October 7th, 2024

Q3 2024

Dear Investors,

Hanway Capital Fund has returned **+0.8% this quarter,** reaching a share price of **€138.5** net of fees and commissions. This brings the year-to-date return to **-1.5%**. Contrary to what might appear from the final result of this period, this has been a quarter with major shocks. At the beginning of August, an investment strategy imploded in Japan generating a panic episode that threatened the bull market and affected us negatively. Sound decisions in September helped us recover lost ground and allowed us to build the strategy for the end of the year. This letter will be somewhat longer than usual as it contains a special report on the November US elections which we hope will be of interest to you.

Betting against Japan, a safe bet

During the 1980s, Japan experienced the biggest speculative bubble of all time. Its economy was the envy of the world: its GDP had been growing at 10% for decades, it looked set to overtake the US as the largest global economy and its exporting companies were the best (Sony, Nintendo, Panasonic, Canon). The Japanese market capitalization reached almost 50% of the global value, surpassing the American 30%.

As the 1990s began, Japanese growth came to a screeching halt, and the bubble quickly deflated. The Nikkei (Japan's benchmark) fell by 46% in less than a year; housing prices in Tokyo plummeted by around 90%. It showed that the Japanese economic model had become outdated: its star product was low value-added technology, and as wages had risen, its competitiveness evaporated.

In any other country in the world, the transition from an industrial to a high value-added economy would have been enormously traumatic: massive layoffs, bankruptcies and defaults. In other words, the process that Schumpeter described as creative destruction. But in Japan, the social structure did not permit such a painful experience. Companies regard their workers as if they were part of their family: many work for the same company from the time they leave university until they retire. In return, workers work tirelessly and with unwavering loyalty.

For this reason, when the crisis broke out, there was an implicit pact between companies and the government: companies would not lay off workers, and in exchange the government would not let any company go bankrupt. This is the only way to understand how, during the 30 years of economic hardship that Japan has suffered since then, unemployment has never risen above 4.5%. Many companies unable to generate profits were kept alive artificially thanks to public aid. Japan's public debt rose from 40% of GDP to 250%, the highest in the developed world.

To prevent the debt tsunami from sweeping away the government's accounts, it was necessary to involve another institution in this social pact: the Bank of Japan, which kept interest rates anchored at 0% so that interest on public debt would not skyrocket.

For all investors who started working after 1992, Japan's interest rates have always been the lowest in the world. This has created numerous distortions over the years, but above all it has meant that many global speculators have used the Japanese yen as a funding currency, because Japanese banks are the ones offering the cheapest lending. That money is then converted into another currency such as the dollar to invest in US assets, or in emerging currencies such as the Mexican peso to deposit it in a local bank and receive the interest. This is the popular carry trade: if a Japanese bank lends you money at 0% and a Mexican bank pays you 8% to deposit, as long as the yen does not appreciate more than 8% against the peso, you will earn money.

Emerging currencies such as the peso have always had internal problems that have caused their currencies to depreciate against more developed currencies. However, the *carry trade* worked well from 2000 to 2020: emerging currencies kept falling, but not fast enough to erode the entire interest rate differential cushion. Over those 20 years, the strategy generated an annualized return of 3.9%.

Starting with the inflation episodes that began in 2022, this dynamic changed: all the world's central banks began to raise interest rates, with the exception of the Japanese central bank, which remained stubbornly below 0%. As a result, the yen began a depreciation that led it to hit a 40-year low of $160/¥ in July of this year.

This tailwind added fuel to the carry trade. Now speculators not only gained from the interest rate differential, but emerging currencies such as the peso appreciated against the yen. In the 2022-2024 period, the peso/yen *carry trade* generated an annualized return of 42%, outperforming even the returns of the S&P 500. Until, in March of this year, the Central Bank of Japan said enough was enough: it gave up and began to raise interest rates.

The first rate hike failed to put the brakes on the wheel, as neither did the Japanese finance ministry's interventions in the foreign exchange market. But on August 1st, the Bank of Japan pulled out all the stops: it raised rates again, halved its quantitative easing program and warned that there would be more rate hikes before year end. That week, the yen appreciated by 4.7% against the dollar and 8.3% against the peso.

The rise and fall of the *carry trade*

The Black Monday that never was

At the start of the following week, during the early hours of Monday August 5th, the yen soared another 3.2%. Japan's stock market, which had benefited from the yen's weakness, plunged 12%, its worst fall since Black Monday 1987. Wall Street futures also pointed to a dramatic opening: they were down 4.5% before the start of the session. The volatility index (VIX) experienced the biggest daily increase in its history: up 42 points in one day to 65.

