Aquila Tax-Free Trust of Arizona

PORTFOLIO MANAGER COMMENTARY

Q4 2023

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

Municipal Bond Market Overview

After continued weakness in the month of October, the municipal bond market staged a powerful rally in November and December during the quarter ending 12/31/23. The 10-year AAA yield, as measured by Bloomberg, declined 119 basis points, from 3.45% on September 30 to 2.26% at the end of the quarter. This resulted in an overall decline in this benchmark yield of 19 basis points for the 1-year period ending 12/31/23, when yields began the year at 2.45%. The market demonstrated a sharp turnaround during the fourth quarter. Following a jump in the 10-year AAA yield, to 3.65% at the end of October 2023, the market began a recovery in November, which picked up steam in December. This delivered the strongest quarterly performance for the municipal bond market since 1986, according to Bloomberg. The Bloomberg Municipal Bond: Quality Intermediate Index posted a positive return of 5.86% for the quarter, which enabled it to record a positive total return for the year of 4.64%.

The municipal bond market also outpaced the U.S. Treasury bond market by a wide margin, as the yield on the 10-year U.S. Treasury bond declined only 70 basis points. This outperformance was largely mirrored across the entire 1-30-year yield curve, reducing the ratio of municipal bond yields to U.S. Treasury bond yields. During the fourth quarter, this 10-year ratio declined from 74% to 58%, while the 30-year ratio declined from 93% to 83%. Although this outperformance has diminished some of the "cheapness" which had surfaced in municipal bond values last fall, the taxable equivalent yields of municipal bonds at the end of the quarter remained attractive relative to recent inflation readings that have remained below 4%. This still leaves municipal bonds in what appears to be a position to offer better risk-adjusted return prospects than other corners of the taxable investment-grade fixed income markets.

While investors have remained focused primarily on interest rate increases in 2023, and intentions in 2024 of the Federal Reserve (the "Fed") and Chairman Jerome Powell, the continuation of the trend of inflation below 4% since last June has begun to provide a supportive tone to the municipal bond market. Coinciding with the drop in market yields was a surge in new municipal issuance during the past quarter. Nationally, issuance totaled $105.5 billion, a robust 39% increase over the $75.5 billion issued in the fourth quarter of 2022. For the year, issuance in 2023 totaled $379.9 billion, a modest 2.9% decline from the $391.3 billion issued in 2022, according to data from *The Bond Buyer*.

The credit quality of municipalities has demonstrated resilience in the face of recession concerns and the wake of the latest U.S. government downgrade last August by Fitch Ratings (from AAA to AA+). A barometer of this was the upgrade of the Metropolitan Transportation Authority ("MTA"), one of the most economically-sensitive New York issuers in the national municipal bond market. The upgrade of the MTA in October by S&P Global Ratings (from BBB+ to A-) reflects how the essential nature of important municipal services (in this case, mass transit in the nation's largest city) is important to credit quality. The upgrade is also a result of the impact municipalities derived from the significant intergovernmental transfers made by the U.S. government to power the COVID-related economic recovery. This included the $6 trillion in CARES Act packages passed in 2020, and the $1.9 trillion American Rescue Plan passed in February 2021.

Arizona Economy and Municipal Bond Market

New municipal bond issuance in Arizona surged in the fourth quarter of 2023. Issuance for the three-month period of 9/30/23-12/31/23 totaled $2.18 billion, a 110% increase compared to the $1.03 billion in new Arizona municipal bonds issued in Q4 2022. Sizeable issues from the Salt River Project ($650 million) and Phoenix Civic Improvement Corporation excise tax revenue bonds ($381 million) accounted for half this amount. Total issuance in Arizona for 2023 was $5.09 billion, a 17% decline compared to the $6.14 billion in new issues sold in 2022. As a result, the volume of Arizona issuance in 2023 ranked 21st among all 50 states, according to *The Bond Buyer*.

The State's economy has begun to demonstrate some moderating shifts in both demographic growth and the pace of economic activity. Year-over-year non-farm payroll employment reported as of November 2023 grew 1.8%, increasing by 54,800 jobs to 3,178,700. The State's labor force expanded further, with a year-over-year addition of 90,00, an increase of 2.5%. This left the unemployment rate as of November at 4.3%, which was above the national rate of 3.7%. This reflects the above-average population growth the State continues to experience, as recent U.S. Census data showed Arizona added over 65,000 net new residents for the fiscal year ending July 2023.

The absorption of Arizona's growing population into the economy has not been a hindrance to economic growth though. Recently released figures by the U.S. Bureau of Economic Analysis showed the State's GDP growth in the third quarter of 2023 accelerated to 4.9%, up sharply from 1.5% in the second quarter, and outpacing the 3.2% growth rate in the first quarter of 2023. Overall, Arizona ranked 20th for GDP growth in Q3.

Fund Strategy and Outlook

Leading up to the fourth quarter of 2023, we took advantage of: 1) "cheapening" valuations, 2) a steeper yield curve, and 3) moderating inflation, and maneuvered the Fund's effective duration to a somewhat longer stance of 5.5 years, with an average final maturity of 9.1 years. Then early in the fourth quarter, we also capitalized on deeply discounted, high-quality AAA issues in the secondary market to further the diversification of bond structure in the portfolio. These actions helped to support the Fund's income and balance the return fluctuations displayed throughout the quarter. As a result, the Fund delivered positive total returns for the 12 months ending 12/31/23, comprised primarily of tax-free income.

With the strong recovery in municipal bond prices towards the end of Q4, we cautiously trimmed our interest rate risk exposure to longer-dated maturity bonds in December after yields fell and the rally progressed. As a result, the Fund ended the fourth quarter with a reduced average final maturity of 8.74 years, and an effective duration of 5.04 years, while maintaining the majority of its holdings (85%) in the AA-rated and higher credit quality categories.

We believe this high-quality and broadly diversified portfolio structure may keep the Fund better insulated from municipal bond market fluctuations that may arise as Fed policy actions and inflation trends unfold in 2024. This is an important consideration for fixed income investors given the influence stubbornly high U.S. deficits may have on the path of long-term rates and potential market volatility. We intend to proceed with heightened caution in evaluating the municipal bond yield curve and the opportunities it presents to enhance the Fund's risk-adjusted income and return prospects.

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

Fund Facts as of 12/31/2023

Lead Portfolio Manager	Inception Date	Total Investments	Number of Holdings
ANTHONY TANNER, CFA®	3/14/1986	$184.8M	98

Independent rating services (such as S&P Global Ratings, Moody's Investors Service and Fitch Ratings) assign ratings, which generally range from AAA (highest) to D (lowest), to indicate the credit worthiness of the underlying bonds in the portfolio. Where the independent rating services differ in the rating they assign to an issue, or do not provide a rating for an issue, the highest available rating is used in calculating allocations by rating. Municipal/Treasury Ratio compares the rates of municipal bonds with those of U.S. Treasury bonds in percentage terms.

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

A credit spread or a yield spread is the difference between the quoted rates of return on two different investments, usually of different credit qualities but similar maturities.

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 Bloomberg Municipal Bond: Quality Intermediate Index tracks the performance of municipal bonds with remaining maturities between 2 and 12 years and a minimum credit rating of A3. Indices are unmanaged and are not available for direct investment.