MBS
MBS Mantra, LLC

Feb 2021 – MBS Mantra MBS High Income/Absolute Return Strategy returns:

	% Net Return	% Gross Return	Since 4/1/2020 Net %	2021 YTD Net %	2021 YTD Gross %	Trailing 1 year Net %
Aggregated SMAs	+0.57%	+0.64%	+15.8%	+1.7%	+1.9%	+1.1%
Founder's Portfolio	+0.44%	+0.52%	+15.7%	+1.5%	+1.7%	+1.2%

Feb 2021 Income: +0.87%%; Annualized: ~13.1% (Aggregated SMAs @ recent marks)
Feb 2021 Cashflow % of invested value: +2.9% (~ 34% annualized rate)
Feb 2021 Loss rate: -0.34%

Hello.

Another good month, outperforming all our benchmarks, except the S&P500, in February. Our Aggregated SMA's had a portfolio net total return of ~+0.6%, demonstrating the core strength of our MBS Income strategy, namely the ability to overwhelm negative price change.

The Income performance of the MBS portfolio was a little lower than recent at 0.87% (still high At 13.1% annualized), mainly due to a slightly higher than usual loss rate of -0.34%. Prices were down slightly on average for most bonds as well. However, the portfolio income dominated and delivered positive total return performance that beat all our bond benchmarks: February returns for the AGG were -1.52%; MBS -0.70%; HYG +0.37%; S&P +2.78%. Similarly, YTD, we are outperforming the other bond benchmarks and our gross return is in a dead heat with the S&P.

Our net return since March 2020's selloff has been around 15.7%, driven by Income, in spite of marks that have not recovered since then.

Whether or not our vintage MBS get marked back up, our higher-than-market income continues to overwhelm markdowns over time. The high cashflow percentage also implies a short duration for the portfolio. The High Income continues to reduce the breakeven prices for each bond we own, and allows us to reinvest and compound over long periods. The High Income investment process that is fundamental to our strategy protects capital, creates durable self-healing portfolios, and is responsible for the non-normal distribution of our returns with positive skew and high kurtosis that makes our strategy unique (please see our paper ‘The MBS Income Factor’ from 10/2019 for details).

