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Franklin Templeton Fixed Income

The Case for High-Yield Municipal Bonds

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Introduction

The municipal (muni) bond market is known for its high credit quality and defensive characteristics. Muni bonds are often chosen for their relatively low risk profile and the tax advantages they offer (interest payments are exempt from federal—and sometimes also state and local—income taxes). However, there is a slice of the sector that is often overlooked by investors: high-yield (HY) munis.

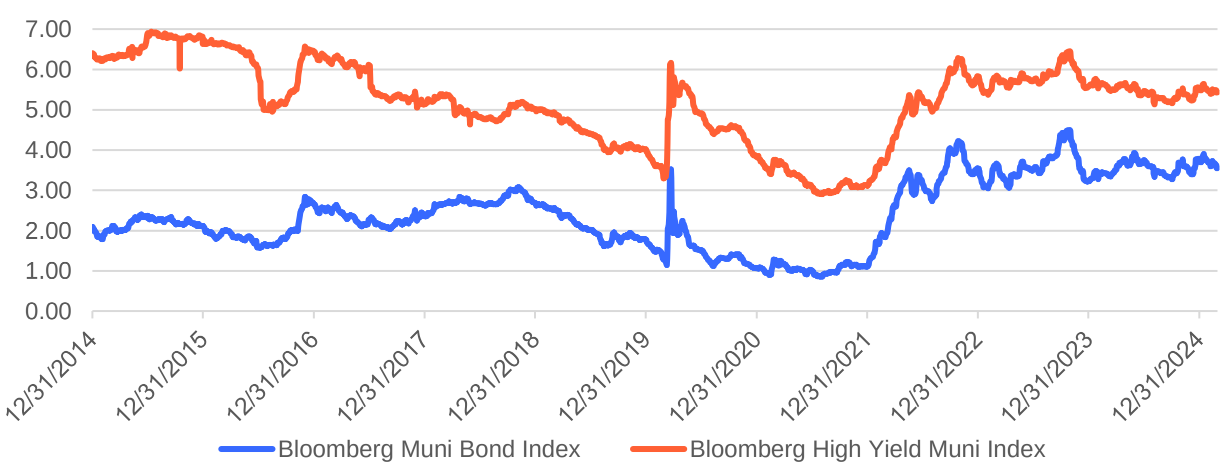
Why Consider HY Munis?

HY muni bonds are securities issued by government entities that are rated below investment grade (IG) or those that have no external credit rating at all. There are multiple reasons why a bond may be unrated, including that a small issuer may prefer not to pay an agency to obtain a rating. While this is not necessarily an indication of a riskier investment, it does require a more thorough due diligence process since the assessment of risk cannot be outsourced to a third party.

This added level of complexity usually results in a higher yield on HY securities which, if chosen well, can be an attractive addition to a fixed income portfolio. Figure 1, below, illustrates the difference in yield for HY munis versus the IG muni bond index over the past five years.

On the one hand, this shows the yield pickup that an investor can achieve when looking for opportunities further down the quality spectrum. On the other hand, the graph shows that even though yields have begun to decline, they are still attractive when compared with historical levels. It is our view that the return benefits that flow from these elevated yields can outweigh the risks of increased volatility associated with lower-rated credits. However, it is crucial to be thorough and prudent when selecting securities to add into muni bond portfolios.

Figure 1: Yield-to-Worst (YTW) for IG vs HY Muni Bonds



Source: Bloomberg, Municipal Bond Index and Municipal Bond: High Yield (non-Investment Grade), as of 2/28/25.

Another potential benefit that comes from adding HY munis to a fixed income portfolio is the element of diversification. Figure 2 shows which segment of the muni market performed best and which worst in any given calendar year over the past 10 years. This suggests that a well-diversified portfolio can achieve greater returns and strong risk adjusted returns over various market cycles.

Figure 2: Annual Returns in the Muni Bond Market by Quality Rating (%)

2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
14.47	4.25	2.99	9.69	4.76	10.68	5.51	7.77	-7.93	9.21	6.32
13.84	3.71	0.85	8.74	1.96	9.94	5.27	4.85	-7.97	8.93	2.87
10.52	3.16	0.35	6.16	1.34	8.10	5.24	2.25	-9.06	7.34	1.78
8.22	2.73	0.05	4.96	1.22	7.12	4.89	0.92	-11.63	5.92	0.79
6.34	1.81	-0.17	4.45	1.05	6.73	4.55	0.47	-13.10	5.80	0.33

KEY:				
AAA	AA	A	BBB	HY

Source: Bloomberg, as of 12/31/24.

