Long/Short
Bank Capital Strategy

January 2025

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Executive Summary

We anticipate a very challenging market environment in 2025 as a plethora of misguided 2024 market developments collide. However, the main driver will be investors' inability to cauterize the wounds of deficit spending and a resulting poor supply/demand balance – Too Many Bonds!

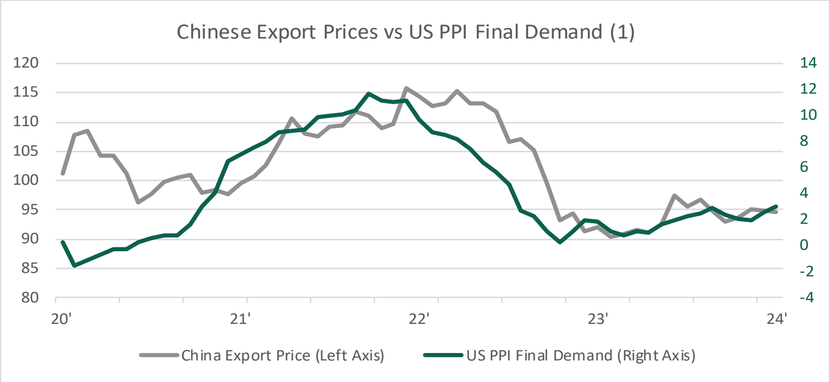
- 2024 Recap – How did we get here?
  - China economic weakness and reluctant policy support drags down goods prices to support disinflation
  - EU weakness holds down long-term rates in Europe which also supports US disinflation
  - US labor market resilience and consumer spending drives above trend growth again
  - Credit market valuations go from stretched to extreme based on generic yield euphoria from investors and expectations that disinflation will support an aggressive central bank easing cycle
  - Bank fundamentals remain exceptional - but capital stack subordination premia are historically low
- 2025 Outlook – Where we are headed….
  - China domestic demand stimulus should put floor under goods and commodity prices
  - Manufacturing and rate sensitive housing/real estate sectors are showing signs of recovery
  - Downside risks to extreme risk asset valuations due to crowding out and Trump 2.0 fiscal projections – the too many bonds phenomenon
  - Bank regulations/Basel III endgame death
  - Valuations across geography and capital stack will trump fundamentals

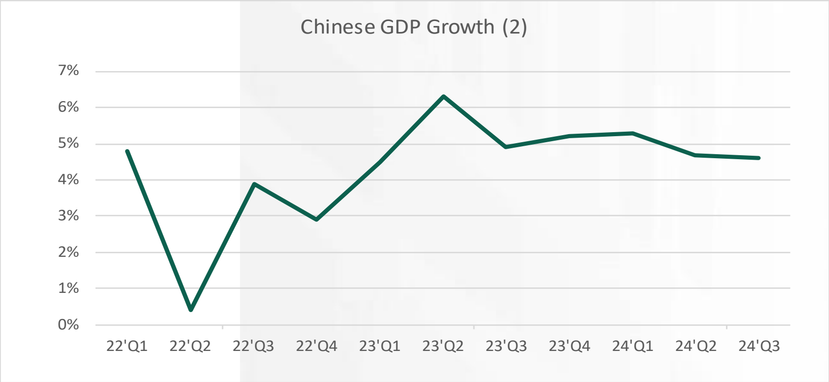
2024 Recap

Macro: International Weakness Influenced Disinflation Success

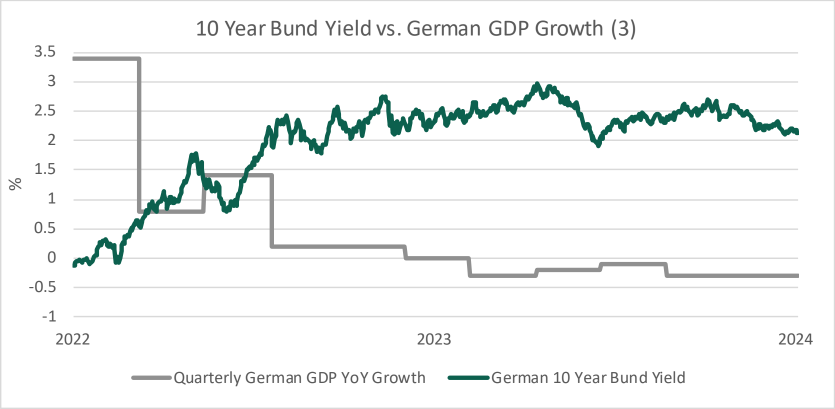
International economic data from both China and Europe highlights how disinflation here in the U.S. was due in part to some specific drivers abroad

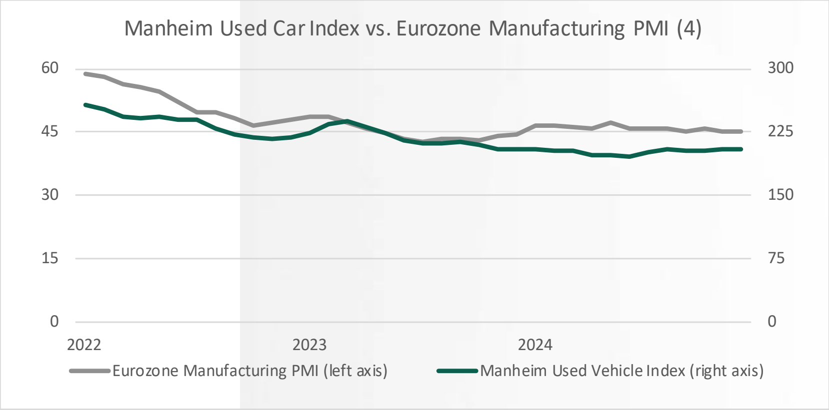
- China's slowdown had a dragging effect on Chinese export prices which subsequently impacted US Inflation data





