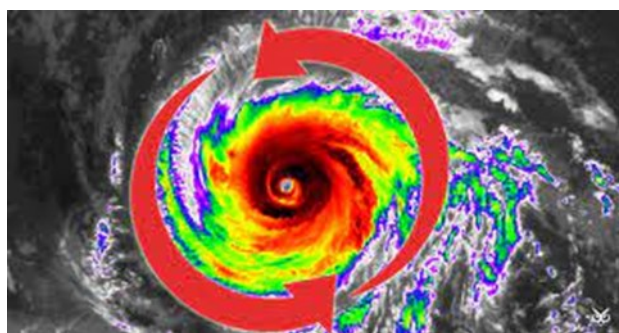


CALLODINE | CAPITAL

Quarterly Market Commentary Q1 2022

“The Great Rotation Begins”

Market Commentary



It's finally happening. After more than a decade of outperformance for long-duration assets like Growth stocks and the long bond, the tenor of the market has suddenly shifted in a decidedly different direction. We believe this is the start of a "Great Rotation" within asset allocation markets—one in which inflation protection, current cash-flow generation, and valuations will supersede the lofty growth targets and money-losing business models that have been market darlings for the past decade. The return of positive real rates and the repricing of risk into asset values will happen one way or another, and it will take markets both time and a seismic reallocation of capital to adjust to this new paradigm.

We admit our bias toward this view, as it is certainly a welcome development for Value/Income investors like Callodine who have decried the market's euphoric and sometimes illogical response to the now two-plus-year global pandemic and stimulus response.

We have been anticipating this moment for some time, highlighting that liquidity was propelling parts of the market to higher highs and extreme valuations. When we published our last quarterly letter, "[The Coyote Is Off the Cliff](#)," several investors asked if we were calling for a bear market outright. This was not necessarily the case, but the title of the letter was intended to address the high-flying Growth stocks that had ascended to exorbitant levels during the pandemic and suggest that the potential for change was finally upon us.

Now that the tide of Federal Reserve liquidity is beginning to abate, we are witnessing a recalibration of sorts. Companies and sectors that have largely been ignored for years, are now being analyzed and valued according to their underlying fundamentals and profitability, rather than pie-in-the sky Total Addressable Markets (or "TAMs") and stock price momentum. In Warren Buffet-speak, the tide is now heading out, and it's time to see who is wearing swim trunks.

What began in late Q4 2021 and has continued straight through the writing of this letter is nothing short of a systematic reordering of stock and bond preferences. Now that it has begun, we believe it will result in multiyear, significant rotation from Growth to Value and from long- to short-duration assets.

As we highlighted in Exhibit 1 of our white paper, [The Case for Value](#), these cycles typically take many years to play out. In fact, if you look at the last secular rotation where Value outperformed Growth following the bursting of the tech bubble, you will see that Value stocks generated +119% of excess return versus Growth stocks over a seven-year stretch. Compare that with the recent four-month 13% run that Value has had over Growth to start this year, and we believe we are only in the very early innings of what could potentially be a dramatic years-long reversal.¹

Value vs Growth Return Cycles

Russell 1000 Value - Russell 1000 Growth Total Return

Nov 1980 through Mar 2022 (Monthly)

Start	End	Return	Length	Theme
Nov-80	Aug-86	31%	69	Corporate Activism and Capital Markets Innovation
Aug-88	Dec-91	-60%	40	Proliferation of the PC
Dec-91	Dec-97	39%	72	Gulf War, NAFTA
Dec-97	Feb-00	-73%	25	Internet Adoption and Dot.com craze
Jun-00	May-07	119%	83	"Peak Oil", Repeal of Glass-Steagall
May-07	Dec-15	-53%	103	Online Consumption, Social Media
Dec-16	Nov-21	-143%	59	Artificial Intelligence, Mobility / Work from Home
Nov-21	Mar-22	13%	4	High Inflation and Fed Tightening

Sources: Bloomberg, Callodine Capital Research Team. Length of Cycle in months. Includes periods of style outperformance that lasted a minimum of 12 months, with the exception of the current period.

