Aquila Tax-Free Trust of Arizona

Podcast Transcript

January, 2021

This is Candace Roane, Director of Marketing for Aquila Group of Funds. Today is January 20th, and I am joined by Tony Tanner, Lead Portfolio Manager of Aquila Tax-Free Trust of Arizona. Welcome to the podcast, Tony.

Tony Tanner:
Morning, Candace, thanks for having me today.

Candace Roane:
Tony, now that we know that the Democratic Party will be controlling the executive and legislative branches for at least the next two years, what are your thoughts on policy changes that may impact the muni market?

Tony Tanner:
Well, I do think that we are going to see some forms of policy changes that are meaningful for the municipal market in two areas. First and foremost are in taxes. We're going to clearly have a more confiscatory attitude towards higher taxes and tax rates as a potential fiscal solution, and that's got great implications for asset allocation. Outside of equities and tax qualified accounts, munis will likely increase in prominence in people's asset allocation considerations. And while I think we've already begun to see a move towards that immediately after the election.

The other area is in policy, and we're going to see policy changes, I think, that will harken back to some comments that we made last March and April in our commentaries and podcasts around the municipal market and credit and the emerging coronavirus pandemic. We talked back then about the very essential nature of the municipal bond market and the inherent differences between public finance and corporate finance. And I think you're going to now see government policies that clearly recognize and acknowledge this. The current recession that we're going through is really a recession that's been self-imposed and self-inflicted as governments at all levels have had to contract economic activity through regulation, through executive order to try to control the spread of the coronavirus. And what we're really looking for out of Washington are forms of subsidies to keep these very essential entities going like airports, like vital transportation systems, like small businesses. And so I think we're going to begin to see more of those policies, and we got a glimpse of that through the first round of stimulus packages in the spring and the summer. Looking back on it, we've already had five different stimulus packages, totaling $6 billion and so a $1.9 billion stimulus package in the next round shouldn't be viewed as outsized or unusual.

What's important is that all of these efforts are well-targeted to areas that have the greatest impact. The other likely thing we're going to see going forward is increased regulation and governance scrutiny within the municipal market and how it operates, which is always helpful to keep the industry operating at a high level of integrity. I do think that the big question people are probably asking is, is the new administration going to restore the ability of municipalities to advance refund their high cost tax exempt debt. And I believe that we're more likely to see $10,000 deduction limitation addressed first than we are seeing the limitations on refunding go away.

Candace Roane:
So you touched on the Tax Cuts and JOBS Act and how that eliminated tax-exempt refunding. With that definitely came an increase in taxable issuance. And we know that muni issuance is currently at a ten-year high across the board. Would you say that taxable munis are gaining popularity with investors and issuers and foreign buyers? Do you expect taxable issuance to stay the same... if you do not expect that to be addressed right away?

Tony Tanner:
Candace, that's a great question. I think there've been a lot of myths and misperceptions around the nature of taxable bond issuance the last couple of years. Certainly it has led to some transformation in the muni market in terms of the composition of issuance. I don't know that I would characterize it as innovation though. The growth in taxable municipal bond issuance has been a direct response to the Federal government essentially eliminating municipalities' ability to refinance and save at will, which is something that we as consumers enjoy

with virtually all of our borrowing vehicles. And so the boost and the large jump in taxable issuance has been a direct consequence of that rule. The increase and outsized growth in the size of the issuance is a combination of that decision and the generational lows that we have seen in taxable yields now. And so, the question as to whether the trend will continue, I don't really consider it a trend, I consider it a response to these conditions. And if those conditions change, future volume will follow.

