



# Aquila Tax-Free Trust of Arizona

## PODCAST TRANSCRIPT

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**Interviewer:**

Hello. Thank you for listening in to the Aquila Group of Funds podcast. I'll be your host today, Phil Felice, the Director of Internal Sales here at Aquila. And joining me as always is Tony Tanner, the Portfolio Manager of Aquila Tax-Free Trust of Arizona.

So, we're here in mid-November 2022, coming to the end of the year, and a year in munis that will likely be discussed and dissected for decades. As we usually do, we'll be discussing all matters regarding the municipal bond market and touch a little bit on the local Arizona economy. As always, welcome, Tony, and thank you for being part of the podcast.

**Tony Tanner:**

Thank you, Phil. It's great to participate. And like you said, boy, there's a lot to talk about.

**Interviewer:**

There sure is, so let's dive right in. As we said, so much has happened this year in the fixed income market and beyond. Can you speak to how the municipal market has transformed this year? How do you see municipal bond yields and prices currently looking, both as an asset class and relative to other asset classes?

**Tony Tanner:**

Well, as we look at the asset class today, a couple things stand out. First of all, the municipal curve has a pretty normal positive slope compared to the very inverted shape of the U.S. Treasury curve. And municipal market yields, on a relative basis, are much more attractive than they were at this time last year. We're looking at benchmark AAA yields at about 70% of U.S. Treasury yields under 10 years. If you go out further, you're talking 80% to 95%. But that sort of belies the value out there. Beyond 10 years in that intermediate range, there's a plentiful amount of good quality AA revenue bonds that are at north of 4%, at 110% to 125% of Treasury bonds. In fact, today, I'll see an offering on some AA and even AAA revenue bonds in 25 years offered a yield of 4.25%, which is more than what the 30-year U.S. Treasury is yielding. So, I believe there's attractive value in the muni market right now, and it's a good opportunity to compare to where we were a year ago, where those same yields were in sort of the 1% to 2% range. And a strong demand for municipal bonds with the prospect of higher marginal tax rates had muni valuations much more expensive. But here we are a year later with the Federal Reserve ("the Fed") having increased the fed funds rate significantly from 25 basis points to 4%. And what we have is the Fed has really created a condition where the investible yields in the muni market provide a more viable long-term potential entry point that may not have existed a year ago. And in terms of considering the muni asset class, it's considered cheap on a relative basis. This past week or a couple weeks ago, we saw an offering sheet on large high-quality airport revenue bonds from across a variety of issuers with 5% coupons due in 25 to 30 years. They were all at discount prices. And so, in terms of characterizing the state of the municipal bond market and values, I've often found that the municipal-to-Treasury ratios and valuation metrics are sometimes a better indicator of what not to do rather than what to do. And so, in current conditions with what I think are attractive valuations, if you have not already exited the muni market for whatever cash raising or rebalancing needs, I think we're at a point where the opportunity cost of foregone income, and being on the sidelines too long has become greater than any remaining interest rate risk we have with this Fed cycle.

**Interviewer:**

Thanks, Tony. Let's stay on that. That was obviously the headline topic for 2022: interest rates and inflation. Give us your thoughts on the Fed's current positioning and possibly where they head next.

**Tony Tanner:**

Well, I've talked about this a lot recently with our constituents. And in my 30 years' experience of managing open-end municipal bond funds across a whole host of market conditions, this year really has a lot more familiarity and has unfolded very similar to the bond bear markets of 1994 and 1998—and in particular, 1994. A lot of comparisons that you see are made to what I call a lot of the "new century dislocations" we've seen since 2000—whether that's the credit crisis, or the 60 Minutes interview, or the Taper Tantrum. Those bond downdrafts with hindsight, for investors with a long-term perspective, really turned out to be short-lived distractions. And going back to the nineties, we're in what I believe is the first Fed-driven bond bear market since 1994/1998. And the big difference is that the disruptions we've seen since 2000 were primarily situational.