Methodology: Return column is calculated as difference in cumulative total return of Russell 1000 Value - cumulative total return of Russell 1000 Growth over time frame.

Some Big Questions Answered

What finally triggered this shift? We believe it has been the answering of several big-picture questions the market has grappled with since the onset of the pandemic.

Following the overwhelming government response to the initial impact of COVID-19 and the removal of the deep recessionary risk the pandemic potentially posed, investors have had to wrestle with a series of questions about the broader economy to inform their view of the equity markets.

1. **Will consumers recover?** In hindsight, this question now seems quaint, as the answer has been a resounding “yes,” but this was unclear after a deep decline due to various COVID-related restrictions. Thanks largely to stimulus and the resulting demand cycle, consumer spending has now eclipsed the 4% pre-COVID trendline growth rate and is currently well above that pace. This situation has led to tight labor markets, a supply chain that is ill-prepared to handle the surge in demand and, ultimately, to higher prices. Cause and effect.

Stimulus → Excess Demand → Labor/Supply Chain Can't Scale → Demand Rationing → Higher Prices

¹ Note: Relative performance as measured by the cumulative total return of the Russell 1000 Value Index less the cumulative total return of the Russell 1000 Growth Index.

2. **Will inflation be transitory?** Just three to six months ago, prevailing wisdom was that higher prices would subside quickly, as evidenced by a 10-year Treasury yield below 1.40% as recently as December 2021. This has proven to be wishful thinking—a risky assumption we highlighted in our Q2 2021 quarterly letter, [“It’s Not a Lie if You Believe It.”](#) Instead, inflation has continued to accelerate against higher comparisons. The median global Consumer Price Index sits at a 30-year high of 5.7%, and the annual Personal Consumption Expenditure deflator in the United States is at a 40-year high of 6.4%.² The Ukrainian-Russian conflict has further stressed commodity markets, and labor market tightness is increasingly viewed as structural, rather than temporary. There are no easy fixes for labor or commodity shortages, and demand exceeds supply—therefore prices need to ration demand. A true lesson in “be careful what you wish for”.

3. **Will interest rates ever increase?** After ignoring the growing and omnipresent signs of inflation, the bond market simply waited for the Fed to tell it what was going to happen, and even then it didn’t believe the Fed right away (as we used Ron Burgundy to illustrate in our last [quarterly letter](#)). But finally, we have received a definitive answer to this question: **Yes**. Nearly 14 years after the start of truly extraordinary monetary policy to stave off the Global Financial Crisis, the Fed has finally succeeded in creating inflation, with an assist from turbo-charged fiscal policy. It turns out that shock and awe stimulus is quite popular, but that runaway inflation is not. So, the risk of persistently high inflation has now forced policymakers to adopt a more hawkish posture, resulting in a sharp rise in rates across the yield curve and particularly at the front end of the curve. As with inflation, we do not think this will be short-lived.

Crossing the Rubicon to “Normalization” and the Path Ahead

We have often written about how starting points matter to investment cycles, because they dictate both the pace and size of adjustments to prevailing conditions as events begin to unfold. In the current market, the starting point remains extreme, in our view, and it will take significant time to reorder itself. In the chart below, you can see the disparity in valuations between the most expensive and least expensive stocks in the S&P 500. While relative valuation spreads have dropped from recent highs, they remain near all-time highs.

S&P 500 Quintile 5 P/E - Quintile 1 P/E

Quintile 5 P/E - Quintile 1 P/E



Quintile 5 - Quintile 1 Market Cap Weight



Sources: Bloomberg, Callodine Capital Research Team

Methodology: Average NTM P/E of S&P 500 companies quintiled on NTM P/E multiple, excluding securities with forward consensus P/E ratios below 3x or exceeding 40x. Calculated on a month end basis from Jan 1990 through Mar 2022.

² Source: Bank of America Research report, “Pricing in bad news,” April 7, 2022.

