Feb 2023 – MBS Mantra MBS High Income/Absolute Return Strategy returns

	% Net Return	% Gross Return	2023 YTD Net %	2022 YTD Net %	2021 YTD Net %	Trailing 1 year Net %
Aggregated SMAs	**+0.81%**	**0.88%**	**+1.5%**	**-3.8%**	**+10.0%**	**-3.2%**
Founder's Port	**+0.67%**	**+0.74%**	**-2.2%**	**-1.7%**	**+10.1%**	**-0.3%**
BB Barc Agg	-2.67%		+0.6%	-13.0%	-1.8%	-9.7%
BB Barc MBS	-2.57%		+0.6%	-11.7%	-1.0%	-8.9%
BB Barc HY	-1.29%		+2.5%	-11.2%	5.3%	-5.5%
S&P 500	-2.51%		+3.6%	-18.2%	28.7%	-7.8%

Feb 2023 MBS Income: +0.73%; Annualized: +9.8% (Aggregated SMAs @ month end marks)
Feb 2023 MBS Cashflow: +1.0% (~12.5% annualized rate)
Feb 2023 MBS Loss rate: -0.18%

Another month where High Income MBS demonstrate uncorrelated returns versus all markets including bonds and generic MBS. We've now had 4 months with positive returns in a row, in spite of the general volatility in the markets.

Our positive returns were primarily driven by our MBS portfolio Income of 0.73% (9.8% annualized), with some drag from cash. Our legacy High Income MBS bond prices were mostly unchanged on average for the month, with some up and some down, unlike the Fixed Income markets in general that were all down about 2% for the month as rates rose once again, with the 10 year breaking higher than 4%. Income was lower than in the recent past, as cashflows declined with slowing prepayments and lower housing turnover. Losses from credit, as usual, were negligible.

Our boilerplate: MBS is a Variable Income asset class and product, and not Fixed Income, as it is widely viewed and categorized. Unlike traditional managers that understand MBS as Fixed Income and do not differentiate between Low-Income and High-Income MBS, we systematically identify and harvest High-Income MBS to construct portfolios that generate total returns with low correlations to Fixed Income as well as with other assets. High Income MBS add to returns in periods with positive price changes, and buffer declines in periods where price changes are negative, creating positive Skewness compared to normally distributed returns that are largely driven by price changes. High Income MBS can be an Absolute Return component of a portfolio, or a diversifier. This is explained in detail in our white paper, The MBS Income Factor.

Rates and Inflation

I've been saying for that past year that Powell will keep raising rates, and that the markets are wrong to expect rate cuts next year (after inflation has been quelled, whenever that happens). I think that he understands that the inflation we are facing is not money supply driven, but is a function of supply chain issues, and a labor market shortage from COVID (we told people to stay home, and they did) which led to unmet demand and has created deferred demand from 2020 – cumulative GDP has not yet caught up - and is not something that raising rates is going to squash. (See our Jan 2022 newsletter for a discussion).

What Powell wants is ammunition for the future, so he can cut rates if we enter a future recession. (Whether this ammunition is blanks is a different conversation).

This is an opportune time to raise rates without getting political wrath for doing so (such as what Janet Yellen faced in 2018). As long as he keeps saying (as he did at the recent Brookings Institution conference) that it takes time for rate increases to affect the economy, and that there are still questions of how much further rates need to be raised to control inflation, he has the cover to raise rates, and I would not be surprised to see a 6% Fed Funds rate.

Housing Turnover

The MBS markets are freaking out about the slowing housing turnover, as 'affordability', and transactions, declines. However, the young'uns that trade markets nowadays don't understand this this is just a reversion to NORMALITY, as Powell raises rates back to more 'normal' levels. It has been over the past 15 years, where rates, and therefore housing turnover, has been abnormal.

The graph below puts this into context.

