October 17th, 2023

Q3 2023

Dear Investors,

Hanway Capital Fund has returned **+2.7% this quarter** reaching a share price of **141.5€** net of fees and commissions. This brings the year-to-date return to **-4.8%**. During the last decade, the zero-interest policy on fixed income led many analysts to recommend investing in equities in the absence of attractive alternatives. However, in the current cycle, interest rates on sovereign debt have reached the highest levels since the Global Financial Crisis. Now that there are other interesting options, the question is whether equities will be able to sustain current prices, or they will have to correct their valuations.

The equity risk premium

As with all financial assets, equities also have their own risk premium. As it is an investment in which our capital is at risk, we expect a higher return than we would obtain by investing in a risk-free asset. If we subtract from the return of investing in equities what we could obtain by investing without risk, we get to the equity risk premium.

The risk-free asset used for this calculation is, for investments in dollars, the U.S. government bonds. Since this is the country in the world with the most powerful military, the largest economy, and the most developed capital markets, owning U.S. Treasuries and receiving its coupons is considered to be the safest investment available. Therefore, investing in any other asset should give us a higher return, otherwise we would simply invest in Treasuries. After a steep rise in recent weeks, the long-term US bond yield currently stands at 4.6%.

The other variable in the equation, the earnings yield, is impossible to calculate accurately, as no one knows ex-ante which way the stock markets will go. In the very short term, prices move depending on unpredictable factors such as the timing of the economic cycle and market sentiment. But in the long term, a company's share price tends to follow its earnings performance fairly close.

So, let's take a look at how fast American companies are accumulating profits. Dividing the earnings per share of all the companies in the S&P 500 ($214) by the price at which they trade ($4,300), we can see that the largest American companies give us an earnings yield of almost 5.0%. If we subtract from this return the 4.6% currently offered by the risk-free investment, we arrive at a current equity risk premium of barely 0.4%. Looking at its historical performance, we can see that it has declined dramatically over the past year.

What this data tells us is that investors are hardly being rewarded for the risk they are taking: for a similar return, they could eliminate all risk from their investment portfolio. Or to put it another way: for the additional 0.4% they expect to earn, they are paying a very high price in the form of risk.

These metrics indicate that this is a very bad time to be invested in equities. A fall of this magnitude in the equity risk premium is very unusual and has only occurred seven times since 1980, coinciding with moments of extreme euphoria or radical changes in monetary policy. Given that this is an unnatural and unsustainable situation, we have set out below the different ways in which this situation can be normalized, assigning a degree of probability to each:

(i) **Deflationary recession** (*15% probability*): In the coming months a recession will hit the global economy so hard that it will allow central banks to lower interest rates without fear of a resurgence in inflation. This will drag down sovereign debt yields, and thus the equity risk premium will return to normal levels as risk-free assets will once again offer no return.

(ii) **Corporate boom** (*5% probability*): Corporate earnings are about to make a radical turn upwards, and the equity risk premium will return to its usual levels (4.0%) thanks to the fact that the earnings yield on equities will rise to almost 10%. This scenario seems highly unlikely given the upward pressure on corporate costs that we expect to continue over the next few years.

(iii) **Lost decade** (*60% probability*): Interest rates will remain at levels similar to current levels and earnings will grow at a similar pace to what they have been growing over the last decade. Stock markets, however, will hardly experience sustained rises and the equity risk premium will recover very slowly as equity prices do not follow earnings in their rise.

(iv) **Stock market crash** (*20% probability*): Stock prices will experience a sharp and rapid correction that will trigger the equity risk premium back to a more sustainable level. Although unusual, the great stock market crash of 1987 occurred without the US being in recession; the market simply corrected in one swoop the excesses that had built up over the years.

On the other hand, leaving aside bond yields, equity valuations are again becoming difficult to ignore. This year the S&P 500 has returned 14%; rising multiples accounted for 12.6% and earnings growth accounted for only 1.4%. So, valuations have risen considerably.

This unfortunately tells us nothing about whether it is the right time to get in or out of equities, as any valuation can always become more extreme in the short term, but it does tell us a lot about potential future returns. Current valuations are more typical of the post-financial crisis era of extremely loose monetary conditions where returns on risk-free assets were virtually non-existent. This has nothing to do with the current situation where the U.S. bond pays a mouth-watering 4.6% risk-free interest.

