CALLODINE | CAPITAL

Quarterly Market Commentary
Q4 2022

“Market Lessons on Pattern Recognition and Mean Reversion”

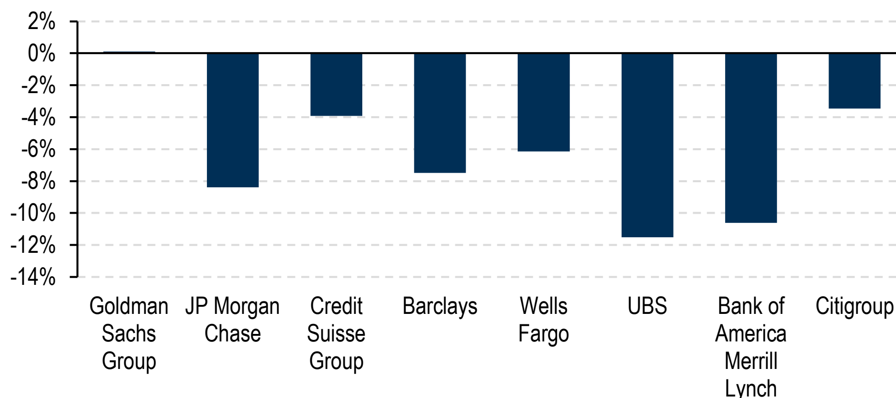
Market Commentary

We all seek to recognize familiar patterns within the chaos of uncertainty. This innately human quality generally serves us incredibly well, and our superior pattern-processing capacity contributes to the success of our species[1].

To gain conviction and comfort from our views, we seek to build consensus and get "buy-in" from others. The feeling that our views align with a broader consensus can settle our nervous system and allow us to function with purpose. This is how a strong consensus can form when we lack a historical corollary to rely on. In other words, "this" sort of feels like "that," and when "that" happened, the right thing to do was "x."

Investors display this behavior when they seek patterns within chaotic markets to help them navigate the way forward. They map to prior cycles that resemble the current environment and then forge ahead. Unfortunately, this behavior is often the wrong course of action—but at least the investors were wrong together, which feels comforting and "safe."

The near unanimous sentiment today is that we are heading into a recession and that earnings are heading lower—a recession (a familiar event) triggered by Federal Reserve action (a knowable event).



Sources: Bloomberg, Callodine Capital Research Team
Methodology: Methodology: 2023 S&P 500 Earnings Estimates are as of 12/17/2022. Growth is 2023 estimate vs Bloomberg 2022 EPS estimate of $223.75 as of 12/31/2022.

This outlook is a plausible consensus view, but it was an equally held consensus view a year ago that inflation would be transitory. While it seems like a lifetime ago, the 1-year Treasury yield was 0.39% at the start of 2022[2]. The inconvenient fact for all investors today is that the historical sample set of "prior-pandemic-induced, record-level stimulus-driven inflationary cycles" is approximately zero. The starting conditions and core drivers of the current economic backdrop are unique.

None of us have witnessed anything like this before, which gives us no playbook to which we can confidently pivot. The reality of periods when both risk and reward are similarly uncertain is that the range of expected outcomes should be correspondingly wide. Yet our nature is to try to compare the current experience to a prior one, which creates potential opportunities to profit by investing outside of the consensus.

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[1] Superior pattern processing is the essence of the evolved human brain, Mark P. Mattson.
Front. Neurosci., 22 August 2014 Sec. Social and Evolutionary Neuroscience https://doi.org/10.3389/fnins.2014.00265.

[2] Board of Governors of the Federal Reserve System (US), Market Yield on U.S. Treasury Securities at 1-Year Constant Maturity, Quoted on an Investment Basis [DGS1], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGS1.

