MONACHIL
CAPITAL PARTNERS LP

APRIL MARKET AND ECONOMIC INSIGHTS

May 2023

Introduction and Overview

Welcome to the April installment of our monthly report, in which we aim to highlight topical matters and assess their potential impact on financial markets.

As an administrative point, we note that going forward these newsletters will focus on economic and market commentary, and that Fund performance data will be provided in our fact sheet, which will be made available on the Fund's website shortly. (www.monachilfunds.com)

In this report we will review notable economic data released in May, and then provide an update on our assessment of the US economy and the likelihood that it will enter a recession.

The Economy will Face Material Headwinds During the Second Half of 2023

In our previous letter, we considered how the resolution of the debt ceiling would likely result in a higher US interest rate environment. We believe the federal spending cuts struck in the debt ceiling deal to be insignificant and we expect the Treasury Department will increase the outstanding balance of Treasury obligations by as much as ~US$2 trillion in the second half of 2023, a sharp contrast to trends in the first half of 2023.

Specifically, after reaching the debt ceiling in January 2023, the Treasury Department continued to spend without a commensurate increase in borrowing, a combination which had a stimulative effect on the economy even while the Federal government continued to run a large deficit, indeed a widening one. The result will be the requirement for the US Government to significantly increase borrowing in the second half of the year, coinciding with a time when the Federal Reserve will likely also be engaged in quantitative tightening and traditional foreign buyers of US treasuries will, uncharacteristically, have limited appetite.

Worsening Trade Off Between Growth and Inflation

The structural changes in the Federal Budget, driven predominantly by the (inaptly named) Inflation Reduction Act, involve higher deficits and new government subsidies and transfer payments that have worsened the tradeoff between growth and inflation for the US economy. With inflation remaining stubbornly high even against the backdrop of anemic economic growth, this suboptimal tradeoff is not just emerging prominently but is actually being exacerbated as the Federal Reserve continues to hike rates.

Private Sector Showing Signs of Recession

Another interesting trend revealed in the data is the bifurcation between certain measures of economic and government activities. We see, for example, that indicators of private sector economic activity are showing signs of weakness even as measures of government spending reveal growth.

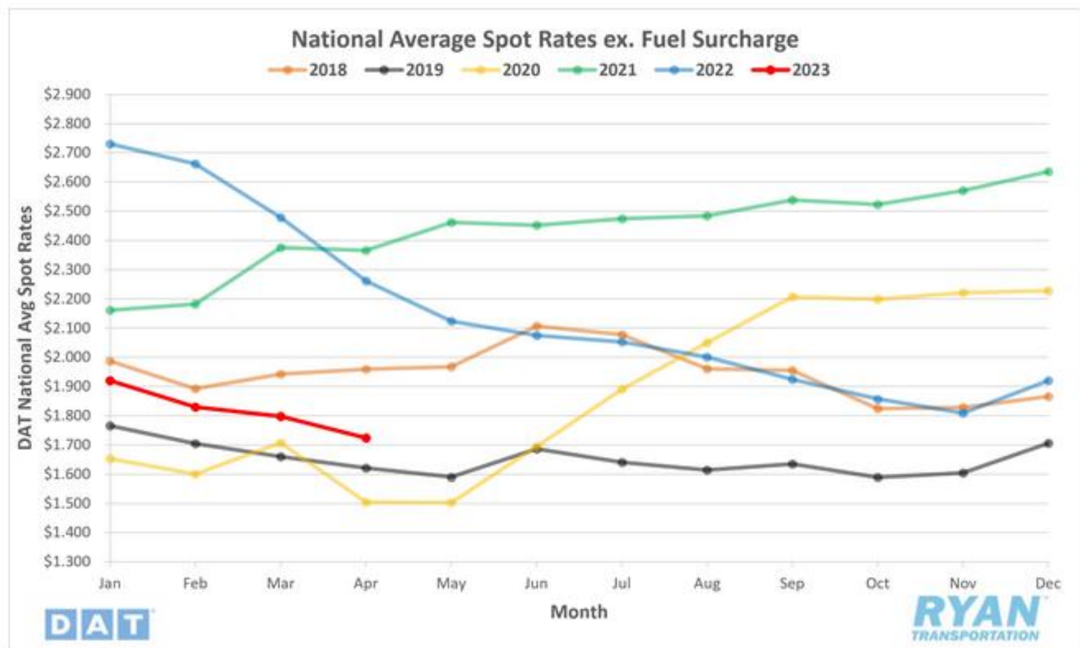
In particular, advance retail sales came in weaker than expected with a modest month-over-month increase of 0.4%, following a revised -0.7% for the prior month.

Furthermore, the University of Michigan Consumer Sentiment index fell 7% in May to 59.2 following a reading of 63.5 in the prior month. Commentary provided by the University of Michigan stated that, "Consumer sentiment slid 7% amid worries about the path of the economy, erasing nearly half of the gains achieved after an all-time historical low from last June."

