CALLODINE | CAPITAL

“From March Madness to April Confusion”

Quarterly Market Commentary: Q1 2025

James Morrow
Founder & Chief Investment Officer

Tyler Bak
Head of Business Development

Ryan Palazzetti
VP of Business Development

Taylor Wood
Quantitative Researcher

Market Commentary

On February 19, 2025, the S&P 500 closed at an all-time high of 6114, trading at just under 22.3x consensus forward earnings, a level that represents the 99th percentile of the last 20 years.[1] To suggest that investors were feeling optimistic might be an understatement, as we discussed in our Q4 2024 letter ("Crosscurrents and an Undertow") highlighting the skepticism-free nature of the market entering 2025.

What followed was a rapid -13.8% correction as of this writing.[2] So, what went wrong so quickly?

The first straw hit the proverbial camel's back a few weeks earlier, with DeepSeek's announcement that it had achieved A.I. performance that potentially rivaled other leading systems using just a fraction of the budgets spent by the Mighty Magnificent Seven. This news called into question nearly every aspect of the bullish A.I. theme that had lifted the market higher for much of the previous 12 months. While the announcement caused this critical cohort of tech stocks to peak in late January, the broader market continued unbowed by the suddenly stumbling lead horses, for a moment anyway.

Next came a blistering series of tariff announcements about on-again/off-again levies at rapidly evolving levels against the three largest trading partners of the U.S.—China, Canada, and Mexico.[3] Then, the "Liberation Day" announcement on April 2 kicked off the third-largest volatility event of the past 30 years, surpassed only by the Great Financial Crisis (GFC) and the global onset of COVID.

Politics aside, it's hard to ignore the fact that the world's largest economy is trying to change the rules of the game when it comes to global trade. "Liberation Day" and the various policy twists and turns that followed have ushered in a new world order for international commerce. For arguably the first time since the establishment of the International Monetary Fund, the largest economy in the world is trying to alter a system that has been in place since 1975—namely, that the U.S. operates at a persistent and growing trade deficit and the rest of the world funds it by buying U.S. Treasuries. Questioning this core principle has potentially dramatic financial implications.

Intended to correct longstanding imbalances in international trade,[4] the recent tariffs feel like a page out of "The Art of the Deal" as opposed to "The Lexus and the Olive Tree." President Trump's new trade policies have clearly caused the sands to shift beneath the feet of corporations across the globe. Regardless of your views on the tariffs themselves or the uneven roll-out of these new policies, they have undoubtedly introduced new risks into the global economy, as well as to many businesses in the U.S. and abroad. Above all, these policies have brought uncertainty into a market that, at the end of the first quarter of 2025, was priced to perfection.

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1 Source: Bloomberg. Percentile Rank of Blended Forward 12M EPS Estimate from 2/20/2005 through 2/19/2025 daily.

2 Source: Bloomberg. S&P 500 total return from February 19, 2025 through April 17, 2025.

3 *Trump's Trade War Timeline 2.0: An Up-To-Date Guide.* Peterson Institute for International Economics (PIIE). (2025, April 23). https://www.piie.com/blogs/realtime-economics/2025/trumps-trade-war-timeline-20-date-guide.

4 *Fact sheet: President Donald J. Trump Announces "Fair and Reciprocal Plan" on Trade.* The White House. (2025, February 13). https://www.whitehouse.gov/fact-sheets/2025/02/fact-sheet-president-donald-j-trump-announces-fair-and-reciprocal-plan-on-trade/.

Given this highly uncertain and volatile economic backdrop, here's what we observe from a market perspective:

1) The Market Is Overallocated to Equities – Household equity holdings have climbed to record highs in recent months, surpassing 60% as a percentage of financial assets. The last time this ratio was close to this level was in 2000, and we all know what happened next.

