

July 15th, 2024

Q2 2024

Dear investors,

Hanway Capital Fund has returned **+1,6% this quarter**, reaching a share price of **€137.4** net of fees and commissions. This brings the year-to-date return to **-2.2%**. Our positioning shift announced in the last letter has begun to bear fruit: as we write this, the fund has turned positive for the year. Electoral processes and their impact on the financial markets will continue to shape 2024: in the UK, the Conservatives have faltered; the European Union has been able to uphold the center, and France enters a period of uncertainty after inconclusive results. However, the financial market's primary focus remains on the most significant event of the year: the US presidential elections in November.

A duel between spendthrift octogenarians

The United States is facing a profound political representation crisis. Unless nothing changes, on November 5th, Americans will have to choose between a Democratic candidate (Joe Biden) showing clear signs of senility and unfit for the role, and a Republican candidate (Donald Trump) convicted by the judiciary and unpredictable to global stability.

The relentless rise in American societal polarization should concern us all¹ due to its role as an economic superpower and global order arbiter. In the face of growing threats from regimes in China, Russia, and Iran against the liberal order established after World War II, weak American leadership will be exploited by its adversaries to undermine it.

The uncomfortable CNN televised debate marked a turning point in the campaign. Like in the classic tale *The Emperor's New Clothes*, where the ruler is deceived into parading naked, believing only fools cannot see his new attire, and no citizen dares to point out the obvious until an innocent child breaks the spell by exclaiming, "*The emperor is naked!*" and everyone begins to laugh.

Similarly, over the past years, we have all ignored episodes demonstrating that the American president was too old to remain in command. But the spell was broken on June 27th when Americans watched in astonishment from their homes as their president struggled to recall arguments or finish his sentences. The polls have shifted dramatically: today, they suggest it is more likely that Vice President Kamala Harris will be the next president instead of the official candidate, Joe Biden. Donald Trump's lead seems unbeatable: the entire world has seen that the emperor was indeed naked.

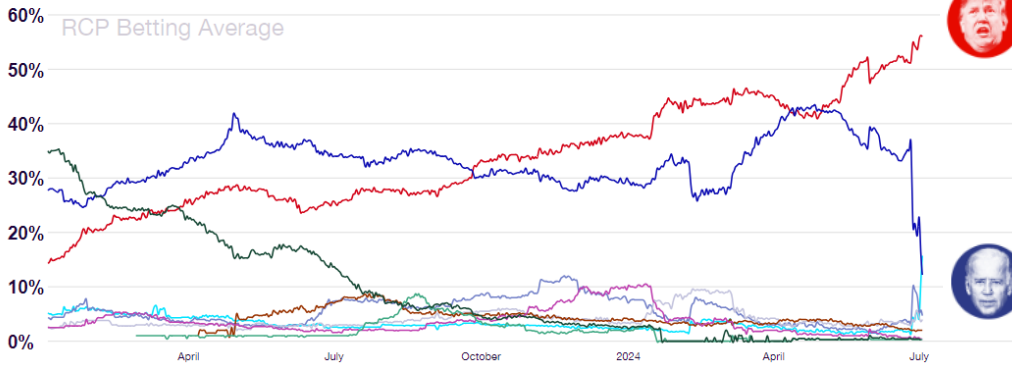
¹ This letter was drafted prior to the assassination attempt on presidential candidate and former President Donald Trump on Saturday, July 13 in Pennsylvania, confirming the high political polarization of this campaign.



RealClearPolitics Betting Average

56.0	Trump	15.7	Harris	12.2	Biden	4.7	Newsom
4.0	Obama	2.0	Kennedy	0.4	Haley	0.3	Ramaswamy

2024 U.S. President



Despite the discouraging political situation, it is crucial to analyze the elections' impact on the economy and the markets. A Trump 2.0 administration would bring more exacerbated protectionism than during his first term. The candidate proposes a 10% tariff on all imports and 60% on Chinese products, potentially sparking an inflationary trade war. But more importantly, neither Biden nor Trump offer a realistic plan to stabilize the growing and enormous American public deficit.

