Sit's Doty Says Meaningful Rate Cuts Aren't Coming Until 2025

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Bryce Doty, senior portfolio manager at Sit Investment Associates. Read the Q&A below as Bryce says the uptick in inflation is not enough to overwhelm the yields investors are earning, noting that real returns may be better than ever. He says investors should enjoy collecting the high yields while interest rates remain high, and while total returns should improve once cuts start, investors will have to wait for that to happen. Doty does not expect meaningful rate cuts this year, he anticipates two reductions, one after the election, but says that the long-term average gap between the Fed funds rate and inflation is well above its typical zero, so the central bank can cut rates and have a positive gap, meaning it can claim to be tough even as reductions start. Doty anticipates the important cuts, the ones which narrow that gap back to near zero, will occur in 2025.

Bryce Doty

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CHUCK JAFFE: We're talking interest rate plays in the wake of higher inflation for longer with Bryce Doty, senior portfolio manager at Sit Investment Associates, 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, 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's going to point you in the right direction. And today we're pointed in the direction of the fixed-income market with Bryce Doty, senior portfolio manager at Sit Investment Associates, where his team manages $10 billion in assets, including $2.5 billion in closed-end fund of funds for separate accounts, learn more about what they do at SitInvest.com. And 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. Bryce Doty, welcome back to The NAVigator.

BRYCE DOTY: Thanks for having me, Chuck.

CHUCK JAFFE: These are particularly interesting times. I mean, we entered this year everyone expecting rate cuts, as many as six depending on who you wanted to believe, now hard pressed to find anybody who thinks we're going to get more than two for the rest of the year, maybe three I suppose. But as you are looking at this market, is this good? The higher inflation, strong economy, rates not being cut, is that a good scenario or have you been preparing so much for rate cuts that you kind of want to have them?

BRYCE DOTY: Well, I think it's a win-win, I don't mind either way. The longer yields stay up, the better it is for earning income, so I love that, and the uptick in inflation is still not enough to overwhelm the yield that we're earning. Closed-end funds, you're getting 6-8%, inflation is running well below that. We haven't seen these kind of real rates in years, if ever, so I'm not concerned about the timing of when the Fed cuts. When they do cut, we'll get a little pop in price if yields go down a bit, so that's just icing on the cake, but the longer we wait, the longer we are able to earn an above average market yield, so I'm just enjoying that.

CHUCK JAFFE: When last you were on The NAVigator it was November of 2023, and one of the things you were talking about at that point was that muni closed-end funds that were using leverage, where the cost of their borrowing was wiping out a lot of their return given the conditions we were facing, well, you said they were more interested in keeping fees high than in making money for shareholders. And you were talking at the time about being more activists, where are you on that today? And is this an environment, given what we're seeing, that activism is that much more important to make things work out?

BRYCE DOTY: We're typically a long-term investor, but when we see things like what you just described, where funds will intentionally borrow money at a higher rate than they can invest it and directly harm the shareholder, we do feel that someone needs to step in and right the ship. We saw the discounts on some of the muni funds that were doing exactly that, and incidentally, they pay themselves a management fee on the money they've borrowed and reinvested, so that breaches some self-dealing issues with the SEC. Not only that, but it does defy all logic, right? Who in their right mind would borrow at five and earn three or whatever? Just crazy, but we do feel that we need to step in and do something about that. Discounts blew out so far, and they stayed out. It's hard for a discount of a closed-end fund to be wider than 10% for very long, right? That's usually enough to entice people to come back in, in the hopes that there's some upside return from that market price approaching back to NAV at some degree. Well, some of these funds were at 10-14% for so long, I imagined a wolf caught in a trap gnawing its own leg off to get out, and that's what some of those shareholders must have felt. Because as rates are going up, their dividend was getting cut over and over and over, because the more the Fed increased rates, the higher the borrowing costs, the more they were upside down on what they were paying on the debt versus what they were earning on their underlying bonds. So we have filed some 13Ds on some of the funds that we think there's hope that they can rectify their bad practices and continue to operate on a better basis. We're hopeful about that, and we think the whole sector is going to recognize that the SEC, shareholders, basically anyone with any common sense is going to frown on these practices and they need to do a better job. That has to help the discounts narrow and benefit shareholders across the board.

CHUCK JAFFE: From an activist perspective, would rate cuts help you because they put more pressure on the fund, make it harder for them to deliver? Or would rate cuts hurt you because, hey, if they're using leverage but the leverage becomes cheaper, they might have more positive impact from that?

