MONACHIL
CAPITAL PARTNERS LP

MARKET AND ECONOMIC INSIGHTS

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Introduction and Overview

Welcome to our March 2024 monthly report. As is our practice in these commentaries, we aim to highlight topical matters and assess their potential impact on financial markets.

We begin this report by highlighting the general sense among market observers and participants that there has been an ease in financial conditions, with inflation retreating somewhat and persistent speculation about imminent rate cuts. We see this perceived "ease in financial conditions" as being less about some reversion to normalcy than it is about the euphoria pervasive in both the public equity and debt markets. Indeed, we're reminded of a headline in our last monthly report which said, "CPI and inflation running hotter than expected, retail sales weaker than expected," which aptly describes February economic releases we have received to date.

In our view, the themes of market euphoria and hotter-than-expected inflation are not just uncorrelated but are rather entirely predictable dance partners at a party deejayed by the Fed. Whether because of lack of supervision or being just too permissive, we see the Fed as taking too soft a stance on inflation, which does very little to fight the creation of asset bubbles. Perhaps it can be argued that fighting asset bubbles is not part of the Fed's mandate, but by not doing enough to fight inflation and even tacitly condoning inflation to run above 2%, the Fed is encouraging stretched asset prices and a model of economic growth fueled by deficit spending.

In this report, though, we will spend less time on what the Fed should be doing if they were serious about fighting inflation, and rather focus on how its soft views on inflation could impact market dynamics and various asset classes.

Fed's soft stance on inflation is fueling asset price appreciation across multiple markets

Over the past few months, we have observed the reaction of various asset classes to dovish comments from the Fed. The market perception of the Fed has shifted to a point where the Fed's framework for setting monetary policy can be characterized as supported by these pillars:

- The Fed believes its current policy stance is adequately restrictive
- The Fed believes that it will be able to bring inflation to 2% while signaling its readiness to cut interest rates
- The Fed believes that it can backstop banks and treasury markets without creating inflationary pressures
- The Fed is looking for hair-trigger reasons to rush toward cutting short-term rates

This perception of Fed policy has been instrumental in creating the current cross-market rally. As a side note, we would also like to note that if the market's perception of the Fed's stance is correct, the Fed will have a challenging time fighting inflation.

The current rally is unusually broad with impact across multiple asset classes, a phenomenon which is typically associated with monetary easing and ample liquidity. This could encourage excessive risk-taking, the formation of asset bubbles in certain sectors, and a looser focus on downside protection in other markets. In some instances, of course, markets feed off each other in a kind of positive feedback loop. A rally in credit markets, for example, could create structural demand for equities by easing access to capital.

Although we pay particular attention to two markets that indirectly impact private credit—the CLO market and the IPO market—signs of exuberance are pervasive across various asset classes, from SPACs and digital assets to commodities such as copper and cacao.

Resurgence in the CLO market continues

An increased appetite among investors and greater allocation of capital to the segment has spurred a significant rally in the CLO market over the last few months. According to VanEck, BB CLO tranches (which we found interesting earlier in the year), having returned 24.52% for calendar year 2023, continue to see strong demand. According to Fitch, annual issuance reached $90.2bn in 2023, and is currently projected to reach $135-145bn in 2024, according to Barclays.

Though we do not have any particular insights to determine if such projections are realistic or not, we would point out that the perception of increased activity in the CLO new issue market has generally signaled market tightening and market tops for credit. New issue CLOs create structural demand for the leveraged loan market, which in turn fuels M&A activity, including acquisition by financial sponsors. They also tend to lead to loosening in covenants and other protections for their creditors.

We think the allocation of capital to the sector, which is fueled by the Fed, will further encourage risk-taking and easing of financial conditions.

Signs of life return to the IPO market

As credit-focused investors, we typically pay less attention to the IPO market, which has been virtually closed for the last two years, but the IPOs of Reddit and Galderma show a renewed appetite for new share offerings.

That said, the dynamics of these last two years have had a profound impact on other asset classes, including private equity (PE). In particular, the closing of the IPO market blocked a vital exit path for PE sponsors and their investments, which curtailed PE sponsors' ability to return capital to their investors. This, in turn, has resulted in increased investor scrutiny on the pace of cash returns to investors.

The increased activity in the IPO market, especially for smaller companies, could enable some PE sponsors to initiate exiting their positions and to return capital to their investors. This could, in turn, increase the urgency to deploy capital in private equity or other asset classes.

Fed policy and easy money is enabling risk-taking in both debt and equity markets

We see the Federal Reserve's casual attitude toward inflation at play in the current bout of risk-taking. While we believe cuts in the Federal Fund Rate are a possibility, we are gravely concerned about the wisdom of taking a *laissez-fare* attitude towards inflation. We note, for example, that the February 2024 CPI print showed a 3.2% increase year-over-year, and CPI Ex Food and Energy came in at a 3.8% increase year-over-year. Since then, commodity markets have experienced increases in pricing (e.g., oil is quoted at $83.11/bbl on March 29th compared to $73.82/bbl on February 1st).

As such, we think it is premature to conclude that inflationary pressures are receding. Despite these factors, dating as far back as December 2023, the Federal Reserve and Chairman Powell have shown eagerness —or, one might argue, at least a readiness— to discuss lowering interest rates, even during periods when the path to achieving a 2% target seemed uncertain.

Downside protection remains paramount

We believe that the current market conditions make essential an increased caution and careful focus on downside protection. Compared to 12 months ago, investors are generally getting compensated less for taking the same unit of risk. In our view, the driver of alpha will be finding transactions and situations where there is a structural shortage of capital and where value is driven by execution and risk management, rather than taking broader views on the "cheapness" of the market.

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