JEFF MARGOLIN
Senior Vice President
Closed-End Fund Analyst

THIRD QUARTER 2022 OVERVIEW

Following a very difficult second quarter of 2022 for the equity and credit markets (https://www.ftportfolios.com/Commentary/Insights/2022/7/19/second-quarter-2022) as well as for many closed-end funds (CEFs), the third quarter of 2022 was also a difficult one. Many of the factors that battered the equity and credit markets during the first half of 2022 were also present in the third quarter, including concerns about the potential for a global recession, rising short- and long-term interest rates, and stubbornly high inflation data. The total return for the average CEF was -6.6% for the third quarter and is now -22.9% for the year, as of 9/30/22. The weakness was widespread and similar to the second quarter, every single CEF category tracked by Morningstar posted a negative total return with the exception of the MLP category where the average MLP CEF posted a third quarter total return of 2.8%. For the third quarter, equity CEFs returned -6.6%, fixed-income CEFs returned -6.6%, municipal CEFs returned -8.5%, and taxable fixed-income CEFs returned -5.1%. As of 9/30/22, the year-to-date (YTD) total return for the average equity CEF was -20.0%, the average fixed-income CEF was -24.3%, the average municipal CEF was -26.4% and the average taxable fixed-income CEF was -22.7%.

Equity CEFs were hurt by a -4.9% total return for the S&P 500 Index as well as by a -9.8% total return for the MSCI All-Country World Ex USA Index in the third quarter. Similar to the second quarter, elevated inflation data helped contribute to rising short- and long-term interest rates which put downward price pressure on several key credit markets during the third quarter. Indeed, the Bloomberg US Aggregate Bond Index returned -4.8% for the third quarter, while the Bloomberg Global-Aggregate Index returned -6.9% for the third quarter. For the third quarter, the ICE BofA US High Yield Constrained Index returned -0.7%, the ICE BofA Fixed Rate Preferred Securities Index returned -1.0%, the ICE BofA US Corporate Index returned -5.1%, and the ICE BofA 7-12 Year US Municipal Securities Index returned -2.6%. (Source: Bloomberg)

Many CEFs Trading at Wider than Average Historical Discounts to Net Asset Value (NAV)

Continuing to reflect the negative sentiment among many investors and challenging environment for the CEF structure, average discounts to NAV widened to -7.5% at the end of the third quarter from the -5.6% level they ended the second quarter. Average discounts to NAV continue to be wider than the 10-year average discount to NAV of -5.3% and are significantly wider than the -2.3% level from which they ended 2021. Average discounts to NAV for equity CEFs widened to -7.4% at the end of the third quarter from the -6.3% level they end the second quarter and are wider than the 10-year average of -6.8%. Average discounts to NAV for taxable bond CEFs widened to -8.2% at the end of the third quarter from the -5.1% level they end the second quarter and are wider than the 10-year average of -4.4%. Average discounts to NAV for municipal bond CEFs widened to -7.0% at the end of the third quarter from the -5.0% level they end the second quarter and are wider than the 10-year average of -4.0%. (Source: CEFdata.com)

Outlook for the Remainder of 2022

If you are a regular reader of this quarterly commentary piece and were expecting me to have a different view from this year's previous commentaries than you might be disappointed. While this has been a very challenging year for the financial markets and while it can be frustrating to endure these periods of weakness and volatility, I continue to believe periods of enhanced volatility can potentially create attractive long-term buying opportunities for investors who dollar cost average across different categories of the CEF marketplace including but not limited to diversified equity CEFs, municipal CEFs and below investment grade high-yield CEFs and senior loan CEFs. I do not know when we will see stability comeback to the equity and credit markets, but I firmly believe that when it does occur that many CEFs will see their discounts to NAV narrow which is why I want to take advantage of the wider than average discounts to NAV that presently exist in the marketplace for many CEFs.

As the Federal Reserve likely continues to raise short-term rates, coupled with the potential for some tax-loss selling in the CEF structure, volatility could continue to persist during the fourth quarter of 2022. However, during periods of challenging drawdowns for CEFs including the worst 3-month drawdown of the 2008 financial crisis (8/31/08-11/30/08), the worst 3-month drawdown of the taper tantrum (4/30/13-7/31/13), the worst 3-month drawdown during the 2018 year-end sell off (9/30/18-12/31/18) or the worst 3-month drawdown of COVID (12/31/19-3/31/20) historically the total returns many CEF have earned tend to be positive looking out 24 months after the drawdown. This is why I continue to advocate that investors stay disciplined, dollar-cost average, collect the high distributions many CEFs provide and focus on the long-term.

Finally, as I stated last quarter, with the Federal Reserve likely continuing to raise short-term interest rates and therefore borrowing costs rising for the majority of CEFs that employ the use of leverage, I think investors should expect distribution reductions for CEFs that invest in fixed-coupon securities including but not limited to municipal CEFs, high-yield CEFs, investment-grade corporate CEFs and preferred CEFs. While there is the potential for distribution reductions for many CEFs during the fourth quarter and first half of 2023, I would expect distribution rates and the cash flow that CEFs provide to continue to remain quite attractive on an absolute and relative basis to other income-oriented investments. Indeed, according to Morningstar as of 9/30/22 the average distribution rate for all CEFs was 9.3%. Senior loan CEFs are one category which could benefit from rising short-term rates given the floating-rate interest that senior loans provide.

Source for CEF performance: Morningstar. All performance is based on share price total return.
Past performance is not a guarantee of future results.
All opinions expressed constitute judgments as of the date of release, and are subject to change without notice. There can be no assurance any forecasts will be achieved. The information is taken from sources that we believe to be reliable but we do not guarantee its accuracy or completeness.