January 12th, 2024

Q4 2023

Dear Investors,

Hanway Capital Fund has returned **-0.7% this quarter** bringing the share price to **€140.5** net of fees and commissions. This brings the fund's **full year return to -5.4%.** In our first down year, we have not been able to turn around a mediocre first half of the year. By the end of October, it seemed that doubts were returning to the market and our defensive positioning was working again, but a series of linked events triggered a historic rally in the last two months of the year. This ends a 24-month period in which both the market and the fund have ended up at square one after two very different paths: we remained almost flat for two years, and the market suffered sharp declines in 2022 that were fully recovered in 2023.

A cycle that has changed everything, but nothing has happened

In the last two years we have witnessed a back and forth leaving everything as it was. It all started to change at the beginning of 2022, when money stopped being free. After more than a decade of stable prices and interest rates close to 0%, a sudden surge in inflation forced central banks to execute one of the fastest interest rate hikes in history. Suddenly the cost of mortgages, commodity prices and interest on loans began to rise.

As we have explained in the past, the interest rate on risk-free assets is the benchmark on which all other financial assets are priced. If we suddenly went from getting nothing for our savings to being able to get around 4% without risk, that should've caused a seismic shift in the investment decisions of economic agents. Economic theory told us that investors would sell their riskiest assets (stocks, real estate, cryptocurrencies, start-ups) to invest in money market funds and earn that 4%.

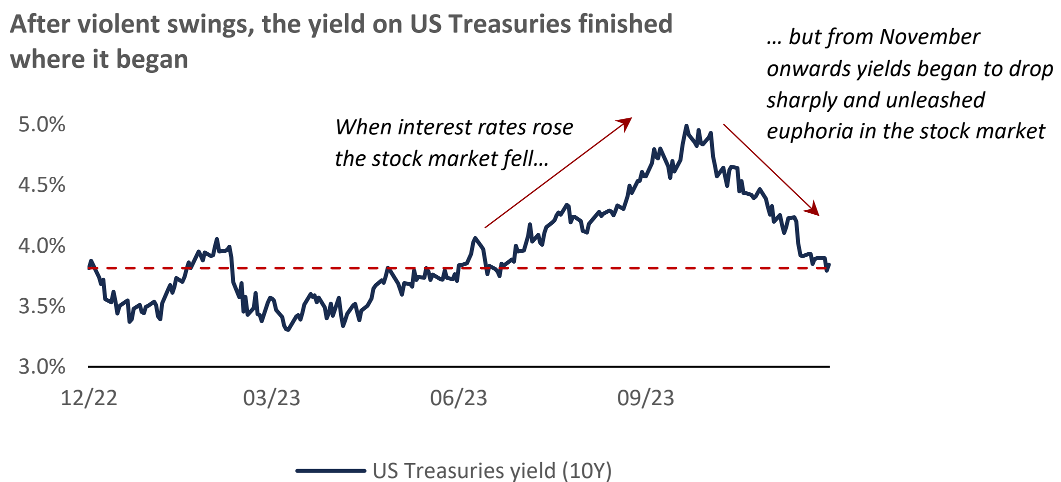
That is what happened to some extent during 2022, without being the paradigm shift we had hoped for. Equities fell 20% overall in their biggest drop since 2008, but that implied that they had barely corrected the excesses of the previous year. Hanway, for its part, navigated the market well, avoiding stock market declines and preserving its investors' capital.

With the change of year, there was nothing to suggest that the trend would change: valuations were still high in many sectors and exaggerated public spending suggested that inflation would remain high, limiting the movements of central banks. However, since January 1st, the direction has completely changed and 2023 has been one of the best years for risk assets in living memory. While the Nasdaq technology index has had its best year since 1999, Hanway has not participated in the rallies. What did we miss? What did we fail to detect and anticipate in time?

Change of script

The factor we did not count on was inflation, or the lack of it. As you know, our obsession with protecting our investors from the effects of inflation led us to correctly predict its arrival, but we were not as adept at predicting its departure. Our analysis told us that price increases would be stickier than they actually have been; and if not, it would be because of a sharp recession for which we were also prepared. What we did not contemplate was that inflation could moderate so easily without economic activity suffering. In all recent history, whenever inflation had exceeded 5%, it had never been brought down to the 2% target without triggering a recession.