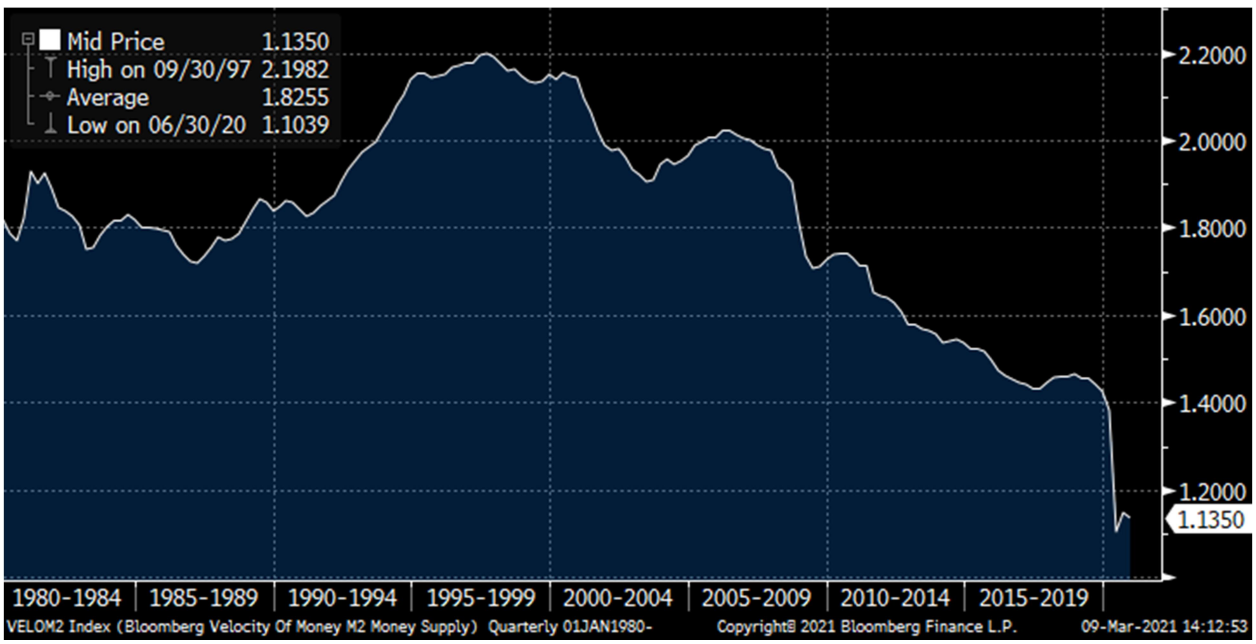
Comments on Inflation risk

The market is currently fixated on the notion that inflation is around the corner, just as it was expected in 2008, 2012, and numerous times since. USTs are being sold, and interest rates and inflation expectations are rising, in spite of Jerome Powell’s ministrations that he will keep rates low for the foreseeable future and tolerate some inflation.

I think the market is wrong, and we will not get significant inflation in spite of the unprecedented growth in the monetary stock.

Here is the graph and data to watch: Velocity of M2 (Velocity of M3 would be better, but we stopped measuring this, a pet peeve for me).

Velocity of M2 Money Supply (Source: Bloomberg)



The rise in M2 velocity from the early 1990s to 2007 is a function of the Yen Carry Trade driving Japan’s capital and QE to be invested in the US, increasing US M3-M2, and resulting in asset inflation in the US (and wealth creation for those with assets), a period I covered in great detail in ‘***The Failure of Macro Economics***’.

Please read John William’s 2012 presentation and speech discussing inflation. It could be have been written yesterday, and explains why the inflation fears from monetary expansion are unfounded.

https://www.frbsf.org/our-district/press/presidents-speeches/williams-speeches/2012/july/williams-monetary-policy-money-inflation/

He starts with:

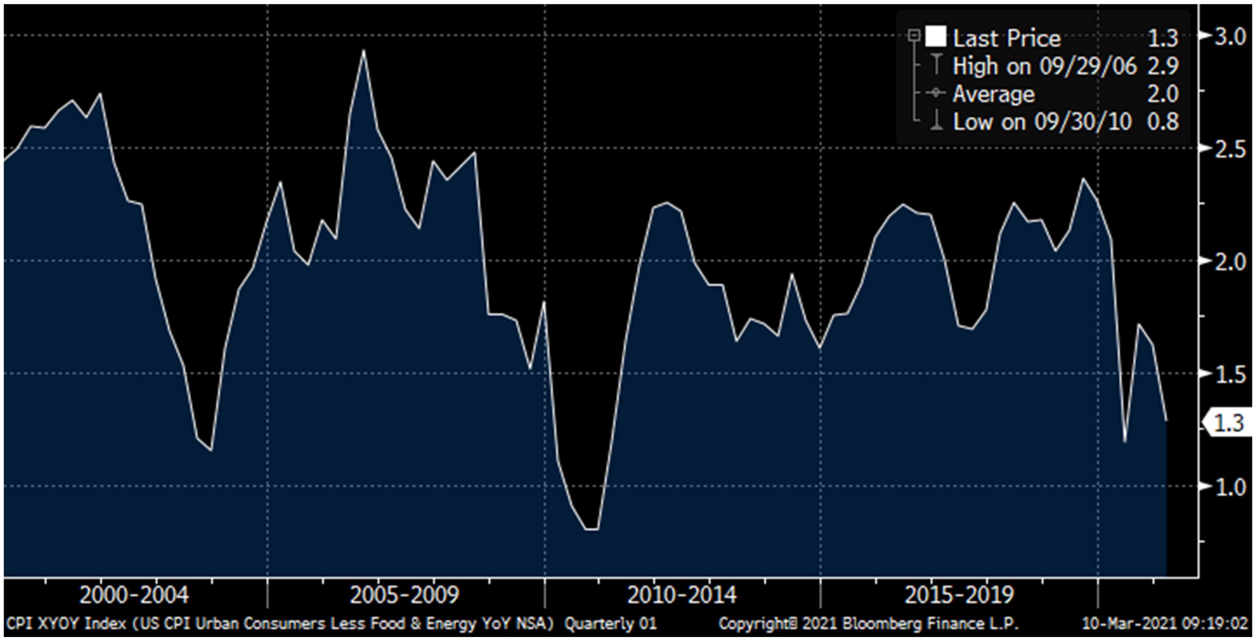
> ***"And I'll begin my presentation with a reference to another pathbreaking monetary theorist. Milton Friedman famously said, "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." We are currently engaged in a test of this proposition. Over the past four years, the Federal Reserve has more than tripled the monetary base, a key determinant of money supply. Some commentators have sounded an alarm that this massive expansion of the monetary base will inexorably lead to high inflation, à la Friedman."***

