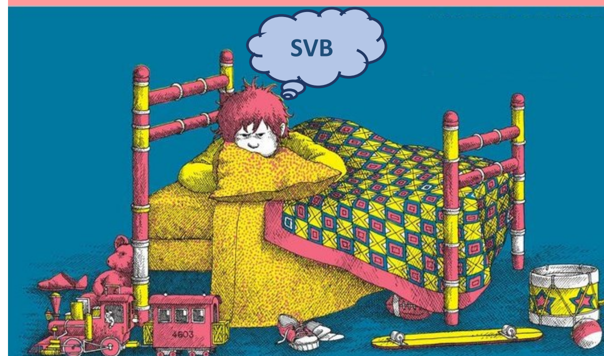
CALLODINE | CAPITAL

Quarterly Market Commentary
Q1 2023

“Pavlov’s Market”

Market Commentary



In the late 1800s, Russian physiologist Ivan Pavlov was studying digestion in dogs when he accidentally discovered what is now known as "classical conditioning." His dogs would salivate at the mere sight of his assistant who came to feed them, associating the assistant with the forthcoming act of being fed. Whether or not the assistant actually fed them was irrelevant—they had become conditioned to respond as if they were about to eat each time the assistant appeared.

For most of the last 15 years, the stock market has viewed the Federal Reserve as Pavlov's assistant and associated the Fed with some new plan to either increase liquidity to "save" the system or lower the cost of capital. We've had an alphabet soup of programs with names like TSLF, TARP, CPFF, PDCF, etc. And, with each one, the market has been trained to take on risk and, specifically, to bet on long duration Growth stocks.

So, in some ways, the market can be forgiven for its predictable response to the newly minted Bank Term Funding Program (BTFP), as well as the reawakening of programs of yore (welcome back, TALF!).

In what feels increasingly like a single-variable market, Q1 2023 saw a move back to "risk on," led by the heroes of the prior cycle. Growth stocks dominated once again with the second-best quarterly performance over Value in the last two years (+13.4%), outpaced only by the Q2 2020 outperformance of +13.6% in the wake of COVID stimulus programs such as MSLP, MMLF, and, who could forget, PPPLF![1]

It was simply a predictable and learned response based on prior experience. Just like Pavlov's dogs, the market is suddenly salivating at the prospect of a decline in interest rates.

We believe that reaction is fundamentally flawed this time around, because the current set of circumstances is completely different from the circumstances in the prior decade-plus period. The past sins of easy money remain firmly in place, and we believe the market will end up with the opposite conditions from what it is anticipating—namely, a return to high growth with low rates—and instead become stuck in a period of higher rates with low to potentially negative growth. Broader market volatility has been pushed into the interest rate market, while exacerbating the Growth / Value divide within the equity market, neither of which shows up in what has been a surprisingly subdued Volatility Index (VIX) Index.

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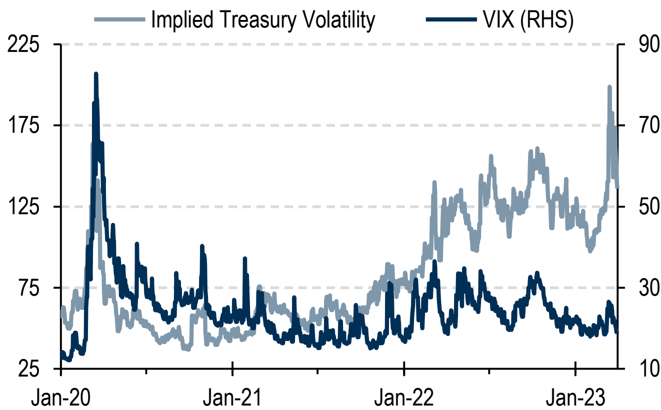
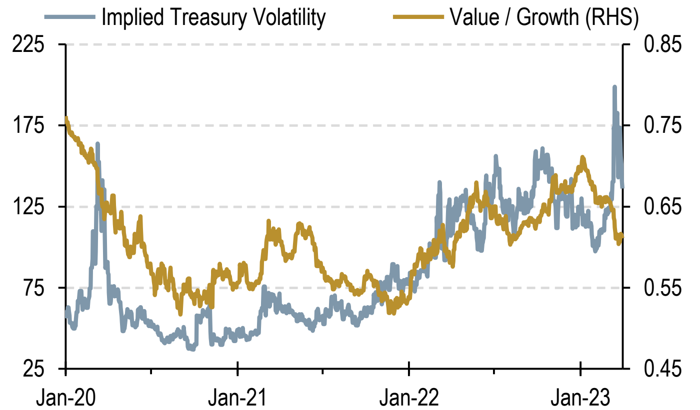
[1] Source: Bloomberg, Callodine Capital Research Team.
Methodology: Russell Growth Index (RLV) minus Russell Value Index (RLV) for periods 12/31/2022 to 3/31/2023 and 3/31/2020 to 6/30/2020.

