Aquila High Income Fund

PORTFOLIO MANAGER COMMENTARY

Q1 2024

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U.S. Fixed Income Markets: Quarterly Review

Despite increased uncertainty related to global economic conditions and geopolitical concerns, highlighted by deadly wars in Gaza and Ukraine, U.S. markets remained remarkably resilient. Domestically, Q1 2024 earnings results were certainly better than most would have expected this long into an economic recovery, with the labor market continuing to produce consensus beating job growth, while overall economic activity provided investors with the confidence to remain allocated to most risk assets. While the Federal Reserve (the "Fed") decided to keep the Federal Funds rate (the rate that banks charge each other to borrow or lend excess reserves overnight) unchanged during both meetings in the first quarter, Chairman Powell and other policy makers indicated they remain data-dependent on future policy. Hence, throughout most of the quarter, market participants had varying degrees of conviction on when the Fed would begin reducing interest rates, ending the period with a July 2024 projection for the first rate cut, and building in less than 3 rate cuts for all of 2024. Comparatively, ending 2023, Fed Funds Futures were pricing in a first rate cut in March 2024, and more than 6 overall cuts to the Fed Funds rate throughout 2024. Yet, stronger and more stubborn inflation data has now tempered those expectations fairly dramatically.

With the aforementioned re-pricing of any potential Fed policy decisions in 2024, unsurprisingly, U.S. Treasury yields moved progressively higher through the first quarter, as investors realized the Fed would remain vigilant in their quest to lower inflation. The anticipated extension of restrictive Fed interest rate policy had a direct correlation to risk-free rates, with the 2-year U.S. Treasury yield increasing 37 basis points ("bps"), while the longer-end of the curve saw 10-year U.S. Treasuries and 30-year U.S. Treasuries rising 32 bps and 31 bps, respectively. This relatively parallel shift in the yield curve kept the yield curve inversion intact, with 2-year rates (4.62%) well above 10-year Treasury yields (4.20%). Although stronger economic data and surprisingly resilient inflation drove the data-dependent Fed to keep rates at an historically elevated level, investors remained in a "risk-on" mode—a continuation of the Q4 2023 environment. This led to the high-yield market producing some of the best results within the fixed income sector over the first quarter. Benefitting from a lower duration than most fixed income asset classes, and a slow grind tighter in credit spreads during the first quarter of 2024, the Bloomberg U.S. Corporate High Yield Index posted a total return of 1.5%, compared to the Bloomberg U.S. Treasury Index (-0.96%), and also compared to longer duration, investment-grade bonds (as represented by the Bloomberg U.S. Corporate Bond Index), which recorded a total return of -0.40% in Q1.

High-Yield Bond Market and Economic Overview

Reflecting another period of risk-taking that followed a strong previous quarter, the high-yield market posted relatively strong results across the credit spectrum. Leading the way was another impressive performance by lower-rated issues in the high-yield market, with CCC-rated bonds up 2.14% in the first quarter. This was followed by bonds rated B (1.4%), and BB-rated issues produced a total return of 1.1% for Q1. Although U.S. Treasury yields moved higher by about 30 bps during the period, the Option Adjusted Spread ("OAS") of the Bloomberg U.S. Corporate High Yield Index moved lower and tightened 24 bps during the period, allowing the Index to post a positive total return of 1.5% in Q1. However, the quarter was not without some initial volatility, as the OAS spiked to a quarterly high of 360 bps in early January from 323 bps at year-end, a result likely driven by some initial profit-taking after a very strong fourth quarter of 2023. Yet, the remainder of the quarter saw a slow grind tighter in credit spreads, reaching a quarterly low of 292 bps in late March, and not too far from the quarterly close of 299 bps. Similar to the first quarter performance across credit quality, there was some dispersion amongst the high-yield sectors. Leading the below investment-grade market was the performance of Other Financials (+2.8%), as the sector likely benefitted from stronger-than-expected economic activity, which supported underlying credit quality of the borrowers these institutions lend to in various markets (i.e., credit cards, car loans and home equity loans). Brokerage and Asset Managers also produced market-leading returns for the period, up 2.6%, driven by increased capital markets activity. Although the stress of geopolitics and deadly military conflicts kept some investors on edge during the quarter, the Energy sector saw outsized gains due to higher oil prices. As crude oil spiked over 16% in the first quarter to over $83 per barrel, the high-yield Energy sector posted a quarterly return of 2.5%. Although the unexpectedly strong economic backdrop supported underlying credit fundamentals within the high-yield market, it did not go unnoticed that some idiosyncratic issues would drag down certain names and sectors. Specifically, within the Communications sector, various bonds issued by Dish DBS, Level 3 and Altice France were down 13% to 39% for the quarter due to company-specific issues, causing the overall sector to post a quarterly return of -1.9%.