This value dispersion has occurred not just on an absolute basis for expensive stocks versus cheap stocks, but also based on the style neighborhood that a stock occupies. For much of the last two decades, the Russell 1000 Growth Index and the Dow Jones Select Dividend Index traded very closely to one another in terms of forward price/earnings multiples, and they enjoyed very similar returns as well. (In fact, from the start of 2003 to the end of 2016, the Dow Jones Dividend Index slightly outperformed the Russell 1000 Growth – 9.7% annualized vs 9.4% across that 14-year run.)³

Something peculiar started in early 2019, even before the pandemic—a march toward negative real rates and a steep increase in the forward multiple of the Russell 1000 Growth, as seen the chart to the right.

Correlation Breakdown

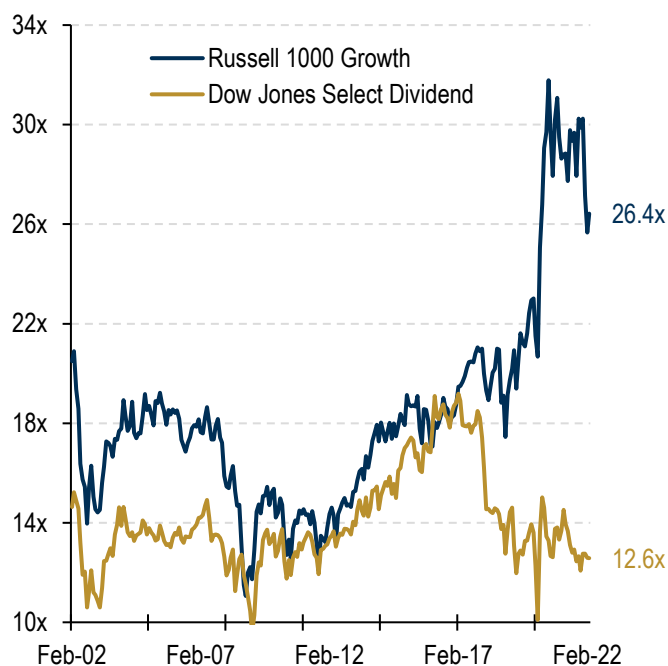
By historical context, negative real rates are both rare and unsustainable, but they sure can make investing fun! With low inflation and even lower interest rates, every great secular growth story told could seemingly command an enormous multiple. The historical tendency for investors to actually prefer dividend-paying stocks as a source of income replacement when real rates get very low broke down completely.

Instead, investors exhibited the strongest preference ever seen in the data for the Russell 1000 Growth Index versus the Dow Dividend Index, as shown in the graph to the left. In our minds, this was the single most anomalous pandemic-induced phenomenon witnessed in the stock market. As negative real rates have started their return to more normal levels, the prior willingness to pay just about any multiple for growth has unwound. It will take time for this journey to be complete, and it will be painful for investors caught on the wrong side of the trade.

Unfortunately, the pain won't be borne only by Growth investors, but by passive investors as well. This is because “Rip Van Winkle”-type investors who fell asleep and haven't reallocated portfolios recently or have just stayed passively invested in the S&P 500 Index have seen much of their capital dragged predominantly into large-cap Growth names. In fact, the center of mass for equity markets has been dramatically pulled into Growth sectors and strategies over time. This capital reallocation is the fuel for the Great Rotation, and the process hasn't even

