CALLODINE | CAPITAL

“Maybe the Market Just Got Bored Waiting”

Quarterly Market Commentary: Q2 2023

James Morrow
CEO &
Portfolio Manager

Tyler Bak
Head of Business
Development

Taylor Wood
Quantitative
Analyst

Ryan Palazzetti
Business
Development
Associate

Market Commentary

Heading into 2023, the standard prognosticator's road map was as follows:

1. Without a doubt, we're heading into a recession in 2023.
2. Earnings estimates are going to decline.
3. The Federal Reserve rate hike cycle will end in 2023, with easing to commence quickly.
4. Sell stocks and wait for the all-clear signal.

These assumptions led many market participants to position themselves for what they viewed as an inevitable recession (as we wrote in our Q4 2022 letter, "Market Lessons on Pattern Recognition and Mean Reversion"). Investors reduced gross exposures, started to get defensive, and waited for the Fed to signal that the coast was clear to resume speculation—and they were eager to put the shocking (to some) market action of 2022 behind them.

How prescient has that consensus call turned out to be at the halfway point in 2023? Well, it's essentially been wrong on nearly every count:

Prediction	Accuracy	Commentary
Recession	✕	Although a recession may still be coming, we are definitively not in one yet, and in fact both GDP growth and employment strength have surprised on the upside.
Earnings Decline	½ Right	While 2023 earnings-per-share estimates are down, the rolling 12-month forward EPS estimate for the S&P 500 has started to rise after nine months of declines (June 2022 to March 2023).
End of Rate Cycle	✕	The Fed rate hike shows no signs of abatement, despite the market's pleadings as indicated by the forward curve, and currently we are still talking about additional increases, not decreases, in rates.
Sell Stocks	✕	The S&P 500 was up 16.9% through the first half of the year but achieved this return with the narrowest market breadth in history (more on this below).

Sources: Bloomberg, Callodine Capital Reseach Team

The reality is that excess liquidity still abounds, which is why we believe inflation has not subsided as quickly as most market participants hoped. It is also the reason why the Fed easing cycle keeps getting pushed out, and why the risk of an ultimate policy mistake by the Fed is rising, not falling, in our opinion.

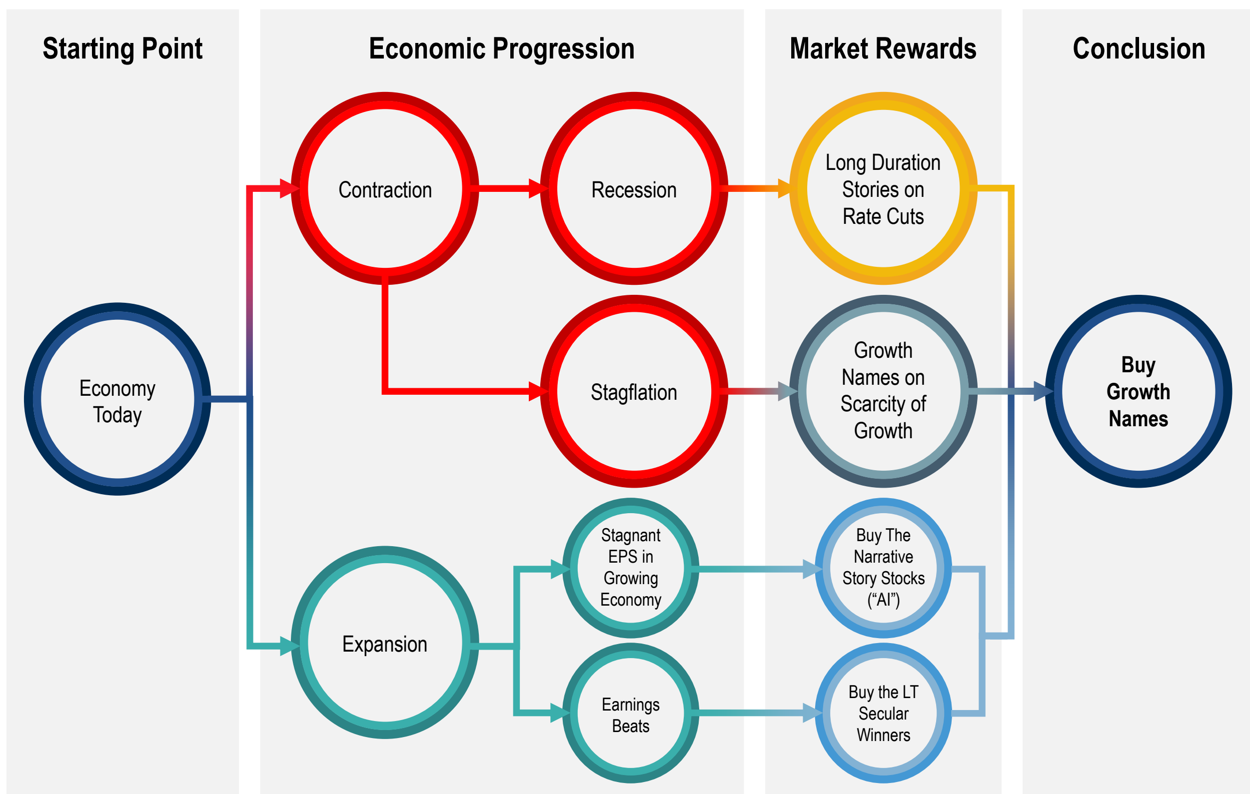
We are sympathetic to the idea that the fears of 2022 and a potential recession still remain in front of us. However, we also believe the market, fueled by that excess liquidity and the joys of rising markets, simply got bored of waiting for bad news to come.

