July 2024 – MBSM High Income Strategy Returns and newsletter

	% Net Return	2024 YTD Net %	Trailing 1 year Net %	3-year Net	5-year Net	2023 YTD Net %	2022 YTD Net %
MBSM Aggregated SMAs	**+10.58%**	**+0.4%**	**+9.0%**	**+11.6%**	**+23.0%**	**+11.5%**	**-3.8%**
BB Barc Agg	+2.42%	+1.7%	+5.1%	-7.7%	+0.9%	+5.6%	-13.0%
BB Barc MBS	+2.58%	+1.8%	+5.1%	-6.4%	-1.0%	+5.1%	-11.7%
BB Barc HY	+1.94$	+4.6%	+11.1%	+6.6%	+22.9%	+13.5%	-11.2%

July 2024 MBS Income: +1.46% (~+19.1% annualized) (Aggregated SMAs @ month end marks)
Income from 3/31/2024: +6.05% (~+18.6% annualized)
Income from 12/31/2023: +9.68% (~+17.1% annualized)
July 2024 Loss Rate: 0.22%
YTD Loss Rate: 0.25%

July 2024 MBS Cashflow: +1.6%. ~19.5% annualized (i.e. a short weighted average life/duration)

Hello.

It's been a few months since I published an MBSM newsletter.

In April 2024, we changed our custodian from Hilltop Securities to Charles Schwab. This transfer has turned out to be complicated due to the legacy Non-Agency RMBS we own for our clients, primarily due to Schwab and it's pricing service not having significant experience with these types of bonds. This has resulted in significant 'paper volatility' in our monthly performance.

Some of the accounts bonds moved in April with the most of the rest in May, further complicating computations as April's total return and performance consist of marks from 2 different custodians.

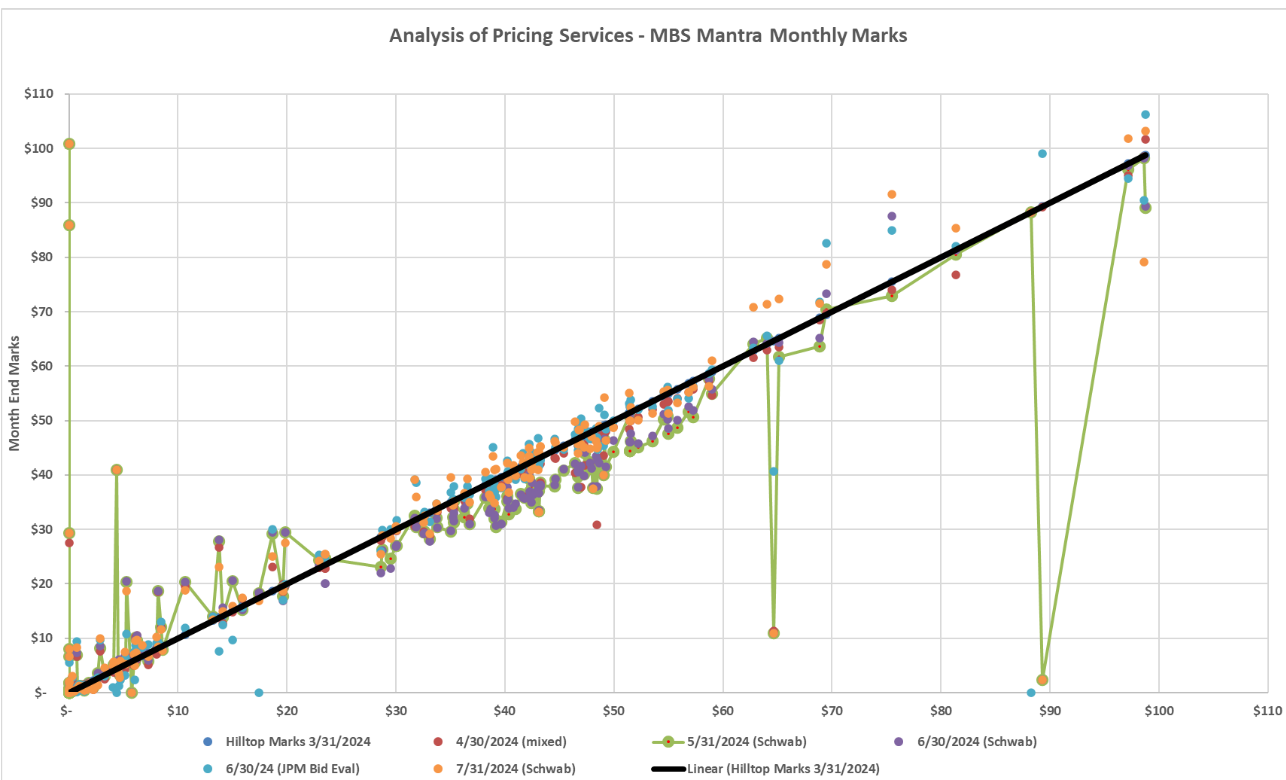
The new custodian initial mark's were way off from the context of market levels, with many bonds instantly being marked down by over 25% from the move. (Some bonds are still 90+% different.) This resulted in a -12% "return" for May.

It turns out that the new pricing service uses the same cashflow engine for Non-Agency MBS as most of the market. The problems arise from the inputs used by its analysts to discount cashflows to generate prices, probably due to a lack of focus on both the basics and the nuances of the bond structures.

A complaint (by me) resulted in a review by the new pricing service, and July's return of +10.6% was the result, partially correcting the mis-marks of April and May, with more of the marks approaching market consensus. The return was further enhanced by a real tightening in MBS in the past few weeks - a recognition of increased demand by numerous money managers of the sector's cheapness.

The portfolio itself has not changed, and the actual cashflow performance is on track, as shown by the High Income and lack of losses.

We are hoping that the pricing service has figured out its models and inputs, and that future mark volatility reflects the market environment, and not the model inputs used by the pricing service.

