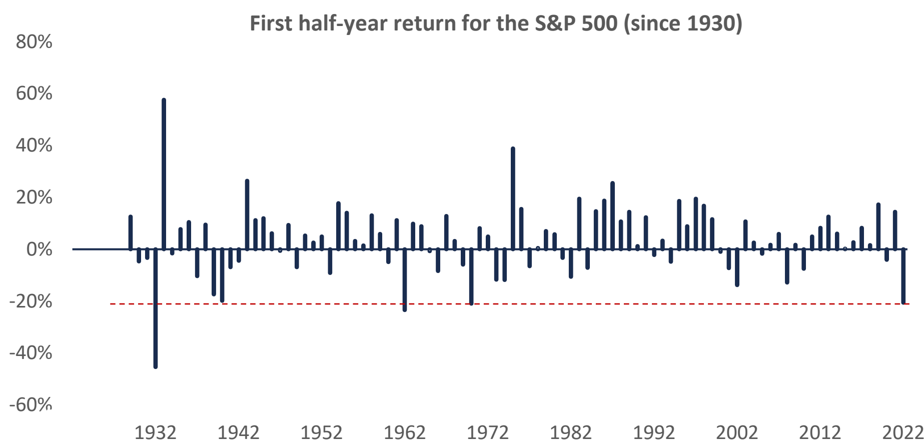
July 8th, 2022

Q2 2022

Dear Investors,

Hanway Capital Fund has returned **-3,7% this quarter** reaching a share price of **€140.7** net of fees and commissions. This brings the year-to-date return to **-3,4%**. In another turbulent quarter for equities, which have suffered their worst start in the last 50 years, only our bet on interest rate hikes has protected the fund. The market seems to take for granted that we are heading for a recession that will return inflation to levels close to 2%, but the fund maintains its view that we are facing a paradigm shift that won't be reversed.



Out-of-control inflation

Far from moderating, the latest inflation figures published by the major economies have continued to set record highs. In Spain, the year-on-year consumer price index rose to 10.2% in June, its highest increase since April 1985. In the United States, the June figure to be released next week is expected to be dangerously close to 9% for the first time since 1981.

Unable to ignore the problem any longer, central banks have radically changed their course this quarter. Less than a year ago, on September 9th, European Central Bank President, Christine Lagarde, indicated that she was not even considering withdrawing stimulus. This time, at its last meeting, she announced the end of the pandemic emergency purchase program (PEPP) and the first rate hike in July after 11 years. Both measures are intended to halt the inflationary spiral by curbing demand

According to classical economic theory, interest rate hikes affect the real economy by increasing the return on savers' deposits. A citizen will be less inclined to spend his money if he obtains a risk-free return for having it deposited in the bank.

The end of the debt purchase program affects the business cycle by increasing the cost of financing for companies and governments. If interest expenses increase, companies will slow down investments. On the other hand, governments will have an incentive to rebalance their fiscal balances as they see the interest expense on their debt increase, i.e., they will cut public spending.

These two tools are unlikely to reduce inflation significantly, especially in Europe. In the old continent we still have negative interest rates (customers are still being charged for having their savings deposited in banks) and even after the planned hikes, current accounts will not start paying interest until after 2023. Savers will hardly have an incentive to curb their consumption and park their savings in banks.

As for halting debt purchases, in practice it will be almost impossible to implement. The huge amount of debt that many developed countries have accumulated in recent years have left them in a situation of complete dependence on central banks, and they could not survive without their direct or tacit support. In fact, six days after her change of speech sent Italy's risk premium soaring to 240 basis points, ECB President Christine Lagarde, announced that she would work on a new debt purchase instrument that would keep risk premiums at acceptable levels. With this promise, the incentive for countries to reduce fiscal deficits disappears and, therefore, it does not seem that governments or companies will be the ones to curb spending and investments to reduce inflation.

With the two classic monetary policy instruments useless, central banks have decided to resort to a third, lesser known but equally effective tool in 2022: the wealth effect.

