Iso-mts Q2 2025 Market Commentary: Too Many Bonds Revisited

Market participants are struggling with the new (investing) world order. The first 16-weeks of the year have largely matched our expectations. Perhaps the best way to highlight this is to revisit the market outlook slides we shared in January attached to this letter. The most important part of the new investing world order…of course deficits matter. More specifically, when the US tells the same foreign investors funding our fiscal deficit (via their trade surplus) that we don't want their money anymore, how are those investors going to continue to buy our bonds? And so, the end of a 40yr bull market for bonds – characterized by globalization, low labor costs and high productivity, low inflation and slow-but steady growth – suddenly comes into focus. But not so suddenly: according to Barclays, 60% of the total global FX reserves are held in USD, but fifty years ago this number was 85%. As investors absorb $1.2-$1.6trillion of net new UST coupon supply every year, and sources of past demand wane (FOMC QE and foreign trade surplus FX reserves), remaining price sensitive buyers will demand great risk premia. In the case of UST that means, risk premia for liquidity, duration, and growth of debt outstanding. For all other asset classes, it means previous valuation equilibria are crowded out…manifestations will vary from wider credit spreads and lower PE ratios to higher performance volatility and lower Sharpe ratios. Investors stuck in the post GFC investing paradigm, waiting for the return of "low and slow", are exposed.

Deglobalization may lead to a broad adjustment of capital allocation, both in the economy AND in the markets. If you turn on the radio or TV, read financial press, you will inevitably find commentary that the current level of US debt is not a problem, but that the path of US fiscal policy is unsustainable. Said simply, most don't yet see a problem but expect it to be in the future. When in the future? The Brookings Institute wrote in the summer of 2020: "*For now, it isn't. The U.S. government borrows trillions of dollars a year at very low interest rates on global financial markets, and there doesn't appear to be much private sector borrowing that is crowded out by U.S. Treasury borrowing right now*." I would love to have provided the author of that paper at Brookings a snapshot of April 2025: interest rates are 4x higher in nominal terms and we have encouraged global investors to go home. Iso doesn't see that 2020 argument remaining valid today. It is likely that the future is now. The amount of debt is a problem. It is so critical to maintain intellectual honesty on this subject, and we try to do that every single day at Iso as we make investment decisions. So where does that put us going forward…

Following several months of extremely rich valuation, Investment Grade and bank credit enter Q2 2025 with greater risk premia – we think it now makes sense to run balanced risk exposures. At Iso, we believe our strategy works well in all market environments, but that it is best suited to environments like the one present as we begin Q2. The universe of securities we focus on is being buffeted by migration of capital (into and out of), a highly uncertain terminal policy rate, and low investor conviction. This often creates opportunity to buy very convex securities too low and sell negatively convex securities too high. For us, this is exactly ideal for our long/short strategy. And if we do our job well, Iso's strategy can win. The past month has been a manifestation of this dynamic. As yields rise, and fixed income losses materialize, credit investors exit the asset class. As of April 13, MTD USD IG total returns of -1.8% were enough to catalyze almost $10bn in outflows – the largest weekly withdrawal since March 2020. Morgan Stanley recently published research describing a regression of IG Credit returns vs fund flows. Not surprisingly, the correlation is positive for 1-month forward fund flows following 3-month total returns. Strong returns pull in money. Poor returns result in money leaving. Capital follows performance. During the second week of April, the 30yr US Treasury bond experienced its largest one-week range since March 2020. Capital also follows volatility inversely – higher volatility is a drag on capital allocation. Not to be repetitive, but the uncertainty created by moves of this magnitude can feed opportunity.

Where does the bank capital stack go amid these factors and how do we intend to make money?

Q1 bank earnings reported over the past two weeks have been exceptional. The succession of banks reporting LOWER year-on-year non-performing assets and/or net-charge-offs while simultaneously generating HIGHER return on equity was very impressive. However, we anticipate that technicals will still outweigh the fundamentals and therefore a balanced approach is warranted. If in 2025 there are indeed too many bonds relative to available capital, if the magnitude of the amount of debt now matters, then business cycles will be shorter (again), characterized by high volatility, with periods of strong growth followed by non-disinflationary recessions. Trade wars have consequences…two weeks ago, foreign investors net sold USD IG credit for the first time in nearly two years. In fact, the net selling of investment grade credit by foreign investors of roughly $800mm in one week was the most since Covid. I wrote in January "*In fact, if long-term rates rise back above 5%, and bond losses again pile up like 2022, we expect the 2025 version of crowding out to be extreme.*" April has experienced meaningful bond losses, and yet long-term treasury yields are not even back above 5%. Credit spread widening is modest to this point: Triple-B rated credits are only back to their 28th percentile since 2010, and the 38th percentile for single-A. This leaves credit markets not nearly priced for recession and not even simply an increased risk of recession. In the bank capital stack, investors had flocked to subordinated and deeply subordinated securities during 4Q24 and 1Q25 in search of yield and returns. They were ignoring relative value and risk. Iso is lucky in that our strategy allows us to express both liquid longs AND shorts and avoid "forced buying" due to a "need to be invested". We intend to never sacrifice investment decisions based simply on what is available. Liquid long/short credit seems to us to be an ideal approach to the environment we find ourselves in as we begin Q2 2025. We now more balanced and remain ready and enthusiastic.

https://www.brookings.edu/articles/how-worried-should-you-be-about-the-federal-deficit-and-debt/