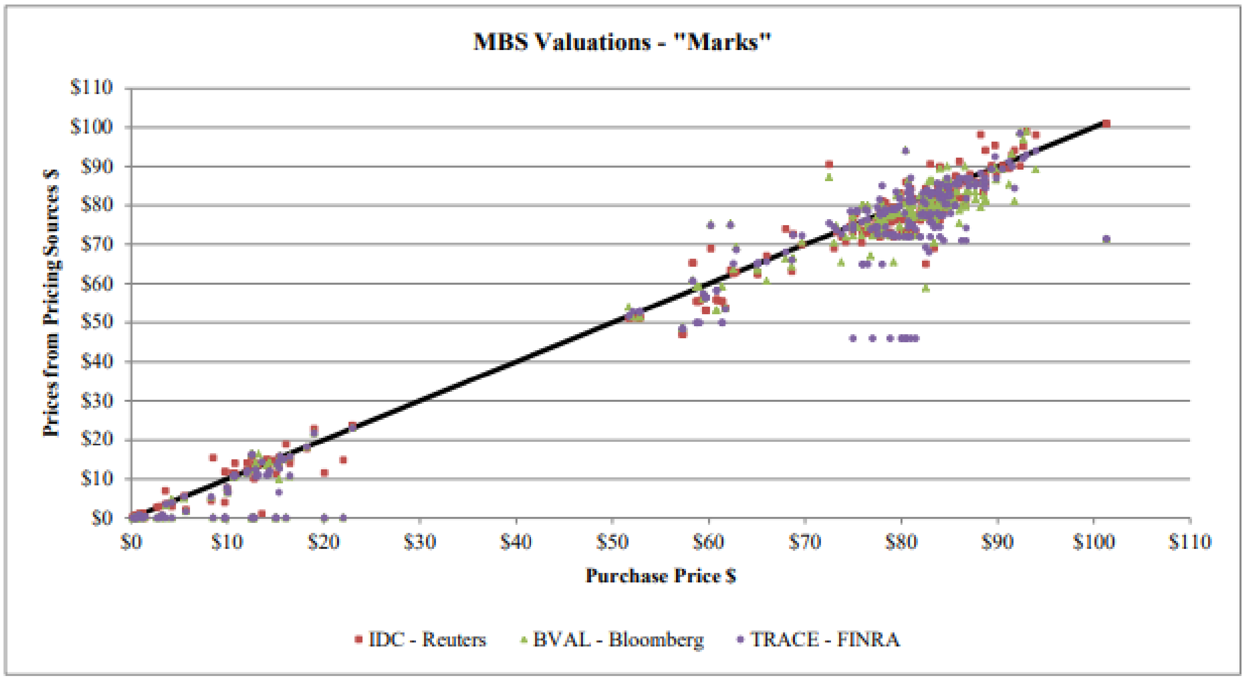


The next section discusses marks.

Marks, Pricing Services, and Returns

I first discussed this in my [Dec 2018 newsletter](), although it was in all my prior marketing decks. In that newsletter, I compared the purchase prices of the bonds I owned with the marks from 3 different sources. I also computed total returns using different marks, and they varied by significant percentages.

The average pricing range across our holdings as of 12/31/2018 was 17%, while the returns could vary by more than 6% over holding periods! Here is the graph from 2018:



Weighted Returns of MBS Mantra holdings as of 12/31/18 from purchase date to 12/31/18

	MBS Mantra Periodic Returns (non Annualized)			Comparable Period Benchmark Returns			
	IDC Marks	Max Marks	Min Marks	AGG TRR	MBB TRR	HYB TRR	SPY TRR
2016-2018 purchases	**4.7%**	7.3%	**1.8%**	**1.9%**	2.1%	-0.3%	-1.6%
2016 purchases	**17.2%**	19.5%	**16.2%**	**3.4%**	2.8%	11.6%	27.0%
2017 purchases	**8.1%**	10.1%	**4.1%**	**1.0%**	1.3%	-0.7%	4.4%
2018 purchases	**1.5%**	4.3%	**-1.4%**	**1.9%**	2.2%	-2.4%	-8.3%

Weighted by the invested size of every MBS Mantra MBS holding; 0% reinvestment rate for MBS Mantra returns; Price return assumes IDC pricing; Benchmark returns are reinvested in the stock.

It was for this reason that, as a fiduciary, I decided that a hedge fund structure was not appropriate for investors in MBS, as charging performance fees based on "marks" would be inaccurate and unfair. To solve for this, I created a unique fee structure, using SMAs, that puts clients first.

In MBS we saw numerous lawsuits against managers for 'gaming' and making up marks to achieve returns targets.

We are seeing this problem play out in private credit currently where marks for the same asset have dramatically different prices. Allocators however still continue to insist on a fund structure for non-exchange traded assets, even though it is not in their interests.

This problem of marks, a result of the inherent flaws in the Fixed Income Market Structure (which I have also written about), has resulted in the volatility in marks experienced by my clients in the past quarter, which has also impacted the reported YTD returns.

The Yen Carry Trade

The past week has seen everyone come out of the woodwork to talk about the Yen Carry Trade.

Most of the comments and 'research' I've seen is emergency stuff, by analysts and CIOs who have had 2 days to become 'experts' on a term they've never heard of about a risk they've never thought of. **The output ranges from short sighted, to incomplete, to wrong.** JPM saying that this is 75% over is one of these – they are just referencing the 'hot money' version of the YCT, not the fundamental version.

I've been studying and writing about the Yen Carry Trade since 2006, and I believe I'm the only one who has done a comprehensive study of this topic. During the GFC, I wrote about it extensively in my Crisis Notes, and used to fill up rooms at LARGE fixed income asset managers who wanted to hear about the next shoe to drop.

Many people are asking me to do a zoom or linked-in call to discuss it. I'll announce this shortly.

You'll find lots of discussion and learnings in my newsletters and on my website. I started alerting people about this event over the past few months, over Linkedin, and again last week before the big selloff occurred. My larger clients also got this warning over email:

Aug 2, 2024, 12:59 PM: ***Yen Carry is unwinding:***

> ***My recommendation is not to be in any stocks. Including Energy.***
>
> ***I'll put together a model portfolio of what to own in the next few days.***

Since, in my opinion, the Yen Carry trade unwind resulted in the GFC, all my MBS Mantra decks, since 2014, include this in the risk section:

“The equity market still seems to be funded by the Yen Carry trade, and in a global selloff, Yen will be one of the best macro hedges even for spread products – it has a very high correlation with the S&P during periods of volatility. Please see our Macro research.”

Here is a summary of the Yen Carry Trade:

- The Yen Carry trade has existed since 1994 and before, and hedge funds have been using it since.
- References to Mrs. Watanabe exist since the 1980s.
- This is largely driven by the interest rate differential between the BOJ and the US Fed Funds Rate. I call this the YCI – Yen Carry Incentive.
- The institutional version of the Yen Carry Trade came into being in 1994, when Japan did the “Big Bang”, that allowed branches of foreign banks to be regulated by the BOJ.
- It came to the US public’s and banking system’s attention in 1998, when Tiger Management spectacularly blew up, as this was reported in all the newspapers including the colored paper ones like USA Today (links in my Crisis Notes).
- Banks started emulating Tiger in larger scale, by borrowing overnight money at the BOJ window, and longer term money through Samurai bonds. This allowed the US banking system to grow at least 4x from 1999 to 2005.
- **EVERY TYPE OF INSTITUTION in Japan, also started playing the in Yen Carry trade, exporting ALL of Japan’s savings.** This was no longer the ‘hot’ money’ of hedge funds, but was in longer term US bonds, mutual funds, etc.
- **When the BOJ does QE by buying USTs, all the money is a direct injection into US banks, increasing US money supply. This started in 1998.**
- When the BOJ does QE by buying Japanese bonds from its intuitions, instead of investing the money supply locally, they buy foreign assets, mostly US debt. This increases US money supply.
- These changes in Money Supply are visible on both the Japanese and US side (or were until we stopped measuring M3).
- Retail products have also been created, such us USD mutual funds for the Japanese, Urudashi bonds, and more, allowing Japanese individual savers to export capital.
- **Today, everyone Yen Carries**, in addition to Hedge Funds and quants. Berkshire Hathaway, Apple and many others issue debt in Japan. Levered Loans and CLOs, that are funding Private Equity are bought by the Japanese.
- **Most of the time, YCI declines have been a result of the Fed cutting rates, leading to unwinds. Today is the first time we are seeing YCI decline as a result of the Japanese raising rates.**
- **I wrote about this last year in: ‘The Greatest Risk is Here’ (Dec 2022 newsletter).**

