CALLODINE | CAPITAL

“Crosscurrents and an Undertow”

Quarterly Market Commentary: Q4 2024

James Morrow
Founder & Chief Investment Officer

Tyler Bak
Head of Business Development

Ryan Palazzetti
VP of Business Development

Taylor Wood
Quantitative Researcher

Market Commentary

"Comparison is the thief of joy" is often attributed to Theodore Roosevelt, and, as much as we respect the 26th U.S. president and hate to play the role of killjoy, we believe the current market environment does deserve some comparative analysis to understand its similarities to and differences from the past.

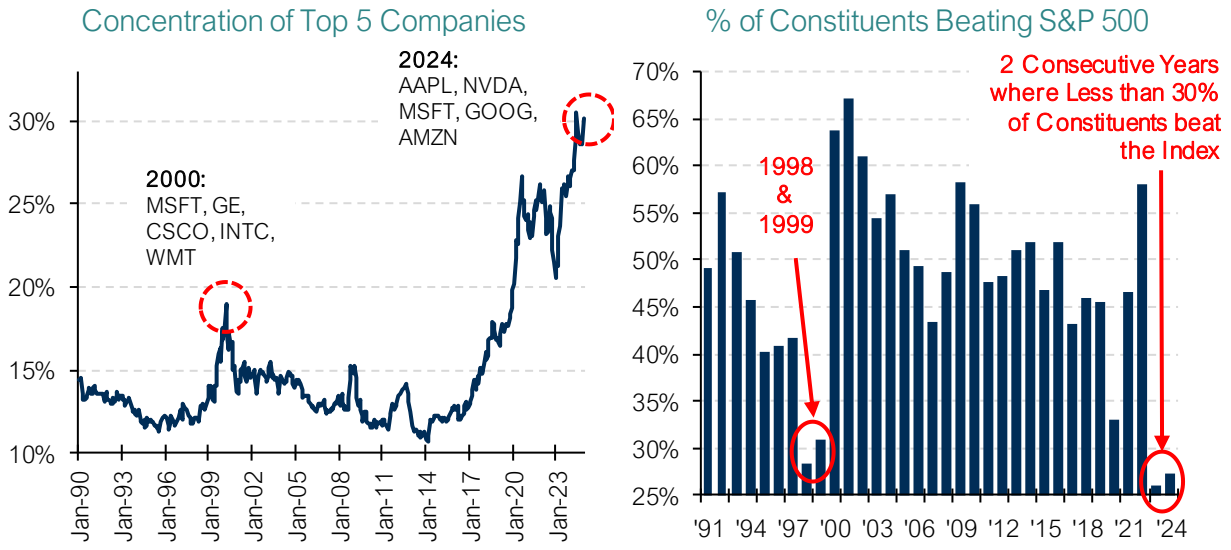
The period from the mid to late 1990s to the 2000 market peak is most often cited as comparable to today's investment environment. How much you believe we might now be similarly positioned within that timeframe depends on your bullishness and devotion to AI, the Magnificent 7 stocks and/or crypto (pick your darling *du jour*), and there are striking similarities in terms of market concentrations, narrowness and valuation levels. (See below, as well as our Q3 2024 letter, "The Lost Art of Skepticism," for additional exhibits on this point.)

Superior pattern processing is the essence of the evolved human brain[1] and our primary differentiator from other mammals. We are exceptionally good at pattern recognition, so it is our natural instinct to want to identify a comparable moment in market history in order to better understand the current one. Unfortunately, this is a grossly oversimplified approach, and it is dangerous to pull out the late '90s playbook or the "Trump 2016" playbook for clues about what might happen next.

In fact, with respect to the stock market and economy of today versus the late '90s, we need to consider several significant contrasts.

Market Concentration and Breadth in the S&P 500 Index

1990 though 2024



Sources: Bloomberg, Callodine Capital Research Team

Methodology: Concentration of Top 5 Companies is the market cap of the largest 5 constituents of the S&P 500 as a percent of market cap of all S&P 500 constituents from Jan 1990 through Dec 2024 monthly. % of Constituents Beating S&P 500 is the percentage of S&P 500 constituents at the beginning of the year that outperformed the S&P 500 total return index over the subsequent year from 1991 through 2024 annually.

