July 8th, 2020

Q2 2020

Dear investors,

Hanway Capital Fund returned **7.5%** for the quarter reaching a share price of **120.8€** net of fees and commissions. This brings the year-to-date return to **19.8%**. During these three months the fund has participated in the recovery of the global stock market which has left the March lows behind. The second half of the year requires extreme caution, since the cheap assets that we identified in April are no longer so, and yet volatility remains at high levels compared to where the year began. We believe it is necessary to maintain a defensive positioning, especially with the American elections in sight for next November.

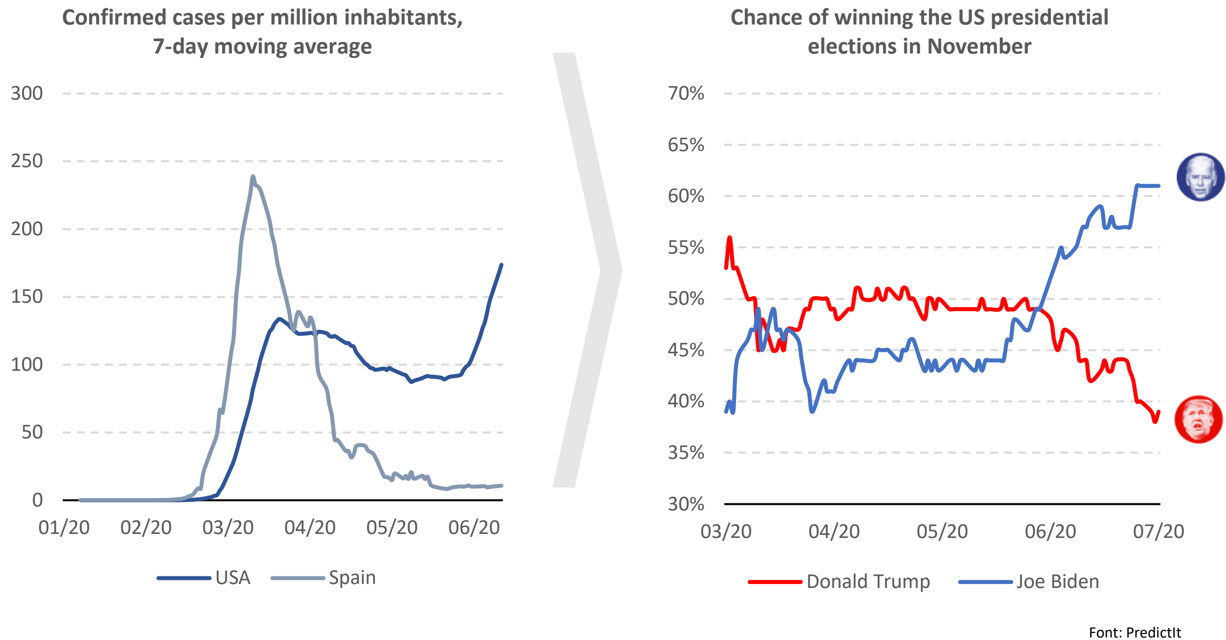
The new normality

Financial markets, with the invaluable help of central banks, cut the crash before things got uglier. The last week of March, after one of the steepest drops in history, the market seemed to hit a bottom 40% below its highs. Thereafter, with almost the same virulence with which it fell, it began a rapid recovery until the beginning of June with a rise of almost 50%. However, the market has been more selective in its rebound, leaving behind the sectors and geographies most hit by this crisis, such as tourism or Southern Europe.

The current situation cannot be described as *normal* under any criteria. The liquidity injections that support the markets are unprecedented, the economies are suffering their biggest contraction since the crash of 1929 and the geopolitical tension continues its slow but constant rise. Coronavirus seems to have remitted in Europe after a strict confinement that has had a devastating effect on the economy, but according to experts, it seems like we will have to live with the virus for a long time.

