CALLODINE | CAPITAL

Quarterly Market Commentary
Q2 2022

“The Circle of Life”

Market Commentary

Sooner or later, nature takes its course. The seasons change, the tides rise and fall, and markets have cycles.

Investing in cycles is perhaps a lost art these days after nearly 15 years of tremendous liquidity and outright market manipulation by central banks around the world. It's been decades since we've seen a market sell-off as deeply and abruptly as it did during the first six months of 2022. As is often the case, there was no warning bell—sentiment merely shifted from euphoric to dour in a matter of a few trading sessions, and investors were either prepared for it or they were not.

What happens next becomes the critical question for investors. Unfortunately for many, this is, in fact, their first rodeo. Let's assume you had to be at least 25 years old to be a "professional" investor—here is how old you would have to be today to have invested through the following events and lived to tell about it:

Event	Year	Age to Have Witnessed
Start of Last Full Recession	2008	39
Start of Last Sustained Value Cycle	2000	47
Start of Last Non-Deflationary Recession	1991	56
Start of Last Sustained Inflationary Cycle	1969	78

I would guess that most firms have very few investors between the ages of 56 and 78, and this cohort certainly makes up a very small percentage of the current crop of "professional" investors. Without that experience to rely upon, a lot of pundits and market neophytes simply try to map this market to the last recession or to the averages of prior cycles (e.g., In recessions, earnings tend to do X, and sectors A, B, and C work best, so therefore do Y, according to our recession playbook). Trend followers dutifully follow suit and chart a course forward based on the assumption that history will repeat itself.

The primary problem with this approach is that the initial conditions we are seeing now are almost nothing like any of those prior cycles. So, while the knee-jerk reaction we are witnessing in the markets is predictable, it is highly unlikely to prove correct, in our estimation.

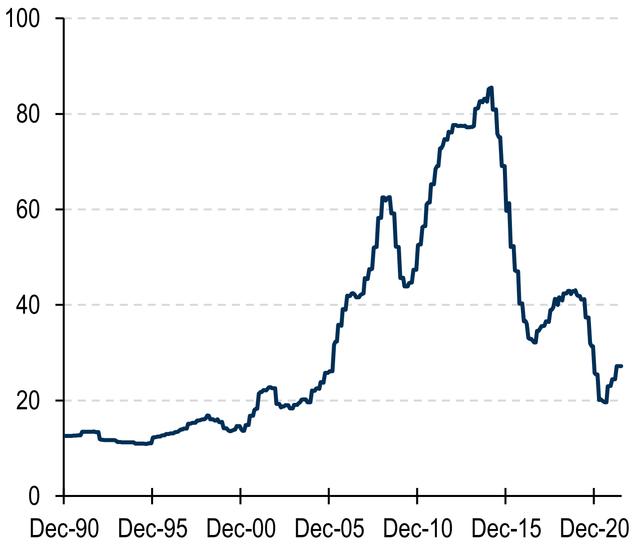
Our base case view is a period of sustained higher inflation and a non-deflationary contraction in economic activity, as all-time-record stimulus effects wear off. Call it a growth recession, a mid-cycle correction, or the end of worlds—but in any of these scenarios, we believe the return on thoughtful investing and fundamental analysis will be very high.

When a regime change happens, markets tend to resist it for a while, hoping to return to what worked in the past—in this case, and for the previous 15 years, that meant buying growth and "good" companies, and ignoring valuations, which were largely irrelevant. This mantra has engrained itself in the minds of many investors as the "right" way to invest. It is secular and sustainable—until it's not.

That approach is precisely what led to the extensive build-up in excess valuations we have recently witnessed, namely the incredible amount of investment that has gone into in all things venture/growth related. These investments demand and devour capital. We believe a classic cyclical framework is in order here, and we strongly prefer sectors of the market where overinvestment didn't occur. Below are examples of how the recent investment landscape looks within the energy sector and venture capital market.