Implications

- **When the YCI is positive and increasing and stable, US money supply increases from the Yen Carry Trade. This boosts US GDP and leads to frivolous investments and high PE rations, and growing real estate prices. Different investors have different thresholds of YCI when they invest..FOMO etc.**

- **When the YCI starts declining the hot money gets margin calls and delevers. This is what we saw on Monday.**
- **When the YCI continues to decline, longer term investors get cold feet. The take losses on their USD bonds due to Yen currency shorts. They sell USD bonds, They refuse to roll over their USD bonds positions when they mature. This leads to a US Credit Crunch.**
- **If you go back a re-read all the stuff that Richard Fuld was saying when he was begging for a bailout for Lehman, you will realize that he was saying that he could not roll over his Samurai debt, and therefore his balance sheet was going to collapse unless he could find other takers for Lehman bonds.**
- **Foreign QE also results in Carry trades into the US.**
- **When balance sheet to hold bonds shrinks, all bonds prices go down to fit into a smaller balance sheet.**
- **The US banking system failed in 2008 when it could not roll over the debt from Japan that grew its balance sheet by 3x.**

The result of the Yen Carry Trade is that Macro Economics works in reverse. Central banking has failed.

- **When the Fed raises rates, US money supply goes up, it is an easing. Leverage, and asset prices go up. (PE ratios are a form of leverage).**
- **When the Fed cuts rates, US money supply GOES DOWN, it is a tightening. This leads to a deleveraging, and assets have to fit into a smaller balance sheet.**
- **Selloffs caused by deleveraging usually snowball.**
- **The only solution then is for the Fed to do more QE to replenish the lost balance sheet. Or let asset prices collapse.**
- **Every re-issuance of QE leads to the next asset bubble and the potential for a bigger future deleveraging.**
- **The combination of global QE, that comes to the US to roost, and Carry Trades, together explain all asset prices – ups and downs – see Understanding Beta linked below.**

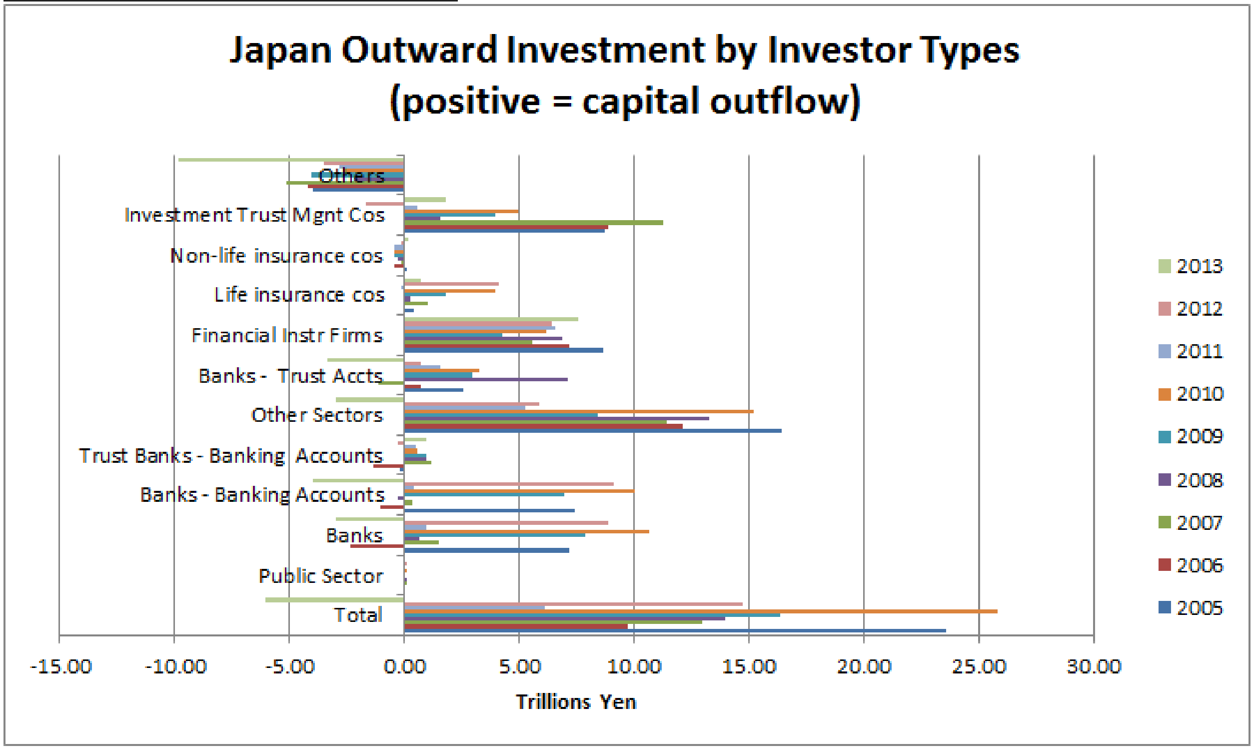
This is going to be a slow moving train wreck, as the bulk of the Yen Carry Trade is not hot money. It will result in a Credit Crunch if the Fed cuts rates, followed by $20T in US QE.

Reading list:

