Aug 2022 – MBS Mantra MBS High Income/Absolute Return Strategy returns

	% Net Return	% Gross Return	2022 YTD Net %	2021 YTD Net %	Trailing 1 year Net %
Aggregated SMAs	**-0.65%**	**-0.58%**	**-1.5%**	**+10.0%**	**+1.3%**
Founder's Port	**-1.00%**	**-0.92%**	**+0.2%**	**+10.1%**	**+2.8%**
BB Barc Agg	-3.04%		-10.7%	-1.8%	-11.6%
BB Barc MBS	-3.33%		-9.0%	-1.0%	-9.7%
BB Barc HY	-2.30%		-11.2%	5.3%	-10.6%
S&P 500	-4.08%		-16.2%	28.7%	-11.2%

Aug 2022 MBS Income: +0.96%; Annualized: +12.2% (Aggregated SMAs @ month end marks)
Aug 2022 MBS Cashflow: +1.2% (~14.8% annualized rate)
Aug 2022 MBS Loss rate: -0.02%

Hello.

Keep reading for some thoughts on Monetary Aggregates, Asset Prices and Employment.

A quiet month for us, as rates underwent an unrelenting and steady rise. The 10-year UST yield rose from 2.57% to 3.2%, leaving most fixed income investors with -2% to -4% total returns for the month. Our portfolio's prices were down -1.6% on average due to marks declining, however positive Income of ~ 1% limited our TRR decline.

Flows remain low in Non-Agency MBS, with limited supply and not much selling. However, when bonds do come up for sale, they appear to trade strongly, often trading over the "marks". (We believe our YTD returns that are based on marks are underestimated.)

As seen in the new table above, we outperformed most "fixed income" asset classes for the month, and quite significantly for the year. Within our portfolios, the client portfolios were down only -0.3%, while my personal "Founder's Portfolio" was off by about -1%, resulting in an average return for the Aggregated accounts of -0.65%.

Overall, the High Income of the portfolio and the balance between our positive duration and negative duration bonds is buffering out negative price returns from market volatility – this is by design and a core feature of our process and portfolio construction. Once rates are done rising and prices have stabilized, we expect High Income to once again dominate our returns.

Cashflow this month was lower than in the recent past, at 1.2% (15% annualized). Income was marginally higher than last month, at +0.96% (12.2% annualized), but lower than earlier this year and last year. However, Income is still higher than the 8% Income we've targeted since our inception.

Monetary Aggregates, Asset Prices and Employment

On Sep 8th, 2022, at the Cato Institute's Monetary Conference, Jerome Powell said something that made my jaw hit the ground.

https://www.youtube.com/watch?v=fVSmA30qWu0

Quoting Mr. Powell at around 20 minutes into his interview and discussion:

"…changes in monetary aggregates have not had a consistent reliable relationship, they haven't been a good predictor of the economy or of inflation…but for now and for really many years now

monetary aggregates don't play an important role in our formulation of policy

and we don't think they are generally a good way to think about policy or of inflation…"

Such lack of understanding about the importance of Money Supply by Mr. Powell does not come as a surprise. To my mind, this should almost disqualify Mr. Powell from being a Central Banker. However, none of the other Central Bankers are any better qualified. It was Ben Bernanke who stopped measuring M3 in 2006, following a proposal from Alan Greenspan I assume, thus putting a brake on the Fed's ability to ever understand the economy and its link to asset prices, using the most absurd explanation I have ever heard.

From Bernanke's testimony during nomination in 2005:

"My understanding is that the Federal Reserve decided to discontinue publication of the monetary aggregate M3 because the costs of collecting and processing the underlying data were judged to exceed the benefits."

https://www.govinfo.gov/content/pkg/CHRG-109shrg26610/html/CHRG-109shrg26610.htm

When has the government ever shied away from spending money? This decision is a result of being unable to explain the growth of M3, which was rising very fast relative to M2 from 1994 to 2005, as money poured in from Japan (Japan also gave us QE in 2002 by purchasing US Treasuries with their QE).

Playing ostrich is not how monetary policy should be conducted.

