MBS Mantra, LLC

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

	% Net Return	% Gross Return	2023 YTD Net %	Trailing 1 year Net %	2022 YTD Net %	2021 YTD Net %
Aggregated SMAs	**+0.56%**	**+0.63%**	**+3.2%**	**+0.8%**	**-3.8%**	**+10.0%**
Founder's Port	**+0.37%**	**+0.45%**	**+3.9%**	**+0.6%**	**-1.7%**	**+10.1%**
BB Barc Agg	-0.63%		+1.6%	-1.1%	-13.0%	-1.8%
BB Barc MBS	-0.76%		+1.0%	-2.0%	-11.7%	-1.0%
BB Barc HY	+0.28%		+7.1%	+7.2%	-11.2%	5.3%
S&P 500	-1.63%		+18.7%	+15.8%	-18.2%	28.7%

Aug 2023 MBS Income: +1.76%; Annualized: +23.3% (Aggregated SMAs @ month end marks)
YTD 2023 MBS Income: +10.2%, 15.5% annualized (current portfolio, excluding bonds no longer in portfolio)

Aug 2023 MBS Cashflow: +1.4% (~17.2% annualized rate, implying a short weighted average life/duration)
Aug 2023 MBS Loss rate: -0.07% (a negative loss rate is a gain from subsequent recoveries)

A good month to bandy the "uncorrelated" buzzword: all our accounts were up for the month, in spite of a significant selloff in the AGG and MBB in August. We outperformed MBB by over ~1.25%!

This outperformance is due to the fundamental nature of our strategy: the High Income of our MBS selections buffers price change, and results in positively skewed returns. This month, the Income of the MBS portfolio was 1.76%, offsetting the negative price changes from marks, which were almost all down in line with most bond market proxies, such as MBB and the AGG.

Between the rates volatility and summer doldrums, this month was relatively illiquid, with not much trading in Non-Agency MBS, and a light BWIC calendar.

For the year, our Income is approximately 10% (~15% annualized). This has been offset by mark-price declines in our portfolios, especially for the fixed rate bonds, as rates have risen. We continue to believe that our floaters are mispriced too low, resulting in under-reported TRRs.gp

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 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.

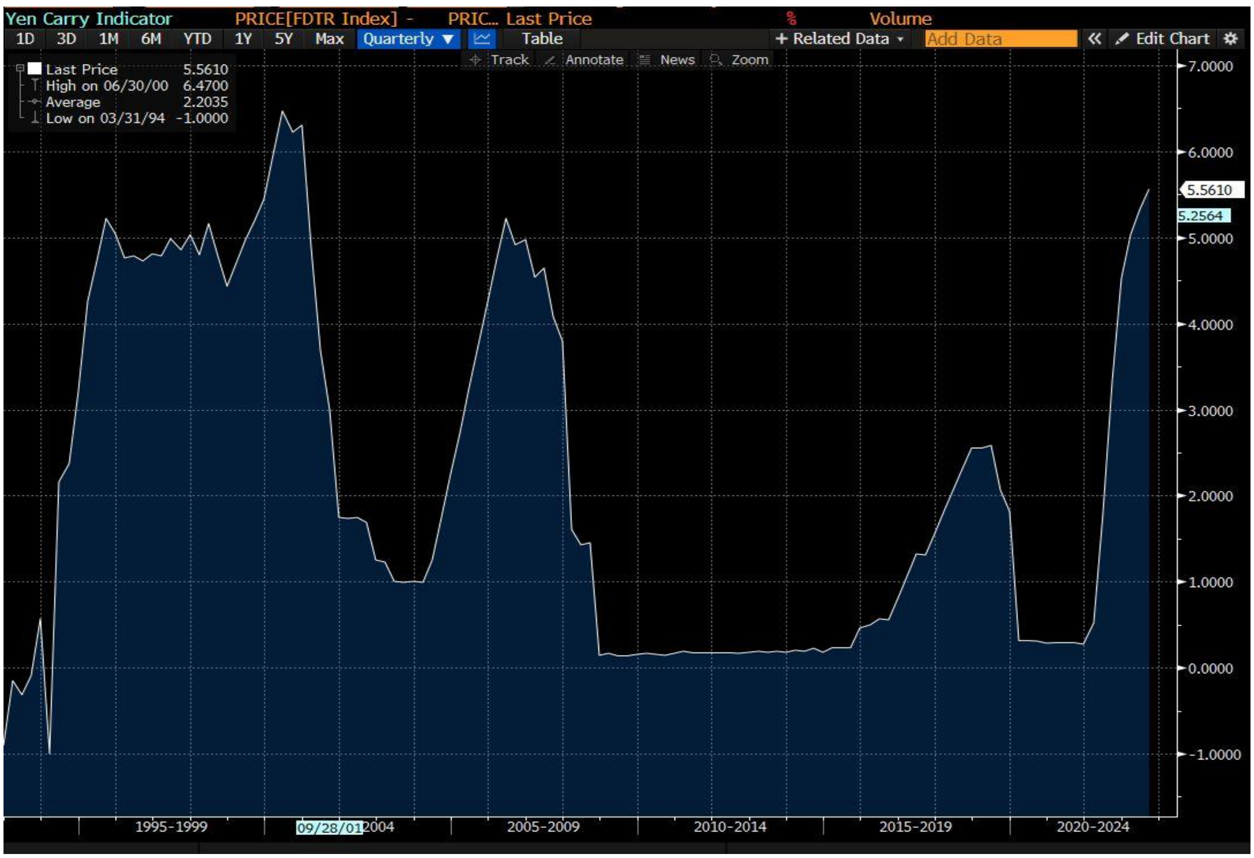
This newsletter will cover a number of topics