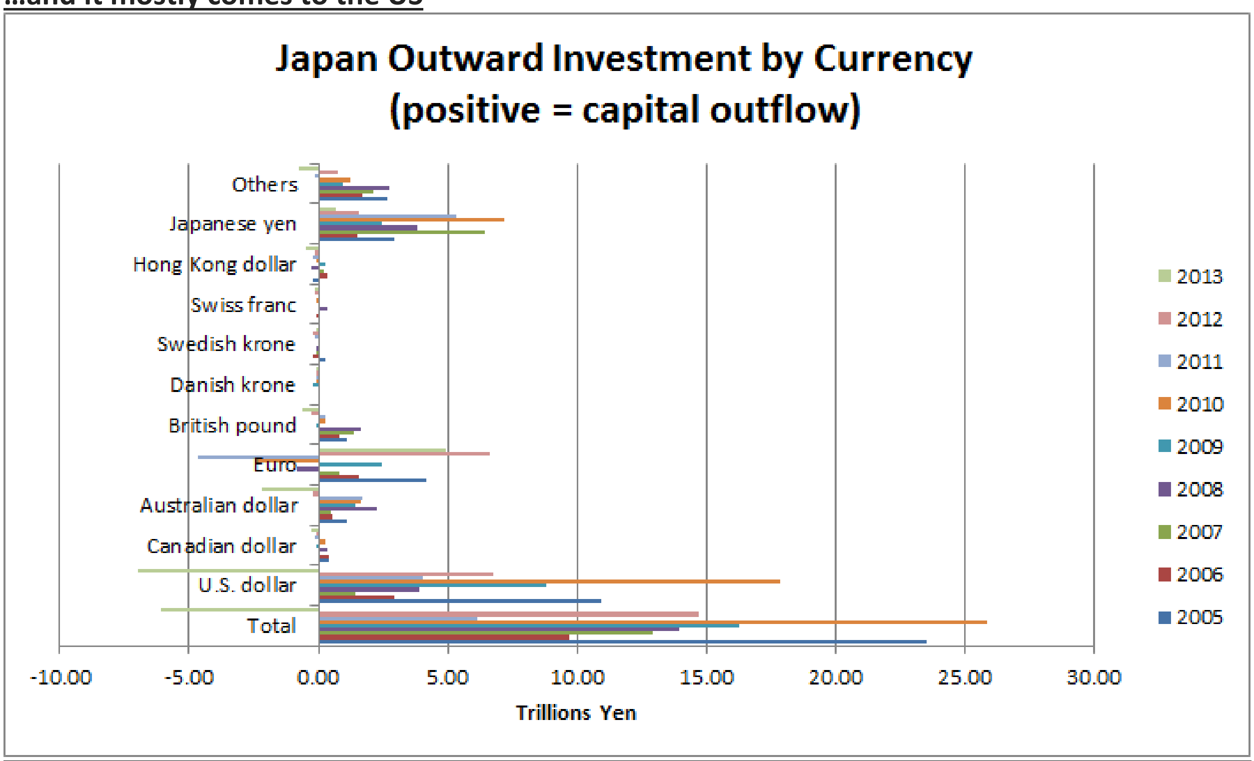
- **4/10/2023 – Crisis Note 2.0.1 - The Greatest Risk is Here (from March 2023 MBSM newsletter)**
- **10/24/2022 – All Roads Start with Paul Volcker**
- **2/24/2016 – The Failure of Macro Economics – Carry Trades, Money Flows, and the Pricing of Assets – Yen Carry in detail.**
- **9/20/2016 – Understanding Beta: Determinants of the US Stock Market**
- **8/10/2007 – Crisis Note 2007-1 - This is NOT a Subprime Problem**
- **8/15/2009: - CN 2009-03 – This is NOT an Economic Crisis; This is an Economics Crisis**

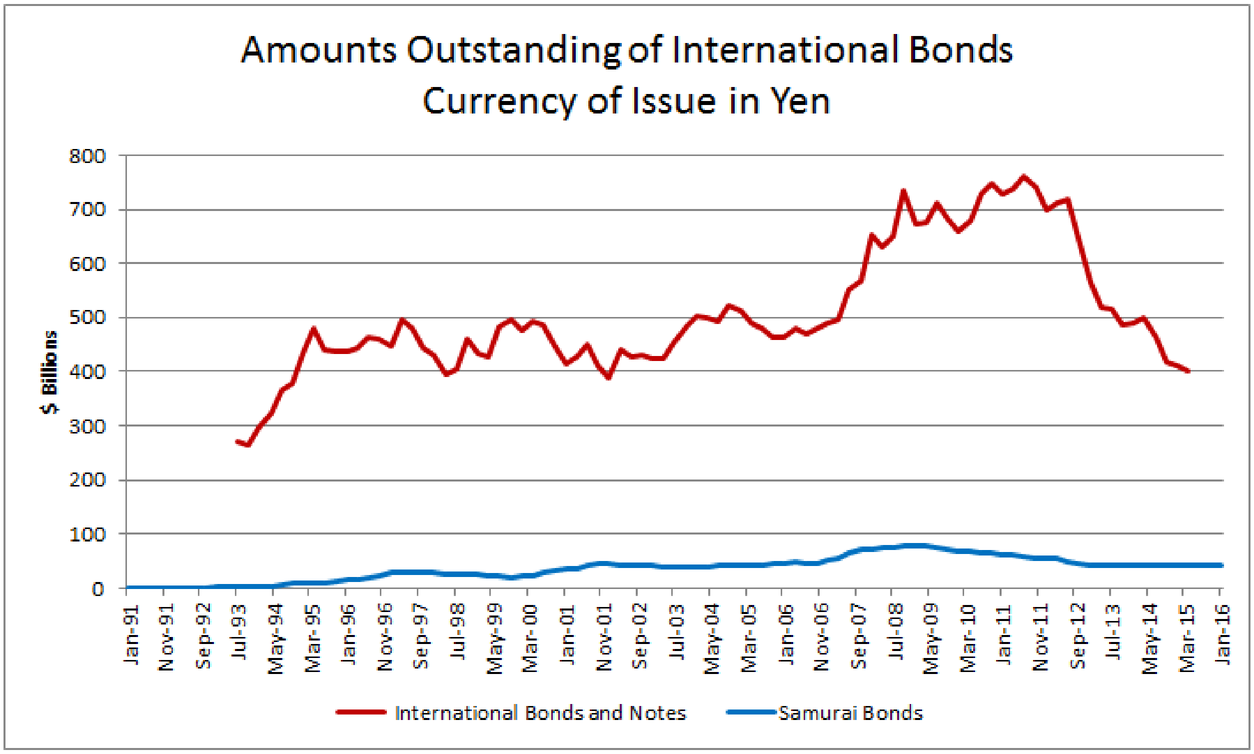
Some Graphs (many from 2016)