Driven by investors' insatiable appetite to lock in historically attractive all-in yields, the high-yield market provided a seemingly perfect environment for companies to continue terming out their upcoming maturities. A combination of additional tightening in credit spreads and positive fund flows in Q1 allowed issuers an opportunity to refinance or fund previously announced acquisitions. For the first three months of 2024, the high-yield market saw an impressive $87.6 billion in issuance, according to J.P.Morgan Credit Research—more than double the $40.2 billion in 1Q23.

Summary of key economic data points:

- Gross Domestic Product (“GDP”) quarter-over-quarter: 3.4% (Q4 2023)
- Consumer Price Index (“CPI”) year-over-year: 3.2% (February 2024)
- Producer Price Index (“PPI”) year-over-year: 1.6% (February 2024)
- Personal Consumption Expenditures Price Index (also known as “PCE Deflator”) year-over-year: 2.5% (February 2024)
- Unemployment rate: 3.8% (March 2024)
- Oil prices (West Texas Intermediate, “WTI Crude”) increased about 16% to $83.17 during the quarter

Fund Strategy and Outlook

With the U.S. economy in an almost “goldilocks” scenario, it appears the Fed may be getting close to executing the elusive “soft landing.” While various hurdles remain to accomplish this difficult task, including continued uncertainty both overseas and domestically, we are encouraged by the surprising resilience in risk markets. With previously announced Federal spending projects just beginning to flow through to the overall economy, these additional funds could supplant the strong consumer spending patterns we saw immediately following the pandemic. This spending shift could support further economic growth, yet create a more stubborn inflation environment for the Fed. In addition, the long and variable lags of restrictive monetary policy continue to work its way through the economy, and we expect this may trigger some difficulty for a small number of high-yield issuers. Specifically, lower-rated companies exposed to floating rate debt on their balance sheet may begin feeling the effects of the higher cost of capital, especially if rates remain at current levels for a more extended period of time. Although market participants have moved their rate cut expectations closer to the Fed’s “dot plot” released in March, indicating three cuts in 2024, we expect the economy and the labor market to remain fairly robust over the coming quarters. Hence, rates may remain at current levels for longer than anticipated.

Strength in underlying credit fundamentals for high-yield issuers in general still appear sustainable for the foreseeable future, especially with fiscal stimulus just beginning to support certain industry sectors. Yet, a mild “rolling recession” cannot be ruled out, as weaker credits could succumb to high interest rates and slowing consumer demand. This type of environment could keep high-yield default rates at a very manageable level, yet highlight the importance of active portfolio management to avoid the idiosyncratic risk that inherently arises as an economic cycle gets “long in the tooth.” Therefore, our investment team remains cautiously optimistic about the high-yield market and will rely heavily on our ability to identify attractive relative value opportunities, while avoiding potential land mines. We will remain focused on limiting potential volatility while generating high current income, as the Fund’s positioning in lower duration and higher credit quality could offset future spread widening. With the weighted average yield in the high-yield market just below 8%, we believe the asset class remains one of the more attractive relative value opportunities in the fixed income market, as investors may see coupon-like returns in 2024.

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 3/31/2024

Lead Portfolio Manager	Inception Date	Total Investments	Number of Holdings
DAVID SCHIFFMAN	6/1/2006	$87.1M	61

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Information regarding holdings is subject to change and is not necessarily representative of the entire portfolio. A complete list of the Fund's current holdings, including percentage allocation, is available on our website and by contacting Aquila Group of Funds.

The Bloomberg U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. The Bloomberg U.S. Corporate High Yield Index is an unmanaged index considered representative of the universe of fixed-rate, noninvestment grade debt. The Bloomberg U.S. Treasury Index measures dollar-denominated, fixed-rate, nominal debt issued by the United States 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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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's prospectus. The prospectus is available from your financial professional, and when you call 800-437-1020 or visit www.aquilafunds.com.

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