Aquila Tax-Free Trust of Arizona

Podcast Transcript

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Candace Roane:
Hello, everyone. Welcome to another Aquila Group of Funds podcast. I'm your host, Candace Rowan. Joining me is Tony Tanner, Portfolio Manager of Aquila Tax-Free Trust of Arizona. In this podcast, we will cover Arizona's economic situation, the municipal market, the Biden administration spending plans and rates and inflation. Welcome, Tony.

Tony Tanner:
Good morning, Candace. How are you doing?

Candace Roane:
Great. Let's start with the significant amount of spending proposals that have been passed and proposed by the Biden administration since taking office. These include the American Rescue Plan passed in February and the proposed American Jobs and Infrastructure Plan. Tony, how do you see this federal spending potentially impacting the economy and the municipal market?

Tony Tanner:
Well, Candace, the recently passed American Rescue Plan comes on top of the already $6 trillion in CARES package, stimulus funds and other stimulus packages that were passed at the outset of the Coronavirus. And this along with any other perspective, fiscal stimulus is just going to continue to assist both the national and Arizona economies in healing from the Coronavirus pandemic.

If you take a look at the breakdown of what Arizona is receiving, it provides a good picture for the significance of the support that state and local governments are receiving. Of the $1.9 trillion American rescue plan, about $650 billion of that is dedicated towards public finance investment. And Arizona is going to receive about a little more than 2% of that, about $15 billion. And these monies have been essentially divided on a pro-rated basis throughout the states based on population. Within Arizona of that $15 billion, about $7.6 billion is going to continuation of the CARES Act, Coronavirus relief funding of which the State's going to get $4.8 billion, but local governments across the state, including cities and counties will get an additional $2.6 billion. And for example, some of the larger cities like Phoenix, which will be getting $416 million, that represents almost a third of its $1.4 billion general fund. Even across the state, you see smaller cities like Kingman, Arizona, which is receiving $7 million, Pace in Arizona is receiving $4 million, and even Paradise Valley is receiving a million dollars, that this money is going to be very helpful to local government budgets.

Maricopa County itself will be receiving $870 million, which again is about a little less than a third of its $3 billion general fund budget. Also, $7.1 billion is going to be going to a variety of statewide agencies to fund critical services. The highlight in that is $3.5 billion dedicated to education that is going to go to K-12 and higher education spending. About $2.5 billion of that is going directly to K to 12 spending. Another $1.7 billion is going to health issues and health services, including the Department of Economic Security and the Department of Health Services. In addition, $1.2 billion of business aid is going to be distributed through the Arizona Commerce Authority, and this is going to be very helpful to local businesses. The Arizona Commerce Authority actually just celebrated its 10-year anniversary. It was created in the wake of the credit crisis and we'll talk a little bit later about the contributions that it's making to the state's economy. So, this is a very big credit positive for the muni market. It marks a continuation of the recognition by both politicians and the marketplace, really the inherent essentiality of municipalities and local governments. So far this year in 2021, we've seen it reflected in the issuers in Arizona that has come to market because they all continue to maintain their very high credit ratings. And we've seen this across a variety of issuers, including small and larger local school districts, a variety of excise taxed bond issues and healthcare issuers like HonorHealth. So the implications of continued stimulus spending for credit in the Arizona market and the municipal market is very important.

Candace Roane:
So we know that spending and funding go together, these programs are expected to be funded with a combination of higher taxes on both individuals and corporations. How can some of the proposed income tax changes be expected to impact the municipal bond market and the economy?

Tony Tanner:
Well in terms of economic impact, these are not going to be insignificant changes. Some of the proposals include increasing the corporate income tax rate from 21% to 28%, taxing capital gains at marginal income tax rates. And potentially, these kinds of tax increases can hinder growth and as a result, offset some of the stimulus impact of some of the government's ambitious spending proposals. A significant increase in the corporate income tax rate. A portion of that is going to eventually be passed onto the consumer, or it's going to reduce the profitability of a company and that can create a disincentive for capital investment. It's important to consider the number of people who are being taxed than the pool of capital that's being taxed by that increase. Taxing capital gains at much higher income tax rates can potentially reduce the attractiveness of economically sensitive investments and alter the flow of capital, the business investment. And oftentimes, people will just simply alter their investment decisions and hold onto their investments. The ultimate result is that you'll see more friction in business and investment decisions, which can ultimately impede job creation. On the other side of the coin for the muni market, these proposed changes clearly increase the value and the attraction of tax-free income investing. And if you look at states like Arizona, where we just recently passed prop 208, which increased the highest state income tax rate to 8%. State income tax rates can be even more fluid and amplify the combined value of the federal state tax exemption. And so, we find that the proposed tax changes are just a reminder that taxes matter when it comes to income investing and that double tax-free income is an important consideration in your asset allocation decision. The other thing that this can potentially do though, is increase the stability of the asset class, which is already relatively high compared to taxable fixed income in U.S. Treasuries. Anything that increases the attractiveness of the investment in the asset class is going to help reduce its correlation with what's happening to taxable yields or what the Fed is saying and doing.

