Nuveen’s Nate Jones: Upward Sloping Muni Yield Curve Creates Opportunities

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Nate Jones, head of fund finance and Treasury at Nuveen. Read the Q&A below as Nate says that conditions and 'market nuances' from late in 2022 have carried into the new year, noting that the yield curve for municipal bonds is sloping upward even more than the plot on taxable bonds, which is creating opportunities for investors to benefit from using leverage to make closed-end muni returns attractive now. Jones also explains the December supply-demand imbalance in muni bonds, and why it might reoccur come tax time, and discusses how rising rates have raised default concerns but haven't led to a significant increase in bond failures.

Nate Jones

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CHUCK JAFFE: We’re talking with Nate Jones, head of fund finance and Treasury at Nuveen about municipal bonds and what closed-end fund investors can expect from them next, welcome to The NAVigator. This is 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 is 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 I’m joined by Nate Jones, he's senior managing director and head of fund finance and Treasury at Nuveen, one of the largest sponsors of closed-end funds, and particular of those in the municipal bond space. You can learn about the firm and its funds at Nuveen.com, and you can learn more about business-development companies, interval funds, and closed-end funds in general at AICAlliance.org, the website for the Active Investment Company Alliance. Nate Jones, thanks for joining me on The NAVigator.

NATE JONES: Thanks Chuck for having me. Eager to be here.

CHUCK JAFFE: It's not just as simple as, "Hey Nate, let's talk about muni bonds," because that's not really what we want to get into. Because your specialty really involves the way muni bonds are used in closed-end funds, taking advantage of leverage and more. Help us get a little bit of an understanding of what's happening in the muni bond market but also why this market is set up pretty well for closed-end fund investors to benefit.

NATE JONES: Sure, sure. As your listeners are all probably aware, 2022 was a very tumultuous year for most asset classes, fixed income and munis fell right in line with all of the activity with long-end rates moving higher, the Fed being very active on the short end, and rising rates. But municipals inherently do have a nice fit for closed-end funds because a majority of the municipal closed-end funds do employ leverage. Now leverage is primarily used at Nuveen, and across I would say most other fund sponsors, to enhance the income benefits for common shareholders. In that sense, asset managers like Nuveen buy longer dated, higher yielding municipal bonds and financing a portion of that through leverage or borrowings that are primarily tied to the front end of the curve, and what we had in 2022 was a pretty dramatic increase in those leverage expenses tied to Fed hikes. The municipal bonds are kind of inherently attractive for this type of structure for a couple of reasons; one, the yield curve for municipals typically is upward sloping, much more even so than I would say the Treasuries, and that's primarily on the short end, municipals trade right around theoretical after-tax benefits, one minus the marginal tax rate. Whereas yields on the longer end tend to trade closer to taxables, if not in excess of taxable rates. The other inherent advantage municipals have in the closed-end fund wrapper is that their borrowing costs are typically tied to some sort of spread to a tax-exempt index. Municipal closed-end funds finance themselves primarily through the issuance of preferred stock or the investment in tender option bond investments. The nuance behind both of those structures is that they're able to pass through the tax-exempt nature of the underlying portfolio bonds, which in essence means that the lender to those closed-end funds gets the benefit of the gross up in tax. This benefits the common shareholder of the closed-end fund because in theory they're able to pay a lower all-in financing cost then for another taxable strategy or if they simply borrowed from some sort of borrowing or credit facility. Again, a very volatile market in 2022, and we particularly found some kind of I would say market nuances towards the latter part of the year. But overall I would say that the municipal curve has remained upward sloping, even more so than the taxables, and we think that creates still opportunities for common shareholders to benefit from the use of leverage in closed-end fund wrappers.

CHUCK JAFFE: There was a lot of action at the end of the year in munis, and there was some talk about how we had a little bit of a mismatch in supply and demand. Was that about the yield curve? Was that about something else going on? And how much does that continue into this year?

