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- **'There's still potential for more pain' with Fed set to hike**

Municipal bonds are heading for their worst start to a year on record, and fund managers say nailing the direction of the $4 trillion market from here likely has little to do with the fiscal health of U.S. states and cities.

It's all about the broader rates market, say portfolio managers including Julio Bonilla at Schroders Plc. And with the fixed-income universe still solidly on the defensive amid speculation the Federal Reserve will opt for an aggressive rate hike next week to combat soaring inflation, that means the slide in munis probably isn't over.

"There's still potential for more pain in the muni market," Bonilla said. The crucial backdrop for him is that Treasuries will remain under pressure as the Fed starts shrinking its balance sheet and as its rate increases boost currency-hedging costs for overseas investors.

Munis have lost 8.7% in 2022, an unprecedented decline for the first four months of the year, according to data compiled by Bloomberg. The broader U.S. bond market has declined even more, falling 9%.

Longer-term benchmark municipal yields have risen to the highest since March 2020, pushing investors to yank billions of dollars from muni mutual funds. Cities and states are finding that they're paying up to get muni deals off the ground as a result.

There's a divide emerging between Wall Street analysts and investors about how to approach the muni market now. Some bank strategists have been more positive lately: Citigroup Inc. and Bank of America Corp. this week both said the market will get support around mid-year, a period when investors traditionally receive principal and coupon payments that they may look to reinvest. Truist Financial Corp. said this week that munis are poised to outperform.

But outflows continue. Investors pulled about $2.9 billion from municipal mutual funds in the week through Wednesday, marking 11 straight weeks of outflows, according to Refinitiv Lipper US Fund Flows data.

And the broader force of rising interest rates has shown a strong precedent this year of overwhelming technical forces like supply and reinvestment trends. Take January, one of the muni market's best months historically because of light supply and strong investment demand. This year, munis fell 2.7% in January, whereas the 10-year average for the month is a gain of 1%, Bloomberg index data show.

Brad Libby, portfolio manager of the $1.8 billion Hartford Municipal Opportunities Fund, said the market could be "closer to the end" of outflows given how high rates are. But he said red-hot inflation is the key risk that could cause the cash exodus to continue.

“If we get to a point where the market is comfortable that rate levels have stabilized and inflation has peaked and going to come down from its historically high levels, I think you’ll find some traction in the market,” he said.

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