



Aquila High Income Fund

PORTFOLIO MANAGER COMMENTARY

Q4 2023



A SHARE: **ATPAX**

C SHARE: **ATPCX**

I SHARE: **ATIPX**

Y SHARE: **ATPYX**

U.S. Fixed Income Markets: Quarterly Review

The early portion of the fourth quarter of 2023 saw risk-free rates remain fairly range-bound, with a slight bias toward a higher trajectory, as the market appeared uncertain about the intentions of the Federal Reserve (the “Fed”) at its meeting in early November. With no action by the Federal Open Committee (“FOMC”) at its September meeting, market participants may have been anticipating a “one and done” hike prior to year-end. However, both the November and December FOMC meetings resulted in no action by the Fed, while more dovish rhetoric by Chairman Jerome Powell and other members of the Committee resulted in a substantial rally in most asset classes for the remainder of Q4. Helping to fuel some of the bullishness in the markets were the revised data points in the Summary of Economic Projections (“SEP”), released after the December Fed meeting. Specifically, SEP revisions showed median estimates for the core Personal Consumption Expenditures Price Index, one of the Federal Reserve’s preferred inflation gauges, dropping to 2.2% in 2025 from 2.3% in the September projections. In addition, the “dot plot” showed the median projection for the Federal Funds rate at the end of 2024 was shifted downwards by 50 basis points to 4.60%, implying more easing in their restrictive policy in the upcoming year.

Similar to Q3, the first few weeks of the fourth quarter saw most fixed income markets produce returns which fluctuated between gains and losses, as investors were uncertain if rates were nearing a peak. However, the aforementioned reaction to dovish Fed commentary, supported by economic data that raised the probability of a “soft landing,” created a “risk-on” tone for investors. Hence, the last two months of Q4 saw a substantial decline in yields, which in turn drove risk assets to recent high valuations by year-end. Over the last quarter of the year, 2-year U.S. Treasury yields declined 80 basis points (“bps”), while the longer-end of the curve saw 10-year U.S. Treasuries and 30-year U.S. Treasuries drop 69 bps and 67 bps, respectively. These large moves resulted in the Bloomberg U.S. Treasury Index producing an impressive total return during the fourth quarter of 5.7%. While shorter duration, lower-quality assets, such as high-yield corporate bonds posted even strong returns (+7.2%), longer duration, investment-grade bonds (as represented by the Bloomberg U.S. Corporate Bond Index) posted a total return of 8.5% in Q4. Not to be over-shadowed by the impressive performance of the fixed income markets, other risk asset indices, such as the S&P 500® Index (+11.7%) and the CRSP U.S. Mid Cap® Index (+12.3%) fared even better during the fourth quarter of 2023 and ended near a 52-week high.

High-Yield Bond Market and Economic Overview

Although the high-yield bond market continued its slide from late Q3 by posting a loss of about -1.0% in September, the Bloomberg U.S. Corporate High Yield Index rallied sharply during the last two months of 2023. Investors were in a “risk-on” mood after the FOMC meeting in early November, as Chairman Powell hinted that the Federal Funds rate (the rate that banks charge each other to borrow or lend excess reserves overnight) may be reaching a peak. With appetite for risk seemingly insatiable during the period, the high-yield market produced a remarkable 7.2% total return for Q4, driven not only a substantial decline in risk-free Treasury yields, but a substantial tightening in Option Adjusted Spreads (“OAS”). Throughout the period, the OAS on the Bloomberg U.S. Corporate High Yield Index fluctuated from a high of 438 bps to a low of 312 bps, yet ended the quarter at 323 bps, which was about 150 bps lower than the start of 2023. Additionally, the yield-to-worst on the high-yield index had a similar decline, starting the quarter at 8.88%, and declining 129 bps to end Q4 at 7.59%. Unlike Q3, which saw lower-quality issues provide the best returns in the high-yield market, investors appeared to rally around higher quality issuers, which historically may be more immune to a potential recessionary environment. During the period, CCC’s returned a respectable 6.9%, yet that was outpaced by B-rated issues at 7.0%, and an impressive 7.4% for BB- rated bonds. Hence, the incremental yield offered by CCC-rated issuers was likely not compelling enough for some investors, who decided to gravitate toward higher quality high-yield paper during Q4. The “risk-on” tone in the market truly was the tide that rose all boats, as every industry sector of the Bloomberg U.S. Corporate High Yield Index provided positive total return during the fourth quarter. Performance ranged from a low of 4.3% for the Transportation sector, (likely held back by the fear of higher fuel prices), to a double-digit return of 11.8% for Brokerage/Asset Managers (spurred by strong capital markets activity). Other notable gains were in Banking (+9.4%) and Finance Companies (+8.4%). In addition to the impressive performance of high-yield bonds throughout the quarter, as well as year-to-date, the 12-month trailing par-weighted U.S. high-yield default rate remained fairly benign, ending Q4 at 2.84%. Although higher than the 1.65% at the end of 2022, according to J.P.Morgan Credit Research, this remains well below the 25-year average of 3.4%.

