Abrdn's Mondillo: Record Discounts Plus Solid Yields Should Pay Off For Muni Investors

Friday, April 26, 2024

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 that record discount levels for municipal bond closed-end funds, coupled with attractive yields on those funds, are creating real opportunities for investors. Though he warns about the middle of the yield curve, noting that the most compelling values are at the two ends of the barbell, the short-term and long-duration paper, which he expects to continue even as the rate cycle plays out and the Federal Reserve finally moves to cut rates.

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

All financial advisors, please take AICA's 2024 Advisor Survey on closed-end funds, take the full survey and be entered to win a one-year free daily alerts email from CEF Data partners. With this survey we will learn more about the current opinions, trends, and needs of financial advisors. We believe this perspective could help with future development of investment products at your firm. Go to AICAlliance.org/survey. This has been developed in partnership with XA Investments and Destra.

CHUCK JAFFE: Jonathan Mondillo, head of North American fixed income at abrdn is here, we're talking historic discounts and attractive yields in muni funds, and much more 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, which is a unique industry organization representing 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 it's pointing us in the direction of the fixed-income market with Jonathan Mondillo, he is head of North American fixed income at abrdn. It's Aberdeen but they took out the E's and they put it this way, so it's A-B-R-D-N, which is Abrdn.com, the website if you're looking for more information. And if you want more information generally on closed-end funds, interval funds, and business-development companies, check out AICAlliance.org, the website for the Active Investment Company Alliance. Jonathan Mondillo, welcome back to The NAVigator.

JONATHAN MONDILLO: Chuck, thanks for having me back. Appreciate it.

CHUCK JAFFE: There's a ton of stuff to be talking about in the fixed-income space, but let's start with the stuff that people are always looking, find me great yields at fabulous discounts. And that's a way to look at if you're an optimistic shopper, right? Great yields, fabulous discounts. The other way is historic discounts that have stuck around for a while in muni funds, so let's start there. What's your take on that space? And is this the great opportunity, or is this the great opportunity that's still going to take a good long while to pay off?

JONATHAN MONDILLO: Well, I think it could take some time. One of the things that we talked about last time is really that catalyst that allows for municipal closed-end funds discounts to narrow, and that's really going to be what happens at the Fed and when we do see the pivot. Obviously when we started the year, markets were pricing in six to seven cuts, that's been pared back quite considerably to one to cuts by the end of this year, but when we do get that pivot, you're going to see those discounts narrow quite substantially. Here at abrdn, when we look at fixed income overall, we're quite constructive within fixed income, munis even more so. And within munis, closed-end fund municipal bond funds, even more so just because of that, discounts at or near record wides. And again, the Fed will pivot at some point, and I think investors want to be positioned in municipal closed-end funds when that does come.

CHUCK JAFFE: You mentioned the last time you were here with us, that was in February of this year, and at the time you were looking for something called a teacup inversion. Have you seen that? And explain a little bit about what it is.

JONATHAN MONDILLO: Yeah, we're still experiencing that in the municipal debt market. So when we look at the yield curve within munis, it's a teacup in nature, why we call it a teacup inversion, right? So you've got this steep inversion at the front end, and then as we get out past 10-years in duration or maturity, it starts to renormalize. So I think when we look at overall portfolio positioning, whether it's our municipal closed-end fund strategies or whether it's some of our segregated mandate or even our open-ended mutual funds that we manage here, we probably prefer a barbell strategy just because of that. So when we see this rate volatility, it's a little bit more exacerbated in that belly of the municipal bond curve or the bottom of the teacup if you will. And I think just our expectations of possible further volatility could cause a little bit of indigestion if you are positioned in that belly of the municipal bond curve. So again, barbell relative to a laddered bond portfolio, and we think investors need to be wary of that and that teacup inversion.

CHUCK JAFFE: So barbell means heavy on the short end of the curve, heavy on the long end of the curve, not so much in the belly of that as you pointed out. But it's interesting because this is a time when a lot of people have been saying, "Lengthen maturities, extend your duration a little bit because we are eventually going to see rate cuts." I know you like a barbell strategy, but is anything about that approach just driven by your outlook on what the Fed's going to do?

