Muni Market Update with Tony Tanner, CFA®

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This is Candace Roane with Aquila Group of Funds. Today is April 6th, and I'm joined by Tony Tanner, CFA and lead portfolio manager of Aquila Tax Free Trust of Arizona. Tony has over 30 years of experience in municipal finance and has managed single state municipal bond funds through many market cycles since the early 1990s. Welcome back to the podcast, Tony.

Tony Tanner:
Hi, Candace. Thanks for having me today.

Candace Roane:
This is normally the time of year we would be reminding investors about the benefits of investing in tax exempt municipal bond funds, but everything has changed. Tax day has been rescheduled. We recently experienced one of the sharpest market declines in history, so let's focus today on the current muni markets, the Fed intervention that was just passed by Congress, and how the Fund has held up in the first quarter.

We last connected on March 17th, and recorded a podcast in the midst of extreme volatility in the muni market, and record high muni to treasury ratios. Can you give our listeners an update on what happened in the market for the remainder of the month?

Tony Tanner:
Certainly Candace, and you're right. When we were speaking a few weeks ago on the 17th, we were in the midst of really the sharpest down draft that I've seen in the muni market in 30 plus years of managing funds. As I said at that time, I talked about how the search for value is not a predictive exercise and at the time we should continue to expect to see continued volatility.

At the same time, we felt that volatility was beginning to create some opportunity as well. In the convening two or three weeks here, what we have found is that the muni market has settled into more of a range, with a little volatility to the upside and the downside. Price and yield wise, we are probably right about where we were when we spoke back on the 17th. A couple of the things that have occurred that have helped to bring some stability to the market have been, first and foremost, the incredible deluge of outflows from funds and ETFs subsided.

I think when we spoke two or three weeks ago, we were in the midst of a week of $13 billion dollars in outflows, and the most recent week, I think we had less than a billion, so that has certainly firmed the tone in the muni market. To me, the most important thing that has taken place has been the intervention of fiscal and monetary policy by the government. I think that has done a very important job of providing a safety net to municipal towns and governments, and has enabled the market participants to take a pause and now begin to better assess the prospects for municipal bonds and municipal finances going forward.

Candace Roane:
Can you tell us how the Fund handled the volatility in March, and did you find any opportunities among the price dislocations?

Tony Tanner:
Yeah, and we found that the Fund performed exactly as we would expect it to, even in a market of extreme volatility and fluctuation. Over this period of volatility, because the Fund is predominantly all investment grade and has an intermediate focus, we didn't have as significant a decline in our NAV as the larger universe of Arizona Funds experienced. Looking at our performance, it's basically been characterized by higher lows and lower highs, compared to the universe of available Arizona Municipal Bond Funds. That is consistent with our thrust to provide a more stable degree of principal of volatility and principal preservation.

In terms of opportunities, yeah the market conditions in the last several weeks are particularly supportive of active portfolio management, and we did take some opportunity to conduct some swaps with an eye towards rebalancing the portfolio and mitigating some of the

reinvestment risk that we had noticed in the Fund when we were in late December, early January, and market yields were at historical lows.

It certainly presented opportunity and a welcome opportunity to put some cash to work over the last three weeks, and so it was really a good opportunity to take advantage where values were more readily apparent.

Candace Roane:
It definitely sounds like the intermediate, high quality mandate worked out in that market. Let's shift now to Arizona. We know the State entered this year on a credit upgrade, lots of strong revenue growth over the past decade. Fundamentals remain strong, but it's unknown how long we will deal with what we're dealing with right now, with COVID-19 and the impact that's going to have on our economy. Right now, are you concerned about revenue declines in Arizona, and are there any sectors that you're watching closely on the muni front?

Tony Tanner:
Yes, this is a market environment, where placing a reemphasis and a sharper eye on credit is very important. Arizona had been on a swing of 112 consecutive months of job gains, and that's going to be ending this month with the next employment reports that come out, and that's consistent with what we're seeing across the country.

As I alluded to, the fiscal stimulus within the most recent past fiscal stimulus package, known as the CARE Act, is going to provide state and local governments with what I consider to be a meaningful safety net. The monies from that stimulus package are primarily targeted towards what one would be considered really essential services and activities and needs within the arena of town and local government finances.

In Arizona, it's an economy where there is a significant employment base in tourism. Within Arizona, about 247,000 people are employed in the state's restaurants, bars and night spots. That's the bulk of the employment within the tourism industry, and so that's clearly an area of the state's economy that's going to be significantly impacted.

Balancing that though, some sectors are seeing continued stability. Two of those being the construction sector, where currently about 7% of the workforce is employed, and that's about 175,000 jobs. There's continued to be stability within that sector. Most of the construction projects in the State are critical, essential, public works projects, or well thought out expansions that have been funded and planned out in advance for several years.

Surprisingly, the healthcare sector is also expected to be a source of stability within employment in the State. At 241,000 people, it employs about 13% of private sector employment. The State has worked to ease requirements to enable hospitals and healthcare providers to add more beds to respond to the Coronavirus pandemic, and while certainly revenues are going to be somewhat constrained with the stay in elective surgeries, long run that is going to have some potential benefit as those elective surgeries and the demand for those services begin to accumulate. When we do reach a point where we've gotten beyond the worst of the Coronavirus pandemic, that is going to be very supportive of the healthcare sector going forward.