- Weak German GDP and manufacturing fed the moderation in car prices



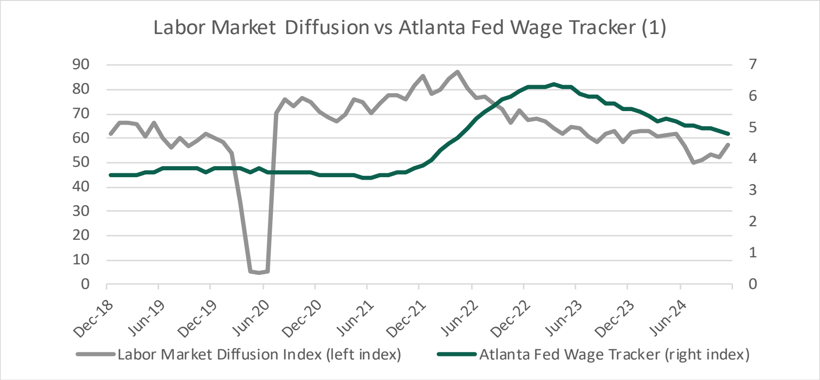


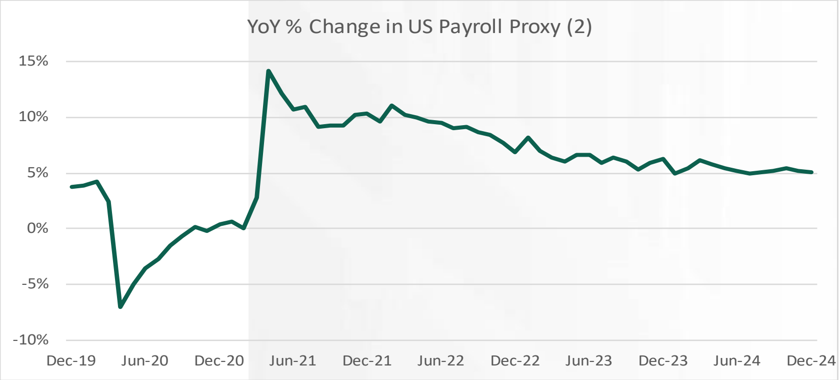
1. Source: China Export Price Index HS2 Total (CHHPETTL Index). Bureau of Labor Statistics US PPI Final Demand YoY NSA (FDIUFDY0)
2. Source: China GDP Constant Price YoY (CNGDPYOY Index)
3. Source: Bloomberg Germany Real GDP YoY% (EHGDDE Index), Bloomberg Germany Government Bond 10 Year DBR (GDBR10 Index)
4. Source: Manheim Used Vehicle Value Index, HCOB Eurozone Manufacturing PMI

Macro: Strong Employment Supports Strong Consumer

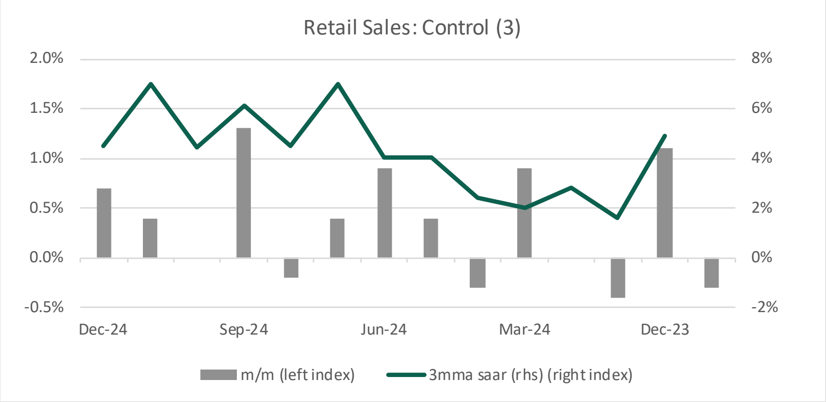
Throughout 2024 a resilient labor market in the U.S. continued to drive consumer spending and growth

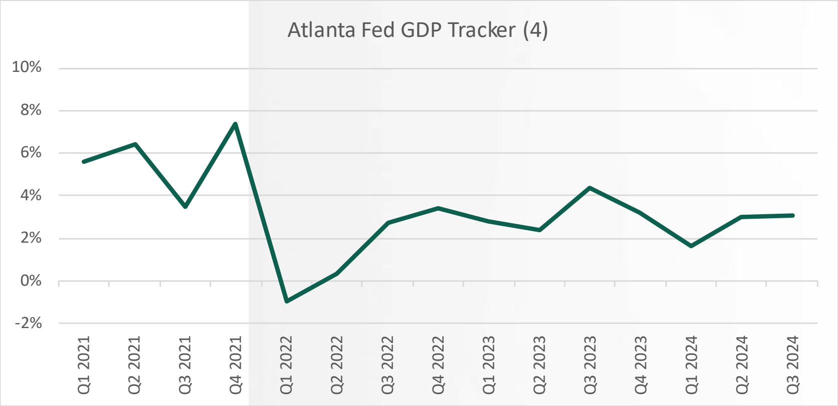
- Payroll proxy (measure of aggregate income growth) and wage data highlight the ongoing resilience of the labor market





- Retail sales are still on an upward trajectory and GDP data highlights ongoing growth despite “restrictive” policies



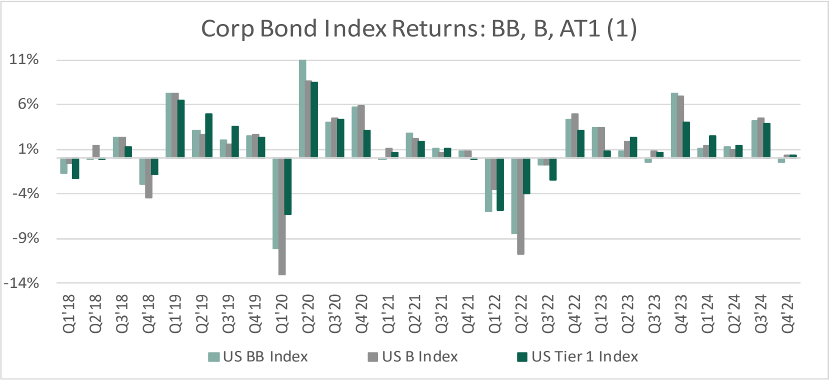


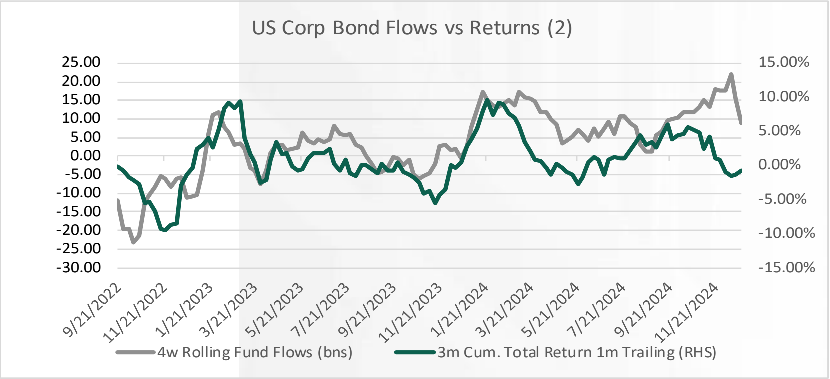
1. Source: Barclays Research, Census Bureau, Haver Analytics
2. Source: Bloomberg: US Bureau of Labor Statistics US Employees on Nonfarm Payrolls NFP TCH Index
3. Source: Bureau of Labor Statistics Employment Diffusion Nonfarm Payrolls +3month SA (EMDINP3M), Federal Reserve Bank of Atlanta Wage Growth Tracker
4. Source: Federal Reserve Bank of Atlanta