1 Source: https://pmc.ncbi.nlm.nih.gov/articles/PMC4141622/.

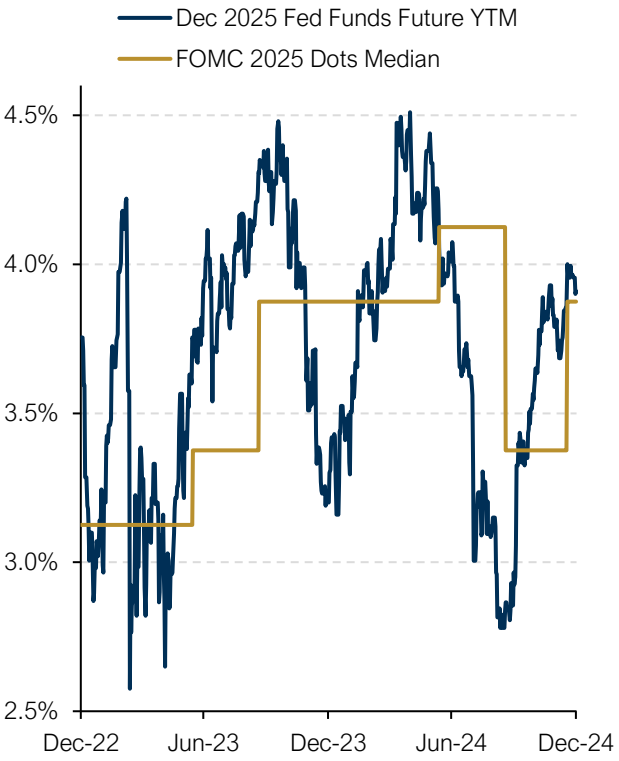
The Monetary and Fiscal Picture: One Foot on the Gas and One on the Brake

Monetary Policy:

From the start of 1995 to mid-1999, the 10-year Treasury fell 200 basis points, lowering prevailing yields from 7.8% to 5.8%, and the spread between the 10-year Treasury and prevailing Consumer Price Index rates was 3.6%. Today, we are in the first period of secularly rising interest rates, and markets have repeatedly been forced to revise their forward rate expectations upward over the past 24 months, as evidenced by the December 2025 futures curve. The culprit has been a persistently strong economy and a much slower reduction in core inflation trends.

As a result, real rates now sit at 10-year highs, and it appears that markets are communicating to the Federal Reserve that it should be more concerned about guarding against the upside than the downside.

2025 Fed Fund Futures and FOMC Median Dot Plot



Sources: Bloomberg, Callodine Capital Research Team

Fiscal Policy:

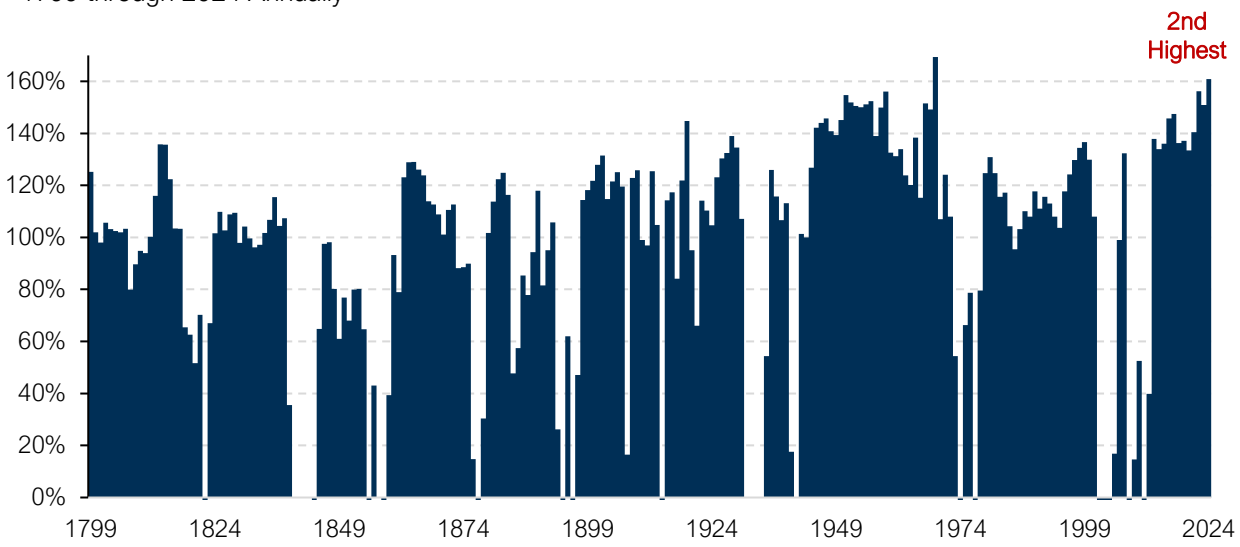
From a purely fiscal standpoint, the mid to late '90s couldn't be more different from the present, as the U.S. economy was growing 6% annually from 1995 to 2000, despite a decline in fiscal support. The U.S. even briefly ran a budget surplus during this era. Despite fiscal discipline, the results were falling bond yields and rising equity valuations, which many market watchers saw as justified, given the enormous and seemingly self-sustaining strength of the U.S. economy.

