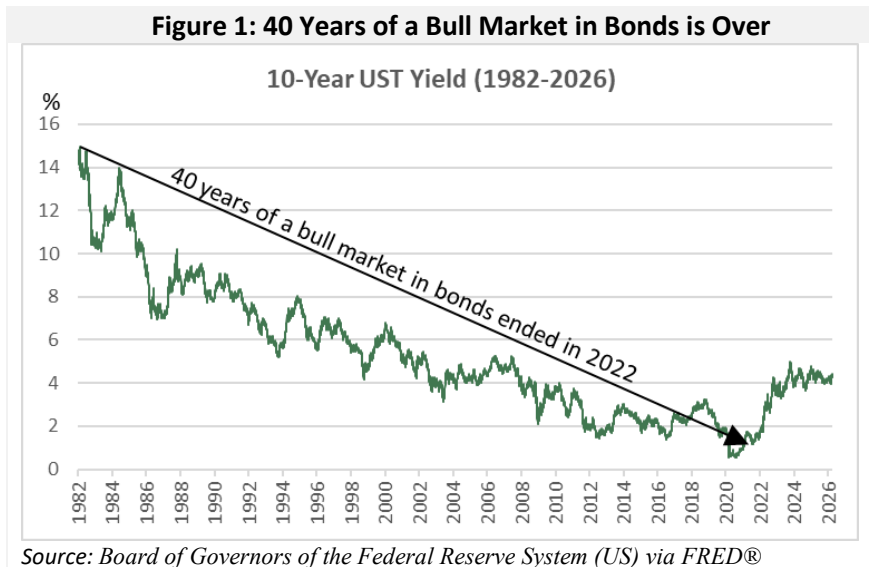




Iso-mts Q2 2026 Market Commentary: It is a “supply-shock” world, and we are all just living in it...

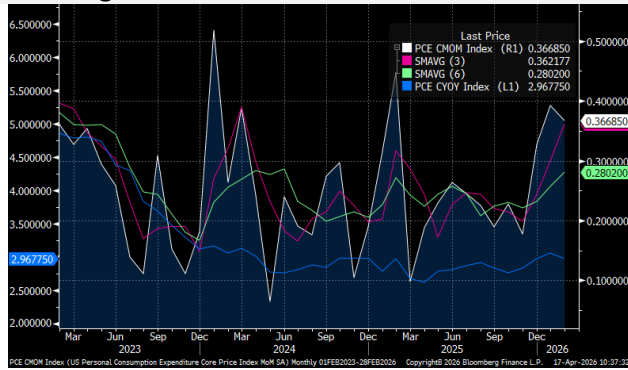
We consider the market unprepared for the roaring ‘20s PLUS inflation. A simple assessment of the FOMC policy rate – using a market friendly/dovish assumption Taylor Rule model⁽¹⁾ identifies current Fed policy as too easy by ~100bps. Why is this the case? I believe this is the case because everyone (including the Fed) wants to live in the low vol, low rate world they are used to. And what are the implications of this? The implications are almost infinite, but for our purposes focusing on banks, I believe the implications create significant opportunity as we begin the era of the Great Releveraging.

Yield is abundant – After 15 years of yields close to zero, many investors have missed the shift to a new regime. We exited the 40-year bond bull market in 2022 (figure 1).



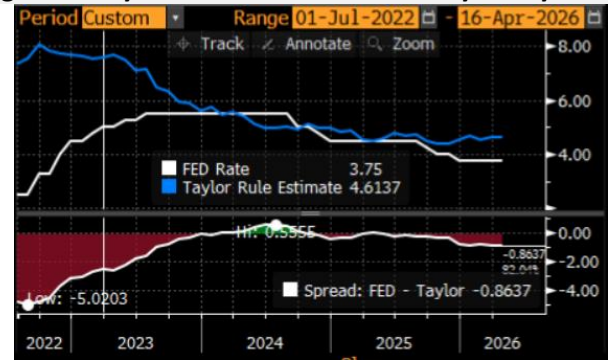
The disregard for this paradigm shift is creating market distortion and opportunity. This time around, the roaring ‘20s brings with it the inconvenience of a lack of disinflation. The supply-shock world has produced over three years of core PCE stuck in an elevated range (before the closure of the Strait of Hormuz). In fact, the 3- and 6-month moving averages are at their highest levels since 2023 and 2024 respectively (figure 2). And yet the narrative is that AI and productivity together with housing will push inflation back down to 2%. Maybe. But probably not. The labor force is shrinking, China is done exporting deflation to the US, and supply chains are no longer just-in-time. If the Fed is going to run easy policy while the global order is turning away from 1990s and China WTO/free trade, instead replaced by de-centralized self-reliant supply chains and resulting supply shocks, investors must adapt (see section on bank credit for how they have not). The Fed claimed to be restrictive (relative to neutral for the past several years). They have cut rates 175bps in this latest easing cycle to get back to neutral. I think John Taylor (Stanford professor, not San Francisco 49ers 1980s wide receiver – playing Robin to Jerry Rice’s Batman) would take exception to this (figure 3). I would argue the FOMC has been one of the most dovish FOMCs in history chasing the “new normal”. Chair Powell described the 2025 cuts as policy risk management. Which part of the risk management did we need? The unemployment rate is falling and 3-mo and 6-mo core PCE are higher. It’s truly remarkable to watch.