In short, the financial market is a system of communicating vessels, where there are always alternatives for investing capital. Now that sovereign bonds have left behind the era of zero or even negative interest rates and are paying an attractive yield, it is to be expected that money will flow out of equities and into fixed income. Add to this the historically high valuations assumed when investing in equities, and there are even more reasons to be skeptical.

Higher for longer

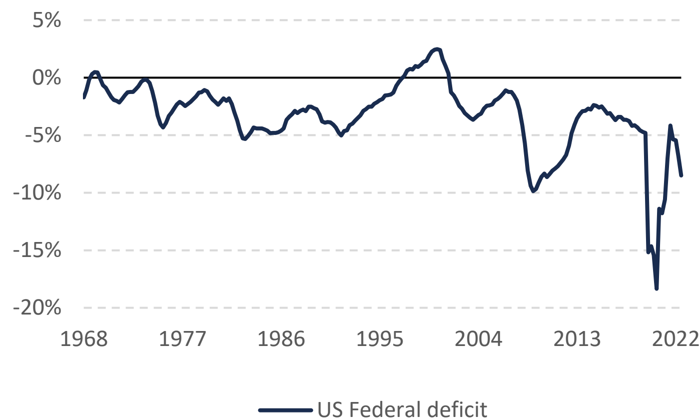
To understand how we got here, it seems appropriate to comment on the causes that have led the interest rate on the US 10-year Treasury to stand at 4.6%, up a full point in the last three months. The unexpected appearance of inflation two years ago triggered the fastest rise in interest rates in the United States and Europe. Remember that central banks are in charge of keeping inflation at bay through the short-term rates they set.

This explains much of the rise in bond yields over the past year and early this year. However, a couple months ago central bankers paused their hikes as they are waiting for more clarity on the macroeconomic picture. At the same time, inflation seems to have peaked and has softened throughout this year. We must therefore look for reasons other than monetary policy that may have triggered such a strong move in long-term bond yields.

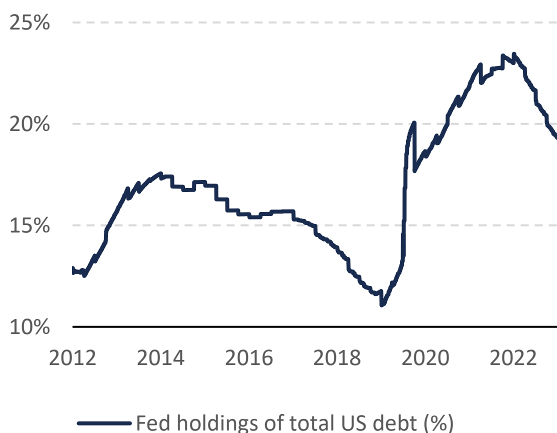
The United States is immersed in a never-ending internal political crisis. The latest victim has been the country's third highest authority, the President of the US House of Representative Kevin McCarthy, forced to resign betrayed by a stronghold of congressmen from his own ranks of the most extremist

wing of the Republican Party. The reason for the dispute has been the constant quarrel over public spending by the American government.

It is precisely this public spending that could be behind the rise in US bond yields. The situation has echoes of the British crisis last fall, when former Prime Minister Liz Truss triggered a tsunami in the British debt market. Announcing tax cuts and an unconscionable increase in public spending, the market turned its back on her and caused the interest rate on British debt to soar. Well, while US economic growth remains robust and inflation remains high, the Biden administration continues to increase government spending, issuing massive amounts of bonds to finance it.



Another explanation for the rise in yield could be found in the changes in strategy of the traditional major buyers of US debt: the Chinese government and the Federal Reserve. On the one hand, the Federal Reserve, forced to fight inflation, has switched from buying bonds to selling them as part of its balance sheet reduction program. On the other hand, while the Chinese government held 10% of total US debt just a decade ago, it now holds only 3%.



