



AQUILA[®]
GROUP OF FUNDS

Investment Commentary

September, 2018



AQUILA[®]
Churchill Tax-Free
Fund of Kentucky

A Shares: CHTFX

C Shares: CHKCX

Y Shares: CHKYX

National and Kentucky Municipal Market

The quarter finished with interest rates on a modest upswing in response to continued reports of stronger economic growth coupled with the anticipation of further rate increases. Benchmark 10-year AAA municipal yields spent July and August between 2.41% – 2.50% before climbing steadily throughout September. Yields rose in September from 2.45%–2.60%, the largest monthly increase since last January when yields jumped from 1.99% to 2.36%.

New municipal bond issue forecasts for the summer called for up \$140 billion in net-negative issuance, and the slow-down occurred nationally as expected. Total issuance through the third quarter was \$249.4 billion, down 15% year-over-year.

In Kentucky, supply was tight for the quarter, except for a \$996 million deal from the Kentucky Public Energy Corporation. We have seen three deals from the Energy Corporation this year, but the Fund did not participate in any of them. Kentucky municipal bond supply up technically up 31% through the end of the third quarter, but if you take out these three deals, issuance for the year is down over 50%.

A \$206 million deal, that was not widely circulated, was brought to market the first week of October by the Kentucky Bond Corporation for Rupp Arena which has a Hyatt and a mall attached. This caught investors off guard as it was not on Kentucky's new issue calendar. The deal was in three tranches with A2 ratings on the two large tranches and an A3 on the smallest \$13 million tranche. The total package with state and local additions was about \$296 million. The bonds offered generous yields and the issuance occurred prior to the major sell-off that we endured the first weeks of October.

With the lack of supply, expect spreads to remain tight across the credit spectrum. Typically, in a rising interest rate environment, higher rated securities perform better, and lower rated credits are usually exposed for their risk.

National Economy

The national unemployment rate dipped to 3.7% in September as the economy added jobs for a record 96th straight month. This occurred as 2nd quarter GDP growth was upwardly revised to 4.2% as the benefits of the 2017 tax reform law began to materialize. Growth over the third quarter is expected to fall modestly in the 2.6%-2.9% range. Overall GDP expectations in 2018 remain at 2.9% and only 2.6% in 2019.

The Federal Reserve raised its target rate 25 basis point on September 26th, its 8th such increase since 2015, which left the Fed Funds Target Rate at 2.00%. The Fed's main concern has been to prevent inflation from accelerating beyond its preferred target of 2%. Most signs indicate inflation remains contained in this range. CPI and GDP price index forecasts from the Blue Chip Economic Survey call for inflation in 2018 to peak slightly above 2% and potentially recede somewhat in 2019.

These forecasts point towards the Fed's current campaign of preemptive moves having success in containing inflation amidst the backdrop of both economic growth and employment gains. The gradual increase in interest rates by the Fed, to date, appears to be accomplishing its goal of maintaining moderate growth, to keep prices and inflation expectations in check, without stifling consumer demand and economic development.

Kentucky Economy

Kentucky's economy continues to grow, but lags the national rate. The State's unemployment rate rose slightly to 4.5% in September, above the national average of 3.7%. While the state ranks high in national categories like affordability, equality and low crime rates, Kentucky ranks 41st overall in the latest US News and World Report Best States ranking; pulled down by the economic and fiscal stability categories. However, we are seeing some positive trends. Kentucky is a tried and true manufacturing economy, and the State has outpaced job growth in five surrounding states with similar demographics since 2009. Personal income, fueled by manufacturing jobs, has been increasing for the past several quarters. Kentucky's Tech Ready Apprentices for Careers in Kentucky (TRACK) program is an innovative pre-apprenticeship platform designed to develop talent starting in High School. This nationally recognized program is effectively developing and maintaining skilled workers for our state.



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Recently, the Kentucky Wired project, which intends to bring high-speed internet to Eastern Kentucky and link all state colleges, hospitals and other state agencies, experienced a state audit. The project was backed by a venture capitalist and also issued bonds. The audit exposed that the project, if completed, will be over budget by an estimated \$100 million dollars. Aquila Churchill Tax-Free Fund of Kentucky has never owned any bonds issued to fund this project.

Kentucky pension issues remain in the news. Oral arguments were heard by the Kentucky Supreme Court on September 20th in the Governor Bevin vs. A.G. Beshear and The Kentucky State Teachers Retirement Fund case. The outcome of this case, which is reviewing how the legislation was passed, may affect the views of rating agencies on Kentucky's credit. If the approved bill that addresses pension reform is overturned, Kentucky may end up further behind in catch-up payments for the state pension system. The assumption is that the Governor may call a special session to attempt to pass the bill again, but that means more time and money spent prior to implementing a solution.

S&P Global Ratings recently lowered their rating on the Kentucky Turnpike Authority's (KTA) economic development road revenue bonds to A- from AA-, and assigned a stable outlook. The bonds maintain their ratings of A+, and Aa3, with Fitch Ratings and Moody's, respectively. According to S&P, reasoning behind the downgrade is related to their change in issuer credit ratings methodology that was effective in January, 2018, as well as increasing financial pressure; primarily, the Turnpike Authority's obligation to fund pension contributions for the State Police Retirement System. As of September 30, 2018, 8.39% of the Fund was invested in Kentucky Transportation Authority bonds, and we believe that even with a ratings downgrade and pension liabilities, KTA is fully able and committed to meeting bond payment obligations.

Fund Outlook and Strategy

Municipal bond yields in the intermediate range ended the quarter offering more value than the past several years, with yields approaching almost 100% of comparable maturity US Treasuries. Conditions in the municipal market have been favorable of our Fund's intermediate, high-quality mandate. The municipal bond curve retained much greater steepness than that of Treasuries after the September rate hike, providing both very high relative yields and added principal stability from rolling down the curve.

We maintain our objective of managing interest rate risk and credit risk, which at this time entails modestly broadening credit diversification to improve monthly income while keeping over 90% of the portfolio rated A or higher. The shape of the yield curve, and where we find value, will dictate our average maturity, which was at 9.20 years at the end of the third quarter.

We believe that one of the benefits of owning shares in Aquila Churchill Tax-Free Fund of Kentucky is having the resources of local portfolio management and credit analysis. We will be monitoring our KTA holdings, as well as the overall portfolio with a view of the local economic and political environment.

For specific information about Fund characteristics and performance please see the Fund [Fact Sheet](#) and [Fund Holdings](#) located on our website at www.aquilafunds.com.

Fund Facts

Lead Portfolio Manager	Inception Date	Total Investments	Number of Holdings
Royden Durham	5/21/1987	\$195.5M (as of 09/30/18)	152 (as of 09/30/18)

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

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