Hawaiian Tax-Free Trust
Podcast Transcript December, 2019

Pierre Etienne:
Aloha and welcome to another Aquila Group of Funds podcast. This is your host Pierre Etienne. Today we have the pleasure of speaking with Janet Katakura, Portfolio Manager of the Hawaiian Tax-Free Trust and Stephen Dodge, Senior Investment Analyst. Thank you both for joining us today. So let's get started.

I would like to briefly get your thoughts on a few topics from 2019 and then talk about the upcoming year. So first, at the end of November, national municipal issuance was up 18% year over year, and many of this year's deals were over-subscribed. Hawaii was also up for the year. Has the fund benefited from any of the tax-exempted issues and have you seen an increase in taxable issuance?

Janet Katakura:
Aloha, Pierre, and everybody that's listening. Yes, we did see a larger than expected number of deals coming to market, mostly at the end of last year. I think this indicates that at that time the yield curve expectations going into 2019 were for higher rates. Rates had begun an upward trend in 2018 and many issuers attempted to lock in the lower rates on the expectation that rates would be higher in 2019. So at the start of this year, 2019, expectations for issuance were very low. Well, what a surprise. Early in the year, sentiment changed, and suddenly rates were dropping and people were preparing for a round of Fed rate cuts. As the Fed cut short term rates, longer term rates declined as well. Muni bond issuance jumped at the chance to issue with these new lower rates. While the State and the City and County of Honolulu were in the market with new issues, various public projects, both Honolulu Wastewater and Hawaiian Electric came to market and afforded us a good opportunity to extend out in duration and take on some good diversifiers. Diversifiers are issuers that don't come to market as often as where we have room to add to our position. This helps increases diversification, or put in another way, it spreads out the risk among the various issuers so we can reduce our concentrations in some of our larger holdings. The Hawaiian Electric issues, and there were two of them, one in July and one in September, came with very generous tax-exempt deals. While they are rated towards the bottom of the investment grade scale, the utility is an essential service and we are comfortable with adding to our positions in Hawaiian Electric bonds. It was a very rare and exciting opportunity.

Pierre Etienne:
Excellent. In your latest investment commentary, you mentioned that Hawaii's economic conditions were strong through the first half of the year. Has that held through to the second half, and what do you expect for 2020?

Janet Katakura:
We've seen moderate swelling in the Hawaii economy through 2019, but that doesn't mean that we're not still growing. In fact, the economic data has largely surprised to the upside in 2019. It had been thought that trade tensions and domestic economic risks would decrease tourism and spending in Hawaii. Fortunately, the economic data has not reflected that theory. In fact, the Department of Business Economic Development and Tourism, or DBEDT, reported a 5.7 visitor growth rate for 2019 thus far. That is higher than both 2017 and 2018.

Now, going into 2020, the forecast is still for a growing economy but with slower growth, largely from expected decreases in international and domestic tourism. The forecast for visitor growth in 2020 is around 2.5%. While this is a lower growth rate, it is still conducive to a growing economy. The construction sector continues to be strong with no indication it will slow in 2020, and the unemployment rate in Hawaii remains exceptionally low. This means that we should continue to see local demand holding up the Hawaii economy.

We have continued to see very strong tax receipt numbers, and this is an important metric as it's the taxpayers that ultimately pay for the municipal debt we invest in. Growth in the Hawaii economy has been exceptional the last couple of years. We're not expecting another blockbuster year and instead we're just expecting a stable economy with modest growth.

Pierre Etienne:
Good to hear. We saw the Fed reverse course this year and reduce the Fed funds target rate by 75 basis points, and some market analysts have said that rate markets have started to price in recessionary conditions. Do you agree with that assessment and would you say that credit market has as well?

Stephen Dodge:
Yes. Those Federal Reserve moves to lower short-term rates this year were a bit of surprise coming into 2019. During the earlier parts of the year, the rates market had definitely priced in some recession risk. This is evidenced by the yield curve inversion in the treasury market. An inversion means that the market participants were willing to buy, say a two-year bond at a lower yield than a one-month bond. The market environment demonstrates that traders were willing to lock in lower yields on longer dated bonds because they expected the Fed to have to lower rates to prop up a failing economy. The combination of Fed rate actions and economic data turning more positive has convinced market participants that a recession is not as imminent they thought it would be earlier in the year.

Now the yield curve inversion has all but disappeared. We are still seeing a flat curve out to about two years, but we are no longer seeing blatant evidence of an expected recession in the rate market. We do not feel the credit markets are pricing in a recession at this time. In fact, credit spreads are amongst some of the lowest they have been in the last five years. This means that traders are not requiring extra compensation for credit risks relative to the treasury market.

