# Aquila Group of Funds ~ Municipal Market Views Podcast Transcript October 16, 2018

**Interviewer:**
Today we're talking to Tony Tanner, Senior Vice President and Portfolio Manager of Aquila Tax-Free Trust of Arizona. Tony, since the inception of each of the Aquila municipal bond funds, there have been several periods during which the Federal Reserve increased the Federal Funds Rate including 1994, 1999, and over the period from 2003 through 2006. You've had experience navigating fixed income markets while managing bond funds during those periods. What similarities or differences do you see in the current round of Fed Funds Rate increases?

**Tony Tanner:**
Having been in this market for twenty some-odd years, you get to see some of the nuanced differences when the Fed is taking a course like it is now, and there are really two different camps of Fed policy campaigns. One is when they're responding to unwanted or unanticipated inflation, which is what occurred in 1994 and 1999 versus today, and to a large degree in the mid-2000s, when they're removing a policy accommodation to support the economy. In this particular case, this has been a very long time coming. It's kind of analogous to keeping the training wheels on the economy until the economy was in middle school. So, it's been a fairly extended period of time.

1999 and 1994 were meaningful bond bear markets that occurred amidst a backdrop of the Fed really trying to rein in a very upward tick in inflation, and one of the things that really distinguishes these periods is the fact that we're now about ready to complete our thirteenth consecutive year of annual GDP and economic growth under three percent, which is the largest period of such growth since the Great Depression. This has been the weakest post-recession economic expansion on record. Compare that to the period from 1994 to 1999 when, in five of those six years, GDP growth averaged over four percent. We haven't seen a four percent growth in the economy since 2003.

So we really have had muted economic growth which really helps to keep inflation in check, and so our current Fed campaign really is one of removing a policy accommodation and has not been really influenced by unwanted inflation.

**Interviewer:**
Would you then discuss inflation trends during this cycle and expectations for inflation looking forward?

**Tony Tanner:**
Yes. Well, this year inflation has finally approached the Fed's desired target of two percent, and its favored measure of inflation – the Core Personal Consumption Expenditure Index which excludes food and energy – recently dropped from a peak of 2.2 percent to 1.8 percent in August. So while we do have inflation that's a number other than zero, it's really a manageable level of inflation and actually a desired level of inflation because you need some degree of inflation of purchasing power for employees and employers to get real wage growth. Going forward, inflation expectations are really muted. The break-even expected inflation for ten years is a little north of two percent. The Fed chairman at a speech in Boston on October 2 really just said that the current economic path really isn't too good to be true.

So this is important because it's really hard to have a lasting bear market in bonds without either a big acceleration in realized inflation and inflation expectations, and we're just not seeing it.

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**Interviewer:**
On September 26, the Fed Funds Rate was increased by 25 basis points and that was the eighth increase since the end of 2015. How has the municipal bond market reacted, and do you believe we might be nearing a period of opportunity in the municipal bond market?

**Tony Tanner:**
Well, you know, since the last Fed increase a few weeks ago, we've started to see an up-tick in municipal volume which is really part of a seasonal increase, and buyers have been somewhat sitting on the sidelines and waiting, and that has cheapened municipal yields further as they've been increasing modestly over the course of the year. And they've actually gotten cheaper relative to taxable alternatives in that time. The other thing that we've observed is that the municipal bond curve still remains much steeper than the taxable yield curve and so for investors, there really is that point now where there's a lot of value in either getting off the sidelines and deploying cash, or revisiting their fixed income portfolios to evaluate whether or not adding to their tax-free income makes sense.

**Interviewer:**
How would you describe the supply and demand dynamics of the municipal bond market currently, and what impact are those factors having on bond prices and yields?

**Tony Tanner:**
Well, as was expected following last year's tax reform, which did away with advance refundings, we have seen a decline in the level of new issues, both nationally as well as here in Arizona. New issue volume nationally is down about 20 percent from $300 billion year to date to about $250 billion. Here in Arizona, it's actually been a much sharper downturn, not just in the volume but in the number of deals. Since the end of June, we've only had ten publicly offered investment grade new issues in Arizona. Two of those were large issues which accounted for about 80 percent of the volume in this period. And so because of the lack of presence in the new issue market, the secondary market is really where the opportunities to capitalize on the higher yields exist.

And that plays very well into the institutional benefits of a mutual fund. Dealers who work with us here in Arizona know what we're looking for and know that we have the capacity to transact in large institutional-sized volumes. So one of the things that we've observed is, with lower prices, institutional buyers and larger portfolio managers are conducting tax loss swapping and that's making available a wide variety of very attractive bonds in the secondary market.
This is where, as an institutional buyer working with dealers, you might see opportunities on bonds that might not appear in an inventory or on a trading sheet. So it's really a very favorable time for mutual fund portfolios to take advantage of opportunities and a way for individual investors to get instant diversification and, at the same time, capitalize on the higher yields that are available.

**Interviewer:**
Taking these factors into account, do you see this as being an opportune time to establish or add to a tax-free bond investment?

**Tony Tanner:**
Well, it's certainly one of the most opportune times that we have seen in the last three to five years I would say. It's important for investors to recognize that income provides the lion's share of the return for a bond investment that's held over the long run. And so investment yields and the entry point for a bond investor really have the largest influence on attaining positive long-term total returns, and more importantly though, preserving purchasing power. With the rate of inflation anchored around two percent and double tax-free yields in Arizona now in the three percent range in the intermediate high quality space that is consistent with our portfolio strategy and mandate, you're now at a point where you can earn attractive real inflation-adjusted levels of income, and we haven't really seen that in a couple years.

While rates can always continue to move a little higher and cause principal value to fluctuate, it's important to remember that the primary way to increase expected long-term returns in fixed income is to invest at higher market yields. For investors that have been starved for income from the last two years of very low interest rates, I really see it as a glass half full proposition right now and really encourage those that have been cautious with their capital to really consider all of the positive investment and return characteristics that they can find in the market now. The decision that municipal bond investors are faced with as interest rates have been increasing and now opportunities are appearing, is really analogous to a home buyer when they're trying to figure out when to apply for a mortgage as interest rates are declining and borrowing costs are going down.

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And in each case, rather than trying to pick the top of the increase in interest rates or the bottom in the decline in interest rates, the real decision is, do the level of rates that I'm borrowing at or yields that I'm investing at, do they allow me to accomplish my objectives? In the current environment, where we now have the opportunity to achieve real inflation-adjusted yields that provide much better potential for long-term total returns, it's really important for investors to consider that question rather than make it one of market timing. In the Fed's current campaign, which has really been a series of preemptive moves rather than a response to any sort of meaningful inflation, do appear to be succeeding in both containing inflation amidst the backdrop of both economic growth and employment gains.

I think that can give investors real confidence in finally getting out from under this period of very low interest rates and really zero yields, when you take inflation into account.

**Interviewer:**
Thank you very much.

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