Credit: Total Returns Drive Investor Sentiment

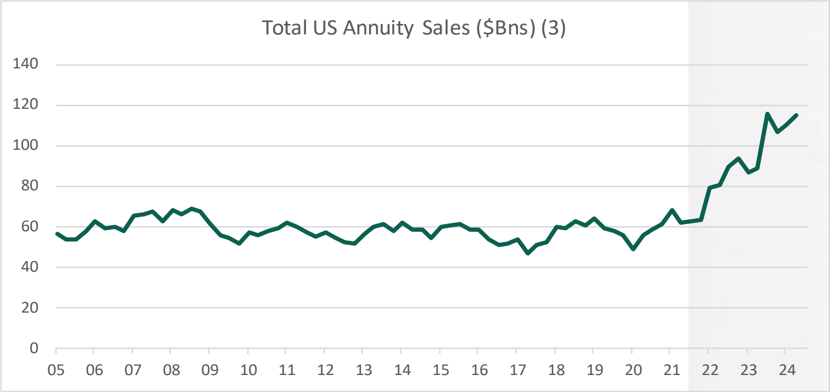
Strong fundamentals and tightening credit spreads produced attractive returns, further supported by yield demand as periodic growth scares supported expectations of Fed easing

- Credit bond indices across asset classes, ratings, and capital structures have performed well, supporting investor interest





- Technicals have also been supported by natural demand, including inflows into credit markets driven by record annuity sales

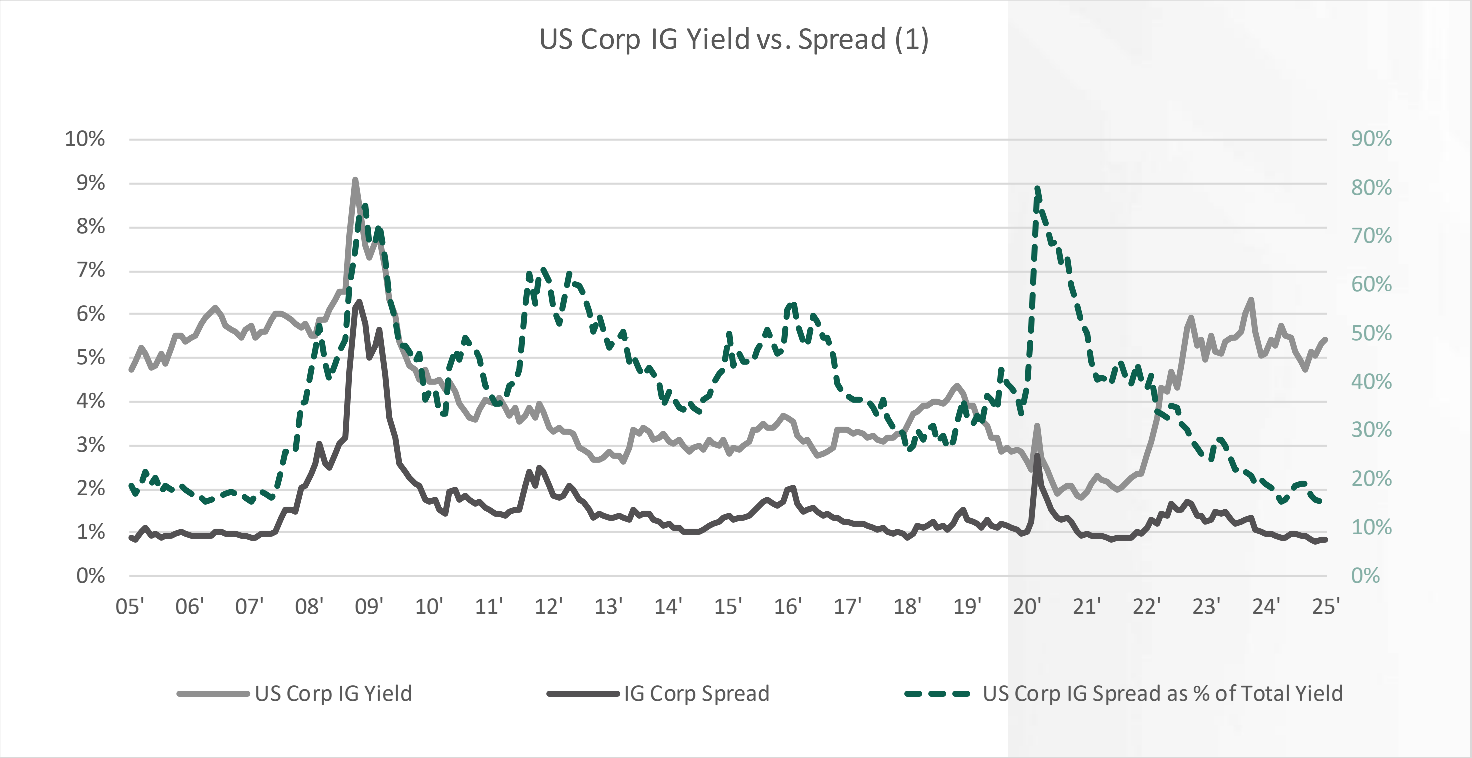


1. Source: The Bloomberg US Corporate Bond Index (LUACTRUU
2. Source: Barclays Research
3. Source: LIMRA (LINSTIAS Index)

Credit: Market Valuations

Causing IG Credit spread valuation to progress from stretched to extreme during 2024

- USD Investment grade corporate bond spreads as a percentage of nominal yield have reached a 20yr low
- As the market is generally not demanding any risk premium for duration exposure in bond portfolios