Fed Tightening Has Driven Treasury Volatility Higher, Which Is Showing Up in Factor Returns





Sources: Bloomberg, Callodine Capital Research Team

Methodology: Data from 1/1/2020 through 3/31/2023 daily. Implied Treasury Volatility is represented by the ICE Bank of America MOVE Index. Value / Growth is the ratio of Russell 1000 Value / Russell 1000 Growth.

As we entered 2023, the consensus view was that a recession was imminent and inevitable. Most investors seemed resigned to an economic downturn, with the hope that a decline in real GDP was likely to stop the Fed from continuing its inconvenient rate push.

With this consensus firmly in place and many investors still smarting from a difficult 2022, markets were poorly positioned for the quick rise in stocks at the start of the year, with the S&P 500 rising 6.3% in January.

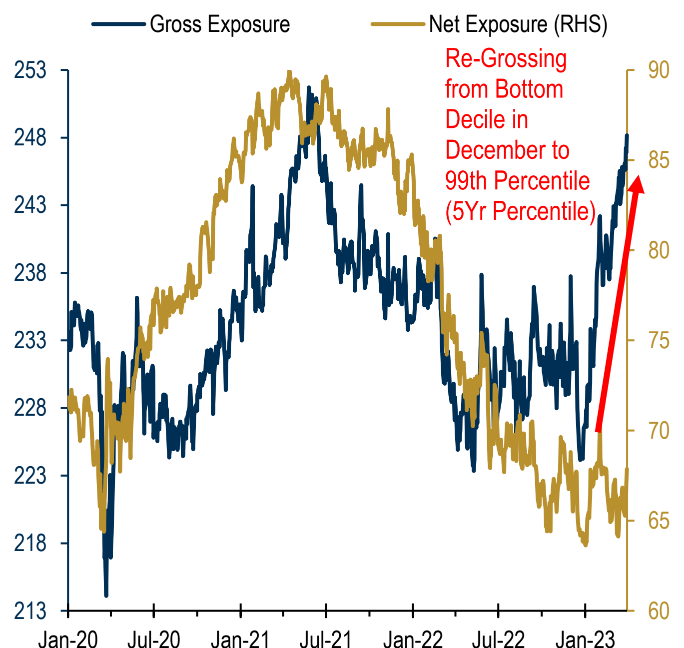
The market view then shifted violently through "hard landing" to "soft landing" to "no landing" over a matter of weeks, kicking off a significant re-grossing event with investors returning to the market from the sidelines, and increasing gross exposures across the board. This re-grossing trade also coincided with Growth stocks regaining market leadership, as if the only strategy the market could imagine owning or buying in an up market was Growth.

The collapse of Silicon Valley Bank (SVB) accelerated the move toward Growth, as all things financial suddenly appeared risky to the market. The result was that both the market and the Growth trade moved toward highs for the year as we exited the quarter, as the market appeared to fear higher rates more than a recession.

