April 5th, 2023

Q1 2023

Dear Investors,

Hanway Capital Fund has **returned -1.6% this quarter**, dropping to a share price of **€146.2** net of fees and commissions. The interest rate hikes that began exactly 12 months ago have claimed their first significant victims: Silicon Valley Bank and Credit Suisse. The former has been the third largest bankruptcy in US history, and the latter has been acquired by its biggest competitor after 166 years of operations. Paradoxically, these accidents have convinced investors that interest rates have hit their peak and will soon start to decline. This change in market consensus has hurt many of Hanway's positions, but we will stick to our strategy as we believe that inflation has not had its last say.

The Federal Reserve was created to avoid dependence on J.P. Morgan

To understand the recent turbulence in the banking system, it is useful to first review a bank’s functioning, and in particular, the fractional reserve system, which is the model used by capitalist economies for centuries. In this system, banks are only required to hold a fraction of their customers' deposits in cash, while the rest of the money is used to make loans and investments. For example, if a bank has a reserve ratio of 10%, it only has to keep 10% of its customers' deposits in cash and can lend the remaining 90%.

This system allows banks to greatly increase the speed of money circulation, as the same euro can be lent several times to different customers, which boosts economic growth. However, this system is not without risks: if there is a massive withdrawal of deposits by customers, even the most solvent bank in the world would not have the necessary liquidity to meet its obligations. This is what we call a bank run, which in its most extreme cases can trigger a domino effect throughout the global financial system and generate a deep crisis with incalculable social consequences.

It was precisely the bank panic of 1907 that led to the creation of the Federal Reserve as the central bank of the United States. The panic began when the third largest bank in New York (the Knickerbocker Trust) loaned a large amount of money to speculators in United Copper stocks. When the stock price collapsed, the borrowers were unable to repay their debt, transferring their losses to the bank. As word spread about this ruinous operation, depositors of this and other banks began to withdraw their funds, which in turn caused many institutions to suspend their operations.

At this point, J.P. Morgan came into the picture. While today we associate that name with the largest bank in the world, in 1907 the man behind the institution was much better known: John Pierpont Morgan. After founding the bank in 1871, Morgan was one of the richest and most powerful men in America when the crisis erupted. He had built a banking empire that dominated all of Wall Street, and he was not willing to let this crisis end it all.

In an effort to restore confidence in the financial system, Morgan brought together the leading bankers and billionaires in New York and convinced them to invest to save the banks in danger of bankruptcy. In addition, he used his own fortune to back emergency loans, which helped restore citizens' confidence and immediately stopped the deposit flight, stabilizing the financial system.

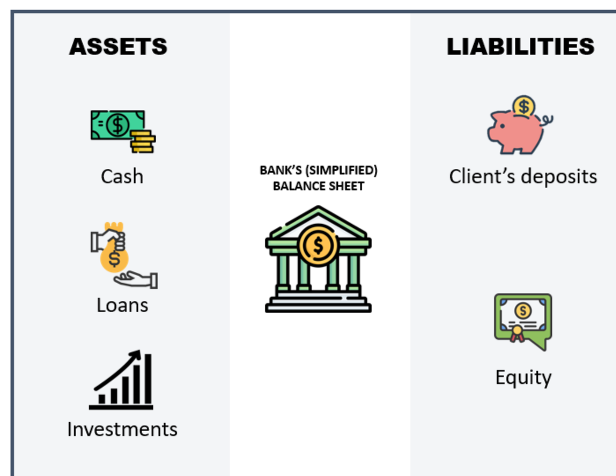
American policymakers understood the imperative need for greater regulation and oversight of the banking system. It was folly to rely on the will of a single individual to contain financial crises: it was therefore desirable to improve coordination between banks and the government to help prevent and mitigate future panics. In 1913, the Federal Reserve Act was enacted, creating a lender of last resort to provide liquidity to ailing banks. Because of this, if a bank today has a one-time liquidity problem due to an unfounded panic, it should not be dragged into bankruptcy because the Fed will come to its aid by lending as much liquidity as it needs.

The end of the Silicon Valley Bank

Just a month ago, no one would have doubted the robustness of the banking system after the strict regulation created in the wake of the 2008 financial crisis. Indeed, betting on European and American bank stocks has been one of the most popular strategies in the wake of the resurgence of inflation.

But as we have discussed in previous reports, when central banks raise interest rates abruptly, something somewhere in the market eventually breaks. Or as Warren Buffet said, "only when the tide goes out do you discover who’s been swimming naked". Well, the managers of Silicon Valley Bank (SVB) weren't even wearing their inflatable cuffs. The speed of the collapse was undoubtedly accelerated by the fact that this was the first banking panic of the Twitter era and by the speed with which we can now withdraw our deposits via an app. On March 9, SVB saw $42bn withdrawn in just one day (25% of all its deposits). No bank can survive something like that, but why the panic, what was SVB hiding?