Yen Carry Trade and US Equities

The market appears mystified as to why stocks keep rallying in the face of a Fed that keeps raising rates.

As I have discussed ad-nauseam since my first Crisis Note of August 2007, interest rate policy works in reverse to how central bankers thinks it works, due to global capital flows and the Yen Carry trade driving flows of capital into the US. Raising rates results in increased money supply for investment (M3-M2) from Carry flows.

Powell's raising of US rates has resulted in a re-peaking of the Yen Carry Incentive (YCI) – Fed Fund rates minus Japan's Call Rate. This is in spite of Japan easing off on yield curve control – the US is still raising rates faster than Japan, increasing the Yen Carry Incentive.



Pre-2007, the YCI (and Japan QE) relationship to the S&P500 was pretty direct. Since 2008 and the advent of US QE, Euro QE, Euro and China Carry, the drivers of asset prices have become more multi-dimensional, reducing the relativce importance and strength of the Japan carry relationship. However, at the margin, YCI still matters, and appears to have driven the recent rally in asset prices.

Currently, I view the YCI declining, or anticipation of this, as the greatest risk the market faces. I had discussed this previously in the [March 2023 newsletter](#).

- In 2007, starting in August 2007, it took a 25bps decline in YCI, as Bernanke cut rates, for the party to end and the world to start delevering, creating the GFC.
- In August 2000, it also only took a 25bps decline in YCI for the S&P to start declining.

I would use a 25bps to 50bps decline in YCI, once YCI peaks, as a signal to start de-risking. Powell is expected to raise rates one more time, so this is not imminent. Watching both Powell and Ueda will be key, as the BOJ can easily do the unexpected and raise rates.

There is also another important implication – until Japan normalizes its interest rates and comes into line with the central banks of rest of the industrialized world, this sword till always hang over the markets. There cannot be a 'soft landing' that will allow relaxation of macro risk monitoring.

You can read more the mechanics of interest rate policy that impact US money supply and investment flows in great detail in the following documents:

First Crisis Note

The Failure of Macro Economics

Understanding Beta – Determinants of the US Stock Market (this is a model of US Equities using purely central banking inputs that were first identified in The Failure of Macro)

Inflation and Real GDP update

For the January 2022 newletter, I created a framework for determining when GDP growth would peak and inflation would subside. My thinking was that, since the majority of our GDP is consumption (primarily of services, which is > 70% of GDP), stimulus driven demand for foregone consumption will keep GDP, and inflation, high, until the deferred consumption GDP from COVID's sheltering was made up.