NATE JONES: I'm glad you brought that up because December was actually a very interesting month. It brought together not only some of the Fed hike activity that we saw at the latter part of the year but also a lot of market technicals, some which aren't very unsurprising to those that follow the municipal market closely. What we had heading into December, and in particular at the end of the November, was SIFMA, so it's the seven-day high grade Municipal Swap Index, which is largely the spread to which leverage costs for closed-end funds are tied to, really outperformed the costs of taxable indexes. Or in essence, they traded at a lower percentage of taxable rate. This is a benefit for muni closed-end fund wrappers, but in essence it got a little bit too rich. We saw at the end of November the relationship between SIFMA and SOFR, the taxable equivalent, was right around 50%. So as a result what happened was we started to see money market fund flows go out at the same time we were preparing for year end with bank balance sheets, so we saw a lot of paper come back to the banks. And unfortunately remarketing agents then had to set the rate higher for SIFMA heading into year-end in order to clear those inventory balances. That mismatch is typically seen across munis at certain points in the year, year-end is one of them, also during April during tax season, but because we're in a higher rate interest rate environment, the impact with the week to week change in the rate was much more noticeable this year. In the third week of December, so December 21st, we actually saw the SIFMA reset at its high at 3.8%, or just under 90% of its taxable equivalent or SOFR equivalent. Not surprisingly though, we anticipated that flows from principal and interest from muni funds, the fact that we were actually at an absolute higher rate would actually bring in flows at the turn of the year. And we saw this start to taper off at the end of December, and quite dramatically reverse itself in the first two weeks of January. On January 4th we saw the rate decline to 3.13%, and on the 11th of January it actually declined down to 2.5%, which is roughly just about 60% of the taxable equivalent. This is actually pretty attractive in terms of its quick recovery, but you do see that volatility with a SIFMA relationship on a week-to-week basis when comparing it to taxables. At these levels we did see money market fund inflows increase by right around, call it $11 billion over that two-week period, and we anticipate that for the next coming weeks to a month that this relationship probably should be a little bit more stable before we head into what potentially may be another hike or two from the Fed as well as the April tax season. But all in all, I would say the recovery of SIFMA from its mid-December highs does pose well for those closed-end fund wrappers that utilize leverage for the benefit of incremental income for common shareholders.

CHUCK JAFFE: And just to make sure nobody gets lost in the jargon, SIFMA, the Securities Industry and Financial Markets Association is the association. But when you're referring to SIFMA, you're referring to what is actually the Municipal Swap Index, which most people call the SIFMA Index. For anybody's who's trying to make sure they understand it, it's the Municipal Swap Index. I think I got that right, correct?

NATE JONES: Yeah. No, that's a good clarification there, and one for folks that use all the time, easy to slip off the tongue here. But yeah, it's the seven-day high grade, and it's really meant to capture cash-like type investments for tax-exempt investments, primarily the investments that a tax-exempt money market fund would hold.

CHUCK JAFFE: Which also makes it particularly sensitive to rate hikes, so what's your expectation on the Fed and what's going to happen down the line? Since you were setting us up for that.

NATE JONES: So throughout the year we saw SIFMA rise, but it doesn't move in lock step with Fed activity. One of the aspects of moving into a higher rate environment that we've seen is that money fund assets have also increased throughout the year, and this does create additional demand for these type of cash-like or tax-exempt cash-like instruments, which in theory then puts a little bit more downward pressure on the rates going forward. But once those relationships get a little bit too out of whack or too attractive for the SIFMA-type paper, you do see the rates kind of backed up. So we do anticipate that as the Fed continues to hike, you will see SIFMA rise as well. Albeit it does become a little bit more attractive I would say in a higher rate environment, and thus we would see it trade or reset at a lower percentage of its taxable equivalent rate.

CHUCK JAFFE: A few years ago there was a lot of talk about potential for defaults in the muni bond space, et cetera, everybody's worried about certain states, Puerto Rico, a bunch of other things as well, and then we really didn't see much in the way of defaults. But now we're in a much higher, much different rate environment, and there is at least worry of defaults being priced into more securities. Do you worry that what we were afraid was going to happen before could come to fruition? Or muni bonds, there's not much risk that defaults are going to go way up just because rates have come way up?

NATE JONES: There's always the concern as interest expenses become higher that the ability to pay on those debts becomes more difficult, but I think you hit the nail on the head, is that we've gone through these rate periods before, we've seen higher rate environments in municipals, and at these levels I don't think that is the fundamental. Again, obviously munis are on a credit-by-credit type review, we think though that the ability to invest in some of those credit names actually provides an opportunity for investors in these kind of closed-end fund wrappers to benefit from that incremental spread. But as a carte blanche I would say just the rising nature of the rates doesn't provide a singular kind of focus around defaults. Again, it still tends to be much more credit by credit, state by state, municipality by municipality type review.

CHUCK JAFFE: Nate, really interesting. Thanks so much for joining me on The NAVigator to talk about it.

NATE JONES: Thank you. Thanks for having me.

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