October 17th, 2022

Q3 2022

Dear Investors,

Hanway Capital Fund returned **7.8% this quarter** reaching a share price of **151.6€** net of fees and commissions. This brings the **year-to-date return to 4.1%.** The unprecedented meltdown in fixed income is hitting 60/40 portfolios especially hard, which are suffering their worst year since 1931. In a quarter where few assets have served as safe havens, Hanway Capital has once again proven to be a true risk diversifier. It is difficult to be optimistic about the current outlook: inflation remains out of control, winter is coming to Europe and interest rate hikes are still on course. In an over-indebted world, we should not be surprised if these hikes lead to a financial crash in the months ahead.

Winter is coming to Europe

The situation on the European continent resembles the plot of the acclaimed series Game of Thrones, an adaptation of *A Song of Ice and Fire,* a series of novels written by George R. R. Martin. Ned Stark, the patriarch of House Stark, appears in the first scene pronouncing the famous phrase that will give meaning to the entire series: *"Winter is coming"*. Most of the inhabitants of the imaginary world of *Westeros* ignore the warning and are more concerned about their internal battles than about the real threat that could come from the outside and wipe them all out.

For years, European elites have been behaving like the wealthy class of *King's Landing*, a southern city and capital of *Westeros* whose inhabitants resided too far from the winterly threat to care. Years ago, the European Union rejected building a common energy policy that would make it sovereign, becoming increasingly dependent on autocratic governments such as Vladimir Putin's. The prosperity of the European industry was based on the premise of permanent availability of cheap Russian gas.

But Vladimir Putin, following the analogy, became the *Night's King* in February of this year, ready to bring the harsh winter to Europe with his invasion of Ukraine. Since the beginning of September, practically the entire flow of Russian gas to Europe has disappeared, whereas before it accounted for 45% of total imports. All this was magnified by the explosion that occurred in the early hours of

September 26th near the Danish Island of Bornholm, which rendered inoperative both Nord Stream 1 and 2, the main gas pipelines connecting Russia to Germany.

This act of sabotage on NATO territory coupled with the advance of Ukrainian troops regaining lost ground have raised the danger of the conflict by a notch. Unlike the Cuban missile crisis in 1962 where neither JFK nor Khrushchev wished mutual assured destruction, this time the Russian president has linked his fate to the outcome of the conflict. When one of the belligerents cannot return home with a defeat, the use of tactical nuclear weapons cannot be ruled out.

There are three possible scenarios in its use. Russia could make a demonstration attack without any civilian or military casualties. The attack would consist in detonating a nuclear bomb at high altitude that would generate an electromagnetic pulse attack, which would destroy all electronic equipment within its radius of action. It would avoid the immediate death of civilians but would effectively return Ukraine to the Middle Age. The second scenario would be direct use against military facilities such as airfields, logistics centers or arsenals, seeking a strategic breakthrough due to the Russian military's lack of resources on the ground. Finally, the Kremlin could decide to directly target civilians by shelling a Ukrainian city to force its capitulation.

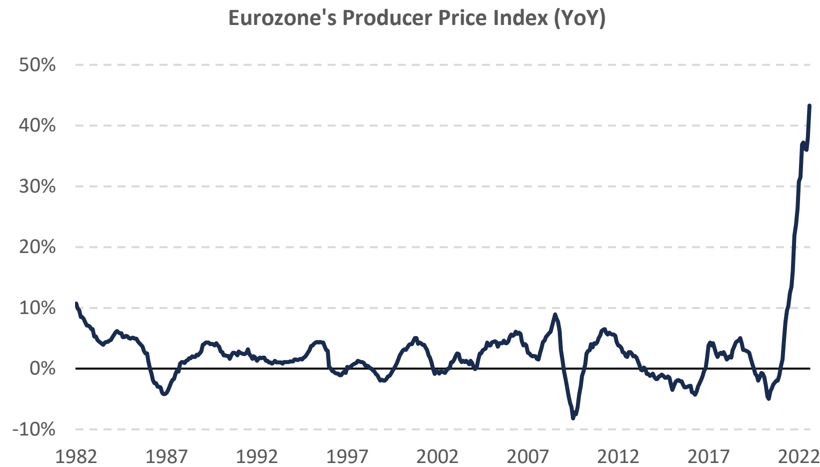
The probability of any of these scenarios is very low but cannot be ruled out. It is therefore useful to analyze what NATO's possible response could be. One option would be to double the economic pressure on Russia, for example, with secondary sanctions that would prohibit trade with anyone who trades with Russia. The West would thus try to get both China and India to turn their backs on Putin; the economic and financial consequences would be incalculable. The other option would be direct military confrontation, also a remote possibility but one that would plunge us headlong into a World War. NATO has never explicitly stated what its response would be, but an attack on the Baltic Fleet or on military installations on Russian soil would be a possibility before a nuclear response.

