AQUILA® GROUP OF FUNDS

AQUILA® Tax-Free Trust of Oregon

Aquila Tax-Free Trust of Oregon Podcast Transcript January 16, 2019

Interviewer:
Today we're talking to Chris Johns, Portfolio Manager of Aquila Tax-Free Trust of Oregon. There've been reports that the Fed will be patient in regard to near-term changes in the Federal Funds Rate. What are your expectations for Fed policy over the course of 2019, particularly as that policy might affect municipal bond investors?

Chris Johns:
There seems to have been a shift in consensus for 2019 in terms of how many times they would raise short-term interest rates. A month and a half ago, or so, the consensus was we would see perhaps three rate increases during 2019. As we speak here in the middle of January, it's now down to either zero or one. I think in any case, the Fed is going to be very transparent about what they're going to do. The last thing they want to do is surprise the market. I think that the comments that the Fed makes each quarter – they're going to do what they say they're going to do. So they're paying more attention to the economic variables right now. They seem to be a little bit more sensitive to going too fast in terms of raising rates. We think it'll be a slowing of the pace of rate increases versus what we saw in 2018. How that affects municipal bond investors, that's kind of an interesting question. In the last year and a half or so, as short-term rates have increased, the interest rates on municipal bonds haven't changed the same way that they have changed on U.S. Treasury securities. We see a very flat U.S. Treasury curve, and by that I mean the difference between say a 2 year yield and a 10 year yield is only about 18 basis points; so very flat. Whereas in the muni area, the difference between a 2 year yield and a 10 year yield on a AAA muni is somewhere between 50 and 60 basis points. Rates on shorter-term munis have not gone up as much as they have on U.S. Treasury securities, so it's been a little less volatile market. The Fed's also talking about a balance sheet reduction. We think that that will continue, but again, we need to monitor the pace. It may not go as fast as they originally intended given new economic developments, so we'll see.

Interviewer:
There was a significant decline in supply of municipal bonds in 2018 largely due to the elimination of advance refunding bonds. What are your expectations for supply in 2019?

Chris Johns:
Well, you're right about that. National supply was down approximately 18% in 2018 versus '17. As far as the pre-refunded bonds, in the last 5 or 10 years or so, these pre-refunded bonds – which are when issuers refinance older, higher interest rate debt with lower interest rates – that has represented as much as 35% to 40% of total new issuance. With that being not available to issuers anymore, it did have an impact on supply, and we think that that will continue through 2019. We'll still have fairly limited supply in municipal bonds nationally. In the State of Oregon this past year, we saw a dramatic decline in issuance. We had a total of $3 billion in issuance in Oregon and that was down 50%, 5-0 percent, versus 2017. I guess the good news is really twofold. In November, we had about $1.4 billion in new issues passed at the ballot box, which there's still about a billion of that to be issued this year. The other thing we know is that the State of Oregon and all the various agencies kind of took the second half of the year off last year, but this year their debt plans are considerably more than they were last year. We think supply is going to be improved in 2019 in Oregon to a more normal level.

Interviewer:
How would you characterize the tone of the municipal bond market currently? Are you seeing any particular opportunities or areas of concern?

Chris Johns:
Sure. I would describe the tone as strong right now, and that's largely driven by demand and supply characteristics right now. We've

talked just a moment ago about supply being kind of tight. Well, demand for municipal bonds is still very high, and as a result, that kind of technical condition favors more stable municipal bond prices. One of the areas of concern that we've seen is, over the last several years in a very low interest rate environment, investors have increasingly gone to lower-rated investment securities to get more yield. As they've done that, the difference between lower-rated securities and higher-rated securities has really compressed. To us, you're really not being paid to take the risk for lower-rated securities these days, so that's something that we're watching pretty carefully. We tend to favor a much higher-quality portfolio in this environment.

Interviewer:
The word volatility is cropping up frequently in the press, particularly in relation to equities. How does volatility in the municipal market compare with that of other types of investment securities?

Chris Johns:
Well, you know, historically, municipal bonds have been a little less volatile than other fixed income markets. I think that's been true in the last year or so and will continue to be true this year, largely because of the demand and supply stuff that I talked about a minute ago. The other thing is that at the present time, there's no specific municipal bond market concerns. We have seen times in the past where there's been news or concern about the tax exemption of municipal bonds or the credit quality of municipal bonds, and we've seen a more volatile muni market. But right now those municipal-specific concerns really aren't there, so we see a lot less volatility. In terms of relative value, the municipal market is fairly priced right now relative to other fixed income markets. We think it's in pretty good shape. At least for the foreseeable future, we don't see a lot more volatility from anything other than just normal interest rate movements.

Interviewer:
Tax returns being filed this coming April will provide investors with some clarity on the impact of the Tax Cuts and Jobs Act. How are you expecting to see the upcoming tax season play out for the municipal bond market?

Chris Johns:
We think the biggest impact there from the tax changes, that we don't feel is really fully discounted in the municipal marketplace yet, is the new limited state and local tax deduction of $10,000 for individual returns. We don't think that that is being properly discounted yet. Basically, what this means is that the value of particularly double-exempt bonds – bonds that are exempt for both federal and state income tax – the value of, or the need for that, is going up because of this limited deduction. I think people will be surprised that their taxes could actually go up this year when they think they're getting a tax cut. They're going to go up because of this limited deduction. The need for double-exempt income is actually going to increase a little bit. That's something we think could impact the muni market in a favorable way, as far as prices are concerned, that is a direct impact of the Tax Cuts and Jobs Act.

Interviewer:
Would you please describe your current strategy and the positioning of the Fund?

Chris Johns:
Sure. In the last couple of years, we've become more defensive in our portfolio, and by that I mean less sensitive to interest rate changes. In the State of Oregon, we've maintained an average maturity of about 7.1 years, duration is about 4.3 years, and 15% of the portfolio is in pre-refunded securities, which provide liquidity, and safety, and yield in the Fund. Then we also have about 88% of the portfolio rated AA or higher, primarily due to the narrow credit spreads that exist in the market today. We plan to keep these defensive characteristics throughout the year. I would suggest that the duration and maturity may lengthen slightly as some of the shorter maturities roll off and we reinvest kind of in the middle of the curve to pick up a little bit of yield.

Interviewer:
Thank you very much. For those of you listening, before investing in the Fund, carefully read about and consider the investment objectives, risks, charges, expenses, and other information found in the Fund prospectus, which is available on this site, from your financial advisor and when you call 800-437-1020. Thank you for listening to this podcast.
