Aquila Tax-Free Trust of Arizona

Podcast Transcript
September, 2020

This is Candace Roane, with Aquila Group of Funds. Today is September 4th, and I am joined by Tony Tanner, CFA, Lead Portfolio Manager of Aquila Tax-Free Trust of Arizona. Tony also co manages Aquila Churchill Tax-Free Fund of Kentucky and Aquila Tax-Free Fund For Utah. Welcome Tony.

Tony Tanner:
How are you doing today Candace? Good to be here.

Candace Roane:
I'm doing well. Thank you for joining me today. We last spoke in April following the quite dramatic market events that occurred at the end of the first quarter. Can you tell us what transpired in the Arizona Municipal Market in the second quarter and through the summer?

Tony Tanner:
Well, amidst what continues to be an unusual and continually evolving economic backdrop, since March, the watch word that comes to mind is normalcy that's returned to the municipal bond market and the Arizona municipal bond market in the past four to five months. In that time, we have seen the new issue market return to normal with a robust level of volume. Trading activity in the secondary market has returned to normal levels, including trading spreads. In general, market yields have responded positively to significant move by the Fed in March to cut rates. And so we find ourselves actually at a point where bond prices today are virtually unchanged from where they were a year ago. So if you weren't paying attention in the middle of the year, you wouldn't really be aware of what had taken place during March.

Candace Roane:
Focusing on the Fund, Aquila's municipal strategies have a relatively conservative investment mandate. How do you think this impacted your shareholders experience during the volatility this year?

Tony Tanner:
Well, I think it positively impacted them in a couple of ways. First and foremost, the Fund during the COVID crisis in March experienced a much lesser degree of volatility and deterioration than we saw in other longer fund products and closed-end funds and individual bonds. And I think that that's very important because having a greater degree of principal preservation, I think helps influence the investors to stay the course. Investors who might have gone to the sideline in mid-March and not returned have missed out on a very strong rally from the bottom. But more importantly, would find themselves now facing a very low yield world to put that money back to work. We've been able to maintain a very large degree of income continuity throughout the year. And that's been very helpful and supportive of the shareholders' experience.

Candace Roane:
Let's shift to the Fed now, what type of stimulative monetary policy do you expect going forward this year? News from the Fed this week seems to signal that we'll see more accommodation soon, potentially this month.

Tony Tanner:
Well, the truth is, from a monetary policy standpoint, the Fed does not have a whole lot of levers left to pull. They have reduced the cost of money to basically free. I mean, we were talking this morning at a time where the 30 year treasury bond is yielding around 1.4%, and the 10 year treasury bond yield is solidly below 1% at 72 basis points. So from the standpoint of stimulating the economy by making borrowing costs attractive and not prohibitive, there's really not much more the Fed can do. Chairman Powell came out and spoke in the last few weeks, and I think what has shifted has been a couple of things. Throughout the course of the year, Chairman Powell and the Fed are increasingly recognizing that they really have not a lot of latitude in terms of stimulating inflation simply by monetary policy and altering the Fed funds rate. And I think they've also acknowledged that inflation is something to worry about when we actually have inflation. And so rather than focusing on just the 2% line as a ceiling, they're going to wait and see if the economy picks up steam, just how much steam it can pick up.

And wait and see if there's a genuine need to ultimately either be less accommodative or more restrictive. And that's a very different tone than we've heard from the Fed in the past several decades. And I think it's a welcome acknowledgement of the limitations that they have in influencing market rates and the economy. The biggest impact and the biggest unknown going forward is the degree of continued fiscal policy stimulus that we're going to see. I think to date, the Federal government's response through the CARES package and programs like paycheck protection program have actually had the very desired effects they intended, in terms of helping maintain a large swath of the economy, maintaining jobs, maintaining income and taxes. The first $6 trillion of stimulus that the Federal government put through in the spring and early summer, some studies have shown it has almost completely offset the expected loss of wage income that the furloughing of the economy was expected to cause. Some continued fiscal policy and fiscal support is going to be needed in a lot of key areas of the economy. For example, Federal funds to support airlines and maintain employment in the airline sector is obviously going to be important to those businesses. From a municipal standpoint, what has transpired is what I expected. That the government recognizes the degree of essentiality of important facilities like airports and like hospitals, and has ensured that the funds that were needed have been directed to those essential facilities to keep them up and running. The last thing that I want to observe about the fiscal and monetary policy is that ultimately, the economy needs to be given the opportunity to return to normal. And it's welcoming to see that the Federal level, a lot of latitude is being given to the states in how they identify and determine what that level of normality is.

Candace Roane:
So while we work our way back to normal, I want to get your thoughts on defaults. Arizona appears to be prepared to sustain temporary revenue shortfalls, but there's a national concern around muni default risk. Looking at Arizona credits, do you consider that concern valid for your market?