The wealth effect in 2008 & 2020

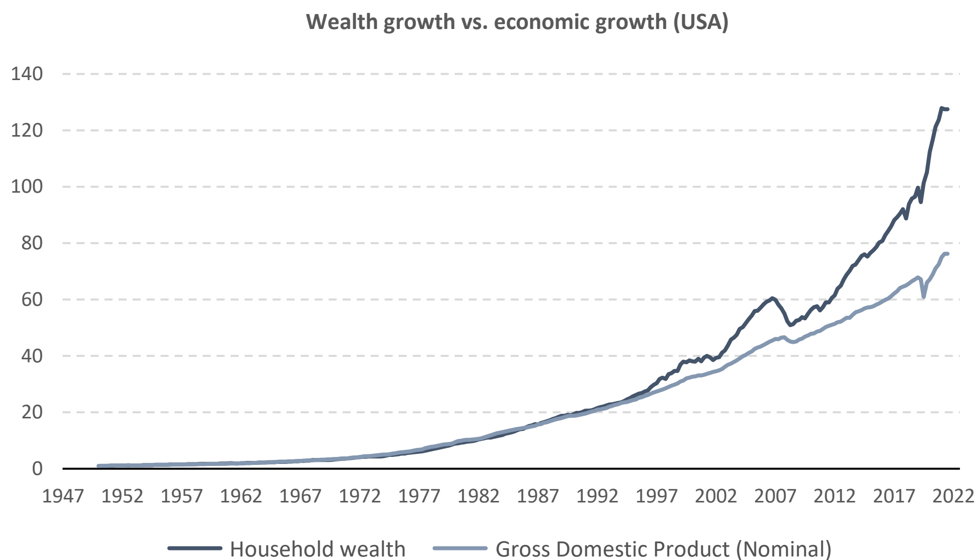
During the 2008 financial crisis, the confidence that underpins our economic system was on the verge of being shattered. When the economy went into recession in the first quarter of 2008, the U.S. Federal Reserve quickly lowered interest rates from 5% to 0% to try to revive activity. However, they soon realized that interest rates had no impact on consumers: uncertainty was such that stopping interest on deposits would not bring consumption back to normal.

Looking for other ways to promote consumption, Ben Bernanke, then chairman of the Fed, noted in a speech that *"if people feel that their financial situation is better because their stock portfolio has gone up or their house is worth more, they will be more willing to go out and spend, and that will provide businesses with the demand they need to hire and invest"*.

In economic theory, the financial market should reflect the state of the economy and the business cycle. If the economy was in a precarious situation, it was only natural that the stock market would also be depressed. Bernanke's brilliant idea was to turn this logic around and, instead of improving the economy and expecting the stock markets to follow suit, he chose to artificially improve the stock market in the hope that the economy would catch the optimism.

Said and done. Through its capital injections, the Fed bought government bonds to reduce the cost of funding for the government, but more importantly, to provide liquidity to investors as it bought their assets. These investors in turn used the proceeds to invest in riskier assets, increasing on paper the wealth of economic agents.

Although risky, the experiment worked in 2009, and again in 2020. During the hardest months of the lockdown caused by the pandemic, central banks flooded the system with liquidity, indirectly driving up the price of real estate, stocks, and even private company valuations. Thus, despite the dire economic situation, households remained confident in their economic situation and continued to spend.



How to curb inflation in the 21st century

To slow the current bout of inflation, central banks this year have tried to do exactly what they did in 2008, but in reverse: make consumers feel less wealthy and as a result curb their consumption.

The first step is relatively simple: interest rate hikes implemented will not affect savers' remuneration but will impact the discount rate used to value companies on the stock market. As a result, expectations of rate hikes have led to equity declines, making investors less inclined to spend.

On the other hand, rising interest rates will also affect the leverage that households can afford to take on to buy a home. With the increases in 30-year mortgages so far this year in Europe, the price of a house one can afford with a monthly payment of €1,500 has dropped from €535,000 to €435,000. It is only a matter of time before this effect starts to be felt in the price of housing, making property owners feel once again, less wealthy.

The effect has also been felt in the valuation of private companies. When central banks printed huge amounts of money to survive the pandemic, private equity funds became flush with capital, which

started a race to invest that resulted in exorbitant multiples for many investment rounds. This in turn made investors from previous rounds and the employees themselves feel richer. With the withdrawal of liquidity, many of those theoretical gains will never be realized, and so those affected will tend to spend less.

Will these actions be enough?

Although during the first months of the year inflation expectations continued to rise, during the month of June the focus of the market changed radically. Fears of inflation have given way to fears of an economic recession caused by tight monetary policies. Over the last few weeks, the price of oil has fallen 19%, commodities have dropped 18%, equities have fallen 13% and bonds have seen a 6% rally.

