Aquila Tax-Free Trust of Arizona

PODCAST TRANSCRIPT

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Interviewer:
Hello, everyone. Welcome to another Aquila Group of Funds podcast. I'll be your host, Phil Felice. Joining me is Tony Tanner, the portfolio manager of the Aquila Tax-Free Trust of Arizona. We'll be discussing a number of topics including infrastructure, municipal spreads, bond rates, as well as the local Arizona economy. Welcome Tony, and thank you for being on the podcast.

Tony Tanner:
Thanks, Phil for having me on the program today.

Interviewer:
Great. So, we'll kick things off with infrastructure. The infrastructure bill, it recently passed through the Senate, and it is awaiting a vote in the House. It's captured much of the attention of investors and market participants this year. If passed, how does this potentially affect supply, and really how does it affect muni markets in general?

Tony Tanner:
Well, Phil, the short answer is a lot less than you would anticipate, especially given the coverage of the topic in the financial press. Earlier in the year, the MSRB pointed out that two-thirds of all public infrastructure projects in the country are already financed with munis. And so, infrastructure finance is already a key part of the issuance and supply side of munis. The most surprising aspect of the Senate bill was the absence of any formal resurrection of the BABs program or a direct pay taxable vehicle, which many people had anticipated. I believe that once this ultimately passes in whatever form it's going to come through, you're not going to see a meaningful or discernible change in the nature of supply from an investor's point of view. That is, any changes in supply, that would come about from this, would be very unlikely to discernibly change the level of investible yields or rates on munis. Whereas the topic of infrastructure and taxable munis is really more important to the sell side of the business. They're heavily engaged in working with municipalities to raise capital. And so, the implications, I think, are much greater for those that are in the business of originating and distributing munis, rather than for investors. One note of observation on this topic is taxable munis. One of the advantages for issuers has been, widely talked about is, that they get a broader audience of people in which to look at their bonds. However, already in the muni market, we see pretty strong demand for the issuance that's out there. We're observing that municipal bond issues are routinely three to five times oversubscribed. And so, there's already a very existing and robust audience for municipal bond issuers that are trying to tap into a low-cost capital. So, I think that moving forward, we're going to see less impact to the investor from infrastructure finance or any policies around that.

Interviewer:
Thank you, Tony. Let's stay in D.C. for one more question. A tax overhaul could be the next big story coming out of Washington. Have you observed any impact on how an increase in taxes might affect the muni markets?

Tony Tanner:
Yes. Since the beginning of the year and really in the aftermath of the election, we began to observe a significant firming of muni values given the prospect of a more environment of being open to higher taxes. The impact that we have seen is that the ratio of muni yields to U.S. Treasury bond yields has changed markedly in the last seven or eight months. And it reached a point, actually in February, where the yield ratios suggested that we were going to be returning to pre-Reagan era tax rates, which is very unlikely. In the last six or seven months, we've seen those valuations ease up a little bit, as both the prospects for tax reform and tax changes continue to meet with challenges. And that legislation is slowly working its way through. But I do think that moving forward, this improved valuation of munis relative and taxable alternative is going to stay in place, because we do expect to see some sort of upward adjustment in tax rates that will continue to enhance the value of the tax-exemption from munis. It's certain that the next duration in tax rates isn't going to be down and certainly feel like municipal bonds are going to continue to offer a continued haven for those seeking tax efficient investments.

Interviewer:
Earlier on, you touched on demand. It's been quite strong, essentially across all muni paper, how does it affect the market? And, can we see demand continuing at these levels?