It is assumed that this will be until a vaccine is discovered, although we prefer to point out that it will be until a vaccine *reaches* the broad population. The nuance is important, because the discovery of a vaccine or treatment does not solve the geopolitical conflict that will arise for the control of doses. Proof of this is the US purchase of all remdesivir doses, the sought-after treatment with inconclusive results from the pharmaceutical company Gilead.

Although the virus has lost strength in Europe due to the good work of the health community and the responsibility of citizens during confinement, the perception that the worst is over is simply not true. Currently, records of daily infections are still being set worldwide and the focus of the pandemic has shifted to less developed countries and the United States. From a healthcare point of view, it can be considered that the management of the crisis by the US administration is being disastrous. The virus, far from being reduced, is in the middle of a second wave. The handling of the crisis is beginning to weigh on President Trump's popularity and could hinder his continuity in the White House in the November elections.



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The almighty central banks and inflation

Although during the worst days of March it seemed like central banks were losing control of the situation - the S&P 500 fell 12% the day the Federal Reserve lowered interest rates to 0% - the truth is that they have retaken the reins of the market. They have successfully dismantled all theories that monetary policy had a limit and that we were close to it even before the coronavirus crisis. Interest rates have been further lowered and all debt purchase programs have been reactivated and expanded to flood the market with liquidity.

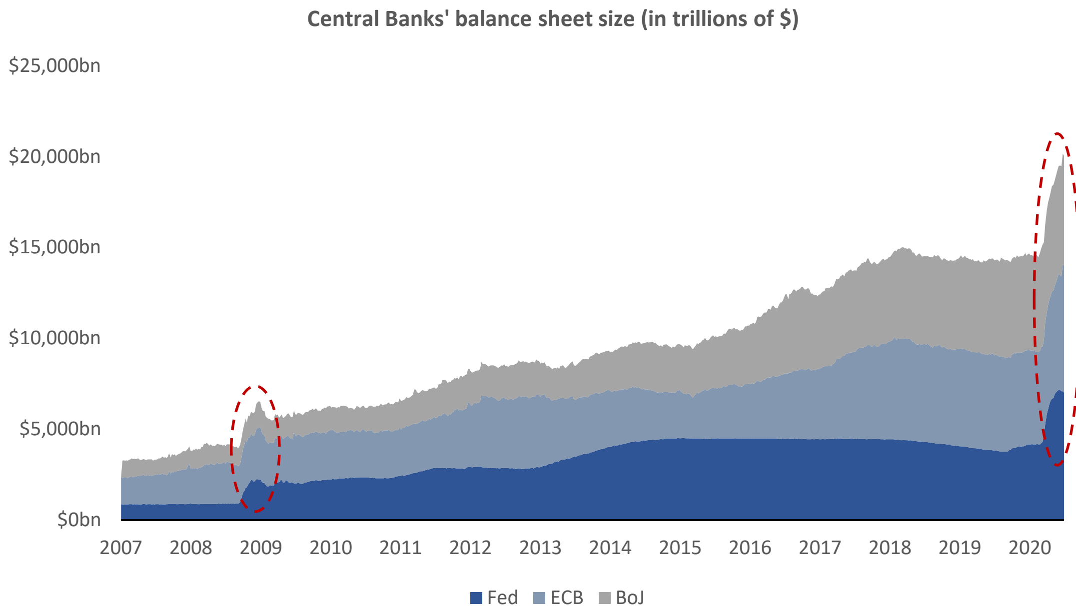
This is the only explanation that while the economy is facing the biggest slowdown in the last 100 years, the stock markets and specifically the US market (with greater weight in the technology sector) are once again one step away from their historical highs.

In our opinion, the recent debt purchase programs to lower financing costs for companies are mistaken for several reasons. First, it increases inequality in society by benefiting only those with financial assets. On the other hand, it makes impossible for Schumpeter's creative destruction to occur, artificially lengthening the life of zombie companies. Finally, it discourages governments from balancing their budgets when many of them already had significant deficits before the crisis. All of this unfairly mortgages future generations.

