MONACHIL
CAPITAL PARTNERS LP

MARCH INVESTMENT AND ECONOMIC INSIGHTS

April 2023

Introduction and Overview

Welcome to the March installment of our monthly report, where our intention is to highlight topical matters and to assess their potential impact on markets.

Monachil Credit Income Fund (MCIF) returned 1.95% in March 2023, bringing its Cumulative Total Return to 5.64% 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%	5.64%
2023	1.43%	1.23%	1.95%										

[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.**

Past performance is not indicative of future results. Current performance may be lower or higher than the figures shown. Principal value and investment returns will fluctuate, and investors' shares, when redeemed, may be worth more or less than the original cost.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Monachil Credit Income Fund before investing. For a prospectus that contains this and other information about the Fund, call (855) 552-5520 or visit our website at www.monachilfunds.com. Please read the prospectus carefully before investing.

In this report, we will focus on the United States Federal Government's increasingly deteriorating fiscal picture and its potential impact on the Federal Reserve, capital markets, and the state of inflation. We believe this fiscal environment is nuanced and is characterized by the interplay between interest rate levels, the availability of capital for the private sector, the health of bank balance sheets and across-the-board asset valuations. Though this condition is subtle indeed, it will have profound implications to be revealed during the next one to three years.

In our view, ongoing extravagant spending fuels the Federal Government's need to borrow more, but this is at odds with the Fed which is constrained from issuing new debt in the face of high inflation, a conflict that can create some short-term price volatility. The market's capacity to hold financial assets is, after all, not unlimited and more borrowing by the Federal Government would require that debt investors earn more as both risk-free rates and spreads remain elevated. We believe that this topic is timely given the ongoing debt ceiling debate.

Economic Data: Continued Worsening Trade Off Between Growth and Inflation

The March 2023 Consumer Price Index (CPI) registered a rise of 0.1% MoM and 5.0% YoY, with gasoline and fuel oil being major contributors to the continued decline from record levels (-17.4% and -14.2% YoY, respectively). Used cars and trucks, which have registered a decline of -11.2% YoY, have been other major contributors to the YoY CPI metric. During the current month, however, the decline

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in the growth rate of CPI was accompanied by sharp declines in retail sales, which fell 1% MoM, likely indicating a proportional decline in consumer spending. The index's rise of 5% YoY brings it in line with the level of short-term interest rates.

We see as noteworthy that the recent mild softening of inflation was accompanied by such a significant fall in retail sales. Although these monthly numbers can be noisy, so to speak, the overall picture nevertheless shows that in months where retail sales grew, inflation also rose more than expected. Conversely, in periods where inflation appeared to be under control, multiple measures of consumer spending came in weaker than had been expected.

Optimistic (or hopeful?) prognosticators have been promoting the likelihood of a "soft landing" in the US economy. We believe that recent economic data suggests that a sustained period of mild inflation combined with moderate economic growth is not in the cards and, as such, we see real recession as the more probable outcome.

Another revelation released within recent economic data indicates a faltering fiscal position for the US Federal Government. On April 10th, the Congressional Budget Office (CBO) published its Monthly Budget Review for March 2023. The report covers the first half of US fiscal year 2023 (October 1, 2022 to March 31, 2023 period) and it paints a picture of a Federal Government with a fiscal outlook that is rapidly deteriorating. For example, outlays were 13% higher while revenues were 3% lower as compared to the similar period in the prior year. Furthermore, the federal budget deficit was $1.1 trillion during this period. (This data was somewhat nuanced, however, stemming from the impact of April 1st falling on a weekend, which had the effect of increasing the reported deficit by $10 billion.) The table below has been excerpted from the CBO report and summarizes the extent of current imbalances.

Table 1.

Budget Totals, October–March

Billions of Dollars

	Actual, FY 2022	Preliminary, FY 2023	Estimated Change	Estimated Change With Adjustments for Timing Shifts in Outlays[a]: Billions of Dollars	Estimated Change With Adjustments for Timing Shifts in Outlays[a]: Percent
Receipts	2,122	2,049	−73	−73	−3
Outlays	2,790	3,147	357	346	12
Deficit (−)	−668	−1,099	−430	−420	63

Data sources: Congressional Budget Office; Department of the Treasury. Based on the *Monthly Treasury Statement* for February 2023 and the *Daily Treasury Statements* for March 2023.

FY = fiscal year.

a. Adjusted amounts exclude the effects of shifting payments that otherwise would have been made on a weekend. If not for those shifts, the budget would have shown a deficit of $1,088 billion rather than $1,099 billion from October 2022 through March 2023, CBO estimates.

Furthermore, we anticipate this picture continuing to worsen over the next few years as outlays continue to increase as the cost of higher debt service begins to be factored into the outlays. In the last six-month period alone, Net Interest on public debt increased from $219 billion to $308 billion, a 41% increase.