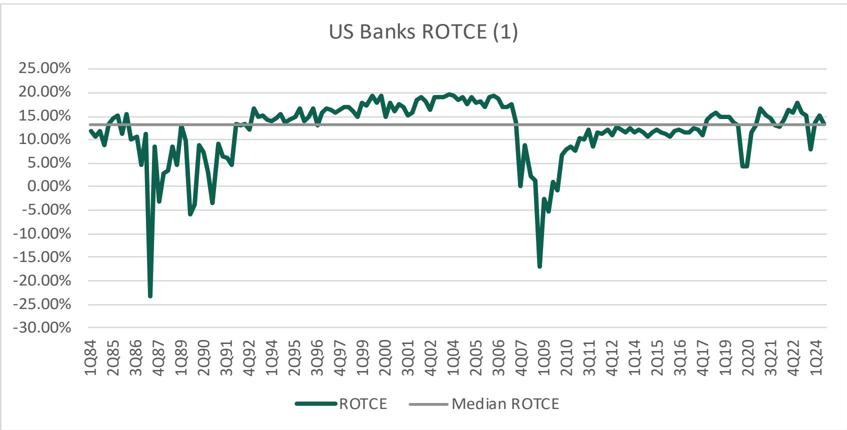


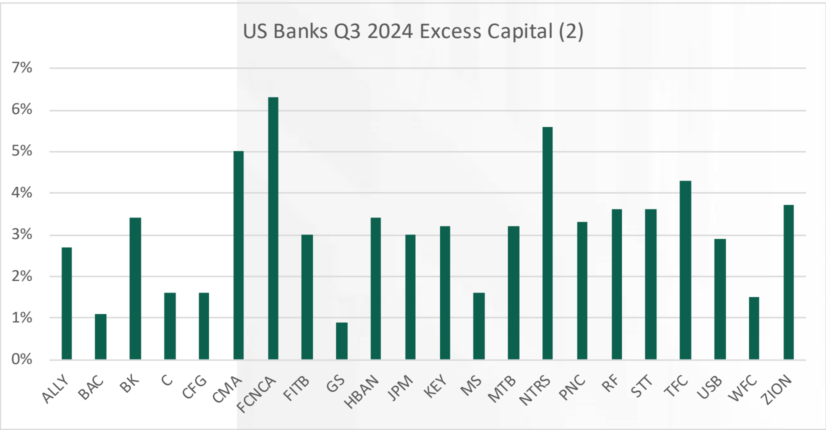
1. Source: The Bloomberg US Corporate Bond Index (LUACTRUU)

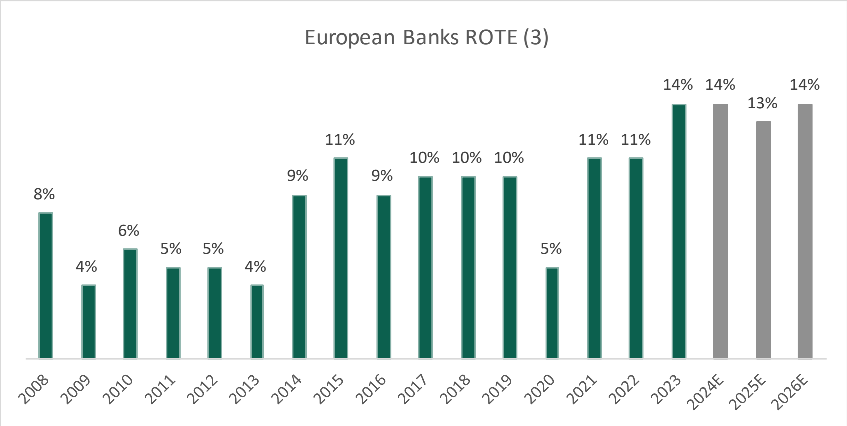
Banks: Fundamentals vs Valuation

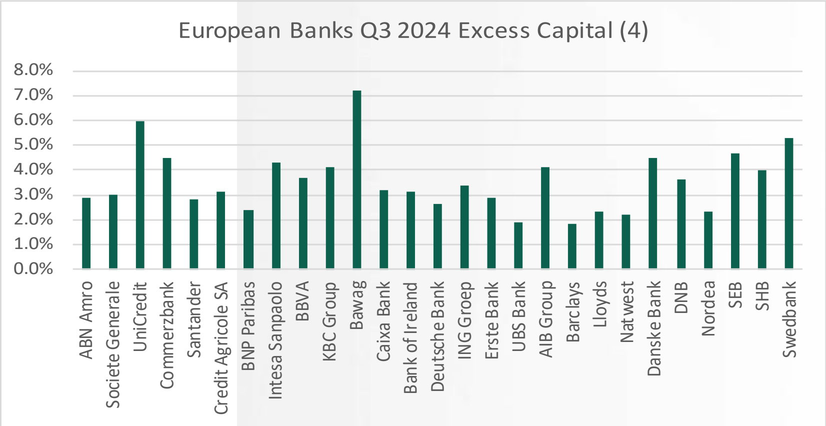
Bank fundamentals continued an upward trend across the globe

- Global Banks are more profitable and better capitalized than they have been since the GFC







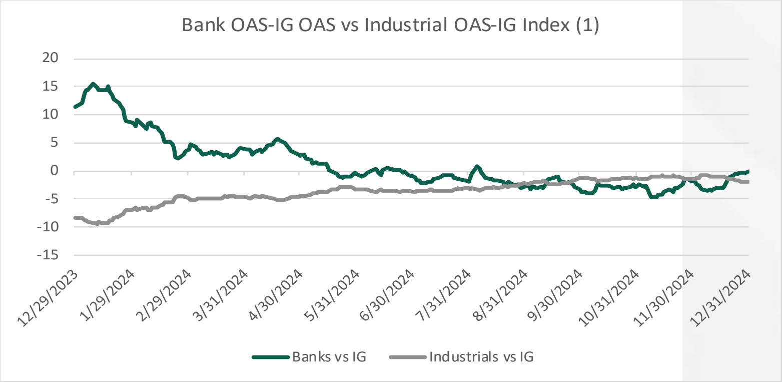


1. Source: Barclays Research and FDIC
2. Source: : Barclays Research
3. Source: Goldman Sachs Research
4. Source: Goldman Sachs Research

