Aquila Tax-Free Trust of Arizona

PODCAST TRANSCRIPT

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Interviewer:

Hello, thank you for listening into this installment of 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. As we are known to do, we'll be discussing all matters regarding the municipal bond market, and touching on the local Arizona economy.

Welcome, Tony, and thank you for sitting down with us.

Tony Tanner:

Hey, good morning, Phil. How are you doing? It's a bright, sunny day today in Arizona. Spring Training is winding down. And as you and I both know, Opening Day is just around the corner next week.

Interviewer:

Right, always optimism in the air. So, it's no secret that 2022 was a challenging period for the fixed income markets. And you did, by the way, a great job summing up the year and comparing it to other years of stress in an update you did for us toward the end of the year. It's on the Insights portion of our website. If you haven't seen it, definitely check that out. So, now we're here recording this. We're a week away from wrapping up the first quarter of the new year. Zeroing in on municipals, how is 2023 shaping up so far?

Tony Tanner:

Well, it's interesting, Phil, because we just had another small hike (25 basis points) in the Federal funds rate (the interest rate that banks charge each other to borrow or lend excess reserves overnight) yesterday (March 22, 2023). And then, sort of looking at how 2023 is shaping up, it's shaping up to be a pretty traditional year of fixed income investing. In looking back over the last 12 months, the market has really transitioned from the reset phase of Fed policy. It's now solidly in what I would consider the fluctuation zone. So, for example, if you go back to May 4 of last year, the federal funds rate was only 50 basis points, and the net asset value of our Class Y share was $9.86. Yesterday (March 22), the Federal funds rate was 500 basis points, yet the net asset value of our Class Y share was $9.83. And so, since early-May last year, for the most part, the muni market has delivered a positive total return over this 11-month period, and it's demonstrated more of a "normal" fixed income investing experience.

The peak and trough total returns over this period have been a modest positive 3%, or negative 3%. We've seen the variation in volatility of principal be about one to two times the level of income being generated. And like most long-term fixed income investments, the accumulation of income has eventually overtaken the changes in the principal value. What I find really interesting about this period is that total returns have been in positive territory 66% of the time. And this is primarily a function of the fact that investible yields moved up very quickly and have remained elevated at the beginning of last year.

Most people are surprised to find that, from the end of 2021 through the first week of May 2022, high-quality 10-year municipal bond yields increased from around 1% to over 2.5%. And so, we are in a position now where fixed income, and municipal bonds, are really behaving, what I think, are quite normally. And within the financial press, the popular narrative has been to say that bonds are back, but the economic reality is that municipal bonds have been back for quite some time.

Interviewer:

Thank you, Tony. That was a great overview on the market. So, digging in a little bit more onto munis, what would you say are the leading factors driving the muni market?

Tony Tanner:

Well, there are two or three key factors that are really driving municipal bond investor behavior that's driving the market. First of all, elevated savings and short-term rates are really influencing investors to stay close to the sidelines, while at the same time, we've had a modest recovery in municipal bond fund inflows. But they're still pretty tepid, and that's kept long-term yields fairly elevated and relatively cheap. What I find that investors are concerned about these days, of course, is the potential for a recession and the condition of municipal credit. And while there are some recession worries, we just came through a pandemic three years ago where unemployment jumped up to 15% in four months, so I don't think we're going to encounter any sort of recessionary pressures like that the muni market can't withstand. And the credit fundamentals of municipals are still quite strong. So, I find that these factors tend to be distracting the muni market, rather than driving it.

You mentioned my *Asset TV* interview and companion thought piece, looking at the bond bear markets of the 1990s. And again, the economic backdrop that we have now is very different from that cycle in 1994. I want to touch upon a couple of things about the economy. The labor market is still really, in my mind, somewhat unsettled, in that it's only returned to levels that it was at the outset of the pandemic. The number of unemployed is relatively unchanged. The number of full-time employed in the economy is only about 1% higher than it was three years ago, and the labor force participation rate is still below where it was then. And so, the labor pie, and the economic pie, really haven't changed that much in the last three years.