Mr. Williams concludes:

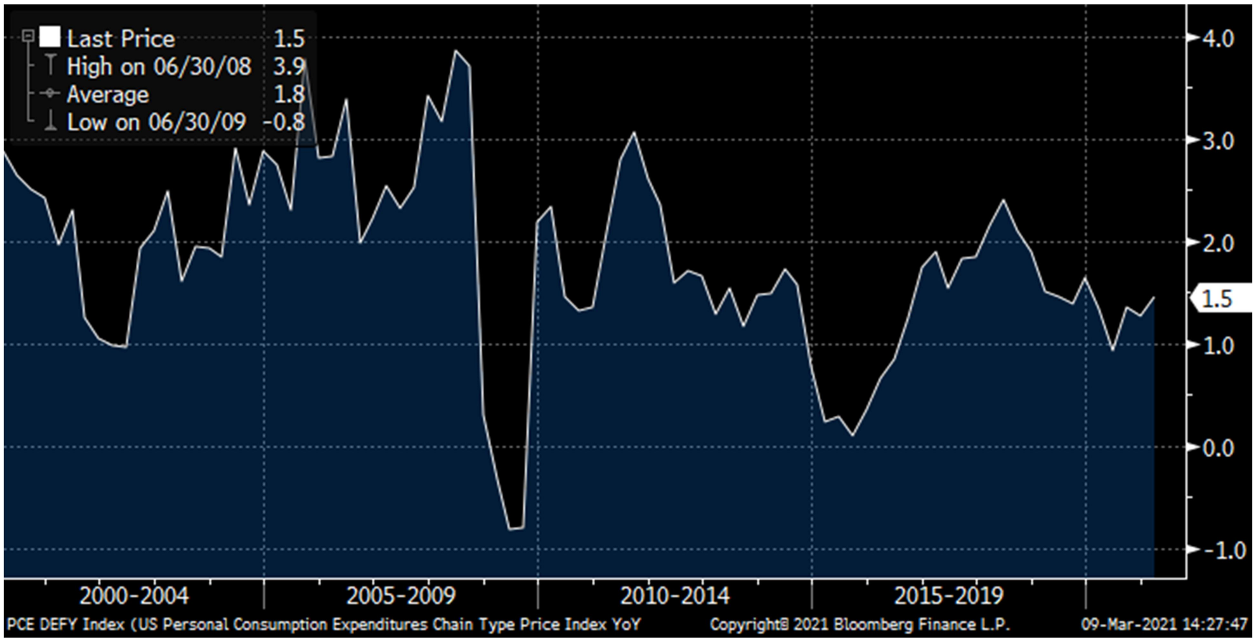
> ***"As a result, in a world where the Fed pays interest on bank reserves, traditional theories that tell of a mechanical link between reserves, money supply, and, ultimately, inflation are no longer valid."***

Since 2008, US QE and central banking policy has failed to generate sufficient demand for capital, probably because cheap and plentiful capital from the aforementioned period from 1994 to 2007 resulted in the global creation of enough hard assets and excess capacity for making most things. Banks, with insufficient C&I loan demand to lend out their capital, choose to maintain a large balance in excess reserves at the Fed. Without demand for "stuff" that can exceed supply, one cannot get inflation, no matter how much money is created. Lest one forgets, Core CPI peaked in 2006, while PCE peaked in 2008 – with neither Bernanke's and Yellen's US QE programs having achieved their inflation goals.

