April 2012 » Putnam Perspectives

Fixed Income Outlook

Key takeaways

- Greece defaults, but orderly, well-anticipated restructuring offers reasons for optimism on the situation in Europe
- High-yield and RMBS sectors lead market rebound in the United States
- Municipal bonds continued to post gains after a handful of high-profile defaults to finish 2011
- Emerging-market debt rally may be difficult to sustain over the longer term

Putnam's outlook

Asset class	Negative	Slightly negative	Neutral	Slightly positive	Positive
FIXED INCOME					
US government and agency debt	●				
US tax exempt			●		
Agency mortgage-backed securities			●		
Collateralized mortgage obligations				●	
Non-agency residential mortgage-backed securities				●	
Commercial mortgage-backed securities				●	
US floating-rate bank loans				●	
US investment-grade corporates				●	
Global high yield				●	
Emerging markets			●		
UK government				●	
Eurozone government		●			
Japan government	●				
CURRENCY					
Dollar/yen	*Favour dollar*				
Dollar/euro	*Favour dollar*				
Dollar/pound	*Neutral*				

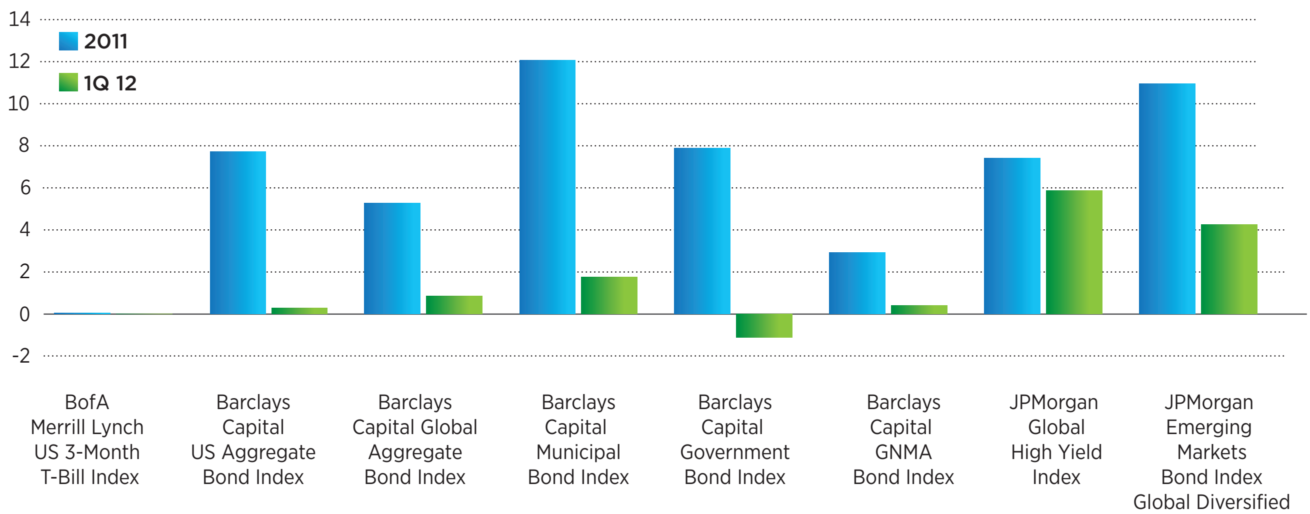
Improving economic data and an orderly Greek default helped rekindle investor optimism in Q1

The fixed income markets in general benefited from a change in investors' risk outlook in 2012. Central banks continued to provide liquidity for financial markets, both in Europe through the Long-Term Refinancing Operation [LTRO] and in the United States, where there is speculation that the Federal Reserve [the Fed] is considering a third round of quantitative easing. This accommodative policy helped offer some level of support for the bond markets after a challenging end to 2011 in which investors demonstrated little appetite for risk.