The Many Paths to the Same Conclusion

Confused about the failure of its narrative at the start of 2023, the market has reverted to its security blanket when wanting to buy stocks, the Growth/tech sector. This time around, the sector rides on the back of the latest "new-new" thing, artificial intelligence, which fortunately can be captured by owning just a handful of already popularly owned tech mega-caps.

Best of all, the new narrative requires few, if any, proof points in the short term, allowing it to be everything to everyone in the moment.

The schematic below summarizes the current deterministic path for many investors—and, in the end, all roads lead to Growth:



Sources: Callodine Capital Research Team. This is not a recommendation to invest in growth names. This is a depiction of how we believe investors are interpreting the current market environment.

It doesn't seem to matter whether the economy is growing or shrinking, earnings are beating or missing, or rates are rising or falling. Among Growth investors, the heart wants what the heart wants.

The result has been the Russell 1000 Growth index has outperformed its Value counterpart by 24 percentage points thus far in 2023, which has largely unwound the outperformance of Value in 2022. As our friends at Bank of America note, the outperformance represents a 98th percentile six-month performance result for Growth over Value.[1]

Growth investors everywhere can rejoice, as the Value rally of 2022 has ended after just 12 months. This has essentially reset the market to the 2022 starting condition, namely 10+ years of uninterrupted dominance by Growth over Value.

We believe the tone and tenor of today's market feels a bit like the summer of 2020, when the forward march of high-multiple stocks continued to expand the valuation gulf. In fact, it would seem that all a company has to do on an earnings call these days is tap its heels three times and say the magic two letters—A.I.—and stocks outperform accordingly. Looking at the chart on the next page, we can see that the 232 companies in the S&P 500 that mentioned A.I. on their earnings calls (yes, an astounding 232 companies played the A.I. card in Q1 2023) outperformed those that didn't by a significant margin. This suggests that the market is once again singularly focused on the narrative over the numbers.

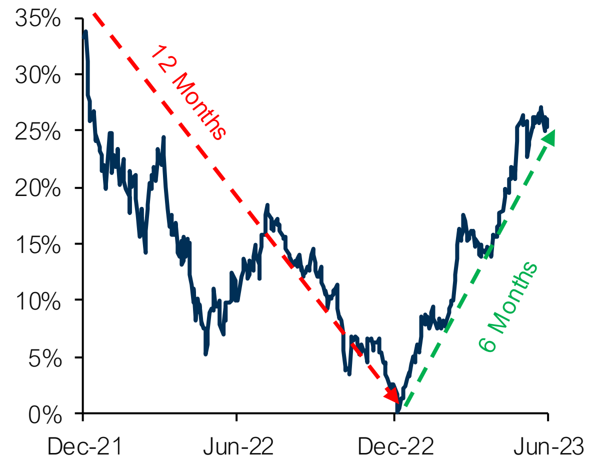
Despite our incredulity at where certain tech stocks are trading based on their fundamentals, advances in technology are wonderful for society, and we are not disputing