To sum it up, the collapse of the 16th-largest bank in the country—one you could argue was among the most systemically important banks to the venture capital world—and the corresponding $1 trillion of deposit flight from the banking system, combined with the likely contraction of credit, all served to rally the NASDAQ. Are you confused yet?

The market appears to agree strongly that lower rates are great for Growth/technology stocks, effectively pricing in a new "growth shock" similar to what we experienced during the 2020-21 COVID response–driven economy.

We couldn't disagree more with this view.



Sources: Goldman Sachs Prime Brokerage. All Client Trading Strategy Classifications, All Regions.

Something Finally Breaks (an SVB Postmortem)

There are two basic risks when running a bank:

1) Credit risk—you make a loan and then don't get the money back
2) Duration risk—changes in interest rates might increase or decrease the value of loans you've made or the cost of deposits you use to fund yourself

With interest rates declining for the better part of 40 years, this second risk seems to have gotten lost in the equation for certain banks, and, not coincidentally in our view, those that specifically served the technology/venture capital (VC) worlds, where respect for the cost of capital or a belief that rates could ever rise seems to have been nearly lost entirely. With the recent bout of rate volatility (shown on the previous page), something was bound to go wrong, and something most certainly did.

In Ernest Hemingway's 1926 novel The Sun Also Rises, a clever line describes bankruptcy as something that typically happens "gradually and then suddenly." The same can be said of SVB's demise, which was the result of years of ballooning deposits supplied by excess liquidity finding its way onto VC balance sheets, a six-month rise in rates, and a corresponding decline in Treasuries. Add in instant feedback via Twitter and a market that seldom looks past top-line growth within quarterly reports, and you've engineered the perfect recipe for a 24-hour bank run.

The speed at which the collapse unfolded was astonishing, and the market's reaction to this event could be described as twofold.

1) The first instinct was to run from regional banks to avoid potential contagion, which made some sense, particularly to anyone who felt the pain of the Great Financial Crisis.
2) The second significant move in the market, which was to hide in technology stocks, was completely irrational to us.

SVB (as well as First Republic) was widely regarded as one of the most borrower-friendly (read: credit-agnostic) lenders to the entire VC/technology ecosystem and its principals over the last decade. In our view, the bank's implosion leaves a gaping hole in the capital markets that fund early-stage, unprofitable growth companies. SVB provided the senior debt that leveraged VC dollars and enabled non-dilutive financing to companies that many traditional banks wouldn't touch. So, for investors to flee financials only to look for safety in tech feels to us a bit like the GEICO commercial where the scared teenagers try to escape the psychopath by hiding behind a wall of chainsaws.

We view the collapse of SVB as a punctuation mark on a trend we've discussed at length with our investors—that the velocity of capital within the technology ecosystem will slow down as excess liquidity drains from the system. This is true across the entire economy, and we believe it will be particularly true with the technology/VC sector moving forward. Why? Because that is where the excess occurred.

Follow the Excess

To determine the potential market vulnerability, we suggest simply following the excess of the preceding bull market. Based on this framework, we would contend that the cycle we are about to enter is far more likely to resemble those of 1990-92 and 2000-03, than either the recent Great Financial Crisis or the COVID cycle, which were typified by moderate slowdowns as liquidity drained from the system, as opposed to rapid, crisis-driven de-leveraging.

So, where was the investment excess in the current cycle?

- Cryptocurrencies: This is an obvious area, but the unwind is already well underway.
- Venture-backed firms: Liquidity, in addition to new entrants, drove valuations and investment ever higher.
- Commercial real estate: Liquidity and low rates have pushed cap rates lower and exit multiples higher.

Venture has enjoyed a period of nearly unparalleled prosperity and access to capital. Returns have been fantastic looking back, which has elicited an enormous allocation of capital to every great new idea. Much like the housing cycle of 2006-07, the telecom cycle of 1999-2001, and many previous cycles, the options you write in the up cycle may come back to surprise you on the downside when the cycle turns. The dry powder that VC firms still have, combined with the unfunded commitments LPs will eventually need to fund, now stand as required capital to fill the breach, likely at poor returns in our view.