Investing through Ambiguity

Despite the current uncertainty, we do not observe a wide range of predicted outcomes. Instead, market strategists are nearly unanimous about the path ahead for the economy and markets:

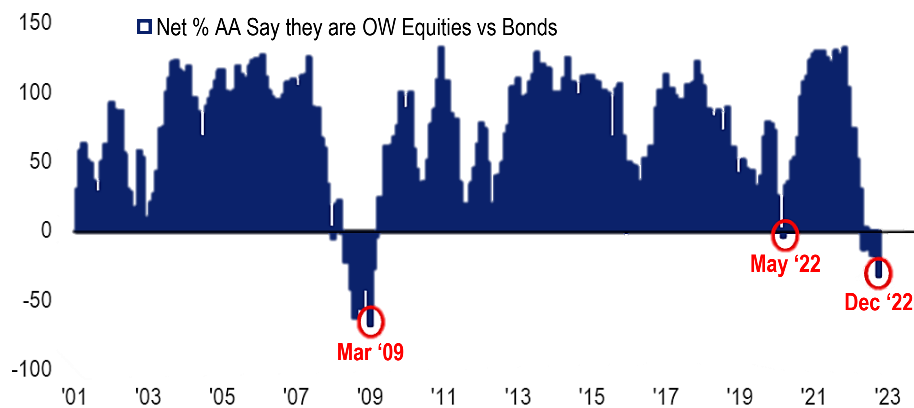
1) There will be a recession in 2023

2) Earnings estimates have not bottomed, so it is best to wait for that trough

The corresponding investment strategy is some variation of "buy bonds or defensive equities and/or wait until estimates bottom," with an S&P 500 target that assumes some "normal" recessionary pull-back in earnings from here, and then some lower multiple applied to said lower earnings. Again, this is a very plausible scenario, but what makes us uncomfortable as long-time investors is that nearly everyone seems to hold this same view. In our experience, when investors get this certain of negative outcomes, markets tend to surprise to the upside, not the downside.

Relative Positioning in Stocks vs. Bonds Now Lowest Since 2009

Net $ of FMS Overweight Equities – Bonds



Sources: BofA Global Research, BofA Global Manager Fund Survey (December 12, 2022)

One thing we do have a reasonable degree of confidence in, however, is that the market is already behaving as though we are in a recession. Specifically, we would point to the following key signals emanating from the equity market:

- ✓ A significant market decline has occurred
- ✓ Forward earnings estimates have started to be revised downward
- ✓ Forward multiples have begun to compress
- ✓ Most cyclical stocks have been punished
- ✓ Most defensive stocks have been rewarded

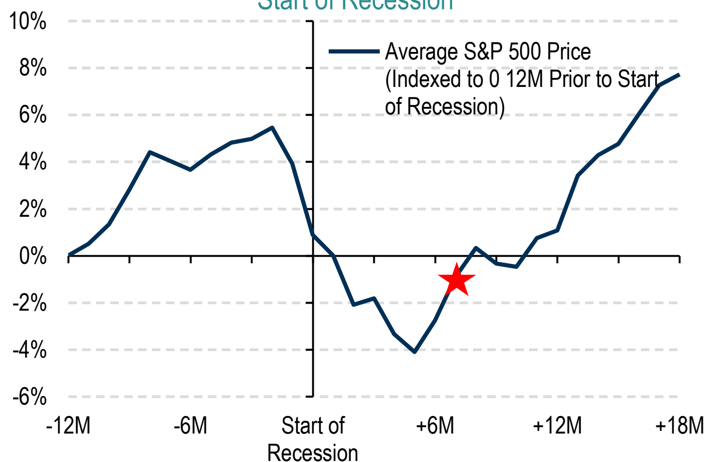
We're not macroeconomists, but, as market participants, we believe it is late to adopt a recessionary viewpoint, given what's been priced into the market.

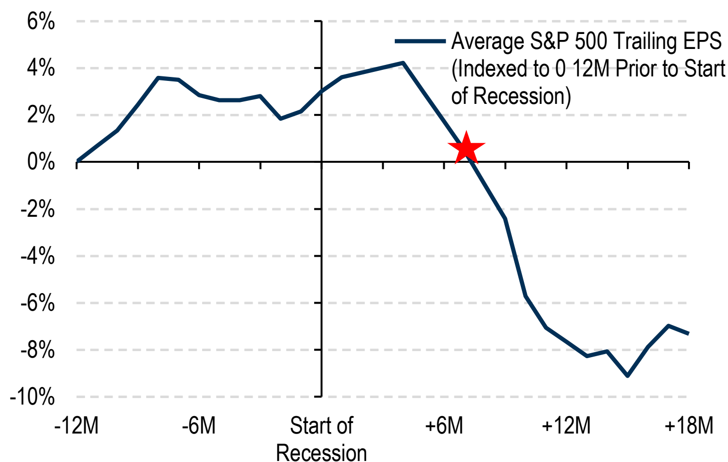
Our second observation is that waiting for earnings to trough has historically been a poor timing mechanism to capture equity gains—markets typically reward foresight, not the consensus or the obvious.

