CALLODINE | CAPITAL

Quarterly Market Commentary
Q4 2020

"Green Shoots for Value"

Market Commentary

To say that 2020 was a volatile year for markets and an unpleasant year for Value investors would be both obvious and an understatement. But humor us as we enumerate the point:

1. The year 2020 was the worst on record for Value versus Growth stocks, with the Russell 1000 Value Index underperforming the Russell 1000 Growth Index by 36 percentage points.
2. The S&P 500 experienced price movements of four standard deviations on 15 trading sessions in 2020. This means that an event with a 0.02% probability of occurring on any given day happened more than once a month, on average, during the year.
3. The volume of small retail purchases (less than 10 contracts) of call options on U.S. equities increased 8x this year compared to last year.

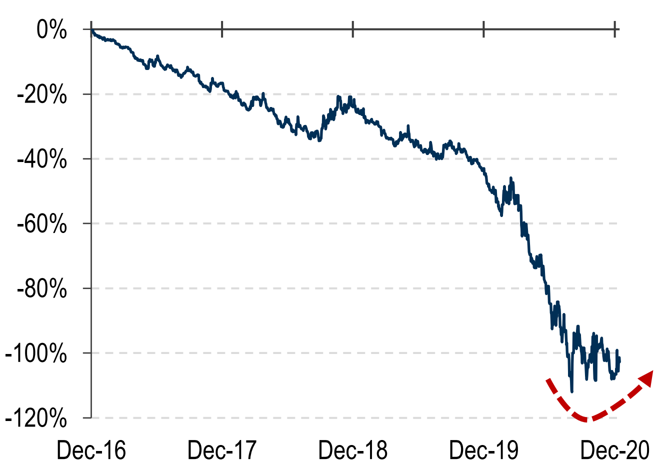
Along with most other Value investors still standing, we have written ad nauseum about the relative valuation disparity that has characterized the markets from April 2020 onward. We have protested astronomical valuations in technology stocks, and we have lamented the market's indifference to steady dividend payers with stable cash flow. However, as we head into 2021 we believe green shoots are finally emerging within the Value segment of the equity market.

Signs of Life

In a reversal from the dominant trend for 2020, Value stocks outperformed Growth stocks (just barely) in the fourth quarter. This represented the first quarter since Q4 2018 in which Value generated a positive return relative to Growth, and it was just the second time this has occurred in the last ***sixteen quarters***.

While the chart below might look underwhelming in terms of the magnitude of recovery, we believe the key development is that the dominance of Growth was halted. This was no mean feat, given the momentum behind that strategy since the bounce off the March lows. In our last quarterly letter, "The Nifty Five," we cited several tailwinds behind Growth's steep ascent, namely massive capital flows, increased options activity, and price momentum itself. As price momentum begins to stall, it is reasonable to assume that the other two variables might also begin to moderate. Investors are less likely to continue allocating capital to technology ETFs or buying call options on high-flying Growth stocks if the returns decline or turn negative for those particular strategies.

Exhibit 1
Russell 1000 Growth - Russell 1000 Value



Sources: Bloomberg, Callodine Capital Research Team
Methodology: Cumulative Total Return Differential from Dec 31, 2016 through Jan 13, 2021 daily.

Does the Value Rally Have Legs?

The Macro: Rates, Inflation, and the U.S. Dollar

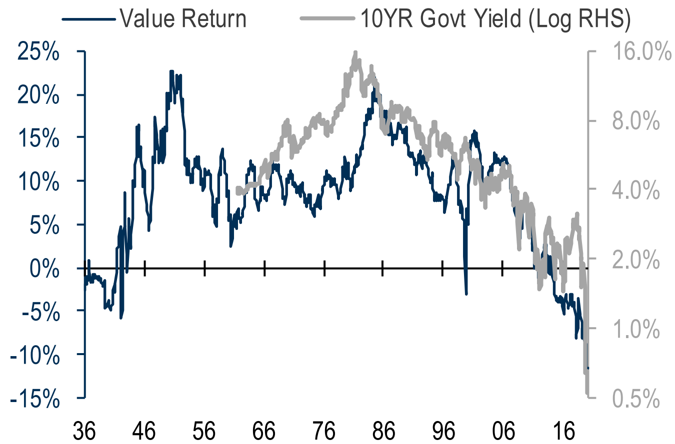
In our Q4 2020 white paper, "The Case for Value: A Roadmap for Regime Change," we articulated several macroeconomic variables that could be a catalyst for Value to reemerge as the dominant investment style after taking a backseat to Growth for most of the last 13-plus years. Over the course of Q4 2020, we saw each of these macro factors trend in favor of Value.