EVERYONE IN JAPAN YEN CARRIES

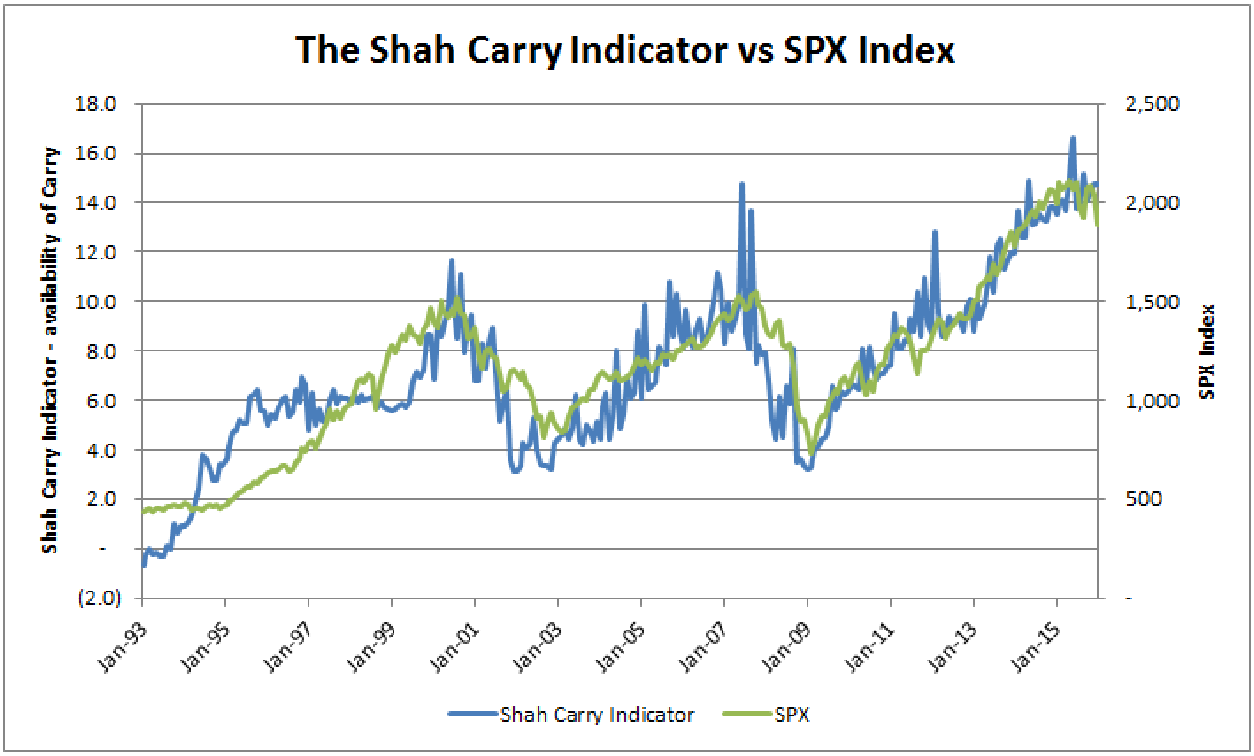


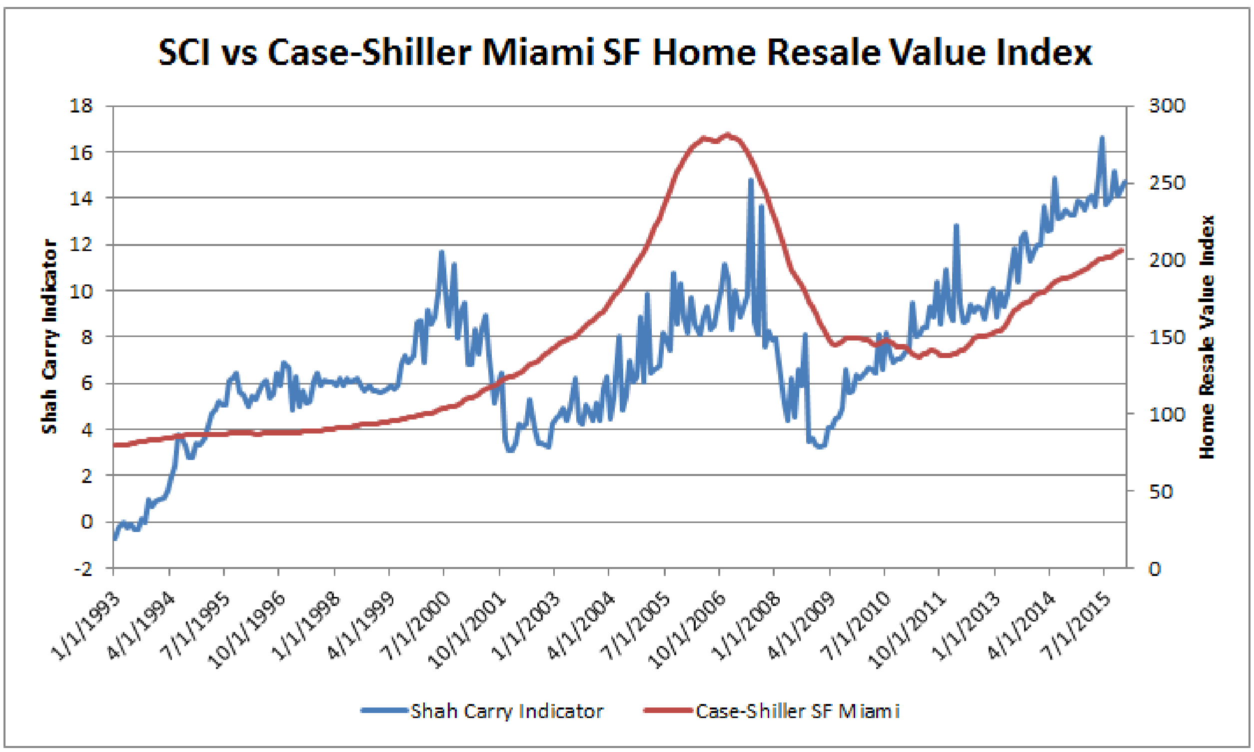
…and it mostly comes to the US





Yen Carry in action – posted on linkedin June 17, 2024 (Hot money)


The Shah Carry Indicator vs SPX Index
Shah Carry Indicator - availability of Carry
SPX Index
18.0
16.0
14.0
12.0
10.0
8.0
6.0
4.0
2.0
-
(2.0)
2,500
2,000
1,500
1,000
500
-
Jan-93
Jan-95
Jan-97
Jan-99
Jan-01
Jan-03
Jan-05
Jan-07
Jan-09
Jan-11
Jan-13
Jan-15
Shah Carry Indicator
SPX


