February 2020 - MBS Mantra MBS High Income/Absolute Return Strategy returns:

	% Net Return	% Gross Return	2020 YTD Net	2020 YTD Gross	Trailing 1 year Net
Aggregated SMAs	**+1.15%**	**+1.23%**	**+2.7%**	**+2.8%**	**+7.4%**
Founder's Portfolio	**+1.74%**	**+1.82%**	**+3.7%**	**+3.9%**	**+9.8%**

Feb 2020 Income: +0.86%; Annualized: ~10.8% (Aggregated SMAs @ recent marks)
Feb 2020 Cashflow % of invested value: 2.0% (~ 23.9% annual rate)

Hello.

February continues the trend that started for us in January – our returns, **+1.15% for Feb**, reflect expected High Income with some additional return from price/marks appreciation, recovering some of the markdowns from the last half of 2019. **The average income rate for Feb was 0.86%, 10.8% annualized**, 1bp higher than in Jan, and above our target range of 8% to 10%, demonstrating the stability of Income that can be created by having a diversified MBS portfolio. Income for individual MBS ranged from -43% to +48%, proving once again that MBS is not Fixed Income. It's a Variable Income class! Total cashflow received was 0.1% higher than last month, 2.0% of the portfolio value at the start of the month, around 24% if annualized, implying a portfolio average life (duration proxy) of around 2.5 years.

There were no clear trends in the marks this month. Some fixed rate bonds were up, while others were down. An example of an absurd markdown this month was a 4% decline in the price of a PO with the Refi index spiking! Floaters continued being marked down due to perceived lack of demand, in spite of there being very clear arbitrage opportunities in this sector (mispriced cheap by 10% to 20+%). Some of the derivatives were down while others were up. In general, the pricing service (Reuters/IDC) is catching up to the secondary market trading levels we have observed for the past few months, that have been mostly at higher levels than their marks. In fact, we sold a few bonds, that were underperforming, at the marked levels, which is a change from the past where we often purchased bonds below the mark, leading to a decline in marks in subsequent months as pricing services readjusted their marks based on our reported purchase on TRACE. (This is a flawed pricing process that the services use – they should either use their models if they think they understand MBS, or use secondary market prices, that can have a 10% or more range on the same bond, but not both, as that leads to a feedback process in markets, but also opportunities and value arbitrages that our process was designed to find.)

With the UST bond market rallying, and corporate HY credit in crisis, there is a 'hunt for yield' in MBS as a safe sector. Ours continues to be one of the very few sectors in the investment world that is not leveraged, and one that in general cannot be easily levered (due to current ratings), giving our bonds insulation from a supply shock induced by margin calls and deleveraging (unlike in 2007-2008). If anything, with rates having rallied, we are expecting even higher income from refinancing related prepayments.

The Canary – Yen – once again

This section has a more strident note than is typical of my newsletter, reminiscent of the Crisis Notes from 2007 to 2012, but there is a reason.

In the past 2 days, one former client emailed: “Do you think we’re at the beginning of a carry trade unwinding? What’s the total approx. size of the Trade.” Another asked “How low can the 10y yield go” and “How about the Yen”. A third actually called to discuss system leverage in response to a Linkedin post I made. I continue to get a few requests to resume Crisis Notes.

For the past 10 years or so, Bloomberg users will have seen my header: “What, me worry? Yes, at Yen 105’. The time has come to worry. The Yen is at 105.96 tonight as I write this.

To answer these questions, I would suggest that readers, in addition to reading this note, carefully read some of the articles linked below. This will take time to read – a lot, it’s years of research and writing - but if you own assets, at the very least it will give you another viewpoint to understand the risks you are taking and facing, if not a comprehensive understanding of how economics really works.

Readers of my Crisis Notes, especially former clients from my sell-side days, as well as readers of this newsletter will have heard this ad-museum from me – the Yen is the best hedge for risk, and is the ‘canary in the coalmine’. If you’ve seen my pitch books, under the Risk and Hedging section I write: “We have not found any hedges that reduce the Standard Deviation of our returns….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”. This is probably the most important statement in my deck.

The Yen matters, as the Yen Carry Trade has funded the US Economy since 1994, as hard as that might be for US patriots and believers of central banker practices and statements to believe. The Yen has been and continues to be the primary funding currency for the US economy, and the tick-by-tick intraday relationship of Yen/S&P is a result of levered stock market trades being funded in Yen by large hedge fund quants. Yen rallies are NOT a ‘flight to havens’, but deleveraging – unwinding of levered trades, typically in stocks by levered momentum and trend following traders. Since 2012, the Euro has joined the game, with large European asset managers sending their assets to the US markets, and now both the Euro and the Yen move in tandem and inversely to US stock prices. The US economy and the S&P define TINA globally - “There Is No Alternative” - for money to go to roost, but this is hot money and the flows are easily reversed.

