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

- Aggregated SMAs: -1.33% Net, -1.25% Gross; 2019 YTD: +3.7% Net
- Founder's Portfolio: -1.60% Net, -1.51% Gross; 2019 YTD: +2.8% Net

- July 2019 Income: ~0.8%; Annualized: ~9.9% (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. The weighted average income for the Aggregated SMA portfolio was 0.8%, almost 10% annualized. The monthly income range was -6.32% to +10.97% (non-annualized), while the annualized range was -64% to +173% (less meaningful). Total cashflow received was 1.7% of the portfolio value at the start of the month.

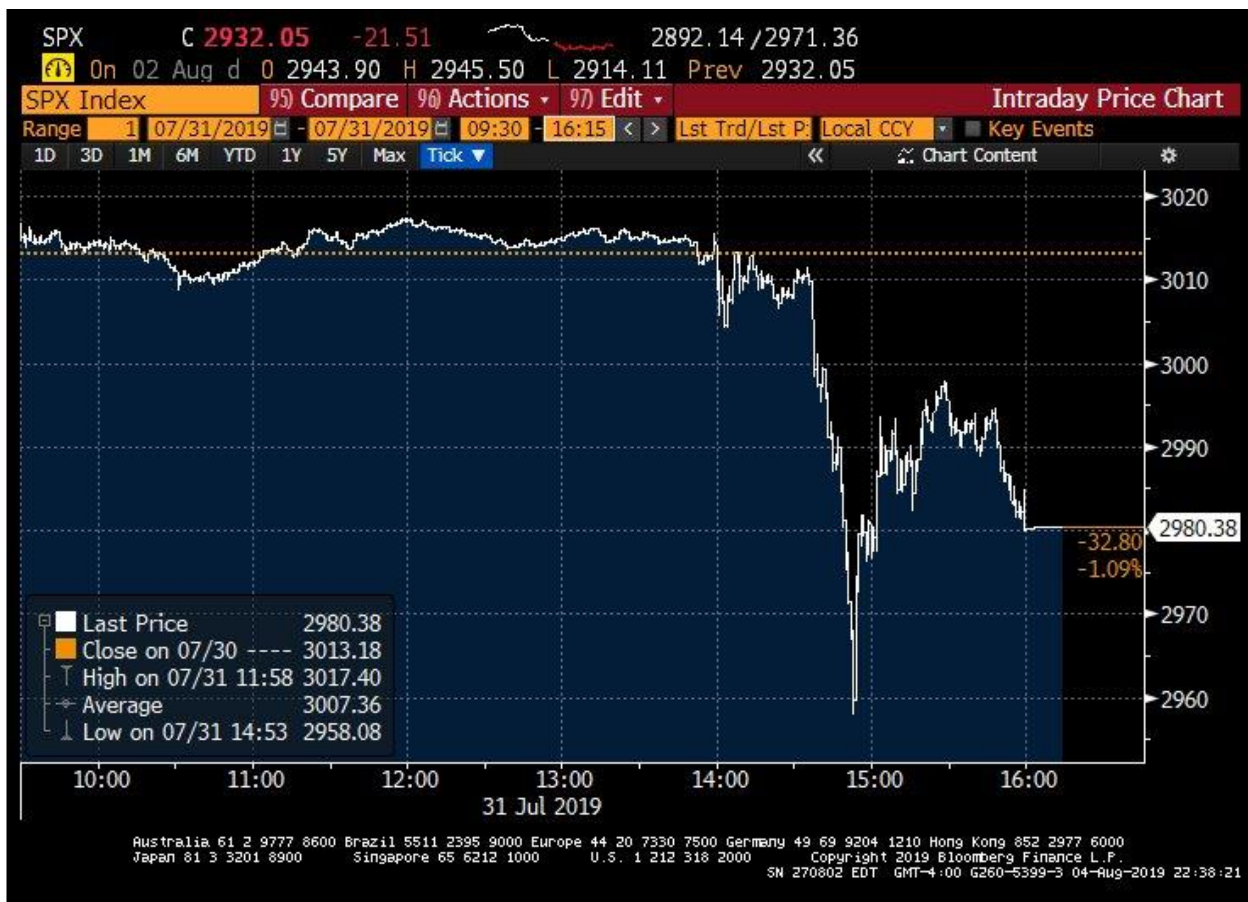
Our returns in May were negatively impacted by markdowns by our custodian's pricing service on the last day of the month, presumably in response to the rate cut and resulting S&P500 selloff. Almost all our positions were marked down, by an average of -1.5%, with a number floating rate bonds (off fixed rate collateral) being marked down as much as -8%, presumably under the assumption that the coupon will decline from Fed rate cuts, ignoring the potential upside for these $50s priced CMOs from the faster prepayments that will result from lower rates. Both the secondary market and the pricing services do not seem to understand the no-arbitrage condition under which CMOs are created, creating the opportunity for high income, mis-priced MBS, and 'prepayment convexity'.

