

Introduction and Overview

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

In this installment, we discuss the possible implications of the 2024 elections on economic and market outlooks, and, in particular, how changes in government control may relate to a shift in US policy regarding tariffs as a tool to raise revenues for the federal government. This discussion aligns with our recent observations on the strength of the US dollar and global central bank policies over the past two months. More significantly, our analysis connects closely again to a major long-term market influencer, and one to which we return regularly: the size and expansion of the federal deficit and the enormity of the federal debt burden.

May Deficits Show US Federal Fiscal Picture Continuing to Worsen; Congressional Budget Office (CBO) revised 2024 deficit to \$2 trillion

The federal budget deficit for the month of May was \$347.1 billion, handily surpassing Bloomberg's estimate of \$276.5 billion. According to the [May 2024 budget report](#), published on June 10th, the deficit for the first 8 months of the fiscal year (October-May) stands at \$1.2 trillion.

For context, the May 2024 deficit of \$347 billion is \$107 billion higher than the May 2023 deficit of \$240 billion. The increased deficit is driven by higher debt service costs and larger direct spending. Even more alarming, these figures do not take into account the cost of student loan debt forgiveness, which CBO estimates will add another \$74 billion to the deficit this year.

On June 18th, as we were finalizing an earlier version of this report, the CBO revised its 2024 deficit estimate. The office now projects that deficits will exceed \$2 trillion, which is on the lower end of Monachil's estimate. We anticipate that deficits will accumulate at a rate that could exceed \$250-300 billion per month for the remainder of the current fiscal year.

It is worth noting that in February, just 4 months ago, the CBO estimated the fiscal deficit to be approximately \$1.6 trillion. Although part of the deficit increase is attributed to the rising cost of military aid, debt servicing the interest also figures prominently in driving the relentless increase. While we are glad that the CBO is now producing a more realistic view of deficits, we find the emerging fiscal picture even more disturbing. Indeed, if earlier signals were "alarming" (to use our word), then the disconcerting chirps of the bedside device have transcended into a kind of Code Red siren.

We expect that higher deficit levels exceeding 7% of GDP will continue to fuel the inflationary environment, making it more difficult for the Fed to contain inflation. Monachil maintains the view that deficits could surpass 8% of GDP by year's end.

In our opinion, the increased costs associated with servicing the federal debt and the necessity for the U.S. to issue more debt remain critical risk factors that will impact markets, particularly the credit markets.

May CPI came in cooler than expected; we remain skeptical about declaring victory

The Consumer Price Index (CPI) for May remained unchanged at 0%, with the all-items index rising 3.3% over the last 12 months before seasonal adjustment. This stability was largely driven by a 3.6% decrease in the gasoline index, which was offset by a 0.4% increase in shelter costs. While some commentators have celebrated this as a sign of inflation moving toward the 2% target, we remain cautious in our interpretation.

Firstly, the declines in the energy sectors appear to be temporary and are not supported by current policies in the US and Europe. In fact, oil prices have started to climb, with WTI now above its May levels. Additionally, copper prices remain slightly elevated, substantially higher than 2023 levels. In short, these factors suggest that the drivers behind May's lower-than-expected CPI print are not sustainable.

Conversely, shelter costs are increasing at an annual rate of 5.4%. We believe that the full impact of housing inflation – where home prices have surged by over 40% since the beginning of 2020, while rents have not yet caught up – is not fully reflected in the reported CPI. This discrepancy will likely continue to drive higher CPI prints. For a detailed Monachil analysis of shelter costs, please review our [March 8, 2024 Commentary](#).

We have been steadfast in our belief that the growing size of the deficit, combined with a Federal Reserve that appears unable or unwilling to tackle inflation directly, remains a significant concern for the US economy. On reflection, markets have vindicated our views on these matters, and we see no reason now to dial down our conviction.

US Elections and Political Economy of Tariffs

With the US elections less than 5 months away, it is time to start reviewing potential policy outcomes of various election scenarios. We see it as telling indeed that much of the debate around economic policy proposals centers on mechanisms for raising revenues for the federal government.

In this election cycle, in contrast to previous ones, there seems to be more common ground between the major parties on the need to increase revenues, and the debate has somewhat shifted to what the specific mechanisms of revenue generation should be and who should be paying for them. The new schism, in our view, can be simplified to a contest of "taxes" vs. "tariffs". On the Democratic side, the policy positions emphasize using taxes as the main tool to increase federal revenues, while on the Republican side, the policy position has shifted significantly over the past few election cycles to advocate for tariffs as an increasingly vital source of revenue for the federal government.