Core CPI YOY (Source: Bureau of Labor Statistics)



Personal Consumption Expenditures Chain Type YoY (Source: Bureau of Economic Analysis)



A rise in the velocity of M2 will tell us when there is demand for capital and lending from banks for investment projects, which will lead to real growth and capital formation, which in turn will eventually lead to inflation in wages and commodities. It is a long way away.

UST Yields and the Shape of the Yield Curve

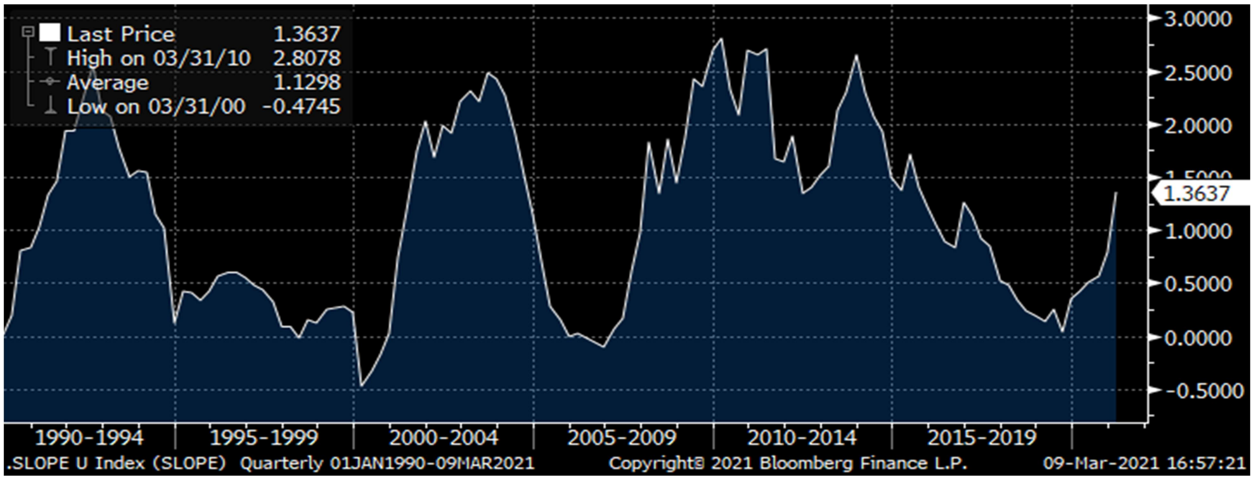
Rising yields and the shape of the yield curve is also of concern to some – namely the steepness of the 10s-2s spread.

My contention is that in today's world dominated by QE and central banks destroying the concept of markets in bonds (where prices and yields were formerly set by the informed decisions of buyers and sellers), yields contain no useful information about real returns and inflation expectations.