Candace Roane:
Great insight on spending. Tony, let's take a further look into Arizona's economy. I'd like to get your insight on how revenue feared over the past year through the pandemic. Looking back at the municipal market over the past year, where have you seen the most recovery?

Tony Tanner:
Well, the Arizona Budget Joint Legislative Budget Committee just released its most recent numbers on the Arizona budget and revenues, and the news has recently been good and is continuing to improve. For fiscal year 2021 through March so far, revenues are up 12.3% and that's accounting for last year's deferral of taxes between April and July. And so, overall revenues have come in at $9.4 billion, which is about $400 million above forecast. What is very positive in these numbers is what we're seeing in a variety of sales tax receipts. Overall retail sales in the state have been up 14.7%. And some areas like building materials and food and liquor are up as much as 28%. Tax receipts from furniture sales are up almost 20%. Overall contracting sales tax receipts are up 18%. And even utilities have seen a 10% increase in sales tax receipts. Lodging is still a challenge. Receipts from lodging are down 37%, but that's having less and less of an overall impact on the economy. Interestingly, this past March was the first month since the start of the pandemic the restaurant and bar sales task collections actually increased the same month year over year. Receipts from bar and restaurant sales had actually declined each consecutive month on a year-over-year basis since the outset of the pandemic, but with the reopening of the economy and continued adoption of vaccinations and looser restrictions, we've seen a good recovery there. And overall year-to-date, you're only seeing sales tax receipts from that part of the economy down only 9%. We've seen the strongest recovery though within the market and within municipal bonds within the hospital and the higher education and transportation sectors. And last year during the March and April Coronavirus sell-off, we took the opportunity here in the Arizona Fund to selectively add credits in those sectors. At the same time, we modestly extended the average maturity of the Fund to capture some of the elevated long-term yield that presented themselves. And by doing so, we've been able to help sustain the level of income and mitigate some of the reinvestment risk that the pervasive low yield environment has created.

Candace Roane:
Tony, continuing with the local economy, are there other national or demographic trends that you expect to impact Arizona?

Tony Tanner:
Yes, and the biggest one is the continued growth in population here. And we've talked in prior podcasts and in our commentary about how Arizona's population growth has been very strong, west of Mississippi and outside of Texas, Arizona's population growth is really beginning to separator from a lot of the Western mountain states. Although in the most recent census, we did not pick up a new legislative seat. What's been interesting to me about the population growth is how widespread it's been throughout the state. The Phoenix metropolitan area actually grew by 89,000 in the last year, which was greater than 46 entire states. Only the three states of Florida, Texas and North Carolina had higher absolute population increases than the Phoenix metropolitan area. But if you look at the state of Arizona beyond the Phoenix metropolitan area, the Arizona stayed in the outlying regions, added 40,000 people, which is a greater increase in population than a lot of fast-growing states like Nevada and Oregon. And so, the continued trend of not just absolute population growth, but disperse population growth throughout the entire state is really attractive. The other thing that we have noticed in Arizona's economy

is the level of job retention. And in the last employment report, Arizona's employment base is only about 2% lower than it was a year ago, which is almost triple the average job retention rate here in the country. And while our unemployment rate remains somewhat elevated above the national average at around 6.7% versus 6%, that's primarily because of this population growth. And the things that we're seeing here in the state point to a lot of attractive job creation and wage growth that are going to be very helpful.

Candace Roane:
Have there been any recent developments that reflect the growth prospect of Arizona's economy or the credit quality of municipal bond issuers in the State?

Tony Tanner:
In the last year, in particular, in the last three or four months, we've seen a lot of announcements and developments in the Arizona business community and economy that really point to a real metamorphosis of the economy from that of one dependent on cyclical tourism and housing, and more geared towards broad, diverse manufacturing. Three years ago, we remarked about the Ascension of Arizona's healthcare economy that has an under doctored population with the growing population, we were seeing increased investments in hospitals and in medical facilities. The Fund made investment in bonds for HonorHealth's North Phoenix campus, as well as the new Creighton Medical School, which have both been helpful to the Fund. And you can see the impact of the community as those facilities were completed and opened up. But now we're starting to see the results from the confluence of several trends that really bode well for the future of Arizona's economy, and as a combination of mobility and migration and innovation and smart policies.

And what we're seeing is the ascension of Arizona is really the smart manufacturing hub of the country. A lot of places in the nation, whether it's Silicon Valley or the Silicon Plains or the Silicon Slopes kind of described themselves to be the center of the innovation universe. But here in Arizona, we're really seeing some tangible changes and growth that really show Arizona being the new hub for some key industries. If you take a look at some recent announcements, last year, Taiwan Semiconductor made a commitment to make a $12 billion investment in Peoria, and just recently made its first hiring of 250 people. A few months ago, Intel announced a $20 billion investment in new fab facilities in Chandler that'll create 3000 jobs. Lucid Motors has opened its electric vehicle plant in Casa Grande. And the state recently announced the establishment of Drive48, which is a manufacturing training facility in Pinal County that will train several thousand people in high tech jobs. And so, the semiconductor electric vehicle, autonomous vehicle and aerospace industries are really becoming a nexus of a high wage, attractive job growth.

