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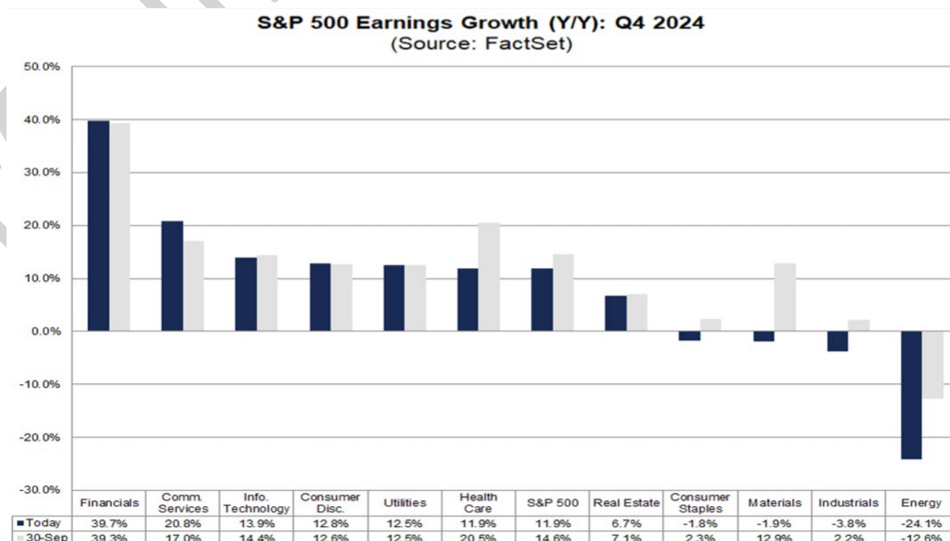
Fixed Income Quarterly: Q4 2024

“The country is going bankrupt. If we don’t take action, the dollar’s going to be worth nothing.” -Elon Musk *(Joe Rogan podcast)*

The Markets:

Though most traditional economic indicators have been pointing towards a slowdown, and December was painful for stocks and bonds, it ended up a banner year for equities with the DOW, S&P, and NASDAQ up 14.9%, 24.9%, and 29.5% respectively, even the S&P Value Index returned 12.2%, indicating that the non-Magnificent-7 names have somewhat rebounded from their slump. Although there is still a very large concentration in a handful of equities that make up a material amount of the indices market capitalization.

Earnings growth fell during Q4, for certain sectors, since Q3, as can be seen from the FactSet chart below, but analysts are forecasting a 14.8% earnings growth during 2025, over and above the 10-year average of 8%. Expectations for the Magnificent-7, 2025 earnings are estimated at 21% with non-Magnificent-7 earnings at 13% vs their lackluster 4% 2024 earnings growth. It’s anyone’s guess how many “revisions” we’ll see in the coming quarters, but IT, Healthcare, Industrials, Materials, Communications, and the Discretionary sectors are slated to have double-digit growth during the coming year.



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Obviously, with increasing earnings, we have increasing revenue expectations and analysts are expecting an increase of 5.8%, above the 10-year average of 5.1%, and a 13% profit margin for the S&P, which would be the greatest margin since the great recession of 2008. This helps explain why the Fed is having such a difficult time getting inflation back down to 2% or lower. Inflation (CPI YoY) has come down from its June '22 peak of 9.1% and stands at 2.7% as of the end of December. Inflation has averaged 3.3% since 1914, but it will continue to be difficult for inflation to fall back below 2% given that price increases are currently, mostly due to corporate profits with labor costs continuing to decline since Q2'23. Housing, groceries, car insurance, and home insurance costs continue to be a burden to consumers. Corporations passed the broken supply chain costs and more on to consumers and even though those costs have greatly subsided, corporations have not passed those savings onto consumers as they did the increases.

