Hawaiian Tax-Free Trust

PODCAST TRANSCRIPT

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Interviewer:

Aloha. Thank you for listening to this installment of 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 Hawaiian Tax-Free Trust. We're here with Reid Smith and Stephen Dodge. And as always, we're here to discuss the municipal bond markets, as well as the local Hawaii economy. Reid, Stephen, thank you for joining us today.

Reid Smith:

Thank you.

Stephen Dodge:

Thanks for having us.

Interviewer:

So, let's dive right in. No secret that 2022 was a challenging period for fixed income markets. Now here we are recording this. We just wrapped up the first quarter of 2023. So, let's zero in on municipals. How is 2023 shaping up so far?

Reid Smith:

Well, the good news is the Federal Reserve (the "Fed") appears closer to the end than the beginning of its objective in raising interest rates to blunt inflation. Although inflation remains above the Fed's stated goal of 2%, it is clearly declining, while the economy is showing signs of weakening. However, on the employment front, the last few months showed strong employment growth. Still, recent troubles with some high-profile banking takeovers have created volatility and worry in the market as a harbinger of recession.

It's a delicate path going forward, and it appears the market is predicting a slowing and some additional rate increases. In reaction to concerns of a recession, interest rates have fallen from the high point late last year to early this year in longer maturities, translating into positive relative performance. We expect high-grade municipal bonds to provide a solid investment as we move into the latter stages of the historic shift in Federal Reserve policy.

When we advise on the management of Hawaiian Tax-Free Trust, the focus on income is based on two key factors. Maximizing the tax-exempt income is the first step. The second step is focused on durability, or consistency, of the income. Usually the longer the maturity, the greater the yield. However, in today's environment, we have an inverted yield curve. That means longer maturities provide less income than shorter ones. The reason for this is the market is forecasting the Federal Reserve will be successful in taming inflation. The natural inclination is to buy short maturities to obtain a higher yield. Nevertheless, this is not a durable income opportunity. If the market is correct in its forecast, the reinvestment in shorter maturities will potentially lower yields, reducing income for the long term.

During these times, we need to focus on durable long-term, tax-exempt income. We're buying longer maturities in the portfolio to balance the exposure of reinvestment risk and locking into a more consistent stream of income for investors.

Interviewer:

Thank you, Reid. That was a great overview. As we look at the municipal markets today, what would you say are the leading factors driving the market?

Stephen Dodge:

Actually, I'll take that one. There are many factors at play in the muni market, but the most substantial is usually interest rate risk, and that continues to be true today. Up until recently, interest rates have been driven primarily by the expectations surrounding the Fed-hiking cycle. But now, the ongoing issues in the banking industry have moved into the foreground of the driving factors.

Prior to March 2023, yields were on the rise due to the market repricing the expectation that the Fed was going to need to continue raising interest rates. For example, from the beginning of February to the beginning of March, Hawaii muni yields increased as much as 80 basis points in the two-year space, and nearly 50 basis points in 10-year maturities. Since that time, with the news breaking about the stress in the banking industry, Hawaii muni yields have dropped as much as 50 basis points in the two-year space, and 40 basis points in the 10 year space.

So, despite the enormous rally in bonds that resulted from the “flight to quality,” we’re still seeing yields higher than they were in the beginning of February. We suspect that the banking sector will not continue to collapse, and that the banks that had these issues were isolated incidents. This is in line with the Fed and their announcement to continue to raise rates in March, where they raised another 25 basis points and reiterated their focus on fighting inflation.

Inflation will continue to be another dominant force in the market until it cools to a sustained level that’s not as damaging to the economy, but it will likely take a backseat until the market has fully digested what has occurred in March.

Another dominant factor has that has been impacting the Hawaii muni market in particular is supply and demand imbalances, but I actually think Reid will talk about that a little more later.

Interviewer:

Thank you. You mentioned supply and demand. Can you talk a little further about new issue supply and what that means for the muni market, and then maybe a little on investor demand?

Reid Smith:

Sure, I’d be happy to. Right now, we are in a drought of supply issuance for Hawaii bonds, as well as muni issuance in total across the nation. Year-to-date through February, national muni supply is down 28%, and down 95% for Hawaii. This comes after a negative 20% for national issuance, and a negative 48% for Hawaii issuance for 2022. Higher interest rates, and relatively strong state and local financials, has slowed bond issuance. In the face of this constrained supply environment, demand remains robust for the benefits of tax-exempt income.