SCI vs Case-Shiller Miami SF Home Resale Value Index
Shah Carry Indicator
Home Resale Value Index
18
16
14
12
10
8
6
4
2
0
-2
300
250
200
150
100
50
0
1/1/1993
4/1/1994
7/1/1995
10/1/1996
1/1/1998
4/1/1999
7/1/2000
10/1/2001
1/1/2003
4/1/2004
7/1/2005
10/1/2006
1/1/2008
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1/1/2013
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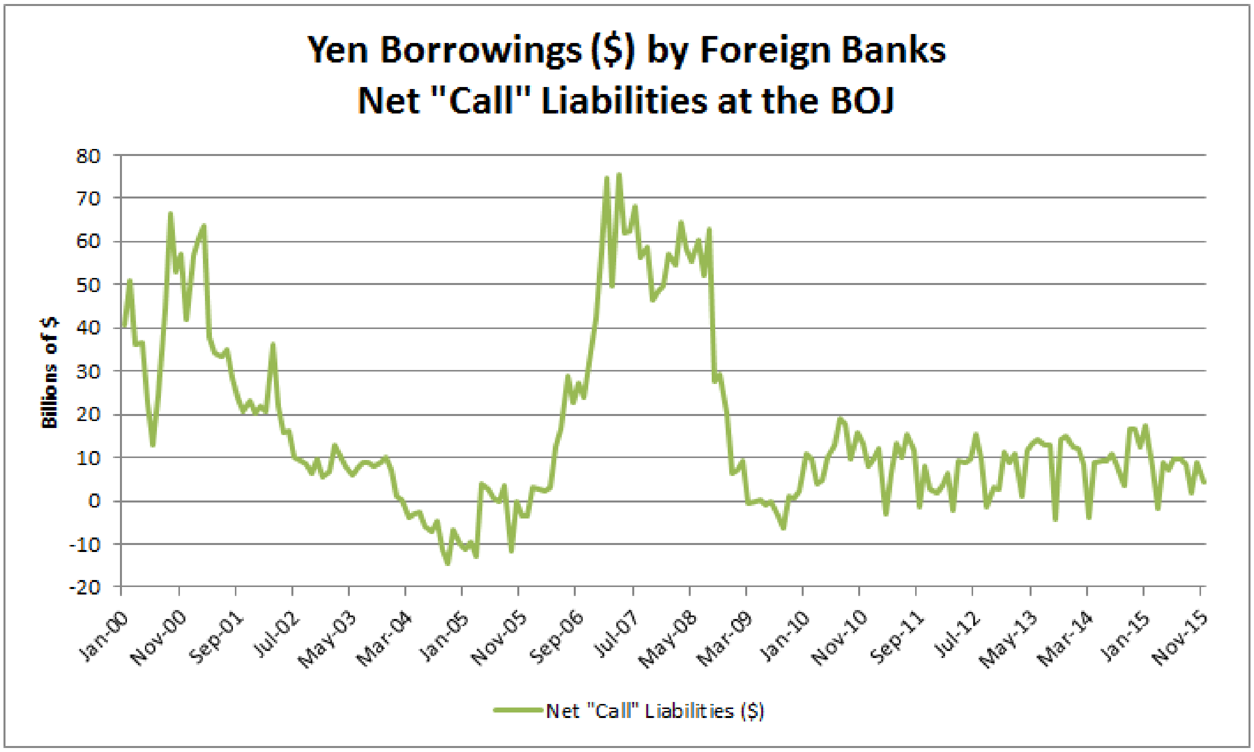
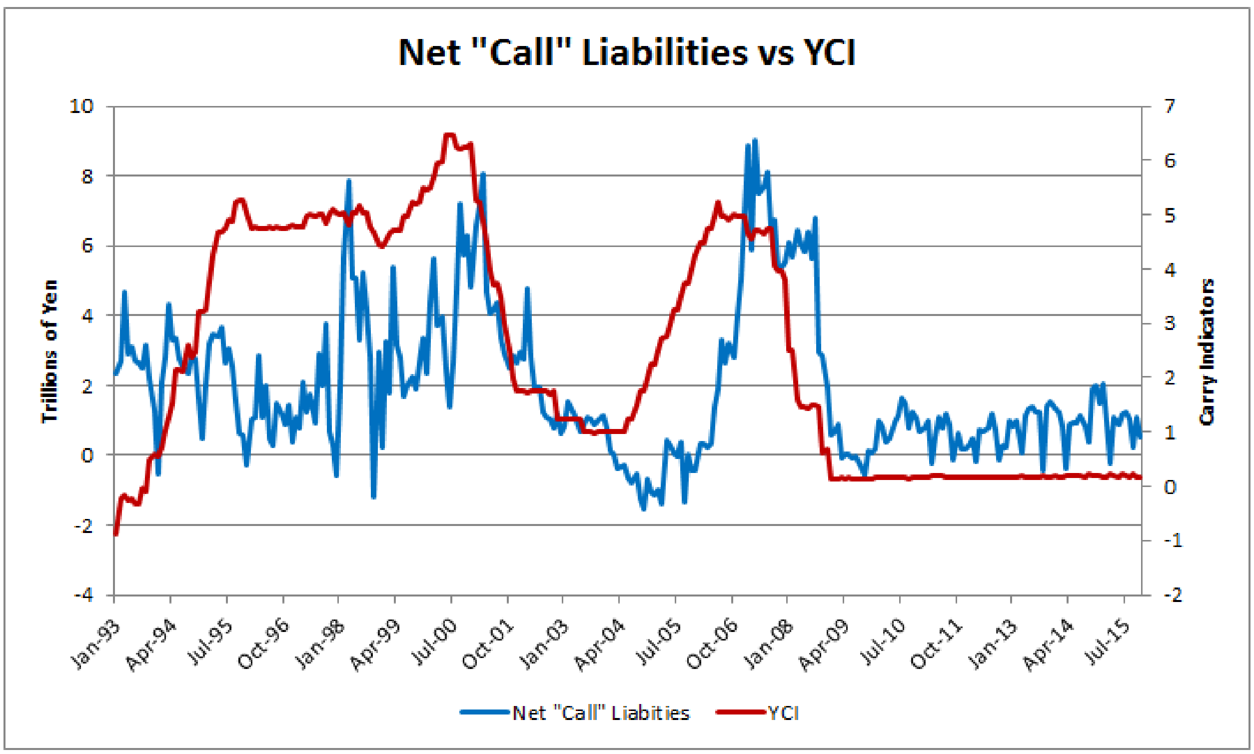
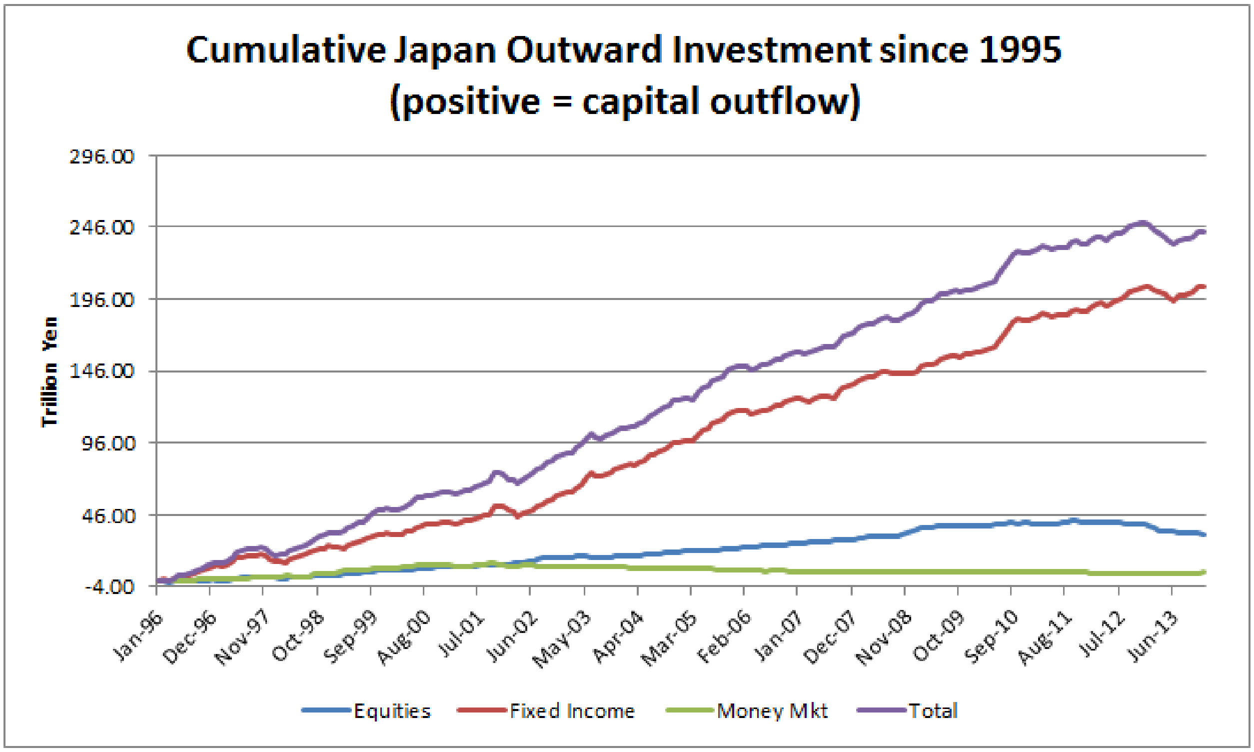
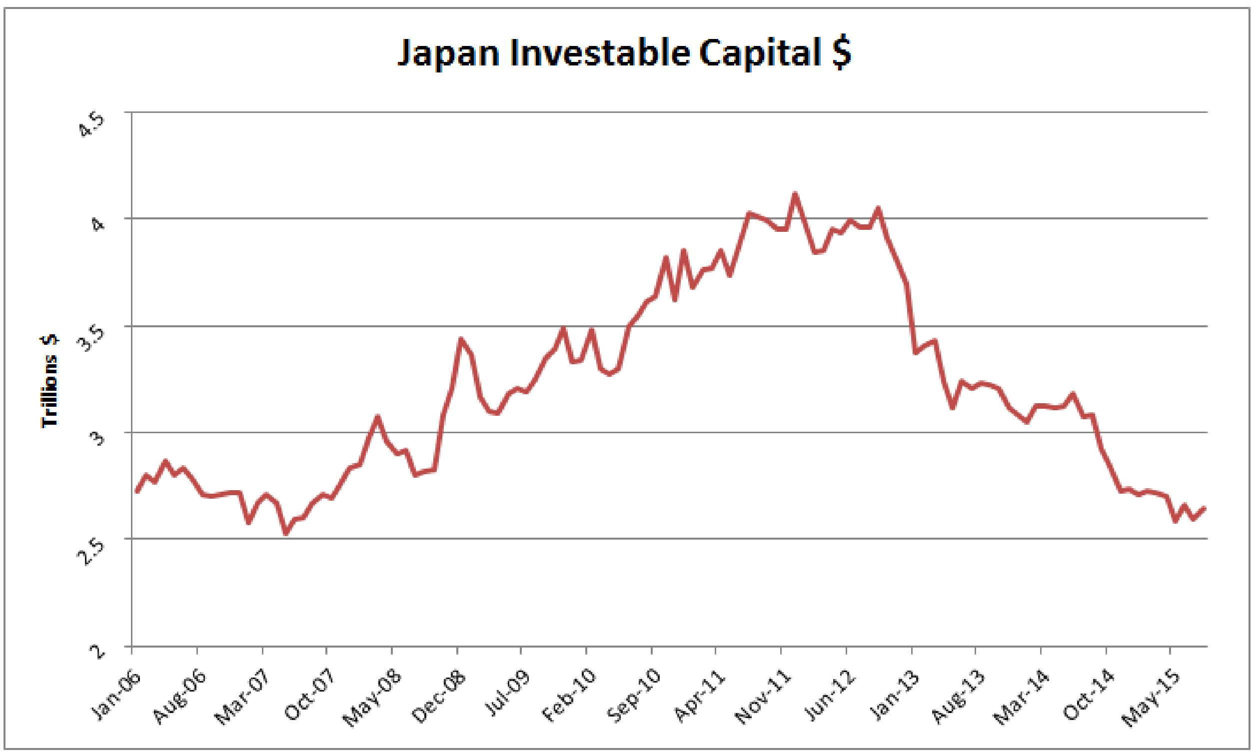
7/1/2015
Shah Carry Indicator
Case-Shiller SF Miami


