Rareview's Azous Talks The Dangers That Rising Rates Pose Now

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Chuck Jaffe, in The NAVigator podcast interviewed Neil Azous, chief investment officer at Rareview Capital. Read the Q & A below as Neil says that 10-year real US interest rates—which have been on the rise for the last few weeks—are 'the most impending danger' to investor portfolios. He says the market is now acting as if the pandemic is nearly over and says that investors need to be thinking of the big economic themes beyond the re-opening, including the changing rate picture.

Neil Azous

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Neil Azous, chief investment officer at Rareview Capital is here and we're talking about rising interest rates now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator's brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today it's pointing us in the direction of Neil Azous, who's chief investment officer at Rareview Capital, which doesn't run closed-end funds itself, it invests in closed-end funds. And it does that among other ways through two ETFs, the Rareview Dynamic Fixed Income ETF and the Rareview Tax Advantaged Income ETF. We'll get back to discussing those and how they're investing in a rising interest rate environment in just a minute, but if you want more information, RareviewCapital.com is the website. Neil Azous, thanks for joining me again on The NAVigator.

NEIL AZOUS: Thanks Chuck, excited to be here today.

CHUCK JAFFE: You're excited to be her. Are you excited about rising interest rates? Because although we're still within the Fed's projections and we're not worried too much about where they're going, they have moved more than a lot of people expected in recent weeks.

NEIL AZOUS: Yes, that's right. That's a fair assessment. So if you take the view that markets are a forward-discounting mechanism Chuck, meaning typically they price in outcomes at least six months in advance, it's clear that markets believe that the vaccination process is a fait accompli, meaning it's done. And that means it's prudent to begin thinking about macro themes beyond the pandemic's evolution, and that means the rates market or the interest rate market is already starting to do that. Specifically it's telling us that 10-year real U.S. interest rates are posing the most impending danger to current portfolio construction. So real briefly, Chuck, just so people make sure they have an understanding, the nominal interest rate was a headline interest rate that we see every day, it is the different between real yields and break-evens. And the breakeven rate is the difference in yield between inflation protected and nominal debt. Well, over the last eight days, or really since they call it, February 10th, if you look at a breakdown of real yields, break-evens, and how that contributes to nominal interest rates, the moves are fairly epic in a short period of time. Epic being defined as multiple standard deviations in statistical terms. At a minimum, there are a couple potential takeaways from that that we need to get our heads around. First of all, there may be a floor in real interest rates and that's been solidified. And then two, real interest rates are unlikely to decline further from here, meaning they may not go even further into negative territory. So what does that actually mean and what does that mean to portfolio construction? So let's assume that if you actually went through the analysis and looked at the environment over the last week, there are many critical signals that crystalize that event.

You can look at something say in the real interest rate market as I just discussed. You could look at something in the nominal yield curve that people are very familiar with. If you have a long history in credit and equity derivatives like us, it allows us to look at the volatility of multiple dimensions. We can see that changeover in volatility markets over last week, especially in the bond volatility market. Collectively, we think that the bond market signaled that the current economic scenario, that growth and reflation optimism would soon lead to the step change in the Federal Reserve outlook. Meaning we're migrating to a tightening stance away from pandemic-led easing, and so this is the phase right before an interest rate hiking cycle. This regime of higher real yields and maybe a different outlook for break-evens has received critical signals or evidence of a regime change, and that has major implications to the type of economic scenario we're in, and then the impact on various asset classes and productions. Whether it be the major asset classes like the US dollar, commodities, credit spreads, etcetera. And then what that might mean to products such as closed-end funds, they're going to have various impacts. It's a material move and we certainly move from one regime where real yields and break-evens were rising in tandem to real yields now rising and break-evens on the inflation side may be more of a sideways situation. That is a different profile than where we've lived for the last several months.

CHUCK JAFFE: You've talked about how this is going to affect both the economy and investments, so let's start with the economy. You've got rising rates, we're not talking about massive increases in rates necessarily but they're going up, that's creating presumably some measure of inflation. You've then got all the economic stimulus that could create more. So the inflation outlook for you is what? And is that making certain types of bonds more attractive to you?

NEIL AZOUS: Going forward from here, in the economic data we certainly see more inflation in certain parts of the segments that make up inflation. How that translates into an economic scenario and then ultimately market impact in specific asset classes is really yet determined. We're sort of in an unknown in the sense that in the past whenever we had a regime change where we had real yields and break-evens rising at the same time, to that now being sort of split apart, that usually is accompanied by some type of Fed messaging that drove the regime change. And in the past if you'll remember, about seven, eight years ago we had this thing called the Taper Tantrum, that was a regime change very similar to now because of Federal

Reserve messaging. The difference today is it's robust economic data over the last month but really over the coming months that is driving that regime change, and that's what's makes it interesting for different asset classes to operate. Meaning a lot of times we would just go in from a rising real yield and a rising breakeven regime into rising real yields and lower break-evens. Now we've got this thing in the middle. Is it Fed messaging or is it economic data? For us it's economic data, and I think we will see an incremental move higher in market-based measures of inflation and that will have some impact on interest rates. But to be fair Chuck, this is not a new concept, this has really been going on since last August in some form. And so the various measures, whether they're market-based or the products that track inflation pretty well track those now and are fairly valued at this stage. So unless we're going to have a much higher impact on inflation or as much greater upside surprise, things are fairly valued, this is not an unknown. What's happening now though Chuck, is that the conversation is migrating away from inflation because that's already discounted, and into will all of these great things that are going on, whether it's inflation, growth, the vaccinations, etcetera, pull the Federal Reserve forward to force them to change their messaging? That's what's happening the market, and that's why as of last week the real yields are starting to lead the way, which has changed the regime.