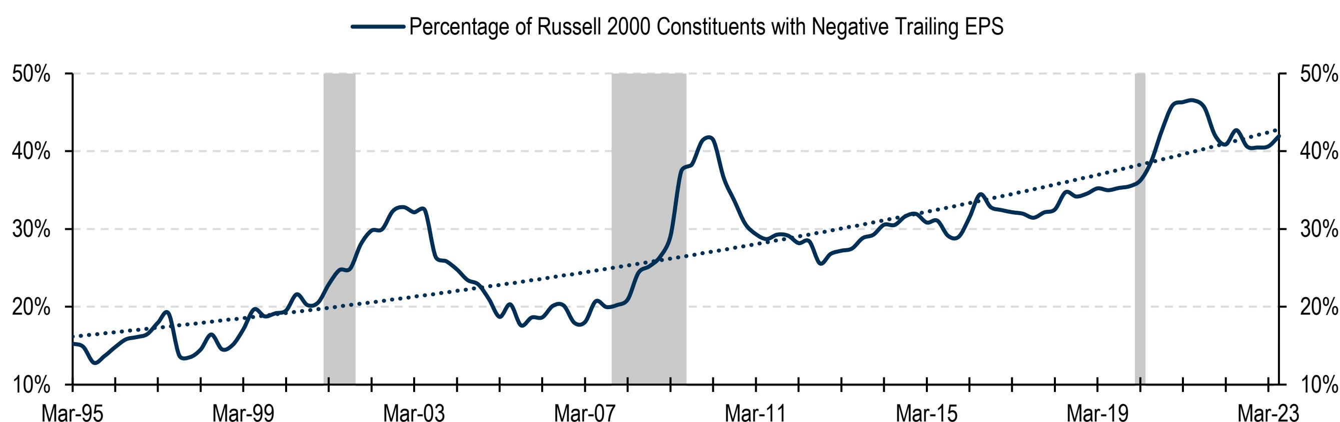
As the quantity and size of venture-backed companies increased and they stayed private longer, the amount of capital required to fuel their cash burn grew dramatically, outpacing the traditional VC system's ability to fund it. If only there were a pocket of well-funded, growth-oriented investors who would willingly outsource deal diligence, but still write big checks to underwrite ever-higher valuations.

Enter the public market players.[2] These firms dwarfed the size of traditional VC players, lacked their experience in allocating start-up capital, and had been richly rewarded for ignoring valuation for the preceding 5-10 years in public markets. They were the perfect fuel to add to this fire.

Why was there a surge of investment into the VC landscape by large mutual fund complexes and hedge fund managers? We believe there were two key drivers:

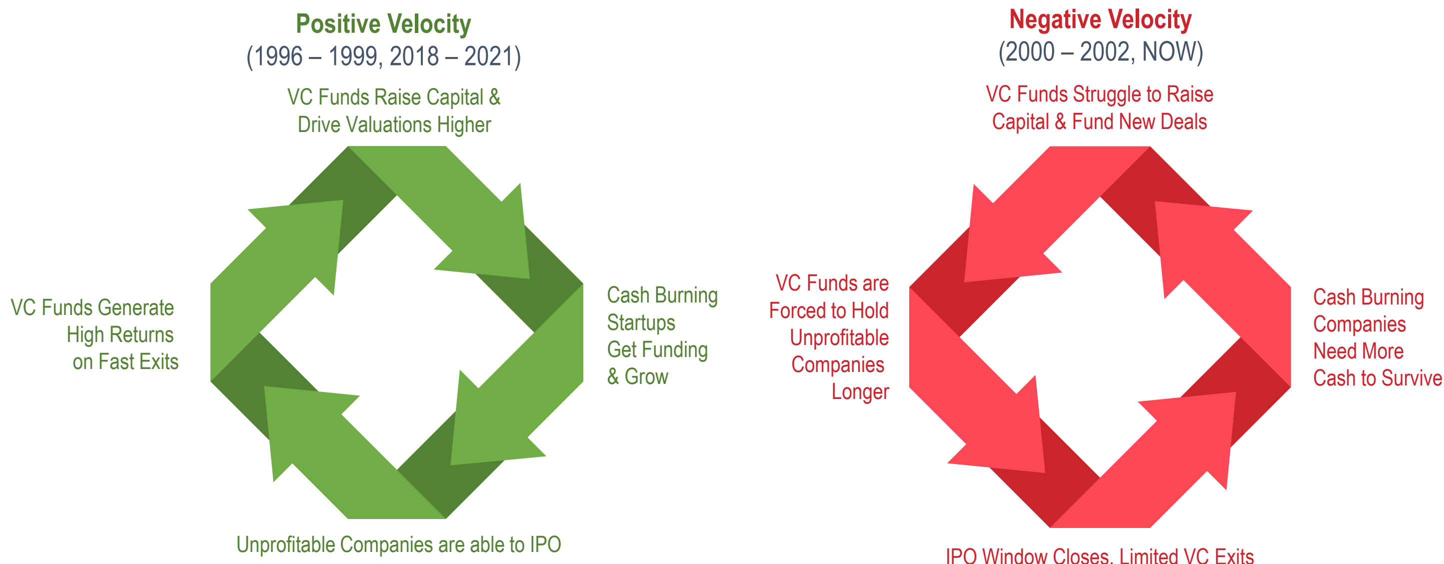
1) Trailing VC returns were strong, as public markets had increasingly accepted money-losing businesses (see chart below).
2) This type of investment became relatively easy to access through venture firm–led co-investment programs.

The boom in SPACs during 2021 only served to further illustrate the first point that public markets were increasingly accepting of unprofitable ventures, which ultimately led to the least-profitable small-cap universe on record. These exits fueled VC returns during the past decade, and they are coming to a screeching halt.



[2] https://www.economist.com/finance-and-economics/2021/11/23/the-bright-new-age-of-venture-capital/21806438

Velocity Cycle of Excess Liquidity in Venture Capital



Sources: PitchBook, Callodine Capital Research Team. "Now" represents cycle from 2022 through March 31, 2023

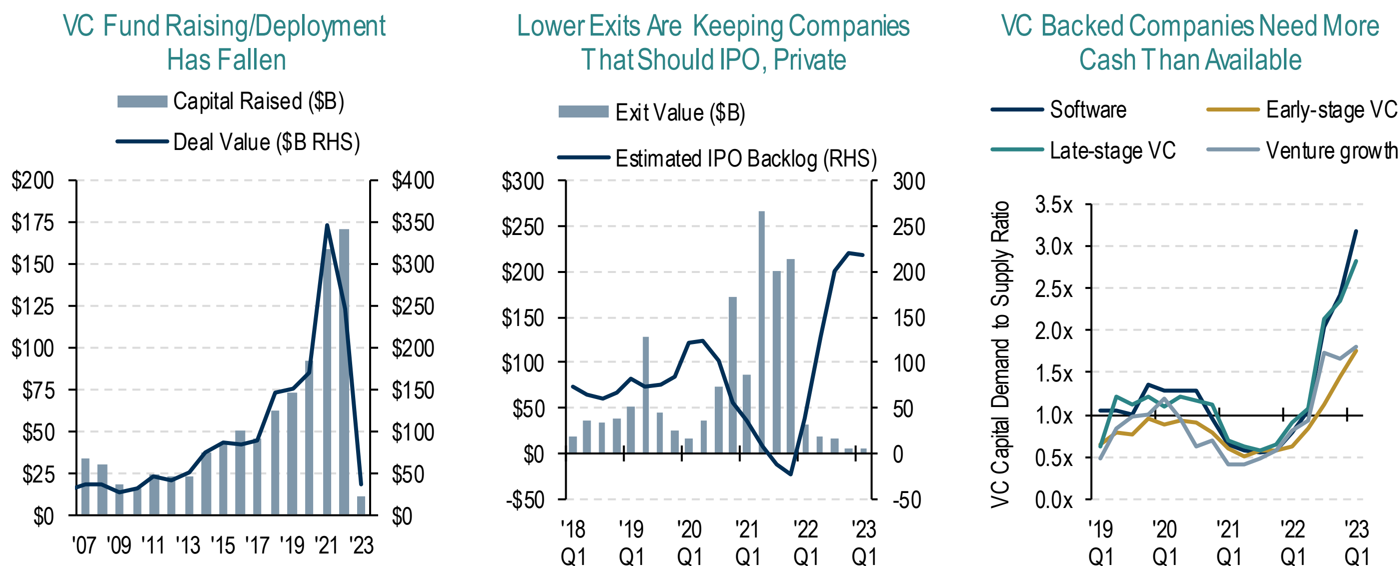
We firmly believe that we have migrated into a negative feedback loop within "high-growth" industries, where lack of capital and a dearth of successful exits will cause the entire system to grind to a halt. Now that capital comes with a cost, we believe companies that can create their own liquidity through free-cash-flow generation will become the new "winners."

