

## Introduction and Overview

Welcome to our monthly report, where we aim to highlight topical matters and assess their potential impact on financial markets.

In our [September 28, 2023 letter](#), we wrote, “The Fed itself has suffered significant losses in its treasury holdings while also employing questionable accounting practices.” This may have struck some readers as an audacious assertion, so we are pleased to see that additional light has been shed on this topic by WSJ Journalist Justin Lahart who addresses the Fed’s accounting approach in a recent piece. We will review Mr. Lahart’s noteworthy findings on this topic and the discrepancy between GDP and GDI, another theme on which we have opined.

We will also continue to cast light on the impact higher rates are having on markets and the overall economy and share some of our observations about the real estate market. Most significantly, we believe some of the disruption we are witnessing in real estate can be extrapolated to other markets, including Private and Public Equity and corporate credit markets.

## Recent widening in long term yields is consistent with our view about the low likelihood of a soft-landing

In last month’s publication, we postulated that current imbalances between savings and investment make a soft-landing extremely unlikely, as the recent sell-off in Treasuries would indicate. The current large supply of Treasuries, courtesy of large federal deficits, may be accompanied by unwanted adjustments to supply and demand for savings. In short, households need to save more, and will do so from the supply of investments available. If corporates and households are incentivized to invest less in productive investments to absorb larger supplies of government securities, the necessary adjustment to savings and investment will not be achieved. Looking ahead, we will very likely see government deficit financing continuing to crowd out private investing capacity, causing GDP growth to suffer and thus requiring asset prices to adjust.

In an interesting plot twist in the ever-unfolding macroeconomics saga, government spending that was presented to the public as “investment” plans (including, for example, the Infrastructure Bill and Inflation Reduction Act) could have the effect of driving down private sector investing and household consumption in the long term. **An example of asset prices needing to adjust is evident in commercial real estate (CRE).**

We were alarmed by the new issue CRE CLO transactions recently available in the market. It is important to note that the basis for our point of view is deal specific rating reports which are published by the established rating agencies and generally made available to the public.

What we found in those reports was that, on the surface, many of these deals look fairly safe, with Loan-to-Value (LTV) ratios averaging in the 50%-60% range. Once we scratched below the surface, however, cracks began to emerge. As a case in point please consider the following:

In CRE transactions, there are generally a few main variables to consider:

- Net Operating Income (NOI) of the properties, i.e. lease income less expenses (including taxes)
- Any investment that needs to be made for improvements
- Cost of financing
- Cost of equity

A combination of these variables are the main determinants of a property's value (or the "V" in the LTV).

There is a natural tension between providers of equity and debt capital to determine which benefits most from a property's value. As the cost of debt financing increases, cashflows available to equity investors naturally decline. Furthermore, as risk-free rates climb, returns demanded by equity investors will also increase. In the current environment, assuming NOI stays constant, the valuation of an equity investment may be poised for a double whammy:

- Less cash is available to provide returns to equity providers as higher debt financing costs eat away free cashflows, and
- This more limited pool of cash available to equity providers is subject to a higher discount rate, thus diminishing its present value.

When measuring value, therefore, it is important to consider which is the right one assuming any given level of NOI. The traditional metric for doing so are cap rates. For example, a cap rate of 5% implies that for every \$100 of value, an owner can expect \$5 of income.

Although this building block is conceptually simple, the reality of determining a valuation in this context is certainly more nuanced. Specifically, one needs to account for the possibility of fluctuations in NOI, including changes in costs driven by increases in vacancies, market rents and insurance, etc. Although the cap rate calculation is straightforward, the application is a different story.

For example, we have recently been hearing more about the use of "negative leverage", i.e. situations where the cap rate is below the cost of debt. Unless there is some asymmetric opportunity that will have the likely outcome of increasing NOI, there is no good reason for negative leverage to exist; where it does, it simply implies that the asset is overvalued.

To put a finer point on this, I will refer to some of the nuggets found in a CRE CLO that we recently reviewed. (Note: I have proportionally modified some numbers to ensure source anonymity.)

Our example will focus on a multifamily development with an NOI of \$1mm, which equates to rents of roughly \$4mm and expenses of roughly \$3mm. The investment thesis was that the property could economically be improved, which would result in the NOI increasing to ~\$3.4mm. For this example, we are not going to opine on whether such an impressive improvement in NOI is realistic and for these purposes simply assume that it is.

The pitch was that the stabilized, post-NOI improvement valuation for the property would be ~\$86mm—a value that strikes us as unrealistic. Against this valuation, the sponsor proposes to borrow \$52mm, claiming that this equates to a modest ~60% LTV.