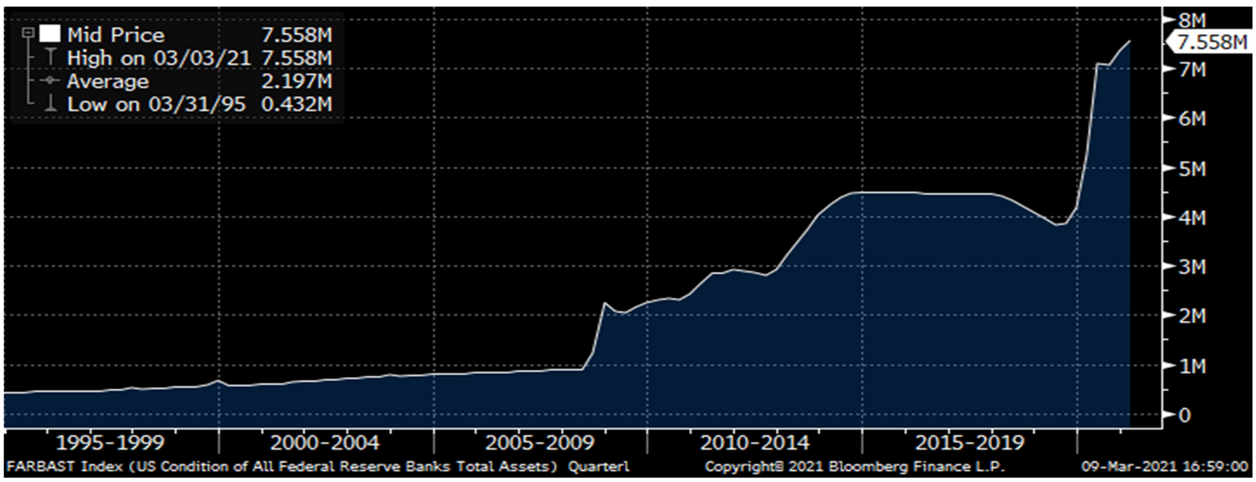
To understand yields, it is imperative to recognize the motivations of the largest and marginal buyers and sellers of USTs: the Federal Reserve, the Bank of Japan, and Risk-Parity funds. Of these, the first two are not making their decisions in any informed manner (Fed – injecting money supply; BOJ – keeping Yen weak), and have obliterated the information content of yields. The third, however, can inject significant risk into the system, as we saw in March 2020's deleveraging.

Foreign central banks tend to buy short duration USTs, steepening the curve, while the Fed buys longer duration MBS and USTs, flattening the curve. Due to the ballooning of the Fed's balance sheets with USTs, TIPs and MBS, it is unlikely that the yield curve will get as steep as it used to in the pre-US-QE periods. (The steepness in the 2000-2003 period is explained in T-Leaf Reading – the steepening resulted from Japan buying shorter USTs to implement its QE and weaken Yen, distorting swap spreads as well).

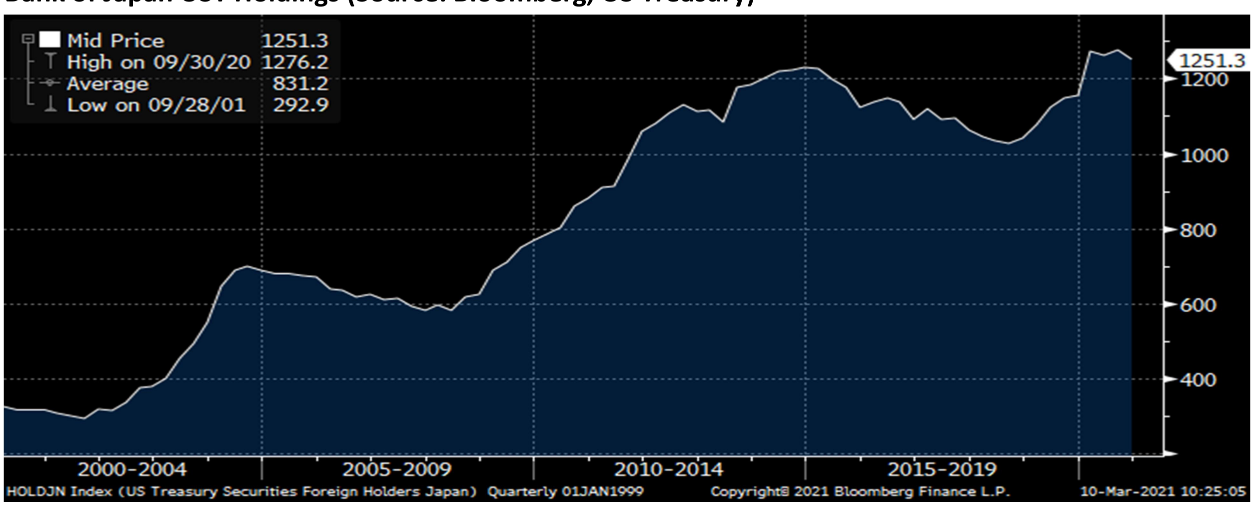
UST Slope: UST 10yr – UST 2yr (Source: MBS Mantra; Bloomberg)



FED Total Assets (Source: Bloomberg, Federal Reserve)