U.S. Households' Equity Holdings as a Percentage of Financial Assets

Q4 1945 through Q4 2024 Quarterly

Sources: Bloomberg

2) There Is Very Little Risk Premium Priced Into the U.S Equity Market – The difference between the forward earnings yield on the S&P and the 10-Year Treasury is the lowest it has been since 2002, which tells us that, broadly speaking, equity investors are not being paid sufficiently for the risk they are taking.

S&P 500 Equity Risk Premium

1/31/1990 through 4/18/2025 Daily

Sources: Bloomberg, Callodine Capital Research Team

Methodology: Equity Risk Premium is the 12 Month Forward S&P 500 Earnings Yield - 10 Year Treasury Yield

3) Volatility Is Higher Today Than It Has Been Since COVID – There are various forms of volatility that a market can experience and absorb. Interest-rate volatility and earnings volatility, both of which are now present in today's market, can be observed, quantified, and incorporated into an investment manager's valuation framework and risk management process. Volatility and uncertainty around policy itself, however, is much harder to underwrite.

VIX Index

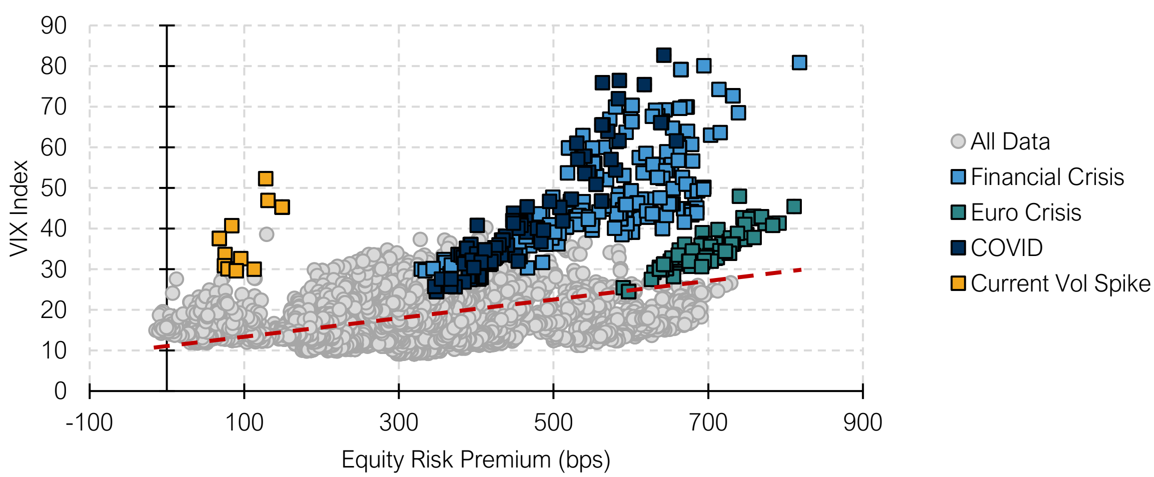
1/1/1990 Through 4/18/2025 Daily

Sources: Bloomberg

The combination of heightened volatility and very minimal equity risk premium is unprecedented over the past 20 years, during which we have seen three previous vol spikes (the GFC, the euro crisis of 2011, and COVID), where the average equity risk premium was +550 basis points compared to less than 100 bps today.

20 Years of Equity Risk Premium vs VIX

S&P 500 Equity Risk Premium and VIX from 4/18/2005 through 4/18/2025 Daily



Sources: Bloomberg, Callodine Capital Research Team

Methodology: Equity Risk Premium is the 12 Month Forward S&P 500 Earnings Yield - 10 Year Treasury Yield. Financial Crisis is from 9/15/2008 through 6/4/2009. Euro Crisis is from 8/4/2011 through 11/29/2011. COVID is from 2/27/2020 through 6/30/2020.

In fact, the orderly and constrained market reaction to the explosion of volatility has been remarkable. The logical conclusion, then, is that one of the following contradictory thoughts must be true:

1) The broad equity market is significantly overvalued relative to bonds for the current set of "unknowns."
2) The equity market doesn't actually believe the tariffs are real or will have any significant impact on earnings.
3) Both the 10-year Treasury yield and the equity market are about to plummet, as tariff fears become realities and a "risk-off" approach rules the day.