Given that we don't know the forward path for the economy (nor does the consensus or anyone else), we are focused on the contrarian outcomes, good or bad, and strategies to safely generate returns within them.

The Market Doesn't Usually Have Much Foresight for Recessions, But Bottoms Well before Earnings

Average Progression of S&P 500 Price and Trailing EPS in the 12 Months Prior through 18 Months Following the Start of a Recession





Sources: Robert Shiller, NBER via FRED, Callodine Capital Research Team

Methodology: Recession Start Dates are NBER based Recession Indicators for the United States since 1900 through 2022. Recession dates include Dec 1902, Jun 1907, Feb 1910, Feb 1913, Sep 1918, Feb 1920, Jun 1923, Nov 1926, Sep 1929, Jun 1937, Mar 1945, Dec 1948, Aug 1953, Sep 1957, May 1960, Jan 1970, Dec 1973, Feb 1980, Aug 1981, Aug 1990, Apr 2001, Jan 2008, Mar 2020. Average S&P 500 Price is the mean of the S&P 500 price indexed to 0 12 months prior to start of recession. Average S&P 500 trailing EPS is the median of the S&P 500 trailing EPS indexed to 0 12 months prior to start of recession.

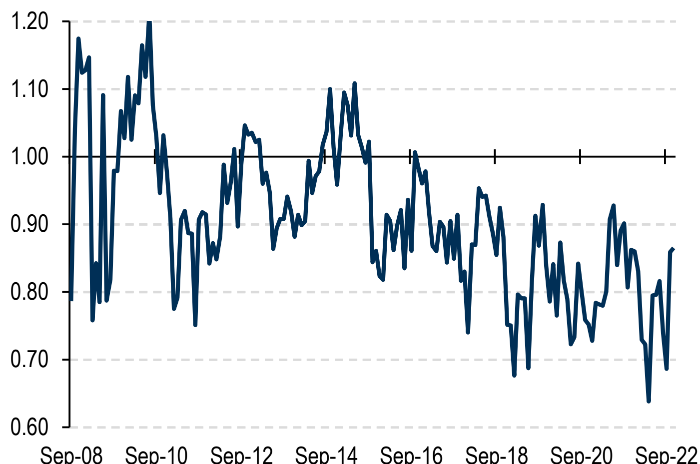
Positioned for a Consensus Outcome

We believe most investors simply want to get this recession over with and have the Fed start cutting rates again, because they remain positioned for that outcome. They simply want to continue believing in and owning what they already own, namely long-duration growth assets.

Declining interest rates and the revival of historic multiples would be a relief for an investor base that remains highly overexposed to all things growth and tech-oriented, and would mean that a likely painful period of marking down venture capital and growth private-equity investments made during the past three to five years could be avoided. It would also mean public market investors wouldn’t have to reposition out of high price/earnings (P/E) long-duration growth stories into sectors like financials or energy, where cash flow is abundant and inexpensively valued.

