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Muni-Bond Market Shrinks at Record Pace.

The U.S. municipal bond market shrank at a record pace in the third quarter, and the amount of bonds held by households, the market's biggest investors, fell to the lowest level in nearly seven years, according to Federal Reserve data released on Monday.

According to figures that raise red flags for the strength of the market heading into next year, the amount of outstanding municipal debt fell to $3.69 trillion, the lowest since the end of 2009, from $3.72 trillion in the second quarter. The $35.3 billion quarterly contraction was the largest going back to 1950 when the Fed started tracking the data on a quarterly basis.

Of the total amount, U.S. household ownership of muni bonds fell by $32.7 billion to $1.64 trillion, the least since the fourth quarter of 2006, according to the Fed's quarterly tally of U.S. financial accounts on everything from stocks to corporate bonds. It was the eighth outflow in the past 10 quarters, and marked a resumption of heavy selling of municipal bonds by households after two quarters of small inflows at the start the year.

"The municipal bond market has been sensitive to both shifts in supply and demand," said J.R. Rieger, vice president of fixed-income indexes at S&P Dow Jones Indices. "Since households are a primary driver of demand for municipal bonds, flagging holdings illustrates a possible headwind for the market in 2014."

Individual investors rushed for the municipal market's exits in the middle of the year on fears about the end of the Federal Reserve's stimulus program. The Fed has been buying $85 billion a month in Treasurys and mortgage-backed securities, a program that has stoked demand for other assets, such as municipal bonds, as investors seek higher returns, and the threat of an end to bond purchases has rattled investors for months.

Detroit's filing in July of the largest municipal bankruptcy in U.S. history, a case that threatens to change some of the long-standing presumptions about the safety of muni debt, has also weighed on the market. Adding to the anxious mood, concerns grew about the financial soundness of Puerto Rico, one of the biggest municipal issuers, with some $70 billion outstanding.

"The third quarter was just a very significant quarter," said Natalie Cohen, senior analyst at Wells Fargo Securities.

Mutual funds, which hold a large amount of Puerto Rico debt, began selling off bonds.

"Once retail opened their statements and saw how much they lost in their funds that perpetuated the selloff," said Cohen. "That makes the issuers more skittish."

Municipal mutual funds dropped $81.9 billion worth of bonds in the quarter, the largest amount shed on records going back to 1976, the Federal Reserve data shows.

The yield on highly rated 30-year munis was 3.83 percent on July 1, the start of the third quarter, on Municipal Market Data's benchmark scale. By the end of the quarter on Sept. 30 it was 4.12 percent, according to MMD, a Thomson Reuters company.

Bond yields and prices move in opposite directions.

The rising yields brought a halt to the refinancing surge and curtailed state and local governments' appetite to take on more debt. In the third quarter, state and local government debt declined at an annual rate of 3.9 percent, after rising about 1 percent in the second quarter, according to the Federal Reserve.

Over the last three years, the level of outstanding debt has fallen in seven of 12 quarters. Before 2013, the largest contraction on record was in the second quarter of 2011, a $29.7 billion drop.

This week municipal bond sales are expected to total $12.6 billion, the largest weekly total this year. The rush comes in the week before the final Federal Reserve policy meeting of the 2013, when top central bank officials are expected to debate when to start winding down bond purchases.

Despite this week's surge in issuance, few expect the level of outstanding debt to rise quickly in 2014. Higher interest rates will likely keep the refunding low, said Cohen.

"I think volume is going to return to lower levels than before the housing boom, lower than before 2001," she said. "It will probably be in the high 200s (billion), not in the 300 to 400 range that we were."