All this has caused inflation expectations in the US for the next 5 years to drop from 3.6% to 2.5%. This change of story has hit Hanway's positions, which, having an inflationary bias, had performed very well during the first months of the year.

Three possible scenarios now appear before us, to which we have assigned our probability forecast:

1. **Persistent inflation and mild recession** (60% probability): All the themes that have protected us during the year should continue to do so. Commodities will rally again, interest rates will continue to rise, and both equities and bonds will continue to fall. Most investors are not used to an inflationary recession like the one in 1970 (known as stagflation) and hence the big risk of betting on fixed income right now.
2. **Deep recession, falling inflation** (30% probability): Assets will behave opposite to the previous scenario. Equities will suffer from earnings contraction, but fixed income will work as in previous deflationary recessions (2008, 2020) acting as an unbeatable protection.
3. **Inflation moderates, recession avoided** (10% probability): Strong rise in equities, accompanied by a good performance of fixed income. Commodities and other alternative assets will perform worse.

The market consensus predicts that in the coming months we will suffer a global recession that will curb consumption and that we will return to the macroeconomic context that we had before COVID-19: controlled inflation, low interest rates and weak economic growth. That is, the second scenario above.

Hanway Capital is reluctant to accept this diagnosis, as we believe that it will be impossible to return to the old status quo. We believe that we are heading towards a world with inflation comfortably installed above 4% for a long period, with growth higher than what we were used to and, above all, with higher interest rates.

Although this is our base case, our job is not to predict the future, but to weigh the possible scenarios and be prepared for any of them. For this reason, in recent days and following the fall in June, the fund has reduced its exposure to risk assets to navigate the uncertain remaining months of the year.

Management report

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

1. **Equities:** To give some context to this quarter’s falls, losses of main indices are only comparable to 2020, 2008 and 2000. The Nasdaq has suffered a 23% decline in three months as the technology bubble and cryptocurrencies continue to deflate. Even sectors benefited by inflation such as energy, which enjoyed good returns at the start of the year, took a heavy hit in June on recession fears. The fund maintains a bearish view on equities. The current drop is due exclusively to multiples contraction, so we believe that if we end up having an earnings recession the declines may accelerate. This quarter, and especially in June, we have not been able to escape the losses and this asset has taken **-4.4%** from our profitability.

2. **Precious metals:** Gold continues to surprise everyone. Even though the economic textbook tells us that it should do very well in inflationary periods, this year it has fallen by -5%. The only plausible explanation is that mistrust in the economic and financial system is not enough to convince investors to abandon the dollar (which is behaving as a haven) and take shelter in gold. Although remote, we believe it is prudent to maintain a small position in precious metal to hedge against a confidence breakdown in central banks. The fund's position in this asset has subtracted **-2.6%** from the net result.

3. **Commodities:** Despite the rally initiated by Russia's invasion of Ukraine and the expelling of one of the world's largest exporters of raw materials from the financial system, fears of a recession are erasing all the year’s gains. As we have discussed in our scenarios, if inflation persists and economic growth turns out to be more robust than expected, materials could gain steam again. We maintain a cautious position but, in the meantime, this asset has subtracted **-0.6%**.

4. **Short position in fixed income:** Our strong bias to an increase in interest rates has worked perfectly. It is the only asset that has generated a positive return and it has helped us avoid the sharp declines that other funds are experiencing. However, in the last 15 days it has turned against us due recession fears. Hanway is of the opinion that most investors are not used to an inflationary recession and therefore are seeking refuge in fixed income as they have always done. We believe this is a serious mistake. The fund maintains its conviction that we are heading towards a world of higher interest rates and therefore maintains the position as an inflation hedge. The fund has benefited from this trend by **+3.8%**.

5. **Emission rights**: In a sudden change of script, the fund has decided to abandon this position completely. As a regulated market, we have always been aware that political risks in this asset were more relevant than market forces. The European Commission has decided to corrupt the asset by monetizing part of its Market Stability Reserve (MSR) to finance its projects. In practice, this implies increasing the supply of pollution permits, which we believe will reduce their price. This behavior seriously damages the credibility of an excellent tool to combat climate change. Despite our belief in this asset long-term, it will be uninvestable until it returns to certainty. It has contributed +0.1% to this quarter result before leaving the fund.

"In times of rapid change, experience can be your worst enemy"

-Jean Paul Getty

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%	1.8%	0.8%	-6.1%							**-3.4%**

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