Aquila High Income Fund

PORTFOLIO MANAGER COMMENTARY

Q3 2022

A SHARE: **ATPAX**	C SHARE: **ATPCX**	I SHARE: **ATIPX**	Y SHARE: **ATPYX**

U.S. Fixed Income Markets: Quarterly Review

During the third quarter of 2022, the fixed income markets experienced truly historic volatility, which was seen across most asset classes. The early part of Q3 saw an incredibly strong bid for risk assets, driving the S&P 500® up over 9%, and the Bloomberg U.S. Corporate High Yield Index up almost 6%, as many market participants began to price in a Federal Reserve ("the Fed") pivot by 2023. With aggressive rate hikes slowing economic growth, it was expected that the Fed would need to begin reducing the federal funds rate by mid-2023, as indicated by the Fed Funds Futures market. However, by mid-August, it became clear that Chairman Powell and his colleagues would remain vigilant in fighting inflation, which was steadfastly reinforced in Mr. Powell's speech at the annual Jackson Hole Economic Symposium in late-August. He acknowledged that this aggressive stance may have negative consequences for the economy, yet allowing inflation to become more permanently entrenched would be a far worse outcome. Hence, the third quarter saw the Fed raise its benchmark rate by 75 basis points ("bps") at both its July meeting, as well as its September meeting, while indicating similar hikes would likely be necessary at future meetings.

With a Fed pivot almost completely priced out of the Federal Funds Futures market after Powell's Jackson Hole speech, risk assets saw a steep decline from mid-August through quarter-end. The Bloomberg U.S. Corporate High Yield Index gave back all its impressive early gains, ending Q3 with a marginal loss of -0.65%—a truly remarkable turnaround. In reaction to the Fed's aggressive policy stance, risk-free rates (i.e., U.S. Treasuries) saw a major move upwards during Q3, with 2-year, 5-year and 10-year U.S. Treasuries moving higher by 132 bps, 105 bps and 82 bps, respectively. This "flattening" of the yield curve created an inversion in rates between 2-year yields (4.28%) and 10-year yields (3.83%)—a relative anomaly compared to a "normal" yield curve with increasingly higher rates as maturities lengthen. The impressive rate moves during the third quarter resulted in all major fixed income indices producing negative total returns for the period. The Bloomberg U.S. Corporate High Yield Index was the relative "winner," only down -0.65%, compared to -4.75% for the Bloomberg U.S. Aggregate Bond Index, and -4.35% for the Bloomberg U.S. Treasury Index, with high- yield bonds likely benefitting from a much shorter duration than most other fixed income asset classes.

High-Yield Bond Market and Economic Overview

Similar to the price volatility experienced across most fixed income asset classes, credit spreads in the high-yield market experienced a wide-ranging move during the period. The Option Adjusted Spread ("OAS") for the Bloomberg U.S. Corporate High Yield Index ended slightly tighter at 552 bps, although the OAS fluctuated widely during the period, peaking at 583 bps in early-July and posting a low of 408 bps in early-August. The theme for most of Q3 seemed to be an "up-in-quality" trade, as CCC-rated issuers in the index produced a return of -2.25%, severely underperforming single-Bs (-0.13%) and BB-rated bonds (-0.82%).

A continued improvement in credit metrics for Energy companies drove underlying performance of their bonds, with the sector producing a market-leading total return of 1.28% during the period. However, a slight downtick in oil and gas prices, and pent up demand for travel during the quarter, benefitted the airlines, allowing the Transportation sector to post a total return of 1.20%. Notable sectors that performed poorly during the period included Banks (-3.91%) and Consumer Non-cyclical (-2.82%), although for vastly different reasons. With a substantial rise in yields and a much flatter yield curve, the banking sector could potentially see net interest margins compress, driving overall earnings lower--an industry-wide concern. However, the disappointing performance in Consumer Non-Cyclicals was driven almost exclusively by the idiosyncratic risk associated with only a few names in the group. Specifically, the sector was impacted by the weakening fundamentals of two companies: Bausch Health (a large high-yield issuer), which resulted in multiple credit rating downgrades during the period, and Community Health Systems, a company dealing with a significant increase in labor costs and declining sales.

The third quarter of 2022 presented another period of very unattractive financing levels for below investment-grade issuers, as the higher rate environment and "risk-off" tone limited new deal flow. According to J.P. Morgan, Q3 issuance of only $18.9 billion was tracking a level not seen since the first quarter of 2009, and is stunningly low compared to a MONTHLY average in 2021 of $40.1 billion. Unfortunately, the lack of new issue supply did not provide much support to the high-yield market, as fund flows continued to negatively impact the sector.

