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U.S. Municipal Bond Market Shrinks to Smallest in Five Years: Fed.

(Reuters) – The U.S. municipal bond market contracted to $3.63 trillion in the third quarter, the smallest amount of outstanding debt in five years, according to Federal Reserve data released on Thursday.

The total was only slightly less than the second quarter, when all outstanding bonds equaled $3.66 trillion, the Fed's quarterly report showed.

A year earlier, the market size was $3.68 trillion and in the third quarter of 2012, it was $3.72 trillion.

The size of the municipal bond market peaked in the fourth quarter of 2010, when a rush to sell Build America Bonds helped push the amount of outstanding debt to $3.77 trillion. Falling interest rates at the time kept cities, counties and states hungry to borrow and refinance, and the market held steady at around $3.7 trillion.

But when interest rates began falling more than a year ago, a borrowing binge ended. Since then, the market has steadily diminished, shrinking 2.6 percent from the first quarter of 2013.

Demand from retail buyers appeared to fall alongside supply in the third quarter, with households dropping $155.5 billion of municipal bonds. The Federal Reserve adjusts data on the flows of municipal holdings for seasonal variations.

This marked the 15th quarter in a row that households, the biggest investors in the municipal market, shed their holdings, according to the central bank. In the second quarter, retail buyers dropped $34.7 billion of bonds.

Buying from institutional investors, though, picked up. Banks acquired $34.4 billion municipal bonds in the third quarter, after buying $17.4 billion in the second quarter. Mutual funds acquired $60 billion, compared to $48.7 billion in the previous quarter. Property-casualty insurance companies acquired $2.6 billion and life-insurance companies $4.8 billion.

The contraction in outstanding debt could pause in the near future, as interest rates on municipal bonds have begun falling again.

According to Municipal Market Data, a unit of Thomson Reuters, the yield on a top-rated 10-year bond is currently 78 basis points below where it began 2014. The yield on a highly rated 30-year bond has dramatically plunged, and is now 130 basis points lower than on the first trading day of 2014.

Last week, an industry group forecast total issuance to rise to $357.5 billion in 2015 from $348.1 billion estimated for this year.

BY LISA LAMBERT

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(Editing by Bernadette Baum)