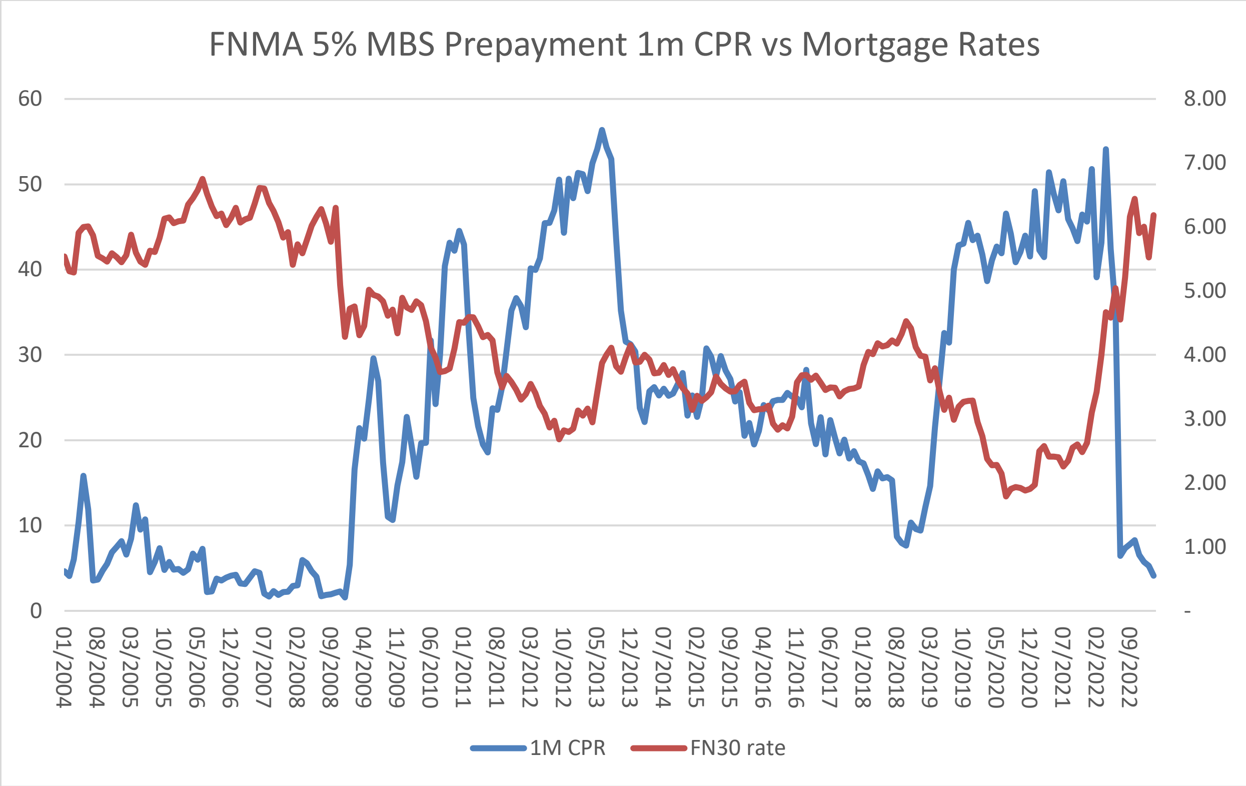
First, let me explain MBS principal payments. MBS return principal monthly to the bonds. This principal can be divided into scheduled principal (i.e. homeowners making monthly mortgage payments based on their balance, rate, and amortization schedule) and prepayments. Prepayments, in turn, can be voluntary (sales of the home, or refinancing of the mortgage, paying off the loan typically at a lower rate, or sometimes curtailments), or involuntary (defaults or buybacks by the originator).

In general, sales of the home tend to be related to economic activity and demographics. They are often a result of upgrading, downgrading, moving to retire, moving for a job change, moving for tax arbitrage, death, divorce, or incarceration. Such voluntary prepayments from sales are known as 'housing turnover'. Using long term historical data, MBS researchers have determined that they tend to level out at 6% CPR (conditional prepayment rate) as an average annual rate, after a 'seasoning period of around 3 years (people don't move immediately after they have purchased a new home). There is also a strong seasonal component to housing turnover, as anyone that has bought or sold a home knows. People start looking at homes in Spring, with the intention of closing and moving in Summer when the school year ends, so as to not disrupt the academic year for children.