Value is Still Underweight

Long-Only Relative Positioning of Financials vs Communication Services vs S&P 500 & Weight of High FCF/EV in Mutual Funds

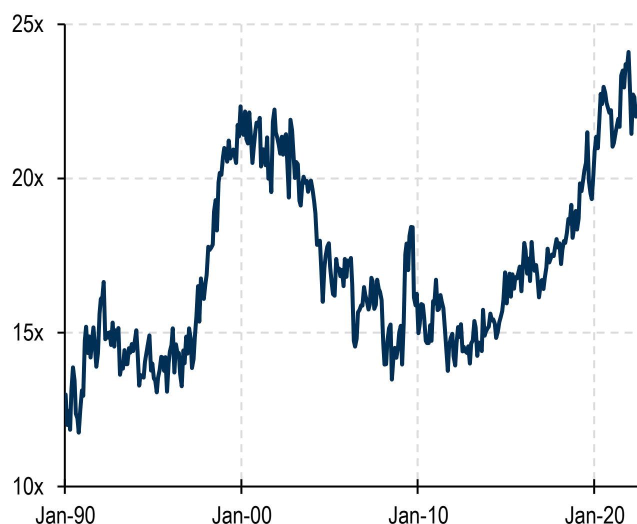


Sources:BofA Global Rsearch, BofA US Equity & Quant Strategy

Methodology: Relative Weight of Financial / Comm Svcs data is from Sep 2008 through Dec 2015 quarterly and Dec 2015 through Oct 2020 monthly. Weight of High FCF/EV in Mutual Funds data is from Sep 2008 through Nov 2022 monthly.

Markets have a funny way of not doing what is most convenient or most desired by participants, and, looking at the charts above, we can see that investors haven't begun to sufficiently reposition themselves. Sectors like financials are still massively underweight relative to communication services, and free cash flow yield still isn't getting the attention and respect that we believe it deserves. We could show dozens of charts that tell a similar story, and we are convinced that the "Great Rotation" has only begun to take hold.

The harsh reality is that strategies that worked before are unlikely to work going forward. The economic and market backdrops are starkly different from what we saw from 2010 to 2020. Investors will need to find the next "next thing," and, for most investors, that process hasn't yet begun in earnest. Mean reversion can be a long process.



Sources: Bloomberg, Callodine Capital Research Team
Methodology: Average NTM P/E of S&P 500 companies quinitiled 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 Dec

Unchartered Waters and Adrift from Historical Correlations: A Tale of Two Markets

As mentioned at the outset of this letter, during the past few months we have observed that investors are trying to use a classic recessionary framework to predict the direction of the market in 2023. The problem is that there's nothing about the current economic environment that resembles the last several recessions, and therefore we believe many previously reliable correlations will fail to hold.

The harder question then is, without the past to guide you from a top-down standpoint, what do you do? Fortunately, the current landscape provides several microeconomic boom/bust cases at the individual sector and company levels to examine. They just aren't as synchronized as cycles have been in the past. We think this creates the potential for vastly disparate outcomes and great investment opportunity.

We've written at length that the COVID-19 pandemic created clear winners and losers, both during the pandemic and in the unprecedented stimulus that followed. The liquidity-fueled tech rally was so one-sided that it produced historically wide dispersion in valuations and investor sentiment.

To put it bluntly, the pandemic experience was not the same for everyone:[3]

[3] Seidell, Streeter J, and Mikey Day. Saturday Night Live, Close Encounter, NBC. https://youtu.be/PfPdYYsEfAE.

So why would the post-pandemic environment be any different? After all, it stands to reason that the market distortion that occurred during the "boom" portion of the cycle would also lead to a distorted "bust" on the back end. Market conditions that would typically be highly correlated in a normal cycle are not taking shape now.

COVID-19 winners did not pull back spending and retrench. They used cheap and readily available capital to expand their capacity and grow their workforce. The velocity of capital within the venture capital–driven technology food chain accelerated and seemingly validated every unicorn's dream business model. AAPL, AMZN, MSFT, GOOGL and META all grew their employee bases 50-95% from the onset of the pandemic to the latest filing, suggesting a low-20% compound rate of growth off a base that had already grown substantially[4].