Growth vs Value Has Made Back Nearly All of Last Year's Loss

Russell 1000 Growth Total Return Index / Russell 1000 Value Total Return Index

Growth / Value - Last 10 Years Indexed to June 2013
6/30/2013 - 6/30/2023 Monthly

Growth / Value - Last 18 Months Indexed to 1/5/2023
12/31/2021 - 6/30/2023 Daily



Sources: FactSet, Callodine Capital Research Team

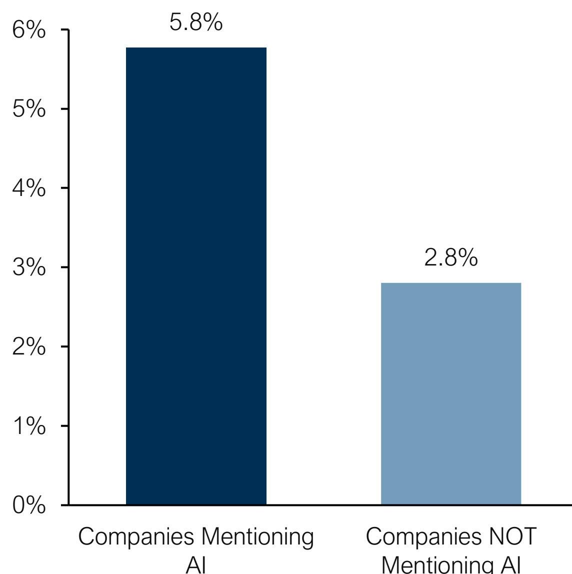
1 Source: Bank of America research, "Everyone was bearish, everything rallied," dated July 3, 2023.

that A.I. could present a productivity boon to the broader economy. The point we are trying to make is that simply *saying* A.I., isn't going change the forward-earnings power and margin profile of your company in perpetuity. Capitalizing a clear hype cycle into valuations is therefore a very dangerous game. People thought the internet would be an amazing step forward back in the late 1990s. They were right, but It turned out that it was just as effective a tool for car rental companies, industrial manufacturers and people that deliver pizza, as it was for the "Pets.com" type of early hyped names. It also turned out to be very bad for many business models and many perceived early winners (Remember Sun Microsystems anyone?) Life can come at you fast.

If we sound cynical, it's because we are. The rally of 2023 has occurred in an incredibly narrow segment of the market. The same segment where investors that entered the market post GFC have been trained that when the market goes up, you want to be (hint: Big Growth Names). The issue is that there are fewer and fewer places to hide from the realities of the real economy. That, in our view, puts the market on very tenuous footing.

Companies that Reference AI in Q1 Earnings Season Outperform

Equal-Weighted Portfolio Total Return During Q1 Earnings Season by if Companies Mentioning AI



Sources: FactSet, Callodine Capital Research Team
Methodology: Total Return from 4/17/2023 through 6/30/2023. Companies grouped by if "Artificial Intelligence" , "AI", or "A.I." is mentioned in Call Street Transcripts from 4/17/2023 through 6/30/2023. Portfolio is equal weighted

Google Trends - Web Searches for "AI"

7/29/2018 through 7/16/2023

Sources: Google

For most market participants, the lack of broader participation in this year's rally is no surprise. Market breadth has been pathetic in 2023, with a handful of large-cap, bellwether technology companies performing the yeoman's work of pulling up the broader indices. Morgan Stanley noted recently that the first half of 2023 marked the narrowest first-half breadth in history, with just 25% of stocks outperforming the S&P 500.[2]