Today, we witness a far different era and attitude toward spending discipline. In fact, throughout the history of the U.S., we have never applied more fiscal stimulus to the economy over a five-year period than from the onset of COVID until today. We'll go out on a limb and say that there is some chance this stimulus has caused growth to be well above trend over that time period. Yet again, deficit spending has proven to be an effective catalyst for growth, but it's also been shown to be less and less effective when it is continually applied to the economy at this magnitude.

The current market stands in sharp contrast to the prior reference period, as valuations are expanding in the face of rising bond yields. As such, equities have done the heavy lifting for a 60/40 blend portfolio over the past five years, as pessimism about the prospects for lower interest rates has produced the weakest five-year bond returns in more than 55 years, as illustrated in the chart below.

Equity Contribution Weight to 5 Year 60/40 Blend Portfolio

1799 through 2024 Annually

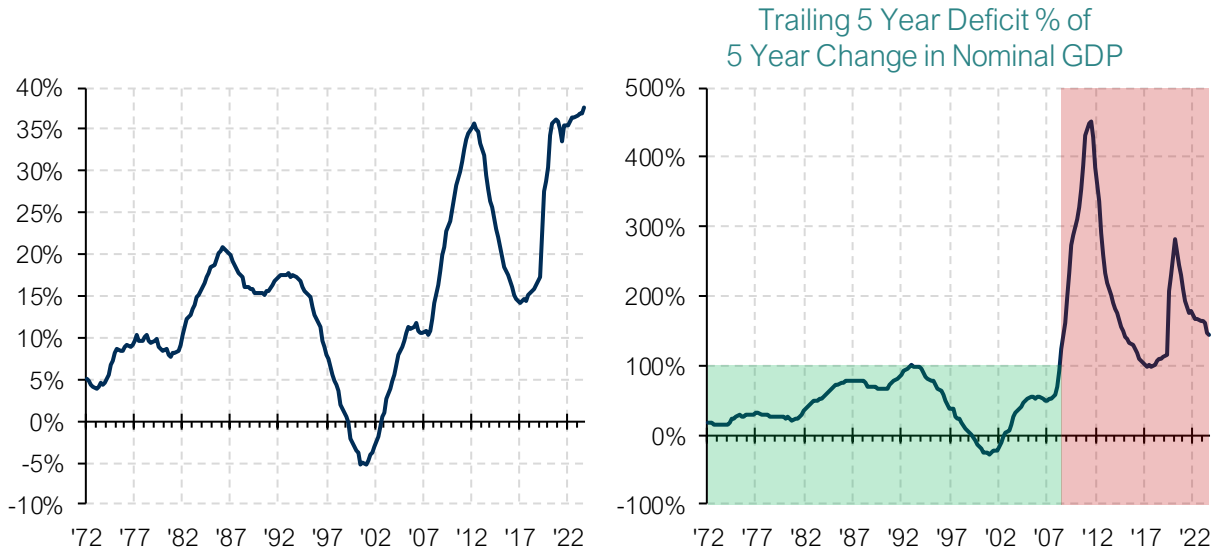


Sources: Edward F. McQuarrie, Robert Shiller, Ibbotson SBBI, Bloomberg, Callodine Capital Research Team
Methodology: Annual Returns. US Equity Returns are composed of McQuarrie Nominal Stock Return from 1793 through 1870, Shiller S&P Comp. Return from 1871 through 1925, Ibbotson® SBBI® US Large-Cap Stocks (Total Return) from 1926 through 1989, and Bloomberg S&P 500 Return from 1990 through 2024. US Bond Returns are composed of McQuarrie Nominal Bond Returns from 1973 through 1925, the average of Ibbotson® SBBI® US Long-term (20-Year) Corporate Bonds (Total Return), Ibbotson® SBBI® US Long-term (20-Year) Government Bonds (Total Return), and Ibbotson® SBBI® US Intermediate-term (5-Year) Government Bonds (Total Return) from 1926 through 1972, and Bloomberg US Government/Credit Bond Index from 1973 through 2024. 60/40 Blend Portfolio is 60% Equity Returns + 40% Bond Returns rebalanced annually. Equity Contribution Weight in 60/40 Blend Portfolio is calculated as log of 5 year Equity Returns / log of 5 year 60/40 Blend Portfolio Returns. Where 60/40 Blend 5 year return is negative, Equity Returns Contribution Weight is 0. Where Equity 5 year return is negative, Equity Returns Contribution Weight is 0.

