Hawaiian Tax-Free Trust

Podcast Transcript

May, 2021

Candace Roane:
Hello, everyone. Welcome to another Aquila Group of Funds podcast. I'm your host, Candace Roane. Joining me is Janet Katakura, Portfolio Manager of Hawaiian Tax-Free Trust, and Stephen Dodge, Senior Investment Analyst. In this podcast, we will cover Hawaii's economic situation, the municipal market, the Biden administration's spending plans, and interest rates and inflation. Welcome, Janet and Steven.

Janet Katakura:
Thanks Candace.

Steven Dodge:
Thanks Candace.

Candace Roane:
Janet, let's start with you. Hawaii was impacted significantly by the COVID lockdown and the lack of travel that resulted, losing over 20 percent of tax revenue in 2020. How has the State recovered now that people are traveling again?

Janet Katakura:
Now, Candace, things are really looking up. We have two main gatherers of economic data here in the State of Hawaii. One is the University of Hawaii Economic Research Organization, UHERO. And the other one is the State Department of Business, Economic Development & Tourism. That's DBEDT. And they're both anticipating that Hawaii's economy will enjoy a robust recovery from the pandemic. The State economy is expected to expand by 2.7 percent this year, and that's compared to a contraction of 10.2 percent in 2020. And this forecast reflects the enormous beneficial impact of federal fiscal stimulus, which was about $22 billion directed at Hawaii and also the State's success in curbing the spread of the virus. And it's important that the vaccine rollout continues to be successful. We really want Hawaii to be a safe place to live, work, and visit. Unfortunately, the recovery of international travel has lagged because many countries have been slower to vaccinate their population. DBEDT expects 5.5 million visitors in 2021. And that's an increase of over 100 percent from 2020. A further strengthening in tourism is expected over the next few years, and that's fueled by a pent-up demand and Hawaii's distinction of being a safe destination. And by the way, if anyone is interested in looking at the various statistics for the local economy, both the UHERO and the DBEDT websites have a lot of interesting information. The unemployment rate, which peaked in the second quarter of 2020 at 20 percent, has been gradually declining. In March of this year, it stood at nine percent. According to the U.S. Bureau of Labor Statistics, that's still quite a bit higher than we've traditionally had, but it's heading in the right direction. Employment has benefited from Federal fiscal support as well as from the State's Safe Travel program, which has reopened domestic travel to the islands. And it's encouraging to know that there are jobs available. One of our local TV news programs recently had a story about restaurants being unable to find enough workers and another story about a hospital in Kona that is holding a job fair. And that's for a variety of positions, both medical and support staff. So yes, hopefully we will remain on the positive economic path. And that's thanks to various federal stimulus programs that have given support not only to the local government but to education, healthcare, small businesses, and families. And that's just to name a few.

Candace Roane:
Steven, I'd like to get your thoughts on the municipal market. How has the market recovered since the dislocation last year, particularly some of the sectors that were impacted the most?

Steven Dodge:
Well, the municipal bond market over the last year was characterized by pockets of extreme volatility. The one-year returns as of 3/31/2021 were strongly positive. The volatility was driven by pandemic-related concerns, as well as political and tax uncertainties. At the onset of the pandemic last March, municipal bonds came under heavy selling pressure and a flight to safety. All fearful investors were drawn to the relative safety of the U.S. Treasury securities with a little sensitivity to the relative view. Municipal investors expected the worst and where frightened about what the financial impact would be from the dramatic shutdown. They're worried about the immediate decline in Hawaii's tourism, and the steep jump in unemployment would surely have a negative impact on the State's budget and tax collections. They