Our view is that the market is essentially discounting scenario 2, but none of these scenarios argue for a "risk-on," unhedged approach to equity markets, because it seems like a highly uncomfortable time to start taking broad-based market risk. A focus on hedged/de-risked, attractively valued cash flows is our preferred approach.

From the Macro to the Market

At the risk of being redundant, this recent policy change is a radical shift in America's posture in international trade. As the recent drawdown in the S&P 500 suggests, the change introduces risk to the fundamental story underlying every nation and industry. Management teams across all sectors will need to re-evaluate their sourcing, manufacturing, and distribution strategies, as well as think long and hard about any capital projects they might have been considering.

Despite the recent market correction, the current valuation of the broader index, as well as that of certain "blue chip" stocks, remains at historically elevated levels. At the start of the month the S&P 500 was trading at a 28.6x normalized price/earnings compared to a historical average of 19.4x, as seen in the table on the next page. And that's before downward revisions to estimates have been fully baked into multiples.

S&P 500 Gain/Loss From Here Using Historical Multiples

As of 3/31/2025

S&P 500 March Close: $5611.85	Current Base Estimate	Current Valuation	1957 To Date: Historical Median Valuation	1957 To Date: Implied Median Market Level	1957 To Date: Gain/ Loss from Here	1995 To Date (New Era): Historical Median Valuation	1995 To Date (New Era): Implied Median Market Level	1995 To Date (New Era): Gain/ Loss from Here
Normalized "Adjusted EPS" P/E	$196.05	28.6x	19.4x	$3,811	-32%	21.9x	$4,301	-23%
Non Normalized Operating EPS P/E	$242.84	23.1x	17.1x	$4,155	-26%	18.9x	$4,595	-18%
ROE Based P/E	$160.42	35.0x	18.9x	$3,030	-46%	22.9x	$3,674	-35%
Price to Cash Flow	$352.46	15.9x	10.3x	$3,642	-35%	13.0x	$4,570	-19%
Dividend Yield*	$78.00	1.4x	2.8x	$2,737	-51%	1.8x	$4,386	-22%
Price to Book*	$1,236	4.5x	2.1x	$2,643	-53%	2.9x	$3,564	-36%
Weighted Average				*$3,466*	*-38%*		*$4,223*	*-25%*

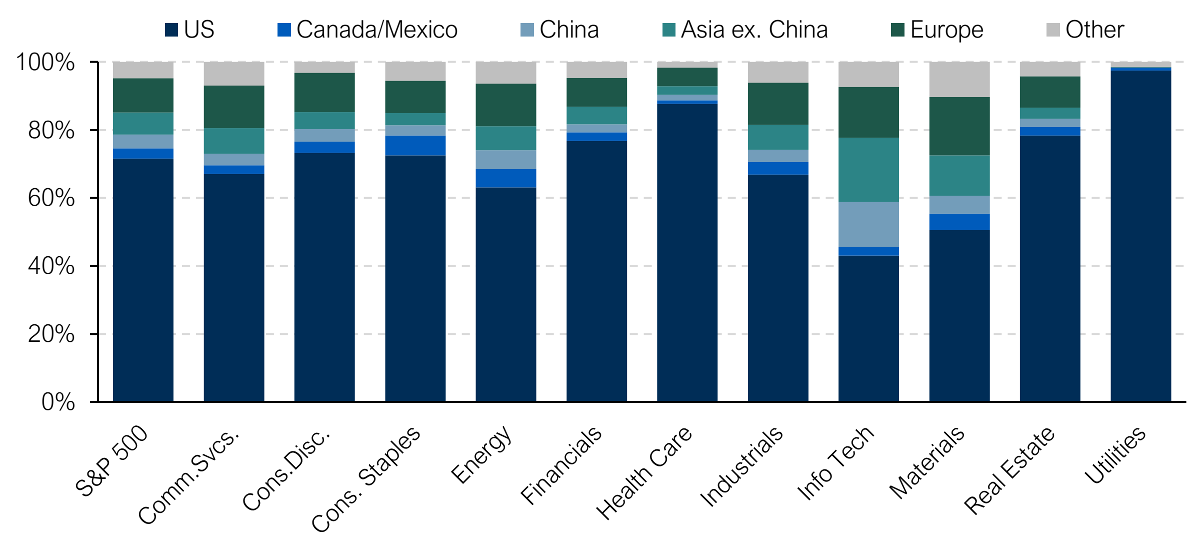
Sources: The Leuthold Group "Perception Express" April 5, 2025

