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Muni Funds' Inflows Face 2022 Headwinds With Fed Shifting Course.

- **More than $96.8 billion went into muni funds and ETFs in 2021**
- **'Significantly lower' muni inflows likely in 2022: Parametric**

Municipal investors, who poured a record amount of cash into the $4 trillion market for state and local debt last year, aren't expected to push inflows to new heights in 2022.

Muni mutual funds and exchange-traded funds took in about $96.8 billion in 2021 through Dec. 29, the highest on record for the period, according to Refinitiv Lipper U.S. Fund Flows preliminary data. Investors seeking higher yield amid historically low interest rates were lured in by issuers' improving credit quality from a rebounding economy and billions in federal aid.

However, inflows could slow if rates begin to rise mid-year and the market experiences volatility it hasn't seen recently, said Jamie Iselin, head of muni fixed income for Neuberger Berman, which holds more than $12 billion in muni assets. The potential for weaker demand looms as a crucial factor for the performance of the muni market in 2022, with some analysts forecasting a third straight year of record issuance.

Even with unknowns about the pandemic and economy in 2021, investors had some assurance of accommodative monetary policy to help bolster muni inflows, Iselin said. That momentum of inflows could extend into early 2022, especially as investors seek some shelter from high taxes, a long-standing benefit of investing in the muni market. Money is expected to flow in, but likely at a slower pace later in the year.

"We don't see 2022 inflows matching 2021, which ended up being a record year," said Nisha Patel, a managing director for Parametric Portfolio Associates, which holds $43 billion in muni assets. "2022 inflows will likely be significantly lower."

The risk of an outflow cycle seems greater in 2022 if "any sustainable and sharp rise in rates" occurs, Patel said. The steady drip of muni demand, particularly from retail investors, usually doesn't stop without a notable disruption, and the gradual increase in Treasury rates during 2021 did not serve as that, said Vikram Rai, head of municipal strategy for Citigroup Inc.

"We have had a very long period of inflows in the muni market," Rai said. "We are very dependent on what happens in the Treasury market."

Through all of 2021, the yield for 10-year Treasuries ranged between 0.91% to 1.74% and the muni benchmark between 0.66% and 1.23%. However, a 45-basis-point move in the 10-year Treasury or 35-basis-point change in the 10-year AAA muni benchmark in one month could serve as a catalyst, Rai said.

Investor demand has been a supportive factor as muni market valuation got richer in 2021, said Mikhail Foux, head of municipal strategy at Barclays Plc. Volatility spilling over from the Treasury market and demand that’s “relatively robust” — but not strong enough to match the record — could mean more difficulty in making calls in the market and less margin for error, Foux said.

The future of federal legislation such as the House of Representatives’s version of the Build Back Better economic package, which includes an expansion of a state and local tax deduction, would also impact demand, Foux said. The signature bill from President Joe Biden has stalled in Congress amid a lack of support for its $2 trillion price tag, and whether the measure will make it into the final legislation is unclear.

Likewise, an adjustment in the so-called SALT cap could affect muni demand if the 2017 tax law change is revised. The cap — which limits state and local tax deductions to $10,000 — is unpopular with wealthier Americans who have since turned to tax-exempt bonds to ease the impact on their tax bill. The lack of a change so far has helped demand, said Dan Solender, director of tax-free fixed income investments for Lord, Abbett & Co., which holds $36 billion in muni assets.

“2022 should still be a strong year for demand but it’s not likely to be the record one like 2021,” Solender said.

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