Almost laughable, if it were not such an enormous mistake with such high costs, during the GFC ("Great Financial Crisis") of 2007-2010, through increased volatility, and through increased Income Inequality.

See below for some other excuses.

Mr. Powell, this is how Money Supply influences the Economy, and how Monetary Aggregates should be used. (links to documents I reference are in the last section).

1) **Monetary Aggregates, M1, M2 and M3**

M1 is physical currency notes and demand deposits outside the US Treasury

M2 is cash in the bank and money market funds plus M1

M3 is cash at brokerage firms, institutional cash and repo (larger deposits and less liquid "near" money) plus M2. M3 is more volatile than M2.

In 2016, in ***The Failure of Macro Economics*** paper, I coin the phrase ***<u>Investible Capital ("IC").</u>***

<u>IC is (M3 – M2). This is money waiting to be invested.</u>

- If money comes in from an external source to be invested in the US, M3 and IC goes up.
- If one buys assets, asset prices go up due to the demand. Without any additional capital import, IC should decline, as well as M3 relative to M2. However, the upward momentum in asset prices usually induces even more capital imports, so IC tends to go up with asset prices, offsetting marginal reductions. In short, IC increases lead to increases in asset prices, begetting additional IC increases.
- If one sells assets, IC goes up as cash proceeds from asset sales end up in M3. Asset prices decline due to selling.
- If money is repatriated by a funding country that has lent us money to invest, M3 and IC decline in the US, and IC goes up in the repatriating country.

<u>Declines in IC are usually triggered by Central Bank policy change activity.</u>

Powell just admitted that central bankers look at <u>changes</u> in monetary aggregates (ie changes in M2 as that is what is available now). As Powell says, they don't correlate. This is the wrong thing to look at.

They should be looking at IC=M3-M2, and more importantly, the changes in IC=M3-M2.

<u>Changes in IC are highly correlated with the economy, GDP, asset prices and employment.</u>

2) **One also has to view the world as one pool of capital, and track money supply and IC in multiple countries.**

This is another fundamental flaw in Central banking – ***every Central Bank and banker has a myopic belief that their policy actions only impact their domestic economy*** – 1930's Hicks IS-LM Keynesian macro thinking – resulting in how they implement monetary policy.

Japan's 1996 "Big Bang", where Japan allowed foreign banks to have access to the BOJ's window to borrow ("call money") fundamentally and permanently changed the world of central banking and money flows, yet the Central Banks are blissfully unaware of this or at least ignore it.

https://www.brookings.edu/articles/the-big-bang-an-ambivalent-japan-deregulates-its-financial-markets/

This is NOT in Ben Bernanke's Macro Economics text book.

Central banking is no longer the single box/country model of the 1930s where interest rate management leads to changes in money supply. **Since 1996, in a multi-box world, macro response works <u>inversely</u>** as money flows

between countries in response to **relative** interest rates – yes, carry trades are implemented – transferring money supply to other countries. Since the US is the only scalable capital market, it is a magnet for foreign capital, and as a result, **rate hikes in the US increase domestic money supply** and vice versa. One can also see this in the price of the dollar relative to the Yen and the Euro.

As an example of using IC - when the GFC hit in 2007, and everyone sold assets, US IC did not go up. However, Japan's IC went up significantly, with the Yen rallying, proving Japan's repatriation of the capital that had funded US banks, leading to the collapse of the banking system, and the decline of ALL asset prices as the inability to roll funding led to asset selling and margin calls. (The GFC was a deleveraging of US assets through withdrawal and non-rolling of short-term funding by Japan – the Yen Carry trade unwound - and not an MBS event. Equities declined even more than MBS).

If you did not look at Japan's IC, you would call the GFC a Black Swan event, which it most certainly was not. The GFC was predictable if you paid attention to how Macro really works. It was triggered by Bernanke cutting rates.

https://shaeshah.blogspot.com/2007/08/crisis-note-2007-1-8102007-this-is-not.html

In *The Failure of Macro Economics*, linked below, I identify every source of Japanese funding of the US economy from 1994 to 2008, and the perfectly Pavlovian micro economic behavior that led to changes in money flows, US money supply, and US asset prices.

