



Hawaiian Tax-Free Trust

PODCAST TRANSCRIPT

November 2022



Interviewer:

Aloha. Thank you for listening in to the Aquila Group of Funds podcast. I will be your host today, Phil Felice, the Director of Internal Sales. Joining me today from Bank of Hawaii are the Portfolio Managers of the Hawaiian Tax-Free Trust. We're going to have Reid Smith and Stephen Dodge on with us.

We're here as always to discuss the municipal bond market. We're coming to the end of the year, and it's a year in munis that will be discussed and dissected likely for decades, and we're going to do a little bit of that here today. So as always, Reid, Steven, thank you for being on the podcast.

Stephen Dodge:

Thanks for having us.

Reid Smith:

Thank you.

Interviewer:

So, let's dive right in. So much has happened this year in the fixed income market and beyond. Can you speak to how municipal markets have transformed this year? How do muni bond yields and prices currently look, both as an asset class and even compared to other asset classes?

Stephen Dodge:

Well, it has been a very volatile time in the market, and munis have not been spared from participating in that volatility. But we continue to believe that municipal bonds offer clients who are subject to high levels of Hawaii state tax a tremendous value. To put some numbers on it, as of November 16, 2022, 10-year munis, were trading around 79% of U.S. Treasuries, even longer munis in the 30-year area are trading around 96% of Treasuries—and that's all without even taking into account the tax benefit. If we adjust for the benefit on the 10-year Hawaii muni, assuming the highest tax rates, we would estimate a taxable equivalent yield of about 5.94%. That's even higher than the average 10-year BBB-rated corporate bond.

Regarding the curve itself, the short-end of the curve has "cheapened up" since last quarter and offers good relative value compared to Treasuries, but not quite to the same extent that we see the value on the long-end. This environment is fortunate for us, since we're able to source liquidity from maturities in the short and intermediate-term area of the portfolio where the relative value is a little less appealing and invest the proceeds in the longer end where we believe relative value makes more sense. Furthermore, because the securities are longer in maturity, it means that these higher yields we purchased for the portfolio, we carried forward for the long-term, helps to make the yield and the Fund even more "durable."

Interviewer:

That's great. Thank you, Stephen. Let's switch gears a bit. The headline topic for fixed income, obviously, in 2022 was interest rates and inflation. Give us your thoughts on the Federal Reserve's current position, and possibly, where you see things heading from here.

Reid Smith:

I'll chime in on that question. Inflation reports have been at elevated levels and have become quite routine. We did see inflation reports surprise to the downside in November, but still, at levels well above the Federal Reserve ("the Fed") pricing target of 2%. During the quarter, the Federal Reserve doubled down with a trio of 75 basis point (or a three-quarters of a percent increases, in the federal funds rate in July, September and November. They also increased expectations for higher rates in 2023. The Fed has charted and voiced a clear resolution towards raising short term rates by whatever is necessary to fight inflation. Fed Chairman Jerome Powell's commentary following the November Federal Open Market Committee meeting focused on the idea that the market expectations for the terminal federal funds rate may be too low, that the Fed may have to maintain these elevated interest rate levels for longer than the market expects. But we're, ironically enough, following the October inflation reports, which came in slightly below expectations. The market experienced a significant rally, or decrease in yield. This is reflective of the market adjusting its expectations on the pace of future rate hikes.

So, despite the clearly stated risks that rates may continue to go up from here, the possibility remains that rates may begin to level off and even fall in the near-term if central banks around the world can successfully put a lid on inflation. We believe that the Fed will continue to raise interest rates in the short-term and may need to maintain them at elevated levels going forward. But we do believe

that some cuts from the peak levels are a distinct possibility in 2023. Honestly, I know we are all pretty tired of hearing it, but it depends on inflation. If it does not start cooling and stabilizing closer to the Fed's target rate under these elevated rates, then the Fed is likely to go even higher than the market is currently pricing in.

Interviewer:

Right, and it's been such a central topic in all markets, the Fed and inflation. Can you address what are the other market drivers currently at play?

Stephen Dodge:

Yes, there's a handful of drivers. I'd say the primary factors driving the municipal bond market tend to be pretty static. It's not an exhaustive list, but I would say the primary factors would be yield environment, supply, liquidity and credit. Lately, the biggest driver has been the volatility in the rates market, with the Treasury yields moving around so much that it just has far reaching impacts across fixed income, including munis. But the yield environment is the part everybody knows about. I think the part of the municipal bond market that frequently goes unnoticed is how impactful supply can be in the market.