BTW, the Euro joining the party as a funding currency is not a newly found relationship, as Bloomberg finally thinks – I showed the charts for the Euro and Yen in 2017’s ***Predictions 2017*** Viewpoint.

I discussed the leveraging of the US assets and the financing and growth of the US and global financial sectors using Japanese borrowing in the ***2007-2012 Crisis Notes***, (originally at ***shaeshah.blogspot.com***), including funding of asymptotic growth of the banking sector. In 2016, I comprehensively analyzed Japan’s export of capital and the incentives for that export, the impact on global GDPs, money supply in both the US and Japan, and the resulting asset inflation in ***The Failure of Macro Economics – Carry Trades, Money Flows, and the Pricing of Assets*****.** I strongly believe that this is the root cause of social crisis in Japan and the income inequality crisis globally as well – only those with assets benefit(ed) from this tsunami of capital from Japan. ESG investors focused on the ‘S’ in ESG should make an attempt to understand this, and put pressure on central banks to understand how macro actually works.

All of this was quantitatively modelled in 2016 in ‘***Understanding Beta – Determinants of the US Stock Market***’. This explains US stock market valuations with a 96% R-squared, and we are seeing this model playing out in real time with a combination of the Corona Virus and Powell-Rate-Cut-caused deleveraging. Further rate cuts by the Fed will likely lead to additional stock market losses due to deleveraging as interest rate differentials decline, exactly as they did in August 2007 when Bernanke cut rates in reaction to a relatively minor subprime lending problem, triggering a global financial crisis. Please re-read "***This is Not a Subprime Problem***", from Aug 10, 2007 prior to the initial rate cut.

To answer the question that my client asked of what is the size of the (carry) "Trade", the answer is found in ***Understanding Beta***. The current value of the US stock market is $33T! The intercept in the model of Equity market cap, when all 'Injected Capital' is zero, is $2.978T. We have 10x asset inflation currently, and a lot of room to decline if deleveraging continues.

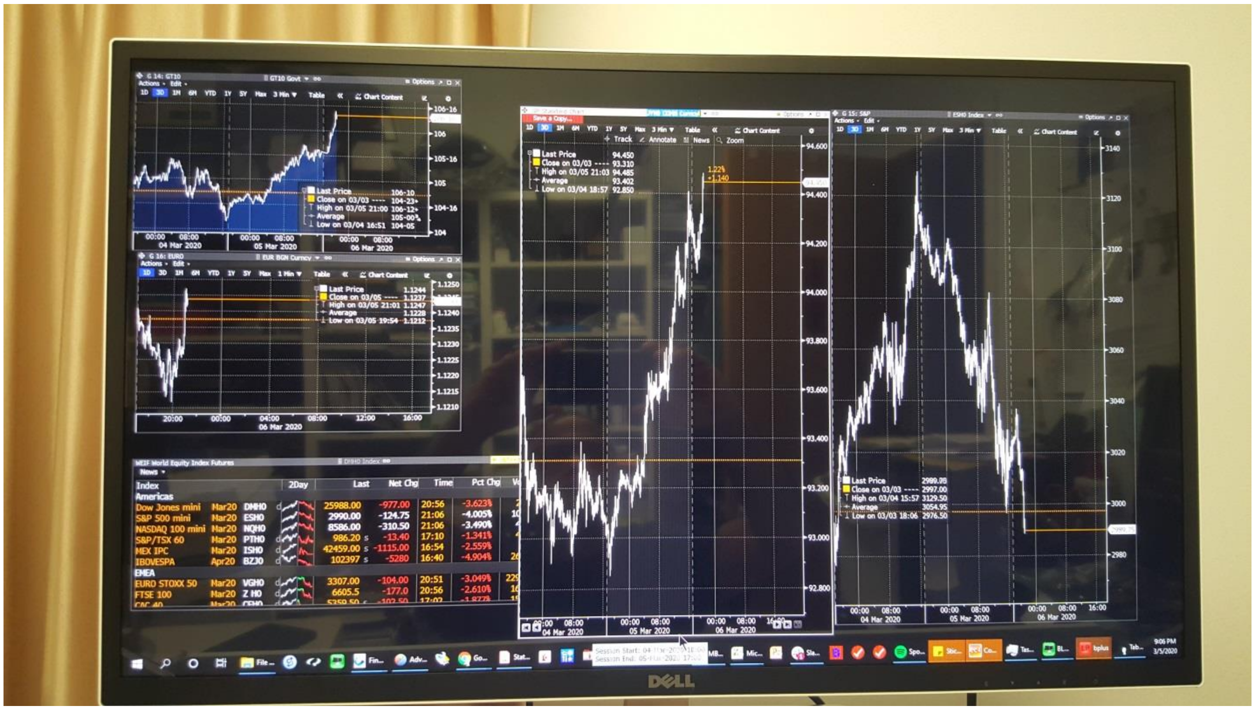
To understand the answer to the question of "How low will rates go", one has to read some of the Crisis Notes and 'The Failure of Macro'. In a 2009 Crisis Note '***This is NOT an Economic Crisis; This is an Economics Crisis***', I proposed a new economic theory – ***When One Economy Enters a Liquidity Trap, All Monetary Policy Fails Globally***. With monetary policy impotent, (and working in a 180 degree manner since 1998), all global interest rates have no choice but to converge. Over the past decade, we have seen this play out, with Japan's liquidity trap having infected Europe. In 2007 I won numerous friendly bets with client hedge fund managers for predicting that FNMA 3% MBS would price at 100 before 2012, and won this bet in 2010 (loser to feed 100 homeless at a food shelter). I predicted this in 2007 when FNMA 3s did not even exist. We continue to see this convergence of global rates, and either other industrialized countries will raise rates or we too will go to negative rates. The timing could be years or decades, but the march is indefatigable. (The ultimate end game can only be a single global rate or country isolation.)