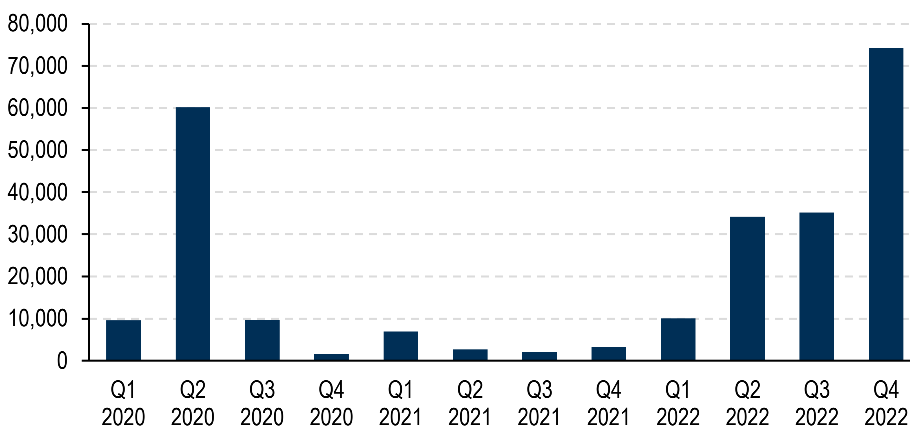
Inflation caused issues throughout the economy due to stimulus, but until recently, that cost pressure was never strongly felt in the technology sector. The beauty of technology is that its products are digital and instantly global. There are limited supply chain concerns (semiconductors notwithstanding), and rising costs of inputs are a non-factor. So, the pain never came.

Unfortunately, the tech sector is now on the other side of the "Great Rotation." Companies over-hired into the boom and exacerbated the problem. These recent headlines from Salesforce.com (CRM) illustrate what happened here and where it is heading[5]:

Salesforce announces restructuring plan aiming to cut operating costs and improve margins
*SALESFORCE: HIRED TOO MANY PEOPLE LEADING INTO ECON DOWNTURN
*SALESFORCE: AFFECTED US EMPLOYEES TO GET MIN NEARLY 5 MOS PAY
*SALESFORCE:PLAN TO BE SUBSTANTIALLY COMPLETE BY EOY FISCAL 2024
*SALESFORCE: WORKFORCE CUT MOSTLY OVER COMING WEEKS
*SALESFORCE TO CUT WORKFORCE BY ABOUT 10% IN RESTRUCTURING
*SALESFORCE SEES $1.4B TO $2.1B IN CHARGES
*SALESFORCE: SELECT REAL ESTATE EXITS & OFFICE SPACE REDUCTIONS
*SALESFORCE TO CUT WORKFORCE BY ABOUT 10%
*SALESFORCE ANNOUNCES RESTRUCTURING PLAN

We believe the downstream suffering within the technology food chain is only just beginning. The velocity of capital in this ecosystem is grinding to a halt, and venture capital strategies will need to be reevaluated and altered with a newfound focus on businesses that can ultimately be profitable (a novel idea). This change will take time to play out and create an earnings headwind across the sector.

