Investment Commentary

December, 2018

AQUILA GROUP OF FUNDS

AQUILA® Tax-Free Trust of Arizona

A Shares: AZTFX **C Shares: AZTCX** **Y Shares: AZTYX**

National and Arizona Municipal Market

It was a tale of two markets this quarter as the municipal bond market shook off a pair of 25 basis point increases in the Fed Funds rate in late September and mid-December to finish on a firm tone with yields actually declining 30 basis points. Benchmark 10-year AAA municipal yields drifted 19 basis points higher through early November following the September hike, only to sharply recede 49 basis points in response to both diminishing inflation expectations and the rout in equity prices.

Nationally, new issue volume in the quarter dropped 40% from $155 billion to $90 billion, reflecting the bloated issuance activity the last quarter of 2017 brought on by the rush of refunding issues. Yearly issuance declined 24% to $339 billion compared to $448 billion in 2017. Issuance in Arizona closely mirrored this national trend. Fourth quarter volume dropped 45% from $3.4 billion to $1.9 billion in Arizona (a third of 2017 Q4 issuance came from two large refunding issues). Yearly volume fell to $4.3 billion from $6.7 billion, a 36% decrease.

There were several attractive Arizona issues that sold in the weakest part of quarter which provided the opportunity to buy high quality bonds at a discount. Most attractive were 15-20 year maturities with tax-free yields of 3.5% - 4.0% which the Fund acquired at the same time that comparable maturity taxable US Treasury benchmark bonds were yielding only 3.2% - 3.4%. Part of this "value dislocation" was driven by overall muni industry outflows which forced issuers to offer significant yield premiums to mover their bonds. These purchases not only helped secure the Fund's dividend, but added an additional component of stability as such outsized muni/treasury yield ratios normally subside over the long run.

There were several significant issues in which the Fund participated from Maricopa County ($422 million), Phoenix Sky Harbor Airport ($226 million), and Honor Health ($237 million). In particular, Maricopa County Special Healthcare District issued Aa3 /AAA rated (Moody's / Fitch) general obligation bonds to expand and upgrade its facilities throughout the county and begin construction of a new teaching hospital facility that is part of the Creighton University medical school. Honor Health (A2 Moody's) raised proceeds to construct a much needed hospital facility to serve the north valley as part of the campus it established with the John C. Lincoln emergency facility. These issues highlight both the vibrant state of Arizona's healthcare market and its vital role in providing essential medical facilities to a growing population.

National Economy

The fourth quarter brought on several economic headwinds that have tempered growth and brought down inflation expectations. The volatility and collapse in stock prices, continued trade policy uncertainties, and government gridlock all seemed to converge at quarter end. As a result, GDP growth estimates for 2019 remain at 2.6% and are now expected to downshift just below 2% in 2020.

Despite these economic headwinds, the Federal Reserve moved ahead with its fourth 25 basis point rate hike of the year in December. Combined with the September 26th increase, that effectively left the Fed's primary short-term policy tool 50 bps higher for the quarter. Following the December increase Fed Chairman Powell began to strike a more conciliatory tone towards further prospective increases in 2019, acknowledging both the impact of equity market declines and bond market sentiment.

More importantly, inflation expectations actually declined gradually throughout the quarter. The Blue Chip Economic forecast for the Consumer Price Index declined in each month of the quarter and stood at 2% at year-end. The Federal Reserves' own inflationary gauges demonstrated similar weakness as well; breakeven 5 year US inflation rates declined from 2% to 1.5%. These measures indicate inflation not only remains under control, but well below the views held by Fed Chairman Powell prior to the December rate hike that "neutral rates might be closer to 3%.