American debt is out of control: at the end of 2019, it was \$22 trillion, and in just five years, it has reached \$35 trillion at the current rate of \$1 trillion every 100 days. Debt increases year after year due to the astronomical annual deficits incurred by American governments. In the past twelve months, they have spent \$2 trillion more than they have collected via taxes (a deficit of 7.2% of GDP). This deficit represents three times the average 2% of other advanced economies and is an unthinkable number outside of an economic recession or a war.

Both candidates have adopted irresponsible fiscal policies when in the White House. It seems their age pushes them to care little about what might happen in the coming decades when they are no longer around.



Après moi, le déluge

In fact, the fiscal and economic situation in the United States has similarities to 18th century France. At that time, King Louis XV squandered vast amounts of the public treasury on unnecessary wars and personal extravagances, generating great discontent among the population. Asked about his legacy and the crisis that might come after his reign, Louis XV is said to have replied, "When I'm gone, the deluge." Indeed, a prophetic phrase since his successor, Louis XVI, who inherited all the problems, ended up at the guillotine.

Likewise, Biden seems determined to overheat the economy before the elections. He knows that his slim chances at the polls will increase if unemployment reaches a minimum by November, the stock market

hits new highs, workers continue to get raises, and mortgage costs start to fall. What happens afterward, like the French monarch thought, will no longer be his problem.

Of course, Joe Biden will not be the first or last politician tempted to spend public funds to win voters' favor. Donald Trump has exactly the same plans if he gains the presidency. While the Democrat plans to continue increasing spending by forgiving student loans or by subsidizing America's industry, the Republican candidate intends to further cut taxes.

Clearly, Biden has no real plan to tackle the growing US deficit. But to be fair, neither does Trump. And it's not hard to understand why: balancing federal finances is painful in the short term, and its gains would only be seen in the long term. Unfortunately, most politicians prioritize immediate victories, especially if they are in their 80s.

Bond vigilantes' return?

The US's massive deficit cannot be ignored forever. In Manhattan, not far from Times Square, the US debt clock reminds passersby of the speed at which it grows: from \$3 trillion when it was inaugurated in 1989 to \$35 trillion today. But it's not just the US; total public debt in developed countries is now higher as a percentage of GDP than at any other time since the Napoleonic wars.

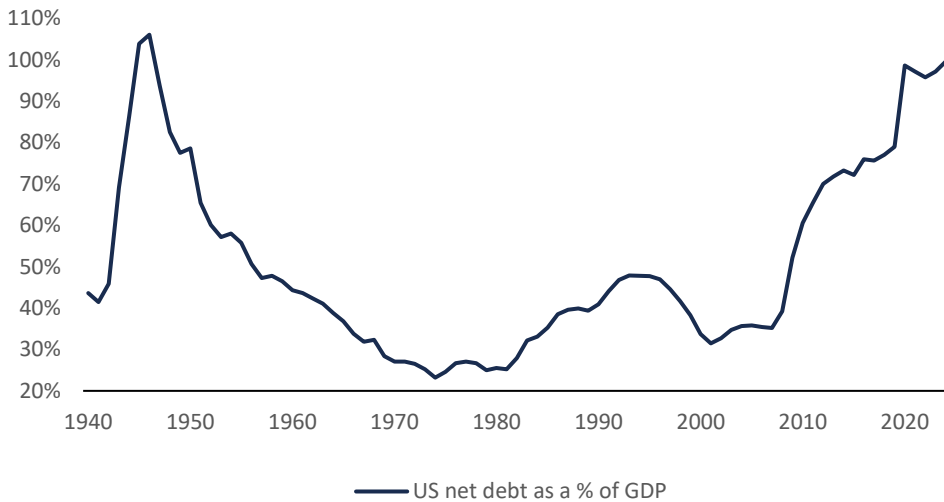


As alarming as it may sound, it's hard to know when a debt crisis might be triggered. In Japan, net debt hovers around 160% of GDP, and they have no trouble issuing new bonds. The US might have some leeway given that the dollar is the world's reserve currency, ensuring foreign appetite for its debt. However, Japan has managed to meet its obligations because most of its debt is held by Japanese themselves and because their interest rates are extremely low. That's no longer the case for America: in percentage of GDP, US interest expenses already double those of Japan. In fact, for the first time in history, the cost of these interests exceeds defense spending, a very sensitive topic for Americans.

