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Wall Street Owning Least Since 2002 Speeds Retreat: Muni Credit.

Wall Street securities firms are pulling back from the $3.7 trillion municipal market at the fastest pace since 1986, helping fuel the worst performance in U.S. local debt in more than a decade.

Brokers and dealers held $19 billion of city and state debt as of June 30, the least since 2002 and a 39 percent drop from three months earlier, according to Federal Reserve data released Sept. 25. It was the steepest quarterly decline since 1986 for the tax-exempt market's middlemen, who typically provide a buyer base during times of stress.

The companies have unloaded further since July, even as municipal debt rebounded after the Fed unexpectedly refrained from reducing its monthly bond purchases, data compiled by Bloomberg show. The retrenchment can increase price swings and elevate the yield levels at which certain buyers will emerge, said Peter Hayes, head of munis at New York-based BlackRock Inc. (BLK:US), which manages $109 billion of local debt.

"When we do see market dislocation, it's probably going to be exacerbated because of the lack of liquidity," Hayes said. "It's going to take a bigger price adjustment or yield movement to attract the value buyer, and for the municipal market, that means the cross-over buyer."

Even with a rally this month, the municipal market has lost 3.3 percent this year through Sept. 25, the biggest tumble since the same period in 1999, Bank of America Merrill Lynch data show. Individuals have joined Wall Street firms in the exodus from local debt, withdrawing a record $43.7 billion from muni mutual funds in 17 straight weeks through Sept. 18, according to Lipper US Fund Flows data.

"We are looking at a somewhat less liquid market, and I'm not sure that changes just because the market stabilizes," said George Friedlander, chief muni strategist at New York-based Citigroup Inc.

With heightened volatility, brokers and dealers are inclined to thin inventories to lessen vulnerability to munis, said Matt Fabian, managing director of Municipal Market Advisors in Concord, Massachusetts. That inflates the cost of borrowing for states and cities, he said.

"It's the legacy of the financial crisis," Fabian said, referring to the 18-month recession that ended in June 2009. "Munis are more expensive from a risk-management perspective. The main concern would be that if the market does weaken, their cost of borrowing will rise faster."

By one measure, 10-year muni yields have been the most volatile in four years. Ninety-day volatility has approached 40 percent since June, almost double the level at the start of the year, and the highest since mid-2009, data compiled by Bloomberg show.

Localities sold about $224 billion of long-term debt this year through Sept. 20, the least in two years. Sales this year are about 13 percent less than the same period of 2012, Bloomberg data show.

“Issuance is likely to remain weak or lower through the rest of the year,” said Michael Decker, co-head of the Securities Industry and Financial Markets Association’s municipal securities division. “So there will be less trading activity and as a result, there will be smaller dealer positions.”

The sales calendar remains slower than average. Issuers from California to Connecticut plan to offer $8.9 billion of long-term debt in the next 30 days, compared with a five-year average of almost $10 billion.

As borrowings slowed, the municipal market shrank about 0.2 percent to $3.72 trillion in the three months through June, the Fed data showed. Households owned about $1.65 trillion of the securities, the least since 2007.

While securities firms and households have been cutting holdings, U.S. banks and depository institutions are buying the most ever.

Banks have added local debt every quarter for the past four years, to about $390 billion as of June 30, almost double what they held at the end of 2007.

That trend may persist, especially if muni yields stay above interest rates on Treasuries, Decker said.

“Banks are flush with cash,” Decker said.

Municipalities plan to issue about $4.1 billion of long-term debt next week, the slowest non-holiday period since August, even as yields are the lowest since June. At 2.69 percent, benchmark 10-year yields compare with 2.65 percent on Treasuries with a similar maturity.

The ratio of the yields, a gauge of relative value, is about 102 percent, compared with a 10-year average of about 95 percent. The higher the figure, the cheaper munis are compared to federal securities.

By Michelle Kaske September 27, 2013