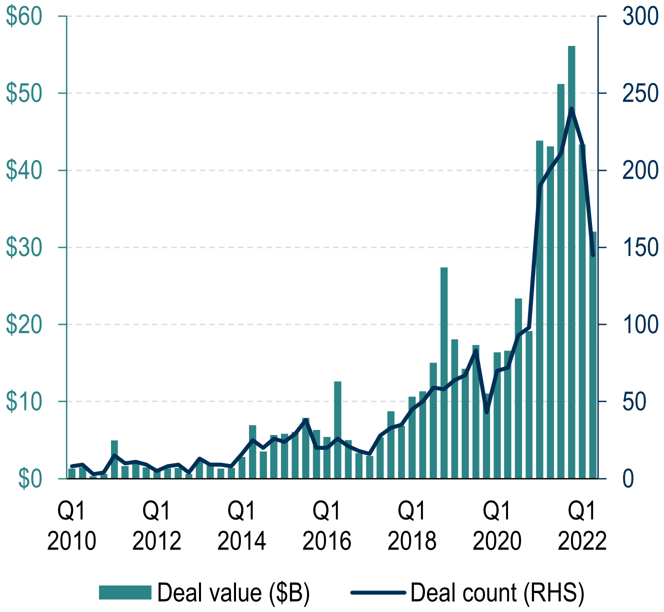
Energy Capital Expenditure

S&P 500 Energy Index Rolling 12 Month



Sources: Bloomberg (Dec. 31, 1990 - June 30, 2022), Callodine Capital Research Team.

Venture Capital Mega-Deal ($100M+) Activity



Sources: PitchBook (Jan. 01, 2010 - June 30, 2022), Callodine Capital Research Team.

We cannot be sure if too much or too little capital went into either sector, but we would note that these two cycles look nothing like one another. Within the energy sector, capital investment has already been in decline for eight years, with a significant further drop occurring over the last two years. We believe these decisions will reverberate in energy markets for the next decade, not just the next quarter or two. Not so in "venture land," where an ever-increasing amount of capital has been deployed confidently into what investors surely believed to be projects with tantalizingly high return potential.

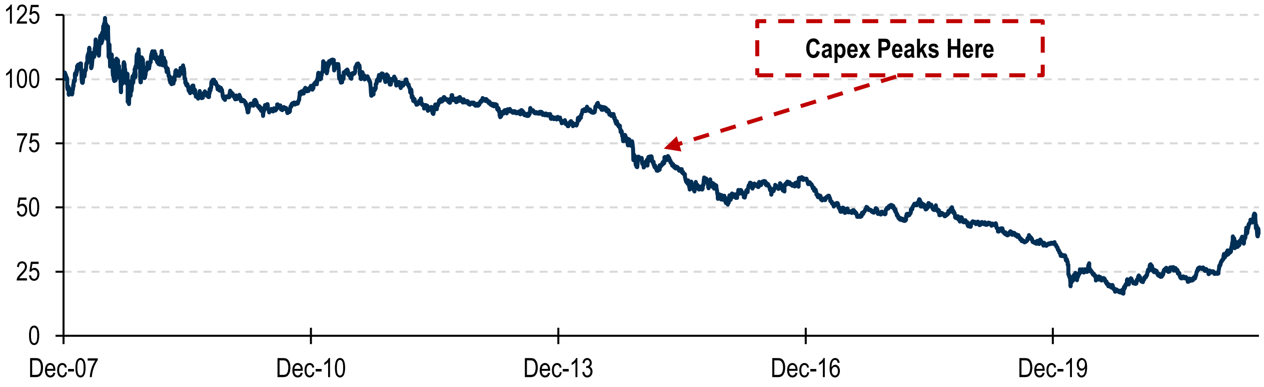
Venture capital has had more mega deal ($100M+) activity in the past two and a half years than in the prior ten years combined, however, such deployment of capital may not result in stellar returns.[1] In fact, venture investors should ask energy investors about running that very same playbook from 2005-2015 (see graph on next page for subsequent underperformance post peak investment) and inquire about how it turned out for them. These issues can take a long time to sort themselves out, well past the myopic horizon of most investors, so we believe one should be careful about "buying the dip." Unfortunately, this is just how cycles work.

The silver lining to all of this is that we believe there will be significant value that accrues to critical thinking for the foreseeable future. This may sound like an obvious statement, but, for the last two-plus years, investors have done well by riding the liquidity wave. "Hold on for Dear Life!" (HODL)—isn't that what the crypto crowd said?