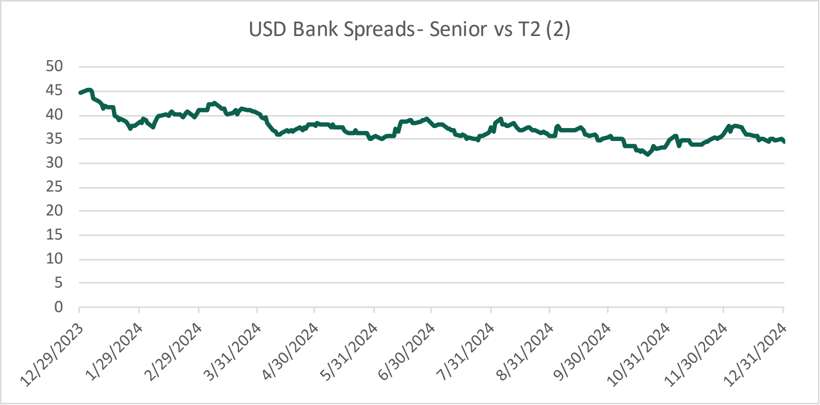
Banks: Fundamentals vs Valuation

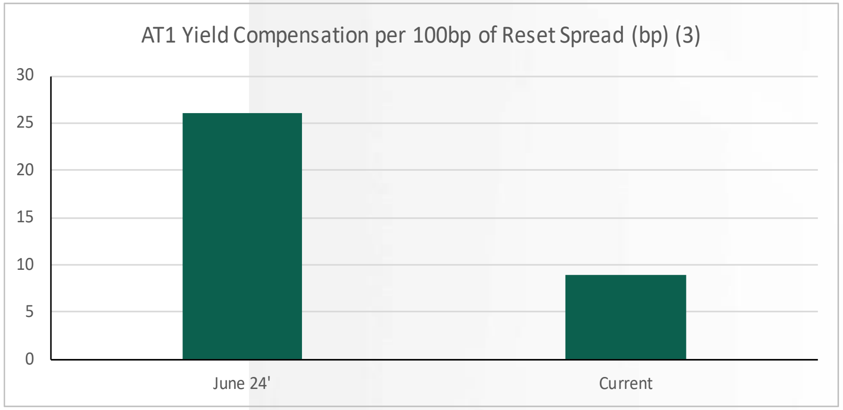
But valuation became so poor that opportunities from the long side were very limited as the year progressed

- On top of generic IG credit spreads being extremely stretched, Banks significantly outperformed Industrials during 2024



- And the value of extension risk in the AT1 market reached an all time low as subordination spreads collapsed





1. Source: The Bloomberg US Corporate Bond Index ((LUACTRUU), Industrial Index (I00277US), and Banking Index (I00408US)
2. Source: The Bloomberg USD Senior Banking Index (I26810US) and The Bloomberg USD Lower Tier 2 Banking Index (I26814US)
3. Source: Barclays Research

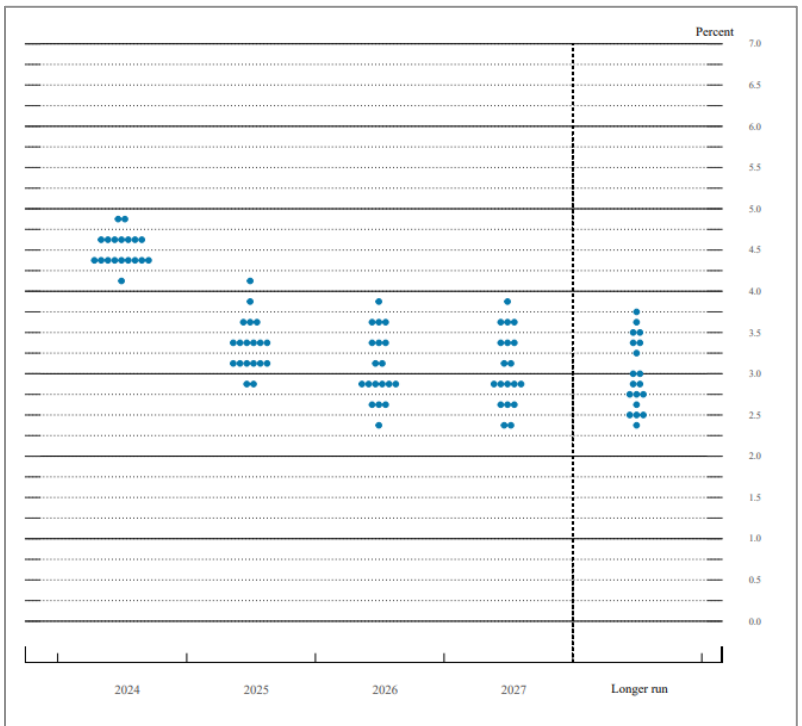
2025 Outlook and Opportunities

Macro: Uncertainty Remains High

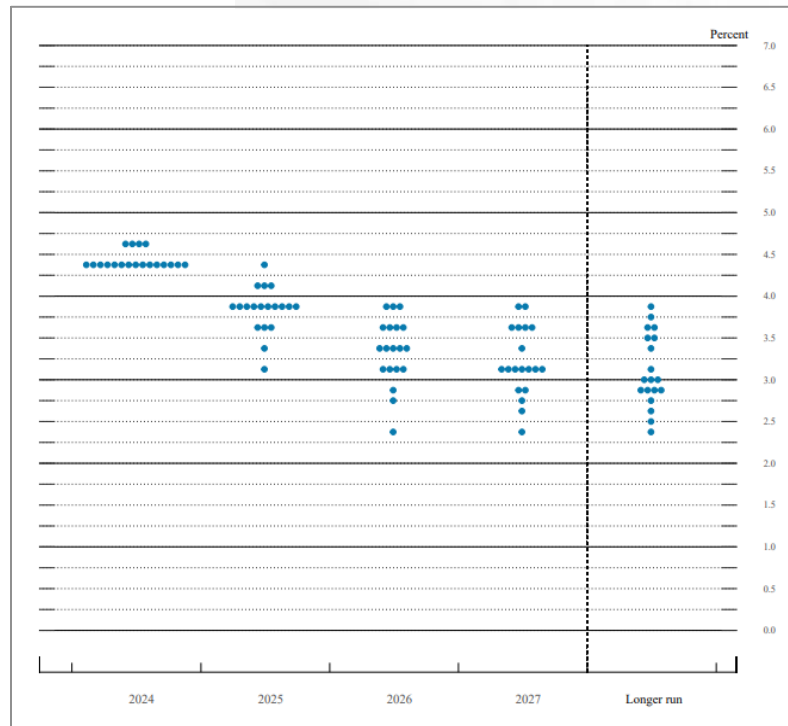
As we enter 2025 uncertainty regarding fiscal policy remains quite high – central banks are struggling to adjust

- Fed short term rate expectations from September to December using SEP – the cutting cycle anticipated in Q3 and early Q4 has largely disappeared

September 2024 (1)



December 2024 (2)

