Sound Income Strategies
Fixed Income Quarterly

Fixed Income Quarterly: Q2 2024

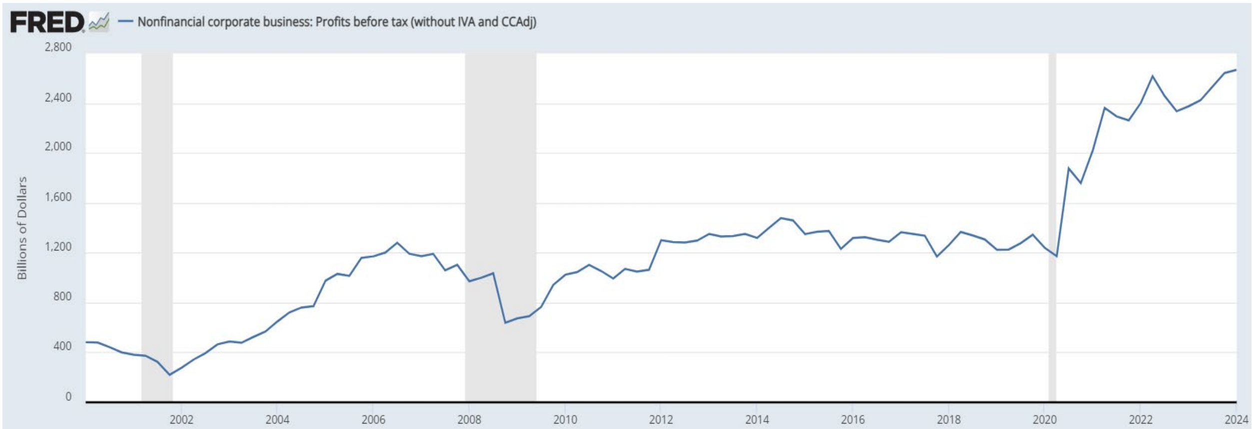
"There is always enough for the needy, but there is never enough for the greedy"

-Gandhi

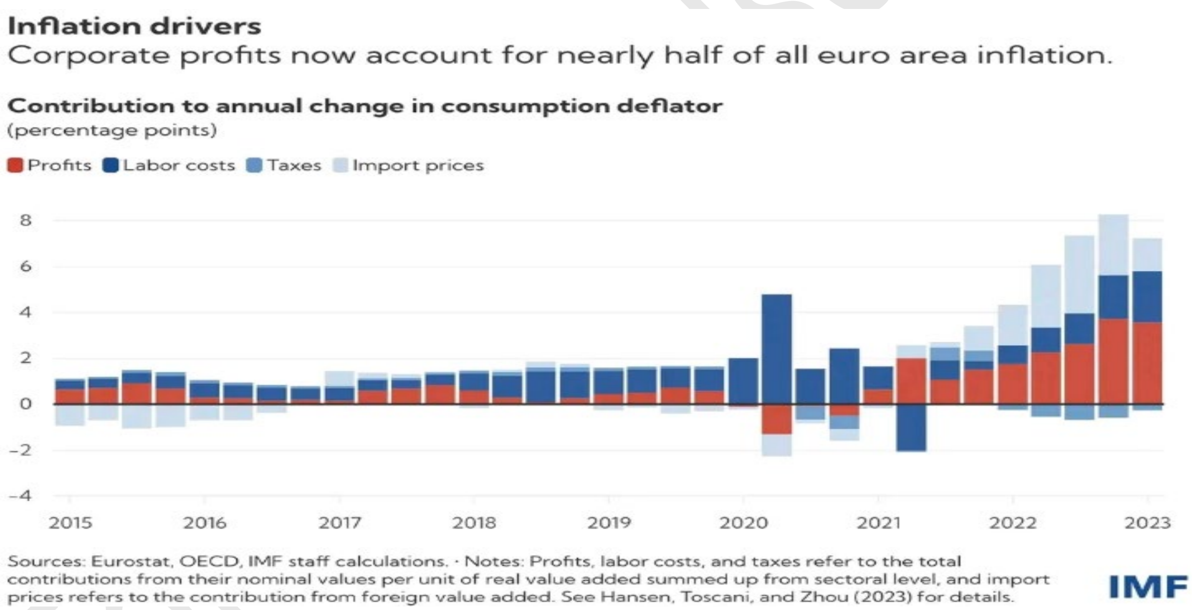
The Markets:

Markets were already nervous going into Q2 as month-over-month inflation numbers were perking up and expectations of several rate cuts for 2024 were starting to fade quickly. April's continuation of "sticky" inflation sent equities and bonds lower during the first half of the second quarter. However, expectations were lower by May, and markets had rebounded slightly. The Dow reached its all-time high in May, followed by the NASDAQ and the S&P500 which both reached their all-time highs in June bringing their annual returns to +4.7% for the DOW, +15.2% for the S&P500 and +18.5% for the NASDAQ. Large-cap/growth led the S&P500 with Technology, Communications, Utilities, and Consumer Staples in positive territory with all the other sectors having negative returns during the quarter. In fact, NVDA, APPL, and AMZN make up over $3 trillion in market capitalization, which contributes over 20% of the S&P's market capitalization. Keep in mind that the top three equities during the "dot.com" bubble only made up 10% of the S&P market cap back in 1999.

Though expected at the tail end of 2023, GDP is now slowing down from the mid-3% range from Q1 to the mid-1% range for Q2 of 2024. GDP QoQ annualized ended June at 1.4%, considering two-thirds of our economy falls to consumer spending it looks like consumers might be starting to tap out. In the US, corporate media often blames employees, or labor for inflation and seldom looks at old-fashioned price gouging or corporate profits. We can see from the two charts below that since the pandemic corporate profits have more than doubled to $2.7 trillion from $1.3 trillion pre-pandemic. As consumer spending falls, GDP falls, and then corporate profits fall, it's not super complicated, but again considering the trillions printed that takes time to work through the system.



Falling net interest payments by non-financial companies means many businesses took advantage of ultra-low interest rates before the Fed tightening cycle and this has also probably been a factor in keeping labor markets from deteriorating faster.

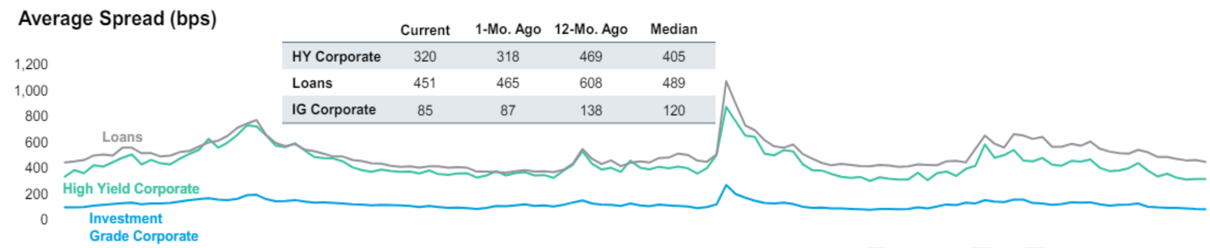


Bond World:

Rates continued to climb at the beginning of Q2 and peaked at 4.72%, which could be expected considering the nervousness around the reacceleration in inflation and changing expectations of the number of Fed rate cuts this year. Since the peak in April rates have fallen back a bit and finished June at 4.38% and expectations have moderated to just one rate cut this year, though the ECB and Bank of Canada already cut rates by 25 bps at their June meeting.

Corporate bond spreads remain tight with most IG sector spreads at below 100 bps and most double B credits between +150 to +185 bps above their US Treasury benchmark. Single B ratings ended the quarter around +290. Spreads on corporate bonds are probably as tight as they are going to get and we're looking for most sectors to widen during the second half of 2024.