1. Increase in Rates

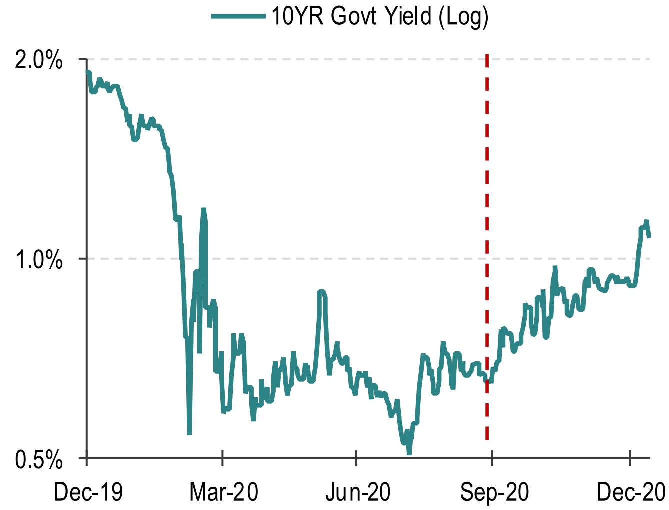
Low interest rates have been the justification for heady Growth valuations for the majority of the last decade. With yields plummeting from an already-low starting point in Q1 2020, the low-rate narrative supporting Growth became even more firmly entrenched. During the fourth quarter of 2020, however, we saw a steady rise in yields. While rates are still at historically low levels, an increase would bolster the case for continued outperformance of Value.

Exhibit 2
Rising Yields Should Provide Tailwind to Value

Panel A:
Value Performance is Tied to 10 Yield US Govt Yield
10 Year Rolling Annualized Return



Panel B:
Yields Have Started to Rise off Historic Lows



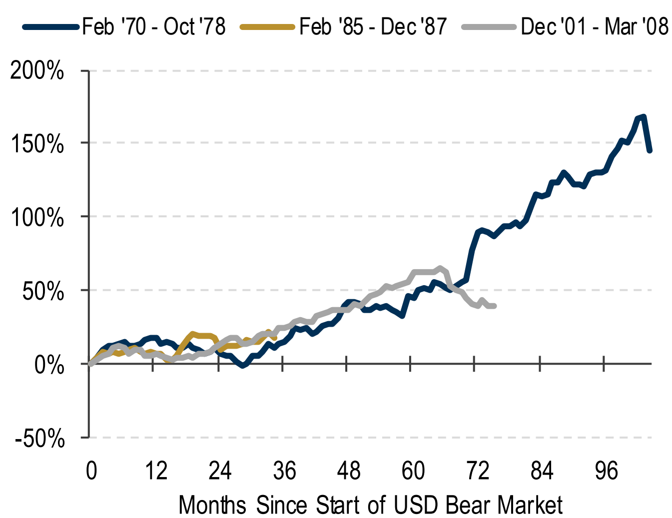
Sources: Kenneth R. French, Bloomberg, Callodine Capital Research Team
Methodology: Panel A - Value Return = rolling 10 year difference of return to high value stocks less low value stocks using Fama-French HML Methodology, annualized. Calculated on a month end basis from Jun 1936 through Nov 2020. Panel B - Calculated on daily basis from Dec 31, 2019 through Jan 13, 2021.

