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# Fixed Income Quarterly: Q1 2025

*"I do not know much about the tariff, but I do know this much: when we buy goods abroad, we get the goods and the foreigner gets the money: when we buy goods made at home, we get both the goods and the money."*

- Abraham Lincoln

## The Markets:

We expected market volatility to increase in 2025, and the first quarter did not disappoint with the S&P increasing almost 4% until the "Don" took the oath of office on the 20th of January, and then we've had a material descent to -4.26% to end the quarter. The tech and growth-heavy NASDAQ also finished -10.24%, with the Dow little changed at -0.85%.

The new administration has wasted little time in repositioning the country's cultural and economic leanings toward a more perceived conservative perspective. The 47th has ended the Federal governments DEI initiatives, taken on fraudulent and unnecessary government spending with the DOGE department, slashed parts the bloated Federal government workforce, has commenced to returning illegal immigrants, especially those that have committed crimes while in the US and with time left over, they're taking on the task of adjusting foreign trade imbalances via a tariff war.

Factors before this new administration took over on January 20, combined with concerns over future growth, are leading toward further economic slowdown. Weaker consumer sentiment, business expectations, softer manufacturing numbers, slower month-over-month (MoM) retail sales, and lower revised numbers are weighing down equities and pushing up US Treasury prices this quarter.

Considering the slight uptick in inflation during the middle of the quarter, the Fed has left the Fed Funds rate unchanged with a collar of 4.5% to 4.25%, as expected. While a full-fledged tariff war could stoke inflation, we could also see the upper-middle class and wealthier households further curtail their spending going forward, which, in all likelihood,

could force some companies to lower their prices, and we could actually see a cooling effect on inflation if demand stumbles enough.

However, the most significant factor for the market this quarter has been on the tariff front. At the beginning of February, the Trump administration slapped a 25% tariff on Canada and Mexico, with a 10% tariff on their energy imports and a 10% additional tariff on Chinese goods. These tariffs, unlike those on metals trying to correct for a structural trade imbalance, were tied to illegal immigration, fentanyl, and other drugs pouring over our borders. These tariffs were paused until March 4, but have since gone into effect. One slight reprieve has been that China didn't match the additional tariffs placed on them, which is now a total of 20% over and above the original tariffs placed back during the first Trump administration. China placed a 10% to 15% retaliatory tariff on mostly agricultural goods such as chicken, beef, pork, wheat, corn, cotton, soy, fruits, and vegetables. China has also placed investment curbs on US company investment in China and banned Chinese firms from investing in US companies. Agriculture products to China represented about $43 billion in 2022, but the Chinese have been looking to source away from the US since then, and Brazil has been a winner by exporting more agricultural products to make up for the drop in US goods.

Trump is trying to run the US Government the same way he ran his billion-dollar real estate business because Donald knows, if you have the money and are the buyer, you get to dictate the rules of the game, not the sellers. Needless to say, this will be a saga that continues to unfold over the next quarter or two, but hopefully, there will be more clarity by this summer. Otherwise, things will get messy quickly.

**Bond World:**

As we all know, the market hates "unknowns," and there are several factors such as tariffs, inflation, Fed Funds rate, corporate earnings revisions, and the outlook for consumer spending, which is estimated to be 70% of our GDP. We won't even touch on geopolitical risk with proxy and foreign wars potentially escalating. The fuzzy outlook on these factors has caused a bit of a flight out of equities and into US Treasury securities.

The 10-year UST returned 4% during the quarter, and given the Bloomberg US Aggregate Index's 43% allocation to US Treasury and Agency debt, it also gained for the quarter, up almost 2.8%. Our Core+ had a decent first quarter and is up +1.4%, though further tariff escalation will drag on our higher-income generating portfolios and probably be beneficial to our basic Core strategy.

As stated above, the Fed left rates unchanged at 4.5%, and I don't think we'll see the Fed even look to lower rates until the end of Q3 or Q4 of this year. Unless we see a massive slowdown in spending from consumers and the government, which materially slows GDP, otherwise the Fed will be watching the inflation numbers to determine if they can lower them or not.

The 10-year ended 2024 at 4.56%, peaked in mid-January at 4.80%, and proceeded to drop to an early March low of 4.10%. Currently, the 10-year yield is 4.25%. The belly of the curve has been the place to be during the first quarter, as 3-year through 10-year maturities rallied the most, and where we've been purchasing bonds. Locking in 5.5% to 6.5%+ in bonds is a good place to be as equities are still overvalued with a 1.5% dividend yield, 26x P/E ratio before XO items, (extra ordinary) and the Shiller P/E ratio, (earnings adjusted for inflation) is at a 36.8x level which is about 17 points higher than the modern average). Even if tech/ AI names are mostly to blame, most equities are overvalued on a historical basis. With no expectation of the Fed lowering rates anytime soon, we should remain in a trading range for US government debt, with the 10-year trading between the low 4% area up to 4.35%, short of any major black swan event.