While rate hikes, foreign QE (UST purchasing), US QT, and bank failures have confused matters, making it impossible to know if inflation would have declined on its own (ie was "Transitory"), given the various governmental interventions, it's still interesting to check out the 'foregone GDP' model. The underlying assumption is the historical real GDP growth rate of 2.24%. Here it is updated for 2022.

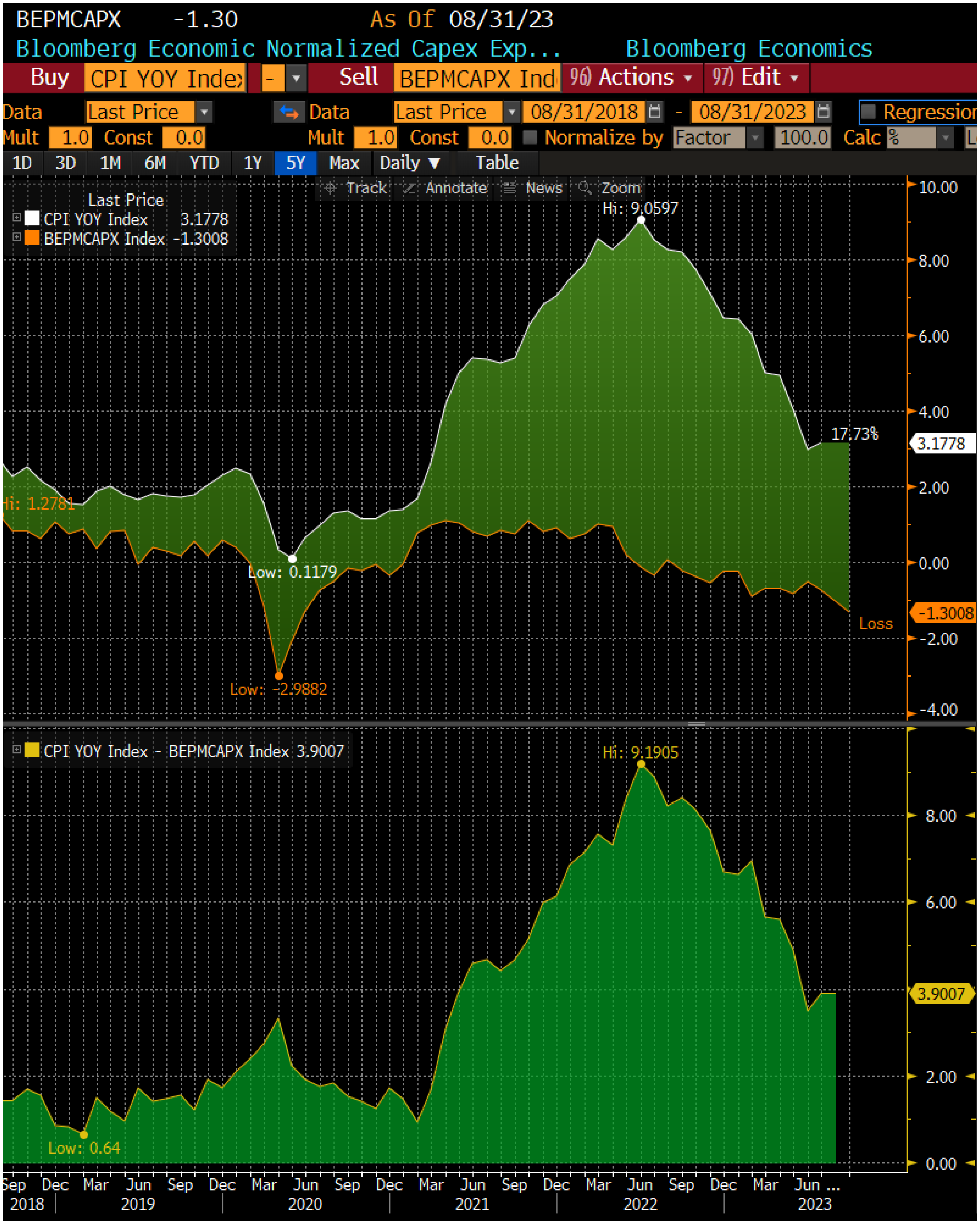
	Actual Real GDP			
	2019	**2020**	**2021**	**2022**
GDP Growth		-2.8	5.9	2.1
GDP index	100.0	97.2	102.9	105.1

