Hawaiian Tax-Free Trust

PODCAST TRANSCRIPT

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Interviewer
Hello, everyone. Welcome to another Aquila Group of Funds podcast. I'm your host, Matthew DiMaggio. Joining me today are our Portfolio Managers of Hawaiian Tax-Free Trust, Reid Smith and Steven Dodge. We'll be discussing Hawaii's post-stimulus economic situation, thoughts on infrastructure, as well as municipal spreads and rates. Welcome, gentlemen and thank you for being here.

Reid Smith
Thank you.

Steven Dodge
Thank you for having us.

Interviewer
Let's jump right in. And we're about seven months down the road from the American Rescue Plan stimulus package. How is the state of Hawaii faring in the economic recovery?

Steven Dodge
Yes, it's incredible. It's already been seven months since the American Rescue Plan, and a year and a half into the U.S. COVID-19 pandemic. And we have come a long way since we first started talking about this. Hawaii, in particular, has had a wild ride regarding the COVID-19 pandemic. While the cases have been low relative to the mainland, the State has had its share of COVID waves, spikes, shutdowns, and jitters. The primary jitters for the State were around the impacts on tourism, because tourism is an important part of the local economy. You know, expectations were that this lockdown and all these pandemic restrictions would keep people in their homes, and keep them from traveling, which was especially frightening to State economists. The expectations were that slowdown in tourism was going to be felt in the State for years to come. Fortunately, the State had ample reserves, emergency funds, and we were able to weather the storm.

And then the Federal stimulus packages started to come in and assured everyone that the State was going to continue to operate and combat the pandemic for the foreseeable future. So, as things calmed down and we had a better understanding of what was going on in the pandemic, we started to relax the restrictions and open back up. That's when things got really shocking. Not only were the tax receipts surprisingly resilient, the State was also quick to implement programs to restart tourism, which gave the State a chance to address the really big question: Will people really want to travel during a pandemic? The answer, as it turns out, has been a resounding "yes." Despite the extremely low levels of international visitors to our islands, the State has seen an incredible rebound in tourism. The recent data from DBEDT (Department of Business, Economic Development & Tourism) as of August 2021 shows that visitor arrivals are currently 78% of the arrivals in 2019, and that's total arrivals, domestic, and international.

So, even more impressive is that number stands at 111.6% of the U.S. visitor count in 2019. That's not the end of the good news for the State finances. The State and many of its municipalities have rushed to take advantage of the extremely low-rate environment, which they use these low rates to shore up their balance sheets and fund upcoming costs at extremely low interest rates. The rates have been so beneficial for them that the State recently did over a billion dollars in taxable refunding. This is where they issued some taxable bonds that do not offer the double tax-exempt income and used those proceeds to forward refund a portion of the State's outstanding debt. This has helped them to reduce the cost of their debt going forward.

If I had to explain with one example how well the state is handling the economic recovery, I would point to the State's plan for the Emergency Reserve Fund. In 2020, the State budgeted to take $350 million out of the Emergency Reserve Fund to ensure ample liquidity throughout the pandemic. The current proposed budget plans to deposit over $1 billion back into the Emergency Reserve Fund in 2021, that is about a $650 million increase over the Emergency Fund in only one year.

Interviewer
Really great insight, Steven. I want to touch now on demand. Demand has been high across all municipal paper with supply on a relative basis being somewhat moderate. How does it affect the municipal markets, and can we see demand continuing at these levels?

Reid Smith

Well, it's a good question. The municipal market has experienced a steady positive flow of investment for almost the entire year into mutual funds. Only during the last few weeks of the third quarter did we see the volume begin to wane. This is consistent with the rise in interest rates at the close of September, which dampened demand. However, this may only be temporary. Supply remains on track at only 2.4% lower than last year through the end of September. And as a reminder, last year was a record year, with municipal issuance at $484 million. We don't expect the same amount for this year, but everything is on track.