even questioned if the hospital's budgets would be stressed with the increase in COVID cases. These concerns were valid but fortunately, after diving into our municipal credits, we realized that Hawaii's municipalities were fiscally conservative and had the ability to still meet all of their debt service payments despite these concerns. Now with much of the U.S., Hawaii included, on the route to recovery from the COVID pandemic, it seems that much the pain was lessened by the extensive fiscal support that came from the Federal Government and has furthermore benefited from the speed that tourists have come back to the State. Many of the sectors that people have been concerned about, like the airports and universities and hospitals, have seen a substantial recovery in their municipal bond prices. The airports here were fortunate that they had a large cash reserve with almost two years of cash on hand to help them weather the storm post-by-COVID. They also have been the recipient of substantial federal stimulus payments. The universities have been under the microscope for many investors, and the University System of Hawaii is no different. The UH System managed to maintain most of its student base through 2021, particularly at its university campuses with most of its declines being concentrated at the community colleges. And they're also a recipient of funding from the American Rescue Plan. And the local hospitals here, while they have certainly felt the impacts from the pandemic with increased cost of treating COVID patients, suspensions of their elective surgeries, and lower overall demand for their services, they were fortunate that they have thus far avoided a large increase in local cases like we've seen on the mainland. All in all, we continue to feel comfortable with all the issues that we are invested in, despite the impacts of the pandemic.

Candace Roane:
Very positive news. Steven, let's stay with you for this one. The Biden administration has proposed a significant amount of spending this year with the Build Back Better plan. The American Rescue Plan was signed into law in March, and Congress is currently weighing the American Jobs Plan. The American Family Plan is expected to be proposed shortly. How do you see all of this government spending coming together and impacting the municipal market?

Steven Dodge:
That's a great question. Well, Hawaii's share of the $1.9 trillion American Rescue Plan, which was signed by Joe Biden, provides a major infusion of federal funding at a time when the State and its residents need it most. According to Governor Ige, it gave us much-needed breathing room so that layoffs and furloughs aren't necessary in the foreseeable future. The State of Hawaii and the four counties will receive about $2.2 billion in assistance to bolster State and county budgets, as well as receive more funds for healthcare, education, and other critical needs. In addition to the funding of education, both at the Department of Education and the University of Hawaii, the state's receiving funding for the SNAP program, childcare, Medicaid programs, rental and mortgage assistance, COVID-19 responses like vaccinations and other public health programs, funding to benefit small businesses and nonprofits, funding for native Hawaiian education, and funding for transportation, which even includes our rail project. And unlike previous stimulus, these funds can be used to make up for lost tax revenue. The State will also receive an additional $116 million for critical capital projects for the pandemic response, as well as funding for education and healthcare. All in all, we feel the federal stimulus will be positive for munis locally and nationally as these funds help to put them on an even more stable financial footing. The potential infrastructure plan is still a hot topic, so we don't truly know what it will be by the time it's up for a vote. GOP has already offered up a markedly different counterproposal for $568 billion instead of $2 trillion, that was originally outlined by the Biden administration. But if it does go through as originally planned, it will affect areas beyond the traditional infrastructure like roads, bridges, and dams. This plan also includes allocations for upgrading underfunded primary education programs, devoting money to research and development of future technologies, and increasing access to childcare. But what will be interesting about this proposal is how it's funded. There's already been talk about raising the corporate tax rate and just last week, the administration put some hard numbers on what an increase to the capital gains tax could look like. If these tax increases are passed, they could make tax-efficient income from municipal investments an even more attractive benefit because they'll be bypassing an even higher tax rate. This could lead to municipal yields dropping and prices going higher, which would benefit the short term outlook for municipals.

Candace Roane:
Thanks for that, Steven. Finally, back to you, Janet. Investors are certainly watching interest rates and thinking about inflation right now. The 10 year U.S. Treasury is yielding 1.6 percent as we speak, up close to 70 basis points since the beginning of the year. What are your expectations for the next several quarters around rates, inflation, Fed policy, and how do you have the portfolio positioned currently?

Janet Katakura:
Well, you're right, Candace. 2021 has been a roller coaster for the 10 year Treasury. Luckily munis haven't had such a volatile ride. I guess you'd say it's more like a kiddie rollercoaster. The yield on a AAA rated 10 year municipal, according to Bloomberg and as of 12/31/20, was 0.67 percent. And now it's around 0.91 percent. Definitely a smaller move than what the 10 year Treasury has done. So it's important to point out that municipals have been able to maintain their value throughout the fluctuations that the treasury market has been having.