Normally during tax season, demand for municipal bonds increases, as investors realign portfolios and seek tax-protected income. At the same time, balancing this, we often see issuers increase new-issue supply heading into the spring months. However, this year is different, as the municipalities continue to shy away from accessing capital in the higher interest rate environment.

If we combine this with a possibility of a higher marginal tax rate, as currently recommended in the President’s budget, it might be a longer-term drought of supply with steady and increased demand for tax-exempt bonds. Rest assured, we have strong relationships in the Hawaiian market, with over 25 years of managing the largest Hawaiian bond mutual fund.

Hawaiian Tax-Free Trust closely monitors local issuance in Hawaii and maintains relationships with over 35 counterparties across the mainland who seek Hawaiian bonds. We like to say, we want to keep Hawaiian bonds at home, and we want to return bonds on the mainland to Hawaiian investors. That’s what we do every day.

Interviewer:

That’s great. So, now let’s hit on Hawaii. What are the latest developments impacting the local economy for local municipalities?

Reid Smith:

Okay. Well, the Hawaiian economy is doing very well, according to State of Hawaii statistics. Tourism is back, with a nagging weakness in Japanese travel. The peak visitor count came in the third quarter of 2019 at 2.6 million arrivals. That’s pre-pandemic. As of the third quarter of 2022, Hawaii visitors reached 2.5 million, very close to those pre-pandemic levels.

During the same time, importantly, visitor expenditures increased from 4.4 billion to 5.1 billion. And as of 2023 to-date, visitor count has increased 26.7% compared to 2022 through February over the same time last year. Strong showing in our visitor industry.

As an additional piece of good news, the State of Hawaii’s unemployment dropped to 3.3%, well underneath the national rate of 3.5%, by the end of December. State finances remained solid. During the first three quarters of 2022, State general funds tax revenue increased 20.1% over the same period the prior year. For the third quarter, transient accommodation tax, or “TAT,” increased by 18.5% over the prior year. General fund balances are robust and State finances are showing a nice comeback from the pandemic situation.

However, on the credit side, two of our counties—Maui and Honolulu—have been downgraded half a notch, to AA by Moody’s. While this is still only two notches below AAA, it remains a very high quality rating. Moody’s Investor Services changed their quantitative modeling on over 340 city and county issuers across the nation. Their review included the four counties in Hawaii. Although the ultimate decision was to maintain the current ratings for Hawaii and Kauai, while notching Honolulu and Maui slightly lower, the commentary reiterated the quality of the two credits. The concern was concentrated exposure to tourism, which we hear quite often, and outstanding debt, including pension and healthcare funding for retired county employees. In effect, there was no change in the credit, but there was a change in the weighting of risk factors by Moody’s. The market showed no reaction to the change in the rating, and we remain comfortable with both.

Interviewer:

Thank you for that, Reid. Stephen shared some great insights, as usual. What would you say as a wrap up? What are the key takeaways from what we discussed today?

Stephen Dodge:

Sure. So, municipal bonds continue to offer a great value for individuals who are subject to a high level of tax. And if some of the proposals to raise income tax at the highest levels gain traction, that could make the after-tax yield of munis even more attractive. Having a high-quality municipal bond portfolio can be beneficial to a portfolio's asset allocation if the economy begins to enter recession, as bond yields typically drop in recessionary environments. This can provide conservative investors with a way to potentially invest their assets more defensively.

The State of Hawaii and its municipalities tend to be high-quality and have long track records of conservative management. In one example, we even have the Board of Water Supply, which was recently upgraded and now carries a AAA rating. The Fund's extension into longer maturity instruments should help to make the income stream and the Fund more durable and with greater opportunities for price appreciation if yields should begin to drop.

Of course, there are still a lot of unknowns in the market today, and we do think that the volatility in the fixed income market will continue for the near-term, as the market seeks to understand the issues surrounding inflation, the banking sector, and the economic outlook. But we're confident in our team, and our active management, to continue to find opportunities and attempt to add value in the portfolio moving forward.

Interviewer:

Okay, Reid, Stephen. As always, thank you for joining us today. I know I always find these discussions incredibly insightful, and I hope our clients and the advisor universe feel the same way. So, thank you. Mahalo for your time and have a great day.

Reid Smith:

Thank you.

Stephen Dodge:

Thank you.

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