Iso-mts Q1 2026 Market Commentary:

"The market can remain irrational longer than you can remain solvent" – JM Keynes

Bubbles put people out of business on both sides of the summit – our industry is perpetuating the likelihood that this could happen again. This letter will cover the following: 1) Q&A I wish I could ask past Fed Chairs/Treasury Secretaries, 2) a review of bank credit and overall credit markets, and 3) some simple conclusions.

If only we could ask…

What if we could sit down with three pre-eminent members of financial markets for a quick roundtable? I get to ask these three esteemed market sages one question each. This hypothetical exercise will hopefully give you room to reflect on what is going on today.

The Iso January 2026 roundtable welcomes former Fed Chairs Paul Volcker and Alan Greenspan, and former Treasury Secretary Henry Paulson. We will pose questions to our guests in historically chronological order:

Mr. Volcker: Your reputation for breaking the back of inflation was hard earned. Like the recent post Covid period, in the early 1980s you inherited a (more) severe inflation problem, and like the current Fed you took difficult decisions to raise interest rates and, in your case, even push the economy into a recession. By the end of 1983 you had inflation back below 3%. Following that painful process, President Reagan introduced significant fiscal stimulus via massive tax reform. At the time you urged fiscal restraint and spending cuts to offset tax cuts. Despite your suggestions, Reaganomics' tax cut stimulus, combined with a robust consumer buoyed by these tax cuts and rising asset prices (whoever dies with the most toys wins was the saying of the day), led to an inflation rebound into the 5%s. *How would you advise this Fed and Federal Government today with inflation finally below 3% in Q4 2025 while GDP runs above potential (2.5%-3%), risky asset prices reflect nearly historic valuations, and the unemployment rate is 4.4%?*

Mr. Greenspan: In 1999, during the productivity boom associated with the birth of the internet, you enjoyed both stable inflation and employment even while GDP ran above trend – but as the equity market pushed to extreme levels, you made periodic attempts to control soaring asset prices. In late 1996 you warned of irrational exuberance. In 1997 you raised interest rates as the equity market soared further, but Long-Term Capital Management's troubles and Russia's default in the Fall of 1998 led to significant stress, forcing you to calm nerves with lower rates. As stocks resumed their historic rally, you once again raised rates in 1999. Unfortunately, as stocks shot the moon you were confronted with Y2K threats to our technology and flooded the system with liquidity at year-end. Ultimately history confirms this period as a bubble. *As you look at today's similarities to that time, is the Fed right to ignore asset prices and focus squarely on its dual mandate?*

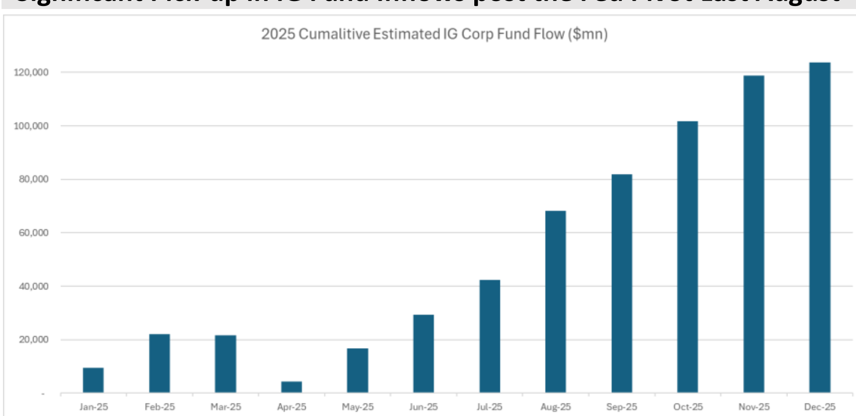
And finally, **Mr. Paulson**, the use of FNMA and FREDDIE as sources of capital to fund housing affordability in the late '90s and early '00s was in most economists' view, a major contributor to the housing bubble that led to the global financial crisis. It appears politicians are again seeking ways to improve housing affordability, including using the GSEs to subsidize home loan costs with President Trump's $200bn MBS purchase "instructions". *Can you comment on the associated costs and benefits of pursuing housing affordability for the lower quartile of the income spectrum and should we use these agencies to improve affordability?*

Banks and Credit Markets

Why do we remain short bank credit spreads with a decompression expression and preference for long convex vs. short negatively convex assets?