Tony Tanner:
Well, from a supply standpoint, this year to date, supply of tax-exempt issues is up modestly about 6%, from around $258 million to $263 million. We have seen a decline in taxable bond issuance as there was a slight increase in U.S. Treasury bond yields. But we think that the supply dynamic is going to continue to be balanced and mostly favorable. The interesting thing about the level of demand that we're seeing for munis, ties to some of the unique aspects of the muni bond market. This year, in the past 12 months through July, have actually been the most tranquil 12 months when it comes to volatility and fluctuation of municipal bond yields for close to a decade. That is, the high-low range of municipal bond yields has been fairly narrow. The other aspect is that we continue to see municipal bond yields near generational lows. And we also then see prices at generational highs. And that create a couple of interesting aspects of this year's muni market. Institutional and individual investors alike are hesitant to realize gains. And at the same time, with little fluctuation in yields, there's less opportunity for traditional tax loss selling. And so, we're seeing very little turnover in the secondary market. Bloomberg had a report recently that noted that trading year to date has been the lowest since the turn of the century. Now, I have to smile a little bit because the turn of the century was only 20 years ago. It's not quite that long ago. But the slow pace of trading and the nature of investors to hold on to their higher yielding bonds and their gains, has really led to what is this somewhat imbalance you see in supply and demand, where new issues are heavily oversubscribed. I do think that that's going to continue to… will ease up somewhat going forward. But I do think that overall, we've not had any huge challenges in obtaining the types of bonds and issues that we'd like to see in our portfolios, nor in maneuvering our portfolios to accomplish objectives for our shareholders.

Interviewer:
Municipal credit spreads have ever recovered very strongly in the past 12 months, which was during the pandemic, and they've narrowed quite a bit. What does it tell us about the mindset of investors?

Tony Tanner:
In what we've observed in municipal bond spreads and credit spreads the last 12 months, to me, it tells us a lot more about the nature of municipal finance than the mindset of investors. The impact on credit spreads from the COVID induced recession, and the volatility that we saw in the spring of 2020, were somewhat unique and unusual market response. We had that period in March where the market sold off. And during that time, yields across the credit spectrum increased about two full percentage points. And that was consistent not only in the highest quality AAA bonds, but also in the lower investment grade spectrum of A and BBB-rated bonds, as well. Typically, when you see an expansion of credit spreads, it results from some economic dislocation that causes the lower rated securities to meaningfully decline much more in price than high quality securities, and we didn't observe that. But once rates peak, what we observed was investors returning to the muni market in a patient manner by focusing first on those highest quality bonds. And so, during the summer and fall, you saw the yields on the highest quality bonds declined markedly, while the yields on those A and BBB-rated bonds tend to remain elevated. Well, what we've seen this year in the last six to eight months, our spreads are finally catching up. And so, as the economy continues to reopen and recover, as we got additional fiscal stimulus, and as we got a vaccine, and we're able to return to a more normal type of economy, those more credit sensitive areas of the muni market have recovered as well. If you look back on it, the recession was really a self-imposed recession. And I think what we've learned from what that was the very inherent, essential nature of municipal bonds and municipal finance, and how that is really distinctly different from that of a corporate finance. This year, we've seen the continuation of stimulus funds. In 2020, beginning with the CARES package in March, the Federal Government released over six trillion dollars of fiscal stimulus into the economy. And the American Recovery Act this spring, I think has helped to continue to support the economy, to support municipal credits. And we're still seeing the impact of fiscal stimulus reverberating. Here in Arizona, it was just recently reported that since the outset of the COVID pandemic and the Federal response, over $4.3 billion of COVID relief funds have been sent to Arizona alone for K-12 education. Much of that money is still available and being distributed throughout public and charter schools in Arizona. So, I think that the impact of credit spreads tells us a lot about the nature of municipal credit and the strength of support for municipalities. And I think that investors have begun to fairly, and continue to fairly, recognize that. And to me, explains most of the dynamic we're seeing in credit spreads. They are indeed a lot narrower than they used to be. Are they insufficient to compensate for the level of credit risk you're taking? I don't know if I would go so far as to say that. They're certainly narrow enough that one should be cautious in allocating towards the lower investment grade spectrum. But that has more to do with the fluctuation in credit spreads rather than the risk of repayment from those bonds.

Interviewer:
Great insights, Tony, on the markets from a macro level. You touched a bit on Arizona. And let's stay there. What are you observing in the State's continuing recovery from last year's COVID- driven lockdowns and the subsequent recession that ensued?