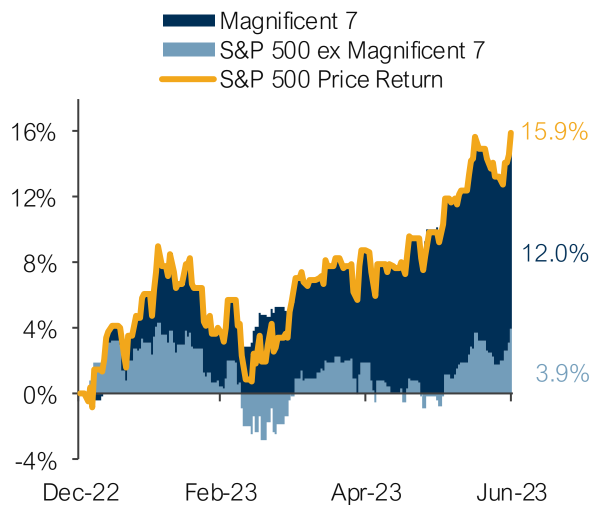
None Shall Pass… (Except the "Seven")

If we drill down further into which stocks have contributed to the S&P's year-to-date performance, we can give most of the credit to the "Magnificent 7," which are providing the vast majority of market-cap creation in 2023.

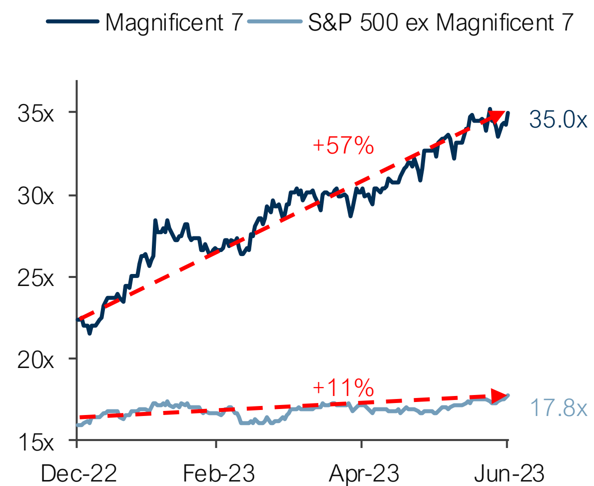
Given the ever-present A.I.-boom narrative playing out on CNBC every day, it may be a surprise that, in the aggregate, this group has seen no increase in expected 2023 net income this year as depicted in the table on the next page, despite a heroic effort by Nvidia. It turns out the whole upswing in the market has been built on higher multiples, not earnings.

Magnificent 7 Has Made Up Most of S&P 500 Gain on Multiple Expansion
2023 P/E Multiple of Magnificent 7 Now Nearly 2x Rest of S&P 500

Year to Date Contribution to S&P 500 Price Return



2023 P/E Ratio Year to Date



Sources: Bloomberg, Callodine Capital Research Team. Year to Date from 12/31/2022 through 6/30/2023

[2] Source: Morgan Stanley Weekly Warm-up: Do Earnings Matter? July 10, 2023

Magnificent 7 YTD Return is Driven by 60% Increase in Multiple

Magnificent 7 YTD Changes in Price, Market Cap, Estimates, and P/E Ratio

Ticker	Market Cap ($B)			2023 Net Income Estimate ($M)			2023 P/E Ratio		
	Dec-31	Jun-30	YTD Δ	Dec-31	Jun-30	YTD Δ	Dec-31	Jun-30	YTD Δ
AAPL	$2,067	$3,051	48%	$99,396	$95,103	-4%	20.8x	32.1x	54%
MSFT	$1,788	$2,532	42%	$76,391	$74,987	-2%	23.4x	33.8x	44%
GOOGL	$1,067	$1,422	33%	$75,817	$75,523	0%	14.1x	18.8x	34%
META	$271	$635	134%	$23,231	$31,867	37%	11.7x	19.9x	71%
NVDA	$360	$1,045	191%	$10,303	$17,499	70%	34.9x	59.7x	71%
TSLA	$389	$830	113%	$18,403	$11,603	-37%	21.1x	71.5x	238%
AMZN	$857	$1,338	56%	$31,524	$27,184	-14%	27.2x	49.2x	81%
Magnificent 7	**$6,799**	**$10,852**	**59.6%**	**$335,066**	**$333,766**	**-0.4%**	**20.3x**	**32.5x**	**60%**