Figure 2: PCE Shows Lack of Disinflation



Source: Bloomberg

Figure 3: Taylor Rule Indicates Monetary Policy Is Easy

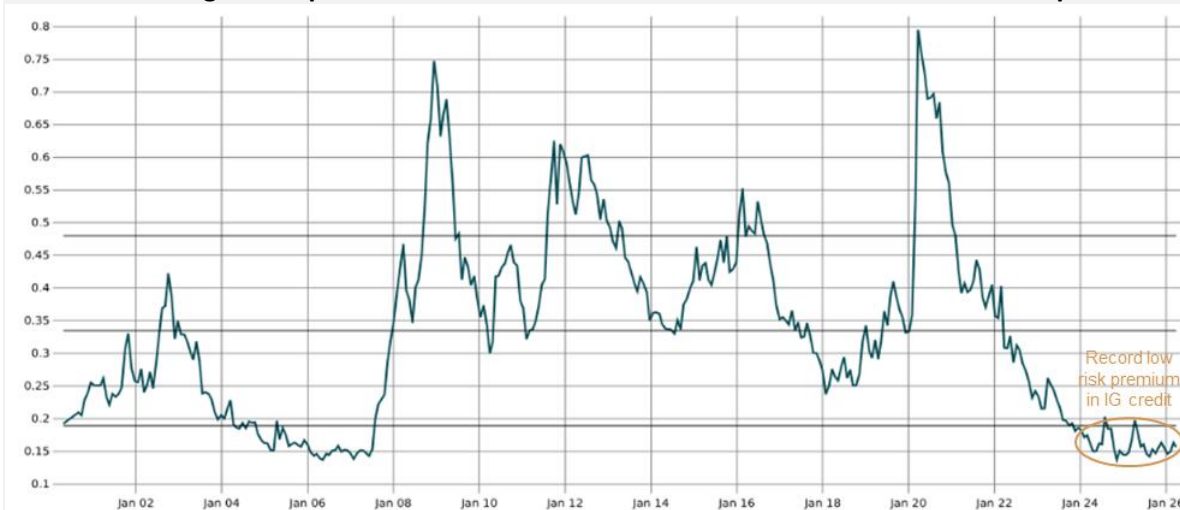


Source: Bloomberg

You don't need to chase credit risk with no risk premium because the associated yield (from risk free assets) is not going to disappear (figure 4). In fact, if you do I believe you are making a significant mistake. In both 2024 and 2025 investor allocations to all forms of credit were (sometimes not so) quiet bets on a return to the "new normal". Think about what investor allocations to credit have been buying - the massive inflows I spoke about in previous letters have been buying zero risk premium. And with interest rates higher, the volatility of returns will be higher (this is the math). So, you're taking on board much higher return volatility with much lower credit spread risk premium. And a generational wave of investor capital has bought this.

In order to get back to the "new normal", here are some of the things that I believe are years overdue in materializing: inflation must go away, the deficit consolidates and tariffs save our fiscal order, immigration policy shrinking the availability of cheap labor won't impact wages or the unemployment rate, among many others.

Figure 4: Spread as a % of Yield in IG Credit is at the Lowest Levels since pre-GFC



Source: BarclaysLive. IG Credit OAS as a % of IG Credit Yield-to-Worst.

The Credit Markets struggled in Q1 – Monthly Total returns for IG credit were the worst in March since October 2024 down -2.1%⁽²⁾ and even lower if you consider "real" returns adjusted for inflation. And yet despite a weak finish to Q1, credit remains expensive. Looking at investment grade in aggregate, spread risk premium began April

below its 10th percentile since 2000⁽³⁾. Herein lies the “significant mistake” I referenced above – buying indiscriminately with minimal risk premium built into the market could end badly.