It may surprise you to learn that the sector of the S&P 500 with the most exposure to foreign sales is the one that has experienced the most valuation excess since the onset of the COVID pandemic: technology.

The combination of elevated valuations and significant exposure to foreign sales would have most market watchers believing that technology would be hit the hardest over the past several weeks, but the market has seemingly done very little homework on the fundamental impact of these tariffs on certain business models. In fact, we have seen multinational retail chains and global suppliers of heavy machinery equipment *rally* into this selloff. As markets speculate about the decoupling of the U.S. from trade partners like China, the price of certain stocks has decoupled from the underlying fundamentals.

S&P 500 Trailing Foreign Sales Exposure by Sector

As of 3/31/2025

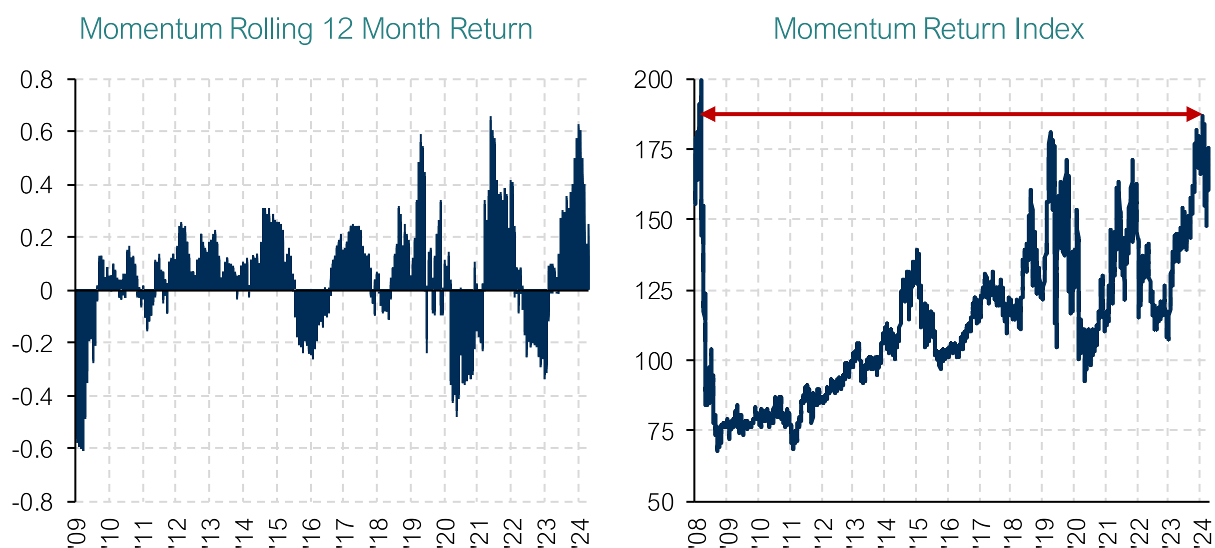


Sources: Bloomberg, FactSet, Callodine Capital Research Team

Investors seem to be having a hard time letting go of the dominant Momentum theme of the post-COVID era. In many ways, the resilience of recent winners should not come as a surprise, given how well they have rewarded investors. Until recently, returns to the Momentum factor had been the highest in three years. As you'll recall, that period was a liquidity-fueled rally off of COVID bottoms, where lower-quality, higher-beta names all soared. In fact, until recently, the Momentum index had reached a 16-year high, having been a winning strategy since the depths of the GFC.

