Recent Muni Market Volatility with Tony Tanner, CFA®

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This is Candace Roane, Director of Marketing with Aquila Group of Funds. Today I'm joined by Tony Tanner, CFA and Lead Portfolio Manager of Aquila Tax-Free Trust of Arizona. He is also on the portfolio management team of Aquila Tax Free Fund for Utah and Aquila Churchill Tax Free Fund of Kentucky. Thanks for joining me today, Tony.

Tony Tanner:
Thank you for having me today, Candace.

Candace Roane:
Today is March 17th and a lot has happened in the first quarter of 2020. Last year was an exceptional year for both stocks and bonds and earlier this year we were hearing expectations of slower growth while the Fed signaled probability for no further monetary action in 2020. Few people anticipated these tumultuous times in the global healthcare system and economy. In fact, many market participants considered last week's municipal bond market movements to be unprecedented. Tony, you have several decades of experience in the municipal markets including managing investment grade single state municipal bond funds beginning back in the early nineties. Can you talk about last week's volatility and what is happening today and offer some perspective on how this market behavior compares to what occurred in prior volatile bond markets such as 1994 and 2008?

Tony Tanner:
Yeah, Candace. I'd love to spend a little time kind of going down memory lane here. Last week and particularly Thursday for me it felt a little bit like Groundhog Day going back to my early years in municipal bond fund management. Last week's market movements and last Thursday's unusually large price change were unusual and they were not what investors are accustomed to. But were they unprecedented? I'd have to say no. I remember back in the mid-eighties during the Reagan tax reform, then senator, Oregon Senator Bob Packwood, proposed making all municipals taxable and municipal bonds actually stopped trading for about a week. But to go back and look at some particular volatile periods, on Tuesday, April 4th, 1994, which came after a long Easter and Good Friday holiday weekend, that was a day in which intermediate and long-term municipal bond fund net asset values actually declined 3% to 4%.

The impetus for that unusually large one day drop was that the Federal Reserve had come into the market that Tuesday morning and had implemented a surprise action in the Fed's discount rate, which had been part of a significant monetary tightening that had already begun in that year. By the end of that Tuesday, the yield on the 10 year US Treasury Bond had jumped up 39 basis points from 675 to 714 and the yield on the 30 year treasury bond also spiked up 32 basis points. The Bloomberg 10 year AAA yield index rose a more modest 25 basis points, but spike in yields occurred in a day of very thin trading. On that day the A share of our Arizona Fund actually declined 19 cents or about 2%, commensurate with the price activity that we saw last week and last Thursday.

Now one difference between what occurred last week and that Tuesday in 1994 was that the last week's volatility was induced primarily by economic stress from the current coronavirus pandemic ,whereas in early '94, that was response to a Federal Reserve policy and the direction of a long-term interest rates. What we saw last week shared more in common with the themes that we saw near the end of the 2008 Great Recession. If you look back from mid-November before Thanksgiving of 2008 to December 15th, long-term and intermediate municipal bond net asset values in that compressed three-week period actually had declines of as much as 7%. That was in the shadow of a lot of potential corporate bankruptcies and bailouts that were being weighed.

The NAV of the A share of the Aquila Arizona Fund only declined a little more than 4%. And that again points out how our intermediate maturity focus has really helped us historically mitigate a great degree of the extreme downside risk that can occur and has occurred in the markets. What was really unusual about that period in late 2008 was that the Fed was in the midst of aggressively cutting rates to shore up the economy. So while muni market yields were moving higher, during that three week period, the yield on the 10 year treasury bond actually dropped 126 basis points from 377 to 251 and the benchmark 30 year treasury bond yield actually moved from 4.23% to 2.95% while muni yields were actually going up 60 basis points. So there we had the unusual circumstance of muni bond prices declining at the same time that benchmark prices were increasing.

Candace Roane:
Can you elaborate on how increased volatility across the financial markets and the abrupt turnaround in Federal Reserve interest rate policy has been impacting municipal market activity?

Tony Tanner:
Certainly. So a week ago, Sunday is where this increased volatility really all began. A week ago Sunday the Fed initiated an emergency cut in the Fed Funds rate of 75 basis points and the next day the price of the 30-year benchmark US Treasury Bond jumped up 10 points that morning. Very unusual activity. This past Sunday the Fed of course moved its benchmark policy rate to near zero and began a very significant practice and a program of injecting liquidity into the markets starting with $300 billion in treasury buybacks. Through all of this, we're really in a process of price discovery in all fixed income markets. Last week the price on the 30-year treasury bond ranged between 106 and 126, so it's really an unusual period in terms of market activity.

On the municipal market, last week municipal bond exchange traded funds have a weekly outflow of $246 million and several large significant ETFs saw record outflows of as much as 2% of their assets in one day. In fact, the Fed had to begin restricting the short sale of muni ETFs last week to curb unwanted speculative activity. So right now the activity in the fixed income markets and in particular in the muni market doesn't make it a productive time to engage in market timing. It really presents a great opportunity to reassess asset allocations, to take a look at long-term goals and to properly assess whether munis now offer return attributes that can help advisors and investors achieve important goals such as providing retirement income or protecting purchasing power.

Candace Roane:
Tony, would you say there are characteristics unique to the municipal bond market that are contributing to the current activity in munis?

Tony Tanner:
Yes. The one thing that is really unique about the municipal market is, not only that it is an over the counter market where trades occur by dealers connecting over the phone and some centralized trading exchanges, but the fact that on a typical day only about 2% of the outstanding municipal bond market is normally traded on a daily basis. So over very short periods of time last week when trading activity can sometimes be much thinner, it makes the muni market very choppy for retail investors. For institutional investors, it can exacerbate price moves if you were forced to sell bonds at a time that you would rather not. So the kind of volatility we're seeing within the muni market is not surprising because quite frankly, last week the muni market behaved in a very normal fashion for how it behaves in times when markets are decidedly abnormal.