	Real GDP Target			
	2019	**2020**	**2021**	**2022**
Hist GDP growth		2.24	2.24	2.24
GDP index Target	100.0	102.2	104.5	106.9

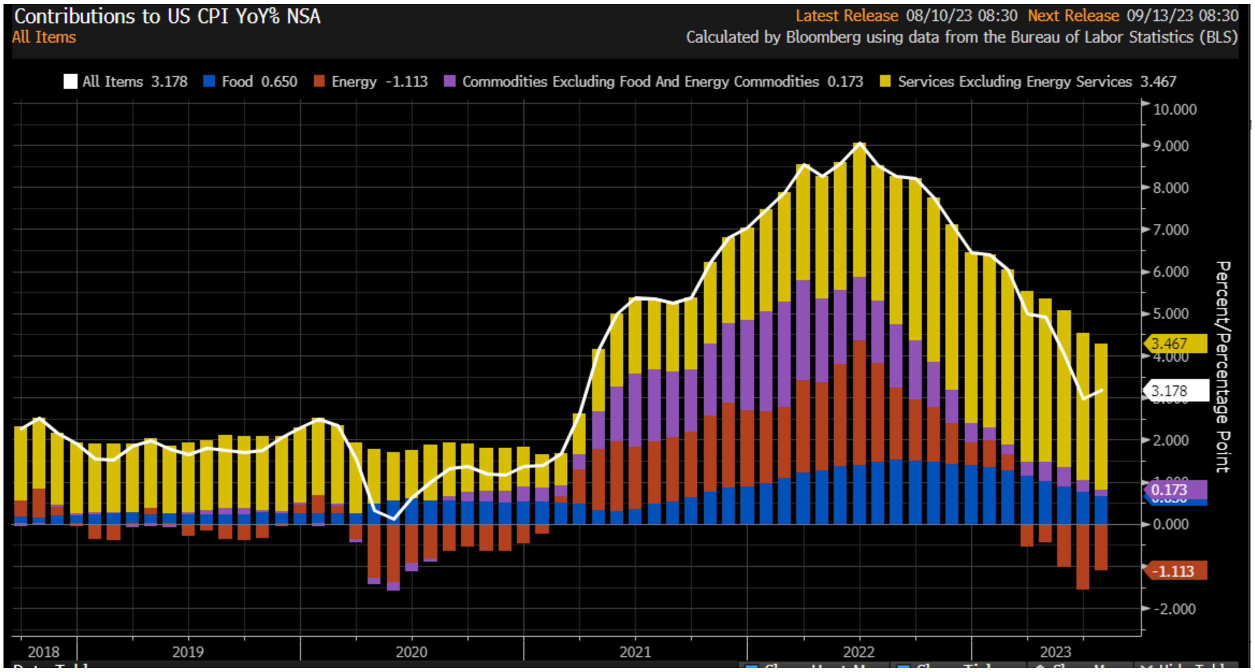
Foregone GDP Gap	0.0	-5.0	-1.6	-1.8

This model suggests, not only is there outstanding unsatiated consumption demand (the Foregone GDP Gap), but that the gap has grown since 2021.