2. Weakness in the U.S. Dollar

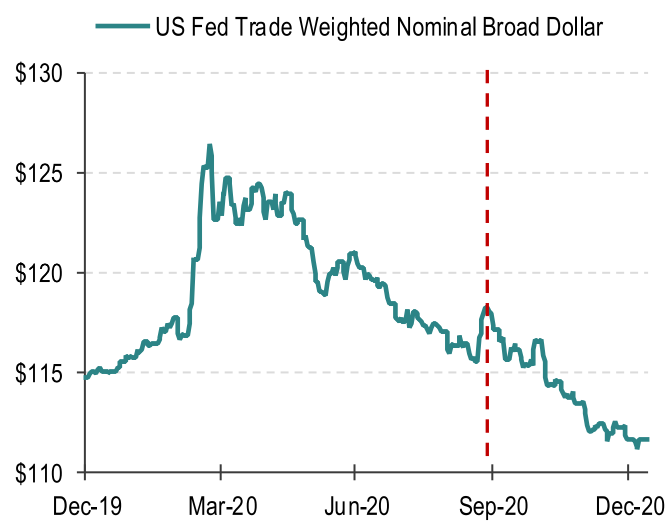
Even if U.S. interest rates increase, we may continue to see weakness in the U.S. dollar, due to soaring budget deficits. The U.S. federal budget deficit is projected to reach a record $3.3 trillion in 2020, largely as a result of government spending in reaction to the COVID-19 pandemic. With a "blue wave" government now coming into office, we would not expect fiscal frugality to be at the forefront of the policy agenda and therefore potentially could see prolonged budget deficits and a weaker currency as a result.

Exhibit 3
Weaker Dollar Should Provide Tailwind to Value

Panel A:
Value Returns are High During USD Bear Markets



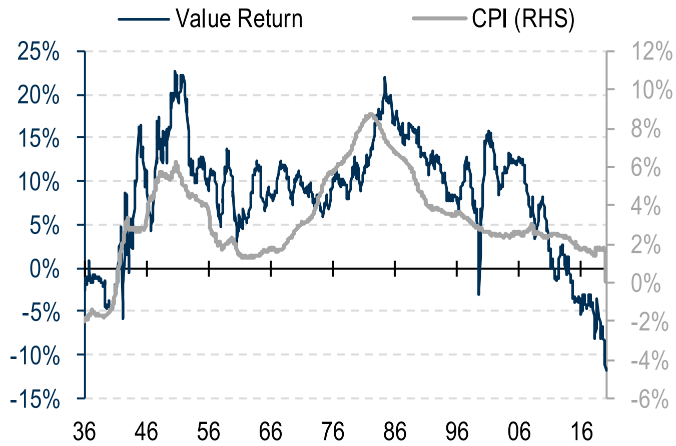
Panel B:
USD Has Been Weakening



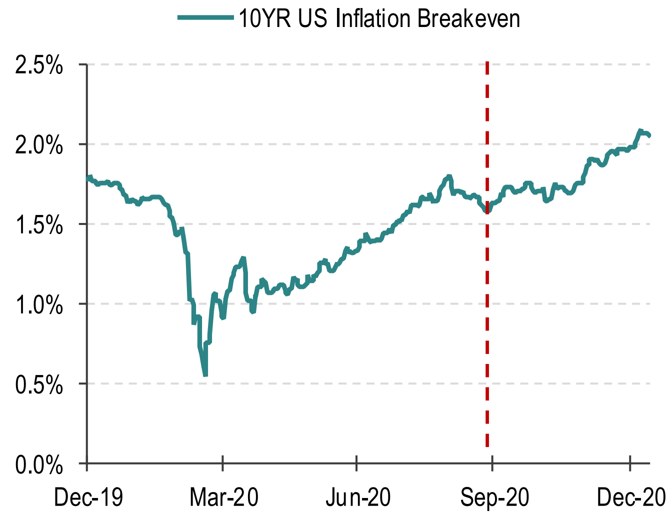
Sources: Kenneth R. French, Bloomberg, Callodine Capital Research Team
Methodology: Panel A - Value Return = rolling 10 year difference of return to high value stocks less low value stocks using Fama-French HML Methodology, annualized. Calculated on a month end basis. Panel B - Calculated on daily basis from Dec 31, 2019 through Jan 13, 2021.

Exhibit 4
Higher Inflation Should Provide Tailwind to Value

Panel A:
Value Performance is Tied to Inflation
10 Year Rolling Annualized Return



Panel B:
Inflation Breakeven Are Rising



Sources: Kenneth R. French, Bloomberg, Callodine Capital Research Team
Methodology: Panel A - Value Return = rolling 10 year difference of return to high value stocks less low value stocks using Fama-French HML Methodology, annualized. Calculated on a month end basis from Jun 1936 through Nov 2020. Panel B - Calculated on daily basis from Dec 31, 2019 through Jan 13, 2021.

