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Junk Munis Head for First Drop in Six Months on Slowing Demand.

- **Bloomberg Barclays high-yield index is down 0.09% this month**
- **Despite slowing inflows, Parametric not expecting outflows yet**

The riskiest debt in the $4 trillion municipal-bond market is headed for its first monthly drop since February as the resurgence in Covid-19 cases in the U.S. increases uncertainty around the nation's economic recovery.

The Bloomberg Barclays High Yield Index, which includes debt from convention centers and airline-backed projects, is down 0.09% this month. Investor appetite for the riskiest state and local debt is showing signs of slowing as inflows into high-yield muni mutual funds have fallen in five of the past six weeks, according to Refinitiv Lipper US Fund Flows data. High-yield muni mutual funds saw a $389 million inflow for the week through Aug. 18, the lowest in seven weeks.

"What caused the weakness is simply the Treasury yields rose a little bit and you have more uncertainty about the virus," Kathleen McNamara, senior municipal investment strategist at UBS Global Wealth Management, said in an interview. "Those two things weighed on the market. It was due to take a little bit of a breather."

High-yield munis have delivered outsized returns all year as the market rallied while yields on top-rated state and local debt stayed near record lows. Junk muni bonds surged as the U.S. economy reopened earlier this year and more Americans boarded planes, conventions restarted and office workers returned to high-rises thanks to the vaccine roll out. Now the resurgence of Covid-19 amid a slowdown in vaccinations and the emergence of the delta variant, is raising questions about the return to normal.

Last week, Nuveen said it plans to shut its high-yield municipal bond fund, the biggest focused on state and local government junk bonds, to new investors after the end of next month. The move follows a similar step by rival Invesco Ltd., which closed its $11 billion high-yield muni fund to new investors.

After five straight months of high-yield muni index returns topping 1%, "it's not surprising to see some fatigue in August," said Gabe Diederich, a portfolio manager for Robert W. Baird, which has $9.6 billion in muni assets.

"The tailwind of improved fundamentals, cash inflows, reopening and potential tax hikes set up lower quality municipals for a strong performance run," Diederich said. "In recent trading sessions, it does seem as though the market is looking for additional clues on economic openness as well as monetary and fiscal policy."

Some high-yield bonds are seeing spreads widen from just two months ago. For example, the spread on 30-year bonds issued in March 2020 by Illinois's Metropolitan Pier & Exposition Authority for the expansion of McCormick Place, the largest convention center in North America, was 55 basis points over benchmark on Aug. 16, compared to 46 basis points in June.

The decline in high-yield munis could be temporary, according to Nisha Patel, a portfolio manager at Parametric Portfolio Associates LLC. They are still the best performing class within fixed income. There's the prospect for higher tax rates, which bodes well, and lots of cash waiting to be invested as supply of new debt has lagged demand, she said.

"Outside of economic data deterioration, I don't see how we see massive outflows as of now," Patel said.

"Investors are just taking some pause here," Patel said. "Munis are having a hard time continuing to grind lower in spreads" because investors are starting to question if the income they are getting is worth the higher risk, she said.

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