But perhaps more importantly, the Greek default, which occurred in February, was an orderly one, and appears unlikely to start a wave of restructurings in other peripheral European countries or force European banks to rapidly deliver and raise capital. That said, whilst the short-term liquidity issues at stake in Europe appear to be under control, the larger, long-term structural problems have been largely unaddressed thus far. Europe is home to a variety of economies, each with its own set of challenges, whether a housing market bubble, an over-leveraged banking sector or a workforce struggling to remain competitive. These economies no longer have as broad a set of policy tools to address their challenges, either through devaluing their currency or adapting monetary policy tailored to their particular circumstances. As it stands, the European Central Bank can only set a single policy for this diverse group of economies despite their different dynamics and different needs. Until that fundamental problem is addressed, we believe investors will continue to see waves of volatility from the European bond markets.

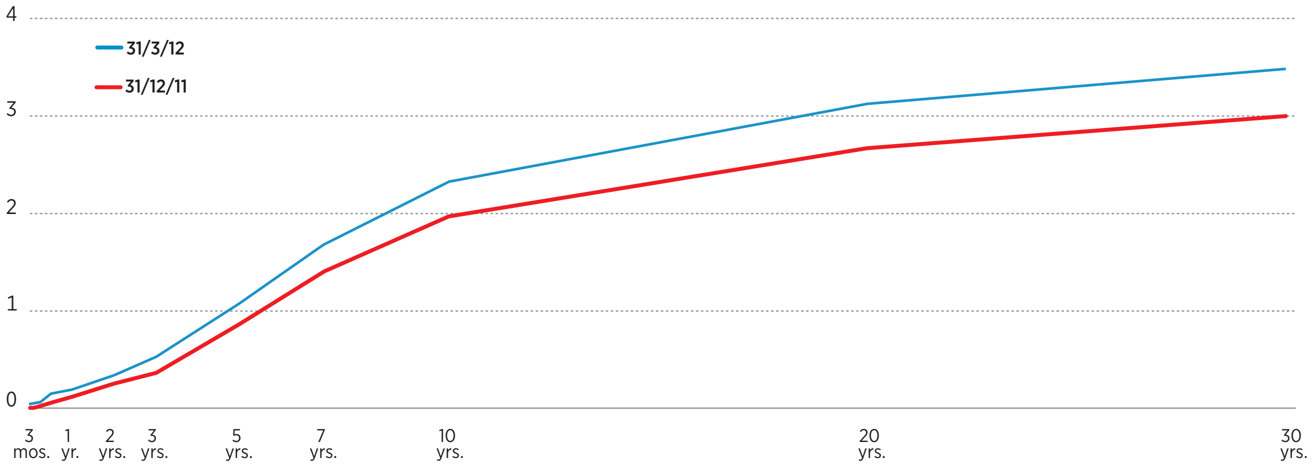
In the United States, interest rates climbed higher, even on the short end of the yield curve, in part reflecting increasing optimism about the strength of the economic recovery. Recent economic data, whilst not indicative of a strong recovery, has generally come in better than anticipated. There continues to be some speculation as to whether the Fed intends to launch a third round of quantitative easing. Recent statements by Chairman Ben Bernanke suggest that the Fed is carefully monitoring the health of the economy and that more policy intervention is a possibility. Some market-watchers have been raising questions as to whether the stronger-than-expected economic data were driven by the unusually warm weather in much of the United States. We won't know the answer for sure until data for March and April become available as points of comparison, but it is an issue we're keeping a close eye on nonetheless.

Figure 1. Spread sectors posted strong Q1 gains



Source: Putnam research, as of 31/3/12. Past performance is not indicative of future results.

Figure 2. Interest rates crept higher in Q1 despite the Fed's continuing accommodative stance



Source: US Department of the Treasury, as of 31/3/12.