Capital raising and deal activity have both fallen off a cliff, while the IPO backlog continues to balloon and VC-backed companies across the board are requiring more cash than is currently available to them. This confluence of events is like removing oxygen from the room for cash-burning companies across the VC landscape.

As illustrated in the charts below, the last several years have been the quintessential example of a virtuous cycle within the VC ecosystem. Low interest rates and an abundance of capital available to start-ups and other unprofitable businesses created a positive feedback loop where success begot greater success. Lubricated by ample liquidity, there was no friction in the system. Unfortunately, all good things come to an end, and the unwinding of the built-up excess can be painful and, perhaps more importantly, incredibly long in duration.

As Value investors, we saw how that story played out in the energy sector in 2015. Overzealous executives with aspirational growth objectives spent their way to oversupply, and it has taken years to correct the resulting imbalance. We foresee a similar issue in tech, with companies that can rein in capital expenditure doing so quite rapidly, and companies that don't have the luxury of pressing pause simply running out of money.

Lower VC Fund Raising & Exits Have Lowered Deals, While Demand For Capital Is Outpacing Supply



Sources: PitchBook as of 3/31/2023

Cash Is King (Except in Memphis)

To summarize our current view of the near-term direction of the market, we believe that:

- Liquidity will become increasingly scarce.
- Both debt and equity capital will have higher costs moving forward.
- Capital-intensive industries will have to produce cash-on-cash returns or change their models.

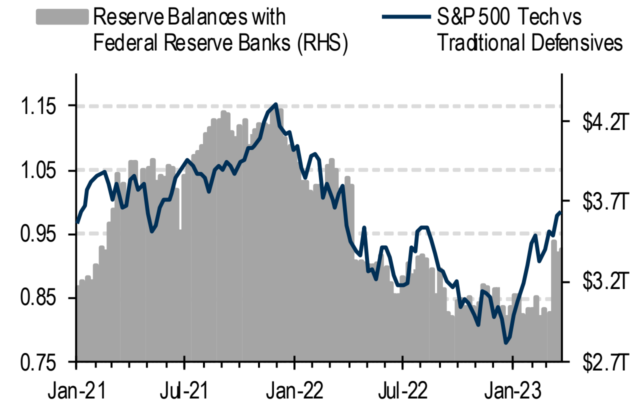
We can think of no clearer signal that faith in banks is wavering than the fact that uninsured deposits have effectively become a toxic asset for banks. This is unprecedented in the history of the industry, as far as we are aware. The result has been the flow of cash away from smaller and regional banks and toward the largest money-center banks and money market funds.

