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Aquila Tax-Free Trust of Arizona
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Interviewer:
Today we're talking to Tony Tanner, portfolio manager of Aquila Tax-Free Trust of Arizona. There have been reports that the Fed will be patient in regard to near-term changes in the Federal Funds rate. What are your expectations for Fed policy over the course of 2019, particularly as that policy might affect municipal bond investors?

Tony Tanner:
Well I certainly expect that the Fed is going to be more cognizant of market conditions in 2019. I think the autopilot stage of their campaign to raise rates has come to an end. There's certainly a dichotomy between what the bond investing professionals believe is going to take place versus some of the more recent Fed dot plots, but it's very unlikely you're going to see multiple increases in the Fed Funds Rate this year. Most of the common thinking is possibly two semiannual increases this year. But quite frankly, given that inflation not only remains under control at around 2%, but the fact that expected inflation has been declining gradually throughout the fourth quarter 2018, and economic growth is already forecast to decline slightly in 2019 and 2020, it's much more reasonable to expect that the Fed is going to be on hold for a considerable amount of time.

Interviewer:
There was a significant decline in the supply of municipal bonds in 2018 largely due to the elimination of advanced refunding bonds. What are your expectations for supply in 2019?

Tony Tanner:
Well in 2018, total supply came in at right around $340 billion, which was indeed about 25% below the total of $450 billion for 2017. The fourth quarter of 2017, there was indeed a rush to sell advanced refunding bonds in advance of prospective tax law changes. For this year, I don't expect there to be a whole lot of deviation in supply. Quite frankly, those changes in national supply don't have a very meaningful effect on bond price and yield levels, nor in selection. Curiously, we had a significant drop off from quarter to quarter in fourth quarter issuance here in Arizona and nationally, and yet for the majority of the quarter, bond prices were falling and yields were rising. So there's a lot less correlation and influence on bond prices and yields, by supply levels, than is often perceived in the popular press.

Interviewer:
How would you characterize the tone of the municipal bond market currently? Are you seeing any particular opportunities or areas of concern?

Tony Tanner:
Well the bond market itself is very firm right now with market yields having declined from their peaks in the middle of the fall but still remaining above where they began 2018, so they still represent a lot of opportunity. Virtually all reports and measures of state and local government finances are showing continued strength and improvement. The Urban Institute recently put out a report on state and local government revenues and showed that year-over-year growth as of, I think, the second quarter of 2018 was on average about 7%. For the most part municipal revenues have surpassed their pre-recession peaks and show healthy growth with no real signs of distress, save for maybe some small pockets of pension concerns. But in general though, the economy has certainly strengthened and bolstered

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municipal state and local government finances.

Interviewer:
The word volatility is cropping up frequently in the press, particularly in relation to equities. How does volatility in the municipal market compare with that of other types of investment securities?

Tony Tanner:
Well municipal bonds by their nature have much less variation in their market values than do equities and quite frankly than a lot of other fixed income asset classes, such as corporate bonds and higher yielding bonds. Unfortunately, the word that doesn't crop up in the financial press is 'rebalance'. The fourth-quarter demonstrated what are the real genuine diversification benefits of municipals and fixed income, and that's the fact that over the long-run and in periods of acute volatility, they tend to have much less, if not negative, correlation with what equity prices are doing. Having a really generally diversified multi-asset class allocation to both fixed income and equities is very important. The fourth-quarter demonstrated a great example where stock prices began to come off their highs in the middle of the fall in October and November while at the same time fixed income prices and particularly municipal bond prices were declining and those yields were rising as investors were more focused on what the Fed was doing. Taking a step back and realizing that you could get out of, or reallocate some portion of, your equities into muni's at a time that they were yielding well north of 3% is a terrific opportunity. While volatility is, at least within the financial press the connotation is, a bad thing, volatility in the equity markets often presents great opportunity on the fixed income side.

Interviewer:
Tax returns being filed this coming April will provide investors with some clarity on the impact of the Tax Cuts and Jobs Act. How are you expecting to see the upcoming tax season play out for the municipal bond market?

Tony Tanner:
Well I think it's going to reinforce the value of the tax exemption both at the federal and state level. I just came from a presentation earlier in the week where the New York City based chief strategist of a very large Wall Street asset manager pointed out the fact that he got an unpleasant call from his tax attorney the third week of December saying he owed a lot more than he was expecting because of the limitation on state and local tax deductions. So I think that as the tax season plays out, it's going to illuminate and redirect investor attention towards the benefits of federal and state tax exemption, in many cases, on municipal bonds.

Interviewer:
Would you describe your current strategy and the positioning of the fund?

Tony Tanner:
The positioning of the fund is pretty consistent as an all investment grade, intermediate portfolio. It pretty much consistently has an average final maturity in the 11 to 12 year range, and an average duration in the five year range to five and a half year range. From a strategy standpoint, I'm paying attention to the fact that, since the end of January of last year, the yield curve hasn't so much flattened or increased, as it's twisted. Since January 31st, the Fed has had four separate interest rate increases totaling 100 basis points. In that time, some portions of the muni yield curve, such as the area under five years and the area out 15 to 20 years, yields have risen slightly, whereas in the very middle of the curve those bond yields have actually declined slightly. I'm focused on where the cheap portions of the maturity curve and yield curve spectrum are. That changes over time and throughout the year, so it's much more of a value focus; stay broadly diversified not just across credits, but also across interest rate exposures.

Interviewer:
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