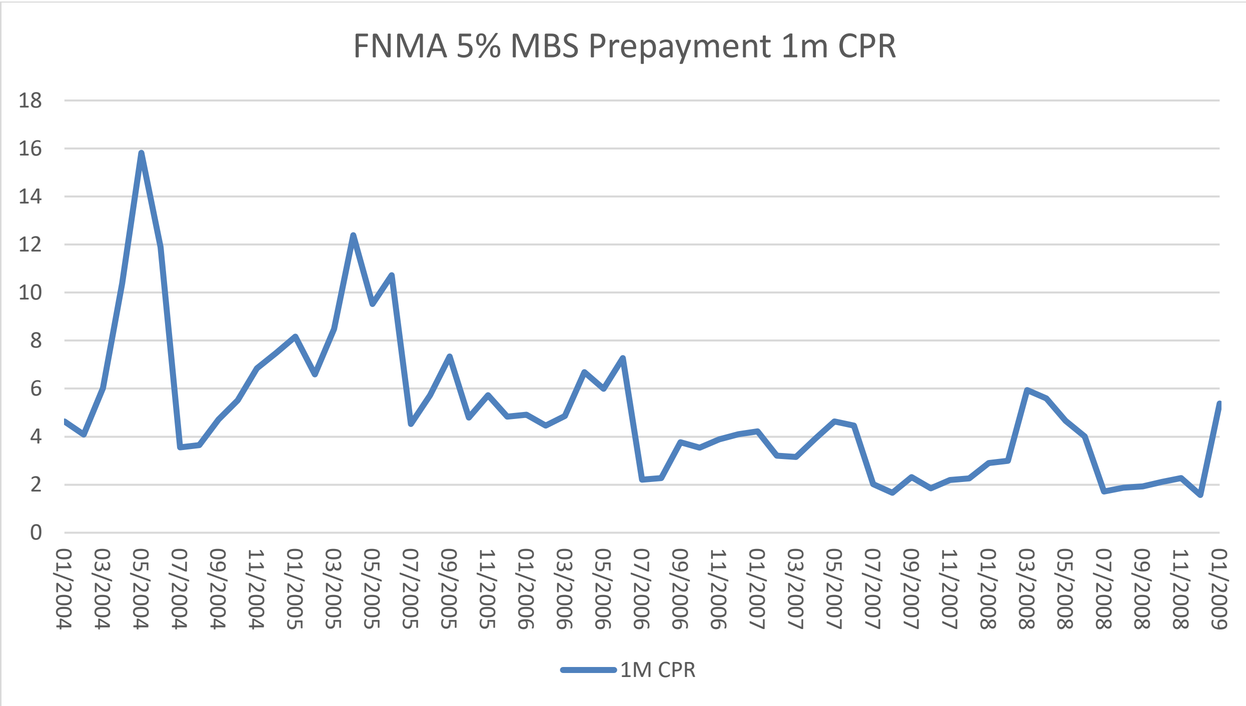
The other main type of voluntary prepayments is from refinancing of mortgages, as interest rates decline, which has been dominant over the past decade. Over the past decade, we've had both a QE-led strong economy along with declining rates driven prepayments, leading to lots of housing activity.

So as rates rise, rates-driven refinancing prepayments decline. However, housing turnover tends to be stable, as it is driven by demographics, and could even increase if the rate rise is in response to a strong economy.

What the graph below shows is prepayment rates and housing turnover are reverting to 2004-2008 levels, before the FED's QE and rate cuts led to accelerated, and abnormal, housing turnover over most of the past decade. (I'm using FNMA 5s as a random example.)



