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Bond Rout Pummels Muni Funds.

Investors are slashing bond holdings and questioning whether tax changes will dull muni demand

Money is pouring out of municipal bond funds at the fastest pace since the 2013 “taper tantrum” as investors slash bond holdings and wonder about potential changes to the tax code.

Investors pulled $3 billion from muni bond mutual and exchange-traded funds the week after the presidential election, the largest such withdrawal since June 2013, according to EPFR Global and Bank of America Merrill Lynch. The $7.3 billion iShares National AMT-Free Muni Bond ETF, ticker MUB, has fallen 3.4% this month and is on pace for its sharpest monthly drop since Sept. 2008.

Municipal bonds are considered nearly as safe as Treasurys, since the debts are backed by the revenues of states, cities or services. Investors also like munis since interest payments are typically free from federal taxes. But in a stark reversal from earlier this year, when muni fund assets hit an all-time record, what were viewed as perks have turned into reasons to sell.

Municipal bond investors have taken cues from U.S. government bonds, which have been hit by heavy post-election selling. The yield on benchmark 10-year Treasury note rose to 2.411% on Wednesday from 1.867% on Election Day.

Meanwhile, investors are considering whether a package of tax cuts eventually passed by Congress could diminish the after-tax yield advantaged that munis hold over comparable Treasury bonds.

“The municipal market appears to have already priced in a significant cut in federal tax rates,” wrote Guy Davidson, chairman of the tax-exempt fixed income investment policy group at AB, the investment firm known until recently as AllianceBernstein.

The idea is that lower marginal tax rates could prompt the highest-earning investors to put their money elsewhere. At the same time, institutional buyers of muni bonds — banks and insurance companies — could find them less advantageous should corporate tax rates fall.

“Given the recent spike in yields and the murky policy picture, tax-exempt municipals may face continued near-term volatility,” said David Hammer, head of municipal bond portfolio management at Pimco.

Such volatility is evident in muni-bond closed-end funds that own municipal debt. Unlike mutual funds and ETFs, closed-end funds have a fixed number of shares and sentiment changes can swing prices of the securities to premiums or discounts to the value of the fund’s holdings. The discount of the $2.7 billion Nuveen Quality Municipal Income Fund, ticker NAD, has widened to 8.8% from 6.6% in September, according to Morningstar and Nuveen.

Market watchers caution that, historically, changes to taxes have had little impact on the municipal bond market. Vikram Rai, who heads municipal strategy at Citigroup, said that changes to the top marginal tax rate for municipal bonds since 1980 has fluctuated with “no correlation” to retail demand.

Still, Mr. Rai recently warned that muni bonds are likely to be under pressure as long as Treasury yields are on the rise.

“Municipal yields have been unsustainably rich for an extended period of time due to large inflows into this asset class driven by a reach-for-yield,” Mr. Rai wrote. “We are quite pessimistic that municipal funds can endure the size of backup which seems to be taking root in Treasuries.”

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