Corporate Bond Market Update



	Current	1-Mo. Ago	12-Mo. Ago	Median
HY Corporate	320	318	469	405
Loans	451	465	608	489
IG Corporate	85	87	138	120

Past performance is no guarantee of future results.
It is not possible to invest directly in an index. Source: J.P. Morgan and Leveraged Commentary & Data (LCD), as of 5/31/24. Data provided is for informational use only. See end of report for important additional information. Corporate spreads are in basis points and measure option-adjusted yield spread relative to comparable maturity U.S. Treasuries. Loan Index spread represents the three-year discounted spread over SOFR (Secured Overnight Financing Rate).

Though the bond market gave us a little scare at the beginning of the quarter, volatility settled down which gave the Barclays Bond Aggregate a chance to catch up and add +6 bps to its quarterly return, yet the Aggregate is still negative for 2024 at -0.71%. Our Core+ and FXED ETF performed a little better at +25 bps in the quarter bringing the YTD average performance to 3.4%, keeping us on track for a 6% to 7% total return for the year, without factoring in potential interest rate cuts.

<u>Trades:</u>

<u>Southwestern Energy Co- SWN 4.75% 2/01/32 (Ba2/BB+ @ $91.60/ 6.14%</u>

Southwestern Energy Company is an independent E&P company that produces natural gas, oil, and NGLs. They have operations in West Virginia, Pennsylvania, Ohio and Louisiana. The company mostly conducts its business through subsidiaries and currently operates in the Appalachian and Haynesville natural gas basins in the lower 48 states. Headquartered in Spring, Texas, Southwestern focuses on the development of unconventional natural gas/oil. Management claims about 22,000 BCF of natural gas equivalent.

Southwestern comprises two operating segments: Exploration and Production and a Marketing segment. Exploration and Production conducts certain oilfield services such as drilling, completions, and water management and movement that explores for and produces natural gas in Appalachia and Haynesville. It has a fleet of drilling rigs and leased pressure pumping spreads, which account for around 70% of company revenue.

The Marketing segment accounts for about 30% of revenue and is responsible for marketing operations through the marketing and transportation of natural gas, oil, and NGLs primarily produced in its E&P operations.

Overall, roughly 60% of revenue was generated from gas, 30% from marketing, 5% from NGL, and about 5% from oil.

Catalyst:

Chesapeake Energy is merging with Southwestern Energy to form the largest pure natural gas plays in the Appalachian and Haynesville basins and the US, measured by market value and production. Management of both firms is committed to building up free cash flow and paying down debt to get leverage back down to X times. Credit ratings for both firms are on outlook positive and will probably move from double B into an IG credit. Even with gas prices down to the $2.50 area, credit spreads continue to tighten in these names.

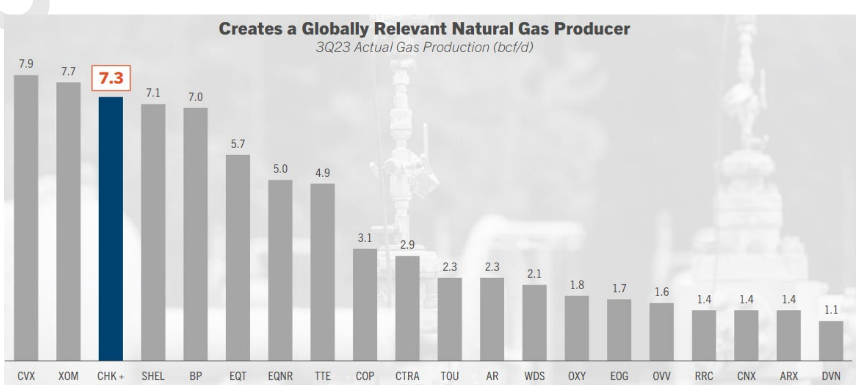
The deal came in at $11.6 billion including net debt of $4.2 billion, and again creates one of the premier natural gas firms with exposure in two prime basins with a combined EV of $24 billion. While Q2 was the estimated closing of the deal, the FTC has asked for additional information that will push out the deal until the second half of 2024, but management estimates nearly $400mm in synergy savings from the deal. SWN's management plans on developing acreage to increase free cash flow to help with a potential 5% drop in production from the 2023 levels. There are material hedges in place versus expected 2024 production and depending on prices and actual production FCF could be very limited for 2024.

