Mar 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	**+0.37%**	**+0.44%**	**+1.9%**	**-3.8%**	**+10.0%**	**-2.5%**
Founder's Port	**+1.05%**	**+1.13%**	**+3.3%**	**-1.7%**	**+10.1%**	**+0.4%**
BB Barc Agg	+2.64%		+3.2%	-13.0%	-1.8%	-4.6%
BB Barc MBS	+1.89%		+2.5%	-11.7%	-1.0%	-4.7%
BB Barc HY	+1.07%		+3.6%	-11.2%	5.3%	-3.3%
S&P 500	+3.71%		+7.5%	-18.2%	28.7%	-7.8%

Mar 2023 MBS Income: +1.37%; Annualized: +17.5% (Aggregated SMAs @ month end marks)
Mar 2023 MBS Cashflow: +1.5% (~17.4% annualized rate)
Mar 2023 MBS Loss rate: -0.22%

We've now had 5 months with positive returns in a row, in spite of the general volatility in the markets. Prepayments have slowed, so almost all the cashflow was Income, at 1.37%, 17.5% annualized.

Our marks were mixed, but down on average, as MBS spreads widened to USTs due to the overhang from the FDICs portfolio from bank takeovers, and uncertainty of the timing and process of disposition.

The high income, as usual, buffered the price declines. Credit losses continue to be negligible, given the seasoning of the portfolio.

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.

Markets are oblivious to the greatest risk it has faced in decades

It's so bad, it's good: markets think that our rate hikes, with their impact on banks and attendant slowdowns in lending, will lead to a recession, which will force Powell to cut rates. So, they appear to be frontrunning the rate cuts by buying stocks, ignoring the possibility of recession.

The most important story of last week, from Bloomberg (attached, I can't find a link), was ignored by most. The story is titled "***A $3 Trillion Threat to Global Financial Markets Looms in Japan"*** (attached)**.** However, this

underestimates the size of Japan's contribution to risk. A subsequent story, "**BOJ's Kuroda Leaves $11.7 Trillion 'Shock and Awe' Experiment to His Successor", more appropriately sizes the risk.**

https://www.bloomberg.com/news/articles/2023-04-05/kuroda-s-boj-legacy-ueda-inherits-task-of-exiting-japan-easing-stimulus

Markets and economists are oblivious to the biggest risk faced by the US and Global Economies – the deleveraging that will occur from simultaneous cutting of US rates while Japan raises rates. This will guarantee Global Recession.

Kuroda retired from his post on 4/9/2023, this past Sunday, and as of today, Kazuo Ueda is the new Bank of Japan governor. So far, he is saying that negative interest rates and yield curve control remain appropriate, but this, and Japanese inflation, needs to be closely monitored.

The risks to markets and asset prices have never been higher.

The US markets, asset prices, and economic activity, have been funded by the Yen Carry Trade since the 1990s. I described the events leading up to this transformational change in how Economics works in '**All Roads Start with Paul Volcker**'.

In 2007, in my first Crisis Note, I warned of the deleveraging that would occur from the unwinding of the Yen Carry Trade if Bernanke cut rates. He did, and triggered the GFC, and Japan withdrew its capital.

> *Yen Carry trade - this is the $1 trillion question mark - how much and how rapidly will this unravel?*
>
> > ** Anecdotal evidence suggests that Japanese housewifes have supported this heavily with retail savings (so called "Mrs Watanabes") everytime the dollar has strengthened, selling more Yen and buying $ and USTs. Will they come to the rescue? Or with USTs rallying, and rates rising in Japan, will they give up and buy back the Yen?*
> > ** I STRONGLY BELIEVE THAT THE YEN CARRY TRADE IS THE REASON THE FED CANNOT CUT RATES.*
> > ** The system may not be able to handle an additional 1 trillion of deleveraging. The graph below shows an incredible correlation between the S&P and the Yen. I have heard many anecdotal stories about how the US stock markets are dominated by program trading, and I suspect that the programs are funding or hedging their purchases and sales with Yen.*