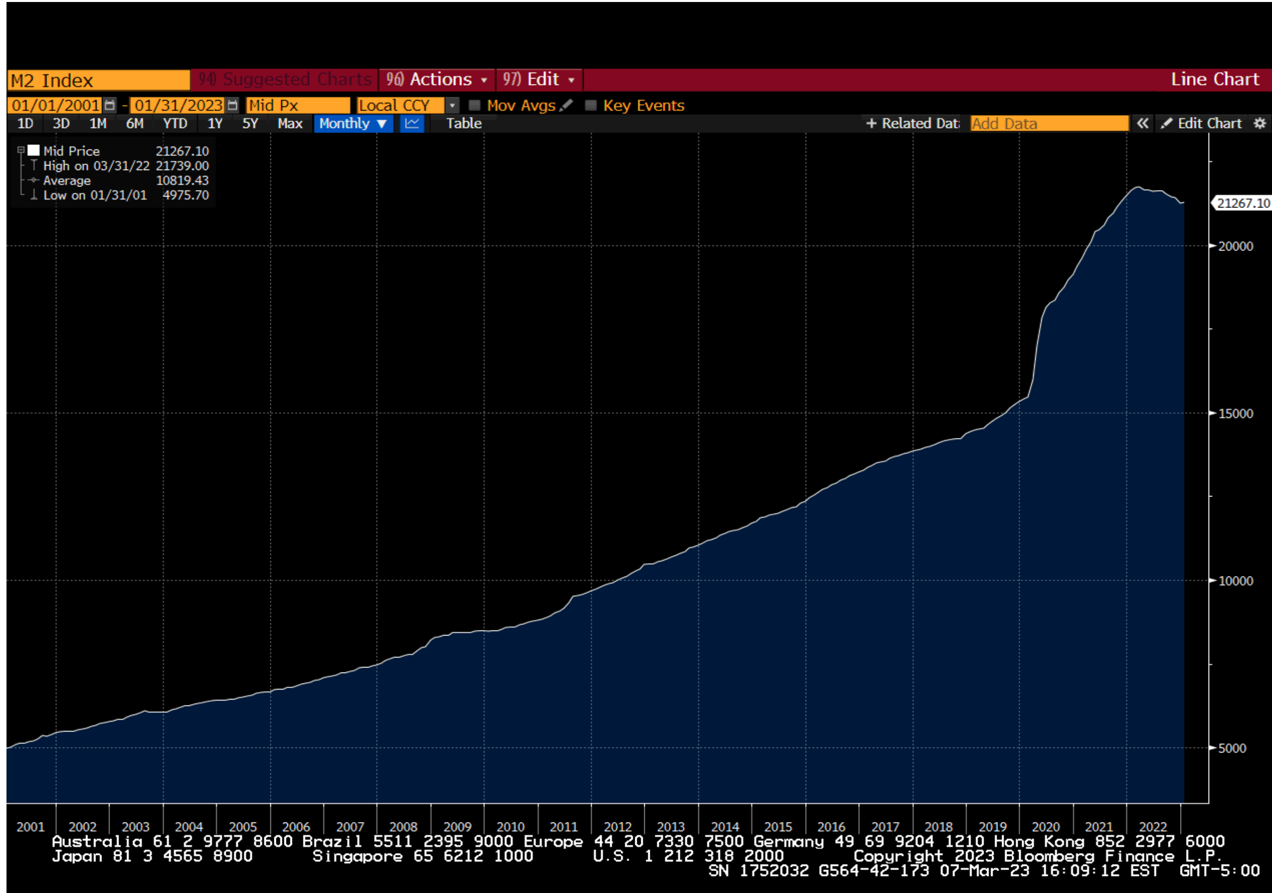
I expect to see faster speeds this summer, as seasonality, once again, becomes important. Speeds pop in April/May. We can see this seasonality in more detail in the pre-2008 CPRs.



Money Supply and Inflation

“M2 has declined, what does this mean?”, an Equities PM friend recently asked me.

Yes, M2 had jumped up significantly in 2020, and now has started declining slightly.