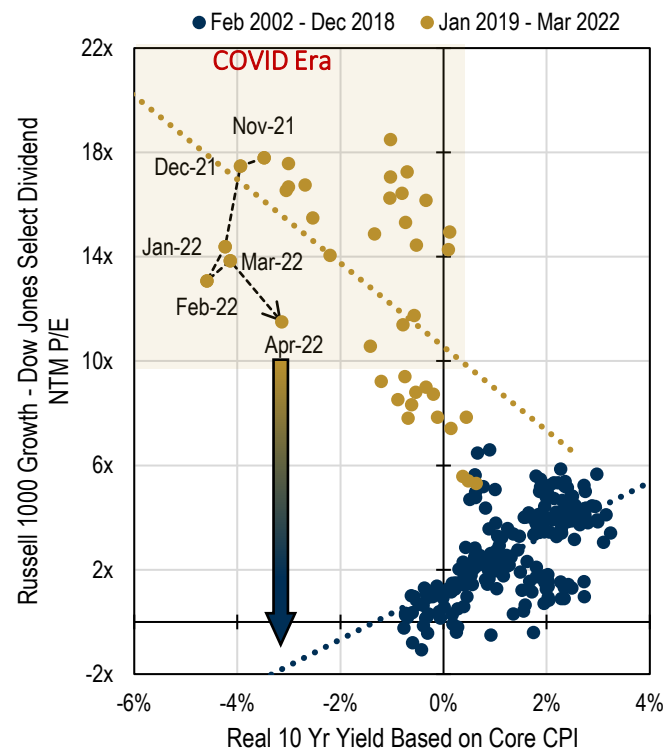
Growth vs Dividend Index Forward P/E Multiple

Monthly Data from Feb 2002 through March 2022



Sources: Bloomberg, Callodine Capital Research Team

Real Yields vs Growth Premium to Dividend Stocks



Sources: Bloomberg, Callodine Capital Research Team
Methodology: Fwd P/E of Russell 1000 Growth - Dow Jones Select Dividend Index

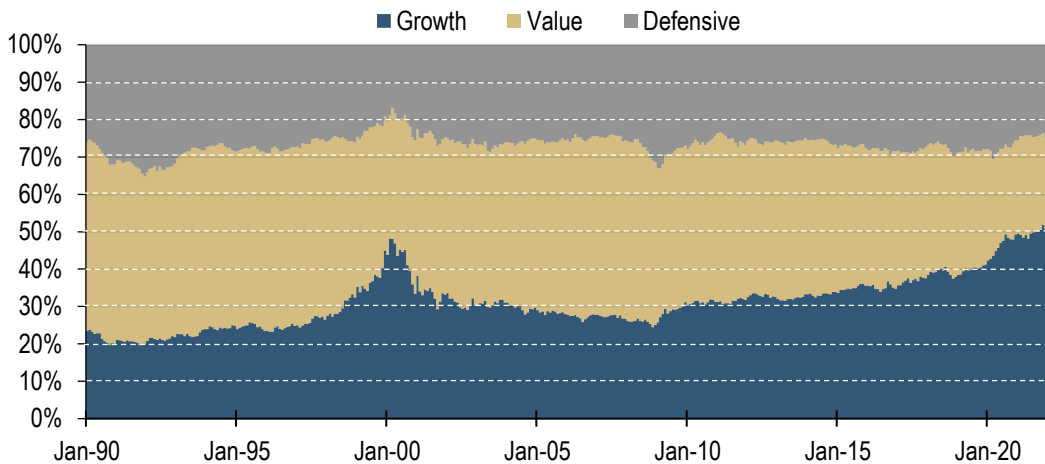
³ Source: Bloomberg, Callodine Capital Research Team

begun in earnest, in our view. Looking at the chart below, we can see that, for much of the 1990s and 2000s, traditional Value sectors represented nearly 50% of the S&P 500's market cap.

Today, those sectors represent just over 25% of the Index's market cap, implying significant room for expansion.

Market Cap in S&P 500 by Sector Group

Monthly Data Jan 1990 through Mar 2022



Sources: Bloomberg, Callodine Capital Research Team
 Methodology: Sum of Free-Float Market Cap of Sectors in Group / Sum of Free-Float Market Cap of All Sectors. Value Sectors contain Energy, Material, Industrials, Financials, Telecommunication Services. Growth Sectors contain Consumer Discretionary, Information Technology, Diversified Telecommunication Services. Defensive Sectors contain Consumer Staples, Health Care, Utilities, Real Estate

The Great Rotation

We're currently seeing the start of this rotation between traditional Growth sectors and traditional Value sectors such as energy, real estate, and utilities. This rotation is driven by the underlying fundamentals of these sectors, and we believe they will continue to be supported by enormous capital flows shifting from one end of the equity market spectrum to the other.

