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Analysis: Little Respite Seen for U.S. Municipal Bonds in 2014 – Reuters.

(Reuters) – The withering U.S. municipal bond market will shrink even more well into 2014, with interest rate and credit risks keeping both investors and borrowers away.

Barring an unforeseen turnaround in the final weeks of 2013, municipal bonds will post their first negative annual performance since the financial crisis, with investors fleeing municipal funds at a record pace and the market's overall size, now less than $3.7 trillion, contracting for a third straight year.

Analysts, portfolio managers and traders say concerns about the Federal Reserve scaling back its massive stimulus, and about the financial soundness of state and local governments, will keep hitting the market at least through the first half of next year. They expect debt issuance to fall further and investors to continue exiting bond funds.

"There are two themes that occurred this year and they're going to carry on to next year," said Chris Alwine, head of municipal bonds at The Vanguard Group, which has $100 billion in assets. "The big news in the muni market was the back-up in rates and the underperformance of the long end of the curve."

Municipal bond yields shot up this year on the Federal Reserve's talk about tapering its monthly purchases of Treasuries and mortgage-backed securities, news of Detroit's bankruptcy filing and Puerto Rico's budget woes. Demand plummeted as investors moved into more promising equities. Supply followed, with outstanding municipal debt hitting its lowest level in nearly four years.

As for performance, the Bank of America Merrill Lynch master municipal index has fallen 2.84 percent this year, putting the market on track for its first negative total return since 2008. Its index of bonds with maturities 22 years or more is down nearly 6 percent.

"Altogether, 2014 will likely be another down year for munis," wrote Thomas Weyl, credit analyst for Barclays Capital in a note. "As we contemplate the taper and rising interest rates, as well as continued municipal mutual fund outflows … it is hard to see the light at the end of the tunnel."

BOND SALES SEEN DECLINING, FUND OUTFLOWS PERSISTING

Total municipal issuance will likely tumble to $349.5 billion in 2014 from the $366.1 billion it projects for this year, according to the Securities Industry and Financial Markets Association's (SIFMA) recent survey of 11 underwriters and dealers, one of several forecasts for a drop in bond sales.

"Although the overall systemic credit quality of the municipal market is strong, state and local issuers remain pressured by a moderate recovery, and the refunding wave has waned," said Michael Decker, head of SIFMA's Municipal Securities Group.

Rising yields have ended the savings issuers could reap through refinancing existing bonds. Sales of refunding bonds are running 30 percent lower than last year and depressing total issuance, according to Thomson Reuters data.

In fact, sales may not even meet SIFMA's projections for 2013. As of Friday, total issuance for the year was $303.66 billion and sales are only expected to reach $2.5 billion next week.

"In the growth years, 2000 to 2010, you had debt for new infrastructure growing significantly and you had refunding," said Chris Mier, managing director of analytical services at Loop Capital, which forecasts 2014 issuance only at $300 billion. "Now you're seeing … new money volume for these infrastructure projects flat because of the political environment and the aversion for taking out new debt."

On the demand side, net outflows from muni funds – which have already hit a record $52.76 billion this year – could persist for three to six months, said Vanguard's Alwine.

Outflows during the third quarter alone, $32 billion, exceeded total net outflows of any entire year going back to 1992, according to Lipper, a Thomson Reuters company.

Many funds hold Puerto Rico bonds because they are exempt from state and federal taxes, and some outflows were driven by the territory's budget woes. Detroit's bankruptcy filing – the largest municipal one in U.S. history – also led to outflows.

Still, "maybe 80 percent was driven by fears of interest rates going higher," said BlackRock Managing Director Peter Hayes, who heads the firm's municipal bonds group.

There will likely be a modest uptick to start the year, as coupon payments and maturing bonds often give investors cash to put back into funds or individual bonds each January, Hayes said, "but I'm not sure how large or sustained they'll be."

CLARITY FROM THE FED

The Fed's discussion of tapering, which will ultimately lead to rising borrowing costs, is also pushing investors into shorter-term funds, said Michael Rawson, fund analyst for Morningstar Inc. Only two of the 16 municipal bond fund categories the investment research group tracks had inflows this year, with the larger inflow in the short-term category.

"The reaction to the prospect of tapering among retail investors has been pretty violent," said David Santschi, CEO of TrimTabs Investment Research, adding $164.5 billion has left the funds since the start of June. "What will happen when the Fed actually takes action?"

Most on Wall Street expect the Fed to hold off reducing its bond purchases until the first quarter, but there is some risk the central bank could move as early as its meeting next week. Either way, the meeting is expected to bring some clarity to the Fed's timeline.

In the past, municipal bonds outperformed Treasuries when the Fed tightened the money supply, and several analysts look for that scenario to play out again, with some market players eyeing opportunity among the municipal market's fat yields, especially relative to other corners of the bond market.

Currently, highly rated 30-year bonds are yielding 4.16 percent on the benchmark scale set by Municipal Market Data, a Thomson Reuters company, compared with a 30-year Treasury yield of just 3.87 percent. Add in their tax-exempt qualities, and they look even cheaper by comparison.

“Some of the hysteria from 2013 has and will continue to yield good buying opportunities that will benefit from spread compression, even if rates continue to drift higher,” said Michelle Knight, chief economist and managing director of fixed income for Banyan Partners, LLC.

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