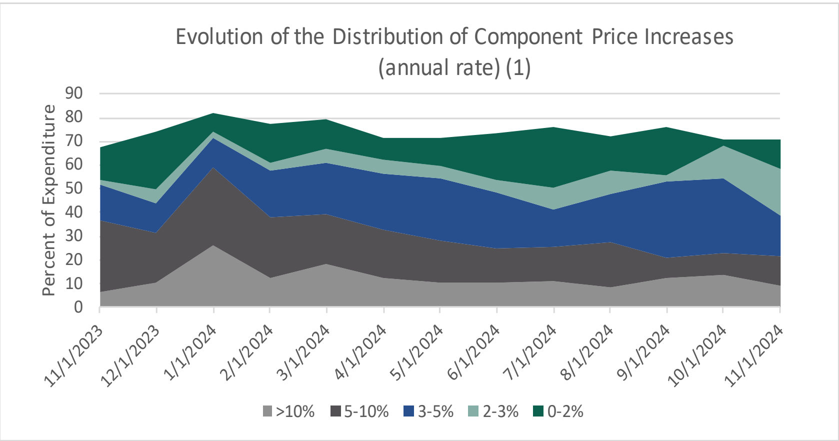


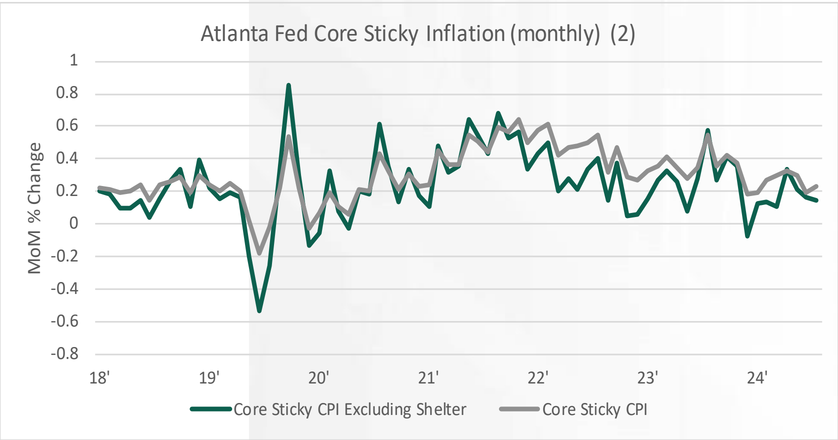
1. Source: United States Federal Reserve
2. Source: United States Federal Reserve

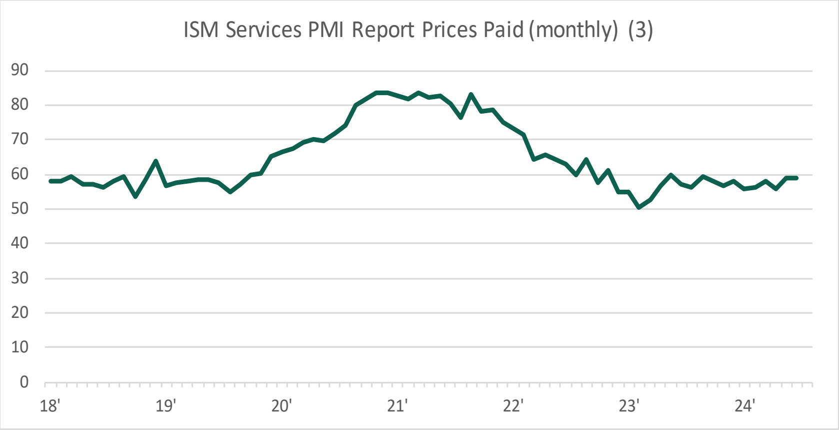
Macro: Inflation Outlook

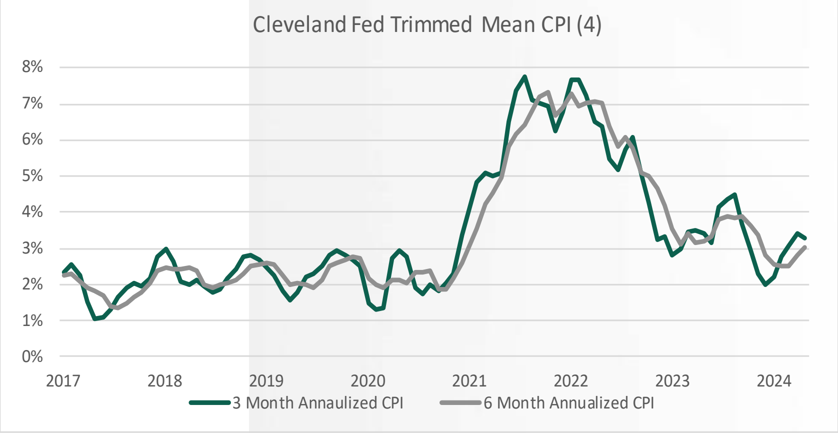
Inflation will continue to be a focus - progress has stalled and China's aggressive stimulus should put a floor under goods and commodity prices, disabling a disinflationary impulse

- A range of measures point to moderation in progress, if not reacceleration









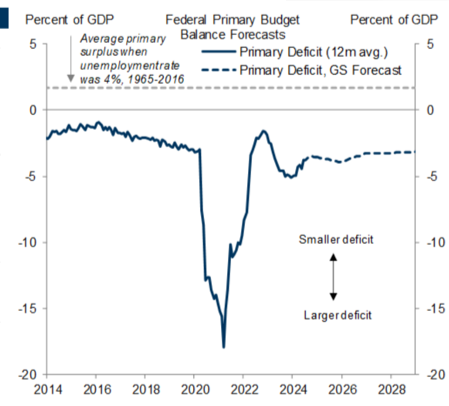
1. Federal Reserve Bank of Dallas
2. Federal Reserve Bank of Atlanta
3. Bloomberg: NAPMNPRC
4. Federal Reserve Bank of Cleveland

Macro: Treasury Supply and Fiscal Outlook

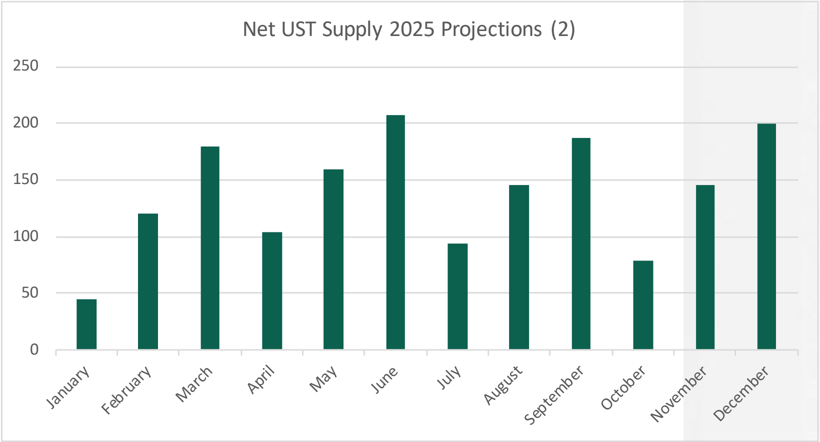
Where the rubber meets the proverbial road – Too Many Bonds

- Trump policy impact on deficit projections: "We expect full extension of the expiring 2017 tax cuts and some additional personal tax cuts, which would keep the primary fiscal deficit much larger than is usual in a full employment economy" (1)