Spread sectors benefited from investors' renewed risk appetites

Non-agency residential mortgage-backed securities [RMBS] represented one of the best-performing sectors in the first quarter after a challenging 2011. Part of what made last year so difficult was the concern that a new round of forced selling would again lead to price volatility in the sector. As many investors will recall, non-agency RMBS experienced significant declines in 2008 as banks sold their positions to reduce their leverage and raise capital, and that memory was fresh in investors' minds throughout 2011, particularly earlier in the year when the New York Fed suspended the auction of its Maiden Lane portfolio. By way of background, 'Maiden Lane' is the name of the New York Fed's non-agency RMBS holdings that it took over as part of the government's bailout package for the financials sector. The Fed had attempted to sell off the bulk of its portfolio last spring, but lackluster demand brought the auctions to a halt, and non-agency RMBS prices suffered.

Investor sentiment changed substantially when the Fed was able to complete its auctions during the first quarter of 2012. Doing so greatly diversified the holders of non-agency RMBS and reduced the likelihood that a single seller could flood the market with excess supply. With this as a backdrop, our non-agency RMBS holdings performed quite well in the first quarter, and we remain optimistic on the prospects for the sector.

High-yield bonds were another strong performer for the quarter, and we continue to find a number of reasons for a positive outlook on the sector. First, the long-term average spread in the high-yield market is close to 500 basis points, so today spreads are at above-average levels. But at the same time, the fundamental backdrop for high-yield bonds continues to be quite strong, with record earnings for publicly traded companies and large amounts of cash on corporate balance sheets.

Over the long term, the reason high-yield bonds offer a spread advantage is to compensate investors for the risk of default. Historically, that par-weighted default rate has been 4.2%. However, today the market has a par-weighted default rate of 1.9%, which is well below the long-term average, and we believe that trend is likely to continue over the near term.

Looking back at historical default patterns in the market, there have tended to be rather prolonged periods of below-average defaults following a spike in the default rate, which is what one might expect. The last significant peak occurred in November 2009, when defaults exceeded 13%. Many of today's businesses that survived the crisis are running very lean organisations, with strong balance sheets and historically large levels of cash on hand. In the current economic environment — which represents a significant improvement from the depths of the recession and financial crisis in 2008 and 2009 — we

Figure 3. Current spreads relative to historical norms

Sector	Average OAS 31/12/97–31/12/07	Month-end OAS 31/3/12	Difference
Agencies	34	36	2
Agency MBS	56	53	-3
Investment-grade corporates	130	176	46
High yield	511	576	65
AAA CMBS	89	169	80
Non-agency RMBS	123	700	577
Agency IOs	150	750	600
Emerging-market debt	425	359	-66

Sources: Barclays Capital, Putnam Research, 31/3/12. Bonds' excess yield over Treasuries is measured by their 'spreads.' Option-adjusted spreads ('OAS') are adjusted to account for embedded option characteristics, which may affect bonds' sensitivity to changes in interest rates. The data charted above reflect the difference between current option-adjusted spreads for various bond market sectors as of 31/12/11 and their 10-year "pre-credit-crisis" averages (1/1/98–31/12/07). The data do not represent the characteristics of any individual bond, but rather the characteristics of all the bonds in those sectors. Past performance is not indicative of future results.

believe that the companies within the high-yield universe should be able to continue to grow their businesses and that the default rate, as a result, ought to remain low. Over time, business fundamentals may begin to worsen for certain sectors of the market, or we might experience an increase in acquisition financing or leveraged buyouts, but that hasn't really been the case since 2008.

Ultimately, we believe we would need to see a significant weakening of the high-yield cohort of companies and a deterioration of business fundamentals for the default outlook to meaningfully change. Moreover, the significant volume of corporate refinancing that has been taking place has also extended companies' runways, so to speak: Maturities on newly issued debt are years if not decades away.

