abrdn’s Laranjeiro: Rate Cuts Should Boost Muni Bond Funds

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Miguel Laranjeiro, Investment Director at abrdn. Read the Q&A below as Miguel says we are seeing "the beginning of a robust in-flow cycle into the muni space," noting that credit spreads and all-in yields are attractive and that the value of the tax exemption will particularly pay off now. He says he expects the Federal Reserve's long-awaited rate cuts will end the longest yield curve inversion ever for municipal bonds. Once the yield curve has normalized, Laranjeiro expects leverage costs to become a positive for the total return of levered muni funds, creating an additional impetus for investors.

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

CHUCK JAFFE: Miguel Laranjeiro, investment director at abrdn is here, we’re discussing the pitfalls and opportunities in debt and credit investments now that the interest rate cutting cycle has started, 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 representing the entire closed-end fund business 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 fixed-income and credit markets with Miguel Laranjeiro, he’s investment director at abrdn, which these days is known with the letter “E”, so it’s abrdn, and you can use those letters to learn about the firm at abrdn.com. If you want to learn more generally about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, that's the website for the Active Investment Company Alliance. Miguel Laranjeiro, welcome to The NAVigator.

MIGUEL LARANJEIRO: Thanks for having me, Chuck.

CHUCK JAFFE: We are just at the start of a rate cutting cycle, and when the Fed announced its cut on Wednesday, it surprised everybody a little bit by going to 50 basis points. For you, the start of the rate cut cycle and the fact that the first cut was maybe bigger than many people thought it would be, does that set things up for what's to come? Does that have you scrambling to find the places that are going to be sweet spots right now?

MIGUEL LARANJEIRO: Going into the Fed decision, the Street had kind of a 50/50 shot on whether they were going to cut 25 or 50 basis points, obviously choosing to go the 50 basis point route. What that will do long term is we think leverage costs will come down, so in the closed-end funds that utilize leverage, the spread between leverage costs and long duration is obviously going to widen, so that should enhance the total return prospects in the closed-end funds, particularly those with high leverage exposure.

CHUCK JAFFE: That's going to create some measure of opportunity, let's look at some specific markets. Because, for example, will this pressure off the municipal market or the high-yield market where there had been talk about how we hadn't seen defaults but we were maybe expecting to see more, will this ease pressure in your mind?

MIGUEL LARANJEIRO: There has not been much pressure from a credit perspective, especially in the high-yield market. High-yield munis has been really the star of the show when it comes to fixed-income asset classes returning about 7% year to date, and that we owe to lower defaults, were down I think 30% year over year, upgrades in favor of downgrades at a rate of 1.4:1, so we still maintain a relatively strong fundamental picture from the credit perspective. With that respect, we really expect high yield to continue to perform well, obviously lower rates will enhance their opportunities to maintain lower leverage costs, potentially inject some liquidity into those high-yield credits where liquidity is running thin, but we continue to like high-yield and BBB credit, particularly in the municipal bond market. When you compare spreads of high-yield credit versus their corporate counterparts, they look relatively attractive historically speaking. You can pick up

20 to 30 basis points on tax equivalent basis by investing in the high-yield municipal market versus their corporate taxable counterpart, and the same is true even for the lower IG/BBB part of the credit curve.

CHUCK JAFFE: The opportunity in munis, and particularly high-yield munis, from the sounds of it, while rates are coming down, it's going to be a while before the attractiveness goes away in the muni space, right?

MIGUEL LARANJEIRO: That's right, that's right. I think this is probably the beginning of a robust in-flow cycle into the muni space. We think credit spreads versus their taxable counterparts look relatively attract, all-in yields look relatively attractive, and then when you're investing at elevated yields like they are today, IG 4% and then in high-yield 5-6% on a tax-equivalent basis, the value of the tax exemption itself is more valuable on the higher income threshold. So at these levels of yields, we think it's a good opportunity to get invested in the municipal market and realize the value of the tax exemption at these elevated income levels, which will also enhance from the total return perspective as interest rates start coming down.