Our views for Q2 - Two significant issues for banks in the near term –

1) Banks are NOT set up for higher interest rates the way they were in 2023 –

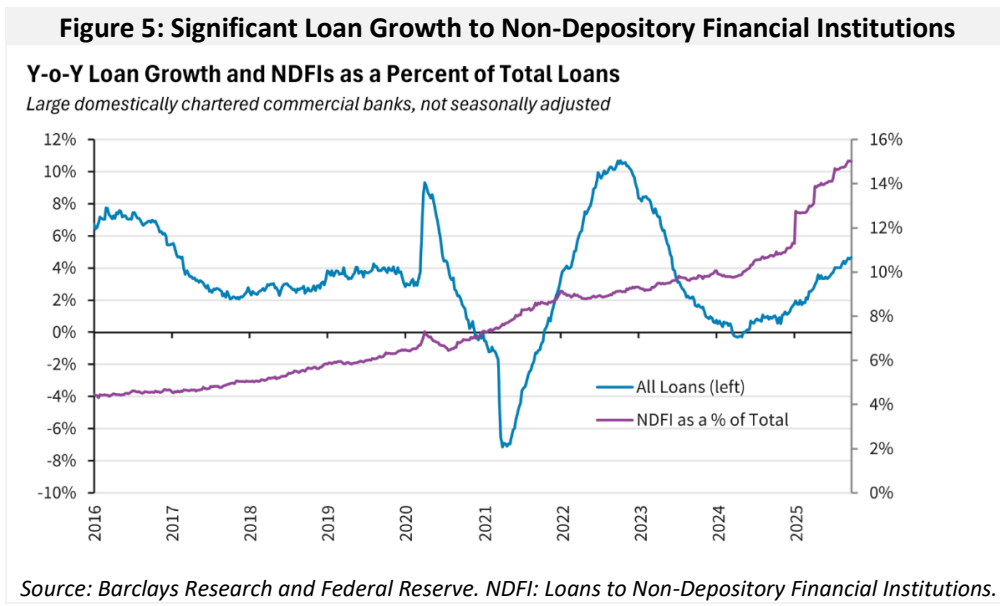
Bank fundamentals for credit investors have turned a corner – and are now going down a one-way dead-end street. This is a multi-faceted picture that I’ll attempt to summarize: 1) Banks spent 15 years since the GFC building capital and insulating their bonds from equity volatility with that capital. The best example is a bank’s common equity tier1 ratio. For 15 years banks have been increasing these ratios – by either shrinking their risk weighted asset footprint, or by retaining earnings (or both). Goldman Sachs was the first bank to report Q1 earnings last week, and its CET1 fell by the most since COVID (which was a unique scenario that management did not control). WFC and Citi also reported lower capital (CET1 ratios). **So begins the Great Releveraging. Today the banks are actively reducing CET1 because regulators are comfortable with it.** After 15 years of tightening the screws on bank regulatory requirements and limiting leverage, things have changed. With the finalization of Basel 3 Endgame, banks are in a position to work down capital ratios and lend much more aggressively. Another dynamic almost as important as all the others required to recreate the “new normal” - banks can’t be in a position to grow lending aggressively. During the “new normal”, banks were stuck deleveraging and cutting all forms of lending commitments. Now, if markets were going to generate only stable conditions for the banks this would be fine...but what if we are right about Taylor Rule estimates of the policy rate? Most banks in the US are trying to protect against the Fed lowering rates further. In banking parlance, they want to be less asset sensitive – this is a fancy way of saying that banks’ net interest income and net interest margin (NIM) will benefit far less than in 2022.

2) A simple and perhaps best example of trading the low vol world: Private

Credit - The great moderation/the “new normal” led to certain firmly held beliefs. If you can capture a yield asset, no matter the commensurate give up of liquidity, it’s worth it. The trade off always makes sense in a zero vol/disinflationary world. Those choices made from 2018-2022 are mistaken. The recent highly publicized outflows from private credit risk a significant forced deleveraging that drives down credit risk prices for an extended period. **I want my money back because I am getting paid the WRONG return in exchange for the terms you provided.** It doesn’t matter that some of the loans are fraud and some of the loans are bad. It just matters mostly that the market condition which created the investment decision paradigm no longer applies. Today you can buy a cash asset at 3.75% or an investment grade bond at 6% with daily liquidity. That makes your 2021 vintage private credit asset well and truly mispriced.