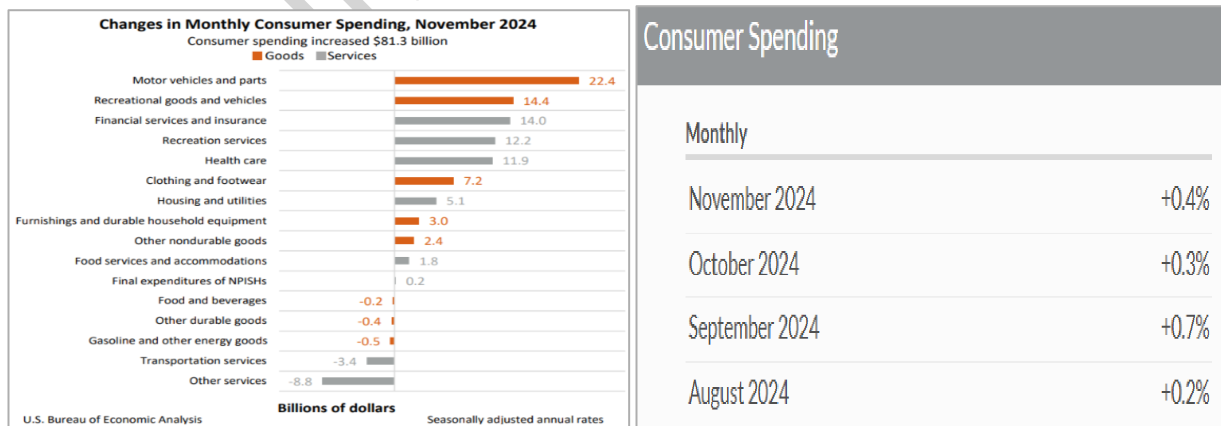
Table 1. Contributions to Price Increases

	Since 2019	Since 2020	Since 2021	Q2-Q3 2023	Q3 2023
Labor contribution	54%	45%	53%	73%	50%
Nonlabor contribution	12%	25%	25%	-27%	-33%
Profits contribution	34%	30%	21%	53%	83%

Source: Bureau of Economic Analysis, National Income and Products Accounts, Table 1.15, Author's Calculations

As I've explained in the past, the Fed can't control corporate price gouging, and until corporations start competing again on price core inflation falling back to 2% or less will probably take several more quarters, if not years.

However, we can't completely blame corporations because the high-end consumer and our government didn't let inflation dictate their spending habits as can be seen from the data. Upper-middle class and wealthier families showed robust spending during the year.



In addition to consumer and government spending helping GDP finish 2024 at +2.9%, and despite the Fed's most aggressive rate-hiking cycle since 1980, there might be the growth of our

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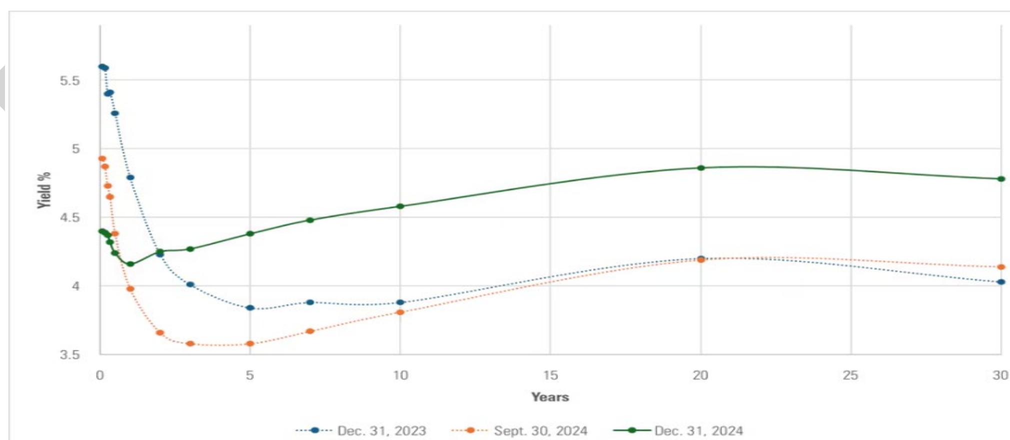
"shadow banking" system. Private equity firms and even our business development company investments have assisted small and medium-sized businesses raise capital that otherwise might not have received financing from our traditional banking system. No doubt these non-traditional sources of funds have greatly added to the growth of smaller and medium-sized firms, which has greatly supported GDP growth. As wealth concentrates in the upper tenth of households and corporations, higher interest rates have much less power to slow down an economy as in decades past given the high cash balances of wealthier households and larger corporations. Given that unemployment ticked up to 4.2% from 3.7%, yet we still had positive GDP growth could also be a sign that shadow banking is having a measurable effect on GDP. Increasing immigration legal and even illegal will also continue to push GDP higher as our workforce continues to grow.