Tech Layoffs Have Surpassed Initial Covid Response



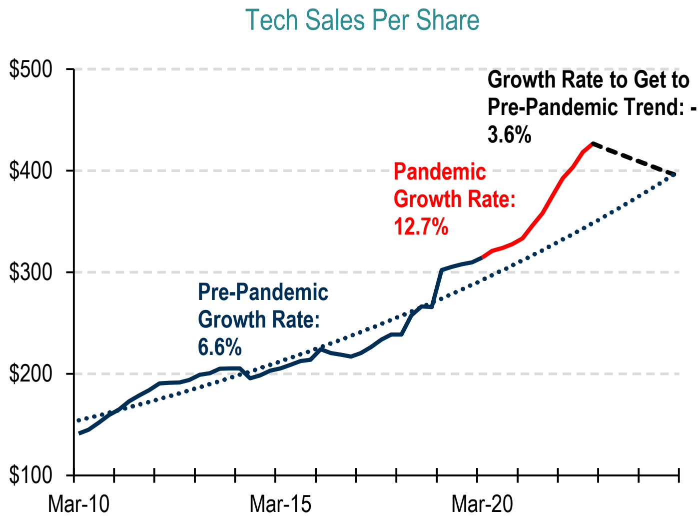
Sources: layoffs.fyi

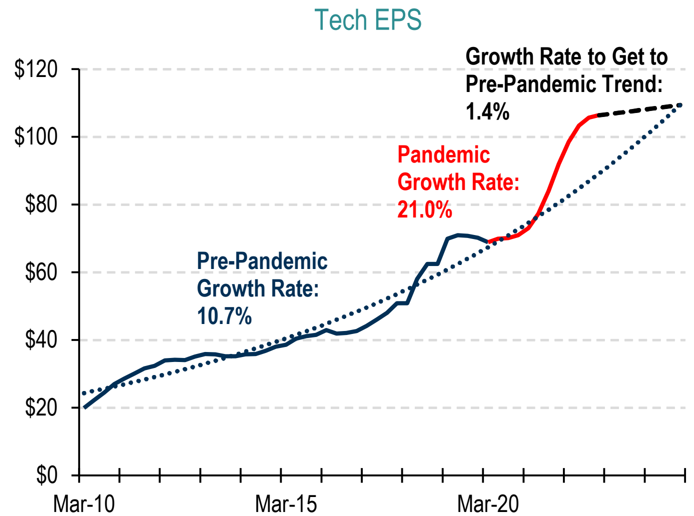
[4] Source: Company filings via Bloomberg.
[5] Source: Bloomberg, January 4, 2023.

In the ten years prior to the onset of the pandemic, the forward earnings per share (EPS) power of the S&P tech sector grew at a 10.7% annualized rate, well ahead of the S&P 500 broadly +5.5%. Over the next 33 months that rate accelerated to 21.0%. Looking at sales per share in the tech sector, the pre-pandemic growth rate of 6.6% nearly doubled to 12.7%[6]. To get back to the previous trend, revenues in the tech sector will not just have to slow their growth, they would have to decline.

Tech Sales and Earnings Growth Has Accelerated Past Trend During Covid

S&P 500 Information Technology Trailing 12M Sales Per Share and Earnings Per Share





Sources: Bloomberg, Callodine Capital Research Team

Methodology: Growth Rate is calculated as e to the slope of the natural log of the series multiplied by 4. Observations are quarterly from Mar 2010 through Dec 2022. Pre-pandemic is Mar 2010 through Mar 2020. Pandemic is Mar 2020 through Dec 2022.

This scenario is starting to play out fundamentally, and it will get worse before it gets better, in our opinion, thereby creating a very difficult set-up for the most over-owned part of the market.

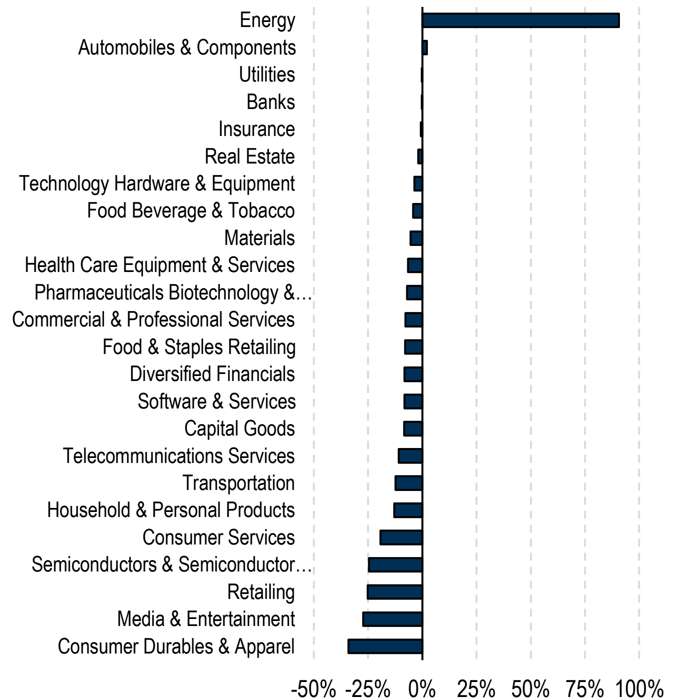
Tech is a sector where we believe sales remain artificially inflated by 10–15%, while margins are 10–15% too wide, and where multiples remain 10–15% too high despite their recent decline. In theory, a recession would make all of this worse, creating a recipe for losing another 30–40%.