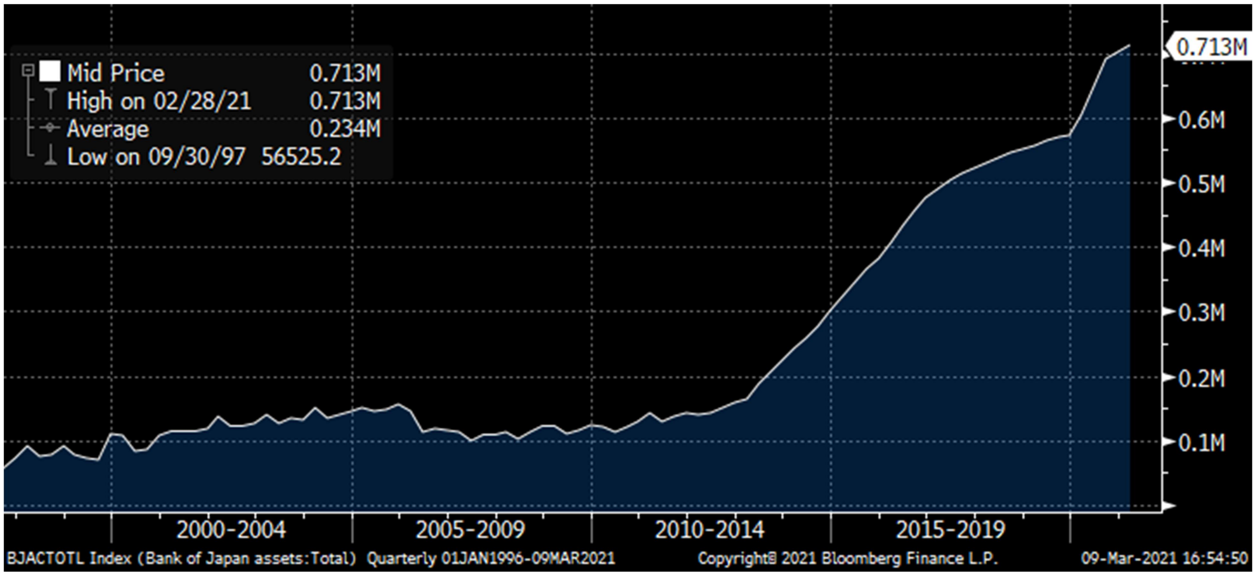


Bank of Japan UST Holdings (Source: Bloomberg, US Treasury)

