Aquila Tax-Free Trust of Arizona

PODCAST TRANSCRIPT

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Interviewer:

Hello, everyone. Thank you for listening in to the Aquila Group of Funds podcast. I will be your host today, Phil Felice, the Director of Internal Sales. And joining me is Tony Tanner, the portfolio manager of the Aquila Tax-Free Trust of Arizona. As we're coming out of the first-half, recording this in fact on June 29th, we'll be discussing all matters regarding the municipal bond markets, as well as the local Arizona economy. As always, welcome Tony, and thank you for being part of the podcast.

Tony Tanner:

Glad to be here today, Phil.

Interviewer:

Let's start with the first question—very direct. On a long enough timeline there are downturns in all markets. In the front half of this year, however, we saw all markets experiencing volatility, along with some of the most severe and volatile muni markets in the last 40 years. So, what was different this time around?

Tony Tanner:

Well, in my experience, what I see as being really different is we're exiting this decade-long period of generationally low interest rates. And so, it's a sea change for all investors. It's sort of a "brave new world." When I take a look at what the Fed is doing, what I really see them doing right now is, they're restoring the rates that they have been paying savers, which they had cut dramatically at the outset of the pandemic. And so, this first series of interest rate increases we are seeing, to me are not necessarily a bad thing. It's difficult to run an economy on the backs of savers when you're paying them nothing. So, the Fed's first step in normalizing interest rates is to restore the rates that they have been paying savers. And so, I think that through that lens, there are some positives to be seen from the current Fed policy.

In looking at the economy that the Fed is responding to, we have had challenges with inflation, particularly with food and gas. However, we're already seeing a continuation of some of the weak GDP growth that is starting to show up. 2022 real GDP forecasts were just reduced to only 2 ½%. And 2023's growth rate was reduced to 1.9%. And I've pointed out in prior podcasts that we're going to come out of this in a three-year period with average annual growth under 2%. And so, to me, economic recovery and restoration are not the same as expansion.

Real inflation adjusted wages have declined now for 14 straight months. This morning, the first quarter GDP performance was revised again, lower to negative 1.6%, and we've had four consecutive declines in disposable income. While employment might be high, I don't know that the economy is particularly prosperous right now. And so, I think that as the economy continues to unfold, once the Fed has normalized these savings rates, it will be interesting to see whether or not they can be as aggressive as they have communicated that they would like to be.

This feels most similar to me, in my experience, to the 1994 Fed policy driven bond market. 1994 was a period where the Fed moved quickly and sizably. It started out with a March surprise at the end of that particular year's March, which sent yields up quickly through the summer. But encouraging to me is that in that bond bear market, the peak-to-trough time period in market yields was only 10 months. And so, I anticipate that we may see this particular Fed cycle, not last as long, nor be as aggressive as being forecast now.

Interviewer:

And with all that in mind, getting back to the muni markets, what does that mean in terms of relative value heading into the second half of the year, comparing it to U.S. Treasuries and even the larger fixed income markets?

Tony Tanner:

Well, value has returned to the muni market in a very large way. And with the Fed's initial interest rate increases, we've seen the most abrupt move in high-quality muni bond yields in the last 40 years in the first six months of this year. The Bloomberg 10-year AAA yield average has gone up already 175 basis points, which exceeded the entirety of the move in those yields during the 1994 bond bear market then. And so, what's happened now is, yields have settled into a condition where we now have a little more steeper yield curve than we had at the beginning of the year. And the best muni values in terms of Muni/Treasury ratios exist out in the intermediate to the long-end of the curve. Five years-and-under Municipal/Treasury ratios are around in the 50s and 60s, but 10 years out to 30 years, they're in the high-80s to the mid-90s. The value is in the long-end, which isn't surprising given that people are cautious about the Fed policy. I would say that with the values they're presented themselves now, when you have the opportunity to lock in attractive 3.5 and 4% double tax-free yields, sometimes the question becomes, "Why don't you want the Fed to raise interest rates, keep inflation under control and protect your purchasing power?"