Today, labor is extraordinarily tight, and a large cohort of Baby Boomers has yet to retire. Commodities have been underinvested in for a variety of reasons, while global demand has moved steadily higher. In addition, supply chains built on a benign geopolitical environment and "just-in-time" flow of goods are newly challenged. Under these conditions, many businesses will need to recalibrate, a process that can take an agonizingly long time to play out. Investors will follow suit, but they often act far more quickly than business models do.

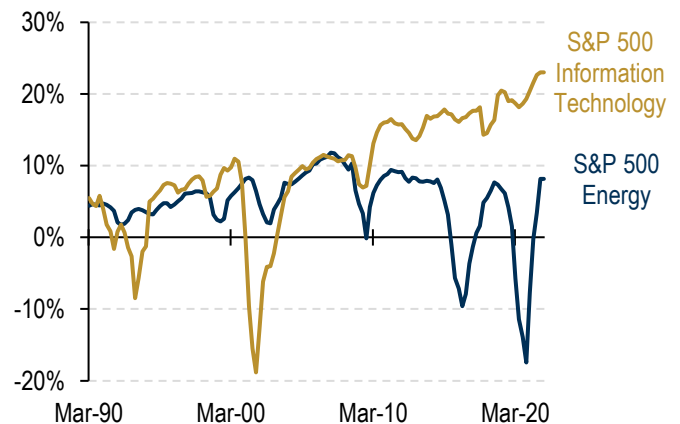
Business models built upon the reliance of these factors will be tested, particularly "capital-light" models, which equity markets have coveted of late. They may suddenly find that labor, as their only cost input, is no longer cheap and plentiful, and it is suddenly a constraint to growth and a source of margin pressure.

At the same time, sectors that have faced severe headwinds from the prior conditions will begin to seem less secularly challenged. While higher rates and higher commodity prices are a problem for most business models, they are the lifeblood of profits for the energy, materials, and financials sectors.

The graph below highlights that, prior to the Great Financial Crisis, the energy and technology sectors earned comparable margins, with Technology the more cyclical of the two. Since then, the divergence has been dramatic, leading to "secular" views on the permanent attractiveness of investment into one sector relative to the other. Prior to this divergence, energy had been overinvested in for a decade, a trend that has now reversed course. At the same time, the technology sector has seen massive investment the last decade and has become increasingly organized around substantial and likely monopolistic profit pools in hardware, software, online advertising, and e-commerce.

Trailing 12 Month Profit Margin - Energy vs Tech

Quarterly Data Mar 1990 through Mar 2022



Sources: Bloomberg, Callodine Capital Research Team

New cycles have a way of undoing the victories of the past and re-energizing the vanquished—this is how business cycles work, and these are the long waves of creative destruction described by Joseph Schumpeter nearly a century ago in his *Capitalism, Socialism and Democracy*. Both profit pools and market capitalizations can, in fact, move from one sector to another over time. This is how cycles always play out, but it's been so long since anyone has seen this occur that it's hard to even fathom the implications.

