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U.S. Municipal Bond Market Struggles to Find Footing.

NEW YORK, Nov 2 (Reuters) – The typically steady-as-she-goes U.S. municipal bond market is beginning to tread on shaky ground, with continuous mutual fund outflows, weaker prices and rising supply in recent weeks.

That, coupled with an expected bump in year-end tax-loss selling, has made participants cautious in the roughly $3.85 trillion market where states, cities, schools and other issuers sell debt.

“On the munis side of things, there have been some challenges and we’ve seen some of those challenges in the last few weeks,” said Peter Hayes, head of BlackRock’s Municipal Bonds Group.

Rising interest rates and inflation concerns have been alarming investors, while potential volatility tied to the outcome of the U.S. congressional elections next week has also kept market participants on their toes. Added seasonal selling of municipal bonds through the end of the year is fueling yield increases.

In the week ended Oct. 31, muni fund net outflows totaled $1.3 billion, the largest since December 2016, following five consecutive weeks of negative flows, according to Lipper data released late on Thursday. Year-to-date, the S&P Municipal Bond Index was down 0.88 percent.

Through the end of the year, the muni market could see an uptick in investors selling their holdings at a loss as a way to offset tax obligations for gains in other more profitable asset classes, like equities, Hayes said.

Supply of new bonds has started to increase in the last few weeks, after sluggish issuance for most of 2018. However, this latest increase is being met by slipping demand.

“All of those things mean that it will probably take slightly higher yields in order to clear all that paper,” Hayes said.

Signs of weakness in the muni market emerged in early October as investors fixated on Federal Reserve rate hikes and inflation fears.

Large moves up in rates are generally a precursor to outflows, said Barclays municipal credit analyst Mikhail Foux, adding: “And that’s what we have this year.”

Foux said he is watching rates and eyeing next week’s election results.

by Laila Kearney