In this year's fixed income market, the muni ratios to me are a better indicator of when not to sell, or when not to buy perhaps though. They're very fluid. And so, sometimes they can actually provide a good check-in point in your asset allocation to make certain you're not moving too quickly in either direction. This year, the muni technicals have really overwhelmed the muni market fundamentals, and the current level of borrowing costs in the issue market doesn't really reflect the strong credit economics of munis. And what's happened in the muni market this year has been a function of a variety of what I would call dislocated factors. This year, with the upward tick in yields, investors finally had the opportunity to engage in tax loss swapping which created a wave of a lot of selling in the muni market. And comparing this current muni bond market to back in 1994, the biggest difference is that with ETFs, the significant portion of investor assets are now in the hands of price takers. That is, large investors who are forced to sell. And so, we've had some waves of selling this year in the secondary market that have really been the culprit for driving up yields. That dynamic though has made the municipal bond secondary market extremely attractive this year, especially for active

portfolio managers, like the portfolio managers at the Aquila Group of Funds. And historically, sometimes this has been a time to switch from defense to offense.

We may not be quite at the bottom yet, but there is some likelihood the majority of principle damage to fixed income investments has been done. And the investible yield that are now available have been restored to attractive levels for advisors and investors to look at traditional asset allocation rebalancing among their equity and fixed income holdings. But what I'm seeing right now is probably some of the best improved long-run, forward total return, and income potential than I've seen in years. There's lots of raw material for active managers to put money to work. If you take the taxable equivalent yields of high quality munis at 3% to 4%, and look at those as the earnings yields, you find that the P/E ratio for munis right now is maybe in the mid-teens, which is very attractive compared to equities right now.

Interviewer:

Thank you, Tony. Great color on this secondary market. Let's switch gears a bit to the primary market in terms of issuances and where you see that heading into the second half of the year. You've alluded to yields. Are you being presented with more appealing yields than you saw coming into the beginning part of the year?

Tony Tanner:

We're seeing more attractive yields by a variety of metrics. The yield spreads in munis, even in the highest quality AA general obligation and revenue bond issues are much wider than they were at this time last year. Last year, maybe you could get an extra 10 or 15 basis points over the high-grade scale. We've seen new issues in the AA and high-quality A sector in the 60s, 70s and even plus 80s sometimes. And so, for active managers, the new issue market has presented a lot of opportunity to capture value when there simply has not been enough buyers around. But the biggest difference is there's been a greater breadth of issuers within the state this year, which has given us an opportunity to make some attractive technical adjustments to the portfolio.

We've seen large issuers like the Gilbert Water Resource Authority come to market with $473 million of bonds. The Mayo Clinic recently sold $300 million dollars of bonds to finance expansion at their main campus in North Phoenix. To me, the most exciting issue this last year was when the Arizona Sports and Tourism Authority issued $158 million of improvements for State Farm Stadium, which is going to be, of course, hosting the Super Bowl next February. And one of those improvements in that bond issue were for upgrades to the HVAC systems within the stadium. A lot of people didn't realize when the stadium was built, that it wasn't built with a heating system. And back in, I believe the 2014 Fiesta Bowl, we had a freeze that night and people attending the game, including a lot of the local sportscasters, discovered that they needed their overcoats because the stadium didn't have any heating. That was a really attractive and interesting issue. And so, this has been a very good period for tactically adjusting the portfolio and increasing the breadth of the portfolio.

One of the things that we've done to take advantage of the conditions in the muni market is to somewhat restructure the portfolio. We've mitigated a lot of the call risk that have been in the Fund and have replaced a lot of soon to be callable bonds that still had high enough coupons that didn't leave very good likelihood for us holding onto them. And we've been able to replace them with good 8-to-10-year, non-callable bonds at investible yields that were well above the long-run rate of inflation. And now we feel the Fund will benefit from having a portfolio that, although it has a significantly shorter average final maturity that we've reduced from 12 to 9 years, it's now going to benefit appreciably from rolling down the steepest part of the yield curve. And this may contribute not only to maintaining the Fund's income, but helping to stabilize and hopefully recover some of the Fund's principal value as well.

Interviewer:

Great. And let's stay local. We are, after all, Aquila, and we know that advisors and the clients of advisors look to us as the local subject matter experts. What are you seeing locally in terms of the general Arizona economy and economic growth within the State?

