



Q3 2025 Market Outlook



Stop playing with QE type valuations before you go and get hurt

The market has decided to mistake yield for risk premium again (again). We think the market will finally recognize yield as abundantly available in H2 2025 – and subsequently be able to finally differentiate nominal yield from risk premium.

As I write this, we see risks everywhere we look – and yet no risk premium.

Groundhog Day indeed.

Investors are correctly happy with bank fundamentals. Through Wednesday's Q2 earnings results, profitability as measured by RoTE had improved in H1 2025 vs H1 2024 in almost every bank's case. If banks are this profitable and very well (over) capitalized, their ability to easily manage through the next economic downturn is strong and thus compelling. Despite this, we know that investors always see banks' extension of credit (the oxygen to markets and to the economy) as very risky. If there are issues in the market and/or economy, they naturally may impact the banks first. We have recently shifted our portfolio back to a short position, but with significant convexity which we believe will allow us to limit losses in a further rally and perform well when assets or valuation become more stressed. Before we define the risks...a brief comment on valuation: credit spreads across asset classes are in their 95th-99th percentile (rich) since 2000. Barclays models credit investor appetite from complacency to capitulation. We are on the edge of complacency. I am often asked for a catalyst to force a reset in positioning and pricing. I will give you 5 (but could give you many more).

- 1) crowding out from massive government deficits in the US/Japan/UK/France and the inevitable new debt load beginning in Germany later this year
- 2) Imminent drain of liquidity following the OBBB passage and TGA rebuild
- 3) A destabilized Fed (see I didn't say loss of credibility...even simply a destabilized Fed isn't in the price)
- 4) Extremely crowded market positioning leading credit investors to move back towards safety of up in quality and cap stack re-allocation
- 5) The unwind of 40 years' long globalization: de-dollarization, shrinking labor forces with rising inflation destroying productivity

Any one of these issues could cause a repricing of markets in short order. If all of them were to happen in a short sequence, we would be ready.

What are we seeing? Still a lot of intellectual dishonesty –

Remember when the market was focused on the inverted yield curve because we believed the Fed was so restrictive? As of this writing, a baseline Taylor Rule estimate for the neutral rate (1% real rate, core PCE of 2.7%, unemployment rate of 4.1%) suggests the current policy rate is slightly accommodative in the low 4%. And yet the obsession with cutting overwhelms.

Remember how we thought deficits didn't matter? The current free-float of developed market bonds has risen since Covid and now the OBBB will generate a funding gap beginning in 2026 for US Treasury – coupon auction sizes will be rising next year. And yet the obsession with a lower term premium overwhelms.

Remember how members of the FOMC were talking as if it was mission accomplished on inflation? Comments like, "we are basically there". The New York Fed's July survey of services industries (I chose this because it should be removed from tariff-related goods inflation) future prices paid index is demonstrably higher on 3-month and 6-month MA basis than any time since summer 2023! And yet the obsession with disinflation trends overwhelms.

Remember how the market rallied most of 2024 because the Fed was beginning a cutting cycle while ignoring their balance sheet shrinkage and plans to continue shrink even after ending QT. How will they do that? By reversing *Operation Twist*: quoting Fed Gov Chris Waller's July comment here *"We have far too many long-term assets on our balance sheet relative to my arguments for how to structure the balance sheet. I argued that long-term assets should only be held against currency liabilities, which are \$2.3 trillion. But we hold about \$2.3 trillion in agency mortgage-backed securities alone! So, the duration of our asset portfolio is far too long for the liabilities we need to hold for an ample-reserves system...In the years ahead, moving our portfolio toward shorter-duration securities will be a slow process unless we were to take the dramatic step of selling existing securities to replace them with Treasury bills."*

Who Cares – risk on? With priced for perfection best describing our asset class (again) – Iso CARES

Iso has been in business for under three years. Liquid long-short credit funds can profit from both long and short sides of a book. We believe there may be an opportunity for the short side of a book to deliver alpha in Q3. Here is why...

- Asian investors: have been gobbling up foreign bonds and driving spreads tighter over many years to diversify their bond holdings and overlay USD exposure. Japan/Taiwan/China/Korea have collectively added nearly \$1tr equivalent of foreign corporate bonds since Covid. The demand has been concentrated in the USD market. A recent Barclays research report looked at buying of credit during Asian hours broken down by sector: financial sector bonds YTD have been 51% of this overnight activity. We think as foreign yields rise, and money repatriates to domestic markets, an adjustment to risk premia follows.
- Credit has outperformed equities on a beta-adjusted basis since the end of April (Goldman Sachs Research).
 - o Why it matters - Credit markets are rich v. equities, but also v. agency MBS and CMBS. The relative value is poor across asset classes, but arguably the most unattractive in IG credit.
- Coming inflation in H2. Goldman Sachs estimates that the tariff announcements so far would have boosted core PCE by almost 1% if they had been entirely passed on to the end consumer.
 - o Why does it matter? - Their analysis concludes that only 40% of the tariff costs will have been passed on to consumers after the first three months. We don't see that as sustainable for margins and therefore even a 50% pass-through would feed a 50bps increase in PCE core...that seems like everyone loses – margins get hit and real disposable income gets hit. Again, not in the price of credit risk
- The OBBB passage and accompanying debt ceiling relief will lead to the Treasury restocking its cash – which then will mechanically produce a massive drain on bank reserves. There is a variety of estimates of how much cash the Treasury Department will want to hold, but assuming even the minimum of \$850bn, the accompanying bill issuance will suck \$500-600bn of reserves out of the system in just weeks. On a monthly basis (beginning now) the net supply of bills and notes/bonds to investors will be ~ \$210bn in July, \$320bn in August, and \$330bn in September.
 - o Why does it matter – dealers hold \$400bn of NET UST already today which is up from \$100bn three years ago. Commercial banks hold \$1.9tr of UST and agency MBS on their balance sheets (up from \$1.7tr a year ago). These assets require financing, and the drop of ~ \$600bn in reserves in Q3 is likely to cause problems.
- Deficits don't matter – until they do. Japan is the latest country to feel the need to spend more money and cut taxes. In Japan's case the July Upper House election could precede a further sell-off in long-end JGB yields. This comes with the UK and France already feeling their lack of fiscal headroom, while the US ramps up its deficit to GDP (~7% in the middle of a growth cycle anyone?), and Germany deciding they want their European dominant economic engine back via a major fiscal deficit spending initiative.
 - o Why does it matter – Classic crowding out is happening...the free float of UST coupons (those securities not held by central banks or in FX reserve accounts) is up to 50% of US GDP. The increase from 35% in 2021 is astounding. And now overlay a massive increase in expected German Bund free float over the next 24-months on top of incremental long JGB supply and we might take crowding out onto the global stage.

Do these items taken alone much less together support QE type valuations? Investors had been living with an absence of yield for so long we forgot what it looked like. Long-only investors appear to be doing some version of mistaking yield for risk premium. We believe there may be an opportunity to monetize a repricing of risk as yield is recognized as abundantly available.

Note: QE refers to quantitative easing. QT refers to quantitative tightening.

Source: Data sources for facts & figures include Bloomberg, BarclaysLive, Barclays Credit Strategy: Capitulation and Complacency Signals, July 14, 2025, Goldman Sachs Credit Strategy: Global Credit Trader, July 10, 2025

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