Banks are exposed – Banks were priced out of small and middle market lending for a few years. Direct lenders stepped in with better terms and better pricing (since they were free of regulation). As the banks lost good loans to these new competitors, they figured out how to make money (as they tend to do). **Why not finance the lender instead of the borrower?** And so, we have an explosion of NDFI (Non-depository Financial Institutions) assets on bank balance sheets. **Federal Reserve Data reflects NDFI loans rising 10 of the past 12 weeks and this past week rising over \$20bn to an all-time record.**⁽⁴⁾ **These loans account for ~15% of total loans on banks’ balance sheets, up from only ~5% five years ago** (figure 5)...clearly the urgency to stay in the game during the private credit explosion has played a major role. One specific example: Wells Fargo disclosed its NDFI exposure in its Q1 earnings release as over 20% of its total loan book at \$210bn. **And the banks are left being effectively the lender of last resort** – not where you want to be for the return they receive in exchange for this risk. And in the case of BDCs, most BDCs have a pool of liquid assets just like banks. However, instead of cash/near cash assets, the BDC liquidity pool tends to be dominated by broadly syndicated leveraged loans – (another vestige of the “new normal” where one assumes cash yields are going lower and therefore cash assets should not be considered). With the liquidity buffer being levered loans, BDCs have overlaid this with lending

commitments from the banks. The way the banks look at it, they are lending indirectly to their old constituency of small and mid-sized companies. Unfortunately for the banks, they have outsourced the underwriting to the BDCs.



Where does this leave us today....?

As we enter the second quarter, we maintain a net short position overall, mostly expressed in senior and subordinated spread securities. Our long positions are focused on areas where we find attractive relative value for a variety of reasons, or recent opportunities created by market volatility. Our short positions, in our view, lack these elements, but benefit from significant relative liquidity allowing us to change our net positioning quickly if desired. More specifically, we think the credit curve is still too flat (see figures 6 and 7 below), both on a spread and nominal yield basis. We favor intermediate longs relative to longer duration shorts. Secondly, **we favor longs in banks that will benefit from a higher rate environment (see figure 8) and factor this into our security selection along with valuation.** Lastly, for the first time in many months, recent price action in the Tier 1 market (see figure 9) provided us with an opportunity to both cover some shorts and add new longs at attractive spreads without sacrificing structure (figure 10). While this has been an opportunity, we remain extremely selective given our overall view on spreads and subordination spreads being too compressed, and structures still not appropriately appreciated. There is an abundance of securities that do not fit this profile and we have maintained shorts in these securities even with a recent price decline.

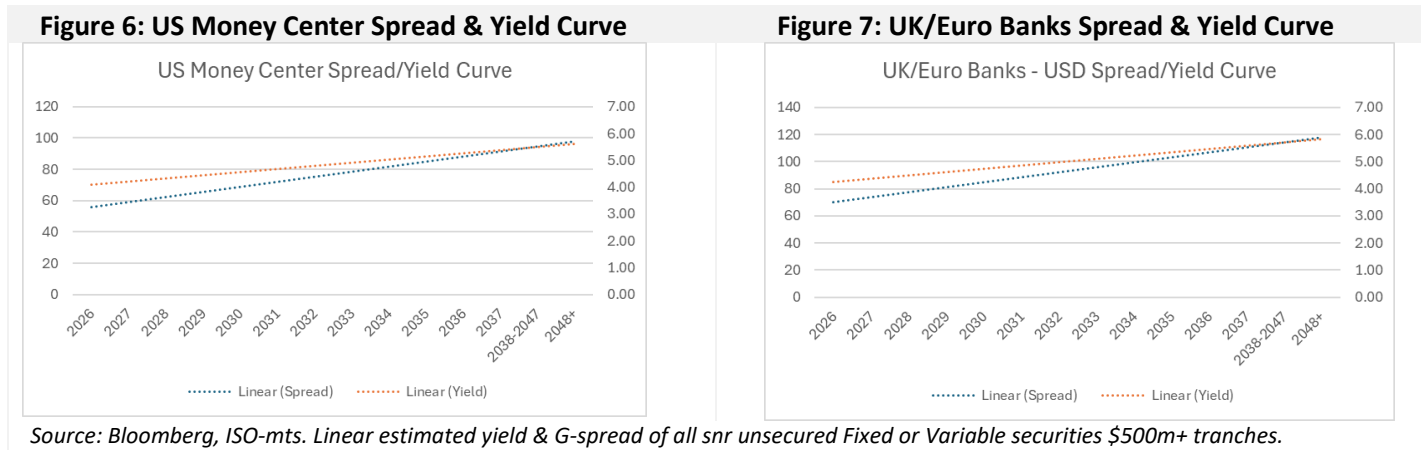
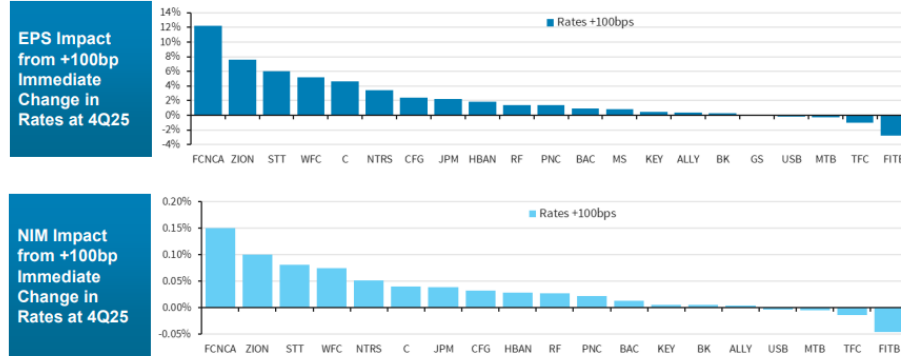