CHUCK JAFFE: You talk about things being fairly valued. Of course when it comes to closed-end funds, what investors most want are discounts. Does it change the discount picture? Does it change what you're buying? Or does it give someone who is playing the fixed-income market with closed-end funds the way you are an edge over somebody who's playing it by holding the bonds themselves?

NEIL AZOUS: I'm going to separate that question into two parts. The first one was really about discounts and then the second one is really what sectors matter. When it comes to discounts or the closed-end fund wrapper in structure, a lot of that has to do with their financing or the moderate amount of leverage that they use. Even though interest rates, for example the 10-year interest rate has gone from say, 0.5% last August to about 1.4% today, almost up 90 basis points. The frontend of the yield curve or where short-term financing is managed has actually come down in yield. And so from a financing standpoint and a leverage standpoint, closed-end funds have not had any really material impact regarding acquiring that leverage. And that's an important thing to recognize because that cost savings is what allows them to pass those savings on in the form of higher distribution yields. And then as those distribution yields and closed-end funds increase, the discounts to the net asset values tend to decrease as those products become more in demand. So to answer the first part of your question, broadly speaking, higher yields are not supportive for most products. In our case, we're really tied in terms of the closed-end fund financing to the very short-term part of the interest rate curve, and that's actually come down in yield as part of the Federal Reserve's messaging. So it's still a supportive backdrop. Secondly, you have to distinguish between what sectors tend to benefit from higher yields and what sectors tend to be hurt from that. In a most simplistic way, sectors like high- yield or leverage loans tend to benefit from that because the higher yield move is being led by growth expectations, not the Federal Reserve. And so if you think about it, you know how many people always tell us Chuck, that "Oh, equities should fall," or "Risk assets should have a difficult time if interest rates rose"? Well, let me ask everybody this, the interest rate on the 10-year yield is up 90 basis points since August, and the S&P 500 is up 20%. So it doesn't really look like that's the case. What it's really saying is that earnings growth remains solid, the absolute level of real yields are still negative, and going forward the moves should be more incremental from here. And so these are actually supportive environments for riskier assets like equities or high-yield or leveraged loans. On the other side of the ledger Chuck, you can't make that same case when it comes to interest rate sensitive sectors like investment-grade credit, or in this case, municipal securities. For people who don't follow it closely, the investment-grade space is a very important part of asset allocation in credit markets. Unfortunately the credit spread is very tight at the moment and they're highly sensitive to interest rates, especially any minor bout of inflation. So to give you guys an idea or a yardstick, investment-grades peak to trough annual drawdown is around 4.7%, which is quite a lot for an asset class like that. But year-to-date, we're already down 4% in the investment-grade market, primarily driven by duration and interest rate sensitivity. And so closed-end funds in that category have seen their discounts widen out, a, because of just general volatility but, b, the net asset value has dropped because of interest rates. So that's been a difficult space. Recently in the last week, municipal securities have seen a decent amount of widening. I would phrase it this way, it's the highest amount of discount widening on the most amount of volume since the pandemic. What did that translate into? Certain securities have dropped somewhere between 2% and

5%, with the combination being discount widening and the net asset value falling because of higher interest rates. So they're very over sold, people are technical people on a relative strength index, some portfolios are probably sub 15%. So they're very oversold, so tactically they have an interesting entry point. I would say strategically they're still are going to have to contend with higher yields between now and the end of the year. But if you're new to it, your total returns should be good when you look out one year. As a reminder, part of that total return should be productive because the Fed is still at the effective lower bound in the front end where closed-ends tend to finance. And so it's a little bit mixed but entry point just became a lot more meaningful in interest rate sensitive sectors over the last seven or eight days.

CHUCK JAFFE: Neil, there's so many more questions I have, I just don't have more time. So we'll have you back down the line to see how it's all playing out.

NEIL AZOUS: Anytime Chuck. Best of luck and talk to you soon.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I am Chuck Jaffe, please check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Neil Azous, chief investment officer at Rareview Capital, which sponsors the Rareview ETFs which invest in closed-end funds. Check them out at RareviewFunds.com and follow Neil on Twitter @NeilAzous. The NAVigator podcast is new every Friday, subscribe on your favorite podcast app and join us again next week to learn more about investing with closed-end funds. Until then, stay safe everybody.

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