As expected, with a large decline in yields, including a substantial tightening in credit spreads, companies were active in the new issue market in Q4. The month of December saw \$13.3 billion in new issuance, while November (\$19.4 billion) and October (\$9.4 billion) were also fairly active. Unsurprisingly, most of this issuance was related to refinance activity, as companies got ahead of the upcoming maturity walls approaching in 2024 and 2025. High-yield issuance wrapped up 2023 with a total of \$175.9 billion for the year, which compares to \$106.5 billion in 2022. Notably, according to J.P.Morgan Credit Research, new issue activity in 2023 was the second lightest in more than a decade.

Summary of key economic data:

- Gross Domestic Product (“GDP”) quarter-over-quarter: 4.9% (Q3 2023)
- Consumer Price Index (“CPI”) year-over-year: 3.4% (December 2023)
- Producer Price Index (“PPI”) year-over-year: 1.0% (December 2023)
- Personal Consumption Expenditures Price Index (also known as “PCE Deflator”) year-over-year: 2.6% (November 2023)
- Unemployment rate: 3.7% (December 2023)
- Oil prices (West Texas Intermediate, “WTI Crude”) decreased about 21% to \$71.65 during the quarter

Fund Strategy and Outlook

With an unprecedented amount of uncertainty on the geopolitical front, as well as the most widely anticipated recession that has yet to be realized, investors could have been forgiven for ignoring the compelling yields provided by the high-yield market throughout most of 2023. Yet the resilience of lower-quality fixed income assets and stronger fundamental credit metrics than most market pundits forecast this late in the Fed’s hiking cycle, supported an almost “goldilocks” scenario for high-yield bond investors. However, as we enter a new calendar year, cracks beneath the surface of a relatively stable economy could be forming. Although the highly-anticipated recession could be kicked down the road a bit further as the Fed continues to walk the tight-rope of a soft-landing environment, we expect some weakness may appear in 2024. The long and variable lags of restrictive monetary policy continue to work its way through the economy and we expect this may trigger what could classify as a “rolling recession.” Although market participants have built in a substantial amount of easing by the FOMC in 2024, inflation remains more stubborn than most anticipated and the labor market continues its remarkable resilience. Hence, we still expect the Fed to remain vigilant in its mandate for stable prices and full employment, resulting in rates remaining at current levels for a bit longer than most are forecasting. As strength of the consumer wanes and savings dwindle, some portions of the economy could experience bouts of weakness, while other sectors may be supported by various fiscal stimulus that has yet to arrive. Therefore, the “everything rally” experienced in Q4 may not have tremendous staying power as we work through the many uncertainties of 2024, though the aforementioned rolling recession may allow high-yield investors to earn coupon-like returns over the next 12 months. This could likely be supported by a still fairly benign underlying credit risk environment, as J.P.Morgan Credit Research forecast the 12-month trailing par-weighted U.S. high-yield default rate for 2024 to actually tick down slightly to 2.75%.

As we have mentioned in the last two quarterly reviews, we still maintain our stance that volatility may remain at an elevated level in the coming year as uncertainty related to both geopolitical risks, as well as macroeconomic factors, drive major fluctuations in investor sentiment throughout the year. A proactive investment approach by the Fund’s management team will be vital to navigating the potential rolling recession, as 2024 may be more of a “bond pickers” market than 2023. Although this weakness in economic activity could be a catalyst for risk-free U.S. Treasury yields to move lower over coming quarters, the Fund’s lower duration could benefit shareholders as we suspect credit spreads could move wider. At an OAS of just above 300 bps, the high-yield market appears priced for perfection related to underlying credit risk. Hence, the Fund’s positioning in lower duration to offset spread-widening and reduce price volatility, combined with an “up-in-quality” bias, continues to highlight our “Do No Harm” risk management strategy for our shareholders.

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 12/31/2023

Lead Portfolio Manager DAVID SCHIFFMAN	Inception Date 6/1/2006	Total Investments \$93.5M	Number of Holdings 65
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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 **S&P 500 Index** is a stock index, weighted by market capitalization, representative of the 500 largest U.S. companies. The **CRSP U.S. Mid Cap Index** targets inclusion of the U.S. companies that fall between the top 70%-85% of investable market capitalization. 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. 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.

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.