The weather, an unexpected main player

The importance of following the evolution of the conflict in Ukraine lies in the fact that it will mark the depth of the energy shock that threatens the old continent. Unfortunately, the weather will also play a role: if this winter turns out to be cooler than usually, a selective cut in energy supplies to both industry and households is guaranteed. The good news is that Europe's strategic gas reserves are almost 90% full. The bad news is that they only account for 20% of winter gas consumption and estimates suggest that reservoirs will be exhausted by early March.

Gas is not only essential for its direct use in many industries such as the chemical industry, but it is also essential for producing electricity. Around 25% of the electricity consumed in the European Union comes from gas, which also sets the final price paid by the consumer due to the marginalist price system. The price of European gas is currently ten times more expensive than the average of the last decade, which has pushed up electricity bills for both households and industry.

Although the different policies adopted by Member States are temporarily softening the shock to households, industries are bearing the brunt. The producer price index (which measures cost increases for companies in the same way as the CPI does for consumers) is running rampant, reaching record highs of over 40%. Clearly, unable to pass this cost increase on to the consumer, many of these companies are on the verge of bankruptcy.



The European Commission is trying to set the guidelines with all members to reduce energy consumption by 10-15% during the winter, thus avoiding a disaster in the short term. Even so, the problem would be carried over to the following year, since presumably during the summer we will not be able to refill the strategic reserves with gas from Russia.

However, most states, far from understanding that the only way to survive the winter is by destroying part of the demand, they continue to be obsessed with subsidizing it. Public aid should be targeted specifically at the most vulnerable families and not to limit gas prices across the board, to subsidize fuel prices or to make public transport free of charge. Such regressive measures benefit equally those who have resources and those who do not, and therefore do not encourage energy saving.

Rowing in opposite directions

This obsession with appeasing any price increases with subsidies or by deferring payments is spreading throughout developed countries. But with inflation showing no signs of abating, these measures are undermining the efforts of central banks. While central banks are trying to curb consumption by raising interest rates and withdrawing liquidity, governments have embarked on an expansionary fiscal policy in the form of increased public spending and even tax cuts, rendering the tools of monetary policy useless.

It is logical that states want to help their citizens in the face of the biggest energy shock in history and the highest inflation in 40 years, but they should not throw prudence and economic logic out of the window. Limiting the price of certain products may be electorally popular, but it will not help to reduce demand and, in some extreme cases, could even cause shortages. Instead, targeted subsidies are more effective in protecting the quality of life of the most vulnerable, while letting the market provide the incentive to curb demand due to high prices.

These energy policies hide a deeper change in the way we have been governed in recent years. Since the financial crisis of 2008, governments have been unwilling to let some sectors of the economy that they consider strategic fall: when a large company gets into trouble, fiscal aid from the public budget quickly follows. All taxpayers end up bailing out the bank that lent to the wrong person, the airline that did not consider a pandemic among its risks, or the energy company with liquidity problems. Profits are privatized but losses are socialized.

Nobody likes to see a business go bankrupt and hundreds of jobs destroyed; the fact that this happens less often is certainly a good sign. However, it is not without its contraindications: capitalism encourages innovation and improves the quality of life through the process of creative destruction. What no longer works disappears and makes way for what works better. In a constantly rescued economy such necessary regeneration simply cannot exist.

The British Inside Job

Judging by actions of main governments, no one seems to remember that governments are more indebted than ever and that rising interest rates are making this debt more and more expensive to service. Germany will mobilize close to 5% of its GDP in aid to companies and families to alleviate the effects of the energy shock. France has nationalized EDF, the country's largest energy company, with millions in accumulated losses. Spain has limited the price of gas, which must subsequently compensate to energy companies via public budget. But the UK is undoubtedly the winner: the new cabinet of Prime Minister Liz Truss announced that it would mobilize aid worth 6.5% of its GDP, while at the same time announcing a massive tax cut for the wealthy.

In financial jargon, the expression "Lehman moment" has been used since the 2008 Global Financial Crisis to refer to a systemic event that could bring down the financial system as a whole. Well, although it is a term that is often abused, what happened in the United Kingdom days after burying its longest-serving monarch was exactly that.