[1] Source: Pitchbook. US Venture Capital Mega Deal ($100M+ USD) Activity data from January 1, 2010 to June 30, 2022.

Relative Performance of Energy vs. the Broader Market

S&P 500 Energy Total Return Index / S&P 500 Total Return Index (Indexed to 100)



Sources: Bloomberg (Dec. 31, 2007 - Jun. 30, 2022 Daily), Callodine Capital Research Team.

Instead, the first half of this year has felt like a game of 52-card pickup, where the market has simply thrown down the hand that it's been playing since the onset of the pandemic, and now it needs to reorganize itself by identifying the next "winners." This is a painful process for any market. Within that environment, we see enormous opportunity for fundamental analysis and applying a rigorous investment framework to both sector and stock selection. This framework should provide significant alpha generation and high return opportunities to investors who have open minds about what could happen next and who are willing to put in the work.

We believe Callodine falls into that cohort and see a fantastic market environment rife with opportunity for active managers willing to take this view now. Simply put, we are bullish on the return set in front of us. However, to be clear, that is not a call on the general market level, but instead a testament to the very wide and disparate outcomes we see ahead for different sectors and stocks.

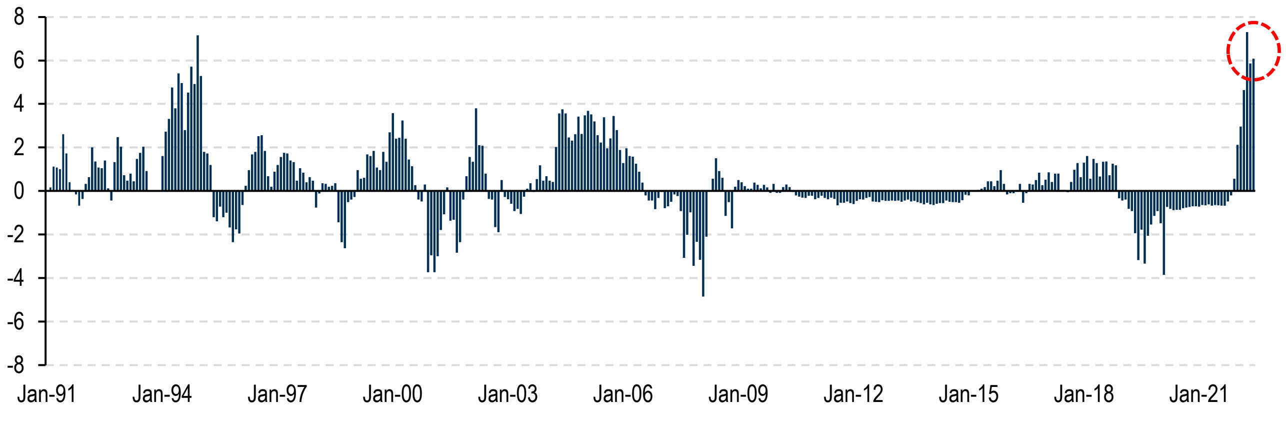
Keep Calm and Carry On

In our last quarterly letter, "The Great Rotation Begins," we discussed how, over the past two years, investors have had to respond to a series of questions about the broader economy in order to inform their investment decisions: 1) Will consumers recover, 2) Will inflation be transitory, and 3) Will interest rates ever increase? Our regular readers know that we've been consistent in our views on each topic, and that the market was arguably late to adjust to what we viewed as inevitable rate increases, shown below by the exponential spike in the number of rate hikes expected by the market.

