MONACHIL
CAPITAL PARTNERS LP

MARKET COMMENTARY

February 2023

Introduction and Overview

Welcome to the third edition of the monthly report we make available to the public. The intention of this commentary is to highlight topical matters and to assess their potential impact on markets.

Monachil Credit Income Fund (MCIF) returned 1.43% in January 2023 and 1.23% in February 2023, bringing its Cumulative Total Return to 3.62% since its launch in December 2022.

Monachil Credit Income Fund Class I Monthly Performance[1]

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Cumulative Total Return
2022												0.91%	3.62%
2023	1.43%	1.23%											

[1] Monachil Credit Income Fund inception date is December 5, 2022. Performance data for December 2022 was calculated starting on December 3, 2022. Refer to Disclosures for more information. The performance shown is net of fees and assumes reinvestment of distributions. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. **Past performance is no guarantee of future results.**

This month we will continue our discussion of the economic outlook in broadest terms while also focusing on the recent upheaval in banks and the financial sector. In particular, we will consider the Asset Liability Management (ALM) mismatches that fueled bank failures and imperiled the financial system, garnering significant attention domestically and internationally. We will also discuss a variety of factors that are contributing to the pressure on banks, and we will highlight how the current banking crisis may impact our economic outlook. Finally, we will reflect on the investment opportunities that will emerge from the current environment, especially those that will become available to us as a better provider of liquidity given the long-dated nature of our liabilities.

Economic Outlook: Recession and Inflation Concerns

Our view of the economic outlook has remained consistent for these months, with our base case being that the US will enter a recession while inflation remains elevated. We view this as a direct result of the worsening trade-off between sustaining growth and controlling inflation, as implemented by the Fed. Furthermore, we consider the newly burgeoning banking crisis to be the latest transmission mechanism by which the impacts of higher interest rates are finally translating into slower economic growth and inevitably lower inflation.

January and February Market Recap

January was characterized by another case of irrational exuberance, epitomized by Bed Bath & Beyond shares rallying even as the company teetered on the brink of bankruptcy. In short, January appeared to be another example of an "everything rally."

February, on the other hand, was more subdued, as misguided optimism for the prospect of lower inflation did steadily fade into a less sanguine reality.

Monachil Commentary and Data

The economic data from January and February painted a mixed picture with some economic data being interpreted as somewhat upbeat. We believe, however, that any positive signs were primarily driven by the noise inherent in seasonal adjustments to which the data was subject. More consequential, in our opinion, were the persistently high levels of inflation, with January's CPI showing a month-over-month ("MoM") rise of +0.5% and +6.2% year-over-year ("YoY"). This was followed by February's CPI increasing by +0.4% MoM and +6.0% YoY. Considering nominal interest rates are below real inflation rates, we are not surprised by these persistently high readings and believe it would be difficult for the Fed to control inflation without creating demand shocks. Despite this evidence, there continues to be speculation that inflationary pressures are easing, with some commentators predicting that the banking crisis could result in tightened financial conditions and thus, lower inflation. We believe such an outcome is plausible provided that the regulatory response to the current crisis does not promote further risk-taking and that the policy response to the current banking crisis does not devolve into uncontrolled money printing, both of which are potential drivers of irrational markets.

Banking Sector Analysis: A Closer Look at Asset and Liability Mismatches and Regulatory Responses

In our assessment, the primary causes of stress on banks can be traced to:

1. ALM and the inherent mismatches that result from banks' over-reliance on deposits as a primary source of funding.
2. The regulatory and policy responses that have been implemented over the past 15 years are now revealing themselves to have been misguided and to have fallen short of their intended goals. Included in this category would be the "Volcker Rule," which aimed to eliminate risk in depository institutions.

The Anatomy of a Banking Crisis: Lessons from 2008

To better understand the current situation, it is helpful to revisit the 2008 financial crisis. Financial markets faced a liquidity crisis catalyzed by the freezing of repo markets and plummeting demand for commercial paper. The market implications of these events reached their pinnacle when Lehman Brothers' holdings suffered material mark-to-market losses, resulting in a sharp decline in the market value of their equity, and ultimately to their catastrophic failure. Regulators, policymakers and politicians misinterpreted these events, which resulted in two misguided conclusions:

1. The primary reason that investment banks Lehman Brothers and Bear Stearns failed was because, unlike commercial banks, they did not take deposits, which were deemed to be a safe and stable source of funding.