While equity market multiples are high at a trailing 26.4x for the S&P500 at the writing of this letter, we could see market multiples tick a little higher before any reversion to the mean.

Bond World:

The fourth quarter poured water on any hopes of another year of double-digit returns for our Core+ strategy and the Morningstar graph below shows why. The rally in the short end of the yield curve mimicking the Fed's lowering of the Fed Funds rate showed expectations that inflation and labor would continue to slow and therefore the Fed would continue lowering rates without pause. However, as economic numbers were released, core inflation remained, "sticky" and the labor slowdown paused, therefore the market quickly reversed course, and more realistic expectations took hold. The belly of the curve and longer-dated treasuries sold off, as expected, and why we've been purchasing shorter-dated bonds and ignoring calls to extend duration throughout 2024. This yield curve shift is typical when the Fed starts to cut rates, with shorter-duration treasuries rallying and mid-to-longer duration treasuries selling off, thereby moving from a typical inverted curve back into a positively sloped yield curve.



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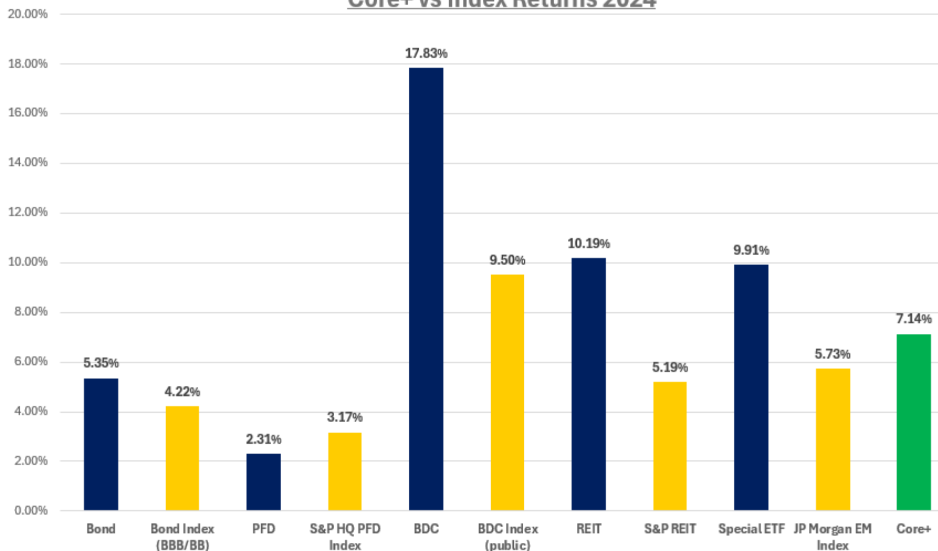
Though spreads in IG and HY corporate bonds have remained tight, this sell-off and increase in treasury yields took its toll during the fourth quarter, especially during the last few weeks of December. This sell-off was underway before the election and post-election it has continued, in part due to expectations that the new administration might introduce policies that are inflationary and therefore will give the Fed pause to further rate cuts in 2025.

Performance was not equal across maturity, credit, or sectors for 2024 with the lower 1–3-year duration, single-B and triple CCC credits leading returns while longer duration and higher quality credits lagged, though still positive, for the year. US Treasuries, as a group, were pretty much flat after accounting for coupon interest earned. Given the volatility, our Core+ ended the year just over 7% and we outperformed in each category, except preferred securities.



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Trades:

Avnet Inc- AVT 5.5% 6/1/32's (Baa3/BBB-/BBB-) @ $99.75/ 5.53%

Avnet distributes computer products and semiconductors, as well as interconnect, passive, and electromechanical components. The company markets and distributes these products and provides supply-chain integration, engineering design, and technical services. They are a leading component technology distributor that serves customers in 140 countries globally. Their customers include smaller startups, some mid-sized businesses, and even larger companies that produce electronics. Most sales are international with semiconductors comprising 80% of revenue and Asia/Pacific also contributing about 40%. There are two reportable segments: electronic components 95% of revenue and 5% contributed by Farnell, a global distributor. The firm was founded in 1921 by Charles Avnet.

