Municipal Bond Update:

PERSPECTIVE ON THE CURRENT MARKET ENVIRONMENT

VIDEO TRANSCRIPT

Interviewer:

Joining us now with a closer look at the municipal bond market, we have Tim Iltz, Portfolio Manager at Aquila Group of Funds. Well, Tim, it's great to have you with us.

Tim Iltz:

Jenna, thank you. And thank you for your interest in the municipal asset class. Historically, municipal bonds have been kind of a sleepy asset class, and we don't get the attention that a number of the other classes get like equities. I do appreciate the opportunity to talk about bonds today.

Interviewer:

Yes. Well, it's a very important asset class, and it might be helpful for our viewers to begin by providing a little perspective here. How would you describe the current state of the municipal bond market? And for context, perhaps compare it to, say, last year.

Tim Iltz:

The last year and a half has been an exceptionally dynamic period of time for the municipal bond market. Looking back, it's been a little bit uncomfortable at times, but we find ourselves in a much more appealing interest rate environment now, particularly when you consider the tax exemption of municipal bonds. Looking back to 2022, at the beginning of the year, 10-year AAA yields (as measured by Bloomberg) were right around 1%. Now, we find ourself with 10-year AAA yields around 3%—so far, more appealing. If you go out to 15 years, municipal bond yields are now right around 4% too. A far more appealing interest rate environment to investors.

The catalyst for this huge move in interest rates was the Federal Reserve (the "Fed") and its aggressive hiking of interest rates to try and control inflation, and bring it back to the 2% target that they have. The Fed's primary goal was essentially to cool down that inflation and to do that through raising the overnight lending rate (the Federal Funds rate: the interest rate that banks charge each other to borrow or lend excess reserves overnight), which controls a very short period of the yield curve. But over the last year and a half, starting in March of 2022, the Fed has hiked rates 11 times for a total increase of 5.25%.

Interviewer:

Yes, that's a lot of tightening on the part of the Fed, Tim.

Tim Iltz:

Yes. It appears that it's been fairly effective too. Although inflation has proven to be sticky, headline inflation (as measured by the Consumer Price Index) was 9.1% in June of last year. More recently, we've seen it down below 4%—a huge improvement in inflation, but there's still a ways to go. Even at 4%, inflation remains at double that of the Fed's inflation target. What I would say is that the Fed's taking care of the easy part so to speak, and now we have the hard part, which is that last 2%.

The Fed's message about rates being "higher for longer," that's certainly something that we're taking to heart, and we would anticipate perhaps another rate increase later this year at the November and December meetings. And then maybe seeing rates staying at current levels or at those levels through the end of next year, or not cutting prior to the third quarter of next year. I would expect to see rates like the Fed is projecting being higher for longer until they feel that they really have inflation under control.

Interviewer:

In light of all these rate hikes, Tim, how has the municipal bond yield curve responded?

Tim Iltz:

Overall, unlike the U.S. Treasury bond curve, the municipal bond 30-year yield curve continues to be positively sloped. However, when we take a closer look at the yield curve, there are periods of inversion. There are periods that are steeply-sloped, and there are periods that are ruler-flat all at the same time. This reminds me of the story of the six blind men and the elephant, where each one touching a different part senses a very different experience.

In the present municipal yield curve, from maturities of one to seven years, there's a period of inversion. But when we go from seven out to 20 years, it's fairly steeply-sloped. And then if you were to look at say from one to about 12 years, things are just about ruler-flat right currently. A lot of the things that we've tried in the past strategically, in this market with this strong inversion, are a little bit more difficult to do.

Interviewer:

That's interesting. What would you say is the cause of the yield curve inversion?

Tim Iltz:

Taking a look at order flows and the participation that we're seeing in the bond market right now, the primary cause, I would say, is the impact of retail demand, separately managed accounts, and shorter ETFs (Exchange-Traded Funds). When we take a look at trade data from the Municipal Securities Rulemaking Board, we noticed that over the past year, we've seen about 36% of trades coming in that are under the 10-year portion of the curve. And about 31% of activity is coming from trades that we call odd lot trades, or under $1 million.

What that really points to is retail investors and separately managed accounts, and their attraction to the shorter duration: one to 12-year portion of the yield curve. One of the strategies that gets used by those particular type of investors is bond laddering. For example, 10 and 12-year bond "ladders" that put a significant amount of pressure on those portions of the yield curve. Somebody might ask, "Why would somebody do that? Why would somebody go out 10 years and lock in rates that are lower than the one-year rate?"

But for those investors, they're a little bit less interest rate-sensitive. What they're looking at now, the rates that we're seeing compared to what we saw historically, they're seeing rates that are higher than what they've seen in the last 15 years for those types of structures. There's still a high degree of appeal for those investors in that portion of the yield curve.

Interviewer:

Now, has the shape of the yield curve impacted your investment strategy at Aquila Group of Funds?