3. A Surge in Inflation

We think there is a key distinction between the roughly $4 trillion in current and expected stimulus ($2 trillion from the Trump administration plus another $1.9 trillion recently proposed by President Biden) and the $700 billion that was put forth to save the economy during the Great Financial Crisis—not just the sheer magnitude of the stimulus, but also the velocity of that cash injection. Whereas much of the $700 billion in economic relief went into the banking system in 2008, much of the 2020 stimulus has gone directly to consumers, resulting in all-time highs in personal income and a surge in personal savings rates. American households have $1 trillion more in checking accounts today than they did a year ago. For perspective, this increase is on top of a base of $800 billion in checking accounts a year ago, representing a 125% increase in cash on hand essentially. We believe this represents a very different initial condition for an economy in recovery versus anything investors have witnessed in a very long time, and one that is highly likely to cause inflation to ultimately surprise on the upside as those dollars find their way into the real economy.10-year US Inflation breakeven rates are near 7-year highs as a result, and yet both Monetary and Fiscal policy remain at accommodating extremes. This creates a potent recipe for inflation as the velocity of capital increases against a backdrop of enormous liquidity.

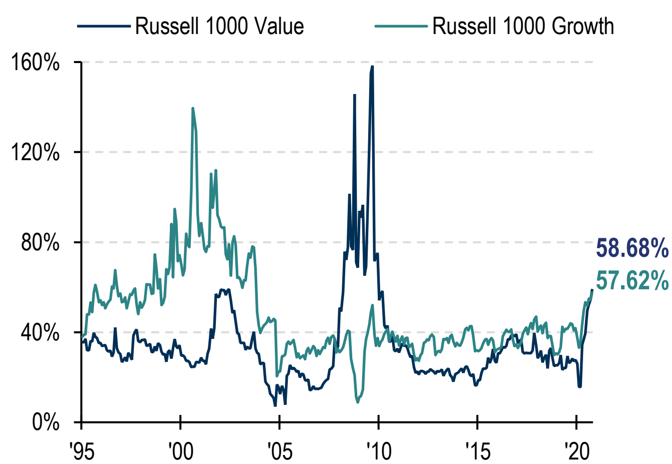
The Micro: Relative Growth from Value

Historically speaking, Value stocks have led the recovery after large contractions in economic activity. However, most market participants would agree that the recovery phase following the -31.4% Q2 2020 decline in U.S. GDP has been anything but normal.

We are currently entering a phase where we expect that Value will have an advantage over Growth in terms of relative earnings performance. Companies such as Netflix, Zoom, and Adobe have flourished during 2020, because the pandemic accelerated the need for their products and services. We would argue that much of those companies' capacity for earnings growth has not been significantly expanded because of the pandemic, but rather it has been pulled forward into the current period. This will make

Exhibit 5
Value Est. to Grow EPS Faster than Growth

Russell 1000 Style 24 Month EPS Growth Est.



Sources: Bloomberg, Callodine Capital Research Team
Methodology: Blended Forward FY3 & FY2 vs Trailing 12M EPS. Calculated on Monthly Bases from Mar 1995 through Dec 2020.

year-over-year earnings comparisons incredibly onerous, as the bar has been set so high. By comparison, Value stocks are coming off trough earnings.

As shown in the exhibit on the previous page, the constituents of the Russell 1000 Value Index are now expected to grow earnings per share (EPS) faster than their counterparts in the Russell 1000 Growth Index. So, not only are these stocks cheaper, but they are also potentially positioned for a period of stronger relative growth. Because many of these companies have cut back significantly on capital expenditures and overhead to survive the pandemic, we anticipate that many will emerge from the recent crisis in much better shape than when they entered it.

At this writing, we are witnessing a continuation of the market trends that we began to see in Q4 2020. And while it is hard to be an "optimistic Value Investor" by nature, we believe we believe we have finally reached an inflection point in style dominance, and what could be the beginning of a years-long secular bull rally for Value.

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