Following the low rates of 2020 and 2021, and the immense amount of refinancing and fiscal support that municipalities conducted and received, the need to issue new debt has been relatively low. And thusly, new supply has been quite limited. Through September 30th, new issuance in Hawaii is 71% lower than it was in 2021. And when securities mature and there's no new bonds for investors to reinvest in, it creates a supply and demand imbalance, and that can be quite impactful on the market. In this case, supply is putting upward pressure on the price of bonds. Liquidity and credit can both be extremely impactful to the municipal market, but they tend to be more isolated to specific events or credits compared to the far-reaching impacts of the yield environment or supply. And we aren't currently seeing any liquidity or credit factors driving our local market.

Interviewer:

Thank you, Stephen. And that was going to be my next question. In regard to credit strength, particularly in the municipal bond market, both at the macro level and, of course, we also like to talk about things at the local Hawaii level. So, for anyone that may be concerned about the state of our economy, how would you assess conditions in terms of credits?

Reid Smith:

Well, the credit quality of the State as a whole appears quite good. The balance sheets of various issuers continue to be strong and tax receipts continue to climb. Tourism has been very strong in returning post-pandemic. Despite inflation, employment is stable and state finances are solid. Going back to the visitor count, it's close to returning to the pre-pandemic levels, even with significantly lower numbers of Japanese tourists, which, historically, has been an important contributor to the local economy. A bright spot is the amount of visitors from the U.S. mainland, up 113% over 2019 pre-pandemic. And their expenditures are well above trend at 6.8% higher than 2019. This has supplemented the still anemic travel statistics from Japan. As you might have heard, Japan has reopened travel, but the strong dollar remains a developing headwind. Although we do see a nearly full recovery of international travels, ex- Japan. State and county finances have also strengthened.

Employment is steadily improved to the rate of 3.5% at the end of September. The State of Hawaii is reporting a double-digit percentage in revenue growth from general excise tax, and individual income tax growth of 31% above pre-pandemic levels. The general excise tax makes up 38% of Hawaii's revenues. Additionally, significant progress has been made by the State with pension and other post-employment benefit ("OPEB") liabilities, which are retiree medical costs liabilities. The Hawaii government workers pension funding has risen from 55% to 65% in a short time period. OPEB has improved from 16% to 30%. Finally, general fund balance has improved (by \$752 million in June of 2019) to over \$2.5 billion in July of 2022. We continue to have a high degree of confidence in our local issuers and believe they're well-situated to navigate a recession, should one come about.

Interviewer:

Thanks. Great info, Reid. We've been hearing that, across our other state-specific muni lineup, credit is a relative strength in the market here in 2022. I do want to switch gears. I have one more question for you, and it's more geared toward potential clients and advisors looking at the Hawaiian Tax-Free Trust. Can you go over, in a very broad 10,000-foot view, the strategy and perhaps even the outlook used to select holdings within the portfolio?

Stephen Dodge:

Sure. As always, we remain committed to providing our investors with a portfolio of high-quality bonds to generate an attractive stream of tax-exempt income. Coming out of the low interest rate environment of 2020 and even 2021, we carried a relatively short duration. But with the onslaught of rate hikes from the Fed and municipal bond yields, reaching levels that have not been seen for nearly 10 years, we've been lengthening our duration. And we believe this position does well for the pivot of the Fed from aggressive hiking to a tapering of their hiking cycle. Furthermore, we're concentrating our purchases in the longer end of the yield curve, which may help preserve current yield environments for our investors and make the Fund's income stream even more durable for the long term.

Interviewer:

Okay, great. Reid, Stephen, once again thank you for joining us. Mahalo for your time.

I know I always find these discussions incredibly insightful, and I hope our clients and the advisor universe feel the same way.

Stephen Dodge:

Thank you very much.

Reid Smith:

Aloha.

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The Fund seeks to provide a high level of income exempt from state and federal income tax as is consistent with capital preservation. Past performance does not guarantee future results.

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A credit spread is a difference in yield between two bonds of similar maturity, but different credit quality. Taxable equivalent yield is the return that is required on a taxable investment to make it equal to the return on a tax-exempt investment.

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