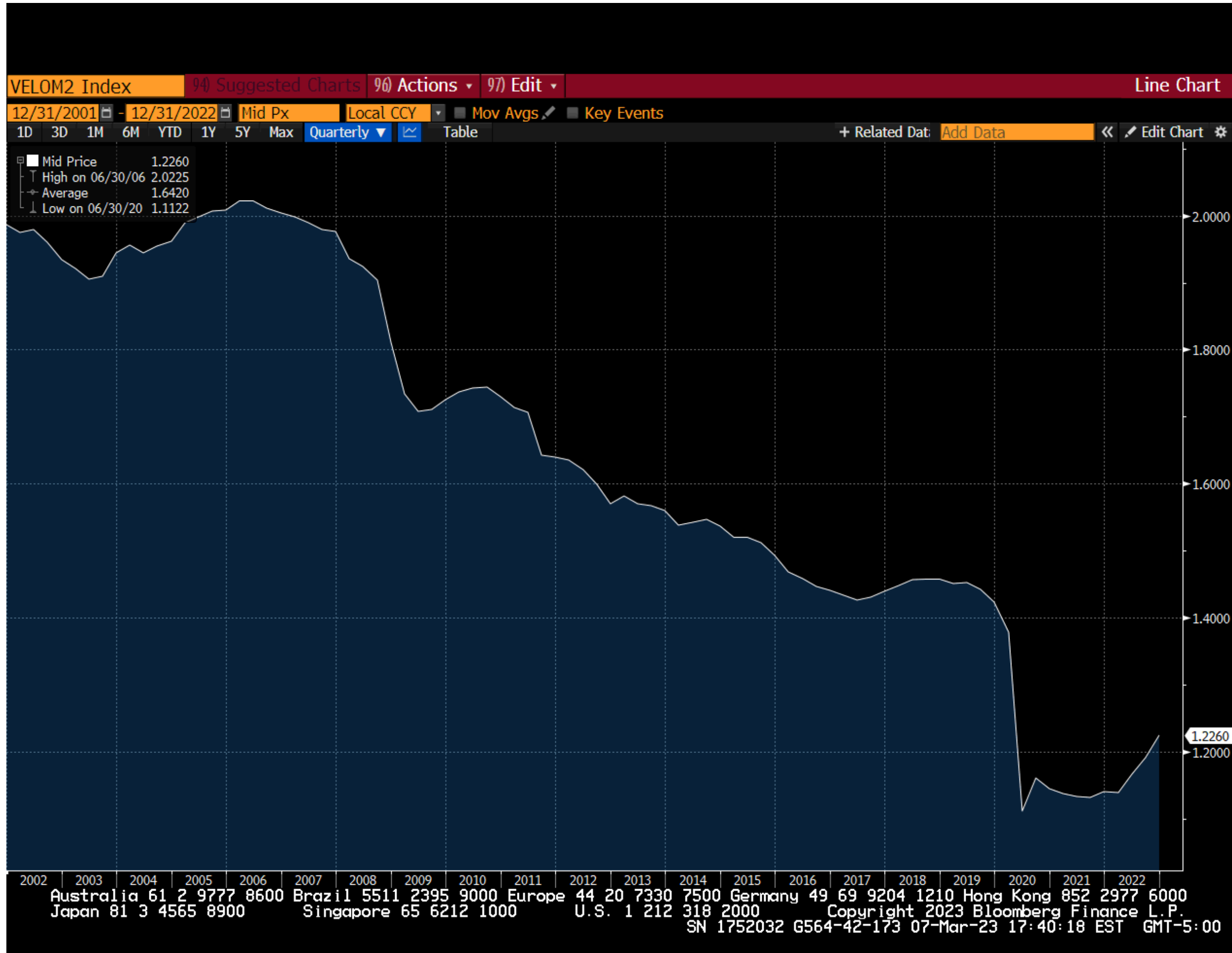


M2 is the U.S. Federal Reserve's estimate of the total money supply including all of the cash people have on hand plus all of the money deposited in checking accounts, savings accounts, and other short-term saving vehicles such as certificates of deposit (CDs). Retirement account balances and time deposits above $100,000 are omitted from M2. (Investopedia)

You’ll note that bank reserves are not part of M2. So, deposits at the Fed are not included. You’ll also note that there were no prior jumps similar to the one in 2020. I’m pointing this out as this demonstrates that QE does not manifest in M2. QE shows up in bank reserves, which tend to be mostly excess reserves (since, as discussed in the past, there is no velocity of money and C&I lending of any note), and are parked at the Fed to earn interest. (QE results in asset inflation through margin lending for asset purchases, but does not result in new assets being build or any productive economic activity. It is a response to and a substitute for velocity driven M3 growth.)

M2 jumped from $15.5T in Feb 2020 to $21.8T by March 2020, a change of $6.3T. This jump of balances in banks was largely due to the Biden administrations $5T+ COVID stimulus injections. While this helped many people maintain levels of consumption, when money was spent, it was simply transferred to the bank account of those who supplies the services and goods from inventory, leaving M2 high.

From August 2022 to Jan 2023, M2 declined by 369B. Some of this will be PPP loans being paid back. However, M2 Velocity has picked up a little too, suggesting that some productive investment is happening reducing bank balances, probably due to onshoring for just-in-case supply chain management and maybe small business creation. We are still a far cry away from the 2-ish velocity rates of 2006-2007.



Please call anytime with questions or to just chat.

Regards, Samir Shah

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