Muni Market Update with Chris Johns

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AQUILA® GROUP OF FUNDS

AQUILA® Tax-Free Trust of Oregon

This is Candace Roane with Aquila Group of Funds. Today is April 7th, I am joined by Chris Johns, portfolio manager of Aquila Tax Free Trust of Oregon. Chris has been managing the Fund since 2011 and he has over 30 years of experience managing single-state municipal bond funds for Aquila. He has managed funds through several volatile markets like we are experiencing today.

Welcome to the podcast, Chris.

Chris Johns:
Thank you, Candace.

Candace Roane:
This is the time of year that investors would normally be filing tax returns, which gives us a great opportunity to remind them about the benefits of investing in tax exempt municipal bond funds, but tax day has been rescheduled this year due to the current COVID-19 pandemic, and since we recently experienced one of the most precipitous market declines in modern history, let's focus today on what happened in March and how it impacted the municipal bond market and on the opportunities that may exist.

To start, The Bond Asset Class is typically a place of respite for investors during times of economic unrest, but the recent virus induced volatility took municipal bonds on a ride along with other bond sectors and equities. Chris, can you give our listeners insight on how investor sentiment changed and the impacts that had on the municipal bond market?

Chris Johns:
Yeah. We've seen really unprecedented volatility in the muni bond market in the last three weeks or so, and it really began three weeks ago with the breaking news of the coronavirus where the financial markets became highly concerned about what the future held. And what we experienced at that time was almost every single asset class, whether it be stocks, bonds, municipal bonds, gold, whatever the case may be, people really had a strong desire to convert those financial assets to cash. And the municipal bond market, although historically is less volatile than other parts of the fixed income market, we had a situation in the municipal bond market where over the last two or three years we had seen an increasing interest in the municipal bond mutual fund asset class, and a lot of money going into that space for large national municipal bond funds.

In addition to that, money had flowed into exchange traded funds or ETFs, many of which were leveraged. And so, what happened as people began to try and convert to cash, we experienced a demand and supply imbalance in the muni market, where we didn't have enough people to reinvest in munis as wanting to get out of munis. So we saw a fairly precipitous price drop over a short period of time. Well, what happened after that is we had a major dislocation between the interest rates that were paid on US Treasury Securities, and those paid on tax exempt municipal bonds. In many cases, the tax exempt municipal bonds were several times the yields on the corresponding treasury maturity. So as a result of that, we saw some, what we call crossover buyers, coming back into the municipal bond market. And what crossover buyers are traditionally considered investors that buy taxable securities.

Well, when you have municipal tax free yields that are some multiple of what taxable yields are, it's pretty easy for those investors to come into the market in a fairly strong way. And those investors included banks and insurance companies that have kind of been out of the municipal bond market because of the tax cuts and jobs act, lowering their tax rates. They didn't really need tax exempt income, but they came back in a big way that allowed us to really kind of snap back in price over a few days. So we had a very volatile four or five days there. And the relationship that still exists now is that municipal yields are still very attractive relative to US Treasury yields. As we speak today on April 7th, a two-year AAA muni has a yield that is four times what a two year treasury is, a five year AAA muni has a yield that's two and a half times what a five year treasury is. And in the 10 years space, the tax exempt yield is more than double what a 10 year treasury is.

So, as an asset class munis are still very attractive relative to treasuries at the moment. The primary reason for that big dislocation is the fact that the Federal Reserve has been buying billions of dollars of treasury securities on a daily basis, which has really driven those interest rates lower. And as of yet we haven't seen the Federal Reserve participating in the muni market, which we'll talk about in a little bit. But that's why that relationship still exists. So I would say as far as the investor sentiment now, it seems to be improving here in the last few days and munis are not a feared asset class, if you will. And I think it's really important to know that this supply and demand imbalance that we have was really not a credit event. It was not because there was something wrong with the munis, it's just that everybody wanted to do the same thing at the same time and it created this price volatility. So, it really wasn't that there was anything wrong with them. It was just really cash-flow.