3) The US is largely a services economy, driven by Asset Prices.

According to Statistica, services constitute 77.31% of US GDP.

https://www.statista.com/statistics/270001/distribution-of-gross-domestic-product-gdp-across-economic-sectors-in-the-us

Services and GDP, at the margin, are driven primarily by changes in asset prices.

When asset prices go up, the wealth effect leads to additional consumption of services, which trickles down through the economy. Unlike money supply velocity, there is a "velocity" to services spending.

I'll make up an example. If your wealth increases, you buy a larger house, construction of which is roughly 50% direct and indirect services and 50% material. You then hire painters, carpenters, plumbers and lawn care people, increasing your expenditure on services. If you buy a US made car, the majority of the car cost is labor assembly and transport of materials – services - with a significant proportion of the parts being imported and not manufactured in the US. You then buy insurance (more expensive for a new car), and take the car to expensive dealers for service, and finance the purchase, growing the services component of the economy. New clothes get dry cleaned. You go out for dinner more. Etc. The people that you supported through your spending, in turn, do something similar.

When asset prices decline, discretionary spending gets cut, leading to a direct hit to the services economy, thus increasing unemployment along with declining GDP as services velocity unwinds. We saw this in 2007, and the opposite between 1994 to 2005. (In 2007 I made, and won, numerous friendly bets with a number of my money manager and hedge fund clients that unemployment would exceed 7.5%, and that FNMA 3s would become the current coupon before 2012).

Changes in IC=M3-M2, through their impact on asset prices, explain and make changes in the economy visible. The Fed, economists, and investment managers are running blind without M3.

Today, without continuous global QE, all of which comes to roost in the US, US IC would collapse, taking down with it asset prices and employment.

Rate hikes are battling the preconception of investment managers that they are "bad" for asset prices. The money that is buying dips is coming from somewhere. QE on the other hand is a Pandora's box that cannot be closed. Like Bernanke during his 2013 Taper Tantrum, I doubt that this Fed will tolerate a large decline in asset prices that will result from QT, and so will cut rates again when that happens, potentially accelerating declines in asset prices at that time.

I have written about all this in great detail in the past. It is a lot of reading, and it is all available on my website:

https://mbsmantrallc.com/analysis.shtml

The 2007-2011 Crisis Notes during the GFC are in the right column of the Analysis tab, where I start discussing Macro, Carry Trades, asset prices, bank funding and balance sheets, etc.

IC is defined in 2016's ***The Failure of Macro Economics (Carry Trades, Money Flows, and the Pricing of Assets)*** in Section 3, along with exhaustive detail about the funding of the US economy by Japan, and the impact on asset prices, durable goods orders etc.

https://mbsmantrallc.com/macro.shtml

Japan's Big Bang and the Black Swan event that led to it, and all that has followed since is discussed in ***T-Leaf Reading***:

https://static.wpb.tam.us.siteprotect.com/var/m_0/00/003/44984/793445-T-Leaf_Reading_3-12-2019.pdf

To understand and model Asset Prices, one can bypass Monetary Aggregates, since M3 is not published anymore.

Instead, one can directly measure Central Bank inputs – creating what I call "***Injected Capital***" - to model and predict Asset Prices. This is modelled in ***Understanding Beta – Determinants of the US Stock Market***. This model has a 96% adjusted R-squared to the market value of US Equities.

https://mbsmantrallc.com/var/m_0/00/003/44984/689019-MBS_Mantra_-_Understanding_Beta_-_Determinants_of_the_US_Stock_Market_-_Sep_20_2016.pdf

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Stay tuned for a comprehensive piece on this topic, with updates of the models. I've started it, but constantly run out of time to work on it – it's a huge project that the Fed should be doing, and working on it does not pay the bills.

In the meantime, enjoy some excuses that are more realistic than those of central bankers:

https://myassignmenthelp.com/blog/20-most-funny-excuses-for-not-doing-homework/

Regards, Samir Shah

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