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Investors Dip Back Into Municipal Bonds.

Exchange-traded funds see record inflows as muni prices rebound after mostly falling all year

Investors are creeping back into the municipal-bond market, eager to take advantage of bargains.

Municipal-bond exchange-traded funds took in a record $1.8 billion for the week ended May 25, quadruple their weekly average for 2022, according to data from Refinitiv Lipper. Municipal-bond mutual funds continued to lose investor cash, but outflows fell to their lowest level since March.

Prices climbed as buyers ventured back in, with municipal bonds returning 2.9% from May 18 through Thursday, according to Bloomberg index data. Nuveen LLC, one of the largest managers of municipal bonds, said it plans this week to reopen its national and California high-yield funds, which closed to new investors last summer as prices skyrocketed.

Municipal bonds have returned minus 7.59% this year as of Friday, counting price changes and interest payments, according to Bloomberg index data from FactSet, pulling slightly ahead of other fixed-income investments. The Bloomberg U.S. Aggregate Bond index—largely U.S. Treasurys, highly rated corporate bonds and mortgage-backed securities—has returned minus 8.47% this year through Friday.

“I think things are turning around. I don’t think it’s a blip,” Municipal Market Analytics partner Matt Fabian said of the rally. “I think munis had gotten too cheap.”

A contributing factor in municipal bonds’ rise: They are in high demand in early summer when a swath of outstanding municipal debt gets paid off and investors need new sources of tax-free income. High-net-worth investors favor the roughly $4 trillion market for state and local government bonds because the interest they throw off is typically exempt from federal and often state taxes.

Muni prices have been dropping fairly steadily all year as yields rose in response to Federal Reserve efforts to rein in inflation. The prospect of newer, higher-yielding debt flowing into the market caused outstanding lower-yielding debt to lose appeal for investors. Bond prices fall as yields rise.

Part of the downward pressure on muni prices came from steady mutual-fund outflows, which amount to more than $40 billion so far this year, according to Refinitiv Lipper. Mutual funds control nearly $1 trillion in outstanding municipal bonds, according to Fed data. When those investors pull their money in unison, fund managers must come up with the cash quickly.

The record inflows into exchange-traded funds, which unlike mutual funds can be bought and sold at any time of day, likely reflect purchases by younger or more nimble investors, Mr. Fabian said. Some of the cash might also come from mutual-fund managers temporarily parking investors’ money while they look for bonds to purchase, he said.

Many remain wary of declaring the 2022 bond rout over. Economic turbulence, volatile bond rates, or more bond issuance than expected could push prices downward, Mikhail Foux, head of municipal strategy at Barclays PLC, wrote in a research report Friday. “The market is not out of the woods as of yet.”

But municipal credit has remained strong, with states, cities, and school districts flush with tax revenue from the Covid-19 recovery and federal aid from pandemic rescue packages. That creates an incentive for investors to tiptoe back into the market as prices drop, and increasingly they have.

One early entrant was New York state resident Jonathan Kahn, who said he bought his first muni bond in two years on April 6. Before purchasing a bond, Mr. Kahn said, he typically checks public trade data posted by the Municipal Securities Rulemaking Board, a self-regulatory organization, to see how much a dealer last paid for the security. Unlike in the stock market, there is no publicly searchable daily price information for municipal bonds, and many trade infrequently. Debt is issued by about 35,000 different borrowers ranging from states to sewer districts and rural hospitals, according to Municipal Market Analytics.

Mr. Kahn said that before April the last time he found a bargain was March 2020, when the onset of the Covid-19 pandemic prompted market panic and muni prices cratered. Over the past two months, Mr. Kahn said he has made 15 purchases in the muni market.

“It’s an open question as to how long yields will continue to go up and prices will continue to remain attractive,” he said.

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By Heather Gillers

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