Iso-mts 2025 Market Outlook: Too Many Bonds…

Market participants ran the same play during 2022, 2023, and 2024: Invest and allocate on a dogmatic assumption that high interest rates were certain to slow and eventually stall the economy, causing the Fed to cut their policy rate and bond yields across the curve to fall. In the summer of 2024, strong conviction that this scenario had finally arrived manifested as a broad-based growth scare and significant rally in treasury yields.[1] Chair Powell concurred with the risk assessment, finally giving the market what it craved - 100bps of rate cuts. Time will tell if this made practical monetary policy sense, or if the Fed was erroneously still influenced by fighting the *last* war (slow growth and no inflation). The fact that the FOMC was concerned about a 4% unemployment while real GDP and core inflation both grew at 3% felt to us like the beginning a new reaction function framework. Considering the massive Federal deficit, this new framework risks losing the plot before the first page is read. It stands to reason that if the Fed never killed off strong consumer demand, then inflation might never truly come down. In 2024 US consumer real wages increased together with household wealth.[2] Labor market conditions confirmed little concern among workers toward losing their job. Instead growth in consumer income and spending created its own positive feedback loop. This virtuous cycle of these strong consumer demand dynamics feeding strong labor markets and strong wage growth feels enduring. The overlay of Trump tax cut extensions, and near-shoring becoming onshoring in Trump 2.0 sets the stage for significant volatility. Such a confluence of events will lead to painful consequences for credit and equity market investors. This is our base case.

These consequences will be driven by valuations, not fundamentals. For example, the banks (our area of focus) were remarkably profitable in 2024. Asset quality improved and loan loss reserves were released.[3] Net interest income and margins improved as the treasury curve steepened.[4] The deposit fears of 2023 were long-gone by the second quarter 2024, and while loan growth was anemic, the banks delivered record profits on efficiency improvements. Operating leverage in the fourth quarter turned positive for the first time since mid-2023.[5] Costs fell (as deposit costs stabilized) and then fell again even more significantly as the Fed began easing. These forces combined to generate exceptional bank return on equity metrics, which are now back above the long-term median for the first time since pre-covid.[6] With these fundamentals impressing investors, bank credit performed extremely well across the entire capital stack during 2024. Investment grade credit spreads reached their lowest levels since 1997.[7] Bank credit, senior, tier 2, and preferred/AT1 securities were aggressively bought throughout the year. We considered resulting valuations generally too expensive to express any significant longs.

Investment grade and bank credit enter 2025 with the smallest risk premia in over 25 years.[8] The equity market has received attention for its two-year performance numbers and stretched valuations, but the credit market has also rallied significantly on economic resilience and higher nominal yields. We continue to believe long exposure offers almost no value. 2025 outlook letters from large bond investors, as well as sell-side 2025 best ideas reports, express optimism towards (just) earning carry and enjoying these unfamiliar high nominal yields…we believe this is code for wishing they didn't have to be long (only).

And yet the inflows continue! A spike in sales of "old-style" annuities and rapid growth of credit ETF AUM have pulled record amounts of money into the asset class.[9] According to Goldman Sach, the AUM of ETFs focused on

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[1] Bloomberg and Barclays Research
[2] Barclays Research
[3] Barclays Research
[4] Barclays Research
[5] Barclays Research
[6] Barclays Research
[7] Bloomberg and Barclays Research
[8] Bloomberg and Barclays Research
[9] Barclays Research and Goldman Sachs Research

USD IG has nearly doubled in 5 years to ~ $750bn.[10] Investors have fallen in love with exciting bond yields, believing they cannot last. These yield driven investors have pushed risk premia to decades' lows as a percentage of total yield. Simultaneously, the risk (duration of the index) to these "carry returns" is as high as it has ever been. The US investment grade corporate bond market used to have a weighted average duration approximating a 5 year bond. Today it is roughly a 10 year bond. Any rise in yields and/or widening of spreads will easily wipe out long-only returns.[11]

Many have written this, including me, but it bears repeating: In the coming year(s) it is very likely those investors following previously effective behaviors associated with the great investment successes of 2010-2020 and 2023-2024, will meet painful outcomes. Now we are getting to the heart of the matter - where we see the best opportunities in 2025…too many bonds. The points we have touched on thus far, including higher interest rates and stronger nominal growth, together with uncertain inflation bands, are unlikely to marry well with extreme equity and credit spread valuations. On the contrary, this setup will require a skilled and nimble touch – and an embrace of things that are certain to feel uncomfortable (if you were not alive in 1985). We are entering a period where the supply-demand balance in global bonds is terrible…deficits, higher interest rates and inflation require a new approach – in 2025 investors can and will perhaps make as much money being short as being long despite a strong economy. The amount of debt governments must issue to finance themselves has exploded.[12] Some may correctly argue that this issuance has already occurred in each of the past few years, during exceptional equity and debt returns. However, this argument misses the significant impact of the cumulative growth in "free float" of government debt.[13] Economists sometimes call it the "stock effect". We think the need for private capital to absorb and maintain ownership of these assets will lead to inefficient adjustments of other financial markets. There will be enough bonds to bury valuations.

Where does the bank capital stack go amid all these factors and why do we prefer to begin the year short? As highlighted, we have not seen a combination of bank profitability and capitalization so compellingly favorable in decades (if ever) – bank fundamentals are exceptional. We see these factors are "already in the price" (except for certain bank equities). Banks are likely to grow profits again in 2025, but crowding out from fiscal deficits may overpower this fundamental strength. In fact, if long-term rates rise back above 5%, and bond losses again pile up like 2022, the 2025 version of crowding out may be severe. As risk premia have fallen, investors have crowded into subordinated and deeply subordinated securities in search of yield and returns. Senior bank spreads have become so compressed that it has led to a mass migration down the capital stack. These masses are willingly ignoring risk features that require attention and premia. Iso can benefit from our strategy's inherent liquidity across longs AND shorts. We anticipate that this liquid style of investment strategy will be among the most efficient ways to make money in this next era. We are ready.

Sincerely,

Justin D'Ercole
CIO

[10] Goldman Sachs Research
[11] Barclays Research
[12] Barclays Research and Goldman Sachs Research

[13] Barclays Research and Goldman Sachs Research

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