We did get some trades in during the quarter and even added an additional fixed-income strategy called "Ultra," which was yielding 7.45%; however, down to 7.12% as of this writing. Ultra will be the riskiest of the income-based strategies, and we'll try to keep the yields up as high as possible without sacrificing quality, with 7% to 7.5% as the range to start based on the current level of interest rates. We changed around some weights to asset classes versus the Income+ strategy and swapped out the Sovereign Debt names for higher-yielding bond ETFs listed below in the "Trades" section of the letter.

**Trades:**

**Arrow Electronics Inc- ARW 5.875% 4/10/34's (Baa3/BBB-/BBB-) @ $100.15/5.85%**

Arrow Electronics Inc. sources and engineers technology for thousands of leading manufacturers, service providers, and users of enterprise computing solutions. The company has an immense portfolio of product offerings from leading electronic components and enterprise computing solutions suppliers, as well as a range of service solutions and software solutions to help industrial and commercial companies further innovate products. The firm has been around since 1946 and was incorporated in New York. There are two main reportable segments, global components and global ECS. ARW distributes electronic parts to OEMs and EMS providers through its global components and provides enterprise computing solutions to VARs and MSPs. There are currently 140 sales facilities and 36 distribution and value-added

centers, serving over 85 countries with 72% of revenue from global components and 28% from global ECS (Enterprise Computing Solutions).

Per the firm's annual report, Arrow's business strategy is to be the premier, technology-centric, go-to-market and supply chain services company. The company's portfolio is designed to enable technology across major industries and markets, including industrial automation, edge and cloud computing, smart and connected devices, and transportation to deliver new technologies. Arrow aggregates disparate sources of electronics components, infrastructure software, and IT hardware to engineer complete solutions for customers on behalf of its suppliers. The company aims to help enable secure and consistent supply chains and drive growth on behalf of its suppliers.

**Catalyst:**

The electronic components market size is a $400 billion industry and is expected to grow to $850 billion within the next eight years, a 10%+ CAGR as the growth in electronic devices continues. Advancement in technology for smartphones, laptops, tablets, toys, and a secure supply chain for electronic parts should continue even with a potential slowdown, given the move towards miniaturization of components and devices. The "internet of things" is increasing demand for parts, and nanoscale electronics are moving wearable tech into biomedical implants, furthering product development and growth potential. Every industry is an end user of electronic components, with telecommunications, automotive, industrial, consumer, healthcare, energy, and utilities all making advancements in products and services. Though the sector is still in a sector-bear market, ARW is considered one of the highest quality distributors given their scale, breadth of products/services, and client retention rates. Management has alluded to an uptick in book-to-bill rates, and we could be in a very early-stage upturn.

**Risk & Outlook:**

This credit trades a little wider than most triple-B technology peers, given the semi-conductor/ chip demand slowdown that began in '23, but we could be coming out of the slump towards the end of this year along with an improvement in inventory turnover and demand improvement in trailing-edge semiconductors which is material to ARW's revenue.

One risk that has crept up is the new administration's tariffs, to which ARW has already updated its prices accordingly. Granted, if tariffs get too high, it could affect the growth in demand for components and delay the sector's early-stage upswing, but ARW has dealt with tariffs during the first Trump administration. Arrow has a similar business model to pipelines and is just "passing" product along for a fee, where end users or producers could have a more adverse reaction than ARW.

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## Recommendations:

Given our low exposure to the sector and +145/+150 spread for a 9-year solid IG credit and potential end-of-year improvement for the semiconductor/electronic component sector, we're adding the credit to our lineup.