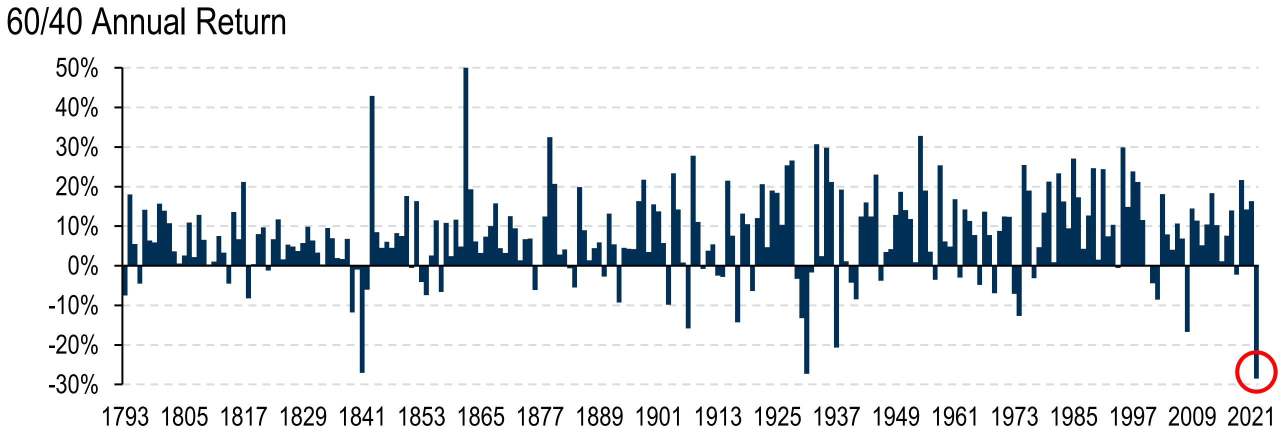
Now the next question investors must answer is whether the economy is careening toward a recession, and, if so, how bad and how long will the fallout be? If you use the U.S. equity market as a barometer, the answer is that it's going to be a doozy. The 20% decline that U.S. stocks experienced in the first half of 2022 was the worst since 1962 (-22%) and the second-

Implied Number of Rate Hikes (Cuts) in Next 6 Months

Difference in Yield of Fed Futures Expiring in 6 Months - Upper Bound Fed Rate / 25bps



Sources: Bloomberg (Jan. 01, 1991 - June 30, 2022), Callodine Capital Research Team.



Sources: Edward F. McQuarrie, Robert Shiller, Aswath Damodaran, Bloomberg, Callodine Capital Research Team
Methodology: 60/40 Return is 60% return from Equities and 40% return from Bonds. 2022 return is through June, annualized. Equity returns are composed of McQuarrie Nominal Stock Return from 1793 through 1870, Shiller S&P Comp. Return from 1871 through 1927, Damodaran S&P 500 Return from 1928 through 1989, and Bloomberg S&P 500 Return from 1990 through June 2022. Bond returns are composed of McQuarrie Nominal Bond Returns from 1793 through 1927, Damodaran US T. Bond from 1928 through 1973, and Bloomberg US Treasury Index (LUATTRUU Index) from 1974 through June 2022.

worst start to the year since 1935.[2] Adjusted for inflation, this performance looks even worse. Bond markets didn't fare much better, with yields gapping higher as investors finally acceded that the Federal Reserve was going to have to raise rates quickly. Poor performance across the board has brought bond returns to historic lows, with the U.S. Treasury Bond Aggregate Index down nearly 18% on an annualized basis.[3] Taken in concert, a typical 60/40 blended portfolio returned a staggering -29% on an annualized basis, which would represent the worst return in history for that investment strategy.[4]

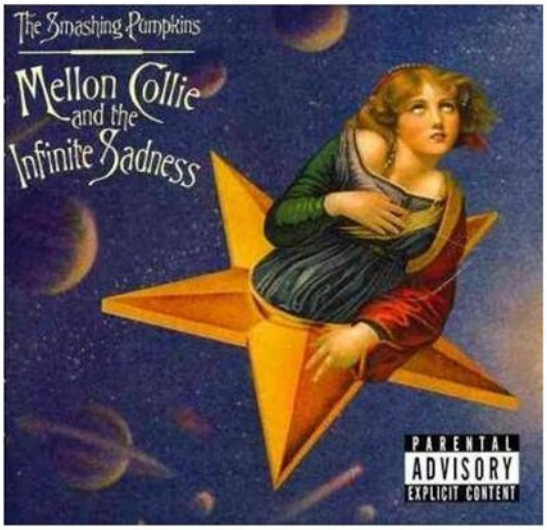
What were previously regarded as safe-haven assets certainly didn't feel that way for the first six months of 2022, a situation we discussed at length in our white paper "The Search for Alternative Yield." Duration risk had crept to all-time highs in fixed-income markets just as rates reached all-time lows, a perfect recipe for the recent carnage.[5]

This "flushing" of assets regardless of investment characteristics or risk profile feels less like a reflection of where the broader economy is headed and more like a reaction to the draining of liquidity from the system as investors are forced to raise cash.

