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Munis Seen Enduring Another Span of Underperformance Before Fed.

- **January's 2.7% loss compared with 1.9% decline for Treasuries**
- **Muni fund outflows fueling 'huge supply-demand imbalance': Rai**

The municipal-bond market may extend its underperformance versus Treasuries through February as jittery investors yank money in advance of a widely expected Federal Reserve interest-rate increase next month.

U.S. state and city debt has joined a broad bond-market selloff to start 2022, triggered by elevated inflation and concern over the Fed's path. Muni yields enter February close to the highest since April 2020, leaving the securities roughly the cheapest relative to Treasuries since late 2020, data compiled by Bloomberg show.

Munis have trailed Treasuries to start the year, after outperforming in 2021, as investors started cashing out. Muni mutual funds saw $1.4 billion withdrawn in the week ended Wednesday, the biggest outflow since April 2020, according to Refinitiv Lipper US Fund Flows data.

"It's all about rates, right? Rates have sold off and fund outflows have started," said Vikram Rai, head of the municipal strategy group at Citigroup Inc. "When mutual fund outflows start, it causes a huge supply-demand imbalance, meaning that demand kind of just disappears."

As the market braces for a projected Fed hike as early as March, Rai says the underperformance could persist for the "next four weeks at least."

State and local debt posted a 2.7% loss in January, while Treasuries slid about 1.9%, according to Bloomberg index data.

That marks a reversal from 2021, when munis lured a flood of cash in part as federal lawmakers debated raising income levies on the wealthy. That backdrop helped keep municipal yields low and made the debt relatively expensive, said Peter Block, a managing director at Ramirez & Co.

Some money managers are starting to see an opportunity in the slide, especially with Treasury yields having plateaued in recent days, at least temporarily. Citgroup's Rai said he's telling clients to buy now, but to keep cash handy in case the market cheapens further.

In the market's favor, municipal credit remains robust, with the economy on the mend and federal pandemic relief replenishing the coffers of states and cities. And bond issuance continues at a steady clip, showing local governments have the need and confidence to take on new projects.

"Deal flow continues to be solid," Leslie Martin, a tax-exempt portfolio manager at Cavanal Hill Investment Management, said via email. "We expect this will continue as state and local governments have a backlog of delayed capital projects."

But some investors, especially individuals, may not be ready to dive back in just yet until they have a stronger sense that the bond market has stabilized.

“As investors see the negative total returns, they panic and pull money from munis,” she said.

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