In contrast to the robust economic backdrop of the Clinton years, today we see crosscurrents in the macro environment that create uncertainty about the forward direction of both the U.S. economy and financial markets. We have a newly sworn-in Republican president who is highly likely to be more business friendly than his predecessor from a regulatory and tax perspective, which would be positive for growth, but who may also look to eliminate government excess by cutting federal jobs, which would be negative for growth. Additionally, he may reduce the labor force through immigration policies and increase tariffs on trade, both of which are potentially inflationary measures. The net result on the economy, inflation, interest rates and the equity market is anyone's guess.

Trailing 5 Year US Deficit vs GDP and 5 Year Change in GDP

Q4 1972 through Q3 2024 Quarterly



Sources: Bloomberg, Callodine Capital Research Team

Methodology: Sum of trailing 60 months US Treasury Federal Budget Debt Summary Deficit NSA / Sum of trailing 4 quarters US GDP Nominal Dollars NSA. Sum of trailing 60 months US Treasury Federal Budget Debt Summary Deficit NSA / Change in trailing 4 quarters US GDP Nominal Dollars NSA from 5 years prior.

No one has a clear view of what lies ahead, but it's likely to contain surprises and the potential for volatility. The prospects for macro volatility and monetary, fiscal, and economic policy errors seem high to us, given what little room for error exists. The positive impact of incremental fiscal help seems marginal at best. In fact, the bond market looks increasingly uncomfortable with the level of deficit spending in an already strong economy. We shall see where rates (and those pesky bond vigilantes) may take us.

From the Macro to the Market

At Callodine, we are not macro investors—when it comes to macro events, we simply observe the starting point and consider the range of probable outcomes. When we zoom in to focus on prospective returns for various asset classes, we get more opinionated.

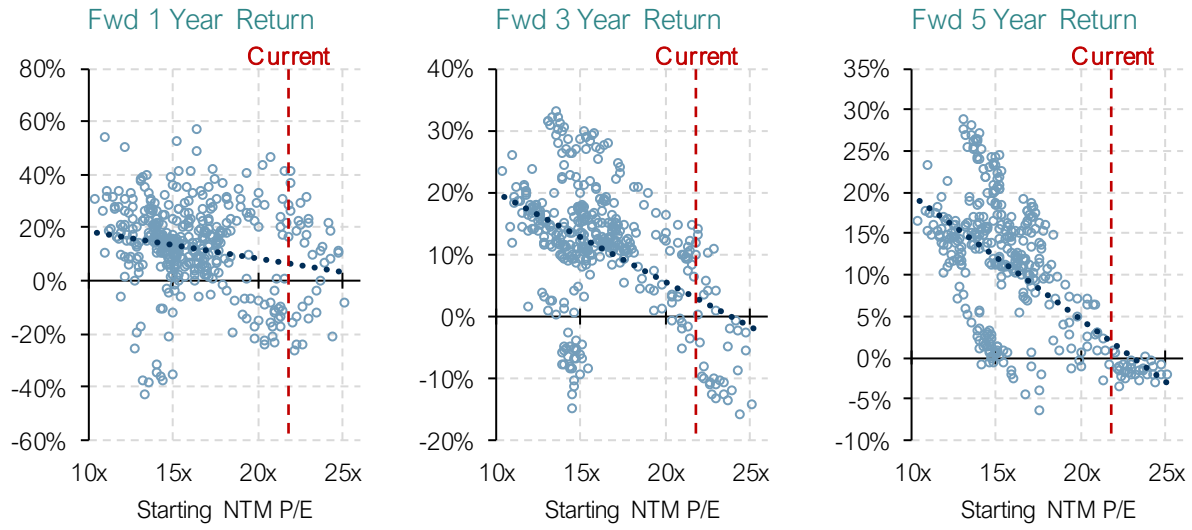
Let's take a step back and look at what we know today:

- Earnings growth has been strong at 19.2% during the last three years.[2]
- This strength is expected to continue, with 16.2%[3] earnings-per-share (EPS) growth anticipated for the S&P 500 in 2025.
- Current earnings are the result of all-time high margins across the market, as the sector mix in economies (and the index) continues to shift toward higher-margin categories, namely technology.
- We can infer that investors are very confident that current margins are sustainable and the forward growth outlook remains robust, as evidenced by current forward market multiples.

Valuation is a funny thing—it can matter very little in the short term, but its importance to forward returns becomes increasingly undeniable when viewed through a longer lens. Taken at face value, this reality does not bode well for the broader U.S. equity market returns over the next half decade. However, as Value investors, we are eager to point out that high-quality portfolios can be constructed well inside of the current market price/earnings (P/E) multiple (more on that to follow).

S&P 500 NTM P/E and Subsequent Annualized Returns

January 1990 through December 2024 (Monthly)



Sources: Bloomberg, Callodine Capital Research Team

2 Source: S&P Dow Jones Indices. Percentage change in trailing 12-month operating earnings of the S&P 500 Index from Q3 2021 to Q3 2024.

3 Source: S&P Dow Jone Indices. Percentage difference in estimated 12-month trailing operating earnings of the S&P 500 Index for Q4 2025 vs Q4 2024. As of 1/16/2025.

U.S. Valuation Confidence Index - Institutional

October 1984 through November 2024

% of Survey Respondents who Think Valuations are "Too Low" or "About Right" Excluding Survey Respondents who Chose "Do Not Know"

Sources: Yale School of Management https://som.yale.edu/centers/international-center-for-finance/data/stock-market-confidence-indices/united-states

The fact that the market is expensive is obvious to investors[4]. So why does the market continue to attract capital and push higher?

We are at a point in the market cycle where persistent, strong economic growth is now embedded in earnings and margin structures and a high degree of optimism is priced into the forward outlook, even beyond the robust current conditions. The market isn't providing a great cyclical setup from a fundamental or valuation perspective, nor is it sounding the alarm to batten down the hatches and become defensively positioned.

We are now five years into a risk-on rally (except for a nine-month respite in 2022), but there are mixed signals about whether the current trend will continue. There are times when the market is paying investors to take risk and times when it is paying them not to. Our view is that we are currently betwixt and between.

So, what is an investor to do when the forward outlook is so binary? In golf terms, we believe it's time to take out the 5-iron and don't try to be a hero. Take what the market is giving you. Buy attractively valued stocks that should benefit from continued GDP growth and run from those that are priced for perfection.

4 Source: https://som.yale.edu/centers/international-center-for-finance/data/stock-market-confidence-indices/united-states.

Conveniently, the market is presenting a large dichotomy among investment choices in this regard, with enormous value dispersion in the current environment. Over the past decade, dispersion has gone from very narrow (2010–2018) to very wide (2018–today), as shown in the chart below. Cheap stocks are incredibly cheap, and expensive stocks are horrifically expensive.