Market Colic and the Infinite Sadness

Survey after survey confirms the state of outright sadness in the current market. While the pessimism of the moment is palpable and very real, we believe there is a reasonable chance that what consumers and investors are experiencing is simply reversion to the mean.

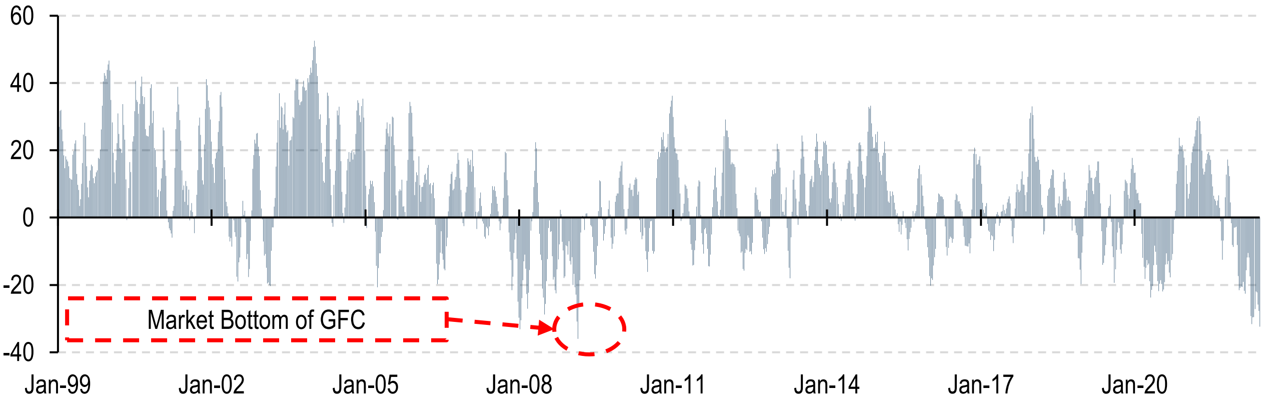
Once upon a time, money was free, you could "work" from home forever, imaginary digital "currencies" went up every day, there was no traffic, and, well, everything was just awesome. Now, conditions have evolved into something "less than," and this change has depressed the market, causing a great reduction in risk appetite (see the graphs on following page).



[2] Note: 'U.S. stocks' represented by the S&P 500 Index.
[3] Source: Bloomberg. Data is from January 1, 2022 to June 30, 2022, annualized, for a 60/40 Return Portfolio. 60/40 Return is 60% return from Equities and 40% return from bonds.
[4] See '60/40 Annual Return' chart for detail on source and methodology information.
[5] Source: Bloomberg, Callodine Capital Research Team as of June 30, 2022. Duration represents the modified duration of the Bloomberg Global Aggregate Total Return Index as calculated by Bloomberg, and Yield represents the Yield-to-Worst of the Bloomberg Global Aggregate Total Return Index as calculated by Bloomberg.

AAII US Investor Sentiment Bullish - Bearish Readings

Rolling 4 Week Average Dec 31,1998 - Jun 30, 2022



Sources: American Association of Individual Investors via Bloomberg, Callodine Capital Research Team.

To be certain, second derivatives are negative in many places these days. Conditions are slowing in a lot of areas, purchasing power and the growth in discretionary spending are declining due to inflation, job growth looks ready to slow or decline, and a return to pre-pandemic "norms" may be reducing newly found free time. None of that is pleasant.