The picture below is one of the monitors on my desk as I write this. ESH0 = S&P 500 future; JYH0 = Yen future; EUR = Euro; GT10 = 10yr UST price. If you look carefully, they all move in tandem perfectly, tick by tick, highly if not perfectly correlated. I showed graphs of Yen and S&P in the 2007 Crisis Note as well.

I explained why the relationship between Yen and UST exists in my ***Nov 2018 newsletter***, when the Yield Curve inverted, and went into much greater detail in March 2019's ***T-Leaf Reading*,** and added more data in the 9/20/19 Viewpoint "***Interest Rate Differentials***". Japan buys UST's to keep the Yen weak and any strengthening (usually due to a deleveraging is US stocks) in check, resulting in UST yields declining when stocks decline. This playbook was first executed in 2002 after Greenspan's rate cuts after 9/11/2001 led to a deleveraging, leading Japan to buy $400B in USTs and inadvertently give us our first QE between 2002 and 2004. This is also described in T-Leaf Reading. Without Japan's current UST purchases, that continue to give us Quantitative Easing (QE), the Yen would be in the 90s, given the declines in US stocks.

At some point, I will have the time to make this into a macro strategy that I will offer as a product. For now, I am sharing this as a risk management process.

The target for the Yen? Finger in the wind prediction: 50 without BOJ intervention. In 2007, Yen was at 123, when I started telling all my clients to hedge with Yen (as I was doing). It declined to 77 by 2012, on its way to 50, when Abe was elected in 2012 and promised to take it to 112 with his Three Arrows, reversing the strengthening.



In last month's newsletter, I said "*The coronavirus is an unexpected event, but by no means is it a 'Black Swan' event as far as asset prices are concerned, as Barron's and others were suggesting last week. The history of so-called Black Swans (also detailed in T-Leaf Reading) is all about declines in money supply or leverage that result in changes in asset prices, brought about by the unintended consequences of central bank or governmental policies… As long as central banks keep money supply flowing through QE and QE-like actions, I do not expect asset prices to go into free-fall. The Yen is back to 109.90, with leverage flowing to support asset prices.*"

With the Yen now at a 105 handle, it is time to be concerned. Most of the market action feels like opportunistic trend following quant Hedge Fund trading and market making activity and not real deleveraging – the correlations among the big 4 are too tight, implying systematic trading. Investors are expecting other central banks to cut as well, maintaining interest rate differentials. But if Japanese or European institutional or retail investors delever in response to Powell's rate cut, all bets are off.

In ***2007's first Crisis Note***, I said "I don't see how the global unwind can be stopped. While most of these assets are money good, it's going to be hard to find enough balance sheet for them. That means prices will need to cheapen." In the next Crisis Note, "***Rate Cuts Will Not Work***", I commented "What's a PM to do? One word: SELL (while you can)."

In today's world, I think the central banks are far more irresponsible, which is good for asset prices, as politicians seem to tolerate huge debts (by most standards this is irresponsible; by my standards, rate cuts are irresponsible) and will print money and do more QE. This will dampen asset price declines, and I am not expecting a 2007-2010-like deleveraging that took stocks down to a $5T market cap.

However, I would still recommend, as I have been for the past months and year, to reduce exposure in stocks, high yield bonds, CLOs, probably real estate, and any other assets that are inflated due to the supply of leverage – they will lose value as the world slowly delevers, in spite of lower funding rates.

If Yen breaches 100, I would suggest aggressively selling as that would imply that the BOJ has lost control of its ability to weaken the Yen. The quants will get margin calls on their Yen shorts and delever their S&P longs and crash the world, as selling snowballs and accelerates.

We welcome your questions and comments.

Regards, Samir

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