Catalyst:

The run-up in goods purchased during Covid led to material increases in chip prices given so many goods are now utilizing microchips. Post-Covid, there has been a continued decline in NAND/DRAM chip prices given the post-Covid drop in demand and increase in microchip supply. Though DRAM HBM, (high bandwidth memory), demand will continue to grow, the supply will continue to meet any new growth due to AI. There seems to be a continued sluggish consumer market which doesn't show any signs of near-term improvement given the wide gap between spot market prices, channel prices, and OEM contract prices. There continues to be a delayed deployment of AI applications and smartphones, and PC makers have been reducing their expected demand.

Electronic components have also had decelerating sales given overall consumer demand, but with increases in data centers almost doubling globally since 2015, demand for chips and electronic components has probably bottomed out. This year, 2025, it's estimated that 20% of the global semiconductor market revenue is due to data centers alone. Servers, AI-equipped PCs, and smartphones are expected to increase in 2025 fueling a recovery for passive, semiconductor, and interconnected parts. World Semiconductor Trade Statistics expected a 16% increase during 2024. Lead times for the electronic component market continue to fall, which should help consumers. Overall, it's expected that the post-Covid slowdown is behind the market and while the overall trend isn't looking for massive gains, the market looks like it has stabilized, short of any material recession. One thing that could slow production/supply would be any further port strikes from longshoremen or weather-related issues such as Hurricane Helene and Milton. These hurricanes severely damaged the small town of Spruce Pine, NC, which has the purest quartz in the world for making semiconductors, solar panels, and

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fiber-optic cables. While companies can spend capital on improving quartz for component grade material, it's cheaper and faster to use the quarts minded from Spruce Pine.

Risk & Outlook:

The industry has some basic risks such as EU environmental compliance risks, and single source dependencies, where one manufacturer can delay the supply chain, though since Covid, this risk has improved. There are also obsolescent risks of inventory and weather risks to supply chains, such as hurricanes in the west and typhoons in the east. The ever-present cyber security risk and key raw material shortages. On the positive side, we have increased global demand due, in part, to advancements in AI and the Internet of Things (IoT) and increased investment in automation and digitalization. The largest positive for the domestic market will be the $52 billion Chips Act in hopes to ramp-up domestic chip production in hopes to bring jobs and a more stable chip supply chain. Silicon Valley remains the global leader in cutting-edge technology and any additional tariffs will affect the supply chain, but it's too early to make definitive opinions.

Recommendations:

Avnet Inc. is a 103-year-old company with much expertise in the chips and electronic component space. The domestic electronic component and manufacturing industry should be positively assisted by the Chips Act and strict regulations against China now and near future should benefit domestic companies from increased demand for locally produced products. If the "Internet of Things" and AI have growth, the market is estimating there will be a positive increase in top-line revenue and earnings, all else equal.

While we aren't taking equity risk on this name, we are comfortable with the current Investment Grade rating on its debt and added it to our bond line-up.

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PPC US Equity

Financial Metrics	Q2 2024	Q1 2024	2023	2022	2021
Adj Revenues		$ 4,362	$ 17,362	$ 17,468	$ 14,778
% chg	-100.0%	-3.67%	-0.6%	18.2%	22.2%
Adj EBITDA		$ 371	$ 1,096	$ 1,705	$ 1,364
% chg	-100.0%	20.7%	-36%	25.0%	221.8%
Capex		$ 108	$ 544	$ 487	$ 382
% chg	-100%	-0.57%	12%	28%	-57%
Interest Exp		$ 31	$ 167	$ 144	$ 140
Net Leverage (ND/EBITDA)			2.74	1.87	2.36
CFO		$271	$678	$670	$327
FCF		$163	$134	$183	-$55
Cash & Equ		$871	$698	$401	$428
Equity Price	$ 38.01	*RQ005*			
Market Cap $B	$ 9,006	*RR902*			
BV Equity	$ 3,345	*RR007*			
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*			

Near-Term Debt

$1 billion in 2027, $900mm in 2028, $677 in 2029
$1.25 billion in 2030. Total outstanding $3.4 billion

Key Transactios, Material Changes

Ratio Analysis	**PPC**	**vs Comps**
Current Ratio	1.83x	1.64x
Quick Ratio	0.83	0.74
Debt/Mkt Cap	41.2%	41.9%
T.Assets/T.Equity	2.80	2.41
Debt/ Assets	37.94%	34.87%
Debt/ Capital	51.47%	44.83%
Debt/ Equity	106.05%	87.80%
N.Debt/ EBITDA-Capex	3.90x	5.09x
EBIT/ Int Exp	6.49x	6.34x
Net Debt/ Adj. EBITDA	2.43	3.98
FCF/ Debt	0.16%	0.1%
Asset Coverage	1.44x	1.52x
Gross Margin (LTM)	8.8%	13.1%
Operating Margin (LTM)	5.7%	6.7%
Profit Margin (LTM)	4.0%	4.0%