Tony Tanner:
I don't find that to be a heightened concern in Arizona, nor in the municipal bond market in general. I've spoken on a variety of occasions recently, that the municipal market has a degree of essentiality that's just not seen in the corporate bond market. And so we've seen far fewer actual defaults and actual cases of real meaningful fiscal strain. In the last three or four months, we've seen the city of Phoenix pass a $1.3 billion budget with little fanfare or news around budget cuts or revenue shortfalls. The State entered the COVID crisis with a billion-dollar rainy day fund. And as recently as a month ago, the budget estimates were showing that the expected budget gap had narrowed from over a billion dollars to less than 500 million. And in fact, we've seen some surprising positive revenue outcomes in places like building and construction. And so the whole combination of Federal government stimulus and wise and thoughtful budget considerations have resulted in relatively few, if any, real gaping holes that have needed to be filled in municipal budgets, and municipalities ability to cover and service their depths.

Candace Roane:
Tony, you talked a little bit earlier about this year's new issuance and supply in Arizona. What is your outlook for the muni market going forward, regarding new issues and supply and demand as we head into the end of the year?

Tony Tanner:
Well, the big shift in the municipal market has been the emergence of taxable bond issuance. Almost all of the growth, the absolute growth of issuance nationally has come from taxable issuance. It's important to draw the distinction that that taxable issuance hasn't been in place of tax exempt issuance. Rather, it has been municipalities taking advantage of the fact that they can sell taxable bonds to advance refund outstanding high cost tax exempt debt, and still achieve savings. So while the most recent tax modifications of a couple of years ago did away with tax exempt advance refundings, the state of interest rates overall is still enabling issuers to take advantage of selling taxable munis.

In Arizona, issuance is off by about 30% year to date, as we have not seen very much at all in the way of taxable issuance in the state. One of the most interesting deals in the state recently though, and I think it exemplifies the health of both the Arizona muni market and the Arizona economy, children's hospitals sold a $250 million A rate of municipal bond issue about a month ago, and received $5 billion, that's billion with a B, in orders for $250 million of bonds. It was 20 times over-subscribed. And their top borrowing costs on a 30 year bond was only 2.5%. So I think that really demonstrates the resilience of the Arizona economy, and in particular, the healthcare sector. And also, it's a really good lesson in staying the course with munis and understanding the staying power of municipal credits.

During the credit crisis of 2008 and 2009, Phoenix Children's Hospital was downgraded to triple B. And a lot of people were expressing concerns in the local market and financial press about their financial strength. So, Children's Hospital is a good lesson and example of staying the course and evaluating essential credits and in demonstrating the resilience of the Arizona municipal bond market. The last thing I want to add to that is, I think, one of the things that's also helped contribute to the strength and resilience of the Arizona economy and muni market has been the way in which the state has handled the ongoing coronavirus pandemic. One of the things that I monitor is the Arizona Department of Health Services website and scoreboard of COVID statistics. And what I find interesting is that although utilization rates for things like ventilators or emergency department beds or hospital beds are up significantly since the end of March, the fact is that Governor Ducey and Dr. Chris, I think skillful management of marshaling resources and managing those resources in the state have actually resulted in there being more ventilators and emergency department beds being available now than there were at the end of March. And so there's a lot that goes into trying to balance the reopening of Arizona's economy with realistically addressing the health concerns that the pandemic presents. And I think that Arizona as a state has really been a model of that balancing act. And it hasn't been perfect, but in the current climate, you can't wait to figure out what perfect is before you enact it. You have to try to take the best steps that you think are going to work and learn from those steps. And I think Arizona has done an exemplary job of that.

Candace Roane:
Let's build on hospitals and healthcare here, and finish today with sectors. Are there any municipal sectors that you're watching closely for opportunities? And conversely, any red flags out there in Arizona right now?

Tony Tanner:
I haven't seen any real red flags anywhere for a ... and part of that is because the underlying economic trends that were supportive of the state are continuing on with the pandemic. Prior to the pandemic, West of the Mississippi and outside of Texas, Arizona was leading this part of the country in job growth, in employment growth and in population growth. We're in the midst of now our fifth consecutive year where we'll be attracting more than 100,000 new residents. And those broader socioeconomic and demographic trends are going to be continuing and will accelerate as we ultimately get a vaccine for the coronavirus and we return to a more normal economy that we were accustomed to prior to the pandemic. And going forward, those demographic trends are really going to enable even smaller municipalities to sustain their budgets. And I feel very positively about the Arizona municipal bond market going forward.

Candace Roane:
As always, it was a pleasure chatting with you, Tony. Thank you for joining me and offering your insight and expertise on the Arizona muni market and the economy as a whole.

Tony Tanner:
Thank you very much, Candace.

Candace Roane:
I'd like to remind our listeners that Tony's thought leadership articles may be found on our website, aquilafunds.com, and his latest quarterly market commentary is always available on the Aquila Tax-Free Trust of Arizona Fund page. Thank you for listening.

Disclosure:

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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 the 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 in excess of 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 of time. 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.

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.