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Taxable Municipals: High Yields Provide a Rare Opportunity in a Defensive Asset Class

Authors

Jason Kosty
Portfolio Manager

Megan Poplowski
Portfolio Manager

Michael Adams
Institutional Portfolio Manager

In brief

- The taxable municipal bond asset class received a global popularity boost when supply increased dramatically from 2019 to 2021.[1]
- More supply deepened the asset class, and its inherent strategic attributes drew the attention of institutional investors attracted to its high quality, low default rates and breadth of maturities.
- Supply has since returned to the longer-term average, while yields have climbed to levels rarely seen over the lifetime of the index. More recently, market volatility has also risen to extremes, heightening the need for high-quality diversifiers like municipal bonds.
- Key takeaway: If you are seeking to capture the current relatively attractive yields and mitigate volatility, taxable municipals may be a solution with ongoing strategic benefits to consider. Further, to generate an optimal exposure, we suggest considering a flexible, active approach due to highly restrictive index construction rules.

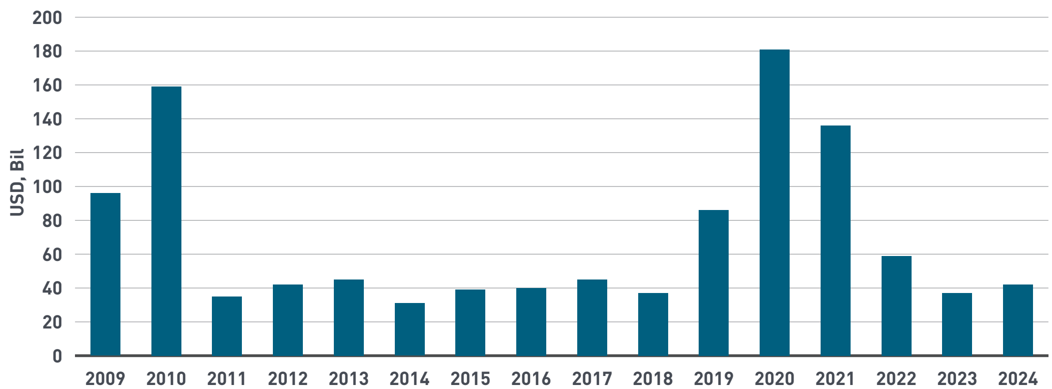
The shifting investment landscape

Municipal bonds — historically, a relatively safe asset class in investors' asset mixes — have received their share of the spotlight this year, stemming from targeted federal funding cuts and potential changes to the US tax code. While the final tax legislation is far from clear, reductions in federal funding or the removal of the tax-exemption for municipal bond interest payments would likely spur issuance in the taxable municipal market. We believe that this possible increase in issuance and the current higher yielding backdrop creates an unusual opportunity for investors to consider the asset class. At the same time, structural attributes, including high quality, broad maturity range and historically low default rates may support a strategic allocation over the long term.

Potential for higher taxable issuance

Supply of taxable municipal bonds has varied over the years, depending on federal initiatives to either stimulate investment or due to changes in the tax law. For example, the Build America Bonds program subsidized borrower interest costs to spur infrastructure investment in the aftermath of the Global Financial Crisis and the Tax Cuts and Jobs Act disallowed advanced refunding of tax-exempt debt with additional tax-exempt debt, leading to the use of taxable bonds for this purpose. Those initiatives caused taxable municipal issuance to balloon to 3x to 4x its baseline of around $40 billion per year in 2009, and 2018 to 2020. While the change in the TCJA remains in place, the increase in yields over recent years has made it uneconomic to advance refund tax-exempt debt with taxable debt, thus lowering issuance. A drop in yields would restore this relationship, and taxable advanced refundings would become more appealing. In 2025, the Trump administration is identifying funding sources to extend tax cuts, bringing the tax-exempt status of the $4 trillion municipal market into focus. While a wholesale elimination of the exemption for the entire market is not anticipated, a targeted approach for subsets of the market may gain traction. For instance, eliminating the tax exemption on Private Activity Bonds (PABs), issued by private entities such as airports, hospitals, and private universities for qualified infrastructure projects, may be considered. In 2024, private activity bonds represented 23% or $117B of tax-exempt issuance,[2] a sizable amount when compared to the $42B in taxable municipal issuance last year.

Exhibit 1: Annual Taxable Municipal Bond Issuance



Source: J.P. Morgan Research. "2025 Municipal Market Outlook." Annual data from 1 January 2009 to 31 December 2024.

An increase in supply would deepen the asset class, which remains relatively small compared to most fixed income sectors.[3] With only about $40B in typical annual issuance and a massive global appetite for quality fixed income, higher supply would present an opportunity for institutional investors to increase an exposure, as has been the case during past waves of supply.