COVID-19 losers, on the other hand, have already endured a full-blown depression. Capacity has likely exited permanently for hotels, airlines, cruise lines, restaurants and, increasingly, office space. These segments of the market don't have excess labor, but rather insufficient labor after tightening their belts to survive the pandemic. Part of the economy is battle hardened, and we do not believe these segments are heading toward massive earnings declines. Just because there's a recession coming in California doesn't mean the same thing is happening in Nebraska or Missouri.

This is the great mean reversion event that the market requires to finally re-orient itself after the roller coaster ride of the pandemic years. The lack of precedent for the current background creates an enormous opportunity to generate alpha through fundamental analysis and portfolio construction.

Industry Group 2023 EPS Revision

S&P 500 Industry Group Level 2023 EPS Revision (Dec 31, 2022 vs Dec 31, 2021)



Sources: FactSet, Callodine Capital Research Team

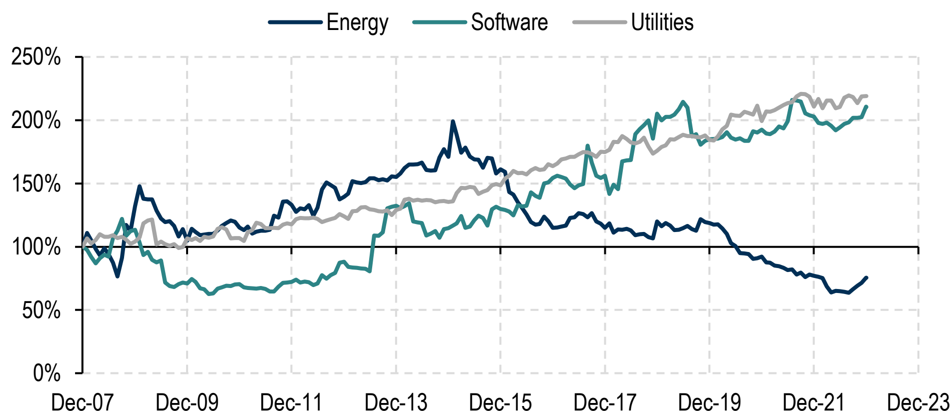
[6] Source: Bloomberg, Callodine Capital Research Team.

Where Are Returns Highest for Taking Contrarian Risk?

If the traditional cyclical playbook is not to be followed, what should an investor do today? In our view, it's best to simply follow the excess from the prior cycle to know where to avoid applying capital today.

At Callodine, we've been asking ourselves where we can safely make money, outside of the consensus. We are fascinated by the collision course between revenue cyclicality (as distorted by pandemic-related factors) and the impact of higher interest rates on the changing economic landscape where capital intensity resides.

Take the technology, energy and power sectors, for example, which are the three most capital-intensive areas of the broader market.



Sources: Bloomberg, Callodine Capital Research Team

The trends here are remarkably divergent since the last recession and the last time the market experienced rates near current levels. Today, the software industry spends more on a CAPEX-to-sales basis than the energy sector does, and utilities are spending 3x as much[7]. Both sectors have doubled their capital intensity since 2008, and we believe this situation will be significant in a higher-rate environment[8].

To those downstream from this CAPEX tsunami, it has felt like a secular tidal wave lifting their businesses higher and higher. In turn, they have invested in their own capacity accordingly, and, in our view, they are wholly unprepared for the spending pullback that is beginning at the top of the food chain. The tech intelligentsia will tell you AI and Big Data will overwhelm all of this, but they said that about the internet in 2000, and it subsequently proved to be a very long and cold winter for tech spending. Caveat emptor.