Risk & Outlook:

Management is expecting an investment-grade quality capital structure and expects less than 1.0x net debt/ EBITDAX within one year of closing the deal and states that they'll use cash on hand to repay debt with a target of $1.1 billion by 2025. However, these and other management estimates are based on $3.00/mcf and $4.5 billion of less proforma net debt. As with all energy companies, there is some level of commodity price risk, even if production is hedged with contracts. The $400mm in expected annual synergies could also be overestimated thus lowering accretive key metrics such as cash flows and the NAV.

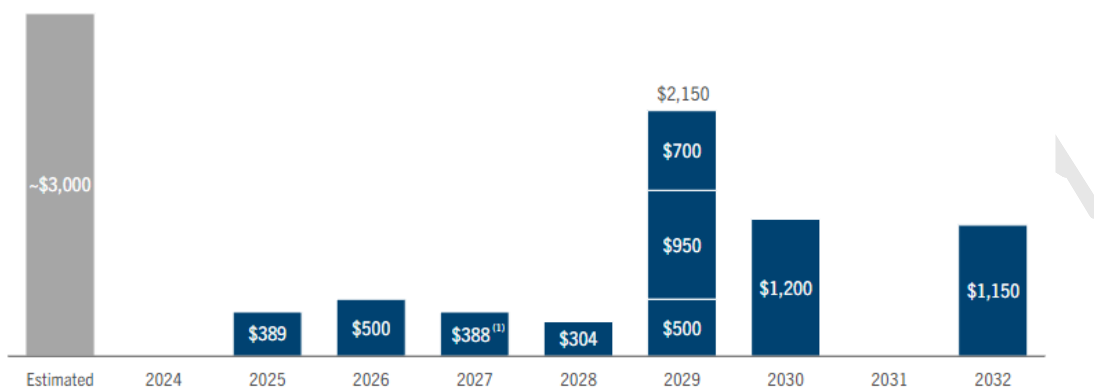
Recommendations:

Given the expected merger benefits, putting these lesser double B-rated E&P companies together to form the third largest natural gas producer with a manageable debt structure and no material refinancing until 2029, could be a good catalyst to move up into the investment grade category for the combined entity.



Given the amount of tightening we've seen with spreads the past 9 months and the expected Fed moves near the end of the year the pool of good credits that still pay over +175 bps or 6%+ in yield has been shrinking. I believe this will be a good credit upgrade trade in time given the potential for this merger with manageable debt maturity.

