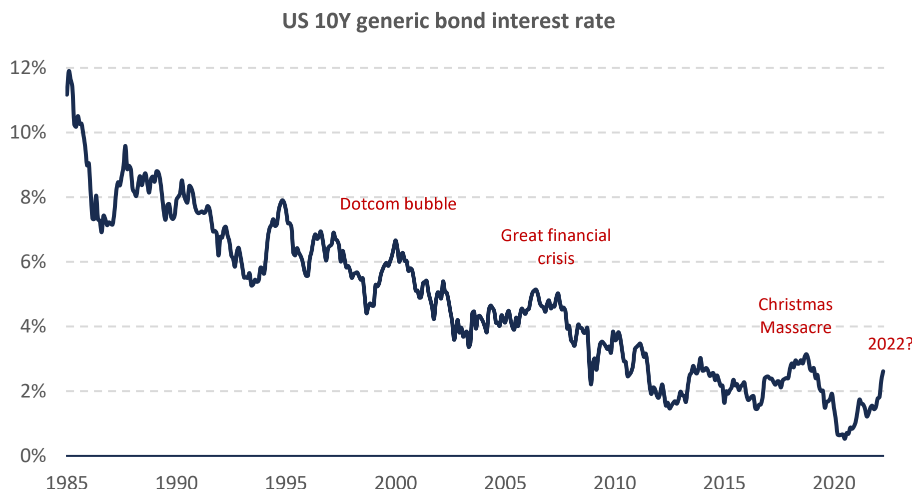
In our view, inflation will persist for many months to come as it begins to affect people's consumption and investment decisions. For this reason, the fund is sticking with its bets on those assets that protect our investors from inflation. It shouldn’t be forgotten that the current inflation shock is demand-driven, not supply-driven, and will therefore persist beyond the conflict in Ukraine. The only way to stop this spiral is to implement restrictive monetary policies that will cause an economic recession to slow down demand. Never has inflation above 5% been curbed without triggering a recession.

The fixed income market awakens from a sweet 40-year slumber

We’ve been warning for some time about the risk of investing in fixed income and the ticking time bomb it represents. Specifically in our letter two quarters ago where we made the *Ligne Maginot* simile and in a 2019 report where we warned about the hidden risks of fixed income. The beginning of the year has marked the beginning of the explosion: this has been the worst quarter for fixed income in 40 years with a 6% drop. Cumulative declines since January 2021 now exceed 11%, its biggest drop since the 1980s. Although if measured in real terms, after discounting for 7% inflation the real decline has been 18%.

Despite the historic decline, we believe it still has a long way to go. Fixed income has enjoyed from a long 40-year macroeconomic cycle that has been very favorable: low inflation expectations, steadily declining interest rates and moderate growth have served as tailwinds.

The graph below, which shows U.S. 10Y bond interest rates prove a strong downward bias since 1985. This has generated a dynamic in which, when the slightest interest rate spike jeopardizes the trend, a financial accident arises. Based on history, it would be unwise to ignore what the current rate spike may cause.



All of this has an indirect impact on equities and valuations. The more of a company's earnings are trapped in the future, the more sensitive its share price will be to a rise in interest rates. Due to the time value of money, higher interest rates will mean lower value for those future earnings. This is the only explanation to the brutal crash we've witnessed in recent months in unprofitable companies. Rewarded by the market during the low interest rate environment, investors are no longer willing to tolerate executives from those companies underestimating the importance of being profitable today.

The man who changed the course of war

When the invasion of Ukraine began on the 24th of February, the world's stock markets initially reacted positively, and oil prices fell. The explanation is simple: the whole world believed that the conflict would last only a few days, and that the Ukrainian army would suffer the same fate as the Afghan army at the hands of the Taliban in 2021. Its rulers would flee to exile, soldiers would quickly surrender, and Putin would win a quick victory to further expand his zone of influence.

However, the Ukrainian people, inspired by their leader Volodymyr Zelensky, have shown steadfast resistance in the defence of liberty. It was his lead and his constant televised harangues to Western leaders that forced them to launch the biggest financial attack ever seen. The economic sanctions against Russia have made the global financial system the spearhead of Western weaponry.