Expected Fiscal Policy Changes	Impact, per Year
Extension of 2017 Tax Cuts	
Full extension of expiring 2017 Tax Cuts and Jobs Act tax cuts in early 2025	--
Reinstatement of 100% bonus depreciation, research and development expensing, and interest deductibility	$60bn
New Personal Tax Cuts	
Expand state and local tax (SALT) deduction	$30bn
Exclude extra 50% overtime from income tax	$20bn
Exclude tips from income tax	$10bn
New Business Tax Cuts	
Lower corporate tax rate for domestic manufacturers to 15%	$25bn
Other Fiscal Policy Changes	
Allow enhanced ACA subsidies to expire	-$20bn
Limitations on green subsidies	-$15bn



- Net UST supply projections remain elevated



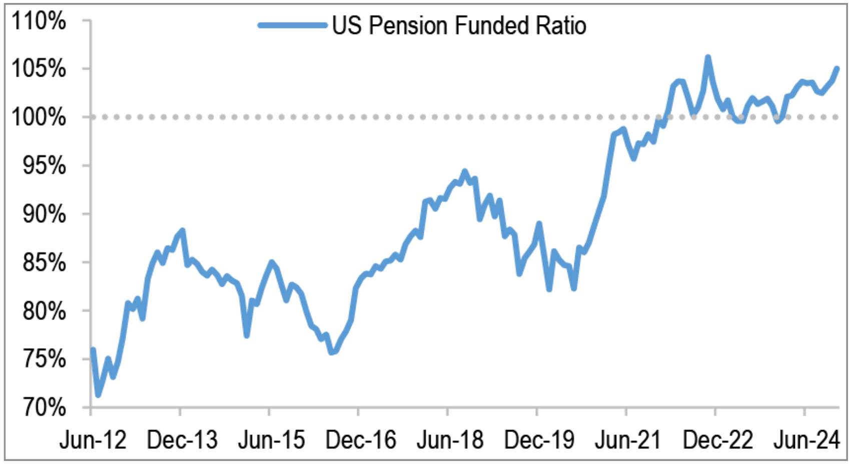
1. Goldman Sachs Global Investment Research, Congressional Budget Office
2. Barclays Research

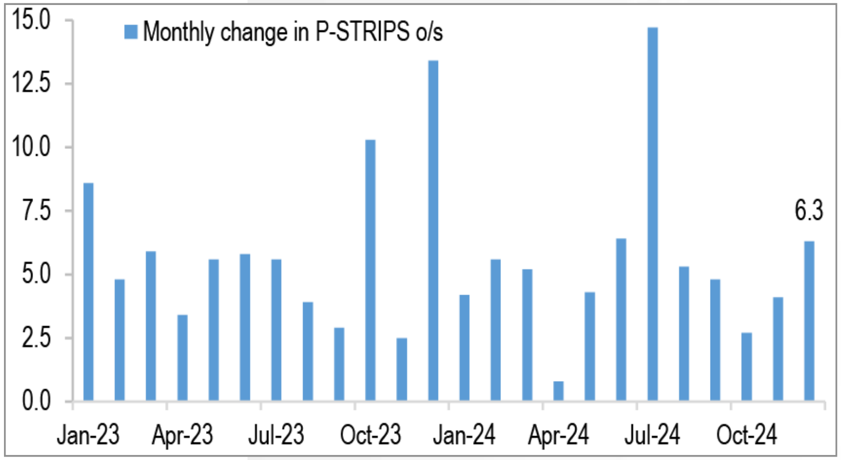
Macro: Rise in Rates Could Crush Duration Demand

Pension funds have driven much of the recent demand for duration, but this technical is at risk

- Pension funded ratio of 105% is the highest post GFC indicating both a lack of demand and a performance issue that cannot be buffered amid a dramatic move higher in rates

- Pension demand for duration, exhibited by stripping activity, hit a record high in July 2024 before dropping amid rising rates later in the year



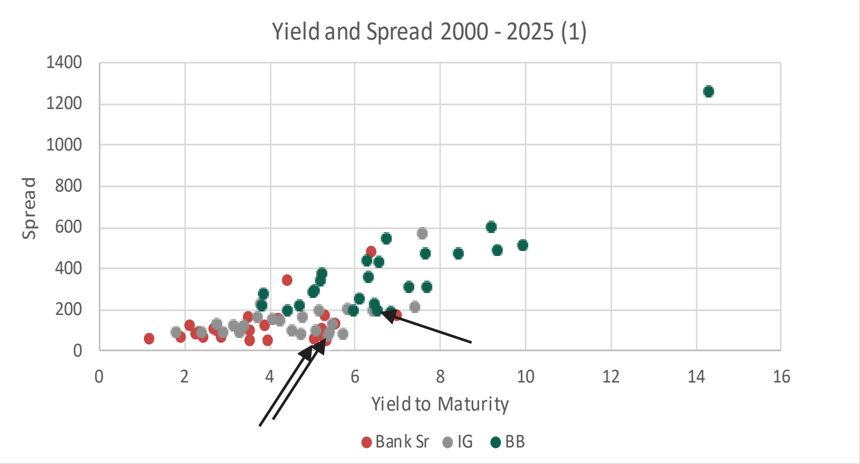


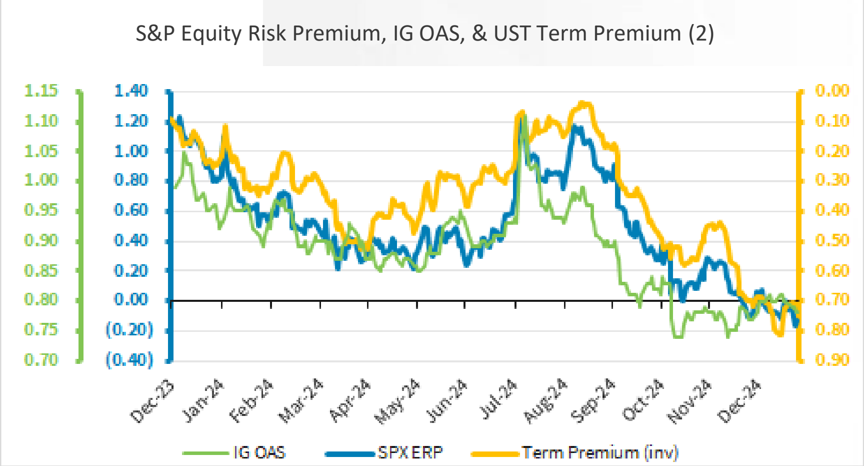
1. Source: Milliman 2024 Corporate Pension Funding Study, J.P. Morgan

Credit: Market Valuations

Picking up where we left off in 2024

- At the start of 2025, spread premia for both investment grade and BB credit remains at or near the lowest levels to begin a year since 2000 – there is no room for error
- In addition to credit spreads, S&P Equity risk premium is below -10bp and UST treasury term premiums is above -70bp, also at or near decade extremes