Long-Dated Capital Structure with Low Coupons

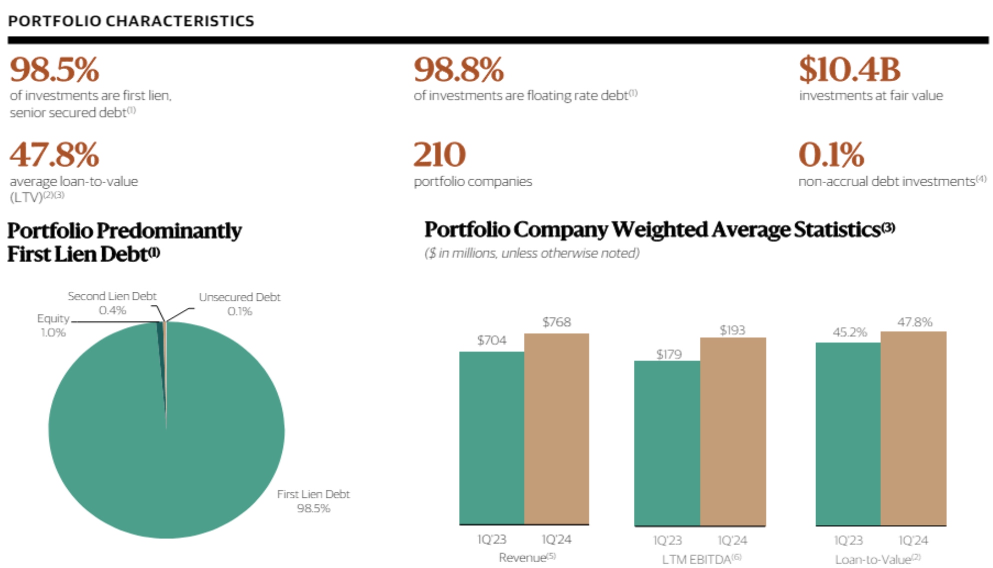


SWN US Equity									
Financial Metrics	Q2 2024	Q1 2024	2023	2022	2021	Near-Term Debt	Ratio Analysis	SWN	vs Comps
Adj Revenues		$ 1,417	$ 2,640	$ 9,167	$ 6,667	Next maturity date is $389mm in 2025, $500mm for 2026, $388 for 2027	Current Ratio	0.62	1.75
% chg	-100.0%	-46.3%	-71.2%	37.5%	188.9%	$304 for 2028 and three issues totaling $2.15 billion for 2029	Quick Ratio	0.26	1.37
Adj EBITDA		$ 732	$ 2,122	$ 8,622	$ 3,318		Debt/Mkt Cap	52.1%	16.9%
% chg	-100.0%	42.1%	-75%	159.9%	682.5%		T.Assets/T.Equity	2.38	1.83
Capex		$ 521	$ 2,170	$ 2,115	$ 1,032	Key Transactios, Material Changes	Debt/ Assets	39.82%	23.25%
% chg	-100%	-76%	3%	105%	15%	Chesapeake Energy and Southwestern Energy announced a merger in an	Debt/ Capital	48.68%	28.50%
Interest Exp		$ 141	$ 142	$ 184	$ 136	all-stock transaction valued at $7.4 billion. The entity becomes the largest	Debt/ Equity	94.85%	48.83%
Net Leverage (ND/EBITDA)						pure natual gas producer in the US and management expects $400mm in	N.Debt/ EBITDA-Capex	5.69x	1.79x
CFO		$496	$2,516	$3,154	$1,363	synergies annually. They also plan to buildout a global marketing and	EBIT/ Int Exp	0.76x	107.24x
FCF		-$25	$346	$1,039	$331	traing presence in Houston with the goal of increasing cash flow and	Net Debt/ Adj. EBITDA	-	0.83x
Cash & Equ		$29	$21	$50	$28	paying down debt.	FCF/ Debt	-0.04%	1.7%
							Asset Coverage	2.51x	7.95x
Equity Price	$ 7.23	RQ005					*Gross Margin (LTM)	36.6%	37.5%
Market Cap $B	$ 7,957	RR902					*Operating Margin (LTM)	-145.0%	-3.0%
BV Equity	$ 5,888	RR007					*Profit Margin (LTM)	-108.0%	-2.4%
Gross Debt $B	$ 4,098	RR251					* Bad quarters hurting the		
LTM FCF $mm	$ (146)	RR843					space due to 1x imparment charges and a huge drop in		
FCF Yield (LTM)	-1.8%	RX072					commodity prices. Forward estimates are much better		
P/CF	4.24	RR908							
P/E (LTM)	15.28	RR900							
Dividend Yield	0.0%	DV012							
Payout Ratio	0.0%	RR049							

Blackstone Secured Lending Fund- BXSL 9.71%

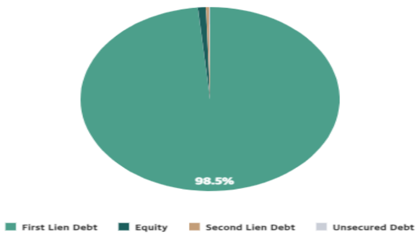
Blackstone Secured Lending Fund is a BDC that focuses on investing in privately originated senior secured floating rate loans. Given that over 98% of its loans are first-lien senior secured it's considered a fairly conservative BDC working with upper middle-market firms. The fund has credit ties back to Blackstone's credit platform which also brings credit and additional analytical support from the world's largest alternative asset manager at over $1 trillion in AUM. That additional support from Blackstone's platform gives the BDC a broad deal funnel, cheaper funding, and lower operating expenses. The firm's debt is IG at all three agencies with a "stable" outlook and a recent upgrade from Fitch during Q1'24.