Tony Tanner:

We're observing a continuation of the drivers that are really helping the Arizona economy pivot and transform away from its traditional roots in more cyclical areas of the economy. Compared to the last recession coming out of the credit crisis, one of the major developments was the establishment of the Arizona Commerce Authority, which just recently celebrated its 10-year anniversary. And that was the beginning of the State making a very concerted effort to begin to evolve away from the much more highly cyclical areas of the economy and to attract a more stable, a more growing, and higher wage jobs. And in 2021, growth in Arizona is really characterized very differently from those cyclical drivers of residential real estate and tourism and hospitality. And the growth is really fueled by technology and innovation. Throughout the last twelve months, in our quarterly commentaries, we've chronicled this ongoing transformation by pointing out some of the significant major announcements we've seen in what I call the smart manufacturing area of the economy. You've seen significant announcements by Intel and Taiwan Semiconductor and other innovative companies in bringing manufacturing operations here. And we've seen other major announcements across the semiconductor, autonomous and electric vehicle space, and within aerospace. What we're now observing moving forward though, is we're seeing a burgeoning ecosystem that's needed in support of these major manufacturers and this major transformation in the nature of the economy. And to me, nothing exemplifies that more than the patterns that we're seeing in business relocations and company relocations and headquarter relocations to the State. There was a recent study put out that looked at the wave of California headquarter relocations that has taken place in the last three years. And what it points to is something that we've been observing for several months. And that is the west of the Mississippi and outside of Texas, Arizona is really beginning to separate itself from the pack in the west and the southwest. Since the beginning of 2018, there've been over 250 California companies who have relocated their headquarters. And the lion's share of those, one hundred seven of them have gone to Texas. After that, 22 of those companies relocated to the state of Tennessee, which has a very low state income tax rate. And Arizona was third on that list, garnering seventeen of those California headquarter relocations. And that's a very significant number in comparison to a lot of other traditional states. Oregon during that time attracted three of those headquarters. Even states like Colorado and Florida, which got fourteen and thirteen relocations, respectively, still trade that of Arizona. And so, we're witnessing this really phenomenal and game changing transformation of the economy. And then you see that reflected in the actual economic performance of the State. The State's last unemployment report showed that with the unemployment rate dropping to 6.6%, it's now down more than 50% from the peak of unemployment at the outset of the recession. The State's recovered 165,000 jobs. And now, the current level of nonfarm payroll employment is only about 12,000 jobs below the peak. So, we've basically recovered all the jobs that we lost in this self-imposed recession. And you see that translated in the State's budget. The fiscal year, 2021, Arizona budget finished with a cash balance of $929 million dollars, which was double the forecast of $442 million dollars. The State budget surplus for the year was four hundred eighty-seven million dollars above forecast. And so, you see that growth translate to strong performance at State levels. Personal income tax revenues in the fiscal year grew by two billion dollars. And as a result of this, the State introduced a new flat income tax that's going to take out the existing progressive state income tax structure. And it proposes a flat tax rate of two and a half percent to be phased in over the next three years. And even with the proposition 208 surtax that was passed, it will be incorporated into it such that the overall highest rate will be capped at only four and a half percent. And that reflects the fact that we've got these strong revenue streams in a variety of other areas beside personal income taxes. Year-over-year, we saw double digit increases in retail sales tax receipts, in contracting receipts. And we even saw a growth in restaurant and bar tax receipts. So, the outlook for the state economy and translated to the outlook for municipal credit in the state, is really quite positive.

Interviewer:

So, with all that to consider both of the Arizona level and the larger market, what are your expectations for the rest of 2021 heading into 2022 around rates and inflation?