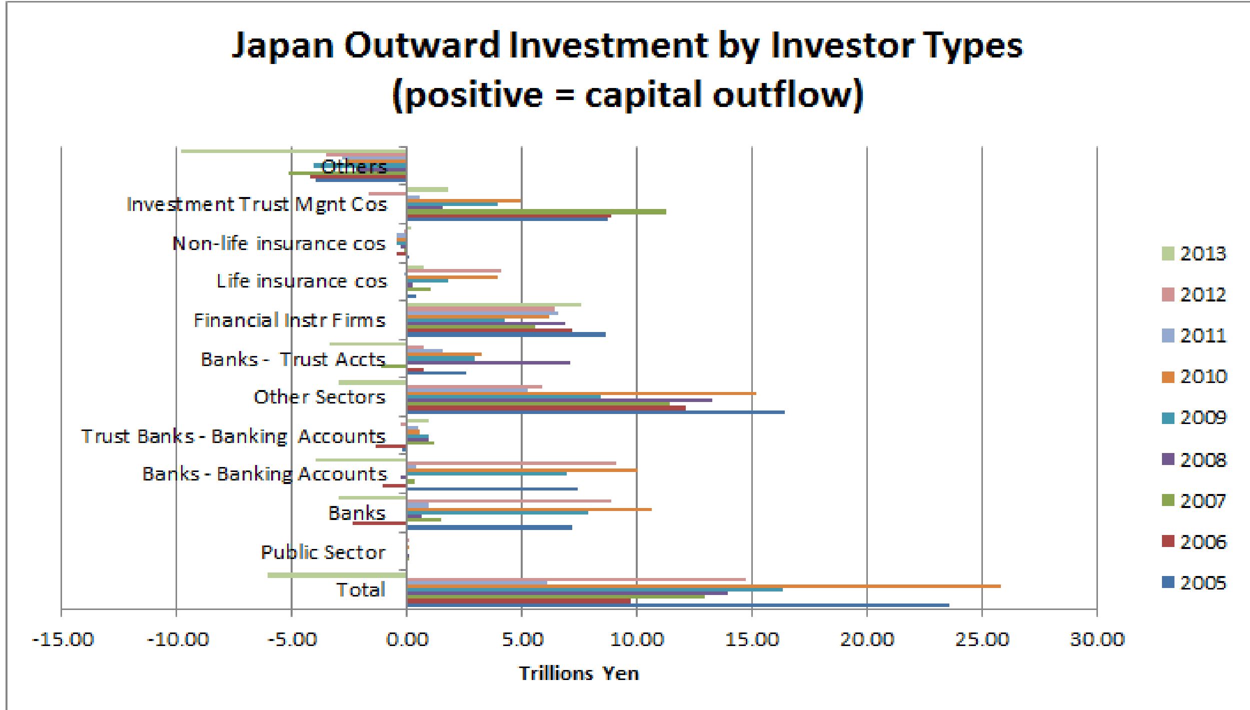
At the time, the majority of US financial institutions got both their long-term and short-term funding (almost their entire balance sheets) from Japan (Samurai bonds and interbank transfers of Call Money from the BOJ), and they were unable to roll their debt, thus having to flood the markets with assets (that had been created and help on balance sheet to arbitrage the cheap leverage that was available). This financing led to the quadrupling of the size bank balance sheets between 1999 and 2005, well above and beyond what was needed by the economy.

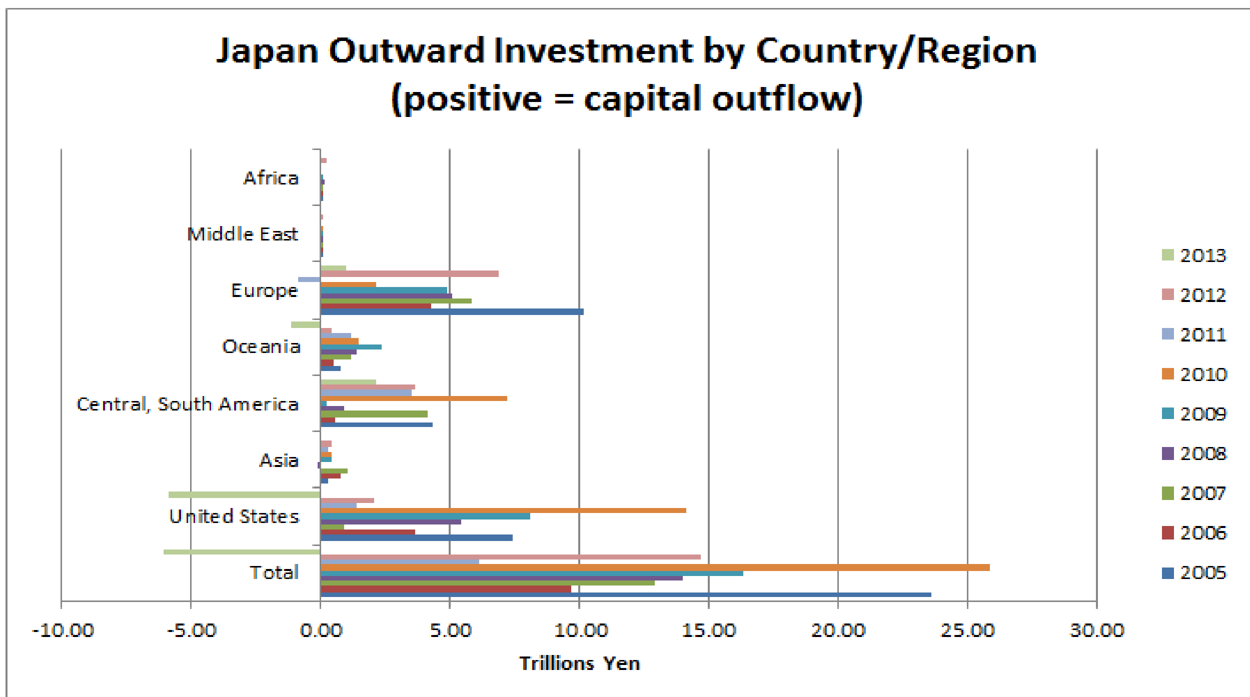
Once Japan started QE in 2002, by buying US Treasuries, that capital too ended up in the US, and helped create assets in the US, drove economic indicators such as Durable Goods Orders, and drove up US asset prices and PE ratios.

