Aquila Tax-Free Trust of Oregon

PODCAST TRANSCRIPT

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Interviewer:
Hello, everyone. Welcome to this installment of our Aquila Group of Funds podcast. I'm your host, Matthew DiMaggio. Today, we will be discussing the municipal markets with Tim Iltz, Portfolio Manager of Aquila Tax-Free Trust of Oregon. Thanks for joining us today, Tim.

Tim Iltz:
Hi Matt. Thank you for checking in.

Interviewer:
All right, Tim. So, let's just jump right in. It's no secret, 2022 was a challenging period for municipal bond market and, of course, fixed income in general. Hopefully the worst is behind us. How would you say 2023 is shaping up so far in your view?

Tim Iltz:
So far, despite recent headlines in the banking sector and some volatility in the Treasury market, municipals have been relatively quiet. This month, the 10-year U.S. Treasury has bounced around between 3.34% and 4.05%. While 10-year munis has been much more stable, with a much more narrow range of 20 to 25 basis points, some of the inaction in the municipal sector is a result of low new issuance levels, where reference points have been largely missing. But overall, we're experiencing much less volatility and more stability, and more attractive yields than we saw in 2022.

Interviewer:
I want to address interest rates. Rates have certainly had their effect on municipal bonds. As you look at the current yield curve, where do you see relative valuations and yields and also potential opportunities for attractive risk adjusted returns?

Tim Iltz:
Recently, the municipal yield curve has developed a peculiar bowl-shape over the first 10 years. This is highly unusual for the municipal yield curve, which is typically positively slope to what we call "normal." However, after this initial bowl, the muni curve is upward-sloping, with a fairly significant gain of 50 basis points from the 10 to 15-year range, which is where we're seeing a little more value.

As a measure of relative value, municipal bonds are often compared to Treasuries, with tax-exempt muni yields expressed as a percentage of treasury yields. Currently, municipal bonds are relatively rich compared to Treasuries. The 10-year Municipal-to-Treasury ratio is about 69% right now, versus a long-term historical average closer to 85%, which demonstrates munis are a bit rich right now relative to Treasuries—and they become richer as you look at shorter durations.

We see more relative value a bit further out the curve past 10 years, where ratios approach 85%. However, given the stubbornly high inflation levels, particularly relative to the Federal Reserve's 2% target, we're cautious right now about meaningfully extending our duration.

Interviewer:
Great details there, Tim. As you look at the municipal market currently, what would you say are the key factors driving it?

Tim Iltz:
Low new issuance levels is one of the most significant factors affecting munis. Sourcing new bonds has become significantly more difficult this year than it has in the past. Nationally, muni issuance is down about 18% compared to last year at this time, and it was down 20% as of the end of the year. This broad drop reflects the slowest third to a year for sales since 2018. As the Federal Reserve's move to lift rates to tame inflation, it's dramatically increased borrowing costs for municipalities. It's not uncommon to see municipalization was dropped just before that announcement. We saw visible supply fall 68%. In the week before the last February rate hike, it was even steeper than the 54% drop that we saw last week.

Sales typically jump up again once the Federal Reserve (the "Fed") passed their decision. One of the reasons we are seeing lower new issuance is a positive credit trend, which is that many local governments are sitting on piles of Federal pandemic relief cash, and many are also running budget surpluses, so they simply don't need to issue bonds right now.

Interviewer:
Fantastic, Tim. And the other end of that supply issue is, of course, what's happening with demand. Can you talk further about new issue supply and what that might mean for investor demand?

Tim Iltz:
Investor demand continues to be strong, which also makes it more challenging to source bonds. Here in Oregon, Forest Grove School District came to market last week with a $90 million general obligation bond. Several maturities were nine times oversubscribed. However, more significant was the result of the State's $800 million general obligation bond issue, which had maturities as much as 12 ½ times oversubscribed. Despite the large issuance size of the State's issue, it could have sold theoretically, multiple times, more bonds than they issued and not met demand.

Interviewer:
Great, Tim. And since we're on the topic of Oregon already, what can you tell me about Oregon in terms of the latest development impacting the local economy, and the municipalities themselves?

Tim Iltz:
In Oregon, the labor market remains tight, and as the State economist recently commented, nearly everyone who wants a job has a job. Workers have fully returned to the Oregon labor market, with approximately one and a half job openings for every unemployed worker. But of greater significance to our strategy, at the local level, property tax collections that support general obligation bonds remain elevated throughout the State. With property taxes being collected in Multnomah County, at levels of 98%. And in Marion County, also at 98% really high levels historically for these areas. This is important because these are the taxes that support the general obligation bonds in our portfolio. Although we expect some weakness in the housing market due to recent increases in mortgage rates, we don't expect this to have a meaningful impact on profit tax collections.

Interviewer:
Tim, I have one final question for you. It would be great if you could briefly summarize a few key takeaways for our listeners.

Tim Iltz:
Our portfolio positioning of shorter duration, higher credit quality, and higher- than-average coupon bonds has been relatively advantageous during the current dynamic market conditions. We continue to resist the temptation to meaningfully extend portfolio duration. But if the yield curve were to steepen, we would take advantage of the higher rates by slightly extending our portfolio duration to our target portfolio duration of 4 ½, to 4 ¾ years.

Most importantly, credit research continues to be the cornerstone of our strategy. With our overall defensive strategy, 90% of the portfolio is rated AA or better due to narrow credit spreads and the lack of reward for taking risk in the current market, particularly for longer maturities. We continue to review market conditions and are prepared to assume additional credit risk when we feel it's sufficiently rewarded.

Interviewer:
And that's all I have for you today. Tim. Thank you again for joining us. And, of course, thank you to our listeners.

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Modified and effective duration both measure the value of a security in response to a change in interest rates. Effective duration also takes into account the effect of embedded options. The weighted average life, also referred to as weighted average maturity, is a reflection of the quickness with which the principal of an issue is expected to be paid.

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.

Yield is expressed as a percentage based on the invested amount, current market value, or face value of the security, and includes the interest earned or dividends received from holding a particular security. The yield ratio represents the comparison of the expected yield of one bond to the expected yield of another. A yield ratio is important when deciding whether to invest in one bond or another. Generally, the higher yield is considered better.

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