The cost of debt was assumed to be SOFR + ~4.75%, or 10%, which is a rate that we view as very reasonable. In spite of this anchor in reality, the insurmountable issue was, given where current swap rates are (5-10 year SOFR currently around 4.4%-4.5%), the long term cost of financing this property would be around 8% (a fairly generous assumption on our part because it may actually be closer to 10%).

Assuming an 8% cost of debt, following the aforementioned NOI improvements, this property would barely manage to support its debt service on \$52mm given that its Debt Service Coverage Ratio would be below 1. Furthermore, at a 10% cost of debt, this property will be massively underwater.

It should be noted that the post-improvement cap rate being applied when deriving a value is ~4%. which we believe to be significantly off.

The moral to this story is that we believe that target cap rates for these deals need to move materially higher. For example, assuming a cap rate of 12%, this property would be worth around \$28.5mm. At that valuation and with an NOI of \$4mm, a stable and sustainable balance sheet would be comprised of \$21mm of debt returning 10% and \$7.5mm of equity returning 17.5%.

So, what is the current context of the market? Currently in the CRE space, there are precious few examples of deals that trade above an 8% cap rate, leaving most valuations, in our view, with an imbalance of risk to the downside.

Needless to say, we passed on this transaction.

In the CRE space, given our view that cashflows from many of these assets will not cover the cost of interest, we expect many to end up in foreclosure over the next few months, which will force valuations to be adjusted accordingly.

We view all of this as a cautionary tale about the current state of the wider market. There are many assets—not just those in the “relatively safe” corner which are the CRE markets—where valuations need to be adjusted (down) towards reality.

### **Impact of higher interest rates on valuations is not a bug. It is a feature!**

It is relatively easy to demonstrate the effects that higher interest rates have on valuations, performance and the investment decisions that sponsors face. At higher interest rates, the number of projects or developments that provide adequate investment returns should—and will—decline.

This is one of the mechanisms by which higher interest rates tame inflation and lower demand. Referring to our CRE example, developing real estate requires labor, materials and energy. With some of those scarce resources being diverted to pay for government projects, the respective markets for such resources will find equilibrium

through a combination of higher prices and lower demand, and a real estate correction will feature as part of that lower demand story.

### **Valuation confusion is not limited to real estate**

The valuation challenges mentioned for CRE, including the potential double whammy to equity valuations, are not unique to CRE assets.

We believe, for example, that similar challenges exist in both public and private equity markets as we do not believe these markets have fully adjusted to the reality of higher rates and the inevitable incoming supply of treasuries.

Furthermore, for many asset classes, the inherent relative value between debt and equity has changed. Without an adjustment in such premiums, derived by using higher discount rates, higher cap rates, and lower valuations, the new equilibrium will not be reached.

### **Fed questionable accounting practices also impacting the GDI reports**

We noted in our previous monthly commentary a questionable accounting practice being employed by the Fed. As a refresher, we are not referring to mark-to-market losses, which at this point exceed a trillion dollars and are the result of the decline in the market value of securities purchased during the QE binge. We are instead referring to the Fed's negative carry problem resulting from having a securities portfolio that yields less than its cost to finance it.

In response to this growing issue, the Fed has come up with a way to hide these losses which is to report them as "negative remittances to the Treasury" without the Treasury making an offsetting entry. In other words, the Fed is recording a negative liability—effectively a receivable—without the Treasury recording a payable to the Fed. To be sure, no regional bank could get away with this level of accounting "creativity," and we were pleased to see that this theme is receiving more attention than just within these four corners.

[In a recent WSJ article](#), Justin Lahart reports on these Fed losses as well as on the discrepancy between GDP and GDI, a theme highlighted in our [August 25, 2023 Commentary](#). According to Mr. Lahart's report, one reason for the discrepancy between the GDI and GDP is that interest expense incurred by the Fed and interest income earned by the banks should be reported in equal amounts. In this case, NOT doing so has resulted in slightly higher GDI numbers, albeit GDI numbers that are still materially below GDP numbers.

Where does this leave us? When it comes to government accounting, neither the Fed nor the Treasury Department seems to be recording losses in asset values on their balance sheet, which leaves us to wonder about the unseen impact on the calculation of GDP. Is this, after all, a central bank that is generating losses that should be negatively contributing to the GDP? And if this is the case, by how much?



As Congress is turning its attention to the budget process and deficit spending, perhaps the Federal Reserve and Treasury Department's questionable accounting practices will start to receive some much-needed scrutiny.

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