I don't believe that--counter to what we might be seeing in the popular press - I don't believe that taxable municipal bond issuance and taxable municipal bonds are moving in a direction where they're going to supplant traditional core tax-exempt financing. And by that, I mean, core investors lending to municipalities for core borrowing purposes. I don't know of too many treasurers or municipal finance officers that are going to deliberately incur a higher borrowing cost for taxpayers to bear just of because who the buyer is. And so, if you look at the numbers in 2010, with the BABs program, taxable issuance was 30% of total issuance, but remember that wasn't tax exempt issuance to the issuer. Following the end of that program from 2011 to 2018, taxable issuance only accounted for between seven and 10% of total issuance. And then after the elimination of the advanced refunding ability, taxable issuance grew to 17% of issuance in 2019 and 30% last year. Almost all of that increase was targeted towards refinancing tax-exempt interest costs with taxable costs. In 2018, taxable municipal bond issuance for refinancing was only seven and a half billion. Last year, it was $87 billion and two-thirds of all taxable issuance. So going forward, I don't believe, again, the taxable municipals are going to supplant tax-exempt issuance. I think they're going to be primarily a creature of opportunity.

Candace Roane:
With the increase in issuance, obviously we've seen an increase in outstanding muni debt. So I want to get your thought on defaults. We've covered this topic before, but I think it's worth talking about again. We have a new administration committed to focusing heavily on implementing measures to control the pandemic. Do you see continued stress on certain muni sectors?

Tony Tanner:
Well, what I expect to see is the economy and municipalities and issuers continue to adapt to the pandemic and to navigate it. I don't expect to see meaningful increase in defaults in bread and butter sectors. Certainly there is some potential that you will see dubious projects within the municipal bond market face greater challenges, and it really leads to something we've talked about in the past. And that's really the inherent difference between public finance and corporate finance. Again, municipal bonds are the primary tool with which towns and governments implement public infrastructure policy. And we've always said that corporate bonds are a tool of risk capital. And in the municipal bond market, you do see something sometimes the issues that are referred to as venture capital, the kinds of project finance for speculative projects or projects that are rooted primarily in feasibility studies, and those are going to increasingly face challenges. However, I think the authentic muni market that's really driven by core borrowing purposes is going to continue to survive well. I think the primary challenge is credit spread risk, especially in the lower sectors. Credit downgrade from triple B to non-investment grade is really a jump-off a cliff when it comes to widening credit spreads and lower market prices, but I think within the A-rated and higher sectors, we're not going to see meaningful downgrades or defaults in that area.

It's important to recognize that the pandemic is what I describe as partisan agnostic, and that we need to kind of temper expectations around how our ability to get our arms around the pandemic and control, how quickly that's going to go. But this conversation really leads to an important topic around the risk attributes of munis and the diversification that they bring to asset allocation. If you look at long-term correlations between municipal bonds and other asset classes, that you'll find that municipals have a 57% correlation with the returns of the treasury market and the investment grade corporate bond market. But when you move to the more speculative areas of investing, municipal bonds have a correlation with the stock market of less than 1%. And they actually have a slightly negative correlation with the high yield below investment grade corporate bond market. And so, going beyond just the basic notions of stronger, more essential credit quality, municipal bonds are really that true diversifier within an advisor and investor's asset allocation that can be a valuable tool when the economy is in such an uncertain period like we have now.

The other point that the pandemic, and lesson that I think it's illuminated, is the value of credit research conducted at a local level because doing that enables portfolio managers to construct genuinely diversified portfolios that have the ability to still throw off income and to experience greater or improved stability over other taxable fixed income or equity-like asset classes.

Candace Roane:
Tony, you emphasized local management and credit research. Can you tell me what you're seeing in Arizona right now?

Tony Tanner:
Yep. Here in Arizona, what we're observing are two important trends. First is just the continued strong amount of population growth and strong degree of really capturing a large share of the population that is transient and moving. The most recent census figures released for July of 2020 showed that Arizona has the third largest absolute increase in population of 129,000, trailing only the growth in Florida, which was 240,000 residents, and Texas, which was 373,000 residents. But Arizona had a much higher growth rate of 1.8%. But if you look West of the Mississippi, outside of Texas, you will see that Arizona is really emerging as the primary economic hub of the region. Looking at those states West of the Mississippi, the only state that grew faster than Arizona was the state of Idaho. In fact, Idaho is the fastest growing state on a percentage base in the country. Compared to a lot of other states West of the Mississippi, Arizona's population growth on an absolute basis was double that of neighboring states like Colorado and Nevada and Utah. And in fact, California had a small population decline. And so that has huge implications for being supportive of the economy.