Candace Roane:
How has the Fund's investment approach handled the recent volatility? And do you see current market conditions creating potential investment opportunities?

Chris Johns:
Yeah. So over the last couple of years, and if you've listened to our podcasts or read any of our strategy pieces, over the last couple of years we've really felt that risk was mispriced in the muni market. We'd seen a situation where the yield curve, in other words the difference between short rates and longer rates, became flatter, so reducing that difference between short rate and long rates. And then to us probably more importantly was the difference between high credit quality bonds and lower credit quality bonds had also narrowed dramatically. So you weren't getting additional yield to take more risk either through longer maturities or through lower credit quality. So for us, we began to take risk off the table a couple of years ago and shortening our duration a little bit and increasing our credit quality because we felt that you just weren't getting paid to take risks.

And so it got to a point where 90% of our portfolio was rated AA or higher, we had a strong percentage depending on when you're talking about, anywhere from 8 to 12% in pre-refunded bonds that are backed by US Treasuries. So we had already been in a very defensive position going into this event. And so we held our own very well through this event. And we think that the worst of the market volatility is behind us. Not to say that it couldn't happen again, but at least in the short run here, in the next few weeks or month or so, we think we've seen most of the volatility that we're going to see.

Has it created opportunities? Really with the market being so volatile, sometimes you can get an opportunistic trade in there, which we have. But to us it's really more important overall portfolio characteristics as it's what's going to serve our investors. Well, not necessarily a great trade that we make, but rather the overall characteristics. And we think in time we will see more credit spread widening here, and that will really provide the opportunity for us because of our strength of credit research, we may be able to take advantage of any higher yields that are offered by slightly lower rated municipal bonds.

Candace Roane:
So, we know that most states and municipalities entered this year with strong revenue growth after almost over a decade of recovery. And at this point credit fundamentals remain solid, but we don't know when activity will return to normal. Are you concerned about revenue declines in the State and are there muni sectors that you're watching closely?

Chris Johns:
Yeah Candace, we are blessed here in our state in that we have come from a very strong economy and because of that most of the issuers in the state are in very healthy conditions, so that's a good point to make. It's not like we were just coming out of a recession and they were recovering, they were all in very good shape. And the question you asked about how much time, and that's really the critical element here, how long is this economic slowdown that we're most likely going to experience, how long is that going to last. Now one thing I would say is that municipal issuers are more resilient to economic downturns, than say corporations would be. And the reason for that is the nature of the revenues that we played in this municipal bonds, essential service things like electric utilities, water utilities, and then property tax backed bonds, which are very resilient to economic downturns over time.

So overall we don't see a huge risk at this point in the municipal bond sector, other than perhaps some credit rating downgrades, which would happen in any kind of economic slowdown. But once again that could be an opportunity for us because credit spreads would widen and we might be able to add a little bit more in yields.

In Oregon the transportation sector is probably one of our greater concerns and that's primarily with aviation facilities, in this case the airport. But the Portland Airport is in pretty good shape, the Portland Airport has almost two years worth of operating funds in cash on their balance sheet and that gives them some financial flexibility moving forward.

The other thing that's happening with that is that the Economic Stimulus Act, the CARES Act, which was passed last week by Congress, provides ten billion dollars for U.S. airports and of that money that's going to the airports, Portland Airport looks at this point is eligible to receive about fifty-five million dollars in Federal aid under the CARES Act. And when you combine that with a cash level that's able to support its operation for over two years, and the fact that the bonds are supported by a reserve fund, a debt reserve fund, we think that for the time being the airport's in pretty good shape.