We just came off a three-year period of 2020-2023 where average GDP growth was below 1.5%, and now it's decelerating. And even forecasts for this year and in 2024 show that, or expect that, GDP growth will still be under 1.5%. So, the pie is not really getting bigger. And so, when I think of the economy, I think of it as being more constrained from trying to exercise itself from the pandemic, as opposed to being tight because of rapid expansion.

In short, it just appears that the pandemic economy has outlasted the pandemic itself. And my guidance around those topics are that now the investible yields have reached meaningful levels in terms of long-run inflation rates and taxes, it is an opportune time when there is some fluctuation to look at those opportunities. If you're traveling along the highway at 70 miles an hour and you come up to a closure, you have to pull over to the side of the road of the shoulder, but you typically don't wait for traffic to resume going 70 miles an hour before you start inching back into traffic. So, the things that are sort of driving and distracting the muni market will hopefully abate and allow investors to focus on the long run fundamentals that are quite solid.

Interviewer:

So, I want to dig deeper into interest rates. Municipal bond markets are not immune to changes in the rate environment. And we'll file that under "if you didn't know that before, you do now." A lot of movement has taken place when looking at the yield curve. So, as you look at it currently, where do you see value, or where do you see potential opportunities?

Tony Tanner:

Well, the muni yield curve has an unusual shape now, especially relative to the U.S. Treasury curve. The U.S. Treasury curve has a classic inverted structure, where 30-year yields are well below savings yields and two-year rates. And the municipal bond market yield curve has somewhat of a yield "bowl" right now, where from one year to ten years, yields are still about the same. And in fact, seven to 10-year yields are slightly lower than short-term yields, but long-term yields are still fairly elevated above 3%. And looking at this unusual shape of the muni yield curve, where I'm finding value is, in focusing on the parts of the curve that are cheap, which would be towards the longer end of the spectrum—maybe out 15 to 20 years, and combining that with shorter three to four-year/five-year type securities that allow me to buy bonds where I get attractive yield. But I'm avoiding the potential for reinvestment risk and a change in Fed policy, and also not missing out on locking in longer-term yields that are elevated.

And so, it's a really unique time in the muni market from a value standpoint. But for active portfolio managers like ourselves here at Aquila Group of Funds, to me it presents extraordinarily good raw material with which to work.

Interviewer:

Thanks, Tony. That was really good stuff. I want to switch gears a bit and dig deeper into the local Arizona economy. What are some of the latest developments impacting the local economy, or even the municipalities?

Tony Tanner:

Well, if you've been listening to my podcast and reading our quarterly commentaries, you know that, for the better part of the last year to year and a half, I've been drawing attention to the evolution of Arizona's economy into what I call "the smart manufacturing hub of the nation." It's well-known that there's been great expansion of the semiconductor industry here in Arizona that goes back a year to year and a half to the announcement of Taiwan Semiconductor's first multi-billion dollar investment, as well as Intel's expansion of its chip manufacturing capacities, and the expansion to industries, such as autonomous vehicles, electric vehicles, and battery manufacturing. It's interesting, last month, The New York Times ran a headline story about the Arizona economy and the semiconductor industry, and declared that the State had become a semiconductor hub.

But what I find most interesting recently about the economy is more traditional manufacturers establishing manufacturing bases in Arizona. Proctor & Gamble and Kohler are two of those recognizable manufacturing names that are now putting in manufacturing facilities in Pinal County that will employ over 1,000 people. We're seeing similar, smaller-type manufacturing wins throughout the State in places like Flagstaff, Tucson and Kingman. And so, it's very healthy for the economic expansion to be rippling throughout the State. It's also well-known that population has been a big driver of Arizona's economy, but a recent change that was publicized has been just the amount of wealth migration that the State is attracting.