I really believe that it's been the demand that has outstripped the supply. The ratio of yield of tax-exempt bonds to comparable taxable alternatives is at historically low levels, indicating a relative richness in munis. Normally, the fourth quarter coming up is a time of heavy issuance, as it was last year. When combined with the slackening of demand, we could see tax-exempt bonds returning to more attractive fair value. To be sure, the window may be narrow, as we expect long-term demand returning at year-end during the tax-exempt market seasonal spike with maturities and coupon reinvestment. Long-term demand for municipal bonds is also underscored by investors' anticipation of a trend to higher Federal tax rates. Although it's hard to predict tax legislation, the market clearly views tax-exempt bonds as a safe haven with the advent of higher personal income tax rates. Over time, absent a strong directional selloff in the bond market, we expect demand and remain solid for that longer term.

Interviewer

Good insight, Reid. Regarding supply, we've heard about the infrastructure bill, and it was recently passed through the Senate and is awaiting a vote in the House. If passed, does this bill affect supply and the muni markets in general?

Steven Dodge

Yes, that's an interesting question. While we're confident that an infrastructure deal of this size, that they've been talking about, would be impactful in the market, including the muni market, it's still very hard to tell what those impacts may be. The details of the plan are still being ironed out and the methods of funding the deal are still very opaque. It's possible that an infrastructure deal would help to increase muni supply, even if the deal itself doesn't involve the issuance of munis. This is because large Federal programs may incentivize partner and/or subsidize other municipal projects. An increase in muni supply would be a welcome change in the muni market. But while the impacts of the infrastructure bill on muni supply are unclear and at this point a bit more speculative, one thing that is more certain is, if the deal results in an increase in tax rates, municipal investments are likely to see an increase in demand. That could help drive municipal yields lower and the price of bonds higher.

This is because the tax benefit of municipal investments becomes more appealing, which could increase demand, much like it did in 2018 after the state and local tax deduction was minimized, and the most recent tax law change. That pushed more investors into munis, where they avoided paying taxes, and a tax rate hike could have similar impact. While we're certainly paying attention to the movement of the infrastructure bill, we are even more sensitive to the changes to the tax code that are being discussed. And given the enormous stimulus that's been handed out by the Fed, there may even be a tax hike without an infrastructure bill.

Interviewer

Moving on to credit spreads. So municipal credit spreads are at narrow levels and have been for some time. What does this tell us about the mindset of investors?

Reid Smith

Well, the tightening of municipal credit spreads slowed during the third quarter. Lower market yield and expectations of a recovery economy have continued to push investors towards lower quality bonds. Additionally, stimulus funds, provided to state governments through the American Rescue Plan Act, have reinforced investor confidence in municipal credit. However, demand has greatly compressed the normal differentials between credit and risk to a historic low. While we are constructive on the recovering economy and credit, it's hard to envision much relative value for seeking risk. Perhaps the opposite is true, which without much to give up in income moving to higher quality debt, offers safety with a minimal cost. Much of the future will be determined by the Federal Reserve action in guiding monetary policy, as we exit into the post-COVID environment. We feel comfortable in the relative safety of higher-quality debt in the Fund.

Interviewer

For my last question, I want to ask you what your expectations are for the rest of 2021 heading into 2022, around the topic of rates, inflation, and how you have the portfolio position currently.

Reid Smith

Well, we expect the economy to continue to move forward towards recovery in the near term, as well as into next year. As we move along, questions, barriers, and unknowns have appeared. Although we have a positive economic outlook, we are currently experiencing bottlenecks and labor shortages – all expected, as you would expect, as the world economy restarts after a devastating pandemic. Still, the spectrum of inflation has appeared amidst the recovery. The question remains outstanding: if

upward pricing pressure on wages in goods is transitory. However, we will need to wait and see if the bottlenecks subside and inflation eases. We remain vigilant at the controls of the portfolio for the potential of higher yields. We don't believe we see any dramatic shifts Rather, a slow unwinding of easy monetary policy. At the end of the third quarter, the Federal Reserve announced an intention to begin a tapering of open market operations. That is, purchasing outstanding debt. As we know, much of the Federal Reserve activity is data dependent. They are carefully watching the green shoots emerge and monitoring growth. At this point, the Fed remains accommodating, but has signaled the beginning of a shift in policy. The portfolio is braced with a slightly lower interest rate posture in a high-quality bias. We are set to weather choppy water or a calm sea.

Interviewer
Thank you, Reid and Steven for joining us today and providing such valuable insight.

Steven Dodge
Thank you. Our pleasure.

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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 a difference in yield between two bonds of similar maturity, but different credit quality.

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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.