Yen Borrowings ($) by Foreign Banks
Net "Call" Liabilities at the BOJ
Billions of $
80
70
60
50
40
30
20
10
0
-10
-20
Jan-00
Nov-00
Sep-01
Jul-02
May-03
Mar-04
Jan-05
Nov-05
Sep-06
Jul-07
May-08
Mar-09
Jan-10
Nov-10
Sep-11
Jul-12
May-13
Mar-14
Jan-15
Nov-15
Net "Call" Liabilities ($)

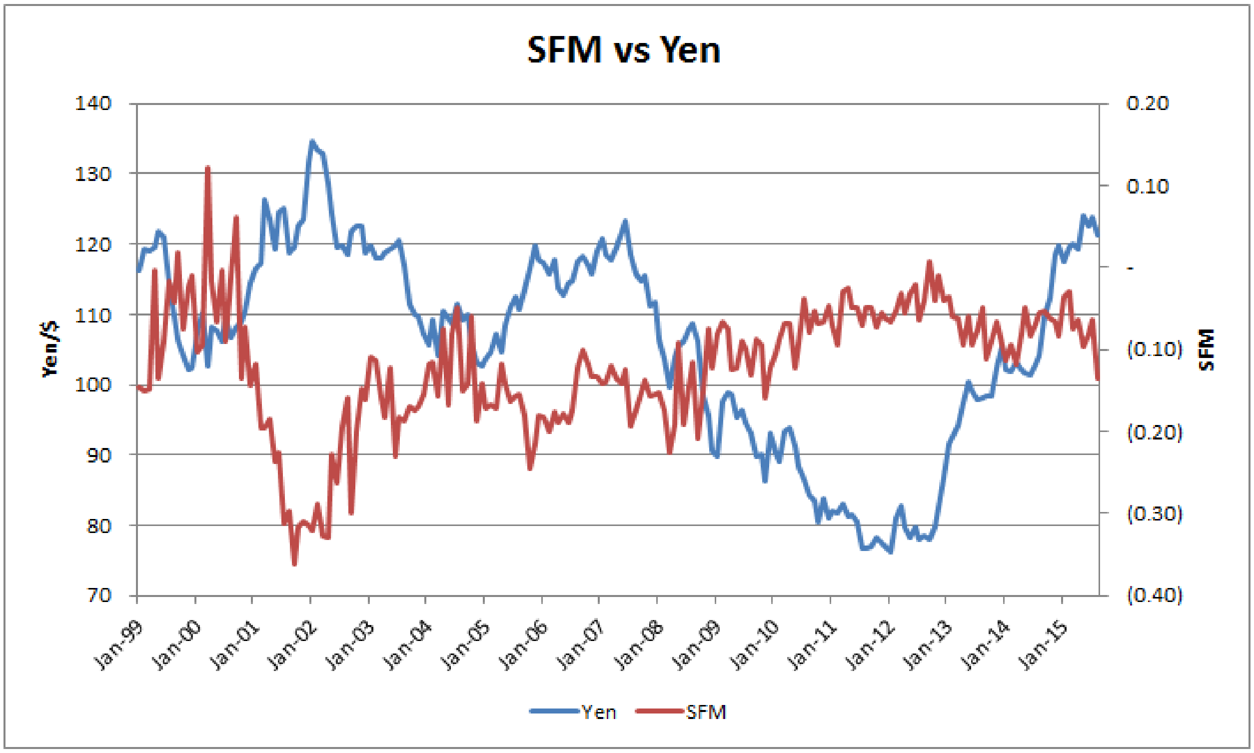

Net "Call" Liabilities vs YCI
Trillions of Yen
10
8
6
4
2
0
-2
-4
Carry Indicators
7
6
5
4
3
2
1
0
-1
-2
Jan-93
Apr-94
Jul-95
Oct-96
Jan-98
Apr-99
Jul-00
Oct-01
Jan-03
Apr-04
Jul-05
Oct-06
Jan-08
Apr-09
Jul-10
Oct-11
Jan-13
Apr-14
Jul-15
Net "Call" Liabities
YCI