Pierre Etienne:
Thanks for the feedback, Stephen. Well, munis tend to be sensitive to credit spreads in other markets. What are you watching globally and do you see trade tensions, global growth, and in an election year impacting your market and the trust, and other any other risks that you are currently watching or looking out for?

Stephen Dodge:
We keep an eye on most every corner of the market. As the world grows more interconnected with trade and technology, it becomes increasingly important that we as portfolio managers make sure we have a good depth of understanding of the markets both domestically and globally. Trade tensions have to be monitored closely because dramatic changes in the ways goods and services are traded could have a drastic impact on the global economy, and in turn the Hawaii muni market. That being said, we don't see this as a large issue at the moment. The breakdown in communication, the further escalation of tariffs and a full stop on trade with China could have far-reaching negative impacts for the US and the world. But it's our belief that this cost is too big on both sides of the table for the US or China to allow this to happen.

The global growth slowed in 2019, but we have been seeing economic data turn lately. For example, Germany was able to avoid going into a recession, which bodes well for Europe as Germany is a manufacturing powerhouse in the eurozone. And elections are always monitored closely, but evidence has indicated the trading portfolios around which party is or isn't in the White House is not a good way to manage portfolios as it doesn't reliably predict market returns.

Pierre Etienne:
Let's turn to another popular topic, pensions. So last year Barron's called the estimated 1 trillion in unfunded pension liabilities the ticking time bomb in the municipal bond market. Can you give us an update on the pension situation in Hawaii?

Janet Katakura:
Pension liabilities can be a big risk when they're mismanaged. I will say that the state of Hawaii has differentiated itself from other states by taking steps to address their pension issues starting back in 2017. At that time, they established a four-year plan to increase the state's contribution to the pension and implemented annual stress testing to have a better grasp of the risks. The state has also made great progress towards reducing the cost of future benefits by reducing the benefits available to new public employees, and this is reflected in the state's credit rating. It's been upgraded a couple of times by the national rating organizations, and we have a very solid credit rating among the states.

Pierre Etienne:
On the retirement side, we are seeing a large demographic shift with baby boomers moving into retirement. Do you see this shift changing municipal demand and the fixed income market, in general?

Janet Katakura:
The wave of baby boomers retiring has been building for a few years now. We don't think we've seen the peak yet, but it certainly is a meaningful change in demographics for the United States and for its financial system. We have seen an increase in demand from munis, but it's hard to say how much of that is due to the influx of baby boomers and how much is due to the tax law changes that were implemented back in 2018. Evidence of the pool of money looking for income has been pretty clear on the financial markets for the last few years. From demand for munis to high yield to dividend stocks, there has been a synchronized demand for yields, which is likely due to the income requirements from retiring baby boomers.

We expect this to be a pervasive presence in the fixed-income market as a whole for many years to come. We see no reason for that demand to decrease, especially within the muni market due to the tax efficiency of muni bonds. The tax-exempt income is also appealing to long-term investors as a tax exemption means that muni bonds are some of the highest yielding investment grade securities on a tax-equivalent basis for many high income individuals.

Pierre Etienne:
Great. So as we wrap up the podcast today, can you give us an overview of how the Hawaiian Tax-Free Trust is currently positioned as we enter the new year?

Stephen Dodge:
Absolutely. As always, we manage this fund to our core targets of principal protection with a high level of tax-free income. This means we work hard to build a diversified portfolio of high quality municipal issuers based here in Hawaii. We are going into 2020 with a municipal portfolio that is shorter in duration than the benchmark and has a higher level of diversification and credit quality. All three of these metrics demonstrate our lower risk posturing due to our focus on principal protection.

Through 2019, we have made investments in longer dated securities where we have been seeing the most value. We've also taken strategic positions and some lower rated issuers that we have high confidence in. These serve to meet our second mandate of providing a high level of tax-free income.

Pierre Etienne:
Great. Mahalo for your time today, Janet and Stephen.

Stephen Dodge:
Thank you, Pierre.

Janet Katakura:
Thank you very much for letting us give this presentation.

Disclosure:

Thank you for listening to this podcast. 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.

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For certain investors, some dividends may be subject to federal and state income taxes, including the alternative minimum tax referred to as

A and T. 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 credit worthiness of underlying bonds in the portfolio. Where the independent rating services differ in the rating fee 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 for the purpose of retiring or regaining 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.

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