US Momentum Long-Short Rolling Returns & Index Level

12/31/2008 through 4/18/2025 Daily



Sources: Morgan Stanley via Bloomberg, Callodine Capital Research Team
Methodology: MSZZMOMO is a custom index that represents an equal notional pair trade of long The Morgan Stanley US Momentum Long Basket (MSQQUMOL) and Short The Morgan Stanley US Momentum Short Basket (MSQQUMOS). Performance reflects each side rebalanced back to equal notional at the close of each trading day.

At the end of Q1 2025, the runaway train of Momentum finally broke, as you can see in the chart above. If and when volatility turns into capitulation, stocks that benefited from the Momentum factor might very well be buried by it.

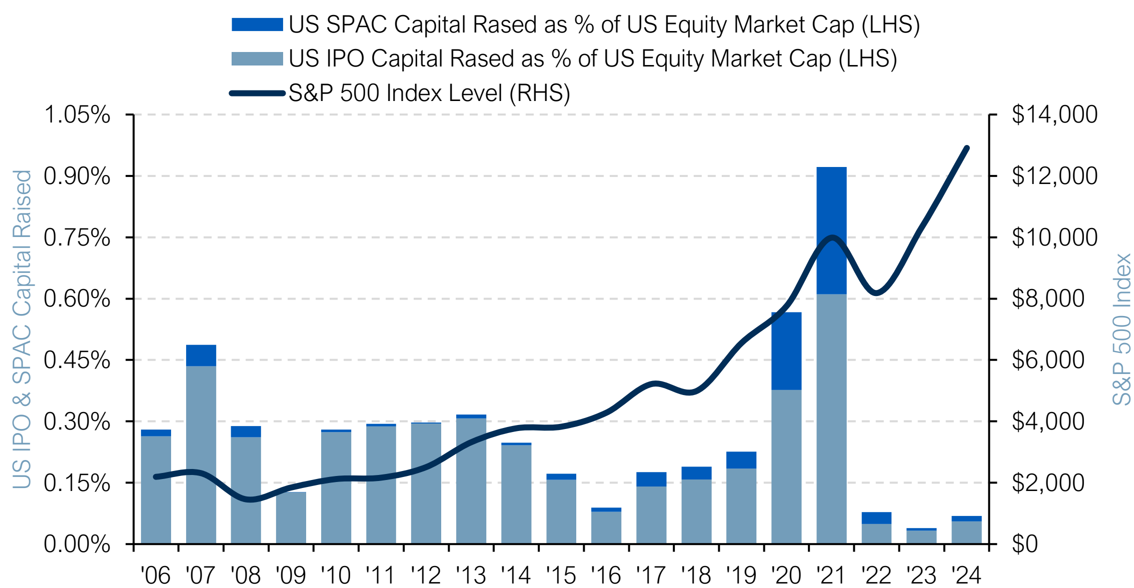
So, we're left with a myriad of cross-currents. In conversations with investors, we have compared recent market action to a game of 52-card pickup, where there is little rhyme or reason behind the movement of certain stocks. In our view, this situation represents an alpha-rich opportunity set.

30,000-Foot View: Is the IPO Market Broken?

Stepping away from tariffs for a moment, we want to address another by-product of the decline in active investing (which we discussed in our Q2 2024 Letter, “Passive Aggressive”) that we’ve observed recently: the IPO coma.

Much to the chagrin of investment bankers and their (prospective) issuer clients, the IPO market has largely been in hibernation for the last three years, despite the S&P having recently come off all-time highs.

