Aquila Tax-Free Trust of Oregon

PODCAST TRANSCRIPT

October 2023

Interviewer:
All right. Thank you for joining us for another Aquila Group of Funds Podcast. I'll be your host, Matthew DiMaggio. Today we are joined by Tim Iltz, Portfolio Manager of the Aquila Tax-Free Trust of Oregon. Thank you for being here today, Tim.

Tim Iltz:
Matt, thank you. And thank you for checking in.

Interviewer:
So much has happened in this monetary tightening cycle by the Federal Reserve [the "Fed"]. For a time this year, it seemed like we were through the price volatility, but it seems to be lingering just a bit. Where do municipal bonds stand, as the Fed comments on keeping rates "higher for longer?"

Tim Iltz:
I agree, there was a period of time in September, just before the Federal Open Market Committee met, that bond pricing seemed to settle in. However, during the September Fed meeting, although the Fed paused, its message was a more restrictive policy for a longer period of time, which essentially means there may be higher rates for longer. As a result, the bond market is very data-dependent right now, so we're seeing heightened volatility as the bond market responds to every piece of economic data that's released. And I would say that until the Fed changes its narrative, we expect to continue to experience a bumpy ride.

Interviewer:
Great color there, Tim. What should municipal bond investors be looking out for as we navigate these markets?

Tim Iltz:
There's a few things. One of the big ones is reinvestment risk. The Federal Funds rate [the interest rate that banks charge each other to borrow or lend excess reserves overnight] has a very significant impact on a very short period of the yield curve. But as a result, we're seeing very appealing rates at the short end of the curve, and so it's very tempting right now for investors to focus on that. But the question should also be, "Can you replace that yield?" And one of my colleagues, David Schiffman, did a great job of writing a piece that we have posted on Aquila Group of Funds' website under "Insights," specifically on reinvestment risk. I would refer anybody to that.

The other thing that I think is really significant right now is yield curve positioning. Although the majority of the municipal yield curve remains positively-sloped, the portion of the curve encompassing the first five years has remained inverted since the fourth quarter of 2022. Right now, the yield curve is all at once flat, steeply-sloped, and inverted. And depending upon where you look on the curve, for the first 1–5 years, the curve is significantly inverted, from 1–12 years, it's ruler flat, and from 10–15 years, it's steeply- sloped. And so, depending upon an investor's strategy, they can have a dramatically different experience right now.

But from a portfolio perspective, we're an intermediate fund, and so that's our approach. We have adapted things a little bit just because of this precarious situation with the unusual yield curve shape. Where we've adapted more of a barbell-type of a strategy, trying to minimize share price volatility and interest rate risk at the same time. So, from a portfolio perspective, we're looking at the short end and the longer end in that 10–15-year portion.

And the last thing that I would point out is credit spreads right now. What I'm talking about is the difference in various credit categories, such as AAA to A-rated bonds, or AAA to AA-rated bonds. Overall, the perception of credit quality of the municipal asset class remains high, as credit spreads have tightened over the past quarter. But still, investors need to remain cautious and make sure that they're getting paid for the risks that they're taking. The Federal Reserve is not the only one that's concerned about inflation right now. Local governments are facing significant inflation, cost increases, and material increases. And although the market is currently assuming a "soft landing," I don't think we can entirely dismiss the possibility of a recession at this point.

Interviewer:
Great color all around, Tim. I want to talk a bit about supply here nationally. Across the country in 2023, perhaps as a result of elevated rates, new issue supply has been a bit limited. What's your take on that?

Tim Iltz:
The decline in new municipal bond issuance continues to be a significant factor in the municipal bond market. As you pointed out, this is primarily due to the substantial increase in interest rates, and the accelerated pace of rate hikes over this past year and a half. Nationally, we've seen issuance decline by 25% during the first half of this year. More recently, as of earlier this week, it was down about 7%. So, issuance is catching up. However, the lack of new issuance supply has made sourcing bonds challenging at times. But I think it's important to point out that this slower pace of new issuance also points to a positive credit trend for municipals—that many local governments are sitting on significant amounts of Federal pandemic relief cash and running budget surpluses, and therefore, not needing to access the capital markets.

Interviewer:
So, now drilling down on Oregon a little bit, are there any developments happening in the State as it relates to municipal projects, or the State-specific landscape in general?

Tim Iltz:
We were just talking about issuance and the importance of municipal bond issuance to the overall market. In the Oregon market, the November election has always been an important source of new bonds. At Oregon's November 2023 Special Election this upcoming November election, several general obligation bond measures have been approved and placed on the ballot, including bonds from six school districts in two cities. However, the total par amount being requested is only about $500 million, which is approximately a third of what we saw last November, when voters approved approximately $1.5 billion of new bonds. So, even if all the measures are approved, Oregon issuance will likely be more subdued going into 2024.

The big news in Oregon is that the State has confirmed it will distribute a record $5.6 billion through its "kicker" to taxpayers. This is due to personal and corporate tax collections exceeding the State's expectations. The kicker is essentially Oregon's income tax refund or credit, if actual revenues for the biennium are more than 2% higher than forecast at the time the budget was adopted. Although the kicker is good news for taxpayers, it poses certain budgetary challenges to the State—particularly if the kicker is paid out at the ending of an expansion cycle and the beginning of a recession, which has been Oregon's experience following both the technology and housing boom in recent decades.

In Oregon, October 25 is the last date for tax collections to be mailed out from various tax collectors around the State. So far, from what we've seen, taxpayers should expect to write a larger check this year than they did last year. We're seeing significant increases in property taxes in Washington, Marion and Polk Counties. A couple examples: The city of Independence had taxes increased by an estimated 9.5%, as a result of property taxes approved by voters for the fire district that covers the city. And also, the city of Monmouth, which is in Polk County next door, had a similar experience, where they had also approved taxes for the fire district, and had approved bonds for the construction of a new City Hall. They're seeing property taxes increased by about 12.7%. And then closer to the Portland metropolitan area, the city of Beaverton is likely to see taxes increased by about 8.5%, due to the city increasing their operating levy to cover higher costs.

Interviewer:
Great color on the State. If I may, one last question.: How is the Fund positioned in this market?

Tim Iltz:
There are a couple of things that I'd point to. First is high-quality, the second is intermediate maturity. Our portfolio positioning is shorter duration, high credit quality, and higher average coupons, which has been relatively advantageous during the current economic market condition instead of the volatile daily changes. And I'd say that given the current shape of the yield curve, and the potential for continued monetary policy tightening by year-end, we remain cautious in our selection of municipal bonds. Under our overall defensive portfolio strategy, as of September 30, the Fund holds approximately 90% AA or higher credit quality bonds. Credit research remains a cornerstone of our strategy and our local approach, with vigilant monitoring of both issuers and sectors. And lastly, I'd point out with all this discussion that we've had of taxes, higher property taxes, and higher taxes in general, the tax-exempt nature of municipal bonds is a significant factor right now.

Interviewer:
That wraps up our podcast. Thank you for listening. And thank you again for joining us, Tim.

Tim Iltz:
Thank you, Matt.

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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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