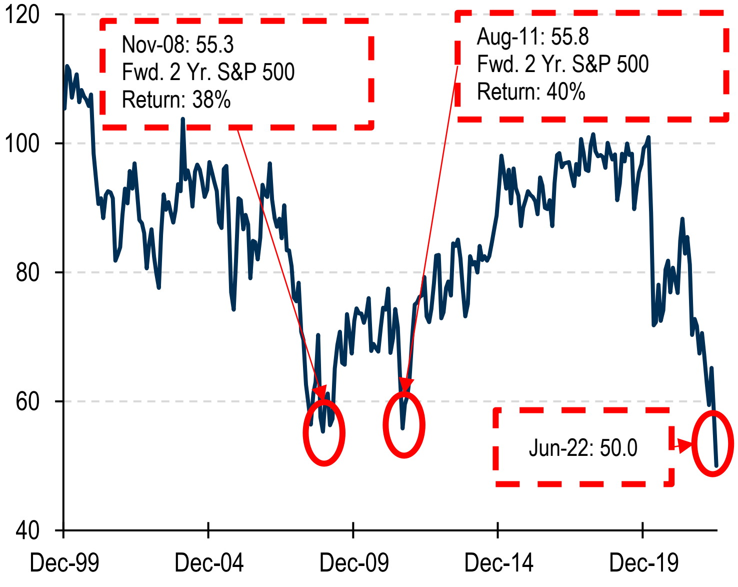
However, the situation is still pretty great on an absolute basis. In October 2008, the economy had already shed millions of jobs and witnessed a 2-percentage-point increase in unemployment before people got *really* bearish, the financial system felt as if it were on the verge of collapse, and home prices were seven quarters into a decline.[6] In fact, there was very little doubt that a serious deflationary recession was upon us, and financial leverage was high.

Now? None of that. Consumers are in record great shape, the job market never filled all the jobs it wanted to, and neither consumer nor corporate debt are at threatening levels. Are we building too many houses or cars, typically tell-tale signs of flagging demand? We would suggest no, and that, in both cases, supply has been far below demand, causing prices to leap higher and leaving inventories depleted as opposed to overbuilt. Demand corrections are far easier when you don't also have a big oversupply to work through, and that is the situation in these two major purchase categories for consumers.

It is a fair argument that the market is just being incredibly anticipatory this time, showing off a newfound ability to forecast with great precision. To that theory, we'd point out that, just six months ago inflation was "transitory," the 2-Year U.S. government bond yielded 73 basis points (bps), and the stock market was at an all-time high.[7] So call us skeptical.

To be clear, the future is highly uncertain and dangerous, as is always the case. But steep drops in sentiment and markets like the one we've just witnessed are almost always an opportunity to buy, not sell. Had you bought the October 2008 trough in investor bearishness, which coincided with a 32% year-to-date decline in markets to that point, you were in for a very wild ride ahead, but in fact the market was up 13% a year later and 28% two years later.

University of Michigan Consumer Sentiment Score



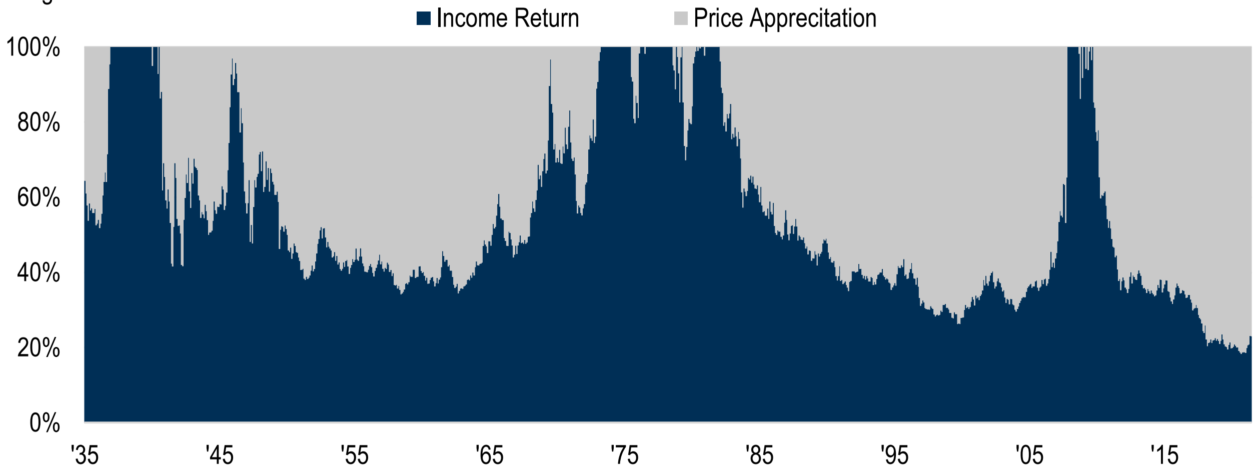
Sources: Bloomberg (Dec. 31, 1999 - June 30, 2022), Callodine Capital Research Team.