ARW

**ARW US Equity**

| *Financial Metrics* | Q1'25 | 2024 | 2023 | 2022 | 2021 |
|---|---|---|---|---|---|
| Adj Revenues | | $ 27,923 | $ 33,107 | $ 37,124 | $ 34,477 |
| % chg | 100.0% | -15.7% | -10.8% | 7.7% | 19.2% |
| Adj EBITDA | | $ 1,294 | $ 1,830 | $ 2,362 | $ 1,852 |
| % chg | -100.0% | -29.3% | -23% | 27.5% | 58.4% |
| Capex | | $ 93 | $ 83 | $ 79 | $ 83 |
| % chg | -100% | 11% | 6% | -5% | -33% |
| Interest Exp | | $ 270 | $ 329 | $ 186 | $ 132 |
| Net Leverage (ND/EBITDA) | | 2.48 | 2.12 | 1.65 | 1.45 |
| CFO | | $1,130 | $705 | -$33 | $419 |
| FCF | | $1,038 | $622 | -$112 | $336 |
| Cash & Equ | | $189 | $218 | $177 | $222 |
| | | | | | |
| Equity Price | $ 108.94 | RQ005 | | | |
| Market Cap $B | $ 5,665 | RR902 | | | |
| BV Equity | $ 5,832 | RR007 | | | |
| Gross Debt $B | $ 3,391 | RR251 | | | |
| LTM FCF $mm | $ 1,036 | RR843 | | | |
| FCF Yield (LTM) | 17.8% | RX072 | | | |
| P/CF | 5.13 | RR908 | | | |
| P/E (LTM) | 10.67 | RR900 | | | |
| Dividend Yield | - | DV012 | | | |
| Payout Ratio | 0.0% | RR049 | | | |

**Near-Term Debt**

$350mm due 2025, $30mm due 2026 with $1.9 billion available then $500mm due '28,'29,'32 and '34.

**Key Transactios, Material Changes**

No material M&A the past few years

| Ratio Analysis | ARW | vs Comps |
|---|---|---|
| Current Ratio | 1.46x | 1.68x |
| Quick Ratio | 1.05x | 1.05x |
| Debt/Mkt Cap | 36.8% | 34.3% |
| T.Assets/T.Equity | 3.73x | 3.02x |
| Debt/ Assets | 15.59% | 20.81% |
| Debt/ Capital | 36.77% | 34.32% |
| Debt/ Equity | 58.15% | 61.42% |
| N.Debt/ EBITDA-Capex | 3.08x | 2.55x |
| EBIT/ Int Exp | - | 4.67x |
| Net Debt/ EBITDA | 3.4x | 2.5x |
| FCF/ Debt | 0.31 | 0.11 |
| Asset Coverage | 2.18 | 2.78 |
| Gross Margin (LTM) | 11.0% | 10.1% |
| Operating Margin (LTM) | 2.7% | 0.5% |
| Profit Margin (LTM) | 1.4% | -0.9% |

Source: Sound Income Strategies/Bloomberg 2024

## National Storage Affiliates-NSA @ 6.0% yield

National Storage Affiliates Trust is a real estate investment trust headquartered in Greenwood Village, Colorado. The REIT owns and operates self-storage properties predominantly located within the top 100 domestic metropolitan areas. The Company directly and indirectly owns interests in 1,070 self-storage properties located in 42 states and Puerto Rico, with approximately 81 million square feet. NSA is about the fifth-largest self-storage REIT out of all public and private REITs.

## Key Points:

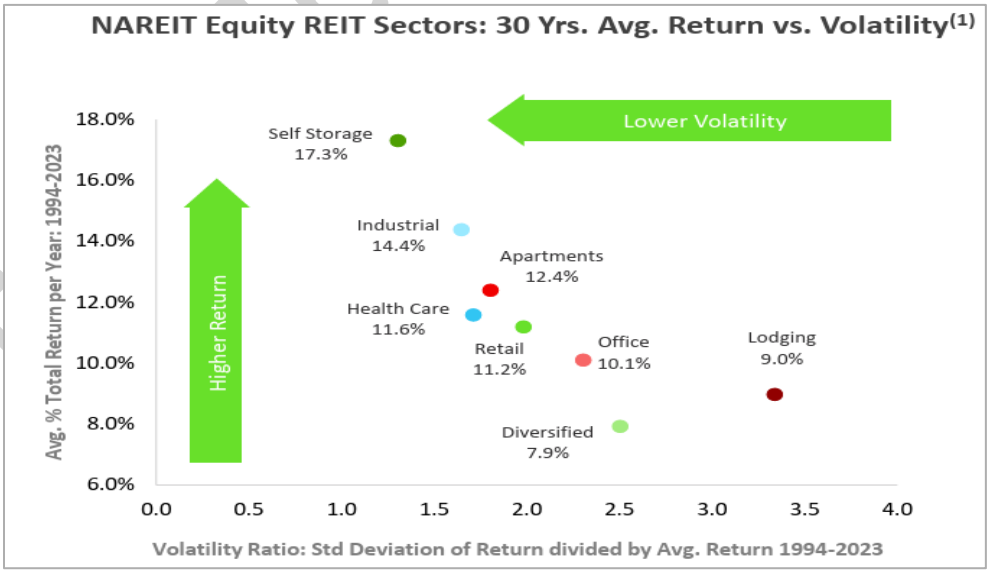
The self-storage industry is fairly fragmented, with approximately 52,000 facilities in the US, and 66% of this market being operated by small private operators. NSA storage REIT sees the current state of this industry as an opportunity. Currently, they are trying to consolidate operations of 12 national brands across the US and PR, down to 7, and move all of the various brands and properties under one website: NSAstorage.com to lower SG&A costs with consolidated national advertisement, improve ranking on the internet, and overall customer experience.