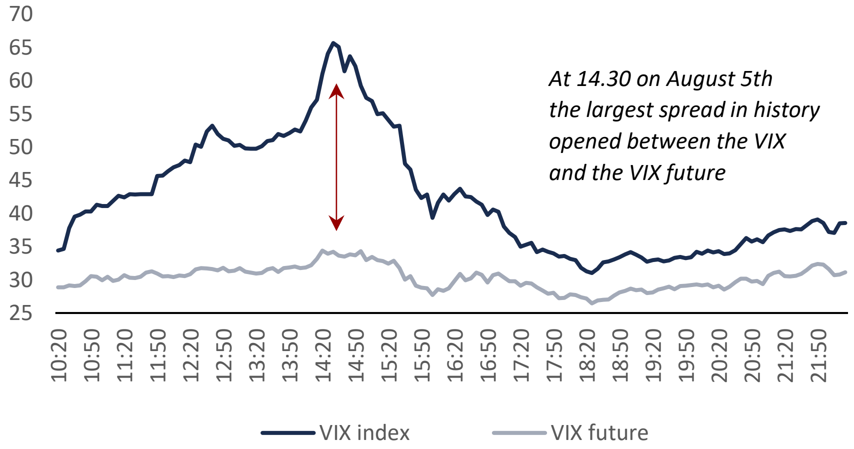
That morning, internally, we had to decide quickly whether this move was the start of a historic day for the stock market (similar to Black Monday or the day of the Lehmann Brothers bankruptcy) or a temporary flash crash that would only last a few hours. If it was the latter, the correct course of action was to ride out the storm without doing anything; but if it was the former, we had to find an asset that was not yet in panic mode to protect our investors: the VIX future.

The VIX future usually trades very closely with the index; only in very specific episodes do the two quotes diverge. In fact, the VIX index cannot be bought, only its future. At the beginning of the covid crash, for example, the index quickly shot up to levels of 40, but the futures did not quite buy into the panic and barely went above 25 points. It was not until after a few days when both converged to the upside that the worst omens were confirmed.

Finally, as our analysis indicated that there could be many speculators trapped in the yen carry trade, we decided to buy VIX futures at a level of 30 with the idea that they would converge with the index at a higher level. It seemed to us the most prudent decision to protect our investors from a possible stock market crash. However, the whole episode was just a scare: three weeks later, the S&P 500 had recovered all the losses of that fateful day and our VIX futures had dropped to 15 points, eroding our profitability.

Judged with the benefit of hindsight, this investment was a bad decision. However, given the data we had at the time, it seemed to be the right choice. Risk management is one of our core values, and in the face of a potential Black Monday, not acting was never an option. Unfortunately, hedging can be expensive, and most of the time it will be in vain. But it is always better to act, because sometimes it makes all the difference.

The VIX soared to 65 points, second only to the Lehman Brothers bankruptcy and COVID-19.



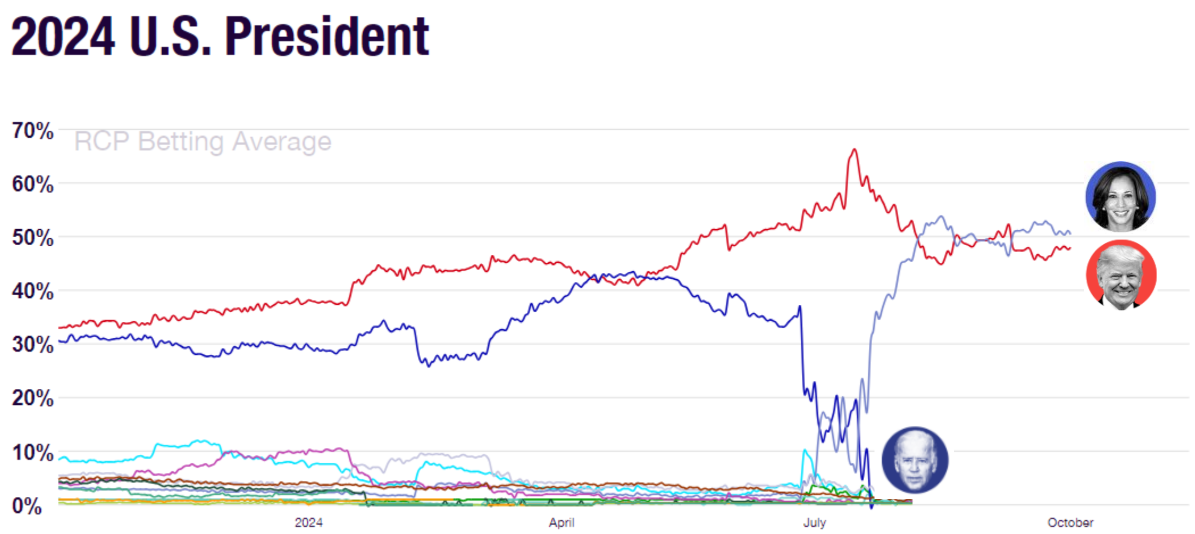
An election with multiple unexpected twists and turns