US IPO Market by Year



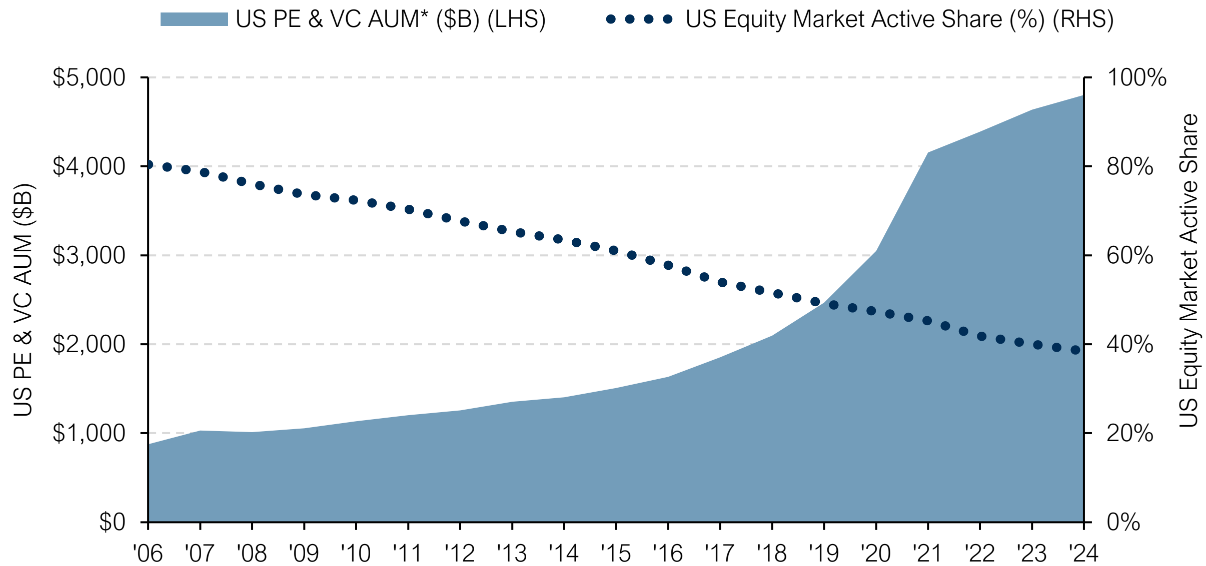
Sources: Bloomberg, Callodine Capital Research Team

With record-high markets and ample liquidity, why haven’t we seen more companies going public? Why are there fewer exits via the IPO market from premier sponsor-backed companies than we’ve seen in past years?

We would argue that this has become a structural issue with today’s market. As private equity has raised greater sums of investable capital over the last decade, it has been able to keep companies private longer. Mega funds, in partnership with large limited-partner co-investors, have allowed big, high-quality companies to stay private longer and for multiples to climb higher.

When these companies finally decide to go public, there are fewer active market participants to help Wall Street banks price and support these IPOs. Consider the first 30 days of trading for CoreWeave (CRWV) or Newsmax (NMAX). Neither price chart screams “rational price discovery.”

US PE & VC AUM & US Equity Market Active Share



Sources: Morningstar, PitchBook's 2024 Annual Global Private Market Fundraising Report, Callodine Capital Research Team
* As of 6/30/2024 and is the latest data available.

While passive flows have driven valuations higher for incumbents, they offer very little for stocks that haven't been public long enough to find their way into an index or trading basket. And, perhaps to state the obvious, passive strategies don't participate in primary capital raises. They need active market participants to set the value for a while before they start blindly buying a stock, as even parasitic business models know some limits.

This is especially true when markets become volatile; investors want and need liquidity to maintain confidence in the system. Historically, active management provided liquidity during times of stress, serving as a buyer when stocks became oversold and a seller when valuations reached levels that were no longer supported by fundamentals. Passive management, however, consumes liquidity by always being on the same side of the trade as everyone else. As such, there are costs to trying to "out-consensus" the consensus.

So far, liquidity has not been an issue, despite the recent tariff-related volatility. Let's hope the secondary trading market doesn't start to exhibit the same lack of liquidity as the primary market.

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