I researched this extensively in 2016's '**The Failure of Macro Economics – Carry Trades, Money Flows and The Pricing of Assets'**, and described the precise and Pavlovian manner in which Japan responds to interest rate

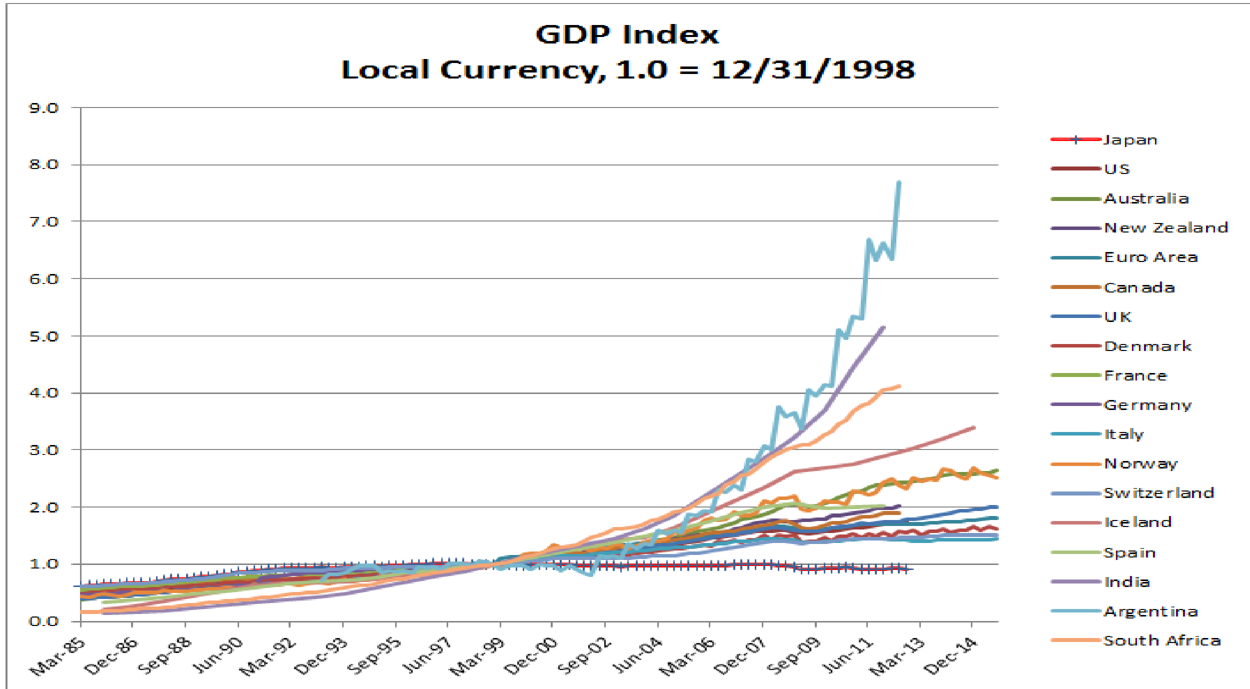
differentials to export and re-import its capital. Micro economics works with precision, and undoes Macro and Central Banking wishes through cross-border flows, making interest rate policy work in reverse.

Graph 15 shows the capital exporters of Japan (everyone) and Graph 17 shows the recipient countries of Japan's Carry Trades (primarily the US).