Tim Iltz:

It has, yes. What I would say about that is, for the fairly rich portion of the yield curve where things are inverted, we're taking a look at that as an opportunity to sell some bonds that we purchased in 2021 and 2020—in earlier periods, at lower relative rates of interest. By selling those bonds, we're able to lock in tax loss carryforwards that are valuable because those may help offset gains. At the same time, when we're selling those bonds, we may be purchasing bonds out a little bit further in the yield curve where interest rates are steeply-sloped.

Currently, an investor can potentially go out 15 years and lock in yields that are 90% of the 30-year curve. At the same time, we're taking a look at the short end of the curve to add into the diversification of the portfolio, and to take advantage of those historically high rates on the shorter end of the curve.

Interviewer:

How do you feel municipal bonds currently look on a relative basis in terms of relative valuations and yields?

Tim Iltz:

One of the natural comparisons for municipal bonds is Treasuries. One of the things that we take a look at is the ratio of municipal yields to Treasury yields. Historically, those have been in the high-70s to the mid80s (on a percentage basis). In the two-year tenor of the municipal yield curve, municipal bonds are currently about 68% of Treasuries. If we move out to 15 years, it's about 81%. So, significantly more relative value to going longer in this example.

And then, when you go out to the 30-year end of the yield curve, all the way out to the end, the Municipal-to-Treasury ratio is about 89%, which sounds appealing. But historically that's actually a little bit rich. Presently, on a relative basis, municipals are a little bit rich, or fairly rich on the short end, and a little bit rich on the long end. There's a compelling argument in the middle on a relative basis, particularly when you factor in the tax-exempt nature of municipal bonds.

Interviewer:

What are some of the key factors currently driving municipal bonds, Tim?

Tim Iltz:

One of the primary factors that have driven bonds this year has been supply—a limited supply of new-issue municipal bonds. Municipal issuance is down about 15% nationally. But when you take a look at individual states, it's quite a different story. Within the states that we manage, both Colorado and Arizona are down about 50% for the year. But when you take a look at states like Oregon and Rhode Island, those are over 100% of issuance compared to last year.

The observation that I would make is that, even in those states with strong issuance, they're still seeing increased demand from those other areas that are seeing less issuance. The demand is piling into those markets. In the new issue market, it's not uncommon to see a new issue 10 to 14 times oversubscribed. This can be very discouraging for a retail investor who's unfamiliar with those markets. I would say, even looking at net issuance, when we consider the impact of maturities and bond calls, the municipal market overall is contracting right now.

As of the end of September 2023, the municipal market is about $5.6 billion negative in supply. In other words, the municipal market is shrinking by $5.6 billion. That's all adding additional pressure onto the supply side of things as a result of this outsized demand that we're seeing for municipal bonds. The other factor that we're seeing that's fairly significant is where demand exists along the curve, like we were talking about earlier.

There's an outsized amount of demand in that retail portion of the yield curve—in the first 10 years—leading to that inversion. But as you go out further, the demand tends to be a little bit spottier. It's primarily coming from institutional investors who are a little bit more valuation-concerned, and also a little bit more price-conscious. That's why we're seeing some of those higher ratios out there.

Interviewer:

Of course, interest rates, as well as economic conditions affect fixed income investments, including municipal bonds. Could you give us a sense of how things may look for the remainder of the year, and perhaps going into 2024?

Tim Iltz:

One of the big debates that's been going on is the debate about whether there may be a "soft landing," or possibly a recession. The consensus is that we're looking at a soft landing, but I think there still is a strong possibility of some type of a recession. I think it's important to keep that in mind. But when we take a look at key economic data, particularly when we look at the job side of things, we're seeing increased labor force participation. We saw an uptick in unemployment, but it still remains well below 4% nationally. We're taking a look at incomes. We're seeing strong growth in income still.

The labor side of things is still fairly strong. When we take a look at inflation, we still remain concerned there. Housing is, in many places, very difficult to find and expensive. And then also, energy prices are quite high right now. When we take a look at real estate values, one of the important areas for municipal bonds is general obligation bonds, which are property tax-backed. In that sector, when we're taking a look at home values, there are concerns about some of the softening that we've seen lately with home values.

But I would note that overall, nationally, home prices remain about 40% above pre-recession levels. Housing prices are really holding in there quite a bit stronger than I would've expected, given the increase that we've seen in mortgage rates. Another thing that I think that's important to take a look at is state tax levels. Over the year, looking through the second quarter what we've seen states report, 10 states were reporting an increase in taxes in nominal terms. But 35 states report that they had received less taxes than in the past.

I would say that just given the level of stimulus that we've seen, states are still in a fairly good condition, but that there's some softening in revenues there. One of the considerations that I think is so important when we talk about state taxes and their overall revenue pictures is the budgeting process, where these states have balanced budgets and are able to count on multi-year appropriations to balance things out. Overall, even though they're seeing some revenue impact from current conditions, the overall budgetary picture continues to be fairly stable.

Interviewer:

What about credit strength and underlying market fundamentals, Tim? Are there other important factors impacting municipal bonds that we haven't discussed yet?