The Strategic and Tactical Cases Are Strong

The strategic case

Taxable municipal bonds have investment attributes that appeal to a variety of institutional investors. For example, insurance companies prioritize quality; mitigation of downgrade risk, and income. Life insurance companies tilt to longer duration, property and casual to shorter duration. Pensions are often looking for yield above the discount rate while targeting a specific duration and limiting volatility and default risks. For investors in some cases currently utilizing US corporate bonds in their fixed income allocation, taxable municipals can complement or replace that exposure with relatively higher quality, lower default rates, and higher yield. Yields for the asset class today are historically high and we feel present an attractive strategic entry point into the asset class, as seen in the Exhibit 2.

Exhibit 2: Taxable Municipal Yields

Source: Bloomberg. Daily data from 1 May 2015 to 9 May 2025. Taxable Municipal = Bloomberg Taxable Municipal Index.

We believe that these structural attributes of the market are complimented by several shorter-term factors, such as historically high yields, that make a compelling case for why investors should take interest in the asset class now. Exhibit 3 below summarizes our thinking on the strategic and tactical cases for institutional investors to consider investing in the asset class.

Exhibit 3: The Strategic and Tactical Cases

The Strategic Case	The Tactical Case
▪ **High quality asset class:** 77% of the taxable municipal index carries a credit rating of AA or higher as compared to only 8% for US corporates.	▪ **Yields are historically high:** Taxable municipal yields currently rank in their top 10th percentile over the last 10 years of history and are comparable to that of US corporates.
▪ **Broad maturity coverage:** Deep maturity coverage with 58% of taxable municipals carrying 10 to 30-year maturities. This compares to only 33% for US corporates.	▪ **Diversification benefits:** Revenue generation for taxable municipal borrowers is dominated by essential service providers who have historically displayed more resiliency than cyclically sensitive sectors of the US corporate market during periods of economic stress. Diversification is even more pronounced versus equities.
▪ **Historically lower defaults:** Significantly lower long-term default rates as compared to corporate bonds.	▪ **Dampens volatility:** Taxable munis typically have a volatility between that of US corporates and US treasuries. Since 2012, there have been 15 periods of global equity drawdowns of 5% or greater. Taxable munis outperformed US corporates in periods of equity weakness in 11 of those 15 instances.

Source: Bloomberg, Moody's, MSCI. Taxable Municipal index data based on Bloomberg Taxable Municipal Index. US Corporate index data based on Bloomberg US Corporate Index. Default data from Moody's Public Finance Report "US Municipal Bond Defaults and Recoveries." Annual data from 31 December 1970 through 31 December 2023. Global equity drawdowns compare the relative returns of the MSCI World index versus the Bloomberg US Corporate Index and the Bloomberg US Taxable Municipal index.

Active Management May Enhance Structurally Appealing Features

The construction methodology of the index coupled with the smaller size and immense number of municipal issues require unique considerations when implementing an exposure.

Indices serve as systematic, transparent representations of segments of the market they are designed to target. In the case of taxable municipal bonds, the index may be used to represent the asset class, but it does a poor job of both reflecting the breadth of the universe and constructing an efficient exposure. With over 75,000 issues in the universe, the taxable municipal asset class is unique in its breadth compared to other fixed income sectors. Like any index, the taxable municipal index applies various inclusion rules. Among the most impactful, the size rule requires that an issue be >$75 million and a security be >$7 million. Issue sizes unable to meet these criteria are not index eligible. The eye-opening result is the exclusion of 88%, or over 66,000 issues, from the index. To the extent non-index issues are disallowed from mandates, optimal construction, including seeking spread and diversification, would be constrained.

Importantly, the issues that are not eligible for inclusion in the index lack only size but otherwise largely possess the same quality, low default and diversifying attributes of their counterparts in the index. We think this creates significant opportunities to take advantage of issues outside the index. In other fixed income mandates, such as a core plus strategy, the hunt for additional yield typically involves investing in lower credit quality cohorts that are outside of a core index. With taxable municipals, yield enhancement can often be found in off-index issues while staying in the same credit quality spectrum. Liquidity may be somewhat lower in off-index issues, but that illiquidity generally carries a yield premium, and longer holding periods are typically well-aligned with institutional investment horizons.

To summarize, we think the index does a poor and inefficient job of representing the broad taxable municipal universe. A flexible, active approach may help unlock potential return and yield maximization while still realizing the benefits of the asset class described above.

Conclusion

Given relatively high quality, low default rates and breadth of maturity, the taxable municipal asset class makes a compelling case to be a strategic holding within an asset allocation in our view. With yields historically high and a historical ability to dampen volatility, we believe that the argument for initiating an exposure to the asset class has rarely been stronger. Changes in access to tax-exempt financing may spur supply, further enhancing the investment opportunity. When initiating an allocation, consider a flexible, active approach that seeks to maximize the full benefits of the asset class given an index that truncates most of the investment universe.

End Notes

[1] The 227% is the percent increase from the 3-year average of 2016 to 2018 and 2019 to 2021.

[2] Bloomberg MSRC. PAB issuance is approximated by screening and filtering all municipal bonds in the MSRC system based on PAB criteria and eligibility. PAB = private activity bond.

[3] As of 28 April 2025 the Bloomberg Taxable Municipal Index had $377 billion outstanding while the Bloomberg US Corporate Index had $7.0 trillion outstanding.

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