May 2019 - MBS Mantra MBS High Income/Absolute Return Strategy returns:

- Aggregated SMAs: +1.15% Net, +1.23% Gross; 2019 YTD: +4.2% Net
- Founder's Portfolio: +1.44% Net, +1.52% Gross; 2019 YTD: +3.4% Net

- May 2019 Income: ~0.8%; Annualized: ~10% (Aggregated SMAs @ recent marks)

Hello.

The average income rates for April remain in our target ranges, with some bonds outperforming and others underperforming, as is typical. Our returns in May benefitted from both income return as well as some price appreciation from marks. Given the significant cashflow generated by our portfolios, our effective portfolio duration is lower than that of the AGG and MBS benchmarks, and we underperformed them this month as rates rallied strongly.

We closed additional positions in May, mostly bonds with declining incomes, and replaced a number of them with new positions that should improve the income profile of the portfolios.

Rates, Inflation and Predictions

With the 10yr UST yield approaching 2% again, with concerns about the inflation, inflation breakevens, and the shape of the yield curve becoming topics-du-jour, I will recommend re-reading the predictions in my Feb 2017 Viewpoint – the fundamentals that I described then are still intact, and after 2 years of euphoria, markets appear to facing reality once again.

- I am going to stick to my 1.5% 10 year UST target – the markets are waking up to the fact that real inflation is a dream that will not be realized anytime soon in the industrialized world. To put it simply, we built too many things between 2002 and 2004, consumed much, and have too much capacity – since then we have primarily been in a replacement cycle. Much of the tech related growth has been deflationary.
- The short end is expecting rate cuts in 2019 from the Fed as well.
- For now, asset inflation continues unabated due to the interest rate differentials between the US and our leverage and capital providers, Japan and Europe, who continue to export capital from savings and central bank QE creation.
- In addition, Japan and other central banks continue to purchase US Treasuries to keep their currencies weak. This active currency management also provides protection to prices of US risk assets, and creates the framework for buying dips. Since October 2018, foreign central banks have purchased $270b in USTs, $70b of which was purchased by Japan. This is QE to the US, more than offsetting the balance shrinkage by the Fed. $250b is roughly half of the amount of USTs Japan bought in 2002-2004 (giving us our first QE at the time, and resulting in the aforementioned abnormal growth in that period – I have discussed this period in detail in T-Leaf Reading, as well as how to interpret the shape of the yield curve).

- Together, these continue to prime US equities, in spite of the fact that the share buybacks have run their course and are declining (EQCOMPBB Index on Bloomberg), and the Trump tax trade has become the Trump tariff war, negating the ‘reasons’ for the rally in risk assets from 2017 to 2019.
- The primary risk to the markets will come from Powell cutting rates, just as Bernanke did in Aug 2007. This will trigger a flight of retail capital back to Japan as it did in 2007-2010 (and Europe as well this time), that will not be containable by the central banks, unravelling the US balance sheet, and resulting in asset price crashes. To understand this, please re-read ‘The Failure of Macro Economics’, found on Analysis tab of my website.

We welcome your questions and comments.

Regards, Samir

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Samir Shah
President and CIO
MBS Mantra, LLC (a CT Registered Investment Advisor)
"Alpha Through Analysis"®
203-388-8356 P
203-273-0360 C
sshah@mbsmantrallc.com
https://www.linkedin.com/in/samir-shah-6a9096a

Please visit our website www.mbsmantrallc.com for important disclosures.

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