Summary of key economic data points:

- Gross Domestic Product ("GDP") quarter-over-quarter: -0.6% (Q2 2022)
- Consumer Price Index ("CPI") year-over-year: 8.2% (September 2022)
- Producer Price Index ("PPI") year-over-year: 8.5% (September 2022)

- Personal Consumption Expenditures Price Index (also known as “PCE Deflator”) year-over-year: 6.2% (August 2022)
- Unemployment rate: 3.5% (September 2022)
- Oil prices (West Texas Intermediate, “WTI Crude”) decreased over 18% to $79.49 during the quarter

Fund Strategy and Outlook

The defensive positioning of the Fund implemented by the Aquila Investment Management team earlier this year continues to be prudent, as the Federal Reserve has indicated it has no intention of changing its aggressive policy stance. With another 75 bps rate hike likely in October, and inflation data still remaining extremely elevated, our team expects additional rate increases through 2022 and into early-2023. Since there is generally a long and variable lag in monetary policy flowing through to many portions of the economy, it remains difficult to determine how quickly Fed policy will drive inflation lower. As strong wage growth, along with elevated rental and housing costs remaining stubbornly high, inflation from core services are expected to move down very slowly. Since the Fed initially mis-characterized inflation as “transitory,” allowing inflation to run higher for longer, Chairman Powell and his colleagues have no choice but to continue their current pace of tightening, yet this may well lend itself to the U.S. economy experiencing a hard landing (i.e. recession). In fact, a number of Fed officials have recently admitted the economy may face some near-term pain in order for inflation to be eventually tamed.

Higher risk-free rates and widening credit spreads have certainly had a “knock-on” effect for high-yield issuers looking to raise capital for debt refinancing or the funding of M&A activity. Some lower-rated issuers have decided current all-in yields have become untenable, causing them to step away from the new issue market. Although overall credit metrics have remained fairly stable for most sectors, the high-yield market has seen a recent uptick in default rates. As the lag effects of monetary policy hit the economy, flowing through to weakening credit fundamentals, J.P. Morgan has recently revised their default rate for 2022, to 1.85% (up from 1.25%), and 2.25% in 2023 (up from 1.75%).

Volatility and liquidity have become increasing risk factors, while geopolitical issues remain a concern of our team. As such, we anticipate the Fund’s lower duration and higher average credit quality to be a benefit for shareholders. Our strong focus on underlying credit trends, while identifying attractive risk-adjusted return opportunities, may generate incremental yield for the portfolio, while potentially providing a cushion as rates rise.

For specific information about fund characteristics, holdings and performance please see the Fund Fact Sheet on our website at www.aquilafunds.com.

Fund Facts as of 9/30/2022

Lead Portfolio Manager	Inception Date	Total Investments	Number of Holdings
DAVID SCHIFFMAN	6/1/2006	$104.3M	72

The S&P 500 Index is a market-capitalization-weighted index of 500 leading publicly traded companies in the United States. **The Bloomberg U.S. Corporate High Yield Index** is an unmanaged index considered representative of the universe of fixed-rate, non-investment grade debt. **The Bloomberg U.S. Aggregate Bond Index** is an unmanaged index considered representative of the universe of fixed-rate, investment grade taxable debt. **The Bloomberg U.S. Treasury Index** is an unmanaged index considered representative of the U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Performance of an index does not reflect management fees and expenses which are reflected in Fund performance. An investment cannot be made directly in an index. Past performance does not guarantee future results.

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Independent rating services (such as Standard & Poor’s, Moody’s and Fitch) assign bond ratings, which generally range from AAA (highest) to D (lowest), to indicate the credit worthiness of the underlying bonds in the portfolio. Securities are classified as high-yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB+ or below. Where the independent rating services differ in the rating they assign to an issue, or do not provide a rating for an issue, the highest available rating is used in calculating allocations by rating. Non-rated bonds are holdings that have not been rated by a nationally recognized statistical rating organization.

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Please refer to the Fund’s prospectus for a complete description of risks associated with an investment in the Fund. These include, but are not limited to, potential loss of value, market risk, financial risk, interest rate and credit risk, and investments in highly-leveraged companies, lower-quality debt securities, foreign markets and foreign currencies.

Before investing in a Fund, carefully read about and consider the investment objectives, risks, charges, expenses, and other information found in the Fund prospectus. The prospectus is available from your financial advisor, and when you call 800-437-1020 or visit www.aquilafunds.com.