A bank's balance sheet works in reverse to that of a normal company. In a very simplified way, citizens deposit their savings in bank accounts: that is part of the bank's liabilities as it is money they "owe". Because of the fractional reserve system explained above, the bank must have a part of this money in cash (called reserve ratio). Another part is used for its banking business, that is, to grant loans to individuals and companies, for example to buy a house, open a business or even go shopping. And finally, the last component of their assets are investments that they make to try to maximize the profitability of deposits.



Regulation is very strict on the type of assets in which a bank can invest; in the wake of the 2008 crisis they were encouraged to invest almost exclusively in sovereign bonds. After all, no one is more solvent than the US government. The problem is that when the Fed raises interest rates, the value of those sovereign bonds fall (the reason why this happens is technical and complex; anyone who wants to dive deeper can consult the report *"The Hidden Risks of Fixed Income"* that we wrote four years ago).

SVB's leadership chose to invest almost all the bank's money in very long-term sovereign bonds, which offer somewhat higher yields than those with shorter maturities. Moreover, and this was their fatal mistake, they decided not to hedge interest rate risk in the derivatives market: they were convinced that rates would remain low forever. Unfortunately, when the Fed hikes began, the Californian bank saw the price of its bonds plummet and began to accumulate losses.

But SVB believed it had an ace up its sleeve. Under U.S. accounting rules, banks are not required to report as losses on declines in the value of government bonds that they expect to hold to maturity. But what if you are forced to sell the bond *before* maturity because customers are withdrawing deposits and you need liquidity? That the losses cease to be theoretical and fall like a slab of reality.

On March 8th, the bank announced that it intended to raise $2MM in capital to cover part of its losses. Panic broke out and the bank, founded 40 years ago, collapsed in just 40 hours; depositors began to withdraw their money in stampede. Another peculiarity that accelerated SVB's collapse was that most of its customers were technology companies and investment funds with high balances in their current accounts. The deposit guarantee funds were created precisely to avoid bank panics, since by law the American government covers up to $250,000 per account holder in case a bank fails. Most of these companies had balances well in excess of $250,000, leaving them vulnerable to bankruptcy.

SVB became insolvent and the US government took temporary control. The failure began to spread to other regional banks; there are more than 4,000 banks in the United States. Many savers succumbed

to panic, as they had no incentive to keep their savings in a small bank if they could transfer their money to one of the four banking giants at no cost and from the comfort of their cell phones. The shares of these regional banks began to plummet on the stock market and the Fed had no choice but to take drastic measures to stem the bleeding.

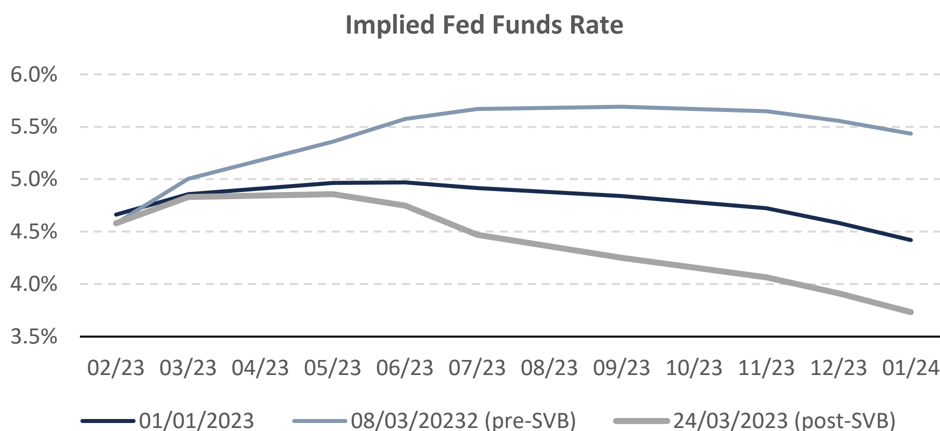
On the one hand, it announced that SVB deposits would be 100% insured even if they exceeded the $250,000 limit; this ironically made SVB the safest bank in the world. Moreover, they announced that central bank loans backed by sovereign bonds would not consider the market value of those bonds but their face value. In other words, banks will receive liquidity for these investments as if they had never fallen in value.

All these emergency measures represent a step backwards in the Fed's struggle to control inflation. In fact, these liquidity injections have meant undoing the last six months of monetary tightening. Jerome Powell, chairman of the Federal Reserve, is faced with a dilemma that is very difficult to solve: financial chaos or persistent inflation.