Similar trends can be observed in earnings reports released by companies understood to be most economically sensitive. Home Depot (NYSE:HD), for example, missed revenue expectations despite how carefully managed those expectations tend to be, and went on to provide a muted outlook for the remainder of the year.

Another real time —albeit "noisy"— barometer of economic activity is the trucking and freight industry. Amidst other industry news, April's freight-related indicators showed further declines. The Cass Freight Index -not seasonally adjusted- showed a total decline of 9.6%, including a volume decline of 2.4% and an expenditure decline of 14%. While the expenditure component includes some (mostly) unrelated effects of energy prices, the volume decline does indicate a slowing economy.

This is compounded by an increased imbalance in the freight market with spot rates having their worst start since 2020 (see chart below).



On an inflation-adjusted basis, current spot rates (ex-fuel surcharge) are below 2019 levels, which could be interpreted as a harbinger of stress in the market, particularly given that 2019 was itself not a particularly strong year for trucking as tariffs on Chinese exports were then starting to take hold. These current downward trends may mean many operators, particularly smaller ones, might not have enough runway for them to stay above break-even. Further affirmation of this trend is

evidenced by a trucking population that contracted in April, with revocations exceeding new entrants by 1,294.

Government Deficit Spending Has Been Propping Up the Economy

While analyzing economic data for the first half of 2023, it is important to note that increased government deficit spending was the factor that moved the economy from contraction to expansion. According to the CBO, the federal deficit is expected to grow from 5.2% of GDP in 2022 to 5.8% GDP in 2023. For context, the average federal deficit between 1973 – 2022 was 3.6%. In other words, the obvious reason that the economy has not contracted during the first half of 2023 is the support lent by excess deficit spending of ~2.2% of GDP.

Another way to calibrate the impact of Federal excess deficit spending on measured economic outcomes for 2023 is to look at both personal income and the impact of government transfers. Excluding government transfers, personal incomes grew marginally —only 1.2%— from $14.48tn in April 2022 to $14.66tn in April 2023 (all measured in 2012 dollars).

For the same period, however, disposable personal income grew from $18.3tn to $19.7tn, an increase of ~7.7%, predominantly driven by government transfers. Over the long term, with respect to impact on the economy, these government transfers are a zero-sum game played using higher taxes, higher debt service, higher inflation, or all of the above.

Increased inflation and higher interest rates are providing the short-term governmental "sugar high" that will inevitably return to equilibrium which, in our view, will include some form of economic contraction.

Some Eurozone Economies Already Contracting & China Underperforming

It may be worthwhile to note that the global picture is not much better than that presenting itself in the US. The German economy, for example, declined by 0.5% in Q4 '22, only to be followed by another drop of 0.3% between the following January and March. Similarly, Eurozone manufacturing PMI dropped from 45.8 in April to 44.8 in May.

The Eurozone economic malaise is, like the US's situation, can fairly be attributed to excessive government growth. In the short term, this condition boosted GDP even as it fueled inflation. In the medium-to-long term, however, expansion of government will trigger further inflation while also leading to higher interest rates and lower economic growth.

As evidence that these conditions are not limited to the West, we note that the Chinese economy – for which there had been grand expectations associated with the country's reopening - has also been underperforming.

MONACHIL
CAPITAL PARTNERS LP

Opportunity Set

These fact patterns, in our view, continue to transfer value from equity investments to debt investments, thus providing increasingly attractive entry points into credit markets as interest rates continue to climb higher. We expect these attractive risk-adjusted entry points to continue to present themselves over the next few months.

Ali Meli

Lead Portfolio Manager

Monachil Credit Income Fund

MONACHIL
CAPITAL PARTNERS LP

DISCLOSURES

This information has been furnished ***as a courtesy by*** Monachil Capital Partners LP ("Monachil"). This document is for informational purposes only and does not constitute an offer or solicitation by Monachil for ***any investment.*** The information set forth herein does not purport to be complete and is subject to change. This information is not to be reproduced or redistributed without the prior express written consent of Monachil.

This document should not be the basis of an investment decision, an investment decision should be based on your customary and thorough due diligence procedures, which should include, but not be limited to, a thorough review of all relevant offering documents as well as consultation with financial, legal, tax and regulatory experts. Although the information provided herein has been obtained from sources which Monachil believes to be reliable, we do not guarantee its accuracy, and such information may be incomplete or condensed. The information is subject to change without notice. No representation is made with regards to the information indicated herein.

Statements made herein include forward-looking statements. These statements, including those relating to future financial expectations or future opportunities, involve certain risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. Prospective investors are cautioned not to rely on these forward-looking statements and projections. Certain information contained in this presentation constitutes opinions, intentions or beliefs of Monachil, which may be preceded by the terms "belief," "opinion," "consider," "anticipate," "seek," or other similar terms. Such statements of "opinion" merely represent Monachil's state of mind and should not be construed as a material statement of fact.