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of Oregon

Aquila Tax-Free Trust of Oregon
Podcast Transcript July 31, 2018

Interviewer:
Today we're talking to Chris Johns, Portfolio Manager of Aquilla Tax-Free Trust of Oregon. At mid-year, we typically see an increase in municipal bond maturities and calls. How would you describe the supply of municipal bonds currently, and what are you anticipating over the remainder of the year?

Chris Johns:
In Oregon, we are down a bit from last year. We have approximately $1.5 billion in new issuance so far this year, which doesn't compare that great to last year, but last year was kind of a record year.

If you look back over the last ten years, what we've seen so far this year is pretty close to normal. The problem we have in Oregon right now is that for the balance of the year, we don't expect much new supply. Typically, the state of Oregon has a number of agencies that are active in the muni market in the second half of the year, and this year they probably won't be.

They're very disciplined about keeping their borrowing costs at about five percent of the total budget in the state of Oregon, and that's about where we are right now, so they don't plan to do any more issuance this year.

We may see some bonds approved in November, and some additional issuance late in the year, but it won't be enough to really make up for that state issuance that we normally see. So supply in Oregon is going to continue to be very tight for the rest of this year.

Interviewer:
Based on comments from the Federal Reserve, it seems as though we could anticipate one or two additional increases in the Fed funds rate during 2018. How has the municipal bond market been trading, and where on the yield curve do you see value?

Chris Johns:
Well, in the last three months or so, the municipal bond market has traded in a very narrow trading range. We haven't seen a lot of change in rates in the last three months or so. Interest rates on municipal bonds have not risen as much as Treasuries in the short part of the curve, and I would measure that by, say, five years and shorter.

I think that the curve right now – you get most of the value around ten years – that spot on the curve. You get about 80 percent of the yield of a 30-year bond at the 10-year mark, so that seems to be a pretty good value place; 10 to 12 years, in there.

Moving forward, I mean, as far as the Fed is concerned, we think it's kind of unlikely that they'll intentionally invert the yield curve. If they come up with a scheduled increase in the Federal Funds Rate, and it could invert the curve, they might wait. It sends a message that the economy may be weakening, and the Fed doesn't believe that. We don't believe that. So I think it's unlikely that they would do that intentionally.

Interviewer:
We've continued to see positive economic indicators in the first half. Are municipal bond issuers seeing improvements in tax collections and other revenue sources?

Chris Johns:
I would say so. Muni credit quality remains very strong as state and local tax collections of virtually all kinds are above pre-recession

highs. In particular, real estate has been especially strong in our state, and helps tax-backed bonds. So credit quality remains strong.

Our one concern, though, about this is that – particularly in the real estate area – housing affordability becomes an issue. We've seen such great price increases it's difficult for people to buy homes these days. That could kind of level off the price appreciation that we've seen in real estate over the last couple of years.

Interviewer:
Given the current market conditions and rate expectations, how have you positioned the portfolio?

Chris Johns:
We've been fairly consistent over the last year and a half to two years. We've become more defensive, for a couple of reasons. The first thing is we've seen the yield curve flatten that we've talked about many times. In other words, we don't get paid much higher interest rates to go further out the curve.

In addition to that, we've seen credit spreads narrow dramatically over the last couple of years. So in our view, risk is kind of mispriced right now. We don't believe that you're paid very much to take the additional risk of longer maturities or lower credit quality.

So our duration right now has been around four years or so. And we're going to kind of keep it there because we believe that the two main risks that face our shareholders are higher long-term rates and a widening credit spread. So we have AA average quality in our portfolio and fairly short duration relative to our guidelines.

The other thing that's important about our portfolio is that we have a big representation of pre-refunded bonds, which are Treasury-backed securities in the muni market that offer tremendous safety because they are backed by Treasuries. They offer good current yields; usually higher than what we can get in the current market conditions. And they also offer a lot of liquidity.

And we've held on to those for those three reasons, and that gives us a lot of flexibility if we get into market conditions that are a little bit more hostile and this part of the portfolio will provide us an opportunity to take advantage of higher rates, should they present themselves.

Interviewer:
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