Four years later, we are once again facing a close American election that will mark not only the future of the American nation, but of the world. For the third time in a row, the controversial Donald Trump is running again.

In addition, the 2024 electoral cycle is taking place in a context of major global imbalances that, as we have commented in other letters, imply a challenge to the liberal world order. While the role of the United States as the arbiter of this order is in decline, the three focal points to always keep in mind are: Russian expansionism, the unstable Middle East, and China's discreet preparation for a possible invasion of Taiwan.

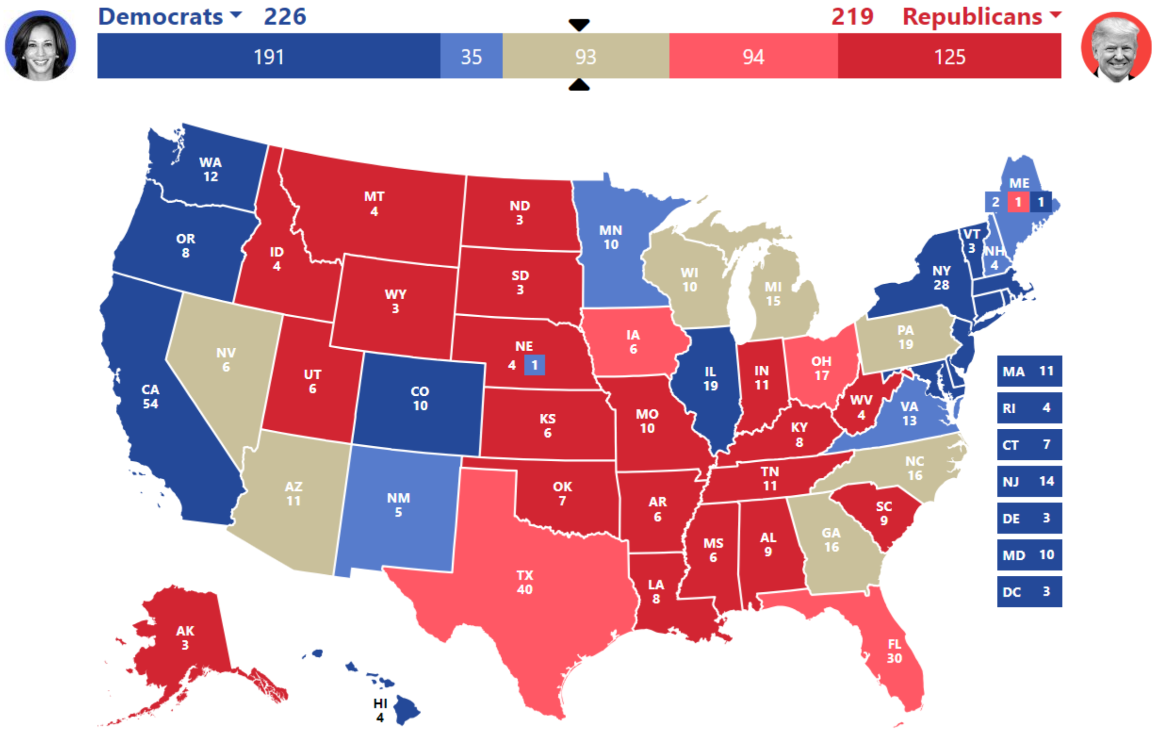
The American election campaign this 2024 is undergoing multiple unexpected twists and turns. After Joe Biden's disastrous debate on CNN, it was only a matter of time before the Democratic party reacted and changed the candidate. Days later, Republican Donald Trump, suffered an assassination attempt when a bullet hit his ear. Few leaders of the Democratic Party could have imagined that Kamala Harris' nomination, Vice-President of the United States, would be such a revulsive when the election was already considered lost.

Since the nomination of Kamala Harris as candidate, the polls have changed radically and where Trump's victory was once taken for granted, the race is now extremely tight. The probability of one or the other candidates winning could be decided by tossing a coin, with a very slight advantage for Harris.