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Equally noteworthy is that remittances from the Federal Reserve decreased from $61 billion to less than $1 billion as the negative carry on its treasury holdings continues to have an impact. Mark-to-market losses of the Federal Reserve's holdings of treasuries and Mortgage-Backed Securities (MBS) tell an even grimmer tale, one which will worsen as interest rates rise. Losses on holdings in the System Open Market Account are estimated to be in excess of 1 trillion dollars (see page 41 of Federal Reserve Banks Combined Financial Statements for the years ended December 31, 2022 and 2021). We would caution that the term "unrealized" in the government's financial statements should be taken with a grain of salt, or perhaps one of planetary proportions. These are real losses and would have been reported as such by any other holder of government securities. More to the point, these losses will actually flow through Federal Government's balance sheet over the next few years and should, therefore, in our view, be recognized now rather than at some arbitrary date in the future. Indeed, the Federal Reserve system would likely be considered insolvent under any other accounting standards.

Returning to the federal budget deficit, the CBO currently projects the 2023 deficit to be $1.4 trillion, which is in line with the 2022 actual deficit of $1.375 trillion. We see this as a material underestimate given that the deficit for the first 6 months of 2023 has been ~$300 billion worse than the comparable period in 2022. In our view, absent an inflationary shock that increases Federal revenues, the deficit for 2023 may approach $2 trillion, particularly given the combination of the downturn in economic activity and higher interest rates. Specifically, spending incorporated in the misleadingly named "Inflation Reduction Act" is expected to be much higher than CBO projections, irrespective of Senator Manchin's dubious assertions that he intended otherwise.

Given this trajectory, debt service will soon reach more than 30% Federal revenues, which, along with entitlements and defense spending, will consume all Federal Revenues. This will make the Federal government reliant on deficits to support its most basic discretionary spending.

We believe that the inevitable longer-term implications of these deficits, including the required issuance of government debt to finance them, will be higher levels of long-term interest rates which, in turn, will cause the Federal government to begin competing with the private sector for market allocations of capital. In our view, proponents of Big Government from either side of political aisle, ranging from Dick Cheney who was notoriously quoted as saying that "deficits don't matter" to left-leaning supporters of Modern Monetary Theory, should be embarrassed by the current fiscal situation.

Given our expectations about the impending trajectory of government debt and interest rate levels, the question that arises is, "Why has there been a limited impact on interest rates to date?" The answer lies in the fact that the US reached its debt ceiling limit of $31 trillion on January 19th, 2023, thus triggering the "debt ceiling limit." While subject to the limit, the government is precluded from increasing the supply of treasuries, forcing the Treasury to use cash, particularly from the Treasury General Account (TGA), to pay government expenses since January 19th. It is reasonable to argue that reaching the debt ceiling creates a covert form of quantitative easing since the Federal Government spends money (and increases the money supply) without increasing the supply of treasuries (decreasing the money supply).

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We believe the debt ceiling limit will be resolved without any real change to federal spending patterns. The implication is that, once it is resolved, a significant supply of Treasury securities will be issued for the Treasury Department to replenish the TGA and other relevant accounts. If the Treasury Department elects to fund $800 billion into the TGA balance to support year-to-date spending while also borrowing another $400-700 billion for subsequent spending requirements, then approximately $1.2-$1.5 trillion additional treasuries will quickly reach the market.

An additional supply source of treasuries stems from the Fed's initiatives to normalize monetary policy and to reduce the size of their balance sheet. As of April 12th, the Fed's holdings of treasuries and MBS had declined by $276 billion from the beginning of the year. At the current pace, the holdings will decline would an additional $682 billion between April 13th and the end of the 2023.

If we add together the treasuries that will hit the market and the size of the reduction in the Fed's balance sheet, there are approximately $1.9-$2.2 trillion of treasuries that the market will need to absorb between now and year end. Who will be the buyers? This may be the first time in 15 years that this quantity of treasuries will be hitting the market in such a short time frame. Since the Financial Crisis of 2008, purchasers and holders of US Treasuries typically fell into the following categories:

- Federal Reserve through its Quantitative Easing policies
- Banks that could hold treasury securities without also holding regulatory capital (they were exempted from regulatory solvency calculations).
- Foreign Central Banks and Sovereign Wealth Funds (including in China, Russia and Japan)
- Other market participants such as money market funds and asset managers.

Given the current financial markets and geopolitical landscapes, we don't expect the first three categories to have much incremental appetite, particularly in maturities beyond 5 years. As mentioned in some of our earlier reports, we have no doubt that the Treasury will find buyers. The question is, "At what price will they find them?" We believe the answer will be at increasingly higher than current yields and with a "term premium" for longer maturities.