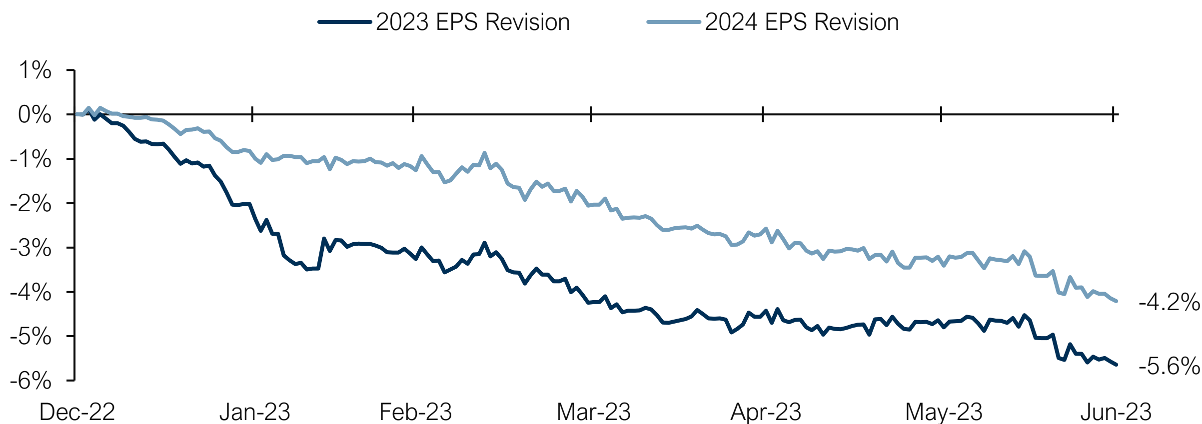
Sources: Bloomberg, Callodine Capital Research Team. Year to Date (YTD) is from 12/31/2022 through 6/30/2023.

But what about earnings revisions more broadly? Surely projected EPS must be on the rise, given the market's newfound footing and seemingly sanguine attitude regarding the consensus recession that everyone saw coming six months ago, yet seems to have forgotten. Not the case, with the "S&P 493" EPS revisions grinding lower during the year thus far.

With recent returns driven almost entirely by multiple expansion, it appears that fundamentals have taken a back seat once again to investor sentiment and a reinvigorated sense of FOMO. Real interest rates still high? Doesn't impact the TAM analysis. Consensus recession just over the horizon? No worries, A.I. to the rescue!

S&P 500 ex Magnificent 7 YTD EPS Revision

2023 & 2024 EPS Revision from 12/31/2022 through 6/30/2023



Sources: Bloomberg, Callodine Capital Research Team

Negative Earnings Yield

To pull back from the Magnificent 7 and drill a bit deeper into the euphoria of today's equity valuations, we need look no further than the earnings yield and implied risk premium of the Russell 3000 Growth Index. We've talked at length about how we didn't think valuations for high-flier Growth names were sustainable and that earnings yields have been insufficient to compensate investors for the risks they are taking in a wide swath of the Growth market, such as in the tech and consumer discretionary sectors. When paired with dramatically higher interest rates, these valuations make even less sense. Looking at the exhibit below, we can see how real earnings yields for Growth stocks have effectively decoupled from interest rates and are now simply ignoring the higher cost of capital facing today's economy.

