
Vanguard's Muni Head Sees Risk-Off Mood Prevailing With Fed Hiking.

- **Tone may persist 'until you re-establish the inflow pattern'**
- **Signposts to follow include reduced volatility, Malloy says**

Municipal-bond investors have plenty to absorb lately, from soaring oil prices to accelerating inflation. But Vanguard Group's Paul Malloy says the focus should be on market volatility and the path of the Federal Reserve.

With investors bracing for the central bank to start lifting interest rates next week to combat the highest inflation in decades, munis have joined a broad bond-market slump. The Bloomberg Municipal Bond Index is down 3.9% in 2022, trailing a 3.4% drop in Treasuries, which have benefited from haven buying amid the war in Ukraine.

As Vanguard sees it, the turbulence roiling markets from equities to Treasuries has spooked muni investors, a mostly risk-averse group that focuses on generating tax-exempt income from assets that don't swing much. Investors have pulled about $12.1 billion from muni funds this year through March 3, Refinitiv Lipper data show. The outflows may persist until volatility ebbs and investors get a clearer idea of when the Fed's anticipated rate hikes will end, Malloy says.

"They are in a risk-off mood because of rising interest rates," Malloy, whose firm held about $258 billion of muni assets as of Feb. 28, said in an interview Thursday. Volatility also "means risk-off for the time being. There's just a lot of uncertainty out there until you re-establish the inflow pattern back into the municipal market."

Malloy spoke on a day of losses for Treasuries, with 30-year yields reaching the highest since May after the latest inflation data. With munis underperforming, the market for state and city debt has cheapened in relative terms. Citigroup Inc. said this week that it may be time to buy.

Malloy sees munis as being closer to fair value, but he's reluctant to call them cheap because Treasury yields have been a moving target, which makes assessing value more difficult. He says munis also become harder to hedge given that volatility.

And with retail buyers still balking, that leaves money managers waiting for stability in markets to assess when the tide will change.

"You are looking at signposts," Malloy said. "The signposts are reduction in volatility, a little bit more clarity on the Fed hiking path, which we have not even started yet."

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