Arizona Economy

Robust population growth amidst steady job gains continued to pace Arizona's economy in the 4th quarter. Through November the Arizona economy has added over 103,000 non-farm jobs in 2018. Reported state job growth in the third quarter hit 3%, well ahead of the national rate of 1.7% and was the fastest in two years. Growth was led by the construction sector with jobs, permits, and prices all exhibiting healthy growth. Manufacturing and the professional / business service sectors all experienced higher growth rates, while financial service sector job growth slowed.

The primary challenge for the state's economy is keeping up with population growth. The State unemployment rate of 4.7% remained stubbornly above the national average of 3.7%, reflecting continued resumption of very strong population trends in the State. So far in 2018 the state ranks 4th in population growth at 1.7% and in absolute growth with a population increase of over 122,000. Most importantly, Arizona is only behind the much larger states of Florida and Texas in net migration with over 98,000 net newly located residents. This placed Arizona well ahead of other south and western states like Colorado, Nevada, Tennessee, Washington, and Georgia.

Fund Outlook and Strategy

While talk of a flat yield curve has dominated the headlines, a combination of Federal Reserve policy, mutual fund outflows, and year end flight to quality produced a subtle shift in the municipal yield curve in 2018 that may open additional investment opportunities for the Fund. Both the shortest and longer maturities across the municipal market actually experienced modest yield increases, while the heart of the yield curve from 10-15 years actually saw yields decline slightly. As a result, not only is the municipal bond curve steeper itself, but now presents a compelling "barbell" situation.

In this case, a combination of 1) longer 15-20 maturities that yield upwards of 125% of their taxable counterpart and 2) maturities of 3 years and shorter which may be more efficiently re-deployed towards any increasing interest rates may provide both higher income potential and greater stability than 8-12 year maturities at this time. This enables the fund to achieve genuine diversification throughout the yield curve and guards against overpaying for fully valued maturities trading at lower safe-haven yields or having the Fund too concentrated in any particular maturity range.

We believe that putting this value-awareness of municipal fixed income dynamics together with a local management presence that observes projects firsthand, and delves into developments within Arizona's economy and municipal market (such as our discernment of the evolving healthcare sector), provides advisors and investors with the most attractive principal preservation, income, and return prospects.

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The Fund posted and an attractive quarterly return which enabled the Fund to overcome the first quarter back up in yields and register a positive total return for the year. Municipal bond prices and yields in general ended the year little changed from late January levels. This was impressive considering that the Fed increased interest rates four times between January 31, 2018 and December 17, 2018, which left the Fed's primary benchmark a full percentage point higher.

The Fund's performance benefited primarily from dividend continuity and very modest volatility. Despite the continued pace of Fed tightening – which doubled the Fed Fund's rate in 2018 – the Fund experienced only a modest 2% decline in NAV that was accounted for by the January decline in prices leading up to the year's first Fed increase.

The fourth quarter also illuminated the prospective negative correlation attributes that municipal bonds have historically introduced to a genuinely diversified, multi asset class allocation. Many market pundits and participant throughout the year seemed to either ignore or abandon this tenet. The bond market stayed in the negative through most of the year and it was only in the fourth quarter that equity markets retreated violently from their record highs. At this point the negative correlation benefits of municipal bonds returned in force. By November, valuations and market movement presented a great rebalancing opportunity to shift exposure from fully valued assets like equities into undervalued municipals whose tax-free yields were at multi-year highs and considered cheap, compared to both benchmark US Treasury yields that remained anchored near 3%, and riskier corporate bonds with lower taxable equivalent yields.

For specific information about fund characteristics, holdings and performance please see the Fund Fact Sheet on our website at www.aquilafunds.com.

Lead Portfolio Manager	Inception Date	Total Investments	Number of Holdings
Tony Tanner, CFA®	3/14/1986	$248.3M (as of 12/31/18)	209 (as of 12/31/18)

Before investing in the Fund, carefully read about and consider the investment objectives, risks, charges,expenses and other information found in the Fund prospectus. The prospectus is available from your financial advisor, and when you call 800-437-1020 or visit www.aquilafunds.com.