Metrics:

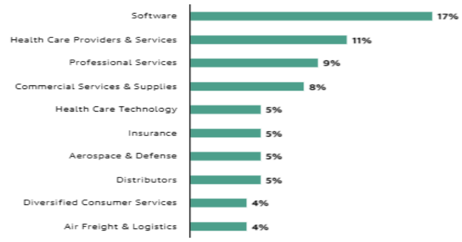


Portfolio Snapshot

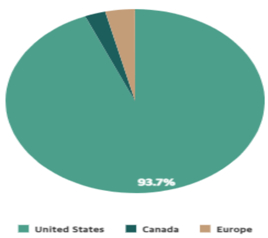
Asset Type



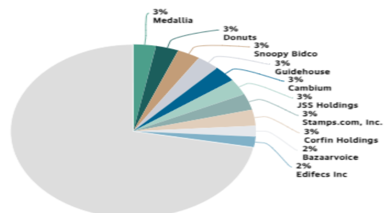
Top Industries (at FMV)[4]



Geography



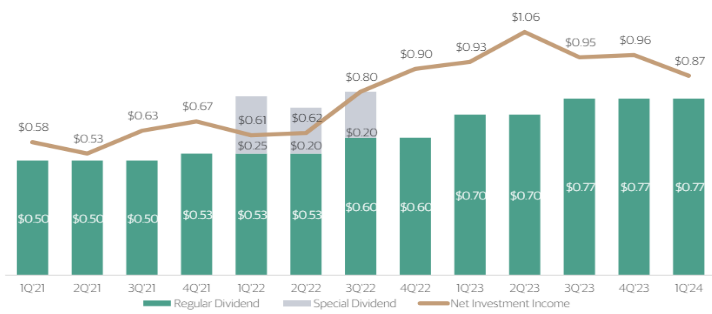
Issuer Concentration



Strong dividend well-covered by NII

- Regular dividend of $0.77 per share, representing an annualized dividend yield of 11.5%[1]

Quarterly Dividend, NII Per Share and Leverage



Quarterly Ending Leverage

0.89x	1.01x	1.09x	1.25x	1.28x	1.34x	1.33x	1.34x	1.31x	1.15x	1.08x	1.00x	1.03x

11.5%
1Q'24 dividend yield[1]

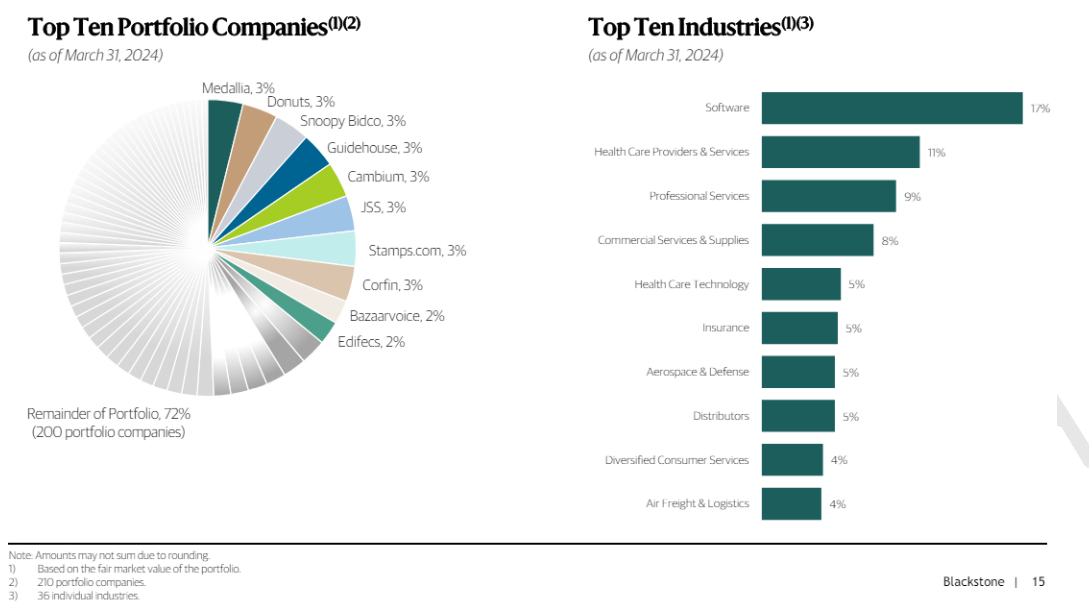
50%+
increase to the regular dividend since BXSL's first dividend[2]

