



Iso-mts Q4 2025 Market Commentary: Circular Reference – A Dangerous Game

What occurred this Summer and into the Fall was simply remarkable. Markets chased themselves in a circular spiral up. To us, at some point during Q3 it no longer resembled investing. Credit markets reached all time tight spreads in August. Equity markets

drove higher on the availability of that credit. Valuation became debated and disregarded. Some of the excited type of commentary that stands out to me⁽¹⁾: 1) Don't worry

about a 10% decline because at the top of a bull market you make enough to absorb the 10% decline before the decline. 2) The market isn't a bubble because people keep talking about a bubble – in 1999, I was there, and half the room hated the rally and called it a bubble. 3) Credit spreads now at all-time tights are OK because the Fed is going to cut rates – which means that credit market total returns are certain despite no risk premium - I think this one means you should ignore what you are buying and just count on the Fed - more on that below. 4) The Fed shouldn't cut but they will...so just buy everything – again I think this means ignore the price you are paying because the Fed is infallible – see below. 5) It doesn't matter that the Fed is being subverted, they are going to cut – doesn't that change the risk profile of what you own? 6) the only thing that matters to the Fed is employment (more on that below) and who cares if stocks are at 30x and credit spreads are at all-time tights, by cutting rates the Fed is going ease financial conditions to create jobs...???

Iso had a difficult run this summer. After successfully managing the mind-numbing volatility of March-May, we wrongly anticipated that bank credit was rich and beta-compressed. In July we took note of a street research piece arguing that high yield investors (looking to hide out from rich valuations in junk bonds) should move into bank preferred and AT1 at better yields. Note the circular reference? Iso believes this is our bread-and-butter. When investors reallocate as tourists on vacation in our market, it tends to be a sign that we don't want to be long. Unfortunately for us, the circular reference carried on. Once AT1 rallied as high yield tourists poured in, it looked compressed to senior and sub – causing both legs of the cap stack to rally further. How did we get here...?

Following three months of market volatility this spring, President Trump's peace proposal to China caught risk way offside. The sequence that followed was classic bull-market into bubble market type stuff. **When the first 90-day delay came in April**, investors had just hedged themselves against further downside. The reluctance to unwind these hedges helped feed the chase for risk that followed the unofficial "deal" between the two countries in May. Finally the capitulation short-covering and hedge unwinds that followed in June probably were good for ~ 50% of what happened this summer. **By July the Fed became the enabler**. This is about the time that research piece went out telling high yield buyers to move into bank AT1. We didn't expect the Fed to go all-in. I wrote an op ed that was published in the FT this summer talking about the Fed. I believe they lost the plot – without spilling too much ink again on this subject:

The Fed transmits monetary policy through financial conditions. To successfully steer our \$30tr economy they use a blunt tool and manage the availability of credit via financial conditions. **We think they could be making a mistake by ignoring the inflationary aspect of a generational drop in the labor force while consumption is strong - they are feeding the chase for risk.** Don't fight the Fed – tends to be a foolproof motto *WHEN THE MARKET IS CHEAP AND MOOD IS SOUR!*

The FOMC made a policy mistake in 1999 ahead of Y2K: flooding the market with liquidity to save our system (computers would know the year 1900 instead of 2000) – alas dot.com mania followed only to be wiped out when liquidity was removed in Q1 2000 (the Y2K that wasn't). In 2007 the Fed, fearing inflation, made an even bigger mistake when they raised rates at the beginning of the GFC – a narrow focus on inflation in that case that vaguely resembles the current razor focus in payroll growth...they cared about oil prices above \$100 and didn't see the mortgage market breaking down in Q3 2007 - enough said. **They are fallible – which means blindly following Fed liquidity into a dark alley bears significant risk.** This year, they decided the marginal job was worth saving despite speculative financial conditions (becoming a bubble that will ultimately take that job away). The unemployment rate is low, inflation is high, the fiscal deficit is around 6% (including tariff revenue) and real GDP is running above 2%. **And the Fed is focused on a notoriously LAGGING indicator – the labor market.** Circular reference ignoring linear thought regarding consumption accelerating in June July and August. Does the labor market lag retail sales? I suspect yes. **When stocks are at 30x and credit spreads are at all-time tight and the Fed cuts, capital gets allocated dangerously** which puts people out of work (when it ends). I believe they have totally lost the plot.

How extreme have valuations become at the end of the third quarter, and why are we (very) short...not because of fundamentals. Large cap banks' senior debt with a 30-year maturity is priced so aggressively that the spread can widen roughly 5 basis points before investors break-even (burn through their carry). **A 5bp spread widening would adjust the risk premium from the 100th to the 99th percentile of the past 30 years.** Back to our circular reference analogy – when spreads are this tight, long-only investors allocate where they can capture their required yield – by justifying the allocation down the capital stack with how unappealing the senior spread is and finding solace that others are doing the same (the research piece telling people to move into bank prefs). Here is the next circular leg to that positioning – as high yield investors begin to find value in their home market, they will allocate away from AT1 and unwind the excess. We estimate **the spread between senior and subordinated securities** has fallen to an average (unweighted) of less than 20bps for US banks and 40bp for European banks.⁽²⁾ These subordination premia are a fraction of the average of the past decade. Similarly, **perpetual AT1 securities have reached their tightest spreads since 2007**, and we estimate the differential between perpetual T1 securities and subordinated debt has dropped to an average of 100bp for US banks and 130bp for non-US banks.⁽²⁾ With bank spreads at such tight outright levels, amid a chase for “nominal yield” across the fixed income markets, risk premia are effectively stuck at “their zero lower bound”. Our analysis argues for staying short. **Any adjustment to the circular reference in place will cause credit spreads to widen because relative value will break down.**

What do we expect to happen from here – There are of course an infinite number of potential future outcomes – but given valuation we don't worry about which one materializes because **being short volatility / long credit / long risk at these levels makes zero sense** to us. We acknowledge that these extreme valuations can continue due to bank fundamentals and profitability, but we see the fundamentals as already in the price. When we overlay what we think the overall market exposure/positioning looks like, we are legitimately concerned. Our base-case: the economy holds up well while a financial market bubble bursts. That was exactly the scenario in 2000 and the first part of 2001. How does it happen? That part doesn't matter.

Notes:

(1) *Commentary does not reflect direct quotes. These are examples of general commentary summarized from discussions with various market participants.*

(2) *Source: Iso estimates using Bloomberg pricing data.*

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