Tim Iltz:

Credit fundamentals continue to be very important. The one thing that I would point to, and like we were talking about with states, is the importance and significance of stimulus to local governments, and state governments also. A lot of local governments are still sitting on a significant amount of stimulus funds that they haven't spent. Financially, they're in a much stronger picture than they've been in the past. One of the things that I would point to is the upgrades and downgrades of credit ratings that we've seen on a ratings basis.

Year-to-date, we've seen $74 billion in downgrades in the municipal asset class, but we've also seen $500 billion in upgrades. Upgrades far exceed downgrades. When we take a little further look back over the last year and a half, about 70% of the ratings actions have been upgrades. There's been a significant number of ratings actions. On average, we're seeing about 100 ratings actions a month—as many as 275 in April. Significant amount of ratings actions, but very positive.

One of the things that I think was most significant is that in the second quarter of this year, we actually saw S&P Global Rating upgrade three states. State upgrades don't happen quite as frequently as what you would see for local governments, but we saw New Jersey, Massachusetts, and Kentucky all upgraded by S&P Global Ratings. The other thing that I would point to, and this is very significant to us, is credit spreads. What I'm talking about here is the difference in interest rates between AAA-rated bonds and perhaps, single-A rated (or other) bonds.

The difference in interest rates—that we refer to that as the credit spreads— have actually widened out over the last year. We've seen them tighten up a little bit recently, but they still remain at relatively wide, attractive levels. That's one of the other aspects that I see is fairly important right now, particularly from a credit aspect, is that right now, unlike a couple years ago, investors are getting paid to take some risk.

Interviewer:
What about public pensions? Are pensions still a credit concern?

Tim Iltz:

We still have pensions as a focus. This year, the pension returns that we've seen through June have been largely in the mid-to-high single digits, which is a nice turnaround from last year when pension returns were negative. But it's nothing like the record returns that we saw back in 2021. Overall, we continue to view pensions as an element that we are concerned about in some cases, but we think it's important to be aware of it and on top of.

In terms of our credit process, we tend to look at not only the pension that the local government has, but also looking at any other pension obligations that they have. One of the things that local governments do is, they go out and sell pension obligation bonds sometimes in order to offset their pension liabilities. We take a look at the entire pension picture, not just the pension obligation itself, but also any other debt that they might have outstanding along with that.

Interviewer:

Now, are there any sectors of the municipal bond market that you're concerned about?

Tim Iltz:

There are a few sectors that we are concerned about. And the one thing that I would say is that, within municipal bonds in particular, it's difficult to generalize. Even within those sectors, there are opportunities there. Some are better than others. But we're generally concerned about healthcare at the moment. We also have some concerns about assisted living facilities, and about student housing in certain states; also, about private higher education in certain locations. Another concern that we have is charter schools. In some cases, just given the high labor rates that we're seeing, we're taking a closer look at school districts and limited tax obligations that they might have outstanding.

Interviewer:

Well, this has been a lot of great information here, Tim. Tying it all together, are there any particular areas of opportunity in your view that you may be focused on?

Tim Iltz:

A couple of things that I would point out. I would go back to earlier in our conversation when we were talking about the shape of the yield curve. I think there's some intriguing opportunities on that steeply-sloped portion of the yield curve. The other opportunity that I would point to is some of these wider-spread opportunities.

I would still suggest staying within the investment-grade realm, but taking a closer look at some of those bonds that might be able to add back in under-allocated sectors to portfolios, or to take a look at perhaps local governments that hadn't been considered in the past just because they were consider a little bit too pricey.

Interviewer:

Well, finally, Tim, to wrap up our conversation, are there any key takeaways that you'd like to leave with our viewers today?

Tim Iltz:

I think the primary takeaway is, just going back to the beginning of the presentation, the concept that we are in a higher interest rate environment, a much more appealing interest rate environment than we have seen in the past. And then to go along with that, just the importance of having a broadly- diversified portfolio, and the benefit of having local portfolio management—in particular, local credit research. It's really important right now.

One of the things that we've seen recently in terms of trends is that a lot of advances in investment software have allowed investors to add credit research on more of an algorithmic approach. The downside of that, of course, is that a lot of credit research that takes place is not quantitative—looking at things like the tenure of management, and policies that an issuer might have in place, and security features that aren't quantifiable. A lot of those factors can't be factored into an approach like that.

Using an approach that highlights some type of local presence, or a strong internal credit management, is more important now that might have ever been, particularly given the outlook for the economy and some of the volatility that we're seeing right now.

Interviewer:

Well, thank you so much for all of your insights today, Tim, and great to have you with us.

Tim Iltz:
Thank you, Jenna.

Interviewer:

Thank you to everyone watching. Once again, that was Tim Iltz, portfolio manager at Aquila Group of Funds. I'm Jenna Dagenhart with Asset TV.

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Yield refers to the earnings generated and realized on an investment over a specific period. 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

Municipal-to-Treasury ratio compares the yields of municipal bonds with those of U.S. Treasury bonds in percentage terms.

Credit spread is the difference in yield between a U.S. Treasury bond and another debt security of the same maturity but different credit quality.

Credit upgrades and downgrades occur when an industry rating agency raises or lowers the credit rating of bonds.

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