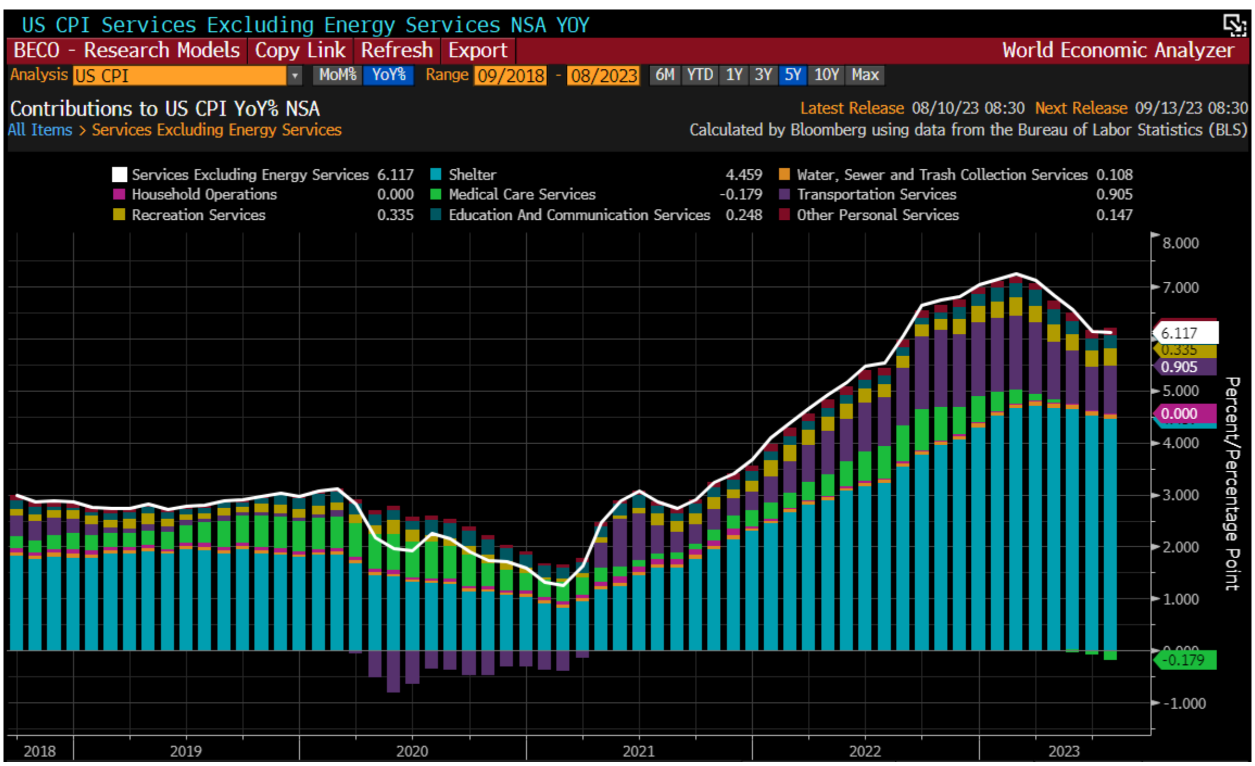
The following chart suggests the sources of the GDP gap – capex spending has declined with rate hikes, going negative, while reducing CPI. However, the forces that are preventing CPI declining more to 2%, I would suggest, are a function of the Foregone GDP Gap.


BEPMCAPX -1.30 As Of 08/31/23
Bloomberg Economic Normalized Capex Exp... Bloomberg Economics
Buy CPI YOY Index
Sell BEPMCAPX Ind
96) Actions
97) Edit
Data Last Price
Data Last Price 08/31/2018 - 08/31/2023
Regression
Mult 1.0 Const 0.0
Mult 1.0 Const 0.0 Normalize by Factor 100.0 Calc %
1D 3D 1M 6M YTD 1Y 5Y Max Daily Table
Track Annotate News Zoom
Last Price
CPI YOY Index 3.1778
BEPMCAPX Index -1.3008
Hi: 9.0597
Hi: 1.2781
Low: 0.1179
Low: -2.9882
17.73%
Loss
3.1778
-1.3008
10.00
8.00
6.00
4.00
2.00
0.00
-2.00
-4.00
CPI YOY Index - BEPMCAPX Index 3.9007
Hi: 9.1905
Low: 0.64
3.9007
8.00
6.00
2.00
0.00
Sep Dec Mar Jun Sep Dec Mar Jun Sep Dec Mar Jun Sep Dec Mar Jun Sep Dec Mar Jun ...
2018 2019 2020 2021 2022 2023

The contribution to CPI graph shows that Services demand is still high and needs to decline for Powell to get to his 2% inflation target.