The dynamic whereby high inflation kept interest rates high, which in turn caused stock markets to fall, disappeared when inflation began to fall rapidly after peaking near 10%. The next domino to fall was sovereign bond yields, which after reaching 17-year highs in October began their de-escalation. And the final straw came from Jerome Powell, chairman of the Federal Reserve, at its December 13th meeting. In a totally unexpected change of script, he abandoned the discourse of fighting inflation and flattened the path towards lower interest rates. A turn of events that came as a surprise to everyone, especially when core inflation in the United States is still at 4% and unemployment has reached historic lows.



The Federal Reserve confirmed what the market had been anticipating all year: that the fight against inflation had ended with hardly any casualties. The most anticipated economic recession in history never came: all the excess savings that citizens generated during the pandemic, and which contributed

to the first signs of inflation, have lasted longer than expected. Many analysts predicted that when those cash excesses disappeared, an economic slowdown would be inevitable, but surprisingly some of those savings remain in people's pockets.

It was also expected that higher interest rates would slow down the economy as companies would lose their borrowing capacity and be forced to postpone investments. However, the huge debt issuance that took place when interest rates were rock bottom left companies in such a comfortable cash position that most of them have hardly issued any new debt for the past two years.

Failing therefore in our main macroeconomic thesis, our objective has been focused on mitigating risks. Unfortunately, we cannot always get it right, and after three very positive years, we have tried our best to contain this bad year to a 5% drop. We believe that it is as important to make money in good years as it is to lose little in bad years. For those of us who were able to anticipate the 2022 debacle, we found it implausible that the stock markets could rebound so strongly in 2023. Let us point out that stocks have returned to 2022 valuations', when rates were at 0%, even though they are now close to 5%.

2024 (and beyond): possible scenarios

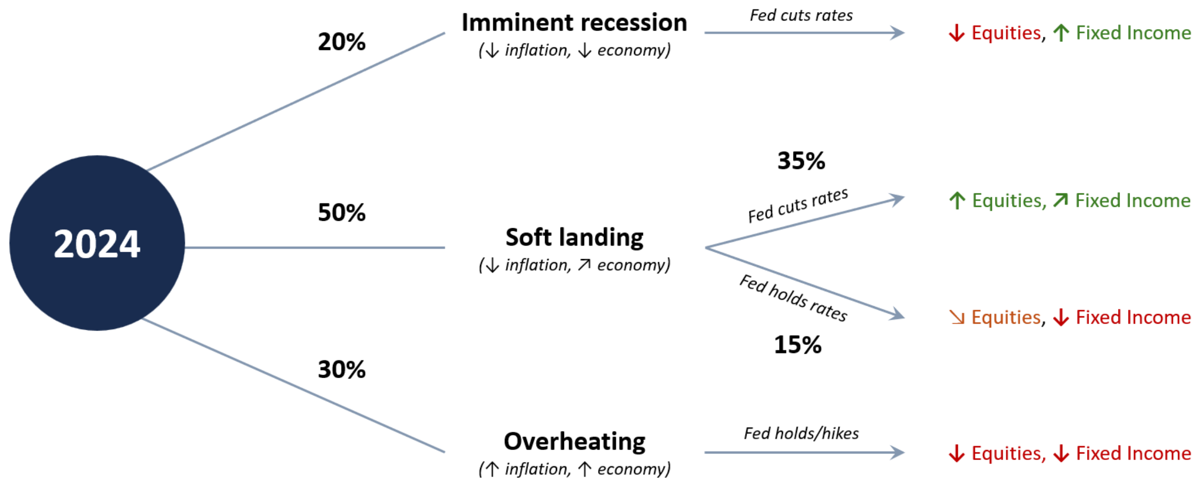
2023 was a year full of mistakes on our side: we were both wrong in our macroeconomic forecasts and in our positioning. Even so, something still doesn't feel right: we are resigned to accepting the optimistic consensus with which the market is starting 2024. As you know, this is a profession that requires a keen eye and long lights; we cannot let the immediacy and excessive noise of the headlines prevent us from seeing the whole picture.

We continue to believe that this decade is unlikely to be as positive as the last for risk assets. We have changed cycle, and the main tailwind that helped markets in the 2010-2020 period (0% rates) is over. No matter how much central banks lower rates this 2024, they will remain higher than in the past decade. We therefore envision two threats to the optimistic case.