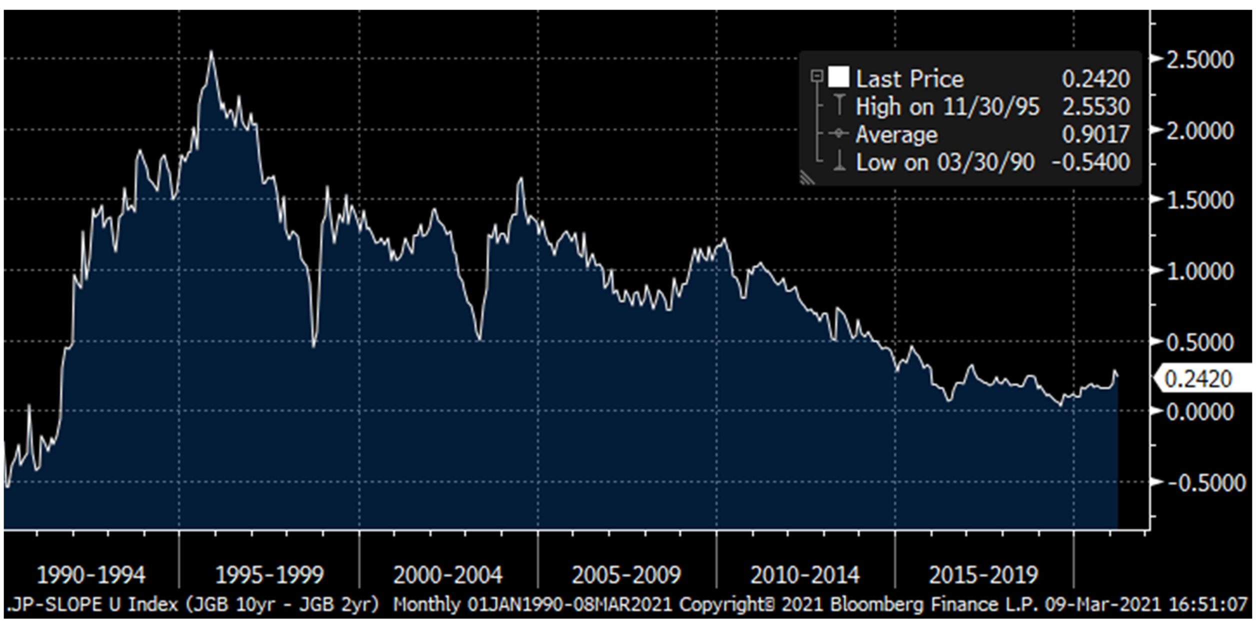


The Bank of Japan started using QE in 1998. The US started QE in 2008. We can look at Japan's yield curve slope history as a template of what to expect in the US. QE destroys the volatility of the slope of the yield curve.

BOJ QE: Bank of Japan Balance Sheet Holdings (billion Yen) (Source Bloomberg, BOJ)

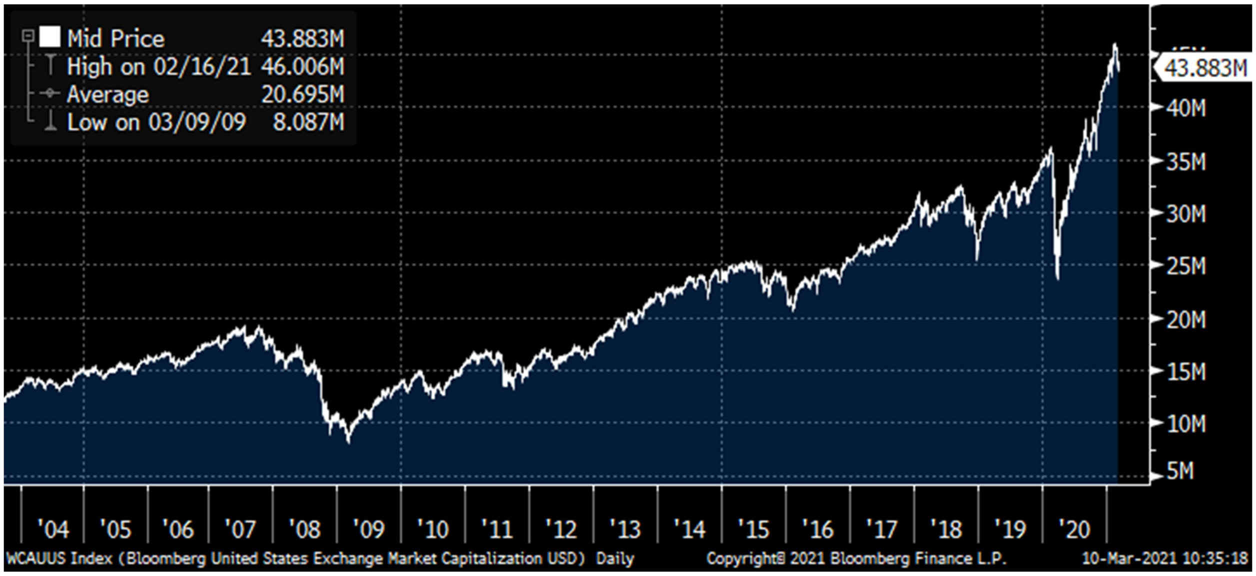


JGB Slope: JGB 10yr – JGB 2yr (Source: MBS Mantra; Bloomberg)



In the meantime, what we will continue to get is what we have been getting for the past few decades during the central banks' experiments with QE: Asset Inflation, especially in US Equities. (We have more than blown through the March 2020 levels!)

Market Capitalization of US Exchange traded securities (Source Bloomberg)



Please stay safe, and wishing you good health.

Regards, Samir Shah

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