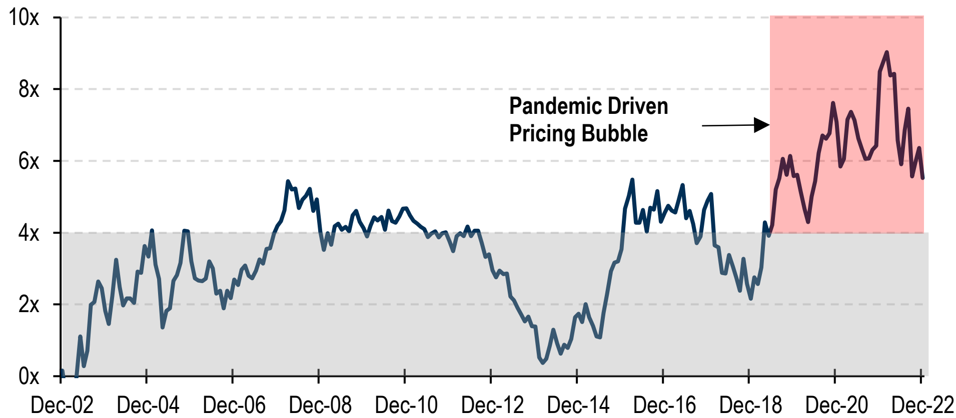
Within much of the energy and materials sectors, the story is reversed. This time around, they weren't aggressive spenders, as they already found themselves in the capital-spend penalty box and sat things out.

Also, energy is still operating below pre-pandemic trend demand levels, given the odd path of the current cycle, so this looks to be an attractive place to take cyclical upside risk, in our opinion. There is no fear of missing out on the next great energy cycle or a view that oil could sustainably trade above $100 per barrel, and that is exactly the point—we see considerable upside for investors positioned for that outcome if it comes to fruition.

Switching to the traditionally defensive side of the market, some of these sectors and stocks have performed just as we would predict if the market were pricing in a recession, while others have not. For example, consumer staples and utilities were great places for investors to hide in 2022, as we did often. Others, like pharmaceuticals, have not seen the same level of reflexive multiple expansion, and it has been far worse in real estate.

[7] Source: Bloomberg, Callodine Capital Research Team.
[8] Source: Bloomberg, Callodine Capital Research Team.

When we look at the underlying fundamentals of staples and pharmaceuticals, we would contend that certain staples are arguably overearning, while most of pharma is not. Staples saw its margins explode, partially due to pantry loading and a generational ability to take price, while pharma had an odd cyclical headwind, because many people weren't getting diagnosed and treated for their illnesses during the pandemic. The relative value between those two sectors has widened significantly. Staples are close to all-time highs relative to pharma. In one case, the multiple went up, and in the other case, earnings grew. This creates relative opportunity.



Sources: FactSet, Callodine Capital Research Team

In a similar vein, we've observed very disparate performance between utilities and REITs in 2022, and we see tremendous value in the yield premium that REITs are currently exhibiting versus utilities. Both are traditional income plays, and utilities have lately been an excellent place for investors to hide, but the pandemic-plagued office REIT sector has been held back from the group. We believe certain subgroups, such as self-storage and multi-family housing, should benefit from higher mortgage rates and prospective homebuyers' recently impaired ability to buy rather than rent.

REITs Offer Tremendous Value in Yield Premium vs Utilities

Sources: Bloomberg, Callodine Capital Research Team

Methodology: REITs - Utilities Fwd Dividend Yield is the difference in forward dividend yield of the S&P 500 REIT Industry Index - the S&P 500 Utilities Sector Index from December 2017 through Dec 2022 monthly. Utilities vs. REITs P/E is the ratio of the S&P 500 Utilities Sector Index forward P/E / the S&P 500 REIT Industry Index forward P/E.

Maybe, But Maybe Not…

At Callodine, we find ourselves in the unusual and uncomfortable position of being less bearish than the rest of the market. Perhaps it is the opportunity we see within our target segment of the market relative to Growth, which we believe is still significantly overvalued.

As our regular readers can attest, since inception we've been highlighting risks (higher rates, persistent inflation, impacts of less liquidity) that we felt the market wasn't adequately pricing in. Today, we believe the market is not pricing in the scenario of a Goldilocks economy, which is not great or awful, but just OK. In our opinion, the risk is to the upside.

Are we careening toward a painful economic contraction that will eat away at corporate earnings and weigh on stock prices for the foreseeable future? Maybe, but maybe not, and the market has created a window of opportunity around that consensus view.

To be abundantly clear, we are not making a call on the economy or the general level of the markets. Instead, we are pointing out that the broader market is making a directional bet. When that happens, we find it best to get granular, focus on the fundamentals, and identify mispriced risk at the individual stock level.

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