JONATHAN MONDILLO: Yeah, I think a little bit of that is certainly. Our expectations are that we are at or near peak rates, that rates are likely to come down over the next 12 months, albeit I think that we've certainly had to pare back our expectations of where long-term Fed Funds is on a go-forward basis. And I think that our expectations, just given the stickiness of inflation, the strength of the overall economy, and the likelihood that maybe the Fed has sort of threaded this needle or landed this plane, that our expectations are that rates will remain a bit higher for longer. So I think for that backdrop we like the front end, but we also think that as we get peak rates here, we're starting to like the longer end. I think as investors look to extend, we just would caution investors on where they're looking to extend, and that's the reason why we prefer that barbell approach.

CHUCK JAFFE: We're talking munis, and obviously a space that's hugely popular with closed-end fund investors, but where are they on the attractiveness scale of debt? Because as long as we aren't watching the Fed do much on the rate front, there's not necessarily a lot of reason for investors to go beyond plain vanilla, is there?

JONATHAN MONDILLO: No we actually think quite to the contrary. When we look at credit spreads, whether it's looking A-rated paper versus AA-rated paper, whether it's looking at BBB-rated municipal debt relative to A-rated municipal debt, as well as when we look at high yield relative to investment grade, we think dipping down in credit quality might make a bit of sense right now in that actually yields look relative attractive as we dip down in credit quality. I think that when we look at the strength of the fundamentals within the asset class, albeit we might be off the peak levels that we saw maybe 12 to 18 months ago, things look still extremely strong when you look at tax collections, when you look at rainy day balances within municipal issuers. And then from the revenue side, by and large, the strength of the economy has really bolstered operations in many standalone [inaudible 0:07:25] and or revenue-backed bonds. So I think that albeit we've seen credit spreads tighten recently, we still think things look attractive both in high yields as well as lower investment-grade issuers within the space. Getting outside of the asset class, when we look at things in the high-yield space relative to high-yield corporate bonds, when you factor in the tax exemption, you're looking at about an 80 to 90-basis point pickup within high-yield munis relative to high-yield corporate bonds which have certainly seen inflows as late, so we think the asset class is extremely attractive relative to corporates as well.

CHUCK JAFFE: And I've asked this question of everybody from money managers to president of the Chicago Fed recently, you're not worried about at some point default risks have to rear their head in a higher rate environment, and as rates stay higher for longer, historically default rates have gone up? That hasn't seemed to have happened this time, but as you're talking about high yield and lower investment quality, et cetera, you're not worried that shoe's going to drop here?

JONATHAN MONDILLO: Yeah, listen, we've seen pockets of weakness, we've seen defaults maybe tick up a bit, but I think one of the things that lends itself to the asset class and municipal debt is that the structure of municipal debt is quite different from the structure that you find in the corporate landscape within high yield, right? So our issuance tends to be longer dated in amortizing, corporate bond issuance tends to be much more shorted dated in bullet maturities. What that does is, and we oftentimes hear this phrase used, is this debt wall or this maturity wall on the corporate side that then leads to higher default rates, right? So you've got a debt wall or a maturity coming due, you've got to as the issuer, refinance that debt in the corporate bond market. At this point in time at higher rates, that leads to those higher default rates. When we look at the municipal debt market though, again that tends to be longer dated, it's an amortizing structure, so you don't have this debt wall or this wall of worry that you might have on the corporate bond side. So again, I think another benefit to the asset class relative to our corporate brothers and sisters on that side.

CHUCK JAFFE: Jonathan, really interesting. Let's talk again down the line as we watch how it all plays out.

JONATHAN MONDILLO: Chuck, I'd love that, thank you very much.

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, and you can check out my hour-long weekday show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about interval funds, closed-end 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, Jonathan Mondillo, he's head of North American fixed income for abrdn, or Aberdeen. Learn more about the firm at Abrdn.com, and they're on Twitter or X @abrdn_US. The NAVigator podcast is new every Friday, make sure you don't miss an episode by subscribing or following on your favorite podcast app. And if you like this podcast, leave us a review and tell your friends, because that stuff really helps. Until next week, happy investing everybody.

Recorded on April 26th, 2024

To request a particular topic for The NAVigator podcast please send an email to: TheNAVigator@AICalliance.org

Click the link below to go to the home page of Active Investment Company Alliance to learn more: https://AICalliance.org/

Disclosure: *Listed closed-end funds and business-development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF's discount will narrow or be eliminated. Nonlisted closed-end funds and business-development companies do not offer investors daily liquidity: often on a small percentage of share on a quarterly or semi-annual basis. CEFs often use leverage, which can increases a fund's risk or volatility. The actual amount of distributions may vary with fund performance and other conditions. Past performance is no guarantee for future results.*