abrdn's Mondillo: Downtrodden Muni Funds Now Represent A Big Opportunity

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Jonathan Mondillo, head of North American fixed income for abrdn. Read the Q&A below as Jonathan says the municipal bond market has been looking at a "teacup inversion," and as that changes when the Federal Reserve cuts rates later this year, it should set up well for a barbell approach, with the bargains and values being at the short and long ends of the curve. He notes that the last 12 to 18 months have been hard for muni debt and closed-end funds in general, but that with rates having come to a peak, there is now real opportunity in repositioning a portfolio with record discount levels holding out potential for attractive income levels and heightened total return for investors willing to swim against the tide.

Jonathan Mondillo

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CHUCK JAFFE: We're talking fixed income and muni bonds with Jonathan Mondillo, head of North American fixed income for abrdn, 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 will point you in the right direction. And today we're looking in the direction of municipal bonds and fixed income more generally with Jonathan Mondillo, head of North American fixed income for Abrdn, learn about the firm at Abrdn.com, spell it without the E's, it's A-B-D-R-N. And if you want to learn more about closed-end funds, interval funds, and business-development companies generally, check out AICAlliance.org, the website for the Active Investment Company Alliance. Jonathan Mondillo, it's great to have you back on The NAVigator.

JONATHAN MONDILLO: Chuck, always a pleasure. Thanks for having me again.

CHUCK JAFFE: Well, last time you and I spoke it was last spring, it was April of 2023, and a few things have happened in the rate market and where we've gotten to on what we expect with the Fed and rate cuts and the rest. So let's start with your take on where things are, market performance for fixed income and munis.

JONATHAN MONDILLO: Yeah, a little bit of a different rate regime and certainly a different backdrop to Fed policy to say the least. I think in terms of the start to the year, it's been very choppy, so a continuation of that rate volatility that we saw for much of really the last 12 months. I think when we look at broad fixed income, we've done a bit of a roundtrip in terms of rates, starting off the year in and around 380, touching just north on the 10-year just last month at 417, and about 30 basis points of oscillation in between. So certainly volatility that markets have generally gotten used to, but I think investors that expect that to subside at least over the next five months in our mind, should probably buckle up because we expect this to be a bit of a volatility to continue through the next, let's say four to five months at least.

CHUCK JAFFE: That volatility, is that part of the disconnect between what people see in the numbers because we're told that the economy is strong and the numbers keep coming out strong and what people feel when they're going to the gas pump and why everybody feels things are miserable? Or because we're talking fixed income and munis, is there more to it than that?

JONATHAN MONDILLO: I think it's a little bit of mixed messaging just when you think about broad fixed income market, when you think about Fed policy, right? So two to three weeks ago some of the commentary coming out of the Fed, and certainly market expectations were for imminent cuts as a result of expectations of an economic slowdown, certainly tight credit conditions as a result of the hikes that the Fed went through over the last 12 months. And then when you look at more recent commentary out of the Fed, maybe pushing back a little bit on that rhetoric as a result of, to your point, pretty strong continuation of that economic data. So we look at jobs, big jobs beat last week, unemployment rate still extremely low, and then when you look at more economic data in terms of economic growth, ISM numbers coming in above expectations, so I think investors are starting to pare back their expectations for 2024 cuts, and that's created that sort of volatility, so there's the messaging, there's the economic data that aren't always aligned. I think that for the municipal debt market, and this certainly speaks to the performance year to date as well, really just getting pushed around a bit by the Treasury market, so when you see Treasury yields tick up 30 basis points, that's going to have an impact on the municipal debt markets. I think the one thing that has insulated performance on a year-to-date basis, municipal bonds outperforming Treasuries, outperforming their corporate counterparts with maybe the exception of corporate high yield is really flows, so we're starting to see more positive flows into traditional municipal mutual funds. I think that's smart money, trying to get ahead of things, get positioned, yields looking attractive, and preparing for what the next cycle, if you will, in rate policy looks like over the next coming months.

CHUCK JAFFE: Let's get your take on how you respond to rate policy, because what we're expecting from rate policy, I never know if the word is un-invert, dis-invert, whatever, but the yield curve is expected to normalize. Are you extending maturities ahead of that dramatically or are you waiting to see it play out the way people expect?

JONATHAN MONDILLO: I think with respect to the municipal debt market, what we've been looking at is what we're couching as a teacup inversion, where you've got that steep inverted yield curve at the front end, lower yields in the belly, and then a renormalization as you get out beyond that 10-year maturity bucket. So I think when we talk to investors about positioning for the next cycle in Fed policy, potential for Fed rate cuts in 2024, and that renormalization of the yield curve, we prefer really a barbell approach within our municipal debt strategies. Reasons being that there's still really attractive yield for coupon clippers at the front end of the municipal bond curve, as well as probably more relative value at the long end at the moment relative to a belly of the curve which we just don't feel really is offering attractive valuations and probably is not going to benefit from Fed policy in 2024. So I think investors need to be really aware of where the most relative value is at the moment, and we think that that's a barbell approach, so it's at the front end and at the long end for investors that are looking to extend in duration.

CHUCK JAFFE: You talked about muni performance picking up, being better than Treasuries, et cetera, but muni bond closed-end funds, they have struggled for a while. That's maybe not surprising, they tend to be more volatile, and of course they trade at discounts, et cetera, but what's your outlook on the closed-end fund space, particularly muni bond closed-end funds?

JONATHAN MONDILLO: Yeah, it's been really difficult I'd say over the last 12 to 18 months, just broadly speaking in closed-end funds, right? You look at the discounts that both equity as well as fixed income, certainly municipal debt, closed-end funds are trading at, and they're at their widest discounts that we've seen in recent history. A lot of that in our eyes has been driven by just how attractive cash is, right? So if you can get a 5% or a 5.5% in a money market fund or a cash or cash-alternative vehicle, it's pretty difficult to attract flows into an income-driven investment closed-end fund. Now where I think the opportunities are is that peak cycle, at peak rates where we are right now, expectation of those cash yields to start coming in, I think for smart investors it's about repositioning, and closed-end funds, certainly municipal closed-end funds, I think offer a really unique opportunity. A unique opportunity really in two different areas, Chuck. The first being attractive income, so our municipal closed-end fund recently raised its monthly distribution yield, I think the expectations are when you see leverage costs come down, you're going to see more and more closed-end funds offer higher distribution yields as a result of that and having the ability to distribute higher income over the coming months. But in addition to that too there's a total return component, so when closed-end funds are trading at or near record discounts, there's significant amount of upside there when we do see money come back into the space. So when money leaves money market funds and cash vehicles and enters the more traditional, what I would consider long-term focused fund vehicles, closed-end funds obviously, we're going to see that whipsaw back. So I think investors need to start thinking about that, need to get positioned there, and at the moment I think it looks really attractive in terms of an opportunity.

CHUCK JAFFE: Jonathan, really interesting stuff. Been great catching up with you, I look forward to talking with you again down the line on The NAVigator.

JONATHAN MONDILLO: Chuck, pleasure.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I am Chuck Jaffe, I'd love it if you'd check out my show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about closed-end funds, interval funds, and business-development companies please check out AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Jonathan Mondillo, head of North American fixed income for Abrdn, learn more about the firm at Abrdn.com. The NAVigator podcast is new every Friday, make sure you don't miss an episode by subscribing or following along on your favorite podcast app. And if you like this podcast, please leave a review and tell your friends about us, because that stuff really does help. We'll be back next week, we hope we'll see you then, and until then, happy investing everybody.

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