But the future is not very hopeful. To reduce annual deficits and start decreasing debt would require more than political will, as a set of structural forces play against it. The aging population and increased life expectancy mean paying pensions for longer and having fewer workers per retiree to finance them. At the same time, the rising interest rates that still underpin the financial system will increase the cost of financing that debt, and this is without considering the possibility of a recession reducing government revenue or, worse, a large-scale war that spikes defense spending.

Not so long ago, concern over the growing federal debt was a hot topic in American politics. During Bill Clinton's first term in 1993, the president tried to create a universal healthcare system. But the debt market began to protest against what it perceived as excessive public spending. Thus were born the so-called "bond vigilantes," disgruntled investors who sold their government bonds, raising their interest rate. At that time, US net debt was 46% of GDP; today, it is approaching 100%.

US debt returns to record highs not seen since World War II



Bond vigilantes raised US debt interest from 5.2% to 8.0% in just twelve months. The Republican Party, which had been in opposition in Congress for 40 years, focused its campaign on balancing the public budget. It then achieved a historic majority in the midterms that forced Clinton to sit at the negotiating table to agree on the budget, thus calming the debt markets.

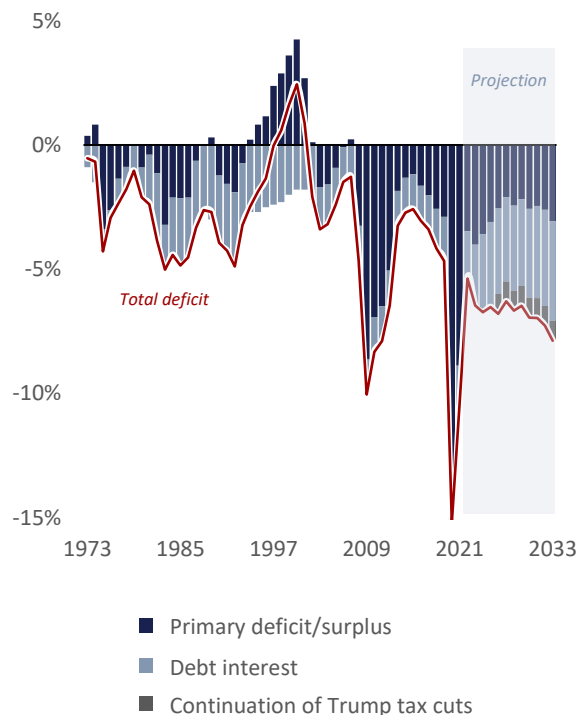
Clinton won reelection two years later because, compelled by Republicans, he promoted spending cuts that led to the first surpluses in a generation. But the circumstances then facilitated fiscal discipline: productivity increased thanks to the spread of computers and the arrival of the internet, and in turn, higher growth raised tax revenues. At the same time, the end of the Cold War facilitated defense cuts, an easy way to tighten the belt thanks to peace dividends.

Today, however, rising tensions with China and Russia will increase defense spending, not reduce it. The energy transition to reduce greenhouse gas emissions and caring for an aging population will also put pressure on the budget.

How could it all end? It's very difficult to predict when a debt crisis might erupt; however, when they do, they tend to unfold very quickly. Former UK Prime Minister Liz Truss, who spent less than fifty days in office, can attest to this.

A sovereign default is impossible given all US debt is denominated in dollars, and the government could always create money to repay. But there are other extreme scenarios. One is "fiscal dominance," where a central bank is forced to print money to finance deficits, causing high inflation eroding citizens' savings. This would effectively be a hidden form of taxation. Fortunately, this remains a

US government budget as a % of GDP



remote possibility in the US, even if Donald Trump flirts with the idea of politically controlling the Federal Reserve.