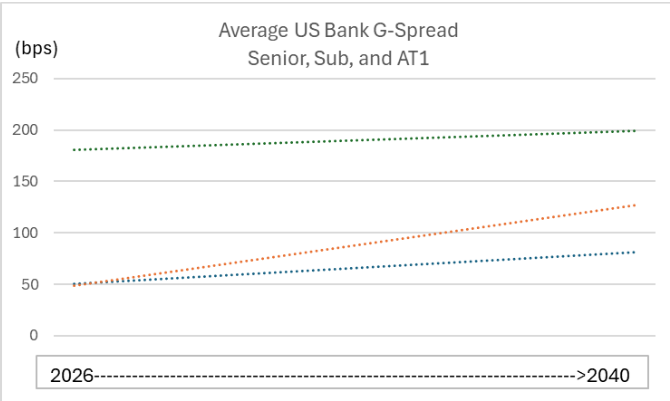
We think risk/reward in investment grade bonds, and more specifically in bank credit, is very poor. Valuation remains stretched. In this case, extremely stretched - IG is at the zero-percentile tights over the last 25 years and the high yield market is beginning 2026 at its tightest spread ever to start a calendar year. We don't see any way to justify being net long today in any part of the bank credit market. Real money nominal yield buyers (including retail) have been willing to ignore this as they chase performance they assume will be driven by Fed rate cuts. Once in a generation fund inflows in H2 2025 being deployed at these stretched valuations reflects this behavior. However, for hedge funds, we believe that any return generated from being long corporate bonds at today's spreads is wiped out from funding and hedging costs. Even with leverage, there is no traditional ability to generate positive return without further compression in credit spreads to drive performance. In our view, this is another reason why investors continue to pursue securities with more yield/spread, which naturally means allocating down the capital structure in banks. **We believe the risk is still abundant here. Assuming you buy a 10yr bond at +125 bps vs UST (cheap to where MS and PNC just priced subordinated deals), we estimate that 7-10bps of spread widening, which is well below simple mean reversion, would wipe out any excess return.** This return profile forces investors even further down the cap stack and explains the ongoing support for AT1 securities – it's just a carry trade. A very risky carry trade. All else equal, both leveraged and high yield investors have to go down the cap stack to AT1 to make any money. While AT1s may provide an opportunity for a high-single digit leveraged return, **it requires no change in price/yield value, rate risk, extension risk, and/or capital structure risk, to work**. Through the cycle, valuation and extension risk should always be important parts of security selection. Others may ignore it, but we won't. We remain net short, with a combination of defensive and tactical higher beta longs versus strategic shorts.

Significant Pick-up in IG Fund Inflows post the Fed Pivot Last August

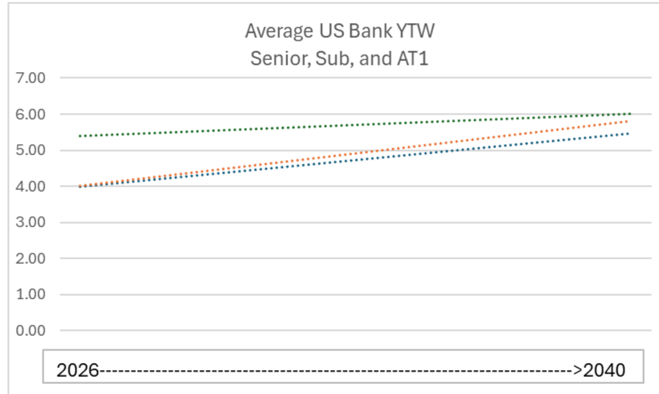


Source: JP Morgan Daily Credit Strategy, 1/9/2026.

These charts highlight the on-going support for AT1 securities at record low comparable spreads and yields

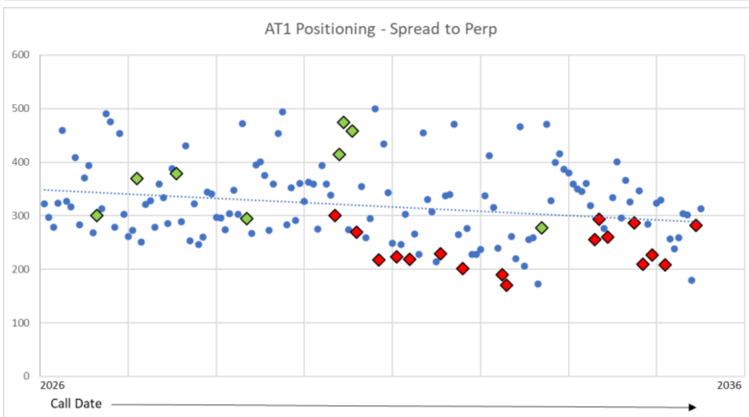


Source: Bloomberg. Calculated using average US Bank spreads by tenor.



Source: Bloomberg. Calculated using average US Bank yields by tenor.

Iso's recently added longs (in green) relative to our largest short positions (in red)



Source: Bloomberg, ISO-mts. Chart includes all Bank AT1s within our investment guidelines.

In Conclusion…

As we enter 2026, most market participants have no interest in fighting the administration. In our opinion, investors and the street are entirely certain that the President and Treasury Secretary are going to exert control. The new Fed Chair is expected to embrace above target inflation and steady employment with more cuts – in essence - cut regardless of asset prices and the easiest financial conditions in 25 years. The thinking goes that even though asset prices are way too expensive, they are going to get more expensive. Banks are entering their first true post-GFC frontier – more leverage, less capital, less regulation, and yes accelerating profits and returns, but much greater risk (on any volatility horizon). Back to my quote from the great JM Keynes…yes, bank credit pricing is irrational but if one assumes an overly active combination of monetary and fiscal policy together with creative market solutions, we can keep the party going. I believe there is nearly universal agreement on this. However, THAT is a bubble.

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