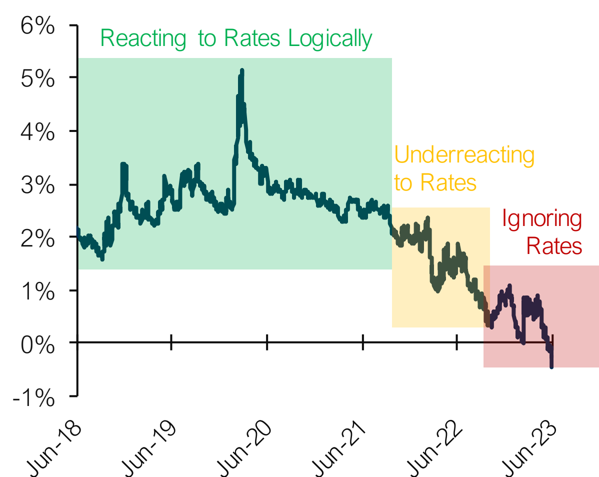
If fear of higher rates was the reason for 2022's selloff in those names, it seems oddly convenient that the pesky discount-rate math is now seemingly being ignored. Perhaps A.I. has solved that conundrum as well, and one of those clever "large language models" has the new discount-rate math hidden in it.

When was the last time that we saw negative real earnings yields for the Russell 3000? You guessed it, the early 2000s, as shown in the below exhibit. Once again, it would seem the equity and bond markets are at odds with one another on the future of the economy. We will see who is right.

Russell 3000 Growth Implied Equity Risk Premium

Russell 3000 Growth Index Fwd. Earnings Yield - 5 Year Treasury Yield

Implied Equity Risk Premium - Last 5 Years
6/30/2023 - 6/30/2023 Daily



Implied Equity Risk Premium - Last 25 Years
6/30/1998 - 6/30/2023 Daily

Sources: Bloomberg, Callodine Capital Research Team

Fear of Missing Out vs. Fear of Losing Money

For students of prior cycles, this type of rally is not atypical inside of a broader bear-market drawdown. It's the type of soothing market action that can dupe some market watchers into waving the "all clear" flag, when in reality the same economic conditions that precipitated the market's decline in 2022 are still prevalent and, in some instances, worse. From our perspective, the recent rally in Growth stocks is simply a siren song beckoning investors back to the names they know and love. Despite the recency of the 2022 experience, the fear of losing money seems lost on many investors.

In the table below, we've mapped prior bear markets dating back to the Great Depression to examine the price action and reversals that occur during extended drawdowns. Out of the 12 bear markets we examined, eight had 10%+ rallies within them, including seven of the last eight (and the only drawdown that didn't was precipitated by the onset of the COVID pandemic and lasted all of one month). We watched this same phenomenon occur at the beginning of 2000 and again during the Great Financial Crisis. The market tends to draw investors back in with relief rallies before taking another, often steeper, step down.

There is a common tale that if you put a frog in boiling water, it will immediately jump out. But if you put that same frog in lukewarm water and raise the temperature slowly, the frog won't realize it's being cooked alive. That's what the current market feels like to us—a steady increase in prices and expansion of multiples in the face of higher rates that is effectively telling investors, "Come on in, the water is fine."

But just as with the sirens of *The Odyssey*, there is danger in the water, and the siren song of FOMO is one we will continue to do our best to avoid.

Bear Market Rallies

Bear Market					Bear Market Rally							
Start	End	Length	Drawdown	Gain to Undo	#1	#2	#3	#4	#5	#6	#7	#8
Sep 16 '29	Jun 01 '32	989	-86%	624%	18%	47%	11%	26%	26%	31%	18%	20%
Aug 02 '56	Oct 22 '57	446	-22%	28%	16%							
Dec 12 '61	Jun 26 '62	196	-28%	39%								
Feb 09 '66	Oct 07 '66	240	-22%	28%								
Nov 29 '68	May 26 '70	543	-36%	56%								
Jan 11 '73	Oct 03 '74	630	-48%	93%	11%	10%						
Nov 28 '80	Aug 12 '82	622	-27%	37%	12%	11%						
Aug 25 '87	Dec 04 '87	101	-34%	50%	15%							
Mar 24 '00	Oct 09 '02	929	-49%	97%	12%	19%	21%	21%				
Oct 09 '07	Mar 09 '09	517	-57%	131%	12%	12%	18%	24%				
Feb 19 '20	Mar 23 '20	33	-34%	51%								
Jan 03 '22	Oct 12 '22	282	-25%	34%	11%	17%						

Source: Bloomberg, Callodine Quantitative Research

Methodology: Bear Market is any drawdown of 20% or more. Bear Market Rally is Gain of 10% or More during Bear Market

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