On the other hand, we believe that there is another risk that should be closely monitored for its possible long-term consequences. The increase in global debt and specifically sovereign debt will reach levels at which the temptation to monetize it will increase, that is, the cancellation of sovereign debt in the hands of central banks. Despite the fact that it has always been a red line due to its consequences, we see no reason why central banks should not continue delving into extraordinary measures.

If it did occur, the consequence would undoubtedly be that we would enter a high inflation period. Perhaps this is in fact the result desired by central banks, since inflation is the only way to make countries' huge debt sustainable. But on the other side, savers who would be the big losers seeing their purchasing power decrease. It is the fear to this unlikely but possible scenario that justifies having

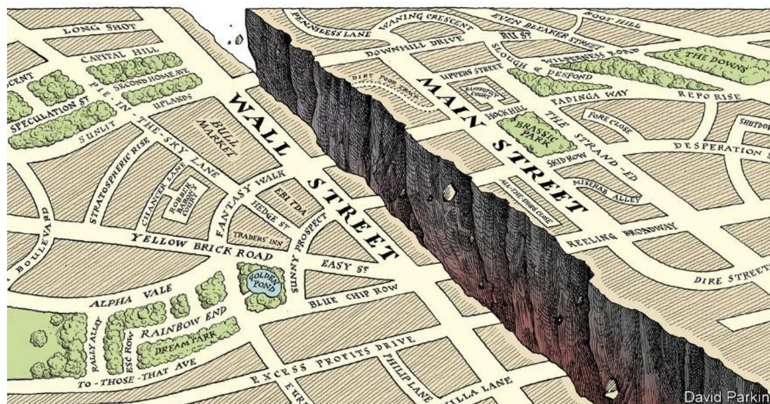
a relevant position of the fund in gold and other precious metals, since its amount in circulation cannot be artificially increased like paper money and retains its value in times of inflation.



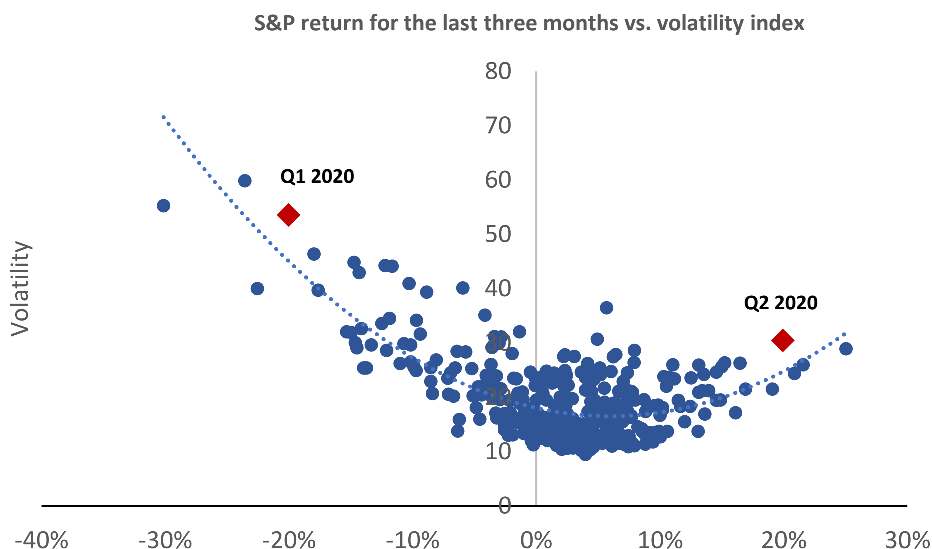
Management report

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

1. **Long positions**: The rebound in world stock markets has surprised us like it has surprised almost everyone else. As reflected on the cover of *"The Economist"* for the month of May, the gap between the markets and the real economy has never been wider. During these months, it has been common to see the market react positively to the release of the worst economic data in history. True is that equities are always ahead of the cycle, but the voracity of the recovery has left the market vulnerable to bad news that cast doubt on the rapid reopening of countries. The fund's equity position, which has decreased from 40% to 30%, focuses on defensive assets - health, food & beverage, and companies with a long history of dividend payments. In this quarter, these positions have provided a 2.1% return.



