Aquila Tax-Free Trust of Oregon

PODCAST TRANSCRIPT

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Interviewer:
Hello, everyone. Thank you for listening in to this edition of the Aquila Group of Funds podcast. I'll be your host today, Phil Felice, the Director of Internal Sales. Joining me today are Chris Johns and Tim Iltz from the portfolio management team of Aquila Tax-Free Trust of Oregon. We'll be discussing, as always, the municipal bond market, as well as the local economy. Welcome, Chris. Welcome, Tim. And thank you for being on the podcast.

Chris Johns:
Thanks a lot, Phil.

Interviewer:
The question I wanted to start off with, it's very direct. On a long enough timeline, there are downturns in any market. But, we saw something different in the front half of this year. Essentially, all markets experience volatility in terms of price, and the muni markets follow it along for the ride. So, what was different this time around?

Chris Johns:
Well, Phil. I would say the biggest difference this time versus what's been happening in the markets over the last 10 or 12 years, is over the last 10 or 12 years, we had a number of events that occurred in the marketplace where we saw some volatility. And whether it was the taper tantrum in 2013, or the credit event in 2011, or even the beginning of the pandemic, where we saw prices move in a fairly sharp fashion. They were also followed by a V-shaped recovery. So, the market quickly understood that these weren't long-term problems. And the market recovered very quickly from all those events over the last 10 or 12 years.

This time around, what's different is this continuing drumbeat that we're hearing from the Federal Reserve ("the Fed") about their efforts to combat inflation by raising interest rates. And the market now knows that this is going to be an activity that takes place over some time. So, I think that's really the difference is that the market has understood now that it's going to take some time for the Federal Reserve to do all the things they say they're going to do—raise the Federal Funds rate. Here we are in the middle of June. They just did their third increase of short-term interest rates, this one, 75 basis points. And the market expects two or three more of those. And in addition to that, they're starting to roll off their balance sheet, where securities that they've owned, they're going to allow to mature without reinvesting. And the magnitude of that is very, very large. So, the market knows that it's in for a slog, and that's really what makes it different this time, is the time period that it's going to take for these efforts to combat inflation. The good news about this is that our style... We have over the last few years, as we've mentioned on this podcast, we've been more in the defensive range. We've kept our duration towards the shorter end of our range. Our credit quality has been exceptionally high. And the reason we've done that is that we felt that this potential for rising rates existed, and we wanted to be as defensive as possible. So, the good news is that that will be a little bit less volatile than the market as a whole because of those portfolio characteristics.

Interviewer:
Thanks, Chris. That was great. And with that in mind, what is the muni market looking like in terms of relative value? And we're comparing it to Treasuries and to the larger fixed income markets.

Chris Johns:
That's a tricky question to answer, Phil. It really depends on the day. Throughout the last year or so, the demand and supply pressures in the municipal bond market have many times pushed the muni market to either behave not the same in magnitude on interest rate moves as the U.S. Treasury market. And many times, not even in the same direction as the Treasury market. At the beginning of the year, the interest rates on munis were very low, compared to Treasury securities. And then we went through a period a month or so ago, where interest rates on munis were actually higher than Treasuries. And as we speak today, what we see is, on the front end, say one to five years, muni investors have really been attracted to that because of the lower volatility of shorter securities. So, those yields are a little rich or a little low in interest rate, compared to Treasuries. Whereas, the longer end, say 10, 20 and 30 years, you see yields closer to what the Treasury yields are. So, it really depends on the day and where you are on the interest rate curve in terms of relative value. One of the good news about this current market condition is it gives us the opportunity to refresh some of the yields in our portfolio—from bonds that we bought over the last two or three years when interest rates were very low, to refresh those with bonds that are available today, at meaningfully higher interest rates.

Interviewer:
That's great, and it piggybacks on to our next question in terms of opportunity for yield. And I think I want to pass this one on to Tim. What are we seeing, from an issuance standpoint, heading into the second half? Are you being presented with yields that are more appealing than what we saw coming into the beginning of the year?

Tim Iltz:
Phil, year-to-date issuance has been down about double digits from last year at this time. Some of this can be attributed to the November 2021 election, which approved about 25% less bonds than the 2020 election did. And some of this can be attributed to higher interest rates. From the beginning of the year, municipal bond rates have risen approximately 170 basis points for a five-year maturity, about 185 basis points for a 10-year maturity. And to put that in perspective, for a five-year maturity, current rates are about triple where they were at the beginning of the year. So, we've seen a significant increase in interest rates. But, as Chris noted, this has given us an opportunity to freshen up the portfolio and add current yield by purchasing bonds at current rates.

Interviewer:
Okay. And so, we've been speaking a lot about the larger muni market, the national muni market. But, we are Aquila, we know that advisors and the clients of advisors look at us as the local subject matter experts. So, what are you seeing locally in terms of economic growth, or anything that you might find interesting for our listeners?

Tim Iltz:
Well, something that's important to note here, I think, is that recent volatility in the markets is not specific to the municipal bond asset class. Most volatility we've been seeing is largely a response to the macro fear of rising interest rates, and the Fed's effort to curtail inflation. Municipal credit has been remarkably resilient, primarily due to stimulus funding through the CARES Act and the American Rescue Plan, strong local property tax collections. The robust real estate market has been a key factor for municipalities relying upon local property tax to fund operations. And though the housing market across the State has been booming with strong demand and record prices, year-over-growth in the metropolitan areas has reached upwards of 20% in many areas. But, with these increases in interest rates, we have also seen inventories start to build in areas around the State. And we're not particularly concerned about this, due to the current shortage we continue to see in the market. And we would expect the impact of this to be more stable prices, rather than the extraordinary prices that we've seen in recent years. But, one of our primary concerns for the local economy is housing affordability and inflation. And we would note that both for households and local governments, these are concerns. But from a local government perspective, many local governments have been preparing for an economic downturn through their budgetary process, and through the CARES Act stimulus, and other efforts by local governments, and awareness of the potential for an economic downturn. We've seen unprecedentedly high levels of fund balance in local government balance sheets through our credit review process.

Interviewer:
Well, that leaves us with plenty to chew on heading into the second half of the year. Chris, Tim, as always, thank you for your time. And in these unique times, we appreciate your guidance. Thank you, and have a great day.

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 principal 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, stands for Public Employee Retirement System. The acronym PERA, 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.