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Muni Bonds Headed for a Rough Patch.

Turbulence is in store for municipal-bond investors following a record run, as a gathering U.S. economic recovery pushes interest rates higher and issuance grows.

In February, municipal debt posted its first monthly decline in returns since December 2013, bringing an end to a record-tying 13 consecutive months of gains. The market this year is off to its worst start since 2008, returning 0.14%, including price appreciation and interest payments, according to Barclays PLC.

“I think volatility is probably going to be the theme for this year,” said Peter Hayes, head of municipal bonds at BlackRock Inc., which has about $116 billion in tax-exempt debt.

Pressuring the $3.6 trillion municipal-bond market is a surge of new issuance by cities, states and other government entities, which sold about $68.5 billion in bonds this year through Friday, according to Thomson Reuters data. That is a record for the period and 88% increase over a year ago.

Many issuers have taken advantage of low yields to refinance outstanding debt, reducing interest payments and shoring up their fiscal health. The flood of new debt is driving municipal-bond prices lower. Yields rise as prices fall.

At the same time, long-term interest rates have begun to pick up following a steep decline, as the U.S. economy gains steam. That has raised prospects that the Federal Reserve may start increasing interest rates as soon as June, undermining the value of outstanding bonds.

The Fed’s monetary stimulus following the 2008 financial crisis has been a big factor pushing up prices in global bond markets.

The 10-year U.S. Treasury yield on Friday hit 2.25%, its highest since December, following the latest strong U.S. jobs report. Despite the February wobble in returns, yields on municipal bonds remain near five-decade lows.

The wave of debt issuance and rising rates has some investors worried that the municipal market could stumble as it did during 2013’s selloff, which was triggered when the Fed began discussing plans to end its massive bond-buying program.

There are seasonal factors are work as well: Muni-bond prices tend to slump in the spring as investors sell securities to raise money for tax payments, said James Iselin, head of municipal fixed income at Neuberger Berman Group LLC, which manages about $9.5 billion in state and local debt.

If demand wanes amid uncertainty about the Fed’s next step, that could put additional pressure on prices.

“My confidence that the market can power through it is less than it was at this time last year,” Mr. Iselin said.

The longest winning streak since 1992 lifted municipal bonds to a 9% return in 2014, outpacing gains in corporate and U.S. government debt.

The broad debt-market rally last year fueled a surge of investor funds into municipal bonds, many of which are considered as safe as Treasurys because they are backed by tax revenue. Investors also like the bonds because they provide tax-exempt income.

Investors are still seeking out such debt, dropping about $7.26 billion into municipal-bond mutual funds in 2015 through February, far ahead of the $1.75 billion that flowed into these types of funds in the same period of 2014, but behind 2013’s $9.3 billion, according to Lipper data. The pace has slowed in recent weeks, however.

BlackRock’s Mr. Hayes said he is taking advantage of recent weakness to buy new bonds from large issuers such as New York, California and Georgia at better yields. Higher yields and lower prices could also mean a buying opportunity for individual investors, he said.

He also said he believed last year’s price rally made many bonds overvalued, contributing to the recent retreat.

Rising rates could also affect the supply of new bonds and slow the “red-hot” issuance seen this year, according to Chris Mauro, head of U.S. municipal strategy at RBC Capital Markets.

“To me, this looks eerily similar to 2013, where you had heavier-than-expected issuance in the first part of the year and then it diminished in the second,” he said.

A Citigroup Inc. report in February predicted about $35.5 billion in March issuance and $380 billion for 2015. Issuance was $27.3 billion last March and $314.9 billion for 2014, according to Thomson Reuters. Sluggish issuance in the beginning of last year helped propel 2014’s rally, with demand for bonds outstripping supply.

Jim Kochan, chief fixed-income strategist at Wells Fargo Asset Management, said bond markets started 2015 priced for weak economic data, and Treasurys attracted buyers from outside the U.S., helping to sustain the rally into January. That created the space for a pullback in February, he said.

“March is going to be volatile,” he said. With U.S. employment growth and wages having picked up in recent months, investors will increasingly have an “eye toward when the Fed is going to start raising the funds rate.”

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