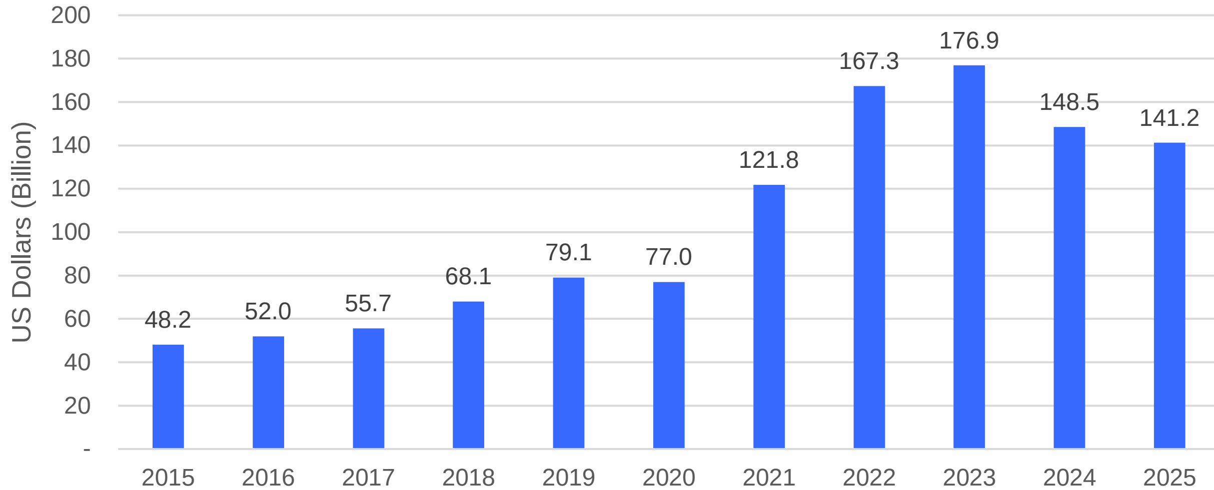
One might also look more broadly at HY munis, not only within a muni bond portfolio but compared with taxable corporate debt. While muni issuers historically display more defensive characteristics with regards to economic cycles—since many operate in essential services sectors such as education, housing or hospitals—corporate HY issuers have often been involved in more cyclical sectors (such as consumer goods, communications or energy).

Knowing this, investors may feel compelled to add to their HY muni allocations. We believe that exposure to this sector can add potential diversification benefits, and that now is an opportune time to lock in the historically elevated yields. Moreover, the financial market volatility that surrounds the US Federal Reserve's monetary policy decisions as well as the first few months of a new US administration can provide an attractive entry point into the HY muni bond sector.

Credit Fundamentals: A Picture of Stability

The term "high yield" is often associated with low credit quality. However, as we mentioned above, this is not necessarily the case. In fact, the cumulative default rate among HY muni issuers over the past 10 years stands at 3.97% versus 32.53% for HY corporates.[1] This points to solid credit fundamentals. Over the past few years, these have been bolstered by federal COVID aid and the post-pandemic economic recovery. The high inflation we witnessed was also beneficial for many state and local governments, as rising prices and wages meant higher sales and income tax receipts. As a result, reserves (or so-called "rainy-day" funds) increased and remain elevated (as seen in Figure 3), indicating that issuers have a healthy buffer to help them deal with a potential economic slowdown.

Figure 3: Total State Rainy-Day Fund Balances



Source: National Association of State Budget Officers (NASBO), Fall Fiscal Survey of States (1989 - 2023) and Spring Fiscal Survey of States (2024).

A note of caution: While the fundamental backdrop in the muni market is solid, this is a broad investment landscape with significant complexities. These factors include regional and macroeconomic issues, understanding the connections between municipal issuers and different government levels, their revenue and costs, changing demographics, and unique characteristics of each issuer. That is why the Franklin Templeton Fixed Income Municipal Bond Team employs a large number of experienced analysts, who are able to take a comprehensive and thorough approach to bottom-up research and security selection. We believe that this offers us a significant advantage when investing in munis, in particular lower-rated and HY bonds.

Conclusion

We see some compelling opportunities within the HY muni segment, as the higher interest rates mean a more attractive income stream, while there is also the potential for capital appreciation if yields continue to decline. Additionally, HY munis can offer diversification benefits that—if securities are chosen well—could improve the risk/return profile of a fixed income portfolio.

Nevertheless, as is true for every investment, there are risks and complexities connected with investing in HY munis, and so we would usually recommend working with an active asset manager in this space. The experience and depth of resources available to active portfolio managers means that they can delve deeper into each individual security and find the most interesting opportunities, while constructing portfolios that suit their client's needs.

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