[6] U.S. Bureau of Labor Statistics, Unemployment Rate from Jan. 01, 2007 (4.6%) to Oct. 31, 2008 (6.8%) retrieved from FRED, Federal Reserve Bank of St. Louis.

[7] Board of Governors of the Federal Reserve System (US), Market Yield on U.S. Treasury Securities at 2-Year Constant Maturity, Quoted on an Investment Basis on December 31, 2021 (73bps), retrieved from FRED, Federal Reserve Bank of St. Louis.

60/40 Annualized Return Decomposition (Contribution)

Rolling 10 Year



Sources: Morningstar SBBI (Jan. 01, 1935 - June 30, 2022), Callodine Capital Research Team.
Methodology: Income Return is the annualized compounded return from income. Price Appreciation is the difference in the annualized compounded total return and income return. Max contribution set to 100%. Min contribution set to 0%. In cases where price appreciation is negative, contribution from income return is set to 100% and contribution from price appreciation is set to 0%.
Note: 60/40 Return is 60% return from Equities and 40% return from Bonds.

Back to the ~~Future~~ Past

WHERE'S
THE YIELD !

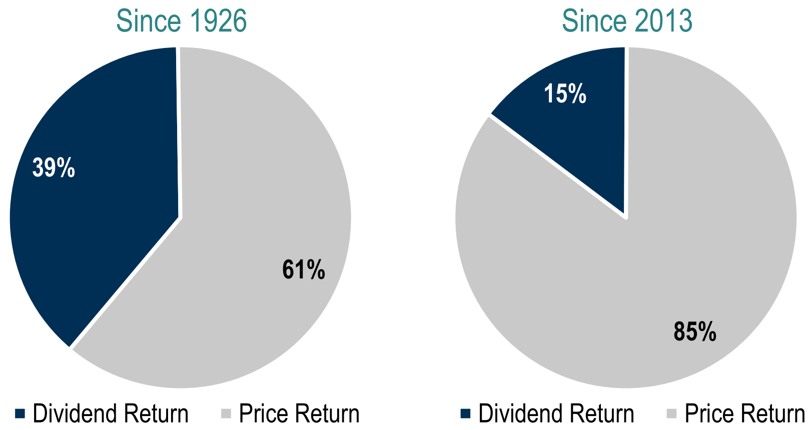
While we may not like it, investing is hard. Yet, over the course of the past decade, both equity and bond investors have had the benefit of price appreciation, courtesy of ever-declining interest rates, to drive outsized returns. This persistent grind higher in asset prices has provided a tailwind to capital markets that has persisted for so long that it began to feel permanent. Businesses were not required to generate cash flow in order to create value. This is unusual over the long arc of investing history.

The percentage of total returns provided by price appreciation (illustrated in our chart below) reached all-time highs recently, and we contend that this ratio will begin to decline/normalize moving forward, with income playing a far greater role in investor total returns.

Believe it or not, dividends use to be cool. In fact, dividends have driven 39% of total returns since 1926, compared to just 15% since 2013.[8] With interest rates potentially rising or, at best, holding stable, the key source of multiple expansion in both stock and bond markets will no longer be available. In our opinion, this will make the yield component of any investment a more critical percentage of its total return and likely cause investor preferences to shift toward investments that can generate consistent cash yield.

Dividends Historical Contribution to Total Return

IA SBBI US Large Stock Price Return and Dividend Contribution to Total Return



- Dividends have Contributed to 39% of Total Returns Since 1926 but Only 15% Since 2013.

Sources: Morningstar SBBI (Jan. 01, 1926 - May 31, 2022), Callodine Capital Research Team.