NSA, along with some other large peers, have been moving towards improving "other" income such as tenant insurance, third party management, parking for RVs and boats, along with

charging for small items needed for storage such as boxes, tape, and locks, all to improve net margins. Storage REITs now trade in a lower range of 16-18x forward FFO per share vs 18-21x during Q4 2024, and the market expects same store revenues (SSR) will pick up during the second half of 2025. There are some common headwinds to this sub-REIT sector, such as a high correlation to housing demand, which is still weak given high mortgage rates. Increasing expenses such as labor and construction costs, along with new storage units or "supply," all play a role in affecting rental unit prices.

## Outlook:

We've been patiently waiting for opportunities to present themselves in the storage REIT space. Given a mandate to seek out equity REITs yielding above 5% has been tough, given most quality names trade in the 3% to 4% yield range. The reason for this is simple: the storage REIT space has historically offered higher total returns with less volatility; therefore, it has outperformed other REIT categories for many years, hence the lower yields. Only more risky companies usually trade at higher yield ranges, but given the "higher for longer" interest rate climate, and weak housing turnover, we are finally seeing opportunities in this REIT sub-sector with these "higher for longer" interest rate pressures and a potentially slowing economy. This pressure on storage REITs has hurt their stock prices, hence the higher current yields, which are starting to look compelling. Although the headwinds for storage REITs aren't over yet and we expect further declines in same-store sales, revenues/earnings, and occupancy levels. We do believe a bottom could be forming this summer in the space, and given the historic performance, this presents an opportunity to pick up a name like National Storage Affiliates at a 6%+ yield.




Source: Nareit/Seeking Alpha 2024

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The self-storage sector had strong demand from Covid-19-related issues from 2020 through late 2022, and there was little new supply being built during this time. Due to a sluggish housing market with higher interest rates during ’22 through ’24, storage demand has also been sluggish, given the high correlation with housing demand/ turnover. While we don’t expect interest rates to fall from current levels during 2025, there shouldn’t be much new storage supply coming online until 2028, according to consensus, which should allow storage REITs to improve occupancy rates in late 2025 and early 2026, slowly.

During Q4, NSAs had core FFO of $81.2mm or $0.60 per share, an 11% decrease vs Q4’23. SSNOI fell by 7.5% during Q4’24 vs Q4’23, driven by a 4.3% loss of SSNOI combined with a 4.7% increase in SS operating expenses and a 1.4% drop in SS occupancy. Full year numbers came in at $183.3mm in revenue, which was over a 22% drop from 2023. Diluted EPS were $1.18 vs $1.48 in 2023. Core FFO of $308.7mm or $2.44 per share, a decrease of 9.3% from 2023.

NSA management acquired 25 properties for $212.8mm and completed sales of 40 wholly owned properties for $273.1mm, and management contributed 56 wholly owned properties to their “2024” joint venture between their sub and a sub of Heitman Capital Management LLC, totaling $346.5mm.

Management also entered into a new agreement for authorization to sell up to $400mm of common shares in their ATM program. NSA expects the internalization of their “PRO” (franchise) structure and recent consolidation to increase SS revenue through better occupancy, given that the non-consolidated properties show 300 bps lower occupancy rates versus the corporate-managed properties. Management has also given ’25 guidance of $2.30-$2.38 Core FFO (AFFO), which is a -4.1% drop from 2024, but baked into equity prices.