0.98x
average debt-to-equity in 1Q'24[3]

113%
1Q'24 dividend coverage[4]

Historical dividend rates may not be indicative of future period dividend rates. Leverage represents BXSL ending debt to equity for the periods shown. **Past performance does not predict future returns.**

1) 1Q'24 dividend yield is calculated as the 1Q'24 dividend ($0.77) annualized and divided by the ending NAV per share on March 31, 2024 ($26.87).
2) Reflects increase to the regular dividend since BXSL's first distribution in 1Q'19.
3) Average debt to equity leverage ratio has been calculated using the average daily borrowings during the quarter divided by average net assets.
4) Dividend coverage is calculated as net investment income per share ($0.87) divided by regular dividend per share ($0.77).



<u>Outlook:</u>

Considering the deal flow that Blackstone Credit can offer the BDC, the 3-year look back/total return hurdle rate on incentive fees, which is friendly to BXSL shareholders, and BSXL's low non-accrual rate we are adding this to our BDC line-up of conservative BDC's. All fees owed to BXSL are paid with no scrape/clawback clauses from Blackstone Credit/Insurance which is another plus.

<u>Pilgrim's Pride Corp- PPC 4.25% 4/15/31 (Ba2/BBB-/BBB-) @ $91.25/ 5.82%</u>

Pilgrim's Pride produces and prepares fresh chicken products in the US and Mexico through vertical integration they control the breeding, hatching, and growing of chickens along with the processing, preparation, and packaging of their product lines. They also have a small line of fresh and frozen pork products under Pilgrams Price, Gold Kist, and Moy Park. They have a global network of 4,950 growers, 35 feed mills, and 45 hatcheries with 40 processing plants, 35 prepared cook plants, 30 distribution centers, and four pet food plants. PPC has over 51,000 grocery store chains, wholesale clubs, and retail distributors, and is 80% owned by Brazil's JBS Foods International, which is a private company that serves customers worldwide.

<u>Catalyst:</u>

Given the continued spread disparity between beef, pork, and lamb prices versus chicken PPC continues to see an increase in their revenue with Q1'24's increase resulting in net leverage at the low end of 2-3x management's target. Input prices, namely corn and soy, are also falling at the same time as beef prices continue to increase, thus improving margins at PPC. During Q1 management reported $4.4 billion in revenue, up +4.7% YoY and $368mm in adjusted EBITDA, which was double Q1'23 levels. Chicken prices should remain favorable versus the continuing pressures of beef prices for the foreseeable future. Between 2018 and 2022 revenue has had an overall increase of 60%.

Risk & Outlook:

While PPC has a favorable outlook, JBS, which owns 80% of PPC will have some issues with their overall business, of which chicken is only a part. The cattle/beef cycle is challenging currently with inflation still a material factor. JBS is an IG bond issuer, but net leverage is between 3x and 4x, a bit higher than PPC. JBS is considering a US listing, which could lower the premium EM spreads on its debt, thus lowering its cost of capital and tightening its spread versus domestic Tyson Foods. Given that 80% is owned by JBS, we have to consider the health of JBS which is also IG at Baa3/BBB-. JBS is also looking to reduce leverage given the recent tender offers to reduce outstanding debt and management is looking to reduce back down to 2-3x leverage.

