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

	% Net Return	% Gross Return	2019 YTD Net	Trailing 1 year Net
Aggregated SMAs	**+1.59%**	**+1.66%**	**+5.3%**	**+5.2%**
Founder's Portfolio	**+2.55%**	**+2.63%**	**+5.3%**	**+6.6%**

August 2019 Income: ~0.8%; Annualized: ~9.7% (Aggregated SMAs @ recent marks)

Hello.

The average income rates for August 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 -9.5% to +13.5% (non-annualized), while the annualized range was -90% to +226% (less meaningful). Total cashflow received was 1.9% of the portfolio value at the start of the month.

As discussed last month, Non Agency MBS continue to be in demand, and numerous bonds have often traded above the 'marks' for much of the second quarter year. The pricing service appear to have noticed, and re-raised a number of our marks. Adding this positive return from Price Change (from marks) to our realized return from Income of ~0.8% explains our return for the month.

With four more months remaining for the year, our stable monthly income of 0.75% to 0.8% implies that we are on track for a 2019 return of 8% to 9%.

Risk and Macro commentary - Interest Rate Differentials

August led to much consternation among financial journalists and economists as bond markets rallied while stocks exhibited volatility. This quote from WSJ's James Mackintosh (WSJ Streetwise, Sep 5, 2019) exemplifies their confusion:

> *"Investors, including myself, have been trying to make sense of the apparent disconnect between the fear on display in the bond market and the high levels of the S&P 500 for months. August seems to have severed the ties between stocks and bond almost entirely, with long-dated bonds metaphorically screaming in panic, while the S&P lost less than 2%."*

At the same time, listening to business TV over the past few months, the amount of discussion of Interest Rate Differentials between countries has increased, with this topic apparently even being discussed at Jackson Hole by central bankers.

Economists and journalists have apparently not realized that the latter leads to the former. I continue to blame this on an inability to look at markets and economics from a 30,000 foot view of the landscape and history. This has resulted in the acceptance of market risk as an exogenous event, instead of risk and asset pricing being an understandable result of micro economics and money flows. Economics, especially, is flawed, as it relies on a 'closed economy' 1930's Keynesian/Hicksian understanding of managing money supply, and does not understand

that the macro world changed in 1996 when Japan opened its markets to foreign banks, allowing its savings to contribute to the money supply of other countries, primarily the US. The discussion by financial economists of yield curves shapes and levels predicting risk and recessions is a result of not understanding the global system of money flows.

The following papers I have written would be a good starting point to get an eagle's eye view of economics and asset pricing.

- Crisis Notes between 2007 and 2011
- The Failure of Macro Economics
- Understanding Beta
- T-Leaf Reading

These can be summarized in the following framework:

- **Interest Rate Differentials between countries result in flows of savings and capital from low interest rate countries to high interest rate countries as a result of microeconomic decisions of savers to maximize their returns – this is 'Hot Money'**
- **This results in growth of money supply in high rate countries, primarily the US, and thus asset inflation as this money chases financial assets**
- **The US, being the largest economy, is the country with the greatest ability to absorb capital inflows and becomes the largest magnet for capital**
- **When the US raises rates, or has a positive interest rate differential to other large economies, capital moves to the US, increasing US capital available for investment – Investible Capital (M3 – M2)**
- **The reverse – rate cutting – results in capital outflows, such as those that caused the GFC**
- **Such flows are also reflected in currency values**
- **QE – Cold Money - is direct injection of money supply and investible capital, but is only effective in the US**
- **Foreign holdings of US Treasury bonds are direct QE to the US and add to US money supply, as are foreign holdings of US corporate bonds (Samurai bonds, CLOs, etc)**
- **QE activities of low rate countries also get exported to the US, and do not achieve the desired result in the local funding country**

This framework was modeled in the ***Understanding Beta*** paper, linked above, resulting in a 96% adjusted R-Squared to the S&P market cap, explaining asset valuations.

The following tables demonstrate the impact of foreign flows of money on US Treasury Yields, from October 2018 onwards, when US Treasury rates started rallying. It is worth repeating that this is effectively QE to the US.

