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Volume Predictions Plunge.

Municipal bond pros are slashing their forecasts for long-term issuance this year, saying the industry is likely to shrink after climbing interest rates curtailed demand for refundings.

Most industry watchers now expect total issuance for 2013 to weigh in closer to $300 billion, down from totals nearer to $400 billion that had been predicted as the year began.

BlackRock, which anticipated in January that $388 billion would reach the market in 2013, has lowered its estimate to $345 billion. Municipal Market Advisors says 2013 issuance could tumble below $325 billion, which would represent the second lowest level in a decade. Citi's number falls even lower, at $320 billion, and that assumes the pace of refundings will pick up.

"We're in a higher interest-rate environment; rate volatility has remained elevated," said Sean Carney, BlackRock's muni bond strategist. "So, issuance will be down. And the two have certainly curtailed the current refundings, either delayed them or shelved them altogether in 2013."

As a result, issuers will not only be less encouraged to start needed infrastructure projects, but the market is likely to contract, Carney said.

"It's still going to be a net-negative year," he said. "We predict the muni market will shrink by $20 billion in size, which in a $3.7 trillion market is not huge. But it's the trend that there's more coming out of the market, via calls, redemptions and maturities than bonds coming to the market."

Investors in a market primed for a drop in issuance could weather more outflows from muni bond funds without an appreciable selloff, Citi Municipal Analyst George Friedlander wrote in a research report. "With issuance that much more infrequent," he wrote, "the market may well be in a position to hold in or even rally modestly despite continuing muni fund outflows."

Volume through August has fallen by 12% from the same period in 2012, to $225.9 billion from $257.6 billion, Thomson Reuters numbers showed.

Refundings are down 29% over the span, to $80.5 billion from $113.3 billion in 2012. New money deals are up 5% through August 2013, to $100.4 billion from $96.1 billion a year earlier.

The fall in refunding numbers makes sense, in light of this year's climb from historic lows in muni yields, analysts say. The 10-year triple-A yield has rocketed 117 basis points since the start of May, to 2.83% by Friday's close, according to Municipal Market Data.

The 30-year has surged 160 basis points over the period to 4.39%. The two-year yield has increased to 0.43%, a 14-basis-point rise.

The calendar through August stands at roughly 96% of the year-to-date average for the last four years, Matt Fabian, managing director at Municipal Market Advisors, wrote in a research report. Issuance in 2013 won't reach $325 billion, should it continue at its current sluggish pace, he added.

“We are thus on track to notch the second lowest year for issuance in the last decade,” he wrote, “2011 was the lowest at $287 billion.”

Fewer refundings account for the difference, agreed Fabian, Carney and Friedlander. As issuance fell 38% last month from August 2012, refundings fell 77%. By comparison, new money deals decreased 7%.

Refis represented a sizable chunk of the calendar in August 2012, at 45%, against 16% of the total last month.

“With yields on the long end at 5% or higher in a number of sectors, and above 4.5% in many more, refundings simply do not make financial sense for a large proportion of potential refunding candidates,” Friedlander wrote.

Citi recently fixed its issuance estimate at $320 billion. But as issuance through August fell more than $31 billion short of the total for the first eight months of 2012, Friedlander wrote, the current pace of refundings and new-money issuance would bring volume in 2013 to $308 billion.

Sales in tax-exempts have fallen 15% for the year through August, MMA’s Fabian noted. And the whole of that decrease involves credits extending out no further than 15-year maturities.

“Note that, we also show a dramatic drop in advanced refunding economics over the summer, implying no ready uptick in longer sales or pre-re generation,” Fabian wrote. “And, of course, new money issuance remains mired at 1997 levels.”

Until state and local hiring appears to improve, he expects no real increase in public infrastructure financings.