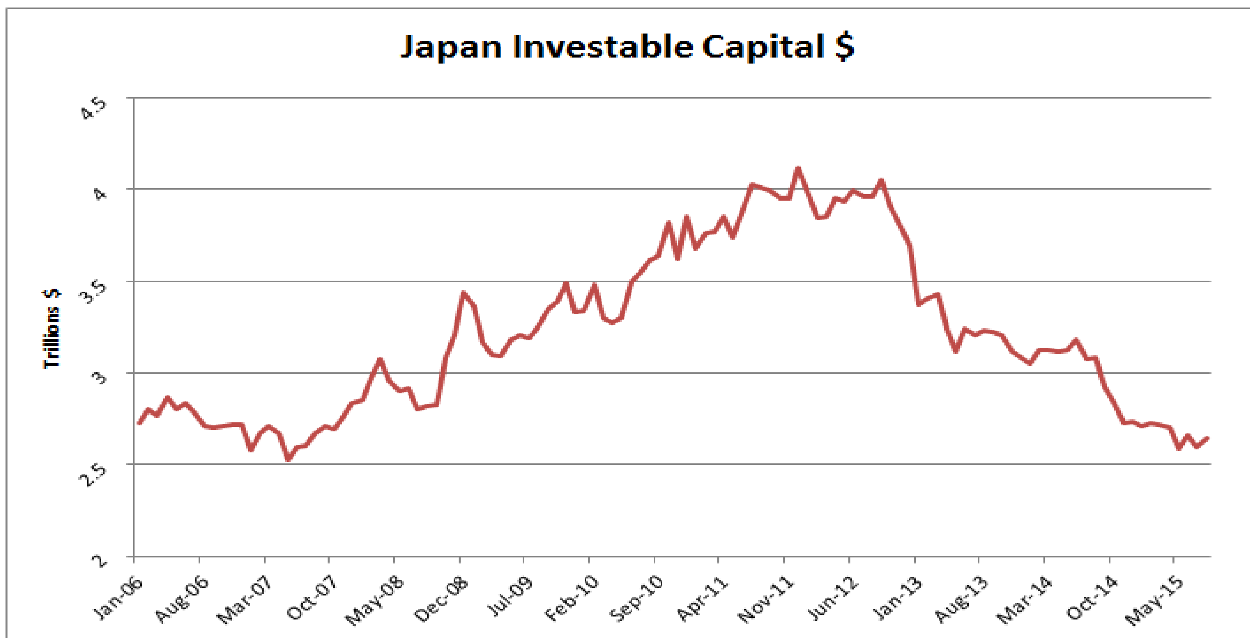




The net result for Japan of its Monetary Policy and resulting capital export has been stagnation for Japan, while the rest of the world, especially in their financial sectors, have benefited.



Graph 93, from Failure of Macro, shows the GFC in one picture – the increase in Japanese M3 – M2 reflect the repatriation of capital by Japan from August 2007, from the delivering triggered by Bernanke cutting rates.

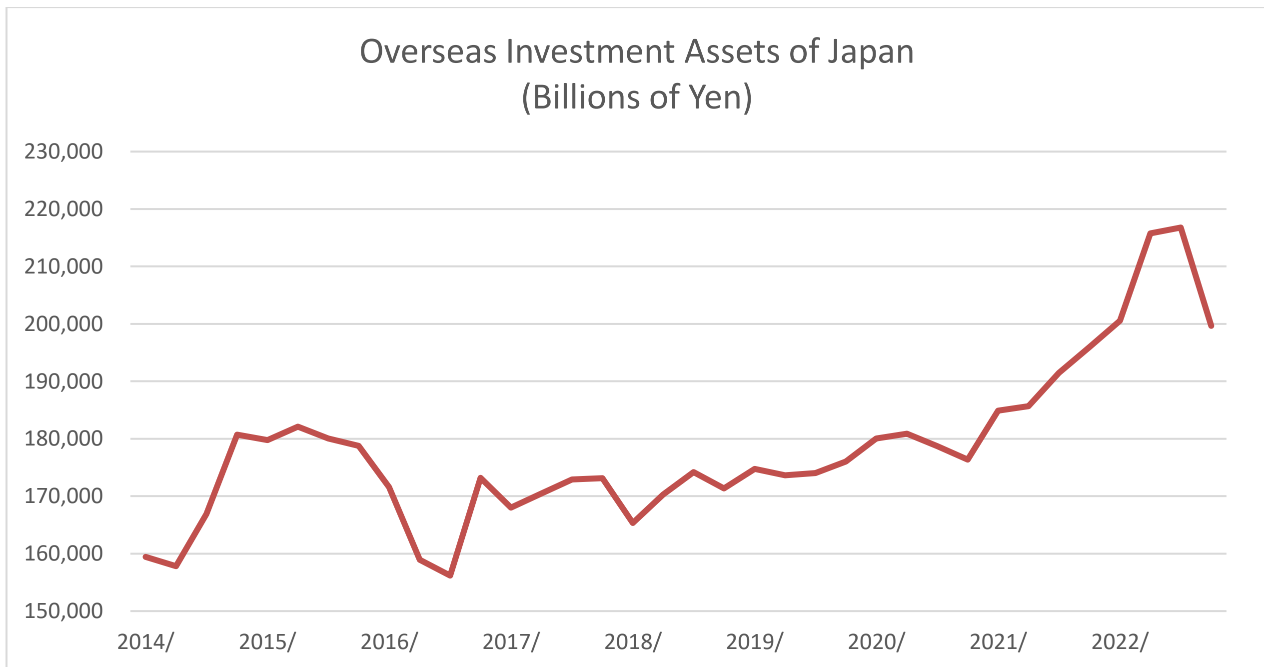


The data on capital exports from Japan are easily found in the Ministry of Finance (MOF) data, which is very granular (and the opposite of the US Fed, who stopped measuring M3 as they could not understand why it kept growing more rapidly than M2.)

https://www.mof.go.jp/english/statistics/index.html.

You can also see this on Statistica: https://www.statista.com/statistics/649756/japan-overseas-assets/