The other area in Oregon that we're looking at is in mass transit. The TriMet System, huge drop off in ridership there obviously as we all stay home. In this case the CARES program is also going to provide some funds to that. It looks like TriMet is expected to receive about one hundred ninety-six million dollars in government support from the stimulus package and they have historically maintained exceptionally high debt service coverage of 10 times to 18 times coverage, which means that their ability to withstand this dramatic drop in ridership is actually quite good as long as it's not extended for years at a time. So those two sectors, aviation and mass transit, are areas that we're watching closely. But in Oregon we appear to be okay for now.

Candace Roane:
You touched on the recently passed CARES Act. Do you have any additional thoughts on how that will support state and local governments and what do you expect from the Fed?

Chris Johns:
The major legislation is referred to as the CARES Act and it covers four basic areas, aid to households, aid to small businesses, aid to businesses and markets, and also aid to governments. And in particular for municipal bonds, the aid to governments is what we're going to care about. And in that area, we're going to see about three hundred thirty billion dollars is targeted for state and local governments. About one hundred fifty billion dollars is direct funding to state and local governments, about one hundred twenty billion dollars to hospitals, and then onto education, transit agencies and airports with several billion in each case. So that's really important for municipal bond issuers is that they are going to receive that aid from the Federal Government. The other thing I would point out about this is, this is just the first round of that, and the Federal Reserve has and the US Treasury has indicated their desire to do whatever it takes to help state and local government stay afloat. So, I don't think this is necessarily a one-time shot. If there's more that's needed, we'll see that.

And so that's going to have I think a positive impact on the municipal bond sector, knowing that the Fed is kind of shoulder to shoulder with state and local government and they're going to get their chance to smooth out their funding.

The other really big news this time around is that for the first time ever the Fed, like I talked about earlier, that is buying billions of dollars with the treasury securities to keep rates low. Last week, they pasted legislation that allows the Fed to purchase municipal bonds in the secondary market, which has never been done before. Previously the Fed with money market activities could buy very short term municipal bonds of six months or shorter, but now this allows them to buy longer bonds.

They have not done this yet and I'm not quite sure how they would affect that transaction, but the fact that they can do it provided some relief to the muni market and has helped flows and trading in the muni market knowing that the Fed could be there if we run into another instance like we did three weeks ago with extreme volatility, the Fed could actually help that. So time will tell if they do that or not or if they need to do that or not, but it's good to know that they can.

Candace Roane:
To wrap up today, we are continuing to operate with a tremendous amount of uncertainty around our healthcare and what type of volatility we may see in the markets going forward. And we're almost certainly moving into a recession. Can you give listeners your thoughts on what you expect moving forward?

Chris Johns:
Yeah, if we go through this period like this, I think it's important to understand that as I said a little bit ago, municipal bonds tend to be a little bit more resilient during these economic downturns due to the revenue sources. And one of the things we do here with the Aquila Funds is we put a really high value on credit research. We're constantly monitoring sector exposures we have, the individual holdings, talking directly to the issuers, and really spending a lot of time and effort on the credit side. So we believe that can help this knowledge of what's going on with local issuers is going to really help us get through this.

And the other thing, that is really important now, is really what we've done over the last couple of years. We have a fairly defensive portfolio where the average portfolio maturity has been between seven and eight years, the duration between say four and four and a half years. And a significant percentage of the portfolio is in pre-refunded bonds, that I mentioned earlier, that are backed by US Treasury Securities, and the fact that 90% of the portfolio is AA rated or higher.

Having all these kinds of really kind of defensive and very liquid characteristics of a portfolio, we think that will serve our investors well in the short run as we get through this situation. Could create some opportunities for us if we see some credit spread widening. Once again, our research may allow to take advantage of higher yields in securities that have recently had very narrow credit spreads. But until we see that we're not going to do it, but I believe we will. We'll take advantage of those things as they present themselves.

Candace Roane:
As always, Chris, thank you for joining me, and for all of your insight.

Chris Johns:
Thank you, Candace.

Disclosure:

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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 the 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 in excess of 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 of time. 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.

Yield ratio represents the comparison of the expected yield of one bond to the expected yield of another. A yield ratio is important when