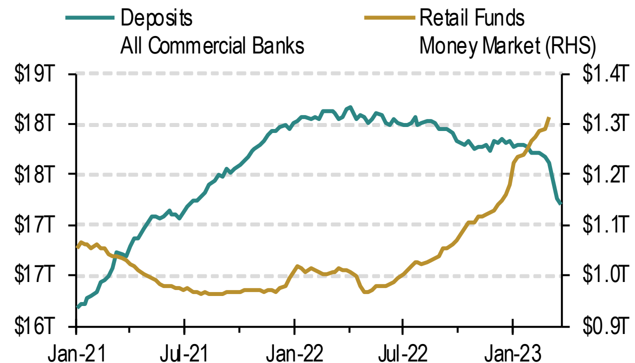
The migration of deposits to large money-center banks is likely to result in increased earnings power at those institutions, as well as a narrower set of financing solutions for borrowers across the country. The flow of dollars into money market funds effectively pulls that capital out of the system and parks it on the sideline in government bonds. Many of our readers may recall this phenomenon from Economics 101 as "crowding out" of private market capital by government borrowing. Those dollars that were previously deposited in banks had a velocity associated with them as they were lent back out into the economy. However, money market funds have no multiplier effect and don't make their way back out into the economy as loans to corporations. Again, this is the opposite dynamic from the COVID-era stimulus that pinballed around the economy and created the current climate of elevated inflation.

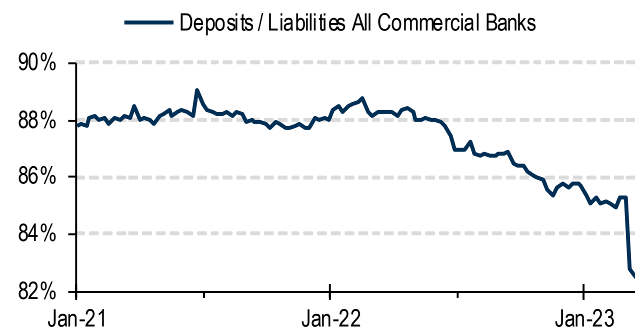
While an increase in the Fed's reserve balances has typically been good for the tech sector (as shown in the top chart to the right), it has usually meant the financial system was flush with cash. Today, those increased balances may be viewed as a sign of fears around both lending risk and deposit flight risk by commercial banks. To illustrate that point, look at the trend of deposits held at commercial banks versus the flow of capital into money market funds. And as deposits leave the system, banks are left with loan portfolios and liabilities that are grossly mismatched and overextended.

The strength in longer-duration Growth and tech stocks in Q1 2023 is more perplexing when you consider that the decline in interest rates since March 2023 is not indicative of more liquidity in the system. In fact, quite the contrary. Exacerbating this issue of liquidity is the fact that the tech sector has always been and is increasingly an enormous consumer of capital. What may have once been viewed as a capital- or asset-light sector has certainly not behaved that way over the course of

Following SVB Collapse Investors Are Using the "Fed Balance Sheet Expansion" Playbook But the Increase in Reserve Balances is Not From Excess Liquidity







Sources: Bloomberg, Federal Reserve Bank of St. Louis
Methodology: Data from 1/1/2021 through 3/31/2023. S&P 500 Tech vs Traditional Defensives is the S&P Information Technology TR Index vs the cap weighted S&P 500 Consumer Staples, Health Care, and Utilities TR Indexes.

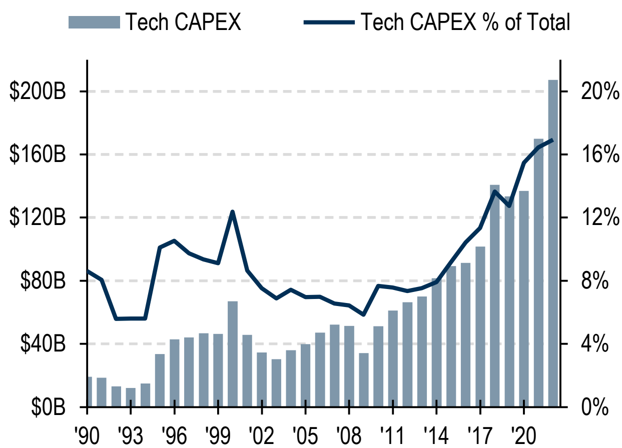
the last decade-plus. As illustrated in the chart below, capital expenditure within the tech sector has exploded from less than $100 billion per annum in 2013 to more than $200 billion in 2022, and the sector is more capital intensive now than the rest of the market.