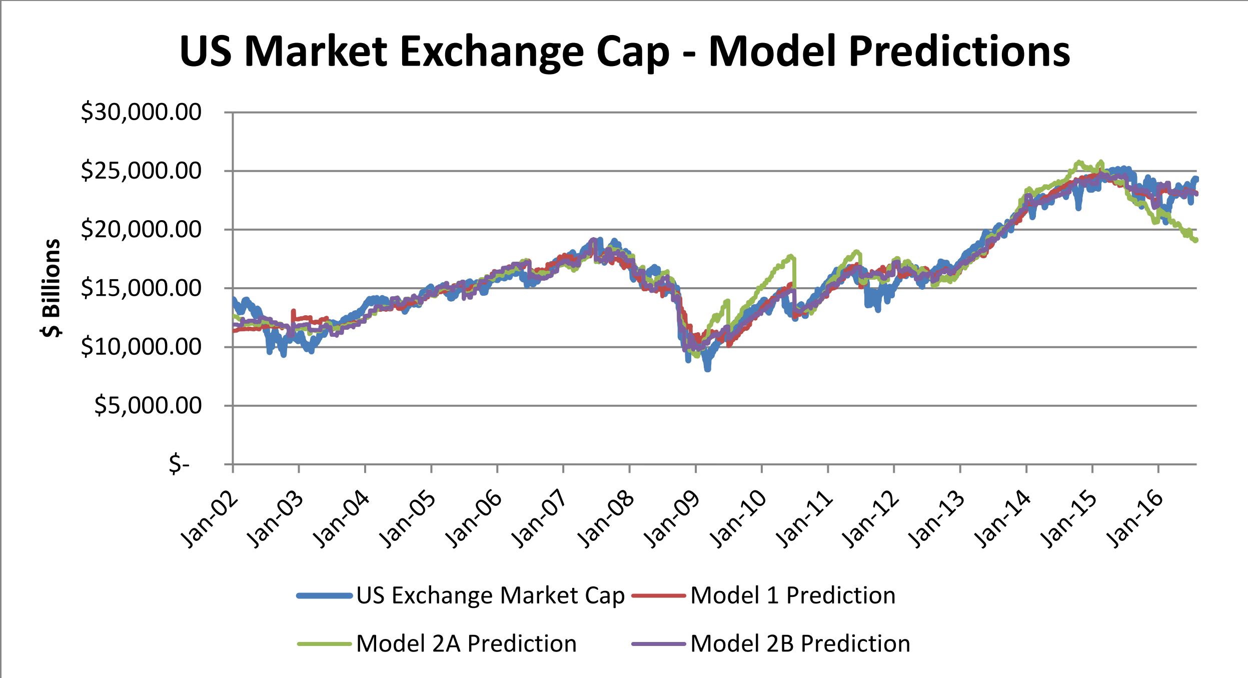
As of Dec2022, at 130Y/$ the Japanese have $10.2T (Y1.33 Million Billion Yen) in foreign asset investments, of which the Central Bank is only $1.53T, with $8.7T is from 'Other than CB'! This is the component that the Fed cannot control (by asking the BOJ not to sell its USTs), and which has the potential for being repatriated if the Yen Carry Incentive shrinks, either by the US cutting rates, Japan raising rates, or both.



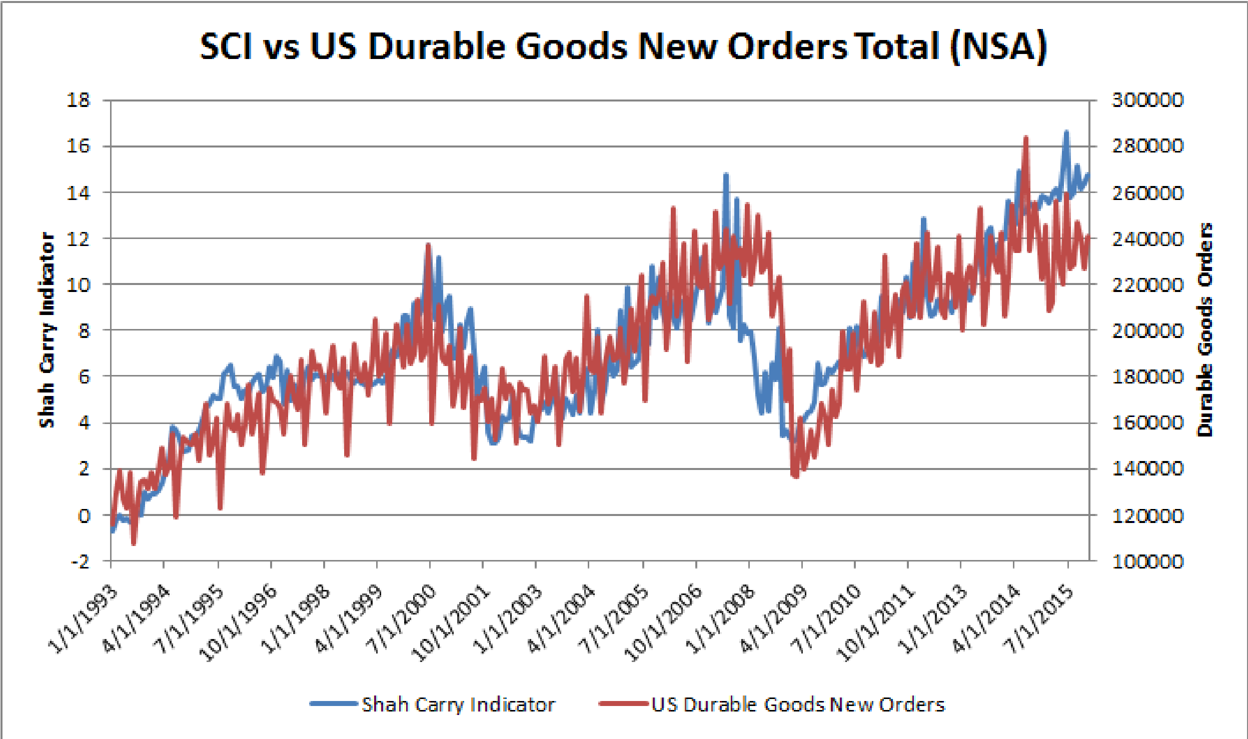
Corroborating the Bloomberg stories I referenced, we can see that this amount declined in the last quarter of 2022, as Japanese rates rose, while, prior to that, it had been growing as the US raised rates.