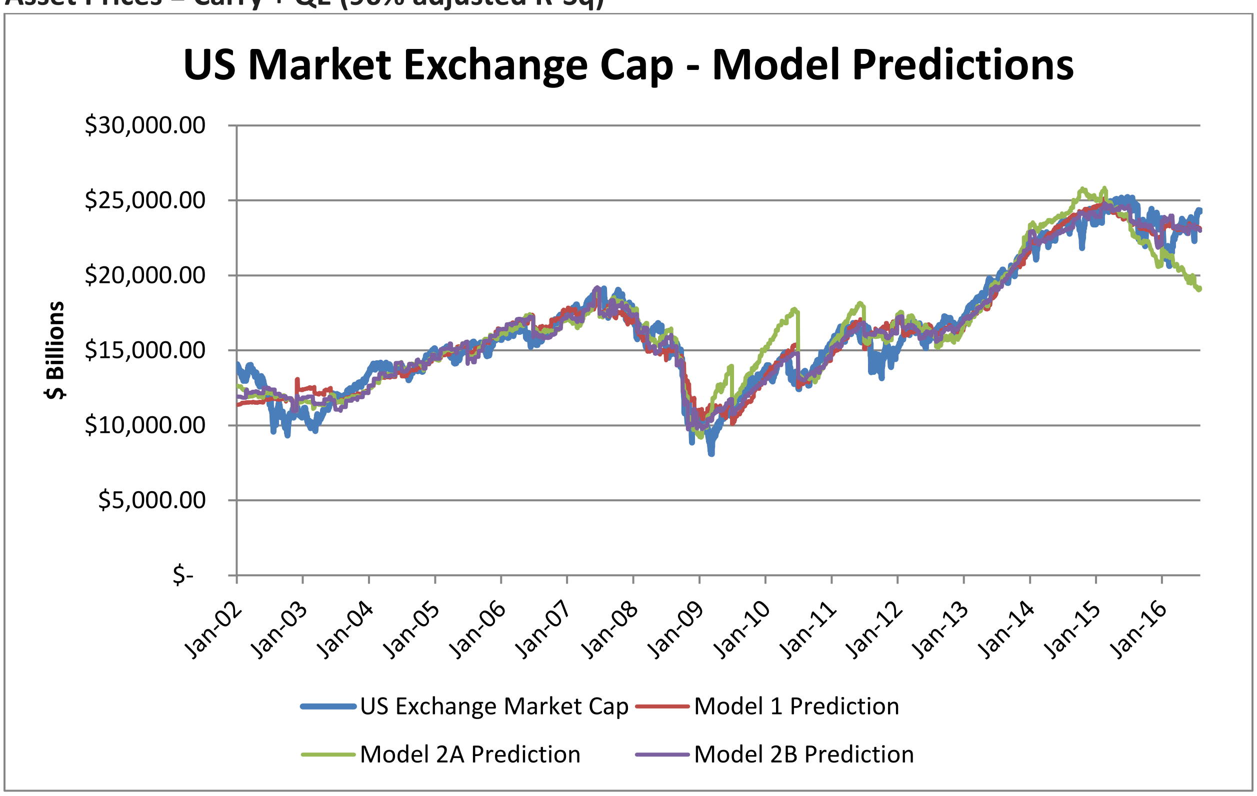
Investible Capital = M3 – M2. When IC goes up, money came back into your economy. This is Japan's repatriation of capital – by refusing to roll US debt – after the GFC - ~ $1T. This was a 4 year process, which reversed after our QE rallied asset prices again.



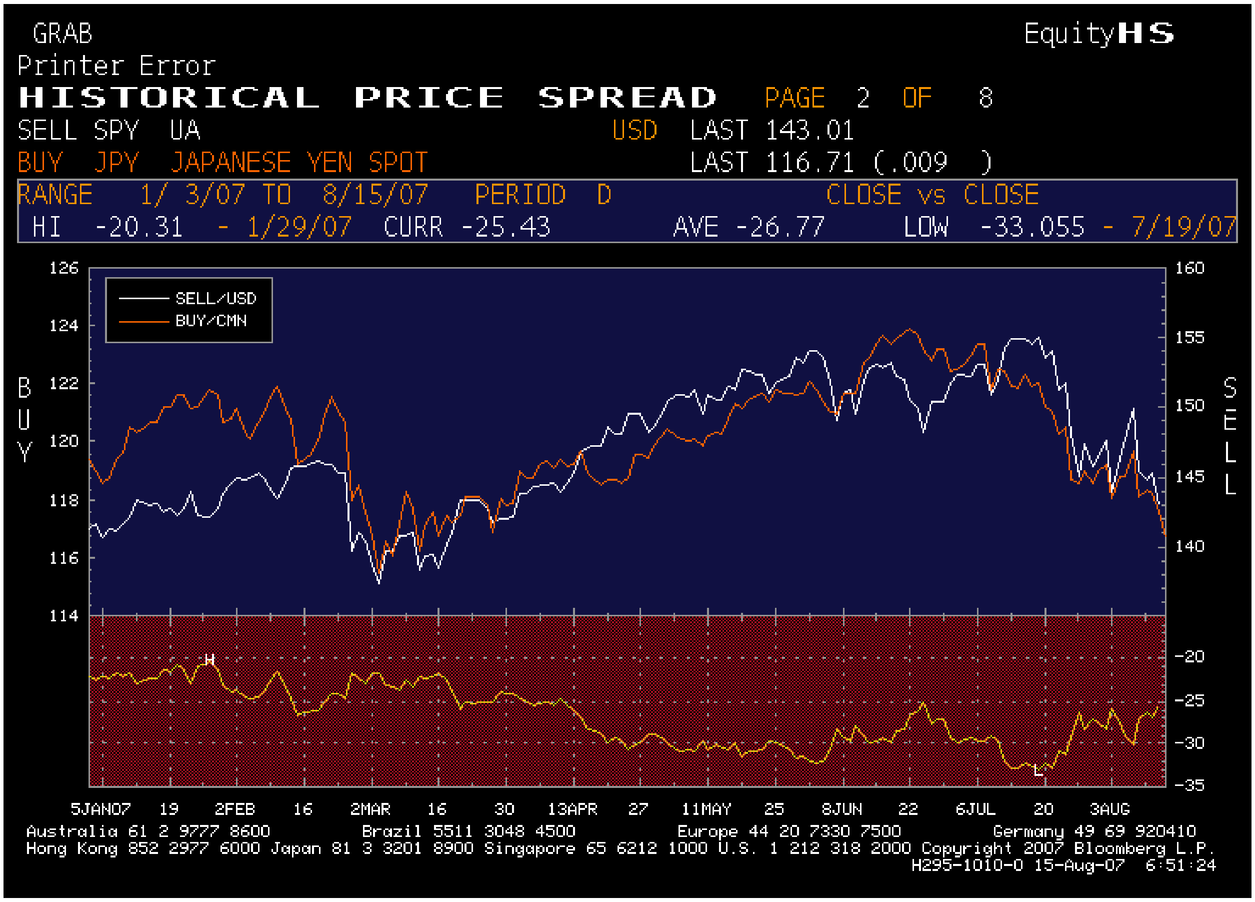
Yen went from 130 to 78



Asset Prices = Carry + QE (96% adjusted R-Sq)



Yen Carry from 2007



Regards, Samir.

August 9, 2024

Samir Shah

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