Looking ahead, our base case is still for a moderate recovery continuing in 2012. Although we're not predicting robust growth, we believe that we could see high-yield spreads tighten from their current levels to something more in line with their historical averages. It is always possible that the market could experience some surprises, akin to last year's Japanese earthquake and tsunami, but barring any unforeseen developments, we believe that solid corporate fundamentals should continue to drive the market. Today, investors are being paid more than usual in the form of higher yields for assuming below-average default risk, and we believe that makes for an attractive combination as we look forward in 2012.

An active approach to emerging-market debt may be key in a more volatile environment

Emerging markets benefited in the first quarter from many of the trends that helped other segments of the bond markets, and the funds' exposure was a positive contributor to performance. But it is important to note that since 2008 developed economies have been on much less homogenous economic paths: The United States is experiencing slow growth, Europe continues to grapple with structural issues, Japan is facing some demographic challenges and parts of Asia are rapidly expanding. This backdrop of much more disjointed growth patterns on the global stage, we believe, will be a challenge for emerging-market economies, which have had for much of the past 10 or 15 years an environment of stable and uniform economic growth in the rest of the world.

We believe the fundamental story in emerging markets is still attractive, with a developing middle class, access to commodities, and in some cases exposure to the rapid growth in Asia. But over the near term, emerging-market governments and central banks face a much less favourable operating environment with regard to capital flows and policy stability in the rest of the developed world, and it remains to be seen how they will navigate this more volatile period.

Given this outlook, we believe that going forward fundamental research and active management within the emerging-market space will be much more important, as the policies different nations put in place are likely to produce a much broader range of outcomes among emerging-market economies. We have maintained a neutral allocation versus the benchmark, seeking to add value when possible through security selection.

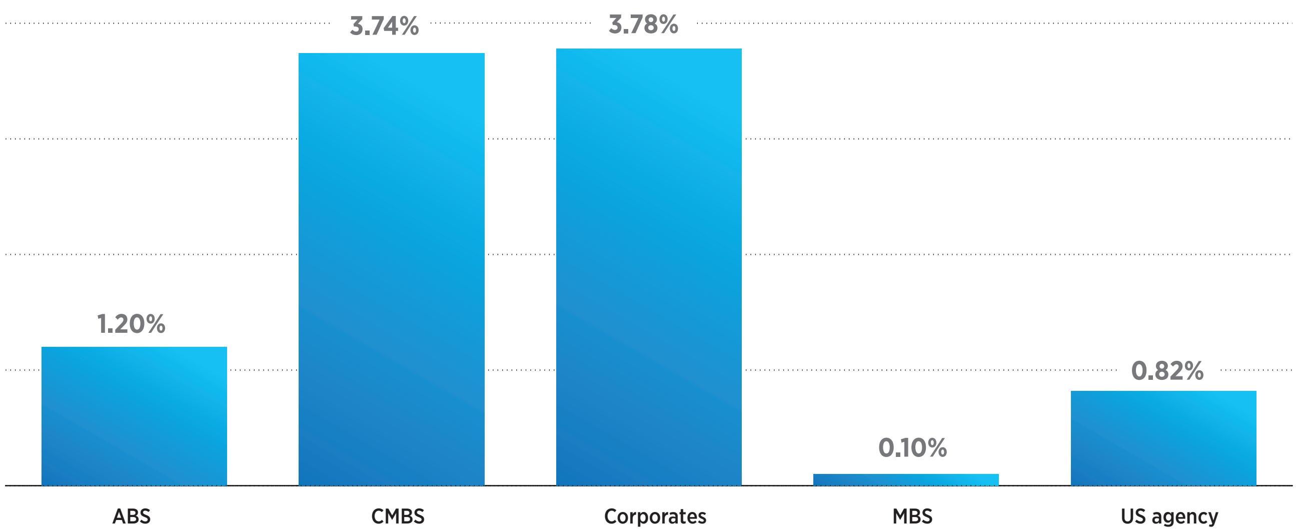
Municipal bonds continued streak of solid returns