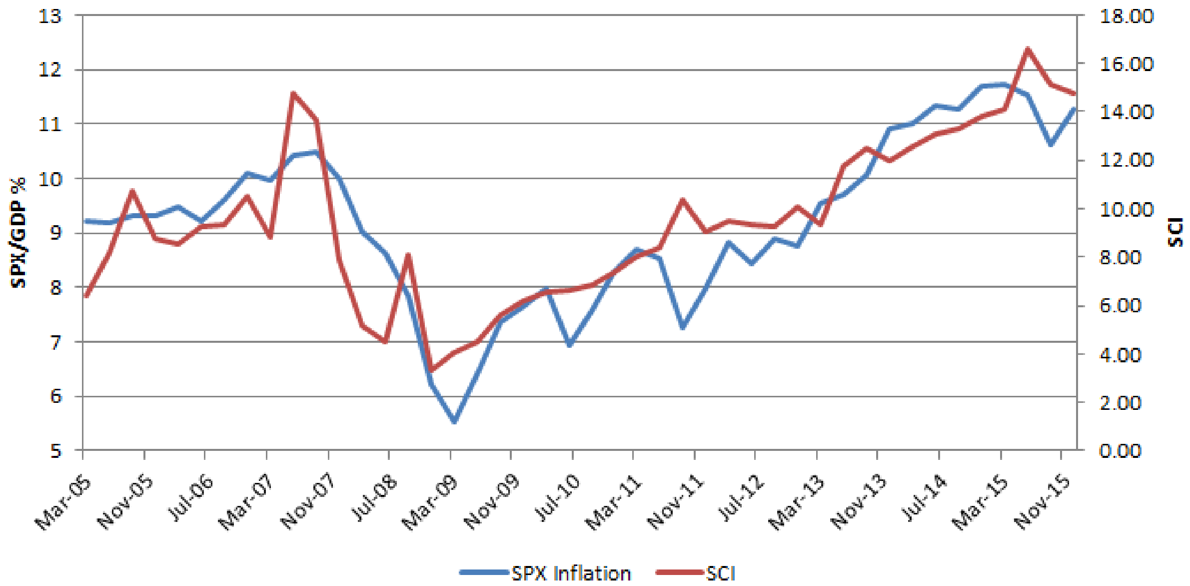
While some of it is trade related (receivables, etc), more than half of this is securities - Equity, Debt, Foreign bank deposits, Investment Funds, and Portfolio Investment.

I modelled the impact on Asset Prices of Central bank policies (interest rate differentials and QE) in **Understanding Beta** . The resulting model has a 0.96 Adjusted R-Squared. There are no Black Swan events in my understanding of the world.



Here are a few more graphs from The Failure of Macro. There is no question to me that the wealth effect created by the Carry trade (and QE) drives US Economic output.




Asset Inflation Proxy: SPX/GDP %
2005-2015
SPX/GDP %
SCI
13
12
11
10
9
8
7
6
5
18.00
16.00
14.00
12.00
10.00
8.00
6.00
4.00
2.00
0.00
Mar-05
Nov-05
Jul-06
Mar-07
Nov-07
Jul-08
Mar-09
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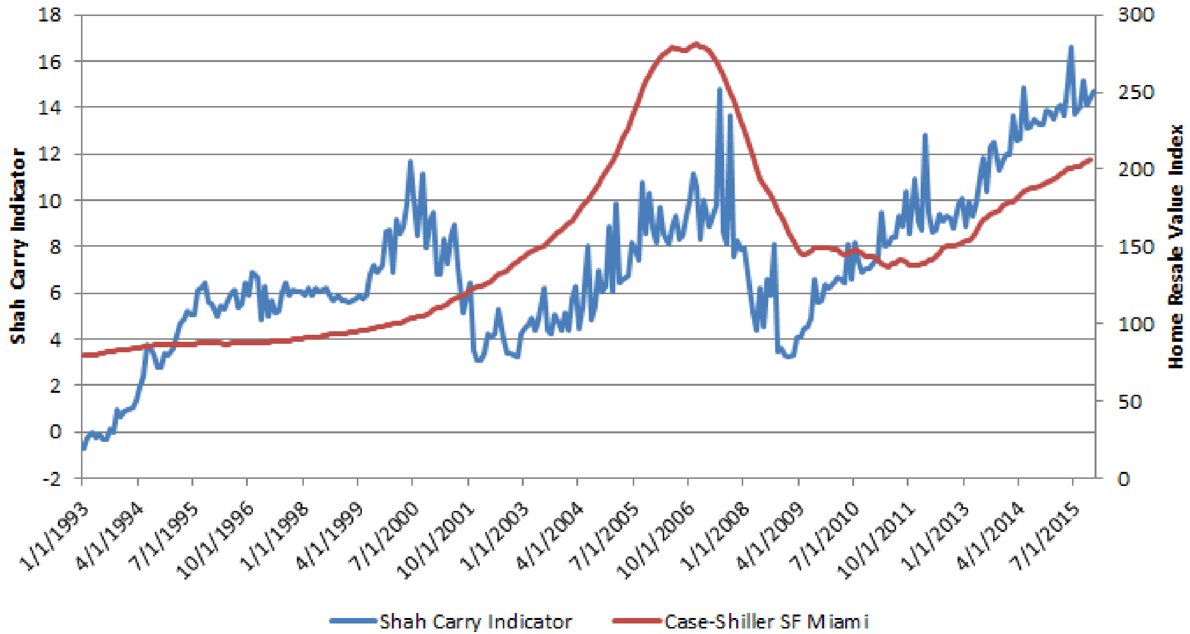
Jul-12
Mar-13
Nov-13
Jul-14
Mar-15
Nov-15
SPX Inflation
SCI