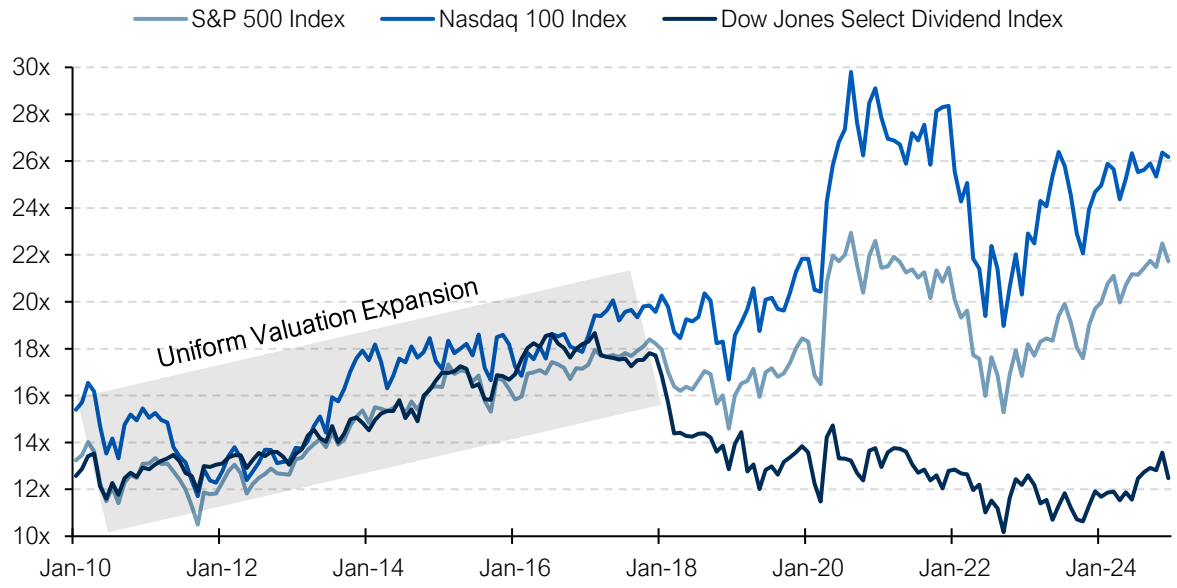
When dispersion gets this wide, the market is expressing a definitive view on "winners" and "losers." Low-multiple stocks have been completely eschewed by the market in favor of higher-multiple "Growth" names. However, most investors do not recognize that this phenomenon isn't just happening with the Magnificent 7 stocks. In fact, we believe the most egregious valuation excess is in the heart of the market—mid- and large-cap stocks across a variety of industries.

To be fair, the NASDAQ 100 has achieved better EPS growth since the pre-COVID era (15% compound annual growth rate since 12/31/19) than the broader S&P 500 (+9%) or the Dow Jones Dividend Index (+7%), but this fact is already reflected in the earnings portion of the P/E ratio.

The key question is whether these higher relative growth rates continue in perpetuity, or at least long enough to justify what is now a nearly 100% premium in the relative valuation between the NASDAQ and dividend payers, as shown below.

Forward P/E Multiples of Select Indices Since 2010

January 2010 through December 2024 Monthly



Sources: Bloomberg, Callodine Capital Research Team

From the Market to the Micro

Here is where things get very interesting from our vantage point and where we see enormous opportunity in this market. To illustrate the value dispersion across a range of sectors and stock types, we conducted a blind "resumé" test for stocks from a handful of sectors to demonstrate this valuation gap, namely within technology (services), consumer staples and energy:

Sector (BICS Level 1):	TECHNOLOGY		CONSUMER STAPLES		ENERGY	
Company:	Company A	Company B	Company A	Company B	Company A	Company B
Earnings Growth:(1)	9.5%	9.6%	18.8%	22.1%	9.9%	6.9%
Operating Margin:	38.5%	21.2%	7.1%	5.8%	12.2%	29.9%
Free Cash Flow Yield:	8.1%	3.9%	9.1%	0.9%	9.8%	5.3%
Dividend Yield:	1.3%	2.3%	2.2%	0.0%	6.6%	4.2%
Leverage:(2)	2.7x	N/M	0.9x	2.8x	3.7x	3.9x
Blended Est. 12M Fwd P/E:	13.1x	27.6x	14.9x	48.2x	12.1x	22.4x

(1) Earnings growth represents 3 Year Estimated EPS CAGR

(2) Leverage represents Net Debt / Blended 12M Fwd EBITDA

Sources: Bloomberg, Callodine Capital Research Team

Note: To make this more fun, we welcome our readers to reach out to our IR team with guesses as to which stocks these might be.

From a fundamental perspective, these stocks are not entirely dissimilar, but the multiples on the red-shaded names are twice as expensive as the green names, or more! This is not a small delta when it comes to the price that an investor pays for an asset and the probability of an attractive forward return.

We believe this is the definition of a rich alpha opportunity set. The market is creating enormous opportunities for investors willing to adopt an opposing view and take a chance on stocks trading at high-single-digit and low-double-digit P/E multiples.

The Socratic Method Applied to a Mercurial Market

At times, we have been accused of being biased as Value and Income investors, so let's take a step back and assess where we stand today at a high level, from both an economic and a market perspective.

Is it easier or harder to earn an attractive forward return in large-cap tech than 10 years ago?