Although there is no official explanation from the Chinese government, it can be interpreted that this strategy is part of the growing geopolitical tension between the two powers. The use of the dollar as a financial weapon by the US and the West since the invasion of Ukraine is forcing non-aligned countries to reduce their exposure to US assets. As Russia discovered last year, your assets denominated in a currency you do not control can be frozen in mere seconds.

In short, the debt market behaves exactly like any other market governed by the law of supply and demand. If two of its big buyers (the Fed and China) disappear from the market, interest rates will tend to rise due to lower demand. The same goes for supply; the more government bonds are issued; the higher interest rates will rise. We believe these dynamics will be sustained in the coming months and years and should therefore keep interest rates on risk-free assets (sovereign bonds) high. All this will have an impact on risky assets, which should see their valuations affected.

Towards an extremely unstable world

It is part of Hanway Capital's strategy to pay close attention to the global geopolitical situation. Understanding the balances of power and the constant change in international politics is increasingly essential for a correct asset allocation. Only like this can we control and reduce the risk of our investments in a world that seems to have accelerated towards instability due to the power vacuum being left by the United States.

The war between Israel and Hamas is of particular importance because of what could happen in the next few hours. Israel is expected to launch a ground incursion into the Gaza Strip in reaction to last Saturday's attacks on Israelis. If the conflict escalates to the rest of the region there is a possibility that Hezbollah could open an additional front from Lebanon. Hezbollah's capabilities are far superior to those of Hamas, and a war on both fronts, with the possible backing of Iran, could be devastating for the region.

Coinciding exactly with the 50th anniversary of the Yom Kippur War, the world's oil supply could once again be at risk. It was that conflict in the Middle East that triggered the first oil crisis, initiating a prolonged recession and rising inflation that lasted until the early 1980s.

Although the current situation is far from what it was 50 years ago, it is relevant because of everything we have mentioned above. If the price of oil soars again, inflation will pick up and interest rates will remain high for longer. This will have consequences for all capital markets.

The front that has opened up in Israel adds to the ongoing conflicts that are forcing countries to position themselves in one of the world's blocs. On the one hand, the West is led by the United States and the European Union, but it is becoming increasingly difficult for them to attract third countries that have been wooed by China economically in recent decades. On the other hand, the axis of autocratic powers seems increasingly compact around China, Russia, and Iran.

These two blocs seem to be irremediably moving towards an economic decoupling that will have unpredictable consequences for world trade, inflation, and world peace.

Management report

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

1. **Monetary markets**: The inversion of yield curves has led to a curious phenomenon: you get a higher return on deposits that can be withdrawn at any time than on investments that lock up your money for many years. In the U.S., for example, money markets return 5.5% while 30-year sovereign bonds pay only 4.8%. It is rare to find investment opportunities that offer higher returns for lower risk, so we have taken advantage of this to park our excess cash and during this period money markets have added **+0.4%** to our returns.

2. **Volatility position:** Following last quarter's restructuring, we have been much more selective in our volatility bets in recent months, as we did not have an equity portfolio to protect. As a result, we have achieved a positive result even though stock market movements have been limited and the VIX has been unable to break the 20-point barrier. This quarter its contribution to the fund was **+1.3%**.

3. **Dividends position:** As an alternative to investing in equities, we find dividend futures interesting: having a much shorter duration than equities, they are not affected by increases in discount rates. In addition, they have implicit inflation protection as long as companies know how to keep expenses in line with revenue. This quarter, dividends have outperformed stocks by a wide margin, adding **+0.2%** to the quarterly return.

4. **FX positions:** Divergences in monetary policy have continued to mark the evolution of currencies in recent months. At first the euro was the big beneficiary of the Fed's pause, but soon the market understood that the ECB is also very close to its interest rate ceiling. Our bet on the US dollar this quarter has paid off, helping performance by another **+1.3%**.

5. **Short position in equities:** This quarter we have also opened some short positions in equities, in those sectors that we believe have more room to fall if, as we expect, money starts to exit the asset class. We will only make a return on these positions if equities turn sharply lower, as their high cost of carry negates slight declines such as those we have seen since the July highs. This was our only negative contribution to the fund, subtracting **-0.5%** from the overall result.

"The sad truth is that most evil is done by people who never make up their minds to be good or evil”

- Hannah Arendt

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%				**-4.8%**

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