SCI vs Case-Shiller Miami SF Home Resale Value Index
Shah Carry Indicator
Home Resale Value Index
18
16
14
12
10
8
6
4
2
0
-2
300
250
200
150
100
50
0
1/1/1993
4/1/1994
7/1/1995
10/1/1996
1/1/1998
4/1/1999
7/1/2000
10/1/2001
1/1/2003
4/1/2004
7/1/2005
10/1/2006
1/1/2008
4/1/2009
7/1/2010
10/1/2011
1/1/2013
4/1/2014
7/1/2015
Shah Carry Indicator
Case-Shiller SF Miami

The past 15 years of abnormal GDP growth in the US have been a result of 3 flows of capital - US QE, Japanese QE and European QE, most of which has come to roost in the US. In addition, interest rate differential carry trade flows continued, in spite of low US rates, as Europe and Japen went to negative rates.

In my conclusions in Failure of Macro, I wrote: ***"When a large economy enters a Liquidity Trap, its citizens rationally export much of their available capital to seek higher yields, thus linking Micro-economic decisions with Macro-Economic implications. Recipient Countries of this Carry-driven money supply lose control of their domestic interest rate policy, and their attempts to control money supply result in outcomes that are the opposite of what is desired. Economic output in these countries rises to the point of saturation of needs (a subject for further research), after which the money supply results in Asset Price Inflation, Bubbles, and creation of excess assets to meet the need for investment. Traditional financial valuation models cease to be useful and rationalizations abound for investing in assets with inflated prices."***

This continues to describe our current status. **With bank prop trading limited by the Volcker Rule, this capital has largely gone to private markets and public equities, creating asset inflation.**

Private Equity, and the LBO market, for example, would not have grown as much as they did without the largess of Japanese fishermen: their pension manager, Norinchunkin Bank ("Nori") – is the world's largest CLO buyer.

https://en.wikipedia.org/wiki/Norinchukin_Bank

https://www.bloomberg.com/news/articles/2022-10-17/clo-giant-norinchukin-halts-purchases-as-uk-volatility-spreads

In Failure of Macro Economics, I also discussed Japanese Reflation. (There is also more on social implications, etc).

> ***"Japanese Reflation" - seems to have been a "Trade-du-Jour" of Macro Funds***
>
> ***The "Japanese Reflation Trade" will not work under current economic system and economic policies.*** *In order for this to happen, significant policy changes need to be made to repatriate capital back to Japan in an orderly manner, allowing its money supply to inflate and thus create domestic inflation. Negative rates certainly will not accomplish this.*
>
> ***It will be trivial for Japan to reflate, if it learns from this paper. All the BOJ has to do is raise the deposit/call rate, say to 5%.*** *The world will experience a sucking sound like it has never heard before, as all the capital in the world rushes to Japan.*
>
> *Doing this, however, will result in huge implosions in global capital markets in the rest of the world, as their assets delever and prices collapse.* ***This is why I believe that Japan poses the greatest risk to financial markets and economies. One has to follow Japan if one is investing.***

If we get either of the 3 whammies – the US Fed cuts rates, Japan's BOJ raises rates, or both, the markets will delever, as Japan withdraws its capital.

While raising rates and reducing the interest rate differential in an orderly manner is critical to prevent GFC II, I am not confident that it is possible to do it in an orderly manner - the PV process of investment managers will cause havoc. The following are a sampling of outcomes in that case.

- The Yen will strengthen. Last time around, I rode Yen from 125 to 78, and it would have gone to 50 had the BOJ not intervened around 80.
- The portfolio companies of PE firms – in other words – most of the levered loan and high yield markets – will have a hard time rolling their debt when it comes due – there is no chance their earnings can be accumulated to pay off debt.
- Everything leveraged will get thrashed. REITs, public PE firms, brokerage firms, banks, stocks etc – see my March 2020 letter to clients for shorting ideas.

