MONACHIL
CAPITAL PARTNERS LP

MARKET COMMENTARY

December 2022

Introduction and Overview

Welcome to the third edition of our "public" monthly report. Our intent with these articles is to highlight items from emerging news and to comment on their potential market impact.

In our prior monthly commentary for November 2022, we highlighted 7 themes that, in our view, will impact the market.

A. Increased government borrowing and spending and an increased supply of Treasuries (and other sovereign bonds) which would need to be absorbed by private balance sheets;
B. Monetary policy tightening in the form of both higher interest rates and government balance sheet reduction;
C. China's reopening and subsequent recovery following their relaxing of its zero Covid policy, and the impact from the ensuing wave of new Covid cases;
D. Commodity prices, with a particular focus on energy prices;
E. Performance of rate-sensitive sectors of the economy, such as the housing and auto markets;
F. Duration of the current inflationary environment;
G. The impact of the recession we believe to be impending, and the associated reduction in economic output.

We continue to use these themes to analyze the economic data and market environment in December.

Monachil Commentary and Data

December appeared to show further signs of economic deceleration, with the US Manufacturing Purchasing Manager's Index (PMI) coming in at 46.2 and the US Services PMI at 44.7, with these measures combining for a Composite PMI of 45. At the same time, the ISM Manufacturing Index came at 48.4 and the ISM Services Index at 49.6, each of which significantly underperforming market expectations. This trend was compounded with December Non-Farm Payroll data revealing average hourly earnings to have increased only 4.6% year over year, while CPI real average weekly earnings <u>declined</u> 3.1% over the same period, all of which we see as problematic for prolonging the trend of negative wage growth, i.e., wages growing at a slower rate than inflation.

Although there may be some lag before lower wages are reflected in GDP and consumption data, we believe the ISM and PMI data do already indicate inherent weakness.

Another data pattern that we see as cause for concern is the diverging trends between the rate of consumer credit growth and the savings rate. Specifically, November's Consumer Credit data published by the Federal Reserve showed an annual increase in credit consumption of a seasonally adjusted 7.1%, with the largest single proportion (16.9%) attributable to revolving credit. According to the same Fed data, the interest rate on this type of credit product has increased from 14.51% in Q4 2021 to 19.07% in November 2022. We contrast this with the US Personal saving rate, which as of November 2022 declined to 2.4%, which we see as being dangerously close to the historical low it achieved in July of 2005 when it touched 2.1%. This is a subtle point to be sure, but we pause to consider this rate compared to its 50-year average of 8.3%.

We interpret this to mean that consumers are dipping into their savings to fill the gap created by the cost of household expenses increasing at the current rate of inflation while their earnings are not. Furthermore, we see the size of this gap continuing to be exacerbated as the cost of servicing debt grows, and more expensive household debt forces consumers to commit a larger portion of their monthly income to pay it. To bring our thesis full circle, this higher cost of household debt is a direct result of the higher level of government borrowing and deficit spending which serve to foster inflation and increase the general level of interest rates, a kind of painful loop of mutually reinforcing negative feedback.

We believe that it is intrinsically self-evident that this situation is not sustainable, and that the only plausible resolution will be lower consumption accompanied by a decline in consumer credit and the emergence of an unambiguously recessionary environment.

Although we witnessed some commentators celebrating December payroll data as a sign of inflation having been tamed and an impending soft landing, we see such celebrations as more hopeful than analytical, and anyway entirely premature, specifically considering the most recent CPI data which reflected a 6.5% YoY increase.

We believe inflation may moderate somewhat, but negative real wage growth is an ominous sign for the health of an economy and is a direct result of lower labor productivity and government deficit spending. In short, we view the factors driving real wages lower, and potentially negative, to be systemic and sustained, while the components driving a decline in inflation may not be. For example, electricity prices have recently shown a YoY increase of 14.3% and we expect this trend to continue as the fuel mix in the electricity grid shifts. Conversely, we are less convinced that the recent 8.8% annual decline in used vehicle prices presents a sustainable trend. While we do believe that the used car price component of CPI may decline in the short term, we see that as mostly attributable to CPI data having not yet caught up with actual auction prices. We further believe that this downward trend will begin to run into supply side issues as 2020-21 autos begin coming off lease and available for sale in the secondary market. In a similar vein, i.e., not so sanguine on inflation, we believe there are limits to the potential for further declines in gasoline prices which have been an instrumental driver of lower CPI numbers in recent months.

Though helpful in the battle against inflation, lower real wages alone are not adequate to declare victory. In our view, any benefit derived from lower real wages will be offset by the impact of China's reopening – which we expect after the Chinese New Year. Fueled in part by the demand that ensues from China's reopening, we believe energy and commodity prices will be increasingly important drivers of inflation in the short term. For context, December saw another 17mm barrels released from the Strategic Petroleum Reserves (SPR), moving the SPR from 389mm at the end of November to 372mm at the end of December. We do not see this as sustainable.

We detect evidence of these conditions being further exacerbated in the dollar index (DXY), which has declined from a September level of 112.12 to 103.52 by the end of December, a decline of 7.7%. This means that some of the disinflationary benefits of a strong dollar will start to reverse, and we expect this will be reflected in the inflation data available over the next few months. Put another way – and with all irony intended - we believe some recent drivers of deflation, including a stronger dollar, may themselves prove to be only transitory, which would mean further restraints in economic conditions may be required to keep inflation in check.

Looking Ahead

As a result of the dynamics that we have described above, we expect some of the weaker hands in various sectors of the consumer finance markets to either exit or face significant challenges over the next few months. We believe this will make for interesting opportunities in consumer Asset-Backed Securities and other asset classes with potentially higher risk-free rates and possibly wider credit spreads providing for increasingly interesting entry points.

Ali Meli
Founder and Managing Partner

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