The first is valuations, which being historically in the high band, can hardly be sustained with high interest rates and a possible recession on the horizon. The problem with valuations is that they are not a good indicator of market tempos. In the long term they tend to be in equilibrium, but in the short term they can always become even more irrational. That means we need to be nimble month to month, but with a very clear idea of the long term. If we were to add to these historically high valuations a possible recession with falling corporate earnings, we would return to a scenario of sharp corrections in the stock market.

The second threat for the coming years, impossible to calculate but also impossible to ignore, is geopolitical risk. Since the United States has begun a slow decline in global leadership, instability has arrived. Events such as Russia's invasion of Ukraine, or the war unleashed in the Middle East between Israel and Hamas are virtually impossible to foresee. But this is no excuse for planning how we should act in each case in an agile manner. The current geopolitical situation forces all funds to be alert to eventualities that can change everything from one day to the next, and those who are not prepared will be left behind.

Focusing the shot specifically on 2024, we believe that the following scenarios may unfold in the coming months:



At some point in the next few months, companies fixed-term loans will expire, forcing them to issue debt at a much higher rate than they were doing; excess savings generated during the pandemic will dry up; and unemployment will rebound. If all these things happen quickly, we could be headed for a recession by mid-year. The longer these tailwinds hold, the greater the chances of a relatively soft landing that will allow the Fed to cut interest rates before crashing into recession.

So, what could happen next year? We estimate the chances of a soft landing (where inflation falls, and interest rates can also be lowered) at 50%. That still leaves another 50% for other scenarios. A recession could come immediately in the first half of the year (20%), as a result of tight monetary policy, or in a longer process in which inflation remains elevated, central banks resume hiking and the economy ends up collapsing under Fed force.

It is exasperating to accept the results of years like this one, but if we lose our long-term vision out of impatience, we can make the serious mistake of abandoning our thesis. Our analysis tells us that it is not a good time to go into risky assets: this implies patience and frustrating periods, but if the thesis is correct the ultimate reward will be worth it. Investing is never a sprint, but a long-distance race.

Management report

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

1. **Monetary markets**: During this quarter, the yield curve has inverted even further. Due to the six rate cuts that the market is pricing for this year, current account deposits pay 1% more than those with a two-year term. While we are waiting for better opportunities to use our cash, money markets have added **+0.5%** to return this period.

2. **Volatility positions:** Hedging against drawdowns has once again been an unnecessary exercise this quarter. Despite volatility being as cheap again for the first time as it was before Covid, the market has only suffered a one day falls above 1% since the start of November. We have slightly increased our exposure to this theme since, as we have discussed throughout the letter, we do not see much more upside for equities. This quarter its contribution to the fund has been **-1.0%.**

3. **Dividends positions:** European companies have continued to announce better-than-expected shareholder remuneration plans: 2024 will be the best year for dividends since 2007. We have considerably reduced our position in an asset where the risk / return trade-off no longer seems so attractive. These months the position has added **+0.3%** to the quarterly return.

4. **FX positions:** To our bet on the US dollar this quarter, we have added a position in the Japanese Yen. As the Bank of Japan is the only developed central bank that has not raised interest rates during the current bout of inflation, its currency has depreciated considerably, crossing the ¥150/$ barrier for the first time since 1990. However, at current levels we believe that the yen represents a good investment opportunity, since, if inflation continues to persist, the Bank of Japan will have to abandon its expansionary policy, but if it abates, it will be the other central banks that will bring their monetary policy closer to that of Japan. This quarter we have been right on the FX, receiving a **+0.2%** return.

5. **Short positions in equities:** As with volatility, our defensive equity positions have not worked out either: equities have again had a great quarter. During the month of October, the S&P 500 fell 6%, cutting its annual gains in half; but since then it has strung two straight months of strong rallies to end the year up 24%. It will be interesting to see if in the coming days it is able to set a new all-time high for the first time since January 2022. This strategy has made a negative contribution to the fund, subtracting **-0.7%** from the overall result.

" You must remain stubborn in your vision so you don't give up but flexible in the details so you can change what's not working."

- Jeff Bezos

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%	-1.0%	-1.2%	-3.7%	-0.1%	1.2%	1.6%	0.2%	-1.0%	0.2%	**-5.4%**

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