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Armada Hoffler Properties Inc-AHH @ 7.5%

- AHH is a vertically integrated, self-managed REIT with over four decades of experience managing, building, acquiring, and developing high-quality retail, office, and multifamily properties located primarily in the Mid-Atlantic and Southeastern United States. In addition to the ownership of their operating property portfolio, we develop and build properties for our own account and through joint ventures between us and unaffiliated partners and also invest in development projects through real estate financing arrangements. We also provide general construction and development services to third-party clients. Our construction and development experience includes mid- and high-rise office buildings, retail strip malls, retail power centers, multifamily apartment communities, hotels and conference centers, single- and multi-tenant industrial, distribution, and manufacturing facilities, educational, medical and special purpose facilities, government projects, parking garages, and mixed-use town centers.

Key Points:

- Armada Hoffler is a unique diversified REIT that is vertically integrated. They have been self-managed for over 40 years and develop, build, acquire, and manage their multi-use properties that consist of multi-family, office, and retail spaces. However, the fund cut its dividend during the pandemic, which had been increasing since its 2013 IPO, by 50% which sent the shares tumbling over 50%. Though the company has increased the quarter dividend back up $0.21 from the pre-pandemic $0.22 level, the price has never fully recovered.

- Managements' strategy was/is to grow coming out of the pandemic; therefore, they've added additional debt to grow their portfolio of diversified assets, and their leverage to an 8x Net Debt/ EBITDA ratio. In fact, the $0.21 dividend isn't fully covered by GAAP earnings, which is a big negative in my opinion, but if AHH can grow their assets enough and keep occupancy high with good net margins they can grow into their financial statement and cover the present and future dividend growth.

- Revenues came in at $183mm vs 162.3mm Q3'23, FFO at $0.14 vs $0.31 '23 and AFFO at $0.32 vs $0.38 Q3'23. Dividends have increased to a quarterly level of $0.21 per share. This equates to a 63% AFFO payout ratio.

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Retail Properties	# of Properties	Net Rentable SF[1]	Average Age	Occupancy[1]	ABR[1]	ABR per Occupied SF
Town Center of Virginia Beach	13	549,317	13	97.9 %	$13,856,480	$25.77
Harbor Point - Baltimore Waterfront	2	57,021	7	71.5 %	1,230,869	30.21
Grocery Anchored	15	1,400,474	14	98.2 %	22,933,867	16.68
Southeast Sunbelt	11	1,077,698	15	95.7 %	22,631,805	21.94
Mid-Atlantic	7	952,788	17	94.4 %	16,741,828	18.61
Stabilized Retail Total	**48**	**4,037,298**	**14**	**96.2 %**	**$77,394,849**	**$19.93**

Office Properties	# of Properties	Net Rentable SF[1]	Average Age	Occupancy[1]	ABR[1]	ABR per Occupied SF
Town Center of Virginia Beach	6	811,457	22	94.7 %	$23,282,795	$30.30
Harbor Point - Baltimore Waterfront	3	1,036,017	9	97.7 %	32,487,973	32.09
Southeast Sunbelt	4	387,245	7	85.1 %	10,834,054	32.89
Mid-Atlantic	1	98,061	5	100.0 %	2,002,945	20.43
Stabilized Office Total	**14**	**2,332,780**	**13**	**94.7 %**	**$68,607,767**	**$31.07**

MULTIFAMILY PORTFOLIO

Multifamily Properties	# of Properties	Units	Average Age	Occupancy[1]	AQR[1]	Monthly AQR per Occupied Unit
Town Center of Virginia Beach	3	759	11	97.0 %	$18,137,748	$2,054
Harbor Point - Baltimore Waterfront	2	392	7	95.2 %	12,149,388	2,714
Southeast Sunbelt	3	686	3	92.1 %	14,088,636	1,858
Mid-Atlantic	3	655	12	96.6 %	12,915,252	1,700
Stabilized Multifamily Total	**11**	**2,492**	**9**	**95.3 %**	**$57,291,024**	**$2,011**