Our prediction is that Democratic candidate Kamala Harris will win this election. The virtuous circle created by her nomination has only strengthened in recent weeks. Trump could win against a weak Biden worn down by Democratic voter turnout, but his polarizing figure fails to attract new voters.

In today's polarized world, elections are won by those who manage to mobilize their electorate. The American electoral system consists, in short, in that each of the 50 states carries out a vote between the two candidates and the one who obtains more votes gets all the electoral colleges of that state. As can be seen in the map below, each State has a number of electoral colleges proportional to its population and the first candidate to reach 270 votes wins the election.



Most of the states are not relevant since the broad preference for one of the parties determines beforehand who will win. This is why the campaign is focused on the famous "swing states", those where the polls are too close to determine the winner before the election. This year they are Nevada, Arizona, Wisconsin, Michigan, Georgia, North Carolina and above all Pennsylvania. Whoever wins Pennsylvania is unlikely to lose the election. There the polls are extremely tight; Trump won in 2016 and so did Biden in 2020.

Remember, remember, the sixth of November

But what is really transcendental this time will not be the elections on November 5th, but the day after. Will the loser concede victory? Will an extremely polarized American society accept the results? The financial market expects great volatility due to the uncertainty of the three possible scenarios that we are going to try to unravel.

The most unlikely and unprecedented scenario would be a tie at 269 votes. This scenario would be the most damaging to our strategy and to the financial market. The uncertainty that would result from a tie and the consequent protests of electoral fraud would further divide American society, generating enormous chaos. The different models estimate a 1 in 300 chance of this scenario occurring. The American constitution stipulates that it would be the House of Representatives that would choose the new president by means of a vote for each state. Donald Trump would probably be the victor even if Harris were to win the popular vote, which would open a constitutional crisis and the furious protest of the Democrats.

The second scenario would be a Donald Trump victory in the election. If the outcome is close, it is likely that some Democrats would try to mount a court battle, but it would end up in the conservative-majority Supreme Court. Most likely, Kamala Harris herself would accept defeat. This scenario should not be negative for the market, as far as the election process is concerned.

The third is the most relevant because it is the most likely and the one we will focus on. The financial market fears that a Harris victory will not be accepted by Donald Trump. In fact, it is no secret: everyone knows that Trump will not accept the result if he loses. On November 6th, if Harris wins, she will be proclaimed the winner in the wee hours of the morning, and then Trump will come out accusing the Democrats of electoral fraud and calling for mobilization so as not to allow the election to be stolen from him again.

Up to this point no one should be surprised, not even the financial market itself. It is what we call the *common knowledge* (what everyone knows that everyone knows). The question is not whether Trump will accept the outcome of the election if he loses. He won't. The question is whether a *sponsor* with effective power will join him.

Effective power implies having executive power over the election outcome, and more importantly, that a critical mass of Americans perceive it to be so. For example, the governor of a state (who must legally certify the results for them to be valid), or the owner of a powerful media group have the ability to change the *common knowledge* on how we should think about the outcome of the elections. In any other country we would also mention an army commander, but the great virtue of the United States is that we do not.

Effective power clearly does not include legislators. The entire group of Trump acolyte congressmen associated with the *Freedom Caucus* (a group of Trumpist congressmen), can tweet all they want about voter fraud. It will be all cheap talk. They will, but both they and the citizens know they have no effective power, pure rhetoric.

But if a governor of a Republican-controlled state, or a reputable media group, were to join Trump in publicly questioning the legitimacy of the election, we would enter an unknown scenario. It is no longer about empty words, but about effective power to change things. When someone with that power asks to delay, challenge or reverse the outcome, those words become a call to action, a categorical imperative as defined by Immanuel Kant 250 years ago. We humans tend to respond collectively to these calls. “Duty" necessarily implies the capacity to act and impels us to do so: if something is morally necessary, it becomes a practical obligation, not simply a theoretical question.

Aligning with Trump from a position of executive power implies an immense risk on a personal and political level. It is stepping outside the political system that conferred you that power and once you cross that door, there is no turning back.

We should recall that during the 2020 elections, although some Republican governors expressed concerns about the electoral process, none openly aligned with Trump in denying the results. Key figures such as Brian Kemp, governor of Georgia or Doug Ducey, Arizona, certified the results in their states resisting Trump's pressures.

In our opinion, for this November's elections, there is no governor willing to take that risk. Going it alone is highly unlikely. For such a move to succeed, it would require a great deal of coordination and that is clearly criminalized as a conspiracy offense with penalties of up to 20 years.