The other is most recent tax revenue figures released by the state and by the Arizona Joint Budget Legislative Committee point to an economy that is increasing in diversification and showing some really impressive resilience. If you look year-over-year, the employment base in the State has declined by only 2.8% over the last 12 months, meaning that the number of people actually working is down about 80,000. However, in that time, 2020 income tax withholding actually increased over 5% this year. And that's because we've seen increases in sales tax revenues in areas like contracting and retail and remote sales, which in the first six months of this fiscal year are up almost 20%. Even in the restaurant and bar sector, those sales tax revenues are only down about 11%. Arizona's tourism industry is still continuing to suffer exemplified by the fact that sales tax revenues from lodging are still down 34%. But overall, these changes mirror changes in the overall US economy. Through November, US durable goods orders and spending rose 13% while services spending had declined 5%. And so on a local level, we're seeing some very positive trends continue that indicate Arizona's growing economic leadership in the region.

Candace Roane:
Let's close with your outlook for the muni market in general, where do you see yields going from here?

Tony Tanner:
Well the best way I can answer that question is to say where I don't think rates are going to go on individual municipal bonds. The 10 year is going to continue to struggle this year to go above 2%. And as we saw from the last jobs report in December, despite the recovery from the furloughing of the economy, we still have a lot of headwinds that I think are going to keep the Fed very cautious when it comes to rates between the continued slack in the economy and the longer runway with which it's going to take to really control the pandemic. It's going to be difficult for municipal bond yields to go back to some of the highs that we saw at the end of the last Fed tightening campaign in the fall of 2018. A very volatile period like we experienced in March, those certainly can occur periodically and cause yields to spike, but it's unlikely we're going to see a steady state elevation of yields. And we're also going to be able to see ratios and valuations continue to be elevated as a tax and redistribute mindset takes place in DC.

And so, looking forward, I tend to see a 2% tax-free yield is now the new 4% when you take a look at the impact of taxes. And that leads me to talk about the importance of looking at components of return in your fixed income investing. Going forward with yields where they are, we're going to have to rely less on appreciation to provide total return and really need to lean on generating that total return from income, which is going to require good research, very good diversification, and professional management that achieves genuine economic diversification.

Going forward, I think it's going to be healthy for advisors and investors alike to consider strategies for operating in a high quality tax-free 2% world for professional managers and mutual fund managers. We have the opportunity in the new issue market to work with underwriters to negotiate what we think are favorable bond structures. I'm finding that looking out long-term, a 15 year bond with a 3% coupon at a premium may not necessarily be a significant risk to take with rates looking like they're going to be anchored below 3%. You're moving down the yield curve very quickly, and with a 3% coupon that borrowing cost is not so high that when you reach a call date, that it couldn't be left outstanding. For investors and advisors, something to consider in terms of efficient asset allocation, combining an investment vehicle and an investment approach that's tax efficient, especially an investment grade, double tax-free investment with say a national tax-free high yield investment, which has the opportunity to take advantage of what I think are now very wide, very attractive spreads between that triple B and non-investment grade tier. Those are ways that advisors and investors can consider overall asset allocations, look at the risk and return attributes of the municipal bond asset class, and take into account the new administration and the realities that we're going to find in terms of policy and taxes.

Candace Roane:
Tony, you've given advisors and shareholders a lot to think about. Great information today as always. Thank you for joining me, and we appreciate your experience and your valuable insights.

Tony Tanner:
My pleasure, my privilege. Thank you, Candace.

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.