BRYCE DOTY: It's both. I think you raise a good point because for the ones that don't see the light, that continue to borrow when they shouldn't, rate cuts will help, it'll help those that can't help themselves. But for the ones that really are on the ball and paying attention, they should be able to just reduce the leverage and increase their dividends automatically with rates right where they are right now, and they can increase the dividends that are being paid

to shareholders and enjoy these higher yields. I think the ultimate thing that some funds should do is increase their dividends to show good faith that they're trying to return some capital to people, at the full NAV so people get some liquidity without having to sell at such a horrible loss, and if it moves the price up enough they should try and do a rights offering. Because if a fund could raise money today and invest in these really high yields, they could lock in a great dividend stream for shareholders for years to come. I'm not sure how many funds are at that level of sophistication though, so I'm skeptical. We've seen it. We've seen it happen, so we know that some funds are heads-up enough to be savvy and take advantage of this, but the muni funds seem to be on autopilot and not really adapt to the current environment very well.

CHUCK JAFFE: When last you were on we were talking about muni funds, and the average discount at that point was above 13.5%. Is that still the sweet spot of closed-end fixed-income investing?

BRYCE DOTY: Well, I think it's crazy that they could even get that wide to begin with, because think of an open-end fund, it would have zero assets in it. That's how unpopular a fund that's trading at 13% below it's NAV is. It means if everyone could have gotten out, they would have, and they're doing whatever they can to get away from the fund if that discount persists at that level, and so I don't think it's going to last. It would be great if you could get in that cheaply, but I would say that they're attractive even at an 8-10% discount because there's going to be some upside. Another factor to keep in mind with these muni funds in particular is their duration, so they're very long, and if there is a cut or any relief on the inflation front, you're going to get some really nice price appreciation on the underlying NAV. And that's why I think as time passes and we get closer to when the Fed will cut, you need to be more willing to tolerate a narrower discount. In other words, maybe it doesn't look so cheap at a 7% discount, but if you know this 12-year duration fund is really going to pop when and if the Fed cuts, not only will you get price appreciation but you should also get an increase in the dividend because the borrowing costs will go down for them, at the same time open-end fund yields will be going down, so the relative attractiveness of these funds will bring in demand. I like how you always ask the really difficult questions. That's what's going on there, it's a multi-layered factor that's really brought it to our attention and we just think the whole sector is looking pretty attractive right now.

CHUCK JAFFE: If I heard you correctly, the way I would sum it up would be that if the status quo continues, if where we're at continues, that's fine but you're waiting, but ultimately things will be more attractive and the returns should be better when the rate cuts start. Do you expect that payoff to arrive, or start to arrive at least, this year?

BRYCE DOTY: You're exactly correct with the summary. The one thing I would add is that you need to get your toe in the water, you need to start accumulating shares now, because by the time you want 'em, it'll be too late and too difficult to get the position you need, and you are getting a decent income while you wait. As far as timing, we thought even, I don't know, the last time we talked in November, we didn't think the Fed would cut meaningfully until 2025, we thought maybe 25 basis points in the third quarter in 2024 and half a percent in the fourth quarter. Everyone got a little over their skis thinking that maybe they'd cut in March, I don't believe any bond manager really truly was betting on that, and so our view hasn't really changed much. We knew there's be a little bit of stubbornness to the inflation data, and the Fed hates being bullied when it comes to election projections. If you have everyone going out and saying, "The Fed's not going to cut because of the election," they'll cut 25 basis points, some token just to prove you wrong. Likewise if everyone says, "Well, they're going to cut because they're trying to influence the election," they won't cut at all in the third quarter. So they'll do something one way or the other to mess with people, and then the fourth quarter after the election's over they'll probably cut half a percent, because even if they do that, the real rate of Fed Funds will be significantly positive. And people forget when yields go up, they forget that the long-term average difference gap between Fed Funds Rate and inflation is typically zero. And we have a massive gap right now, so they could cut half a percent, 1%, 1.5% and still half a positive gap, which means they can still be restrictive, they're still fighting inflation, they can still say they're tough even if they cut. So we still think fourth quarter is a real possibility for half a percent, but the meaningful cuts don't come until 2025.

CHUCK JAFFE: Well, the good news is we'll be sure to be talking to you as we watch those meaningful cuts happen. Bryce, this was great, thanks so much for joining me on The NAVigator.

BRYCE DOTY: Thanks for having me again.

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