Domestic beef prices are an issue, but JBS is supplementing reduced beef revenue in the US with better beef revenue outside the US. While JBS Q1 earnings showed stable levels of organic revenue growth, there is some evidence of increased consumer "trade down" from inflated protein prices, which could continue. There is a class action in Oklahoma against PPC and other chicken producers for not fully compensating broiler chicken growers. PPC, unlike other peers, claims that they had no agreements that stifled competition and have not settled the suit.

Recommendations:

We have fairly low exposure to the Food & Beverage sector, partly due to lower spreads versus other sectors, but this sector hasn't tightened as much as others, offering up an opportunity to pick up 150+ bps or 5.8%+ for a 6.5-year IG name. While we don't expect much more tightening it should be a stable play in this space.

PPC US Equity									
Financial Metrics	Q2 2024	Q1 2024	2023	2022	2021	Near-Term Debt	Ratio Analysis	PPC	vs Comps
Adj Revenues		$ 4,362	$ 17,362	$ 17,468	$ 14,778	$1 billion in 2027, $900mm in 2028, $677 in 2029	Current Ratio	1.83x	1.64x
% chg	-100.0%	-3.67%	-0.6%	18.2%	22.2%	$1.25 billion in 2030. Total outstanding $3.4 billion	Quick Ratio	0.83	0.74
Adj EBITDA		$ 371	$ 1,096	$ 1,705	$ 1,364		Debt/Mkt Cap	41.2%	41.9%
% chg	-100.0%	20.7%	-36%	25.0%	221.8%		T.Assets/T.Equity	2.80	2.41
Capex		$ 108	$ 544	$ 487	$ 382	Key Transactios, Material Changes	Debt/ Assets	37.94%	34.87%
% chg	-100%	-0.57%	12%	28%	-57%		Debt/ Capital	51.47%	44.83%
Interest Exp		$ 31	$ 167	$ 144	$ 140		Debt/ Equity	106.05%	87.80%
Net Leverage (ND/EBITDA)			2.74	1.87	2.36		N.Debt/ EBITDA-Capex	3.90x	5.09x
CFO		$271	$678	$670	$327		EBIT/ Int Exp	6.49x	6.34x
FCF		$163	$134	$183	-$55		Net Debt/ Adj. EBITDA	2.43	3.98
Cash & Equ		$871	$698	$401	$428		FCF/ Debt	0.16%	0.1%
							Asset Coverage	1.44x	1.52x
Equity Price	$ 38.01	*RQ005*					Gross Margin (LTM)	8.8%	13.1%
Market Cap $B	$ 9,006	*RR902*					Operating Margin (LTM)	5.7%	6.7%
BV Equity	$ 3,345	*RR007*					Profit Margin (LTM)	4.0%	4.0%
Gross Debt $B	$ 3,703	*RR251*							
LTM FCF $mm	$ 590	*RR843*							
FCF Yield (LTM)	6.6%	*RX072*							
P/CF	8.10	*RR908*							
P/E (LTM)	15.91	*RR900*							
Dividend Yield	0.0%	*DV012*							
Payout Ratio	0.0%	*RR049*							

Outlook:

As I've stated in the past, the amount of government stimulus, large corporations coasting on low-cost debt pre-pandemic, and consumers running up their credit card debt, (average credit card debt amounts to $8k per household, not including retailer lay-away plans) has all played a part in keeping GDP levels in the mid-3% range. Now, as of this quarter, we're seeing a slowdown to the mid-1% in annualized QoQ GDP. I'll spare you all the Fed Funds rate recession graph in this letter.

However, it's a tale of two consumers. The upper-middle class and wealthy are much less affected by inflation and higher rates. This is probably why we see traditional lower-end retailers, such as Walmart shifting to higher-end consumers, especially in higher-end electronics because management at Walmart knows if they want to keep "revenue up for longer", think (inflation/rates higher for longer), then they need to attract higher earners. After all, the average American household is tapped out. As goes GDP and our economy, so goes earnings, and keep in mind that markets are always forward-looking. Again, we are not there yet since the Fed hasn't lowered rates but keep this in mind when directing your clients' allocations.

Wishing everyone all the best this holiday season, Happy Fourth of July!

Sincerely,
Eric Lutton, CFA
Chief Investment Officer