CHUCK JAFFE: At the beginning of that answer you talked about munis relative to the credit space, obviously a particularly good time for munis, but does this change the picture on the credit space? And is that opportunity not just not as good relative to munis but maybe just not as good in the environment we're about to be in?

MIGUEL LARANJEIRO: Well, from a credit perspective, munis are defensive really in nature. From a default perspective, I think the muni landscape default rate is 1/60th that of credits, so we think from a credit perspective headed into what could be an economic slowdown, muni credits provide a defensive posture for those that are concerned with the slowdown of an economy.

CHUCK JAFFE: Of course here we are talking for closed-end fund investors, and muni funds, well, they've been very attractive if you're a discount buyer, but they haven't as a class necessarily done great on a performance basis. So what do you expect to happen with discount rates in muni closed-end funds?

MIGUEL LARANJEIRO: Obviously discount rates have really-- well, over the last six months they've really reined in, we're still at high 7-9% discount rates for typical closed-end muni NAV funds, and we expect that to rein in tighter and potentially get flat as the yield curve normalizes and leverage costs are accretive to their total return. So I think long duration, higher leverage will probably see a faster pace in renormalization of the discount rates, and that should continue a cycle of tightening of the discount rates. I think at this time last year we were in the mid to high double-digit discount rates for muni closed-end funds, now we're more in the mid to high single digits. I expect that gap to close over this rate cutting cycle.

CHUCK JAFFE: I need to ask, because it raises an interesting question for me, which is just as we certain things that become indicators to us, like we would have expected what would happen when we saw the yield curve invert or what have you, we saw discounts in muni funds get dramatically wider, like historically large, and normally we do expect them to close, but they have been very slow in closing. Even though they've gotten better now, is there a reason in your mind why the discount in the muni space has been so slow to close?

MIGUEL LARANJEIRO: Well, leverage costs have remained elevated, the muni curve has been inverted for two years. It's never been inverted really long than two weeks in its history, so two years, that has been really a headwind for leverage costs in the closed-end space, and with respect to muni funds. That has normalized now, leverage costs have started to come down, although still slightly inverted. We expect that transition to continue, and as that curve normalizes and the leverage costs become lower and there's a spread for duration, we expect that to contribute to total return, and then also contribute to closing the discount and NAV as we head towards a normalized yield curve.

CHUCK JAFFE: How long do you think it's going to take before the yield curve in munis normalizes?

MIGUEL LARANJEIRO: Well, we're almost there, it's really only inverted really in the one to two-year space out to eight years by four or five basis points. We could get there potentially by November, or by year end at the latest. I would expect that by year end that the curve is normal and leverage costs wind up being accretive to the total return of levered muni funds.

CHUCK JAFFE: And so for somebody who doesn't necessarily understand the jargon, what you're saying is that, "Hey, if the rate trend continues, muni funds are likely to get a little bit of a pop here." That's what the rate cutting cycle means most immediately?

MIGUEL LARANJEIRO: That's correct, particularly those that are exposed more so than their peers to leverage costs.

CHUCK JAFFE: Miguel, great stuff. I really appreciate you taking the time to join me on The NAVigator.

MIGUEL LARANJEIRO: Not a problem. Thanks for having me, Chuck.

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 I'd love it if you'd check out my hour-long weekday show on your favorite podcast app or by going to MoneyLifeShow.com. If you want to learn more about closed-end funds, interval funds, and business-development companies, please go to AICAlliance.org, it's the website for the Active Investment Company Alliance, on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Miguel Laranjeiro, he's investment director at abrdn, or Aberdeen without the Es, it's abrdn.com, and on X or Twitter @abrdn_PLC. The NAVigator podcast is new every Friday, be sure not to miss an episode by subscribing or following along on your favorite podcast app. We'll be back next week with more closed-end fund fun, and until then, happy investing everybody.

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