There is no debate that the Magnificent 7 stocks (and large-cap tech, more generally) have been the most attractive place to be for the past 10+ years. This segment of the market has performed exceptionally well for the last decade (which we Value investors admit with envy), and many of the companies that have driven stock price outperformance are good businesses. That said, the go-forward return profile of these companies (or, conversely, the earnings growth that has to be sustained to keep generating recent returns) is daunting:

MAG 7 - Fair Value vs Current EV Using 2 Stage Growth Model

			Assumptions			
	Current EV	Est. Fwd FCF	10 Yr FCF Growth Rate	Terminal Growth Rate	Discount Rate	Fair Value
AAPL	$3,839	$117	5%	2.5%	6.20%	$3,870
NVDA	$3,261	$86	5%	2.5%	5.70%	$3,305
MSFT	$3,152	$74	5%	2.5%	5.40%	$3,147
GOOGL	$2,260	$93	5%	2.5%	7.50%	$2,250
AMZN	$2,377	$61	5%	2.5%	5.60%	$2,422
META	$1,457	$47	5%	2.5%	6.40%	$1,472
TSLA	$1,276	$6	15%	2.5%	4.00%	$1,188

Sources: Man Numeric (https://www.man.com/maninstitute/views-from-the-floor-2025-january-14), Callodine Capital Research Team

Where are we in the economic cycle?

It would be quite the hot take for anyone to claim that we're early cycle today. We've seen 11 consecutive quarters of U.S. GDP growth, and the S&P 500 is coming off back-to-back years of 20%+ returns. These conditions leave us with two options: we are either mid-cycle or late cycle. So, what comes next? Late cycle or early downturn.

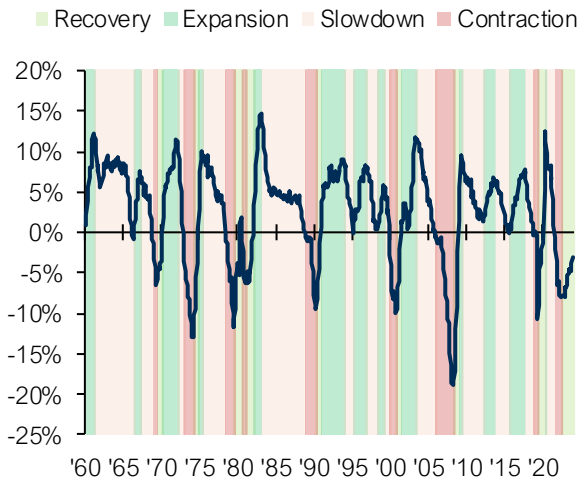
What typically performs well in late cycles or the early stage of a downturn?

It will not surprise you that, although higher-beta Growth names tend to outperform early and mid-cycle, there tends to be regime change when the cycle turns to stocks that are better equipped to handle softness in the economy (e.g., companies with durable earnings power that aren't expensive to begin with).

Looking at the exhibit on the following pages that shows monthly relative returns by sector across cycles, we can see defensive stocks like health care, staples and utilities historically have outperformed on the back end and downside of a cycle.

Sector Performance During The Economic Cycle

Leading Economic Indicators (YoY)



Sector Avg Monthly Relative Returns During Economic Cycles

	Recovery	Expansion	Slowdown	Contract
Cons. Disc	1.9%	0.1%	-0.1%	-0.6%
Industrial	0.3%	0.0%	0.0%	-0.2%
Info Tech	0.1%	0.6%	-0.1%	-0.1%
Financials	0.2%	0.3%	0.1%	-0.6%
Telecom	-0.5%	-0.4%	0.2%	-0.2%
Energy	-0.5%	0.0%	0.2%	0.4%
Health Care	-0.5%	-0.3%	0.3%	0.6%
Utilities	-0.3%	-0.7%	0.2%	0.3%
Cons. Stpl	0.0%	-0.4%	0.2%	0.4%