Here, the decline in bond prices and increases in yield is primarily a function of just the math of market yields. And so, I think that has a lot of implications for how you evaluate the market. If you take a look at industry inflows back in those periods, we're seeing a similar pattern, and that is organic industry inflows probably aren't going to return to the muni market until prices stop dropping. And if you take a look at 1994/1998, the 1994 bear market bears most resemblance to this one. Alan Greenspan at

that time took the fed funds rate from 3% to 6% in a span of about 10 months, which drove up 10-year benchmark new yields about 140 basis points. But afterwards, the inflation risk that he was concerned with didn't really materialize because of a lot of technology productivity in the economy, and rates began to recede for the next four years.

And so, we are at a point where, with inflation possibly appearing to be cooling, it may be a good time to consider how fixed income can allow you to accomplish long-term income-oriented objectives in a way that we haven't been able to see done in several years.

**Interviewer:**

Great. And so as we said, the Fed and inflation has been the market driver this year. But what are the other market drivers currently in play? And I guess the real question is, are there any other market drivers currently?

**Tony Tanner:**

Industry inflows is an important driver because it's one of the primary contributors to keeping the municipal asset class as cheap as it is right now without inflows, and with the modest redemptions that the industry is experiencing. There just isn't the same level of demand that we saw a year ago when everybody was certain that the "Build Back Better" proposal would pass and marginal tax rates were going to go up. And that's created a very good opportunity on a relative value basis. And let's face it, if you invest in an intermediate portfolio that the underlying bonds are at a market yield of 3.5% or 4% tax-free, your question becomes, why don't I want the Fed to raise interest rates? Why don't I want the Fed to get inflation under control? Because now I have a chance to lock in an attractive long-term income stream.

**Interviewer:**

So, let's pivot a little to credit strength. What that looks like in the municipal bond market, both at macro level and of course at the Arizona level. For anyone who's listening that is concerned about the state of our economy, how would you assess the conditions of credit?

**Tony Tanner:**

Well, the credit fundamentals right now are very good, coming out of the pandemic. With both the recovery and \$8 trillion of fiscal stimulus, starting with the \$6 trillion that was distributed in 2020, municipal credit appears firm. Here in Arizona, the most recent budget report showed that 2020 fiscal revenues are 12% ahead of budget and \$300 million ahead of this point last year. And the State is sitting with an \$11 billion operating surplus. And at the state and local level, we've seen local revenue streams weather the pandemic very well and actually begin to accelerate. A recent bond issued by one of the State's largest issuers, the Phoenix Civic Improvement Authority, had some great information about that entity's revenue stream. And they collect tax revenues and excise tax revenues from a whole wide variety of sources. Year-over-year, those revenues actually grew 2.5% during the pandemic, and last year advanced about 5%. So, from a credit standpoint, Arizona and its local issuers are situated very well.

**Interviewer:**

And staying in Arizona, specifically, in maybe broader than credit, is anything else happening locally that our listeners should be aware about in the municipal bond market?

**Tony Tanner:**

Well, I think something that's very important for our constituents to consider is an increasing level of relative value in Arizona munis. That Phoenix Civic Improvement Authority issue I mentioned, when it came to market back in the mid-summer, the yield spreads that the bonds were priced at above a normal benchmark AAA bond—about 50 to 55 basis points. A year ago, the same issuer came to market, and that spread was only about 11 basis points. So, relative to the national market, the Arizona municipal bond market has actually underperformed slightly in the last 12 to 15 months, and is trading at levels and values that I've not seen in 20 years in Arizona. And again, going back to my prior comments, that to me is an indication of how cheap the asset class is, and indicates the kind of opportunity costs that might not be really on the surface when investors are considering what to do with their existing holdings. So, for me as a professional manager in the market on a day-to-day basis, it's breeding a lot of opportunity to put money to work effectively, and to also somewhat restructure the portfolio for the current rate environment.

**Interviewer:**

Thank you, Tony. The midterm elections, are now behind us. And I think we saw whether it's anywhere north or south of \$60 billion of ballot measures for local municipal projects. Anything noteworthy there inside Arizona?