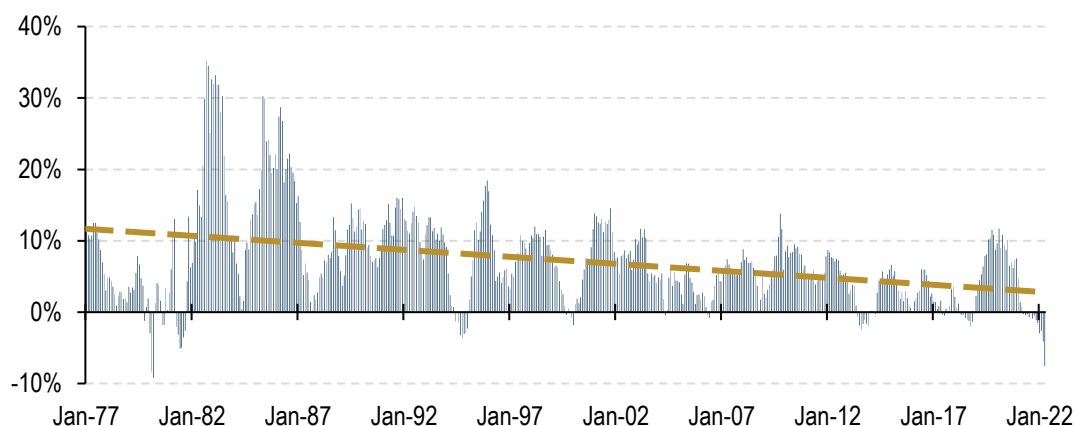
The Death of the 60/40 Portfolio

If the equity markets face a dramatic recalibration 10 to 15 years in the making, then pity the poor bond market and the mixed-asset allocators. Here is where the real long-wave action resides—forty years in the making, and we'd imagine an even more painful readjustment.

The prior 40 years have been characterized by average bond market returns of +7% annually. Over the last 20 years, this has dipped to +5%, but almost never did you lose any money in bonds, not even temporarily. Prior to 2022, you had lost more than -2% by holding the Barclays Aggregate Bond Index during the previous 12 months in just 10 of the 1,300 weekly readings over the last 25 years. This is equivalent to “never” in markets.

Barclays Aggregate Bond Index - 12 Month Return

Monthly Jan 1977 - Apr 2022



Sources: Bloomberg (LBUSTRUU Index), Callodine Capital Research Team

By that same measure, it has happened 15 times over the last 16 weekly readings this year—now that is a paradigm shift, like water turning to ice, as we described in our last quarterly letter.⁴

While market participants watch this figure daily, most investors check in far less frequently, so we believe the reaction to this new paradigm may take a while before asset allocations start to reflect it. This is how long cycles start—when investors find themselves overallocated to the winners of the previous regime, and it's where we currently sit. Simply put, bonds no longer provide the likelihood of positive returns anywhere close to historical ones and, in our view, no longer provide a true offset to equity risk either.

⁴ Source: Bloomberg. Bond market returns refer to the Barclays Aggregate Bond Index monthly return for the period January 1977 to April 26, 2022.

We're Just Getting Started

While it can get lost in a market myopically focused on the here and now, our view is that getting these inflection points right, even generally speaking from a timing perspective, is the key to making money over time and avoiding crowded consensus views that the status quo will remain unchallenged.

Given our view that there is no logical path back to the old regime of low inflation and negative real rates, we believe the equity market debate currently being grappled with is positioning for the following unappetizing fork in the road:

1. **Stagflation:** Positioning for high nominal growth, but potentially low or negative real growth, due to high inflation coupled with margin and valuation compression. Paired with geopolitical instability and elevated energy costs, we sit at a very precarious point in time.
2. **Recession:** Getting defensive as the Fed will not be able to gently guide the economy and inflation back to trend without tipping into a recession.⁵

These outcomes are mutually exclusive in many ways, with strengths and weaknesses in one scenario suggesting the other is more or less likely and making it all the more difficult for traditional trend followers. The only real certainty is that either of these circumstances will require significant repositioning, with the last cycle's winners offering a consistent source of funds.

We see no quick or obvious path back to the old regime of low nominal growth, continual margin expansion, and ever-declining interest rates. That environment was characterized by abundant cheap liquidity, plentiful low-cost labor, low and declining commodity prices, and a free-flowing supply chain. It intensely favored certain sectors in investors' minds, and "secular growth" stories trumped all else against a backdrop of low growth.

This paradigm describes most of the last 10 to 12 years, an investment cycle so lengthy that all of these factors became the secular bedrock upon which equity valuations were built—and so lengthy that many market participants have experienced and can conceive of nothing else. Moving forward, we don't believe any of these conditions will be the "norm" for quite some time. Instead, we believe we find ourselves at the end of that long cycle, and the start of a Great Rotation.

⁵ Heretofore known as landing the Triple Lindy - <https://www.youtube.com/watch?v=rDMMYT3vkTk>

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