Sources: FactSet, Ken French, Callodine Capital Research Team
Methodology: Leading Economic Indicators (YOY) is the Year-Over-Year change in the Conference Board Leading Economic Indicators (LEI) Index, Dec 31, 1960 through Dec 31, 2024 Monthly. "Recovery" periods are months where the LEI YOY is negative but increasing from trough values. "Expansion" periods are months where the LEI YOY is positive and increasing to peak values. "Slowdown" periods are months where LEI YOY is positive but decreasing from peak values. "Contraction" periods are months where LEI YOY is negative and decreasing to trough values. Sector Avg Monthly Relative Returns During Economic Cycles is the average monthly relative return of sectors to the broad market during each of the previously defined periods from Jan 1961 through Nov 2024. Broad market return is the Mkt-RF + RF values from Ken French Fama/French 3 Factor data. Sector returns are from Ken French 23 Industry Portfolios. Cons. Disc are industries classified as Consumer Nondurables. Industrials are industries classified as Manufacturing. Info Tech are industries classified as Business Equipment. Financials are industries classified as Finance. Telecom are industries classified as Telephone and Television Transmission. Energy are industries classified as Oil, Gas, and Coal Extraction and Products. Health Care are industries classified as Healthcare, Medical Equipment, and Drugs. Utilities are industries classified as Utilities. Cons. Stpl are industries classified as Consumer Durables.

What happens if you make a directional bet and you turn out to be wrong?

Today, investors are presented with a fork in the road. If you knew that growth was going to continue unabated, you should go long cyclicals and technology stocks and continue to ride the wave of a 20% annual return for the S&P 500. If you knew that growth was about to stall and rates would decline, you would wistfully say goodbye to the darlings of the last decade and want to own bonds again. To state the obvious, these are diametrically opposed positions.

So, what if you're unsure? Or what if you're wrong? There's a part of the market that has the potential to provide an attractive risk-adjusted return in either scenario. You simply have to be willing to take the middle path and not play for one of the tail outcomes.

Two-Handed ~~Economist~~ Investment Manager

Our regular readers know that we tend not to be bashful about sharing our views on the market, particularly if we believe asset pricing is irrational and has become disconnected with economic reality. We're also not afraid to admit that we don't know if the U.S. equity market is heading for another +20% year, or if inflation will remain stubbornly high and/or growth stalls and the market will come off its all-time highs.

To be clear, it is not our role to provide top-down macro views. We're stock pickers. But from our perspective, this is not a time to be all in or all out on the U.S. equity market. We believe that investors should really be paying attention to what they are buying and how much they are paying for it. Ask yourself, "Am I getting paid to take a directional view?"

At Callodine, we don't need to get the macro correct. Our goal is to evaluate what the market is giving us, analyze risk/reward and find relative value in a bifurcated market. Simple, right?

Disclosure

This document has been provided to you solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The factual information set forth herein has been obtained or derived from sources believed by Callodine Capital Management, LP ("Callodine") to be reliable but it is not necessarily all-inclusive and is not guaranteed as to its accuracy and is not to be regarded as a representation or warranty, express or implied, as to the information's accuracy or completeness, nor should the attached information serve as the basis of any investment decision.

Past performance is not a guarantee of future results.

The views expressed reflect the current views as of the date hereof and neither the author nor Callodine undertakes to advise you of any changes in the views expressed herein. It should not be assumed that the author or Callodine will make investment recommendations in the future that are consistent with the views expressed herein, or use any or all of the techniques or methods of analysis described herein in managing client accounts. Callodine and its affiliates may have positions (long or short) or engage in securities transactions that are not consistent with the information and views expressed in this presentation.

This analysis is for illustrative purposes only. This material is intended for informational purposes only and should not be construed as legal or tax advice, nor is it intended to replace the advice of a qualified attorney or tax advisor. The recipient should conduct his or her own analysis and consult with professional advisors prior to making any investment decisions.

Index returns and other investment products cited within are provided to show an example of return potential during the relevant time periods. Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index.

The S&P 500 is a market capitalization weighted index of large-capitalization U.S. equities that includes 500 of the top companies in leading industries of the U.S. economy. The S&P 500 High Dividend Index is designed to measure the performance of 80 high yield companies within the S&P 500 and is equally weighted to best represent the performance of this group, regardless of constituent size. The Dow Jones U.S. Select Dividend Index aims to represent the U.S.'s leading stocks by dividend yield. The Russell MidCap Growth Index measures the performance of the midcap growth segment of the US equity universe and includes those Russell Midcap Index companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 years). The Russell 1000 Growth Index measures the performance of the large-capitalization growth segment of the US equity universe and includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Value Index measures the performance of the large-cap value segment of the US equity universe and includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

All projections contained herein represent our current beliefs and should not be construed as recommendations or a guarantee of future results.