Hanway Capital against the tide again

The banking panic of the past month has led the market to rethink the macroeconomic outlook, which has affected several Hanway positions. As we have explained on numerous occasions, we expect higher-than-expected global GDP growth (thus avoiding a recession) but also persistent inflation, which will fail to come down to the 2% target and thus force central banks to keep raising rates.

However, the turbulence of recent weeks has led investors to prepare for a rate cut in the face of an imminent recession. This is very clearly reflected in the implied forward interest rate curve. On March 7, two days before SVB's collapse, interest rates were expected to continue rising and end the year at around 5.6%. Today the picture has changed dramatically: investors believe that the 25-point hike at the Fed's March meeting was the last one, and that from June onwards they will start to lower rates rapidly to end the year at 3.7%.



This spread of almost 2 percentage points has caused our assets that perform well in a high interest rate environment to fall sharply. The market seems to be taking the playbook from 2008, but we do not share that view. First of all, in 2008 the financial system collapsed because of a solvency problem, i.e. banks were hiding all kinds of worthless toxic assets on their balance sheets. The losses were

multimillion, causing a standstill in the real economy and a reduction in demand that generated a vicious circle of higher unemployment and lower economic activity. What we have experienced these days has been a liquidity problem, and nothing seems to indicate that there is a solvency problem in the banking system.

On the other hand, the economy remains in robust health. Although some indicators point to a slowdown, there is no sign of a downturn shock. The labor market remains very tight: unemployment in the Eurozone is at its lowest level since the creation of the euro and in the United States there are currently twice as many job vacancies as unemployed. Consumption remains strong despite inflation, thanks to the savings generated during the pandemic and the gradual increase in wages.

That is why we believe that inflation remains the biggest challenge we must protect. In the coming months we will see year-on-year inflation moderate due to the base effect (we will start to compare prices after the start of the war). But from the summer onwards, we will be able to see whether inflation will really ease or if it will pick up and prove to be structural as we forecast.

Thanks to Hanway's diversification and rigorous risk control, the situation has been contained to a fall of -1.5%. It is impossible to be satisfied with the result, although investing forces us to take decisions and make bets, often wrongly. The most important thing for us is that investors understand the reasons for our decisions and trust our analysis and decision-making process, which has a single objective: to preserve your capital in uncertain times and to appreciate it without taking excessive risks.

Management report

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

1. **Equity positions**: The stock market has started 2023 with optimism. The prospects of change in central banks' path have led to strong rises, especially in those indices that suffered the most last year. The technology-heavy Nasdaq, for example, is up 20% after falling 33% last year. Nor has the Eurostoxx fallen behind, which is 14% above where it ended 2022. In contrast, our equity investments have lagged because of our bias towards companies and sectors that are favored by inflation. In such a positive quarter for equities, this asset has only added **+0.3%** to our performance.

2. **Volatility positions:** Once again, the problems in the banking sector have not been enough to wake volatility from its slumber. Even on the day of maximum panic, March 13th, when US regional bank stocks fell 15%, the VIX was barely able to close above 26. Hedging in the face of adversity is proving frustrating in this market, but we continue to believe it is the right thing to do in the face of the many risks that lurk ahead. Over the past few months, this position has detracted **-0.2%** from our bottom line.

3. **Precious metals:** Like stocks, gold and silver have also benefited from falling interest rates. The perception that rate cuts are imminent has driven gold very close to the all-time highs it set shortly after the Ukraine invasion began, at $2,070. Without being our bet, this position of approximately 10% brings us de-correlation with respect to other assets in the fund. This quarter, it has contributed **+0.7%** to the result.

4. **Commodities:** Following the same line of reasoning, the market foresees that what will force the Fed to lower interest rates will be a slowdown in the economy. Such projection, which we do not share, would be very negative for commodities, which have had their worst quarter since the beginning of 2020. Fortunately, the size of this position is not very relevant for the fund, so its impact on performance has been limited to **-0.3%**.

5. **Short position in fixed income:** Our great success last year has turned against us this quarter. Fixed income has had its best quarter since the pandemic driven by expectations of a U-turn in central bank policies. In our view, rate cuts are unlikely this year in Europe, where inflation remains at levels 3 times above the ECB's target. This quarter this has been our worst position, subtracting **-2.1%** from the overall result.

"No problem can be solved until it is reduced to some simple form. The changing of a vague difficulty into a specific, concrete form is a very essential element in thinking"

- J.P. Morgan

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%	1.9%	-2.2%	-1.7%	**2.0%**
2023	1.1%	0.5%	-3.1%										**-1.6%**

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