2. The investment banking practice of carrying trading books at mark-to-market valuations, rather than at fair value or cost, was an accelerant for bank failures.

We believe that both conclusions were not only flawed, but also drew attention away from the real issues. By considering a large deposit base to be a stable source of funding, regulators continued to ignore the inherent resulting ALM mismatch, i.e. between short term liabilities (deposits) and long term assets (like mortgages). Furthermore, criticizing mark-to-market accounting, rather than making it a requirement, meant that hidden losses on bank balance sheets remained unnoticed until they became quickly exposed, and indeed realized when long-dated assets needed to be sold to honor the maturity (withdrawal) of short-dated liabilities. Together, these responses prompted the creation of the regulatory framework that led to the failure of Silicon Valley Bank.

To be more precise, the reason that a funding strategy reliant on an ALM mismatch may eventually result in financial vulnerability is due to two predominant factors that can adversely affect the stability of a bank's deposit base: loss of confidence in the creditworthiness of the deposit-taking bank (the borrower) and the rate of interest paid for those deposits (to lenders). If depositors have reason to question the creditworthiness of their bank or if they identify an alternative that will pay more interest, those deposits can be moved rapidly. These vulnerabilities have been exacerbated by the emergence of online banking, where depositors are only a click away from moving their money with instantaneous effect. The same general phenomena apply not just to retail banks, but to a wide variety of financial institutions, including investment banks.

In short, regulators misjudged the stability of overnight deposits and the wisdom of daily mark-to-market accounting, with the consequences of their miscalculations leading to the failures of both. If regulators required Silicon Valley Bank and Credit Suisse to be funded with more long-term liabilities, to hold more short duration assets and to better understand the value that could be realized for all assets on their balance sheets, their fates could have been different. (That their business models would have then had to be radically different is another matter.)

In addition to these two primary culprits, an additional mistake made in the *ad hoc* formulation of the post-2008 regulatory framework resided in the area of risk management and risk measurement. After the financial crisis, regulators incorrectly singled-out "prop trading" as a significant cause for the failure of Lehman Brothers and Bear Stearns. The response was to simply move to a framework which required banks to change the classification of the risk they were permitted to take, without changing the substance. Trading and holding corporate bonds or loans creates the same risk exposure as directly making loans to corporations. Simply changing the name of the activity from "prop trading" to "investing" or "lending" does nothing to modify the risk banks are allowed to take. We believe the failure to identify substance over form is most pronounced in banks' real estate portfolios. We expect the risk management and regulatory miscalculations made over the past 15 years to become increasingly evident as the current crisis continues on its course.

Returning to our inflation discussion, we view the pressure that banks are now under as a mechanism to begin transmitting the impacts of higher rates into lower inflation.

For example, as deposits continue to leave the banking system, banks will feel the pressure to increase their deposit rate and, thus, be required to charge higher interest rates on their loans, resulting in the size of their loan books being reduced as many people will simply be "priced out."

We believe that there is always risk that policymakers will succumb to political pressure and prematurely ease financial conditions, either by providing cheaper access to liquidity or by failing to continue enacting necessary anti-inflationary policies. We still posit that giving way to those pressures would be yet another policy mistake by the Fed.

Outlook and Opportunities

The many recent newsworthy events caused by ALM mismatches within commercial banks is having a second order effect in creating a growing opportunity set for entities that are funded with long-term liabilities. The Monachil Credit Income Fund, for example, is funded with liabilities that have a weighted average life ("WAL") of more than two years and has an asset profile commensurate to that WAL, making it better positioned to be a provider of long-term credit.

In the current environment, as banks continue to reduce their appetite to take credit risk (in the form of making direct loans), we have observed a sustained widening in credit spreads. We expect this dynamic will persist, thereby creating a scenario where there are more forced sellers (think ALM mismatch and the need to honor withdrawals) and motivated borrowers with fewer alternatives. We believe both situations will present interesting opportunities. As risk-free rates continue to move up while credit spreads widen, we anticipate the emergence of increasingly attractive entry points into markets. In conclusion, we believe the current economic and market climates will persist in providing new opportunities for the Fund. We will continue to monitor the situation closely and adjust our strategies accordingly in order to maximize returns for our investors.

Ali Meli

Founder and Managing Partner

Monachil Credit Income Fund

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