Russia, which had been preparing for conflict for years, had nearly doubled its international foreign reserves since 2015 and was counting on using them to prop up the rubble and its economic system in the face of the foreseeable sanctions. The only problem was that those currencies were mostly in US dollars and euros, and thus within the reach of the central banks that regulate those currencies.

On February 28th, in an unprecedented move, the West not only cut off Russian banks from SWIFT access (the international payment system), but also froze all assets held by its central bank in euros and dollars. The effect was the same as if Russia had forgotten the password to its bank accounts.

Such actions will have a massive relevance on the world order and on international capital flows for the coming decades, with China being the most relevant actor. It is to be expected that the bloc of countries not aligned with Western values will seek to gradually disengage from a financial system

they do not control and will keep their foreign exchange reserves in currencies that are not under the influence of the West.

In practice, we are talking about a retreat from globalization, a reduction in international trade between blocs and perhaps even a loss of the dollar's weight in world trade. If China wants to unseat the United States in the coming decades as world leader, it has learned from this conflict that it cannot depend on a US-controlled financial system.

On the other hand, and to end on a positive note, the war has dragged the Old Continent into an energy crisis from which it will emerge stronger. The European Union is always reactive when it comes to meeting challenges: it was not until the financial crisis that it decided to complete the banking union, and it took the invasion of Ukraine to seriously considered a common energy policy.

As the United States did from 2014, it is essential that the European Union achieves energy sovereignty. This transition will cost lots of resources and its benefits will not be seen for many years to come, but it is vitally important. Hanway Capital's commitment to companies dedicated to the production of renewable energy remains intact and we believe that we are facing a unique opportunity for Europe to become a pole of innovation in this industry.

Management report

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

1. **Equity position**: The rally that began in March 2020 has halted at the beginning of 2022. At first the declines were focused on the most speculative corners of the market (the Nasdaq fell by 21% top-to-bottom) but after the invasion the panic spread to the European stock market. The fund continues to have a very conservative bias in equities, but even so, it hasn't been able to avoid the falls and this asset class has subtracted **-1.9%** from the performance.

2. **Volatility position:** After more than a year without holding positions in volatility, this quarter the fund has started to buy protection against sharp market movements once again. However, despite this quarter's uncertainty, volatility has not performed as expected. Our theory on this is that this protection only works every other crash (in green we show when it works, in red when it doesn't). Its good performance in 2020 has caught the attention of many managers that have used it as protection this time, ironically limiting its potential. While we wait for it to work again in the next panic, this quarter it has depleted the fund by **-0.8%**.

3. **Precious metals:** Following the bullish trend that started at the end of 2021, gold reached record highs above $2,000 on March 8th, but has since corrected a bit. Its function as a safe-haven asset has undoubtedly been vindicated this quarter, because while Russia saw access to its currencies cut-off, no one was able to prevent it from using its gold reserves. The fund's position in this asset added **+1.7%** to the result.

4. **Commodities:** When we announced in our last letter that we had lowered our weight in this asset, we weren't expecting what followed. Commodities have experienced their best quarter since 1990. The expulsion of one of the world's largest commodity exporters from the financial system has created unprecedented chaos in the commodities market, the consequences of which will become clear over the next few years. The contribution of this asset to the fund was only **+1.0%** over the period, given we had lowered its weight.

5. **Short position in fixed income:** The discrepancy between inflation and interest rates has finally begin to close to the upside in 2022. The change in the Fed's rhetoric, which is expected to raise interest rates 7 times this year, has awakened many investors from their lethargy and caused them to abandon their fixed income positions. The fund has benefited from this trend, which we believe still has a long way to go, by **+1.0%**.

6. **Emissions rights positions:** Our best investment of 2021 has had a turbulent start to the year. Rising household electricity costs led some investors to fear that the European Union would temporarily suspend its emissions market for the duration of the war. Thus, between February 23rd and March 2nd, in just 5 days, the price of CO_2 plummeted by 42%. Since then, and in the face of assurances from the EU Commission that it would not intervene, the price has recovered more than half of its losses. Its evolution has negatively affected the fund by **-0.7%**.

“We shall fight on the beaches, we shall fight on the landing grounds, we shall fight in the fields and in the streets, we shall fight in the hills; we shall never surrender.”

- Winston Churchill

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%	2.4%	1.3%	3.1%	**13.7%**
2022	-1.7%	0.0%	2.1%										**0.3%**

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