Another possibility is "financial repression" by controlling the interest curve, forcing market agents to lend to the government at a fixed rate to keep its borrowing costs low. This essentially means the Fed would set an artificial interest rate on US bonds and allow inflation to be higher than that rate. Again, this sounds far-fetched in a country like the US, but we must not forget that this was exactly what was done the last time debt reached these levels right after World War II.

A more optimistic scenario would be that the US manages to control its debt before it's too late. Perhaps, like in the 1990s, it could benefit from extraordinary economic growth driven by increased productivity, this time due to the spread of artificial intelligence. We do not doubt the extraordinary potential of the technology. But beyond composing songs and making life difficult for teachers, it remains to be seen if it can achieve this economic miracle.

Until then, we mustn't stop dancing

As mentioned, these scenarios are very difficult to predict as the situation may drag on for years, but we must be alert and prepared as a small spark can derail everything. The valuations of risky assets, which had slightly corrected in 2022, are again nearing historical highs, creating more fuel for a correction.

We see 2025 as a turning point. On average, US debt benefits from a low-interest rate until mid-2025. If rates remain high until then, there will be a rapid increase in interest expenses. This will coincide with another significant event: by the end of 2025, the tax cuts Trump approved in 2017 will expire. Extending them would cost an additional \$3 trillion over the next decade. The market could react negatively if this coincides with a Trump victory that unleashes a tariff war and tighter political control of the Federal Reserve.

Until then, and at least until we know who the next White House occupant will be, we expect a bullish market, although not in a straight line. It still seems impossible, but the will of Washington elites remains to prevent Donald Trump from becoming president. *Mais après nous, le déluge!*

Management report

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

- 1. Equity position:** As explained in our last letter, we believe equities have room to grow until November. This has been a quarter with two halves for US stocks: first, they corrected 6% following rising tensions in the Middle East, then rebounded 10% to new highs. European equities, on the other hand, fell almost 4% during the period. Our winning bet of the quarter has been pharmaceutical companies focused on GLP-1 drugs for overweight patients; conversely, our positions in European defence companies hasn't helped. Overall, equities have contributed **+0.7%** to the fund's result.
- 2. Volatility position:** Despite a calm May and June, the fund benefited from increased volatility in April. The VIX reached a leve of 20 on April 19th from 13 where it ended in March; since then, it has retraced all that move. The fund was well-positioned for that correction, contributing **+1.6%** from volatility over these months.
- 3. FX position:** Nothing seemed to stop the yen's fall, crossing the ¥160/\$ line for the first time since 1986. The Japanese government's interventions to support its currency have proven futile given the wide interest rate differential with the US. Still, we maintain our investment as protection against unexpected events, believing that in the next crisis, the Bank of Japan will be the only central bank not to lower interest rates. This quarter, our currency positions subtracted **-1.3%** from the overall result.
- 4. Precious metals:** The precious metal has had another great quarter, rising 4% to new highs. As explained last quarter, the combination of excessive public spending and interest rate cuts is the perfect mix for this asset, contributing **+0.3%** to the return.
- 5. Short Fixed Income position:** Interest rates have risen slightly this quarter but remain far from the levels that could unsettle the US government. Our short position added **+0.6%** to the fund.
- 6. Commodities position:** Uranium had a poor first half of the year. After rising nearly 85% last year, it corrected more than 12% in 2024. We still believe that the green transition will drive a strong increase in demand for this commodity, as explained in our previous letter. This period it has cost us **-0.3%**.

"I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I'd like to come back as the bond market. You can intimidate everybody"

- James Carville (Bill Clinton's advisor)

Regards,
Hanway Capital

Appendix: Hanway Capital Fund historical net 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%
2024	-2.5%	0.2%	-1.5%	-3.8%	4.3%	1.3%	3.3%						+1.0%

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