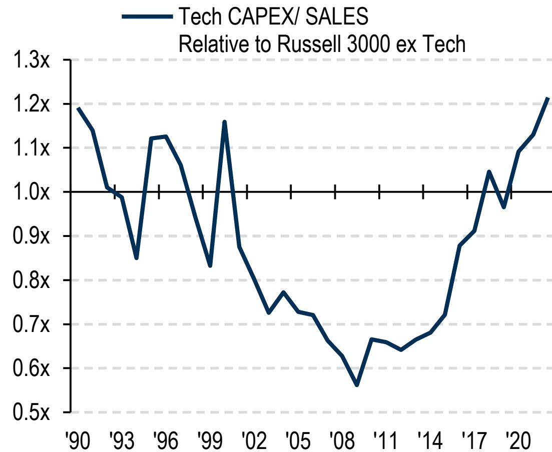
Pundits may say that the mega-cap tech names support this capital expenditure with their ample cash flows, which is partially true, but they themselves have been enormous beneficiaries of the liquidity and spending within the sector. Aggregating their cash flows at the sector level hides the coming problem, namely that a lot of these business models are of dubious success.

In addition, we believe the scarcity of new lending from regional banks is going to have a materially adverse effect on the commercial real estate and non-residential construction markets. Regional banks disproportionately fund those two sectors and now have more exposure relative to their capital bases than before, as many continue to lose deposits to the money center banks. Any economic slowdown will hit those markets, combining to create a gale-force headwind for those real estate–related sectors.

Fear is the ultimate drain on liquidity. When trust in the system begins to falter, the velocity of capital slows dramatically. If banks continue to pull back and rein in lending, the cost of capital for borrowers could increase, even as rates decline. We believe this environment would have a disproportionate and potentially devastating impact on businesses that rely on the capital markets to fund their ongoing operations.

Tech Sector Has Become More Capital Intensive Relative to the Rest of the Market





Sources: Bloomberg, Callodine Capital Research Team

Methodology: Data from 3/31/1990 through 3/31/2023 annually. Trailing Capital Expenditure of Companies in the Russell 3000 Index. "Tech" are companies with Bloomberg Industry Classification System (BICS) sector classification of "Technology" or industry classification of "Internet Media and Services."

Irreconcilable Market Views

The law of non-contradiction states that antithetical propositions cannot be true at the same time. We cannot be on the verge of another banking crisis that could plunge the economy into a recession, while GDP-reliant industries like technology are poised for continued unabated growth. Those two conditions cannot be simultaneously true in our minds. Yet the equity market appears to disagree, based on how it is now positioned after recent events.

The Fed's establishment of the BTFP elicited a conditioned response from the market, not a rational one. The ringing of the liquidity bell triggered a learned behavior that has served investors well over the last decade. When the Fed delivers accommodative policies and programs to the market, tech investors get to eat.

At Callodine, we have a hard time believing that the same playbook is going to work this time, given the economic realities facing the market and, more importantly, starting valuations. It is unclear what the full ramifications of SVB's collapse will be. We are confident, however, that it will not result in a lower cost of capital for unprofitable tech. We believe it is more likely that risk tolerance across the banking system will recede and credit availability will become more dear. In that environment, we favor cash-flowing enterprises that can finance themselves via free-cash-flow generation and defensive businesses that have not yet enjoyed any multiple expansion.

But maybe that's just a conditioned response based on decades of investing.

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