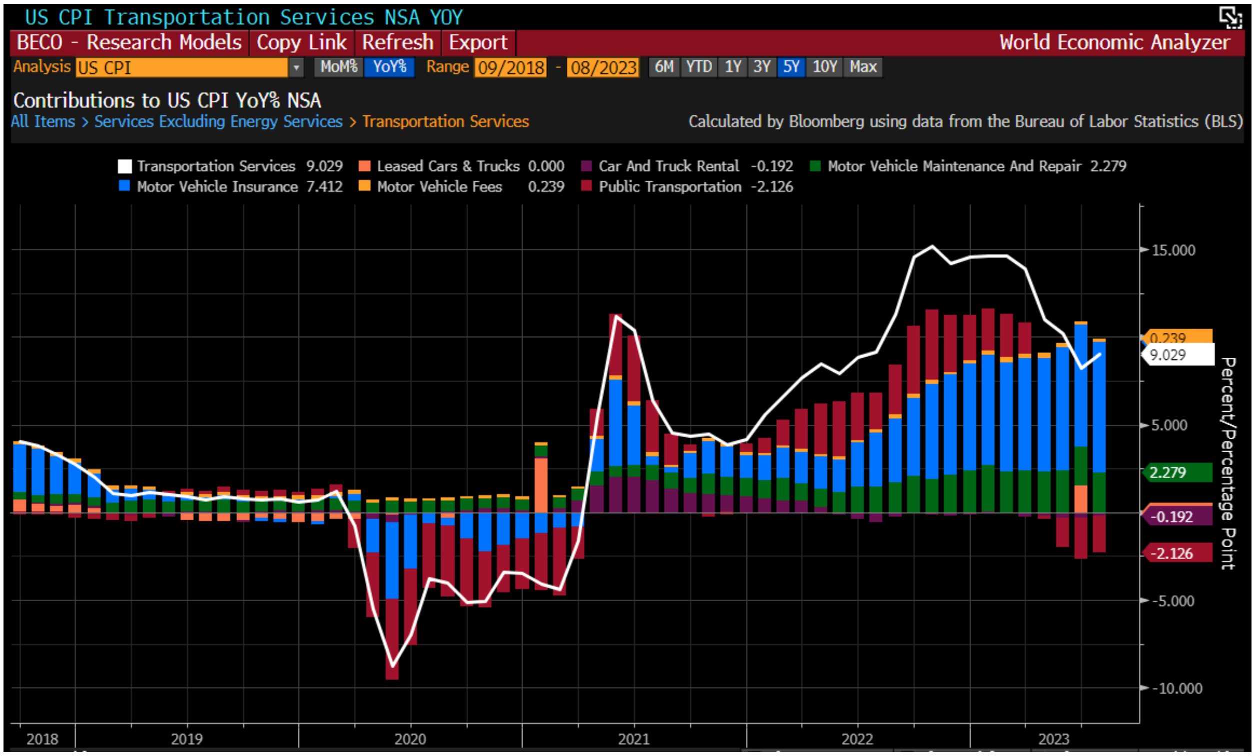


We can see that the services inflation is primarily coming from Shelter, but also Transportation services.



While the Fed's rate policy should and will impact Shelter, and was discussed by Powell at his recent press conference, Transportation services are probably something most people have not thought of.

I found this surprising – motor vehicle insurance as a source of CPI inflation.



This could be a result of the rising costs of new vehicles. Various sources suggest that this might be due to Biden's EV-ification policies, as car makers make up for their EV manufacturing losses and unsold inventories via higher prices on gas vehicles, and the elimination of lower priced compact cars.

https://finance.yahoo.com/news/biden-plan-increase-ev-ownership-124514375.html

If my theory is correct, MV insurance inflation won't be declining anytime soon.

The implication is higher rates for longer.

Please call anytime with questions.

Regards, Samir Shah

September 6, 2023

President and CIO
MBS Mantra, LLC (a CT Registered Investment Advisor)
(dba) Alpha Research and Management
Alpha Research and Consulting, LLC

"Alpha Through Analysis"®

203-388-8356 P
203-273-0360 C
sshah@mbsmantrallc.com
https://www.linkedin.com/in/samir-shah-6a9096a
Please visit our website https://www.mbsmantrallc.com for important disclosures.

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