Figure 8: Interest Rate Sensitivity by Bank

Interest rate sensitivity – rate increase

Recent deposit pressures and hedging have reduced asset sensitivity.



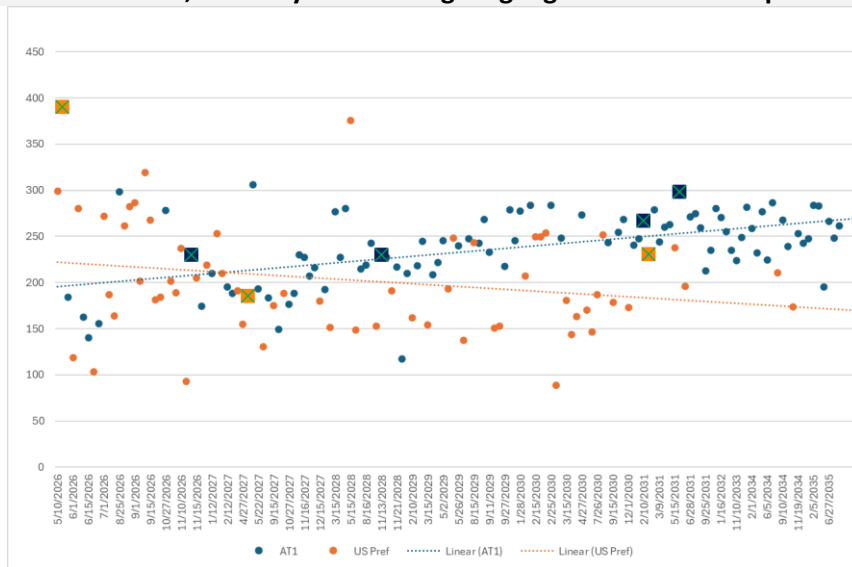
Source: Barclays.

Figure 9: Bloomberg Capital Securities Tier 1 Index



Source: Bloomberg Capital Securities Tier 1 USD Index.

Figure 10: All Bank T1 Securities – Current Spread to Worst (Call or Perp) vs. Call Date, Recently Added Longs Highlighted at Current Spread



Source: ISO-mts Capital and Bloomberg.

Notes:

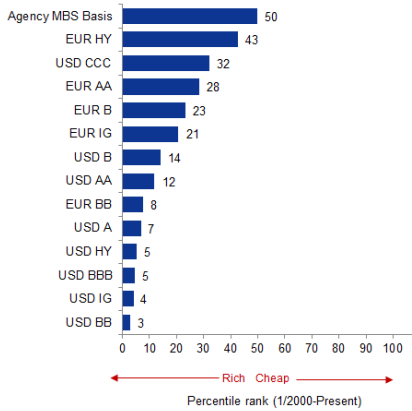
(1) Taylor Rule model calculation:

Taylor	Neutral	Inflation	Okun
Rule Est =	Real Rate +	Core PCE +	[Alpha * (Infl - Target)] + [Beta * Factor * (NAIRU - Unemp)]
4.90 =	0.75 +	2.97 +	[0.50 * (2.97 - 2.00)] + [0.50 * 2.00 * (5.00 - 4.30)]
Adjustment for Policy Inertia =	[Rho *	Prev FED Rate] +	[(1 - Rho) * Taylor Est.]
4.61 =	[0.25 *	3.75] +	[(1 - 0.25) * 4.90]

(2) Source: JPM, Total returns across asset classes JULI -2.1% for March 2026.

(3) Source: Goldman Sachs Research

Percentile ranks for spreads across markets (2000-current)



(4) Source: Barclays Research.

Important Disclosure:

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