Stock market and quant funding and leveraging of equities has probably continued using short term carry funding. This relationship looks less strong now due to the COVID largess from the US government, which ended up in equities as well, but becomes evident in market selloffs as the Yen strengthens (no, talking heads and WSJ, it is not a "haven", its deleveraging).

One of Powell's objectives will be met however – housing inflation will end, and the rental homes hoarded by the Buy-to-Rent private strategies will get released into the markets.

Another moving variable is the Euro. Europe has also been exporting capital to the US via its large asset managers. There is no easy data to figure out these flows, so one can only look at the price of the Euro vs USD to infer flows (I did something similar in Predictions 2017). I suspect that the recent US stock market strength is a result of CS's failure and lack of confidence in European and Swiss asset managers, resulting in flows into the US.

We appear to have reached this point of maximum risk – where the probabilities of these deleveraging events has never been higher.

People don't seem to understand the concept of risk. Risk is a probability. The event of concern does not need to happen and timing can be variable. Asking 'when will this happen' cannot result in an answer.

For example, a partial attempt to cut rates (US) or raise rates (Japan) could result in a different rate path as resulting asset crash might make the central bankers backpedal.

However, history suggests that the Fed does not understand how interest rate policy works, and will cut rates even further and faster than they intended if asset prices decline, as Greenspan did in 2001-2002, Bernanke did in 2007, and Powell did in 2020, which will lead to the Carry trades unwinding, and US asset prices (and M3) collapsing.

As in 2007, there is not enough balance sheet to absorb levered assets. (try reading these early Crisis Notes, Rate Cuts will not work 8/29/2007, Zombies in Disneyland, 11/7/2007, and Where's the Balance Sheet? 12/13/2007)

In 2005, I was looking to start my own broker dealer, and spent significant time with Kaupthing Bank discussing a partnership with them. This is when I discovered the Yen Carry Trade that had financed the global economy – this infamous Icelandic bank, at the time the #5 fastest growing bank in the world, was funded by the Carry trade.

As I researched Carry Trades, I realized that the risk of the Yen Carry Trade unwinding was becoming more likely, and this risk was not in the consciousness of markets. In 2006, I started to raise a fund to capitalize on this, and started warning my clients as well, and started writing posts that became the Crisis Notes. I got nowhere in fund raising, but realized that my clients would need a more robust counterparty than any broker dealer that I could capitalize with my own money. So, I went looking for a brokerage partner with capital but no 'bad balance sheet', and discovered Man Financial (later renamed MF Global), who had capital but did not use their futures client deposits for risk taking. They did not trade bonds and had no infrastructure to do so. I convinced them to let me build a bond/MBS trading business there, and created their infrastructure and Fixed Income brand, opening them to over 500 MBS buy side accounts based on my relationships. When the markets blew up in 2007, as the Yen Carry Trade unwound after Bernanke cut rates in August, I was there to provide liquidity and help my clients protect capital. I built MF Global's most profitable business and Fixed Income brand while being fair to the clients that my desk traded with, which, ironically, allowed Corzine to join a turn-key fixed income trading shop to expand into other Fixed Income markets, which he then bankrupted from incompetence, impatience, hubris, and greed.

I also discovered that many buy-side investment managers were not interested in protecting capital, but rather in maintaining AUM and fees. This is somewhat understandable – when a long-only manager moves to cash to protect capital, clients tend to withdraw the cash, leaving the manager with an ethical quandary – to move to cash or not. I have experienced this myself, except that I take the concept of being a fiduciary seriously, and will and do move to cash to protect my client's capital, in spite of the risk of withdrawals by doing so, waiting for the right re-entry point to invest.

Today, global leverage is deployed largely through post-Dodd-Frank non-bank suppliers of private capital. There will be a different menu of shorts to take advantage of this opportunity compared to 2007, when leverage was deployed through large banks. But the opportunity is the most sizable there has ever been, the mirror image of the current greatest risk ever. Anticipation of the risk also requires different thinking in portfolio construction, and a different liquidity profile compared to whatever portfolio might have been constructed for you until now.

Most investment managers are focused on the trees rather than the forest. The primary risk in investments is Beta risk, not valuation risk. Managers tend to be focused on valuation and have no models for understanding Beta. If even a valuable company like Apple can decline 30+%, their focus is misguided.

Since the mid-1990s, Beta risk has been primarily driven by injected capital flows from Central banks. We have an excellent model for this, understand it, and have a demonstrated history of anticipating Beta risk and protecting client capital through innovative thinking.

I set up MBS Mantra to bypass the investment managers who were not necessarily focused on the client's interests, by investing and advising directly for investment clients.

I can help investors of all types directly through 3 mechanisms:

- **investing directly, in separate accounts or a fund;**
- **being an external CIO or portfolio manager for their portfolio; or**
- **providing consulting on risk and portfolio construction, through a retainer fee-based structure.**

My signature line below lists the entities through which I can do so. I'll also point out our trademarked investment and thought process, **"Alpha Through Analysis"®**, which drives our investments and advice.

Please call anytime with questions or to just chat.

Regards, Samir Shah

April 10, 2023

President and CIO
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