**Tony Tanner:**

There wasn't anything really noteworthy on the issuance front. It was sort of your "garden variety" lineup of smaller school district issues. The biggest development in the State is its emergence as the smart manufacturing hub just keeps rolling on. Taiwan Semiconductor announced an additional \$12 billion semiconductor plant commitment to northwest Phoenix on top of the existing \$12 billion plant that it's building, and that its intentions are over the next 5 to 10 years to invest about \$35 billion in state-of-the-art semiconductor manufacturing. And we're already beginning to see the peripheral benefits along the Northwest Loop 303 corridor, where lots of smaller suppliers to Taiwan Semiconductor are moving in.

We're seeing valuable real estate development for mixed use and residential properties. And the implications there are pretty substantial and positive for that part of the valley. When you think about some of the outlying towns, like Wickenburg

and Black Canyon City, that the space is filling in. A few years ago, HonorHealth opened a hospital facility out there with its emergency room facility. And so, it's really nice progress from that front. We're also seeing some increased breadth in who is coming here. Procter & Gamble just announced a manufacturing facility in Pinal County that will employ 500 people. And Pinal County is becoming somewhat of a manufacturing hotbed itself for more traditional manufacturers, and it's becoming sort of the hotbed of the Phoenix-Tucson corridor. And so, it's good to see some geographic dispersion within the State's growth.

The other thing to me of note is despite the huge run-up in mortgage rates, Arizona's housing market is actually holding up pretty well. And while year-over-year housing permits are down about 10%, they still came in last month at around 43,000 single family permits on an annual basis, which is a very healthy amount for real estate and all the ancillary industries that support it here in Arizona.

**Interviewer:**

Thank you, Tony. So, I have one more question to close out today. We talk a lot to our clients and to advisors about our process—that we're "up in quality," and that we manage from a local perspective. But, for anybody new, for anybody looking at Aquila, thinking about using our Fund lineup, can you give us a 10,000-foot view on the strategy of Aquila Tax-Free Trust of Arizona?

**Tony Tanner:**

Certainly. I can tell you what we have done in Arizona and where we're situated now. I began a pretty defensive shortening starting in the fourth quarter of last year. I had a pretty strong feeling that the failure of the Build Back Better bill and the inaction, our marginal income tax rates would probably remove some of the demand for munis by a lot of the non-traditional buyers that have been in the market.

And so, I took down the Fund's average maturity from 12 to 10 years by the end of 2021. And that's been a benefit for our shareholders, as we've seen the significant increase in interest rates. And throughout the year I've continued to more defensively position the Fund's final maturity exposure. We came in last quarter around eight and a half years. At the same time though, we're restructuring to take advantage of a steeper yield curve and the value of being in the intermediate space. We've actually extended duration slightly from five to five and a half years. And what we've done is, we've mitigated a lot of the call risk in the front-end of the portfolio, where once you get beyond the Fed's tightening cycle and rates start going down, bonds that are approaching their call dates are of a much higher risk of being called away.

And so, we're seeking to insulate the Fund from a great degree of the long-term yield volatility where price sensitivity is greatest, but at the same time, stick with a high-quality intermediate portfolio that's now positioned to better roll down the yield curve and have better long-term total return possibilities, all with the same strong AA level of average credit quality.

**Interviewer:**

Thanks a lot, Tony. A lot of information. Any kind of last words or last thoughts you want to leave our audience with?

**Tony Tanner:**

You know, Phil? Yes, I do. The popular mantra in markets like this is "don't fight the Fed." But, I would really encourage people at this point to "don't reject the Fed." The Fed has done a significant favor to fixed income members, fixed income participants by returning income to the fixed income market. And it's really a whole new ballgame for income-oriented investors, especially those approaching retirement. And so, the 60/40 percent asset allocation proposition looks significantly better than it did a year ago because there is actual income in the 40 percent. And so, this may present an opportunity to deploy some of that sideline money and to lock in income for a long-term basis, because by doing so, you may be able to diversify some of the reinvestment risks that could come about should we see an abrupt change in Fed policy this year.

**Interviewer:**

Tony, as always, thank you for joining us today. I know I always find these discussions incredibly insightful, and I hope our clients in the advisor universe feel the same way. So, thank you, have a great day, and I guess have a great rest of your year.

**Tony Tanner:**

Thanks very much, Phil. Thanks for having me on today.

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