2. **Volatility positions:** Although we typically associate volatility with declines, the truth is that this quarter's rises have been so rapid that volatility remains high. The VIX maturities of April, May and June were 42, 28 and 33 respectively, reflecting the high uncertainty in which we live. However, they were not as extreme as futures hinted at the end of the first quarter, so volatility positions have subtracted 0.8% from this quarter's profitability.



3. **Oil position**: On April 20th at noon, when oil was trading around $15, the Chicago Mercantile Exchange asked its members to prepare for the possibility of the price of a barrel entering negative. Believing that we could be on the verge of a self-fulfilling prophecy (if the operator announced that it could happen, it would happen), the fund sold its long position and bought oil volatility. The decision turned out to be the right one when that same night the oil went into negative territory, which made the overall oil positions contribute 0.4% to the quarter.

4. **Dividends position:** This was undoubtedly the great bet of the quarter and the one that has performed the best *(see report published on April 30th)*. As the uncertainty caused by the virus cleared up and we returned to business, some Eurostoxx companies cancelled its dividend, but many others have kept it for the coming years. Thanks to this, dividend futures have rebounded from very depressed levels, and this trade provided 2.7% return.

5. **European banks:** European banks entered a downward spiral on the 2008 crisis. First hit by a housing bubble and rising delinquencies, followed by zero-rate monetary policy that seriously harmed their profitability. If they were already trading at derisory valuations, the pandemic has been the final straw. In 2009 the psychological barrier to trading below their book value was broken, but with the pandemic they have come to trade below 0.4x their book value. At this point and without betting on the long-term banking industry for its great threats, we thought it appropriate to recommend a position in a sector that we believed has been excessively punished. While the world stock markets and the hardest hit sectors had begun to recover, European banks were unfairly left behind. This position has contributed 2.2% to the result for the quarter.

6. **EUR vs. USD position:** Eurodollar remains trapped in the range where it has been since the end of 2018, between 1.08 and 1.15. Believing that further episodes of panic could cause that

range to break lower, we recommend turning the bullish position in the euro into a position of volatility that will benefit if resistance breaks in either direction. However, this has not yet happened, so this position has neither contributed nor detracted from the quarterly return.

7. **Precious metals:** During these months money printing and liquidity injections have continued to support the markets. Furthermore, in Macron and Merkel's plan to revive the European economy, we have seen for the first time a proposal where governments may receive liquidity that they should not return. For now, these subsidies are not granted directly by a central bank, but that barrier could also fall someday. These types of measures will devaluate fiat money in favor of other assets whose supply cannot be artificially manipulated. For this reason, the fund has added to its gold position another one in silver, and between the two they have contributed 0.9% to the return of the fund.

Currently two very powerful forces want to control the financial market theme. On the one hand, we have a catastrophic macroeconomic situation with unprecedented falls in GDP and a constant threat of virus outbreak that would lead once more to economic paralysis. On the other, a massive intervention by central banks that are showering liquidity to all corners of the market and supporting it artificially. The crash in corporate profits is already obvious which means investors are having to pay more in exchange for less. The pertinent questions that one should ask itself are the following: is 2020 an exceptional slump in the economy? Will we have returned to absolute normality in 2021? If not, is it justified to pay the current multiples? The market situation remains extremely fragile, but central banks have made it clear that they will do whatever it takes to sustain it.

"You can fool some of the people all of the time, and all of the people some of the time, but you can not fool all of the people all of the time."

- Abraham Lincoln

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%							**19.8%**

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