Tony Tanner:

Well, let me address the question about inflation first. I think that in this day and age, if you ask one hundred people for an inflation forecast, you would get one hundred very distinct scenarios. And it's not surprising because of the nature of the economic recession and recovery that we are going through. If you look at the last two years, 2020 for the economy was really one of a writeoff. And now in 2021, it can be looked at as a restructuring. And because of that, it's very hard to get clarity around the state of the economy and the state of inflation. If we look at more recent and forecast economic growth, we had a GDP decline in 2020 of negative three and one-half percent. In 2021, it looks like we're on track for growth, right around 7%. And in 2021, the forecast for growth is still a healthy rate somewhere in the mid to high 4% rate. But if you put those three years together, that's still only results in average annual economic growth of less than 3%, which really isn't a recipe for a significant upward elevation in the rate of inflation. And part of what we're seeing is this adjustment of the economy as it tries to get back on its feet. You occasionally see bumps in the road, in terms of job reports or unemployment reports, that slightly missed the mark. You continue to see supply and demand mismatches in the economy that create bottlenecks. The best comment I saw, back in the spring, was that the highly romanticized outlook that we had in the spring, that the combination of a vaccine and fiscal stimulus was going to give us a very strong, straight recovery. And we haven't really seen that yet, because we're still working through this restructuring in the economy. I don't think we're going to be really able to have good clarity until we get into 2022, where we can draw comparisons against 2019. And then in the meantime, I think we're going to see anecdotal evidence of inflation, that's very lumpy. I saw a recent report on inflation that showed several categories with double-digit inflation. But they were all in categories of very periodic economic activity like hotel room rentals or car rentals or used cars. Where on the other end of the spectrum, the level of inflation, within the higher education sector, was the lowest the last year in thirty years. And so, I have less concern about inflation, mostly because we still are not seeing the likelihood that we're going to achieve an above average growth rate in the economy, well above three percent, which I think is necessary to get that high steady State inflation. Chairman Powell just recently talked about that there's a very good likelihood that the Fed will begin tapering its bond purchases. But the comments were overall interpreted to be fairly dovish by the bond markets. And so, I think it's important to continue monitoring the state of affairs. But I don't think we're going to have real good clarity, until we get into 2022.

Interviewer:

Putting all of this together, where do munis present value to investors, and how do you have the portfolio position today?

Tony Tanner:

Well, I think the best pieces of advice or insight or of guidance, that I could give investors around the topic of munis, is to not let the headline yields fool you. With municipal bond yields in intermediate municipal bond funds still in the two percent range, when you take taxes into account, for a lot of investors, that translates to a taxable equivalent yield well above three percent, which may not sound like a lot. And so, you take into account the fact that most equity indices, that are at earnings multiples of 30 or 40 times, having earnings yield that is really equivalent to that. And so, muni still presents a meaningful and important part of the asset allocation toolbox. And I would guide investors to take that into consideration. We have positioned the portfolio over the last three years to be as broadly diversified as possible in order to have the breadth that enables the Fund to throw off an attractive level of income, and also not be subject to anyone particular return attribute or risk attribute. And so right now, we have an average credit quality of AA-, an average maturity near 12 years and an average duration around five and a half to five and three-quarter years. And I think that's an attractive place to be given the uncertainty around the economy and interest rates and given the lack of real meaningful traction in the economy. It's important moving forward that with rates, near these lows and prices near these high levels, we're not going to get a lot of contribution to returns from NAV appreciation and from price appreciation. And so, income is really still an important component of the risk and return prospects for a Fund. And we continue to position the Fund to number one, take advantage of the benefits of diversification, and for number two, also prepare ourselves to take advantage of opportunity if it begins to present itself again. We're working to improve the flexibility and maneuverability of the Fund with owning good liquid names in sizable amounts, that allow us to be able to make adjustments when opportunities present themselves. And so, we like where we have the portfolio position for investors not only now, but for potential future opportunity. And I think that's an important consideration because I do think we're going to see pockets of fluctuation in yields. Hopefully, some modest increases in yields. And, I've always felt that fluctuation breeds opportunity. It's a chance to identify values and capitalize on values. And I think that moving forward, the current state of the muni market is well situated for investors to find opportunity.

Interviewer:

Tony, thank you for your time today as always, and for your invaluable local Arizona insights and perspectives.

Tony Tanner:

Thank you for having me here again today, Phil.

Information regarding holdings is subject to change and is not necessarily a representative of the entire portfolio.

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. The acronym PERS, stands for Public Employee Retirement System. The acronym PERA, stands for Public Employees' Retirement Association. CARES Act Stands for Coronavirus Aid, Relief, and Economic Security Act.

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.