Overall credit quality across the municipal bond market remains generally sound and is showing signs of improvement. We believe that the fiscal conditions of states and municipalities are showing signs of stability, but that states will continue to face financial challenges as the economic recovery works to gain some traction. Tax receipts are beginning to increase, albeit slowly, and we believe actual defaults will remain relatively low in 2012, but we would not be surprised by an uptick in local general obligation bond defaults. Our primary concerns remain focused on the broad economy and Congress's plans to reduce the deficit. Broad-based tax reform, a change in the tax status of municipal bonds or significant cuts in state funding all would have consequences for the municipal bond market. We are monitoring all of these factors closely, and believe our funds are well positioned for this less-than-certain environment going forward.

Foreign exchange positioning focused on US dollar and commodity-linked currencies

The primary theme in our portfolios continues to be to overweight the US dollar given our belief that a number of interest rates and monetary policies are in the process of converging with that of the United States. Beyond that, we believe that as the global economic recovery continues to build steam, commodity-exporting countries are poised to benefit. We have been implementing that strategy by taking positions in the Australian dollar and Norwegian krone, among other currencies. At the same time, we hold a negative view on the Japanese

Figure 4. Non-government sectors led the market in Q1
Excess returns over US Treasuries



Source: Barclays Capital, as of 31/3/12. Past performance is not indicative of future results.

yen. Japan is a large commodity importer, and rising commodity prices tend to negatively impact the country's economic performance and weaken the yen relative to other currencies. Moreover, the Bank of Japan's recent decision to significantly increase its asset purchase program target could translate into upward pressure on the dollar-yen exchange rate.

Despite the first-quarter 'relief rally,' we continue to view the euro as overvalued versus the US dollar. Investors viewed the sovereign debt developments during the quarter as positive news, but we believe the fiscal and structural headwinds facing the region make the currency unattractive on a relative basis.

Meanwhilst, we have reduced our Australian dollar overweight position due to greater uncertainty around Chinese growth levels and composition, as well as the subsequent impact on demand for commodities in the region. Australian economic data recently have been weaker as well, which could lead its central bank to cut rates over the coming months. We believe this combination may undermine support for the Australian dollar.

Putnam's veteran fixed income team offers a depth and breadth of insight

Successful investing in today's markets requires a broad-based approach, the flexibility to exploit a range of sectors and investment opportunities and a keen understanding of the complex global interrelationships that drive the markets. That is why Putnam has more than 70 fixed income professionals focusing on delivering comprehensive coverage of every aspect of the fixed income markets, based not only on sector, but also on the broad sources of risk — and opportunities — most likely to drive returns.

D. William Kohli
Co-Head of Fixed Income
Global Strategies
Investing since 1987
Joined Putnam in 1994

Michael V. Salm
Co-Head of Fixed Income
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Paul D. Scanlon, CFA
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The **Barclays Capital US Aggregate Bond Index** is an unmanaged index of US investment-grade fixed income securities.

The **Barclays Capital Global Aggregate Bond Index** is an unmanaged index of global investment-grade fixed income securities.

The **Barclays Capital GNMA Index** is an unmanaged index of Government National Mortgage Association bonds.

The **Barclays Capital Government Bond Index** is an unmanaged index of US Treasury and government agency bonds.

The **Barclays Capital Municipal Bond Index** is an unmanaged index of long-term fixed-rate investment-grade tax-exempt bonds.

The **BofA Merrill Lynch US Treasury Bill Index** is an unmanaged index that tracks the performance of US dollar denominated US Treasury Bills publicly issued in the US domestic market. Qualifying securities must have a remaining term of at least one month to final maturity and a minimum amount outstanding of US $1 billion.

The **JPMorgan Emerging Markets Global Diversified Index** is composed of US dollar-denominated Brady bonds, eurobonds, traded loans and local market debt instruments issued by sovereign and quasi-sovereign entities.

The **JP Morgan Global High Yield Index** is an unmanaged index of global high-yield fixed income securities.

You cannot invest directly in an index.

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