Tony Tanner:

Well, the State's economic growth continues almost unabated, and the population growth wins of the last decade here in Arizona are translating to very significant gains and wins in the labor force. This past month, Arizona's labor force grew for the 23rd straight month, and has increased year-over-year by 50,000 labor force participants. Historically, Arizona's unemployment rate has lagged that of the nation because, without size population growth, it takes time for those new residents to be absorbed into the economy and to find work. But now, that dynamic has changed. Just recently, it was reported that as of May, the State has now recovered 115% of the jobs that had been lost since the start of the pandemic versus a recovery rate for the nation of only 96%. The nation is still 800,000 jobs short of where it was nationally at the outset of the pandemic. And so, Arizona's May unemployment rate came in at 3.2%, which is below the U.S. rate of 3.6%, so the State is benefiting from these long-run demographic trends.

And now, we are saying, because of a lot of good budget policies, and because of a lot of relocation and growth by new businesses coming into the State, a very deep, robust employment and revenue situation. Within the State, a lot of the very large announced projects that came on board, including the new Taiwan semiconductor plant in Northwest Maricopa County, are now beginning to yield a lot of peripheral growth projects nearby. Economic development, infrastructure, new home building for all of the employees that are coming to different parts of the valley.

And so, the breadth of Arizona's economic growth continues. And that's a very important factor in the State's long-run stability. A couple days ago, the governor announced the passing of the 2023 fiscal year budget. And it's a record $18 billion budget that has an unprecedented surplus approaching $5 billion. There was lots of good news in the budget, a lot of money going to development, additions to the State's rainy-day fund, an increase in education spending of a billion dollars to $8.4 billion. And probably the most exciting was $3 billion commitment to water development in the State. This includes budget revenues, as well as new bonding authority for the Arizona Water Infrastructure Finance Authority. And so, overall within Arizona, the economy continues to do well. And it continues to do well, I believe, in all the right spots for the Arizona funds of shareholders and its constituents.

Interviewer:
A lot of great stuff and informative info for us to unpack. Tony, as always, thank you for taking time out of your day for us. I know I found it incredibly insightful, and I hope that our clients feel the same way. Thank you and have a great rest of your day.

Tony Tanner:
Thank you, Phil.

Thank you for listening to this podcast. The opinions shared are those of the portfolio managers and do not necessarily reflect those of the Investment Adviser or Sub-Adviser of the Fund.

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Mutual fund investing involves risk. Loss of principal is possible. Investments in bonds may decline in value due to rising interest rates, a real or perceived decline in the credit quality of the issuer, borrower, counterparty or collateral, adverse tax or legislative changes, court decisions, market or economic conditions. Fund performance could be more volatile than that of funds with greater geographic diversification.

Information regarding holdings is subject to change and is not necessarily a representative of the entire portfolio. A complete list of the Fund's current holdings, including percentage allocation, is available on our website and by contacting Aquila Group of Funds.

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. For certain investors, some dividends may be subject to federal and state income taxes, including the alternative minimum tax referred to as AMT. Please consult your tax professional.

Independent rating services such as Standard & Poor's, Moody's and Fitch assign ratings which generally range from AAA highest to D lowest, to indicate the creditworthiness of underlying bonds in the portfolio. Where the independent rating services differ in the rating assigned to an issue or do not provide a rating for an issue, the highest available rating is used in calculating allocations by rating. Pre-refunded or escrowed bonds are issued to retire or regain an outstanding bond issue at a specific call date. Until the call date, the proceeds of the bond issuance are typically placed in a trust and invested in U.S. treasury bonds or state and local government securities.

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 weighted average life, also referred to as weighted average maturity, is a reflection of the quickness with which the principal of an issue is expected to be paid.

A credit spread is a difference in yield between two bonds of similar maturity, but different credit quality.

Taxable equivalent yield is the return that is required on a taxable investment to make it equal to the return on a tax-exempt investment.

For certain investors, net investment income tax, known as NIIT may apply. NIIT is a 3.8% tax established by the patient protection and affordable care act that applies to the lesser of, the net investment income, or a taxpayer's modified adjusted gross income above an applicable threshold amount

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 yield ratio represents the comparison of the expected yield of one bond to the expected yield of another. A yield ratio is important when deciding whether to invest in one bond or another. Generally, the higher yield is considered better.