The same goes for the media groups. The ending of the *Succession* TV show was very creative but neither Rupert Murdoch, nor his son Lachlan (current president of the FOX network), are going to risk their entire empire for Trump. Most likely they will not hesitate to bury him politically. Their relationship has deteriorated since 2020 when FOX refused to align itself with Trump's theses.

This leaves us with only one possible *sponsor* with effective power. A *sponsor* who believes that a Trump defeat would mean an existential problem for him and could even consider, perhaps, risking everything: Elon Musk. Owner of social network X (formerly Twitter) with a penetration of more than 100 million users in the US and the richest man on the planet.

Beyond Trump himself, who could risk prison if he doesn't win the election, we are hard pressed to identify anyone with real power who has more to lose than Elon Musk. It seems that the owners and CEOs of powerful tech companies have finally decided to step down into the political arena. Gone is the appearance of neutrality. And the case of Elon Musk is the most notorious, he has become Donald Trump's real number two, visibly displacing the Republican vice-presidential candidate, JD Vance.

The Harris administration will not hesitate to hinder Elon Musk's empire. After all, Starlink and SpaceX could easily be controlled under a supposed "national interest" law, and Twitter regulated under the guise of disinformation. Musk has effective power, and he does not hesitate to use it in a clearly partisan manner. He will not hesitate to use his tools, primarily Twitter, to spread disinformation and create chaos. But if things get serious, the risk of going all in will be too high, and in our opinion, he will back down.

All this is what really underlies the high volatility expected in the financial market. What really terrifies the market is that on November 6th, the results will be sufficiently close that there is a risk that a *sponsor* will manage to generate a *common knowledge* that the result is inconclusive, that there has been fraud, and that action must be taken so that what supposedly happened in 2020 does not happen again.

In our opinion, we do not believe that will happen. We will see many supposed *sponsors* with no effective power who will bellow in exasperation that they have been robbed of the election and that action must be taken. Even Elon Musk will flirt with the idea of going all-in. But we will not see any governor take the initiative and declare the election illegitimate to convince more governors to follow suit and unleash chaos.

American democracy is robust, and even if it seems more fragile than ever, it will not be this year that we will see it fall. We will therefore position ourselves resolutely to take advantage of a sharp fall in volatility that should allow us to end the year in positive territory if we are right.

Management report

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

1. **Equity position:** Despite two crashes at the beginning of August and September, the stock market continued its climb. As in the second quarter, the geographical differences were significant: the US stock market rose by more than 5%, while the European market climbed only 2%. Looking ahead to the end of the year, we believe that the combination of robust economic growth and lower interest rates will give assets a boost once the electoral uncertainties have been dispelled. Over the past three months, equities have contributed **+2.3%** to the fund's performance.

2. **Volatility position:** Good risk management throughout the quarter has been overshadowed by our early August move, which we have already explained in detail. Looking ahead to the last three months of 2024, we believe volatility remains artificially high due to fears of an inconclusive outcome on the November 5th election. We have therefore positioned ourselves to benefit if the worst omens do not come to pass. This quarter, the volatility contribution to earnings has been **-3.6%**.

3. **FX position:** The yen has finally broken its downward spiral. It took an outright intervention from the Bank of Japan, but it looks like ¥162/$ will be marked as the peak of this episode. Since that intervention, the BOJ has softened its rhetoric and the new prime minister, Shigeru Ishiba, has ruled out further rate hikes this year. This has led us to unwind our position, which has added **+1.4%** to the overall result for the period.

4. **Gold position:** For the fourth consecutive quarter, gold has reached a new all-time high. This time it has had its best performance in 8 years, revaluing by more than 13%. Both candidates for the White House seem willing to increase government spending and the Federal Reserve will back them up with interest rate cuts. There do not seem to be many obstacles in the way for this asset, which has contributed another **+1.0%** to performance.

5. **Short Fixed Income position:** The first interest rate cut by the Federal Reserve since 2020 has been replicated in Europe: the ECB has lowered interest rates to 3.6% from 4.5% at the beginning of the year. Even so, the impact on long-term interest rates has been minimal, and our bearish position has only been hurt by **-0.2%.**

6. **Commodities position:** After falling 33% from its highs in the first 8 months of the year, uranium has rebounded slightly. Undoubtedly, the energy policy of the new American administration will be very relevant in the evolution of this asset, which during this period has subtracted **-0.1%**.

"Nearly all man can stand adversity, but if you want to test a man's character give him power"

- Abraham Lincoln

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%	2.2%	-5.2%	4.0%				**-1.5%**

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