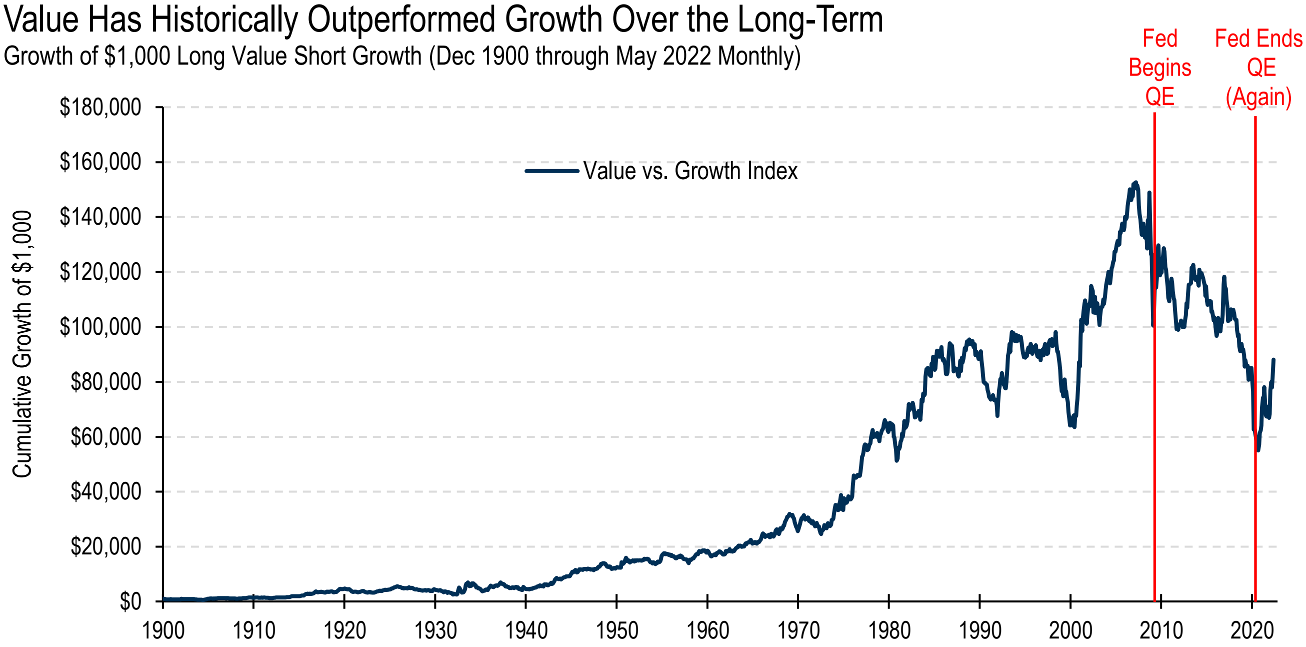
[8] Source: Morningstar SBBI (Jan. 01, 1926 to May 31, 2022), Callodine Capital Research Team. Note: IA SBBI US Large Stock Price Return and Dividend Contribution to Total Return.

In our view, the importance of dividends as a key component of equity market total return is going to become more prevalent over the next decade. In a lower return environment, we would not be surprised to see companies choose to increase payout ratios and share more of their free cash flow with shareholders in the form of dividend payments. If we're correct in our assessment, the ability to analyze the sustainability of those dividends will become a critical skillset that has been conspicuously absent from investors' toolkits over the last decade.

Yield and value are bedfellows in this market environment, and, as shocking as it may be to many of today's investors, Value can work as a style for long stretches of time (raise your hand if you're over 47 and remember this). Despite Growth's dominance since the Great Financial Crisis, the underperformance of Value has actually been the exception over time, not the rule. As demonstrated by the chart below, investors who have favored Value stocks have traditionally fared better when looking at returns over a long-term horizon. That trend seemingly broke down in 2008 and hasn't regained its footing until the last six months.

Value Has Historically Outperformed Growth Over the Long-Term

Growth of $1,000 Long Value Short Growth (Dec 1900 through May 2022 Monthly)



Sources: Kenneth R. French Data Library at Tuck School of Business, Cowles Commission for Research in Economics at Yale School of Management, Callodine Capital Research Team.
Methodology: Cowles (1900-1926), Fama-French (1926-2022)

Free money is a glorious thing for asset prices, and this influx of liquidity diminished the need to maintain investing discipline. Investors' preferences naturally shifted to places where they could get rich very quickly, without having to prove too much. Ideas and Total Addressable Markets ("TAMs") supplanted cash-on-cash returns or even proof of concept. This market phase is also part of the natural cycle for investors, and it has been difficult for Value investors to accept. But that phase feels like it has finally passed.

And so, the Circle of Life continues…

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