In our April newsletter, we described the purchase of some cheap bonds from a dealer liquidation. We sold these at the end of July for a quick 14% return (non annualized), and to also raise cash in anticipation of panic selling due to selloffs in other markets.

Anecdotally, seasoned fixed rate legacy Non-Agency MBS are in strong demand, and there is a shortage of bonds in the market, evidenced by our sale at the end of the month. This contradicts the direction of mark changes by the pricing service.

Risk and Macro commentary

While markets and journalists appear to be blaming the current equities selloff on Donald Trump's tweets about additional tariffs on Thursday 8/1/2019, a closer look at intra-day data also shows a sharp selloff in Equities at 2:32pm on Wednesday 7/31/2019, in response to Powell's rate cut at 2:30pm. (Trumps tweet certainly added fuel to the fire on the following day).



This is precisely what should have been expected – rate cuts lead to a deleveraging in equities, resulting in Macro policy working in reverse, something central bankers have not figured out yet. On the positive side, I am finally hearing Bloomberg TV interviewees – buy side CIOs mostly – finally mentioning interest rate differentials and carry, although they usually hedge their comments and do not fully appear to believe their instincts.

I have written about this – macro working in reverse - at length, starting with my Crisis Notes between 2007 and 2011, proved it by analyzing money supply and flows of capital in 'The Failure of Macro economics' and further modelled it in 'Understanding Beta' in 2016. Readers might want to read (or reread) them. I will also recommend re-reading T-Leaf Reading.

There are two factors preventing a full blown selloff.

1) The key variable for carry trades is not the level of Fed Funds or the direction of change, but ***Interest Rate Differentials*** between funding countries (Japan and Europe mainly) and the US. Both their central banks have already announced their intents to keep policy 'easy', with a ECB rate cut expected in September while the BOJ is open to further easing. This will keep the differential stable. (In 2007, Bernanke unilaterally cut rates, shrinking the differential).

2) I am quite confident that Japan responded to the selloff on 7/31 and again on 8/1 by buying US Treasuries to neutralize the Yen strengthening (ie weakening theYen). This was verified (indirectly) by comments from a strategist I am friendly with.

> The relationship between the S&P and Yen that I first described in the first Crisis Note in 2007 is a result of Yen funding being used for quant systematic trading ie Yen shorts fund US longs. (This was responsible for and verified by the New Year's 2019 holiday (1/3/2019 actually) selloff – read my Dec 2018 newsletter.)
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> If Japan were NOT to buy USTs, the Yen would continue strengthening and stocks would continue selling off as stop-losses get hit, resulting in further sales and at least a March 2018 scenario (Yen went from 113 to 104), if not a 2007-2011 scenario (Yen went from 123 to 76 by 2011). If the Yen is allowed to strengthen, this would cause quant hedge funds that are playing in this trade to suffer losses on both sides of their balance sheets – on stocks and on the Yen – leading to liquidations and resulting in an unstoppable snowballing of the sell-off.

As I write this on Sunday night, the Yen is trading below 106. Beware Yen 105 and then 100. I expect the UST 10 year to get to my 2017 prediction of 1.5%.

We welcome your questions and comments.

Regards, Samir

August 4, 2019

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