It all started on September 23rd, when Britain's recently sacked finance minister released a budget plan that included a substantial increase in spending and a tax cut. With inflation in the UK sitting comfortably at 10% and forecast to rise as high as 20%, markets were in no doubt as to how they should react to the news. The pound began to plummet and the price of government bonds also collapsed amid a sell-off.

Only six days later, on September 28th, the Bank of England's phones were smoking. All British fund managers were looking for a contact at the bank to ask for immediate intervention in the market. That morning, government bonds were crashing and threatened to wipe out the solvency of the country's largest pension funds.

The Bank of England finally intervened that same day at 11 a.m., promising to buy unlimited government bonds until stability returned. An unusual move for a central bank, which would normally wait until the weekend to mull its decision or at least announce it at night when the market was not open. Something very dangerous must had been going on to do it in the middle of the day.

How on earth were pension funds, which are supposed to be low-risk financial vehicles, on the verge of insolvency? The answer lies once again in monetary policy pursued by central banks since 2008, keeping interest rates artificially low or even negative. As we have explained in other reports, many pension funds were forced to take on much more risk if they were to continue to earn the same returns as in the past.

Stealthily, a monster of financial engineering has been erected within pension funds. The simplest strategy was to use derivatives to accentuate fixed income movements. Using a back test of the last 40 years, pension funds believed that in no case could losses from these instruments jeopardize their solvency: they would just have to ride out the downturns calmly.

Unfortunately, the movements of the last month had not been envisaged in any scenario, and soon pension fund counterparties began to demand additional collateral as fixed income positions turned against them (margin calls). This unleashed an even greater stampede of UK bond sales by pension funds, which sold everything they had on hand to meet their liquidity obligations. Had the Bank of England not intervened, many UK pension funds would not have made it to the end of the week.

The British chaos should serve as a warning to navigators. A "Lehman moment" has been avoided for now, but when the financial structure is shaken this way, something does end up breaking somewhere in the market. Governments should exercise extreme caution when announcing tax cuts or spending increases; free money is over for them too.

Management report

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

1. **Equity positions**: Global stock markets are still not getting back on their feet and have fallen again this quarter. In fact, September was the worst month since March 2020, with the S&P 500 falling nearly double digits. October should be a key month for the rest of the year, as analysts will be keeping a close eye on the earnings season that is now beginning. Will companies be able to pass on the cost increases to consumers, or will they see their margins shrink? While these questions remain unanswered, we maintain our low presence in equities, which once again subtracted **-1.0%** from performance this quarter.
2. **Volatility positions:** This has undoubtedly been a very difficult year for funds specialized in volatility. The sector's benchmark index (VIX) has been unable to break out of the range of 20 to 35 points all year. It is proving very difficult both to buy it at attractive levels for protection and to sell it at high levels when the falls come. From our side, we've managed to establish a defensive strategy during the market rallies of July and August that benefited us enormously during the September falls. Thus, this has been our best position, adding **+6.0%** to the fund.
3. **Precious metals:** Rising interest rates have continued to weigh on the price of gold, which does not pay any coupons. This 2022 gold is falling by almost 10%, on track for its worst year since 2015. However, we believe it complements the rest of the fund's positioning very well. We do not believe that central banks will change their tune and abandon their fight against inflation; but if they did, gold would be the big beneficiary. This asset has neither added to nor subtracted from performance this quarter.
4. **Commodities:** Recession drums have not stopped beating and this has affected the price of the main commodities. Oil, for example, which was trading above $120 in June, fell to $80. It will be interesting to see how OPEC, led by Saudi Arabia, will tolerate these declines, as it looks set to make impossible Joe Biden's efforts to keep gasoline cheap until at least after the November Congressional elections. Just a few days ago, the cartel announced a production cut of 2 million barrels per day to defend prices. Over the last 3 months, this position has added **+0.1%** to profitability.
5. **Short position in fixed income:** Our big hit this year has continued to work this period. The Federal Reserve remains unperturbed in its fight against inflation: official rates, which started the year at 0%, are now at 3.25% and are expected to reach 4.5% before the end of the year. For its part, the European Central Bank surprised the market with a 75-basis point hike at its September 8th meeting. Many economists and academics are raising the tone of their criticism of these policies, which they consider excessively restrictive, but with inflation unable to fall below 8% in the West, it seems unlikely to us that they will change their strategy. This position has added +2.7%.

"A nuclear war cannot be won and must never be fought"

- Ronald Reagan

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%	3.0%	2.6%	2.1%				**4.1%**

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