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Aquila Churchill Tax-Free Fund of Kentucky Podcast Transcript December, 2019

Pierre Etienne:
Welcome to another Aquila Group of Funds podcast. This is your host Pierre Etienne. Today we have the pleasure of speaking with Royden Durham, portfolio manager of Aquila Churchill Tax Fund of Kentucky. Royden, thanks for joining us today.

Royden Durham:
Hi, Pierre.

Pierre Etienne:
Awesome. Thanks Royden. So great. 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, if that's okay?

Royden Durham:
Absolutely.

Pierre Etienne:
Great. So at the end of November, National Municipal Issuance was up 18% year over year, and many of this year's deals were oversubscribed. Kentucky's issuance was down almost 30% for the same time period. With just under three billion issued, how have you been able to find opportunities with reduced new issue supply, or have you turned more to the secondary market?

Royden Durham:
Well, Pierre, Kentucky issuance for the year is a bit deceiving in that over three billion in commodity based gas bonds were issued last year. If you take that number out, we are basically on par to maybe slightly above issuance from the prior year. I have generally found that the best values are in the primary market, although these very low rates make it very difficult. Some real museum pieces have recently come to market, comes to mind the AAA rated Louisville Water Company bonds and some AA plus Lexington, Fayette sewers. We rarely see this kind of quality in Kentucky these days. On the other hand, coming here shortly, we'll be BBB3 over BBB minus Ashlyn hospitals and they will be coming the week of December the 18th. We own several of that issue to be refunded and really like the credit, which we treat as an essential purpose bond, and hope they will be priced accordingly as a good value.

Pierre Etienne:
Good to hear, good to here. So I have another question for you. We've seen a noteworthy increase in taxable muni issuance this year. Are you seeing that in Kentucky? And what are your thoughts on what's driving this increase?

Royden Durham:
Well, with the Trump tax plan change that extinguished non-taxable refundings. So if you remember we had an onslaught of refundings at the end of 2018 to take advantage of the old law. The law did not restrict or change the ability of financial advisors to refund non-taxables with taxables. The spreads are very, very narrow right now on a historic basis and primarily due to the very low rate structures, which is creating the opportunity to refund non-taxable with taxables. We've seen several taxable issues in Kentucky over the last several months taking advantage of this. Some examples are Kentucky state properties, about 98 million. Lexington GOs, which I think was about 32 million, Owensboro GOs about 18 million, and some Kentucky association of counties, which was real small at 5 million. No doubt we'll see more.

Pierre Etienne:
So the University of Louisville was recently downgraded by Moody's after the acquisition of Kentucky One Health. I know the Fund only owns one bond that was impacted which amounts to less than 1% of the portfolio, but do you have any thoughts on how this may impact the University in the interim, and will the perceived stress from the healthcare system have any effects on the sector in Kentucky?

Royden Durham:
Well Pierre, we've been dealing with this sector under stress for several years with Catholic Health welching on its promise to invest over 950 million into the Louisville hospital market. This coincided with their credit rating diving from a double A to triple B over roughly a 14-month period. We decided to bail out of the credit and only hold a pre-refunded bond and two medical center bonds which had systems one third participation and a HVAC and laundry shared with other hospitals.

Royden Durham:
U of L purchase of Jewish as stated by the president of the University was essential to protect the medical school's ability to teach heart medicine. They were willing to take the credit risk and downgrade to protect their medical program. Not mentioned in all of this is the fact that all primary and secondary schools such as University of Kentucky, U of L, et cetera, plus all the high schools and so forth, carry Kentucky's rating, which has a state intercept guarantee. So in essence the bond ratings are in the AA3 over A+ area.

Pierre Etienne:
Great. Great. So let's cover another interesting topic here. The current pension situation in the state of Kentucky. Last year Barron's called the estimated 1 trillion and unfunded pension liabilities. "The ticking time bomb in the municipal bond market." Kentucky's governor and the state legislature have been actively working over the past several years to find solutions for state liabilities. Can you give us an update on the pension situation and how you see it impacting the Kentucky muni market going forward?

Royden Durham:
Well, as you know, on a percentage basis, Kentucky has the worst funded state pensions in the country. We had a gubernatorial election November the fifth and our widely despised Republican governor was the only one to lose out of a six state-wide elections. The Republican veto proof legislature has adopted the results as meaning it's not our policies that are in question, it was a prior governor Bevin's personality. Assuming the legislature musters the political will that the voters have afforded them, they can force the new democratic governor's hand and solve most of our pressing problems. This would save the state's credit rating. Note that the new governor is starting out bravely taking the state back into the expanded Medicaid program, which I believe immediately puts the state into a $1.1 billion deficit position. Since the state has a balanced budget mandate, it seems there's little chance the legislature will fund it or there could be drastic cuts somewhere else. You would think that since the competition of low tax states like Tennessee and Indiana that are on our borders are vying for business with us, the legislature and the new governor are going to have to work together if they intend to solve any of the pressing problems.

Pierre Etienne:
The Fed reversed course this year and reduced the Fed funds target rate by 75 basis points and some market analysts have said that the rate markets have started to price in recessionary conditions. Do you agree with that assessment and would you say that credit markets have as well?

Royden Durham:
Well, I think their economic detractors pushed the inverted treasury yield curve as proof of a recession. Since we now have a positive curve, no one seems to be talking about it. We're trading in a limited range now with a daily swings hanging on which ways the trade talks go with China. The economy is doing reasonably well with low inflation and positive net GDP growth of about 2.1%. If a tariff resolution occurs, then expect higher rates. If not, we are range bound. Growth-wise pay attention to small business creation, which is the lifeblood of the economy. It is growing at a very healthy clip with the Fed statement that they will be on hold in 2020 you'd think the trade agreement with Mexico and Canada plus some stage one agreement with China would do nothing but help the economy.

Pierre Etienne:
Perfect. Thank you for your time today, Royden.

Royden Durham:
Thank you, Pierre.

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