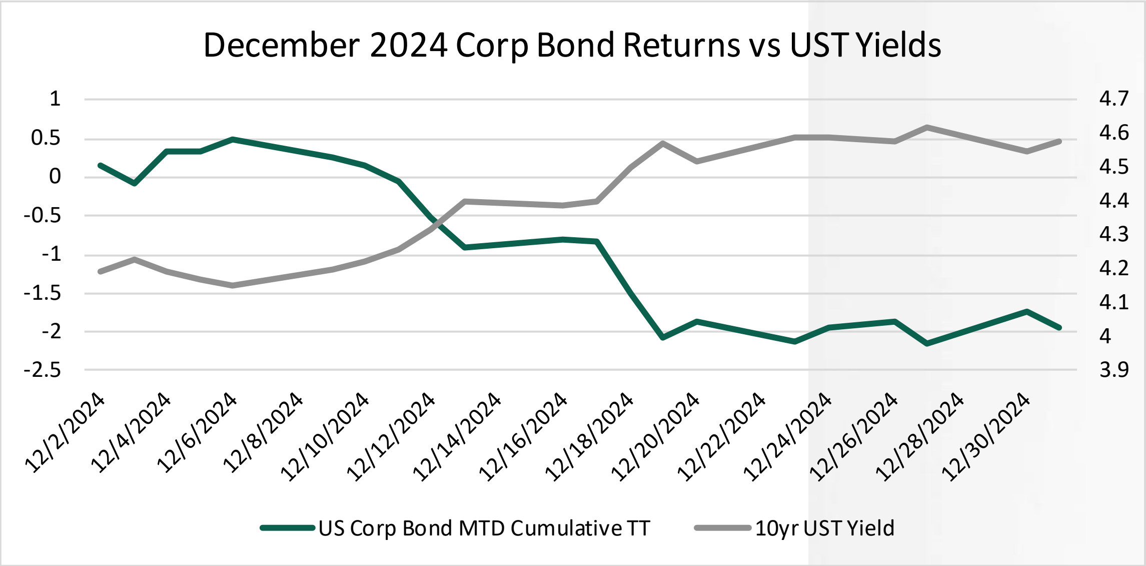


1. Source: The Bloomberg US Corporate Bond Index (LUACTRUU), Bloomberg Investment Grade Banking Senior Total Return Index Value Unhedged, the Bloomberg Ba US High Yield Index
2. Source: Barclays Research

Credit: Market Valuations

Macro volatility and negative returns will not be digested well given current valuations

- While we expect fundamentals generally in credit to remain strong, but other main factors that supported performance during 2024 (performance itself and a “last chance” to buy nominal yield), have a significant risk of being unwound.
- Under this scenario we think significant downside risks exist, mostly associated with old-fashioned crowding out (free float) and just too many bonds.
- “Clipping the coupon” on higher yields offers little value in a dramatic move higher in rates and no spread compression available to compensate

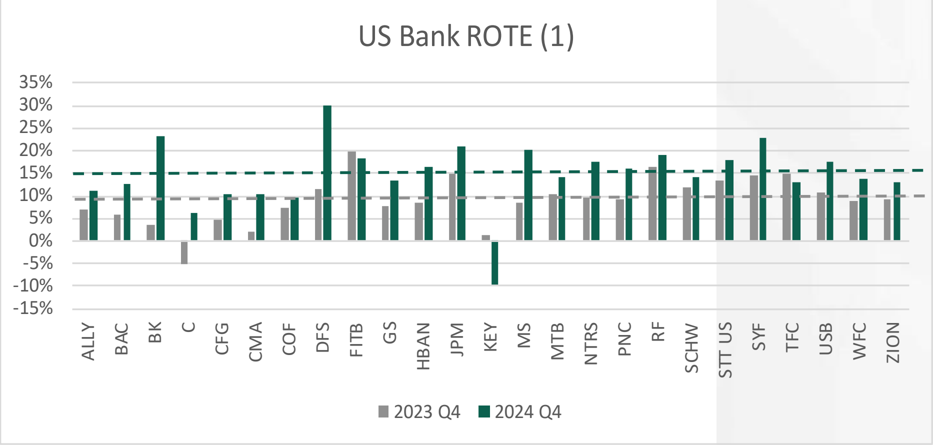


1. Source: The Bloomberg US Corporate Bond Index (LUACTRUU) and Constant Maturity Treasury (H15T10Y Index)

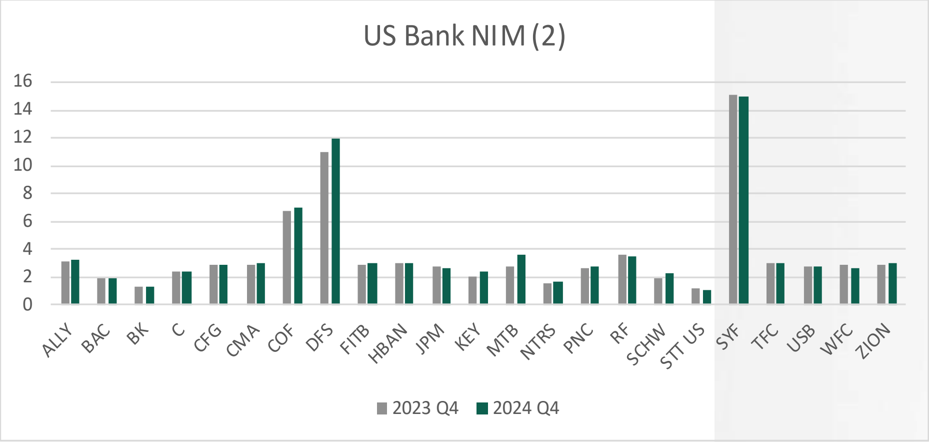
Banks:

While banks remain well capitalized and profiting from higher rates and a stable economy, extreme sentiment and current valuation make outright long performance difficult

- ROTE for the US banks shown below rose an average of nearly 600bp between 4Q23 and 4Q24



- Similarly, NIM rose by an average of 12bp



1. Source: Bloomberg
2. Source: Bloomberg

Current Opportunities:

Opportunities across the bank capital structure remain intact as we enter 2025, driven by several main themes

- **We believe Banks are fundamentally strong across the globe**
- **But valuation is far too stretched across credit and banks are no longer cheap on a relative basis**
- **The entire capital structure (away from perhaps equity) has become too compressed, specifically in the AT1 part of the capital stack where coupon, subordination, liquidity, and extension risk are virtually disregarded at this point**
- **We believe volatility driven by investor positioning and fiscal projections under Trump 2.0 will create a complicated scenario for risk assets**
- **We believe pair trades across the capital structure and credits, combined with net positioning, can create opportunities in any market backdrop, but specifically when the market reaches extreme valuation points as is now the case**
- **We are ready**

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