And that's exactly why you haven't seen a huge fluctuation in the Hawaiian Tax-Free Trust's NAV. Keep in mind that the 10 year treasury duration, which measures its volatility, is around 9.25 years. Hawaiian Tax-Free Trust's duration is much shorter, at around 4.25. So, in addition to munis not having as much of a volatile ride, Hawaiian Tax-Free Trust, with its shorter duration, should be expected to have a more stable NAV. And we continue to adhere to our investment objective, which is preservation of capital by investing in muni obligations, who, which pay interest exempt from Hawaii and state and federal income taxes. In this low interest rate environment, many people are extending along the maturity curve, reaching for more yield. The way of being a little bit more cautious and opportunistic. We think there are some opportunities out there on the secondary market, but we still prefer to buy securities that have a four or five percent coupon to protect the trust in case rates continue to rise or inflation rears its ugly head. We currently do not anticipate inflation as a problem over the short term, but it's always good to be mindful of the possibility. As far as the Fed, while they did recently again announce that they don't plan to raise interest rates until 2023. But don't think that the front end of the maturity curve is tied to the Fed funds rate, but it's also based on expectations of what the Fed will do. We currently have the portfolio in a somewhat barbell structure with securities maturing in the next few years and a slight overweight in longer tenure and out paper with tenure calls. The front end overweight is for one if it does decide to move. The trust would have bonds maturing in presumably a higher interest rate environment. And the longer overweight is due to finding value and the optionality in that area at the maturity curve. With this barbell, we're able to keep an intermediate duration of 4.25. And by the way, we do see some vulnerability in the intermediate area of the muni market because the rates have declined in munis to the point where you can buy treasuries at the same tactical equivalent. So, we're kind of avoiding that area of the yield curve. Going forward we're cautious, but we expect to see strong investor demand for tax good bonds. And that's due to the prospects of higher personal income tax rates, both nationally and locally. Credit quality is likely to benefit from federal government support directed at addressing pandemic-related strains and also aging infrastructure. And we also look forward to higher rates down the road to provide our shareholders with a slightly higher return as shall the maturities mature.

Candace Roane:
Thank you, Janet. Steven, Janet, thank you both for joining me today and providing your valuable local insight.

Janet Katakura:
Hey, thanks for having us.

Steven Dodge:
My pleasure.

Janet Katakura:
And thanks everybody for listening.

Disclosure:

Thank you for listening to this podcast. The opinions shared are those of the portfolio managers and do not necessarily reflect those of the Advisor or Subadvisor of the Fund.

Before investing in the Fund, carefully read about and consider the investment objectives, risks, charges, expenses and other information found in the Fund perspective. The prospectus is available from your financial advisor when you visit www.aquilafunds.com or call (800) 437-1020.

Information regarding holdings is subject to change and is not necessarily a representative of the entire portfolio.

Mutual fund investing involves risk. Loss of principal is possible. Investments in bonds may decline in value due to rising interest rates, a real or perceived decline in the credit quality of the issuer, borrower, counterparty or collateral, adverse tax or legislative changes, court decisions, market or economic conditions. Fund performance could be more volatile than that of funds with greater geographic diversification.

The Fund seeks to provide a high level of income exempt from state and federal income tax as is consistent with capital preservation. Past performance does not guarantee future results. For certain investors, some dividends may be subject to federal and state income taxes, including the alternative minimum tax referred to as AMT. Please consult your tax professional.

Independent rating services such as Standard & Poor's, Moody's and Fitch assign ratings which generally range from AAA highest to D lowest, to indicate the creditworthiness of underlying bonds in the portfolio. Where the independent rating services differ in the rating assigned to an issue or do not provide a rating for an issue, the highest available rating is used in calculating allocations by rating. Pre-refunded or escrowed bonds are issued to retire or regain an outstanding bond issue at a specific call date. Until the call date, the proceeds of the bond issuance are typically placed in a trust and invested in US treasury bonds or state and local government securities.

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.

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 above 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. 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.
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