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- The majority of the properties in AHH's portfolio are located in Virginia, Maryland, and North Carolina, which exposes them to greater economic risks than if we owned a more geographically diverse portfolio. At the end of '23 properties in Virginia, Maryland. and North Carolina markets represented approximately 45%, 25%, and 14%, respectively, of the total net operating income of the properties in the portfolio. In addition, many of their properties are located in the Town Center of Virginia Beach and Harbor Point at Baltimore, and net operating income from each represented 20% and 18%, respectively, of the total net operating income for last year. Due to the geographic concentration, AHH is particularly susceptible to adverse economic, regulatory, or adverse weather conditions in the Virginia, Maryland, and North Carolina markets. For example, the

markets in Virginia, Maryland, and North Carolina in which many of the properties in their portfolio are located, contain high concentrations of military personnel and operations, and a reduction of the military presence or cuts in defense spending in these markets could have a material adverse effect on AHH.

	Years Ended December 31,			2023	2022
	2023	2022	2021	Change	Change
Revenues					
Rental revenues	$ 238,924	$ 219,294	$ 192,140	$ 19,630	$ 27,154
General contracting and real estate services revenues	413,131	234,859	91,936	178,272	142,923
Interest income	15,103	16,978	18,457	(1,875)	(1,479)
Total revenues	667,158	471,131	302,533	196,027	168,598
Expenses					
Rental expenses	56,419	50,742	46,494	5,677	4,248
Real estate taxes	22,442	22,057	21,852	385	205
General contracting and real estate services expenses	399,713	227,158	88,100	172,555	139,058
Depreciation and amortization	96,078	72,974	68,853	23,104	4,121
Amortization of right-of-use assets - finance leases	1,349	1,110	1,022	239	88
General and administrative expenses	18,122	15,691	14,610	2,431	1,081
Acquisition, development, and other pursuit costs	84	37	112	47	(75)
Impairment charges	102	416	21,378	(314)	(20,962)
Total expenses	594,309	390,185	262,421	204,124	127,764
Gain on real estate dispositions, net	738	53,466	19,040	(52,728)	34,426
Operating income	73,587	134,412	59,152	(60,825)	75,260
Interest expense	(57,810)	(39,680)	(33,905)	(18,130)	(5,775)
Loss on extinguishment of debt	—	(3,374)	(3,810)	—	436
Change in fair value of derivatives and other	(6,242)	8,698	2,182	(14,940)	6,516
Unrealized credit loss (provision) release	(574)	(626)	792	52	(1,418)
Other income (expense), net	31	378	302	(347)	76
Income before taxes	8,992	99,808	24,713	(90,816)	75,095
Income tax (provision) benefit	(1,329)	145	742	(1,474)	(597)
Net income	7,663	99,953	25,455	(92,290)	74,498
Net (income) loss attributable to noncontrolling interests in investment entities	(605)	(5,948)	5	5,343	(5,953)
Preferred stock dividends	(11,548)	(11,548)	(11,548)	—	—
Net (loss) income attributable to common stockholders and OP Unitholders	$ (4,490)	$ 82,457	$ 13,912	$ (86,947)	$ 68,545

Outlook:

Armada Hoffler is a diversified REIT, meaning its operating segments come from mixed-use real estate properties that consist of retail, office, and multifamily properties. Further complicating analysis is that this REIT is vertically integrated meaning that it's financing the development of their properties in addition to managing the properties. This could be part of the discount or lower multiple for the REIT, in addition to being 8x leveraged.

However, with increasing topline revenue, FFO, AFFO, and increasing dollar dividend payments with a conservative payout ratio we added the name to our line-up and replaced a lodging REIT with a less stable and lower dividend.