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2024 | 2023 | Change |
| Rental revenue | $ 700,247 | $ 793,966 | $ (93,719) |
| Other property-related revenue | 27,362 | 29,686 | (2,324) |
| Management fees and other revenue | 42,726 | 34,411 | 8,315 |
| Total revenue | 770,335 | 858,063 | (87,728) |
| Property operating expenses | 211,852 | 228,986 | (17,134) |
| General and administrative expenses | 57,606 | 59,281 | (1,675) |
| Depreciation and amortization | 189,855 | 221,993 | (32,138) |
| Other | 13,866 | 11,108 | 2,758 |
| Total operating expenses | 473,179 | 521,368 | (48,189) |
| Other (expense) income | | | |
| Interest expense | (154,260) | (166,147) | 11,887 |
| Loss on early extinguishment of debt | (323) | (758) | 435 |
| Equity in (losses) earnings of unconsolidated real estate ventures | (16,075) | 7,553 | (23,628) |
| Acquisition and integration costs | (3,616) | (1,659) | (1,957) |
| Non-operating income (expense) | 314 | (1,016) | 1,330 |
| Gain on sale of self storage properties | 63,841 | 63,910 | (69) |
| Other expense, net | (110,119) | (98,117) | (12,002) |
| Income before taxes | 187,037 | 238,578 | (51,541) |
| Income tax expense | (3,767) | (1,590) | (2,177) |
| Net income | 183,270 | 236,988 | (53,718) |
| Net income attributable to noncontrolling interests | (71,752) | (80,319) | 8,567 |
| Net income attributable to National Storage Affiliates Trust | 111,518 | 156,669 | (45,151) |
| Distributions to preferred shareholders | (20,445) | (19,019) | (1,426) |
| Net income attributed to common shareholders | $ 91,073 | $ 137,650 | $ (46,577) |

Source: NSA Financials, 2024 10K

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The Ultra Strategy:

Bondbloxx CCC-USD HY Corp Bonds- XCCC @ 11.1%

XCCC is a passive high-yield strategy that tracks the ICE CCC US HY Index with bonds rated CCC1 through CCC3 based on an average from all three major rating agencies. The Media, Insurance, Capital Goods, Telecommunications, and Healthcare sectors make up almost half of the index, with 218 securities, which represent 143 separate issues with an average maturity of 4.1 years, and an OAS of +793.

Eldridge BBB-B CLO- CLOZ @ 9.3%

CLOZ is an actively managed ETF that primarily seeks current income while preserving principal as a secondary objective through investing mostly into a diverse portfolio of 50/50 BBB to BB collateralized loan obligations or CLOs. High-tech, Healthcare, Finance/ Insurance, Business Services, and Hotels/Gaming & Leisure make up half of the allocation.

Xtrackers High Yield Bond- HYUP @ 8.1%

HYUP seeks investment results to the Solactive USD HY Corporate Total Market Index with a rules-based strategy. The managers seek out higher-yielding/higher beta names in the underlying index. The Solactive Index has outperformed the Bloomberg US Universal Bond Index since its inception by a material margin.

Spider Portfolio HY Bond-SPHY @ 7.7%

The SPDR HY Bond ETF is a passive strategy that tracks the ICD BofA US HY Index, with a very low cost of 5bps and looks for issues with at least 18 months left to maturity, fixed coupon, and at least $250mm in outstanding debt. There are over 1,964 holdings with a 350 bps OAS and a 3.0 duration.

Source: Bloomberg 2024

**Outlook:**

The McKinley tariffs of the 1890s increased import tariffs to 50%, mainly to protect our young country's manufacturing and growing industrial base. However, once these large mercantilists became wealthier and often partnered with large Wall Street banks, they realized it was easy for foreign nations to enact reciprocal tariffs upon US goods and the only way to sell more was to lower tariffs here so that foreign governments would repay in kind, hence more consumption of goods and an increase in profits.

The only issue was that their political friends still needed the tariff capital to stay in power and run the country. Less tariff money (government revenue) would be an issue. Hence, the bankers/new industrialists came up with "The Federal Reserve" and the new income tax of 1913 to replace the tariff revenue, and of course, a whole host of other plans we can discuss another day.

To end or lessen the tariff issue for big money, Congress passed the Underwood-Simmons Tariff Act, also during 1913, to start phasing out tariffs which big money believed were hurting their gross and net margins. This way, the bankers/industrialists, along with the political class, could all continue to grow their income and power base.

It's interesting that the Trump administration is taking the view that they can possibly replace the income tax, or at least keep it low, and that tariffs can't make up the revenue difference. While I think that will be an extremely difficult task, I can't argue with cutting out government fraud and waste and holding elected officials and government employees to private industry accountability standards.

While I don't think this administration will accomplish half of its extremely ambitious goals, I do applaud the effort. That said, if the tariff wars don't come to a quick renegotiation of foreign trade agreements, then we'll see more "risk-off" trades and a further decline in equity markets, and this time globally, not just the US. While this will be bullish for US Treasurys as a "flight to quality", we'll see corporate bond spreads widen out and underperform US Treasuries. Overall, our Core and Core+ strategies should be able to withstand the headwinds of a slowing economy, tariff war, and possible escalation of proxy and foreign war. We hope all of these factors come to a peaceful conclusion soon.

*Sincerely,*
*Eric Lutton, CFA®*
*Chief Investment Officer*

Sound Income Strategies