We believe an implication of these higher yields will be a profound impact on the allocation of capital and resources in the real economy. An additional outcome will be to hasten the flow of funds away from banks and into money market funds, thus putting pressure on banks to increase the deposit rates which will, in turn, reduce their ability to be a provider of capital.

Furthermore, as the cost of debt for private sector issuers continues to increase, more value will be transferred from equity holders to debt holders. We believe the ability of debt issuers to service debt at these increasing levels will be challenged, as is currently being observed in the Commercial Real Estate market—particularly for office buildings. This condition may, in turn, create downward pressure on the real estate market. We expect a similar dynamic to exist in most lending, including corporate and middle market lending, as the cost of debt as well as higher risk premiums will put increasing pressure on asset valuations. We have heard several real estate market and private equity commentators talk about "money sitting on the sidelines". We believe the appetite to transact in these markets will be a function of cost of credit as well as returns available from the treasury market.

Compounding the current situation, we believe that there is a “double whammy” taking place. Given the change in the Federal Reserve’s monetary policy where it previously protected asset prices by buying treasuries and lowering rates, the artificial demand for treasuries is gone. This will soon be accompanied by a large supply of treasuries hitting the market, providing a further catalyst of higher rates and risk premiums.

As a side note that we see as somewhat related to our prior discussion, over the past few weeks we have observed some commentary about the increasing challenges for the US dollar to retain its position as the reserve currency. The evidence being presented is that certain commodities or other international transactions typically priced in USD are now being priced in other currencies. In our view, the clearing currency for international trade is less relevant than the currency in which the proceeds are used. We would consider it to be largely irrelevant if Brazil sold its exports to China in Yuan, Rubles, gold, or even by barter. An electronic ledger can handle any fair exchange. What matters most is what countries with trade surpluses do with the proceeds of their trading activity. It would be far more meaningful if surplus countries moved their reserves away from holding US dollar assets.

Correspondingly, US government securities will be far more appealing as rates continue to rise, provided those rates are not manipulated by the Federal Reserve. This is an Econ 101 dynamic that we see in many other countries where central banks increase policy rates to make local currency holdings more attractive. We believe maintaining a sound monetary policy will enable the US dollar to maintain its reserve currency status. Hence, a higher return on treasuries and debt securities denominated in USD may be exactly what the dollar needs.

Outlook and Opportunities

We believe the additional supply of treasuries that will be hitting the markets over the next few months will help to create higher return opportunities for debt investors. A secondary impact of rising rates is likely to be further constraints on banks to be a provider of debt. This combination could result in attractive opportunities for alternative sources of debt capital and for the repricing of debt.

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 to maximize returns for our investors.

Ali Meli

Lead Portfolio Manager

Monachil Credit Income Fund

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IMPORTANT RISK INFORMATION

An investment in the Fund involves substantial risks, including the risk that the entire amount invested may be lost.

The Fund has been organized as a continuously offered, closed-end management investment company. Closed-end funds differ from open-end funds (commonly known as mutual funds) in that investors in closed-end funds do not have the right to redeem their shares on a daily basis. Therefore, an investment in the Fund, unlike an investment in a typical closed-end fund, is not a liquid investment. **To provide some liquidity to Shareholders, the Fund has been structured as an "interval fund" and will provide quarterly repurchase offers for a limited amount of the Fund's Shares (no less than 5%).** In addition, with very limited exceptions, Shares are not transferable, and liquidity will be provided only through repurchase offers made quarterly by the Fund. **Shares in the Fund are therefore suitable only for investors who can bear the risks associated with the limited liquidity of**

Shares and should be viewed as a long-term investment. There is no guarantee that Shareholders will be able to sell all of the Shares that they desire to sell in any particular repurchase offer.

The Fund cannot guarantee that its investment objective will be achieved or that its strategy of investing in the Fund will be successful. The Fund is a "non-diversified" investment company under the Investment Company Act of 1940, as amended and, therefore, may invest a greater percentage of its assets in a particular security than a diversified fund.

The Fund may use leverage. The use of leverage increases both risk of loss and profit potential.

The Fund's investment in debt-related securities could subject it to credit risk which is the risk that a borrower will be unable to make principal and interest payments on its outstanding debt obligations when due. Adverse changes in the financial condition of a borrower or in general economic conditions may impair the ability to make such payments and could result in defaults. Other risk factors include interest rate risk (a rise in interest rates causes a decline in the value of debt securities) and prepayment risk (the debtor may pay its obligation early, reducing the amount of interest payments). These risks could affect the value of a particular investment, possibly causing the Fund's share price and total return to be reduced and fluctuate more than other types of investments.

The Fund's investment objectives, risks, charges, expenses and other information are described in the Fund's Prospectus, which must be read and considered carefully before investing. You may obtain a copy by calling (855) 552-5520 or visiting www.monachilfunds.com. Please read the Fund's Prospectus carefully before you invest.

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