In the last 10 years, Arizona has pivoted to now having more jobs in manufacturing than in construction and increasing proportion of the job creation and growth in the State or in highways jobs. What this translates too for Arizona's municipalities and municipal bond market is not only support of the tax base of these municipalities, but the growth in a variety of income and sales and use tax receipts. Housing in Arizona has been great. Permits are up 24% year-over-year. The average day a home is on the market in Arizona has been down from 64 to 48 days. But it's important to note that Arizona's economy is no longer all about construction and the housing market. And so recently, a major national financial publication dub Arizona as semiconductors central. And so, we're beginning to see a lot of confirmation within the financial press of Arizona's prominence in the 21st and even 22nd century economy. The last thing I want to point out that kind of exemplifies how these developments are impacting the economy. Last year, net earnings in the state, net of stimulus package funds rose 3.5% compared to a national average of 0.3%. And Arizona's GDP last year shrank only 0.9% compared to the national economy, shrinking 3.5%. While the news is good, more importantly, we're seeing it manifest itself in results that point to a strong municipal bond market and a strong economy for Arizona citizens.

Candace Roane:
Let's wrap up today with your expectations for the next several quarters around interest rates, inflation, Fed policy - and how do you have the Arizona portfolio positioned?

Tony Tanner:
Well, it's a very timely question coming on the heels of this week's most recent Fed meeting on Wednesday and the GDP report on Thursday. And certainly there are a lot of perspectives around inflation that the people are concerned. At the same time, we're seeing a lot of indicators that inflation we're going to see in the future, well, maybe slightly higher will be more transitory than structural as Chairman Powell has pointed out. I read a commentary yesterday where the writer opined that we should wait to get our bell-bottoms out, so to speak and was referencing some people's perspective that what we're seeing is similar to what we saw in the '70s. One of the most important comments, I think Chairman Powell made was that, we're not seeing significant increases in wages or wage pressures. And that has always been a key to an increase in the steady state long-term structural nature of inflation. We did see a very solid GDP report on Thursday that

showed quarterly GDP increase of around 6.4%, 6.5%. But if you look collectively at the 3.5% decline in 2020s GDP, and even if we attain the forecast GDP growth for the full calendar year of 7.4%, overall, that just leads to average GDP growth in these last two years of a little over 2%. So there aren't a lot of signs of a very pervasive general overheating of the economy.

At the same time, we are trying to be very mindful of inflation risks and position the portfolio to navigate them in the most advantageous way for shareholders. Taking a look at the Arizona Fund, I mentioned that last year we took advantage of some of the dislocation in March and April. And more recently in February, we tried to capitalize on some of the fluctuation to capture attractive yield that will help us mitigate dividend erosion and re-investment risk while the Fed maintains a very low interest rate policy. We don't see a lot of value in the five-to-ten-year serial bond range right now with those yields hovering at 1% or less. We're finding that it does make sense to extend to some specific 15-year to 20-year maturities with high quality issuers and with premium coupon structures because they give us the best flexibility to capture 90% of the yield available on much longer bonds and at the same time, have us positioned to respond quickly to any sort of upward shift in rates. The Fund's average final maturity has been pretty consistent at around 11 years plus or minus. And the duration has been pretty much around five years plus or minus. And so, we find that that's a good spot to continue to provide an attractive level of income and moderate the interest rate risk. The other things that we have been doing to position the portfolio is we do actively look at. Are there situations where a bond has reached the point of being fully valued that makes sense to not continue holding? And we've noticed that in some areas of the yield curve, municipal and treasury bond yield ratios have reached a point that they appear to be somewhat overpriced. So rather than waiting to hold the maturity, we have been selectively doing some sales to capture value and reinvest in attractive bond structures that help support the Fund's dividend.

Candace Roane:
Tony, you mentioned an upward shift in rates, municipal bond yields remain near historic lows and higher rates are expected in the future. Can municipal bonds still offer value in an asset allocation?

Tony Tanner:
I would say the answer to that is a definite yes. I think of municipal bonds like any tool in the asset allocation chest and sometimes the projects change and the need for the tool might fluctuate, but the impactfulness of the tool still remains. And right now, for most people, a 2% level of yield or income without taxes for most investors that have some sort of tax liability, that translates to a taxable equivalent yield over 3% and sometimes approaching 4%. And it's important to keep that taxable equivalent yield in mind. When you think about the fact that the S&P 500 with a PE multiple of around 30 has an earnings yield of a little over 3%. So you're getting a taxable equivalent yield on an asset class with much less volatility and correlation with the economy than the S&P 500. So I would advise investors and advisors to not let the headline yield number fool you. Municipal bonds still offer demonstrable value implications that advisors and investors may find worthy of consideration.

Candace Roane:
Tony, thank you for your time today as always, and for your invaluable local Arizona insights and perspective.

Tony Tanner:
Thank you for the conversation today, Candace.

Disclosure:

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

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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 US 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 principle 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 (P-E-R-S), stands for public employee retirement system. The acronym PERA, (P-E-R-A), 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.