Candace Roane:
Thank you. Considering the business we're in at Aquila Group of Funds, can you describe where there are benefits to owning municipal bond funds in a market like we see today?

Tony Tanner:
Well, I've always found in my experience that the benefit of owning municipals through municipal bond mutual fund is the degree of diversification that it affords investors. And this diversification comes in the form of maturity diversification, variety of credit diversification and in general municipal bond funds have the ability to assemble a portfolio composition with much greater variety of holdings. That variety of holdings is a key attribute that enhances liquidity at a time when municipals are infrequently traded. That's because if a municipal bond fund manager wants to raise cash, he's much more likely to find a willing buyer if he's got a much wider variety of things to offer for sale.

Municipal ETFs are traded on a daily basis and are a function primarily of the inflows and outflows for those Funds and they typically have to restrict themselves to owning the largest, most frequently traded bonds. Within a mutual fund we're able to achieve a breadth of diversification where we can actively look at different aspects of the Fund, look for opportunities to add value, in particular being able to conduct credit research, and what I call situational surveillance of our holdings to look out for potential trouble spots well in advance or to capitalize on opportunities that the market presents.

Candace Roane:
I know you were watching munis across several states, but you live in Arizona. Are you observing anything in your local market that you can share with us?

Tony Tanner:
Yes. Here in Arizona, for the last several months we have seen a very well thought out and comprehensive response by Governor Ducey and state and local health officials to the coronavirus pandemic. In fact, early at the outset, in mid-February, Arizona had its first coronavirus patient, who was an ASU student, who had returned from China. That particular coronavirus case, the victim self-quarantined and the ASU community and classes continued in a normal fashion. So the state has really had the opportunity to get out ahead of the curve. State and local officials and healthcare providers are doing a very commendable job of getting resources in place should the incidences of cases begin to increase in the state. Maricopa County is now the fourth or fifth largest county in the country. Phoenix is one of the top four or five metropolitan areas in the country and Maricopa County has been the fastest growing county in the country for several years now. And currently in Maricopa County there are only five confirmed cases, and so the state I think is very well situated for the current situation. We continue to monitor the major hospital organizations and health providers, not only both in their response and preparation, but any news that they are sharing about any potential financial impacts they are having. So that's one of the hallmarks of the Aquila Group of Funds investment style in operating across seven states with very varying geographic locations as we really get a chance to see firsthand what is happening on the ground when a period of economic distress occurs like this.

Candace Roane:
You mentioned healthcare and hospitals. Are there any other aspects of the Arizona economy and municipal market that you're evaluating right now?

Tony Tanner:
Yes. Before the outset of the coronavirus pandemic, the Arizona economy had been performing very strongly. The state received a credit upgrade in November of 2019 which was the second it had received since 2015, and the underlying trends that have been driving the state's economy and contribute to that upgrade such as population growth, very disciplined fiscal policy, which has translated to good budget strength and GDP gains and employment gains that are well above the national average. We're keeping an eye on those to see how well those trends will be staying in place. Arizona's the economy has pivoted in recent years from one that would be considered I think nationally sensitive, primarily depending on hospitality, real estate and construction towards one that is a bit more self-sustaining, including significant gains in manufacturing and technology and medical and health sciences. I think those underlying strengths are going to enable the Arizona economy to adapt to the changing economic landscape with the current coronavirus environment.

Candace Roane:
Before we wrap up, can you give us an overview of how you see things playing out in the muni market over the next few months?

Tony Tanner:
Yes. The volatility that we've begun to encounter is likely to persist until we see the extent of the coronavirus pandemic develop. The one thing that is really important to reserve right now is the degree of value that has returned to the municipal bond market. I pointed out that back in 2008 during the Great Recession and the credit crisis how municipal bond yields moved in opposite direction of the US Treasury Bonds. If you look back in 2008, by December of 2008 and January of 2008, 10 of 30-year benchmark municipal treasury bond yields were almost twice that of comparable maturity US Treasury Bond yields. For some perspective, in January of 2009 the Salt River Power Authority here in Arizona issued 30 year bonds with a 5% yield at the time when the benchmark US Treasury Bond was yielding 3%. That is a very unusual degree of value within munis. And last week after the changes in treasury yields and the significant spike in municipal bond yields, we have seen the ratio of municipal yields to treasury bond yields move back to those sorts of levels, where in 10 and 30 years municipal bonds are yielding anywhere from 160 to 180% of their comparable benchmark US treasuries. That value though is not a guarantee that there won't be further fluctuations in municipal bond prices or that municipal bond prices might decline further, but they're rather an indicator of the degree to which municipal bonds can now possibly assist advisors and clients in achieving their overall asset allocation objectives.

It's important to consider that the search for value is not a predictive exercise. So at Aquila Group of Funds we are trying to avoid speculating in the market, but rather using our local presence in the states with which we operate to identify and uncover values that will contribute to the traditional strength of our portfolios, which may have a greater degree of principle stability and preservation compared to long-term funds and double tax free yield compared to short term alternatives or remaining on the sidelines. So in short, I think that the market has returned to a situation where we as local portfolio managers can roll up our sleeves and begin to deliver for our shareholders.

Candace Roane:
Tony, thanks for joining me today. I appreciate you joining on short notice and sharing your experience and insight with us.

Tony Tanner:
Thank you, Candace. Appreciate the opportunity to give some perspective.

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