We find the political economy implications of this shift to be intriguing on several levels, starting with the quasi-philosophical question of who actually pays the tariffs? Some people (be they observers, participants or educated consumers and voters) will argue that producers pay them, i.e. they have to absorb the costs of tariffs to keep their prices competitive; others argue that consumers pay as the increased cost to the producer is passed along to them.

The added benefit of reliance on tariffs is that it protects domestic production (hence its association with “protectionism”). We think this represents a shift in the United States political economy, with voter blocks that have been adversely affected by the trade policy of the past 30 years now flexing their muscles and applying pressure on the Federal government.

We believe the current proposals on the Republican side, including across-the-board tariffs on all imports, provide an opportunity for the federal government to enhance its revenue base. The experience of the past 8 years is that, while imposing tariffs increases post-tariff costs to US consumers, that adverse effect is actually more than offset by strength in the US Dollar (USD).

But, one wonders, is that experience necessarily indicative of a causal relationship, or is it a happy coincidence in a complex, multi-variable ecosystem? That is an interesting question and one that will be debated – even if not opaquely – as the two sides take their platforms to the people. Since we can reasonably expect little clarity to emerge from that discussion, we will opine ourselves...

Our view is that the reality is a mix of both. Tariffs can have a direct impact on the value of the USD through two major mechanisms: first, they result in a reduction in trade deficits; second, they improve the federal government's fiscal picture (i.e., reduce budget deficits). Both factors impact FX flows.

Given that the first mechanism reduces the supply of USD in foreign hands, it shifts the FX flows in a way that strengthens the USD. The second mechanism also reduces the supply of USD. Absent the revenue from the tariffs, the federal government would be forced to borrow more, and given that much of the federal government's increase in outstanding debt has been funded by the central bank printing money (i.e., QE), reduction in the supply of federal debt is likely to result in a reduction in the supply of money.

There are also, of course, discrete costs associated with tariffs. At extreme levels, they can curb trade flows, leading to lower efficiency in the international market for goods and services while potentially prompting retaliation against US exports. However, given the substantial trade deficit, a reciprocal tariffs regime is likely to be more beneficial for the US.

Policy Question About Tariffs vs. Subsidies

Another policy question arises in the context of the previous discussion, and that relates to the relative impacts of tariffs relative to subsidies awarded to domestic production. The CHIPS Act provides an illustrative example, as the US government offered subsidies to some of the largest and most profitable companies in the world to bring chip manufacturing to the US. While the subsidies in the CHIPS Act added to the deficit, they also provided the US with some national security protections.

One could ask, “How would tariffs work if the policy goal remains the same?” Using tariffs, one could argue that these same companies would bring more production to the US, not because they are receiving taxpayer subsidies, but because they have an incentive to avoid the tariffs.

In terms of the relationship between the federal government and these corporations, tariffs are more like a stick while subsidies are more like carrots. Since it is easier for

Congress to spend more money than it is to raise revenues, the preferred political path for encouraging protectionism in chip-making ended up being through subsidies.

Ali Meli

Portfolio Manager

Monachil Credit Income Fund

If you would like to subscribe to receive monthly commentary, please contact us at ir@monachilpartners.com.

DISCLOSURES

This information has been furnished ***as a courtesy by*** Monachil Capital Partners LP ("Monachil"). This document is for informational purposes only and does not constitute an offer or solicitation by Monachil for ***any investment***. The information set forth herein does not purport to be complete and is subject to change. This information is not to be reproduced or redistributed without the prior express written consent of Monachil.

This document should not be the basis of an investment decision, an investment decision should be based on your customary and thorough due diligence procedures, which should include, but not be limited to, a thorough review of all relevant offering documents as well as consultation with financial, legal, tax and regulatory experts. Although the information provided herein has been obtained from sources that Monachil believes to be reliable, we do not guarantee its accuracy, and such information may be incomplete or condensed. The information is subject to change without notice. No representation is made with respect to the information indicated herein.

Statements made herein include forward-looking statements. These statements, including those relating to future financial expectations or future opportunities, involve certain risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. Prospective investors are cautioned not to rely on these forward-looking statements and projections. Certain information contained in this presentation constitutes opinions, or beliefs of Monachil, which may be preceded by the terms "belief," "opinion," "consider," "anticipate," "seek," or other similar terms. Such statements of "opinion" merely represent Monachil's state of mind and should not be construed as a material statement of fact.