Table 4 shows that Foreign purchases of USTs more than dominated the reduction of UST holdings by the FED, as they allowed QE to run off. Between Oct 2018 and July 2019, SOMA holdings declined by $298B, with $160B coming from a reduction in UST holdings, and $136B from a reduction in Agency MBS. **Over the same period, Foreign Central Banks ("FCB") INCREASED their UST holdings by $436B, more than double the UST reduction by the FED, and also overwhelmed reduction in QE from the MBS runoff! (We compare to June 2019 and not August 2019 as the latest TIC data is from June).**

In comparison, US Government Bond ETFs experienced $49B in inflows between Oct 2018 and July 2019, and only an additional $6.9B in Aug and Sep 2019, not sufficient to explain a 0.50% rally in the 10 year.

This purchasing of USTs by FCBs is the primary reason for the rally in UST rates! If the shape of the curve is predictive of a recession, maybe it is of foreign recessions! (This is also why Swap Spreads no longer have meaning, and should not be used for hedging or as benchmarks).

Table 5 shows most of the Foreign purchasers of USTs. Japan is the primary purchaser - $104B. I strongly believe that the reason for these capital inflows is the interest rate differentials between the QE providing countries and the US.

Table 1

	Policy Rates				Differential		
	US Fed	**Japan BOJ**	**EU ECB**	**Swiss**	**US-BOJ**	**US-ECB**	**US-Swiss**
Oct 18	2.25	-0.07	-0.40	-0.75	**2.32**	**2.65**	**3.00**
Jun 19	2.50	-0.08	-0.40	-0.75	**2.58**	**2.90**	**3.25**
Aug 19	2.25	-0.06	-0.40	-0.75	**2.31**	**2.65**	**3.00**

Table 2

	10 yr Govt Yields					Differential			
	US Fed	**Japan BOJ**	**German**	**Swiss**	**UK**	**US-BOJ**	**US-German**	**US-Swiss**	**US-UK**
Oct 18	3.14	0.13	0.39	-0.01	1.44	**3.02**	**2.76**	**3.15**	**1.71**
Jun 19	2.01	-0.16	-0.33	-0.53	0.83	**2.16**	**2.33**	**2.53**	**1.17**
Aug 19	1.50	-0.28	-0.70	-1.02	0.48	**1.77**	**2.20**	**2.51**	**1.02**

Table 3

	US Quantitative Easing - Direct			US Quantitative Easing - Indirect			
	US SOMA	**US SOMA UST Holdings**	**US SOMA Agency Holdings**	**Total Foreign US- QE**	**Foreign Holdings UST Total***	**Foreign Holdings US Agency Total**	**Total US QE - Direct and Indirect**
Oct 18	**3,920**	2,116	1,669	**6,506**	6,200	305	**10,426**
Jun 19	**3,622**	1,955	1,533	**6,983**	6,636	346	**10,604**
Aug 19	**3,563**	1,938	1,490	**6,996**	6,636	360	**10,560**

Table 4

	US QE - Changes Since Oct 18						
	US SOMA Total	**US SOMA UST Holdings**	**US SOMA Agency Holdings**	**Total Foreign US- QE**	**Foreign Holdings UST Total***	**Foreign Holdings US Agency Total**	**Total US QE - Direct and Indirect**
Jun 19	**(298)**	(160)	(136)	**477**	**436**	41	**179**
Aug 19	**(356)**	(178)	(179)	**491**	**436**	55	**134**

Table 5

	Sources of Indirect US QE - Foreign Holders of USTs											
	All For-eign	**Japan**	**German**	**Swiss**	**UK**	**China**	**Norway**	**France**	**Spain**	**Belgium**	**Cayman**	**Hong Kong**
Oct 18	**6,200**	**1,019**	78	225	264	1,139	61	109	35	170	208	185
Jun 19	**6,636**	**1,123**	79	233	341	1,113	99	132	43	204	227	216
Change	**436**	**104**	2	8	77	(26)	38	22	7	34	18	31

Japan is also the majority buyer of US CLOs and likely US corporate debt as well, further adding to US money supply and helping drive yields lower, and equities and other assets higher. (See "*Japan Boosts CLO Scrutiny as Banks Buy Risky Assets*"; '*CLO Market Whale..*")

If I could find the CLO data, I'd write a paper titled "***CLOs are the New Samurai Bonds***". Just as Samurai bonds resulted in the growth in US asset prices from 1998 to 2005, CLOs are likely having a similar effect in the 2010-2020 decade.

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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