The IRS's most recent numbers for migration of wealth, and this goes back to the one-year change from 2019 to 2020, showed that Arizona captured the third-largest amount of adjusted gross income migrating within the U.S. So, from 2019 to 2020, Arizona attracted a net of 42,500 tax filers with an adjusted gross income of $4.8 billion. That was second only to Florida and Texas, and well ahead of a number of states west of the Mississippi, outside of Texas. Nevada was the closest in the region at 16,000 tax filers and an adjusted gross income of $2.6 billion. And so, there's this theme that west of the Mississippi and outside of

Texas, Arizona is really beginning to accelerate its separation from its regional competitors. Since 2018, among the California headquarter relocations that have taken place, Arizona's captured the third-largest number of those California headquarters. A recent study by U-Haul placed Arizona in the top 10 for each of the last three years for net moves. And so, the Arizona economy is not only very vibrant, but is enjoying a robust growth in wealth.

Interviewer:

Thank you, Tony. You shared some great insights there both on the larger muni market and locally in Arizona. If we can, can you give us a couple of few key takeaways from today's conversation?

Tony Tanner:

Well, first and foremost, for advisors and investors, I would encourage you to focus on the relative value of municipal yields, and especially considering them on a taxable equivalent yield basis in relation to the goals that you're trying to accomplish with income-oriented investments—especially your long-term goals. And that any further fluctuation that we might see in muni market yields and valuations could breed the opportunity for long-term, income-oriented investors to really reshuffle the deck, so to speak, and solidify the end component of their returns. You know, Phil, it wasn't that long ago that income-oriented investors were faced with a landscape where savings yields were next to nothing. And you were lucky if you could get 2% on a high-quality bond, and we're already 500 basis points a year into this Fed-tightening cycle. And with the recent troubles within the banking industry, the Federal Reserve (the "Fed") is learning that it can't just raise short-term rates with impunity.

I think that's one of the things that the long-end of the Treasury market is telling us. Participants in the long-end of the Treasury market have a wider variety of considerations, I think, than the Fed does, and I think views the root causes of inflation differently. And so, I'm encouraged by the relative value of municipal bonds throwing out the yield curve. And I also have a natural bias towards Arizona right now because Arizona is really cheap for the national market. And I'll give you an example. In September of 2020, one of the State's largest issuers, the Salt River Power Authority, came to market. And within that bond deal, they priced a 24-year maturity 5% coupon with a 10-year call date at a yield of 1.66%, which was only about 11 basis points better than national high-quality bonds.

In February, Salt River Power Authority came to market for the first time since then, the same 24-year maturity with a 5% coupon priced to a 10-year call date, yielded 3.69%, a full 200 basis points higher than a couple of years ago. More importantly, its spread to national high-quality yields was four times as large (44 basis points). So, it's clear to me in observing the overall muni market, and Arizona's place in it, Arizona munis are really at attractively-priced, and to some degree, "on sale." That would be my first thing.

The other would be to, again, consider the advantages that Aquila Group of Funds brings to the table, having local managers. If you look at the list of top 10 holdings within Aquila Tax-Free Trust of Arizona, you see a lot of names that are tied to the economic vibrancy of the State. The Fund's largest holding is an issue for the Arizona Sports & Tourism Authority. And as you know, we just came off a great February where a million people came to Arizona to see the largest-attended golf tournament on the circuit, as well as the Super Bowl. And Spring Training sites have been sold out for most of the spring, with great attendance at spring training games. You'll find a holding for Arizona State University in that top 10. And it's meaningful, because Arizona was one of only eight states that has seen an increase in enrollment in its public universities since the outset of the pandemic. And then you'll also see holdings, such as holdings for Intel's Chandler manufacturing facility. And that's evidence of the strength of our semiconductor industry. As well as issues that financed Creighton's new medical school. That was completed a few years ago. So, again, I would encourage advisors and investors to consider the benefits that a local manager has of gleaning the trends in the economy, and being able to capitalize on that within their municipal bond portfolio.

Interviewer:

Tony, as always, thank you for joining us today. I know I always find incredible value in our talks, and I just hope that our clients in the advisory universe feel the same way. Thank you. Have a great day, and I'll be talking to you down the road.

Tony Tanner:

Thanks again, Phil. We'll talk soon.

Interviewer:

Talk soon. Thanks.

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