Another sector that surprisingly is seeing continued stability is in trucking and warehousing. With the pressures of keeping the nation's Costcos and retailers stocked with needed essential goods, trucking and warehousing activities have been relatively unaffected during this pandemic, and here in Arizona, about four percent of the workforce is in that sector. So, while there are significant near term employment pressures in the State, the very increased and diverse nature of the economy, I believe is going to help the State weather the pandemic going forward.

Candace Roane:
You touched on the recently passed CARES Act. Do you have any additional thoughts on how that will support state and local governments and what do you expect from the Fed?

Tony Tanner:
Well their initial thrust was to provide support in the money market arena as a spike in short term yields were causing a lot of disruption within not just the muni market, but all credit markets a few weeks ago. The initial focus was on the Fed moving in and purchasing a variety of money fund instruments, which clearly helped ease the liquidity crunch.

The government is working out how it is going to implement supporting the corporate immunity bond markets through purchases of longer term instruments, whether that be through direct buying of bonds, or through more larger and liquid traded ETFs, but the notion of the government positioning itself to provide support has really provided a great degree of ballast to the municipal fund industry, and it's still uncertain whether there is going to be a need for the federal government to actually come in and start buying significant blocks of long term muni bonds.

In terms of other benefits from the CARE package, what we've been going through with the economy, to me can be best summarized as the government essentially furloughing portions of the nation's GDP, and telling productive sectors of the economy to take a breather for several months. The government's quick action to move in with a significant amount of fiscal stimulus to provide a degree of a safety net to those areas of the economy has been really important.

Within the stimulus package, for example, we have about 150 billion dollars of aid that is going to go directly to state and local governments and the Coronavirus Relief Fund, which will help governments cover the costs that are needed to address the Coronavirus pandemic in their communities, but also provide important funds for those that are unemployed, to provide loans to keep businesses up and running.

In addition, there was over 274 billion dollars of state and local community aid in the bill, and that included 100 billion dollars that are going to hospitals and healthcare providers, so they can continue to be funded and equipped in the Coronavirus battle, and so that they will be in the position to come out of the Coronavirus pandemic stronger and in a position to continue normalizing their operations.

They also dedicated 10 billion dollars towards the nation's airports. Here in Phoenix, Sky Harbor Airport will be an important recipient of some of those funds. I think what we're seeing with the CARES Act is the government recognizing that in order for people to follow the mandate of staying home, closing down their businesses, it's important that they also see a strong safety net that will enable them to withstand this period, and be ready to go back to work and to be productive once we get to the other side of this.
Over the course of the next months, we'll still be unpacking how these funds will be directly added, and that's one of the things that we'll be monitoring here in Arizona in terms of looking at sectors and credits, to see that indeed those monies are flowing to where they are needed.

Candace Roane:
Well it's good to hear that Arizona's well positioned, and the government is doing all they can to help us out here through this situation. Since there is still so much uncertainty around how long this is going to last, and how bad this will impact our economy and the market. Do you have thoughts on the future for the rest of the year, volatility wise? How are you positioned at this point? Do you foresee anything changing with that, and then what are your expectations, as we move forward through this?

Tony Tanner:
Well I think the biggest change going forward, compared to the beginning of the year, is you increasingly need to expect the unexpected, and so I do think that we're going to see continued volatility as the market transitions away from concerns of liquidity and crossover buyers, and who's going to be there to shore up the muni market to seeing the actual impacts at the local and the credit level. It will become increasingly a bond pickers market, which I think presents great opportunity for active portfolio management to capitalize on value.

What I've observed is that there has been a modest widening of credit spreads, even in really high quality, AA and A rated revenue bond issuers. One need not take an undo amount of risk in order to find value that really wasn't there three weeks ago. The one thing that I am expecting is that inflation is going to stay low and that inflation expectations will probably be even lower. With the weakness in oil prices, and the significant amount of economic activity that has been pushed to the sidelines, inflation and pricing pressures, I believe, are going to be very subdued in the long run here, which is very supportive of a fixed income within asset allocation, and you combine that with the economic uncertainty, which is resulted in some moderately widened spreads, you can see that even in conservative sectors like the muni market, there's a much greater value now in even high quality munis than we found three months ago.

As recently as a couple months ago, if one were to wonder into the Arizona municipal bond market, you would be lucky to get one percent on a seven year, high quality muni. Now that actively managed portfolios have seen their net asset values discounted as much as five or six percent, advisors and investors now have the opportunity to take a look at the landscape and maybe find the potential to shore up retirement income, or solidify an asset allocation plan in a way that they couldn't as recently as three months ago.

So, I think the primary focus going forward here in Arizona, and for Aquila Funds is being able to use our local market knowledge to unearth those select opportunities that arise within the intermediate investment grade space. I think we've witnessed, in the last month,

the inherent value that has within the asset allocation tool box for advisors and investors.

Candace Roane:
I am feeling very optimistic after listening to this, and I'm glad that you've left us with some optimism and opportunities in the market here. So, thank you for joining me again so soon, and for all of your insight, Tony.

Tony Tanner:
Thank you much Candace.

Disclosure:

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CARES Act Stands for Coronavirus Aid, Relief, and Economic Security Act.

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