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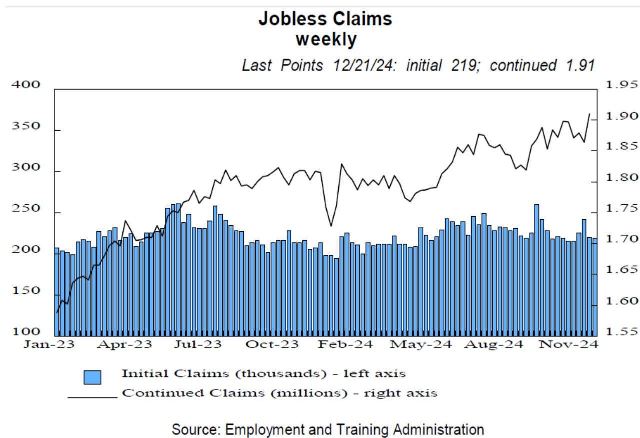
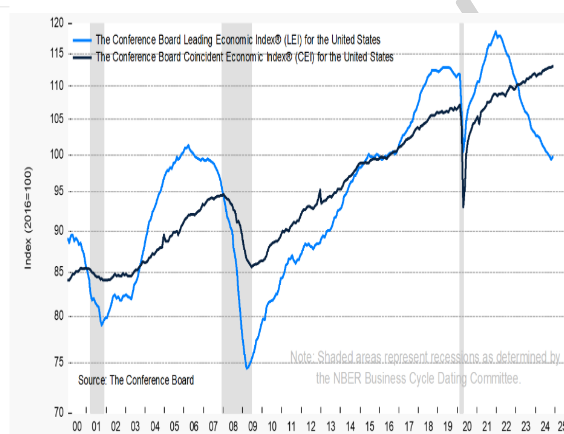
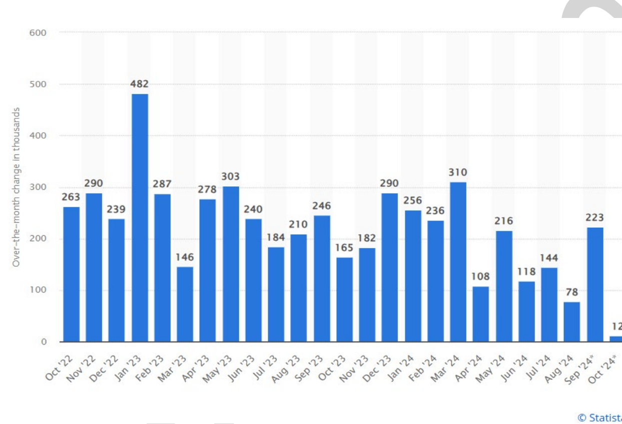
Outlook:

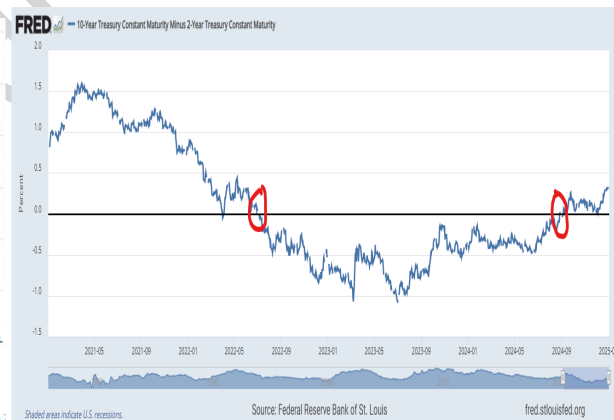
By all traditional measures the economy was slowing down, leading economic indicators had been negative for a prolonged time, an inverted yield curve for 25 months, jobless claims continued to increase, (although initial claims have been stable), non-farm payrolls had grown weaker since Q1, household credit card debt is at an all-time high at $1.17 trillion, household savings back below 5%, and the Fed has begun their easing cycle.





Non-Farm Payrolls





However, with the Republican sweep, we'll see an extension and possible increase of the Tax Cuts & Jobs Act, tariffs will more than likely be used as a negotiation tactic, and material increases in M&A activity and government deregulation could all spur economic growth from this point forward, although it will not be easy given the government debt overhang that has to be addressed at some point. If useless foreign wars, though they pad the pockets of many in Washington, can be curtailed along with other useless spending, and those resources used more productively and efficiently, we could see material growth in our economy going forward.

I believe the potential for a recession has been greatly reduced given the election results, but not to zero. S&P earnings will be revised down from their current levels and the Fed Funds rate

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might come down a total of 50 bps for all of 2025 and that will be a gift. Expectations for the Core+ strategy will be similar to our 2024 returns and hopes for lower volatility next year. Regardless, we will continue searching for yield in quality companies with the goal of increasing dollar income each year. We'll continue to have additional changes in our line-up come Q1.

Sincerely,
Eric Lutton, CFA®
Chief Investment Officer

Investment Advisory Services offered through Sound Income Strategies, LLC, an SEC Registered Investment Advisory Firm.

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