August 2016

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Proceeding toward Brexit: Economic headwinds and policy possibilities

Key takeaways

As the United Kingdom moves toward separating from the European Union, our chief concerns are risks surrounding the British pound and European politics.

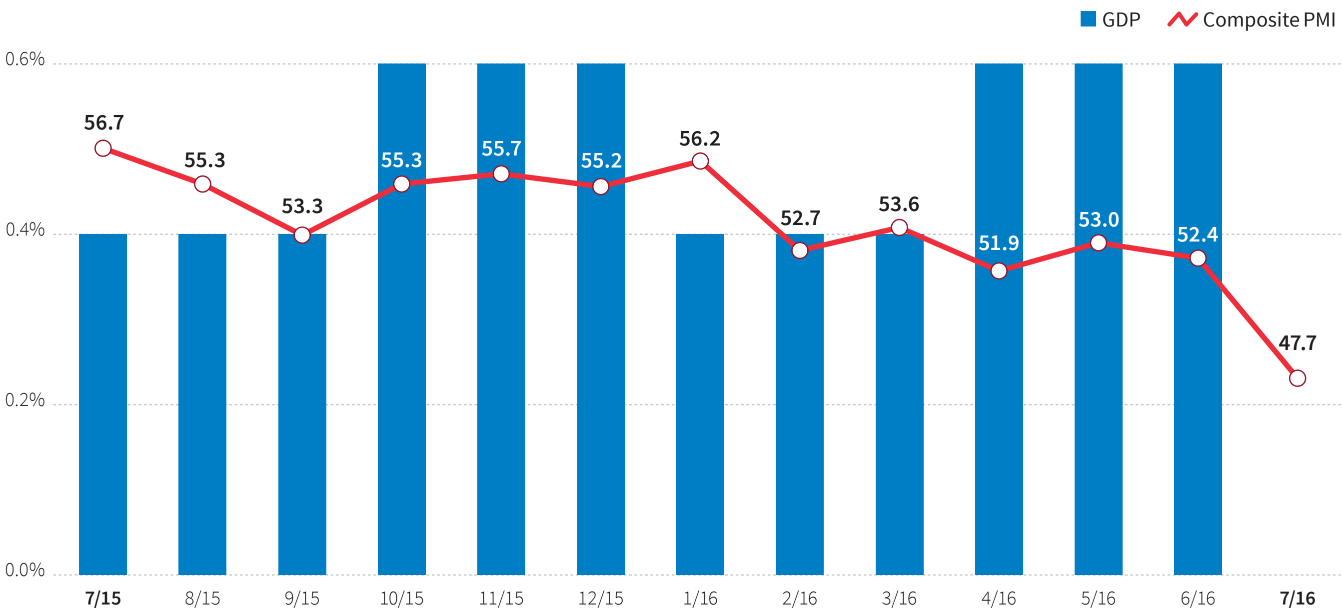
Policy responses both within and outside of Europe could generate new investment opportunities.

Indiscriminate selling and currency moves have led to opportunities emerging for longer-term investors.

The victory for the "Leave" campaign in the United Kingdom's June 23, 2016, referendum on the European Union surprised global markets, particularly in light of pre-election polls that favored a win for "Remain" voters. The initial market response of falling bond yields and stock prices has subsided and reversed course somewhat, but we continue to see vulnerability in the British pound and the economy, as well as a number of secondary effects that could unleash more volatility.

> "Following the referendum, we face a time of great national change. And I know, because we're Great Britain, that we will rise to the challenge."
>
> **Theresa May**
> Prime Minister of the United Kingdom

U.K. Purchasing Managers' Index report indicates a weakening economy



Sources: Markit/CIPS (PMI data); U.K. Office for National Statistics (GDP). Latest data available at time of publication.

A U.K. recession is likely

SAM DAVIS

The primary effect of the Brexit vote is to raise the risk of recession in the United Kingdom. In the vote's immediate aftermath, the greatest impact was on the British pound, as well as on U.K. stocks that were mainly exposed to the domestic economy. Stocks of smaller banks and housebuilders, for example, fell more than 30% in the two days following the vote. The resulting uncertainty is likely, in our view, to have a negative effect on investment, hiring, and consumer confidence, slowing growth in the United Kingdom, with potential spillover effects across Europe.

SHEP PERKINS

As the world's sixth-largest economy, the United Kingdom is not insignificant, but at less than one-sixth the size of the U.S. economy, its impact on global growth is likely to be somewhat muted. Nevertheless, it is a major trading nation, and the pain of a recession in the United Kingdom could certainly spread across a number of markets, most notably those in continental Europe.

The U.K. economy could get worse if the pound plunges

SAM DAVIS

One of our chief concerns related to Brexit is the vulnerability of the pound. The United Kingdom runs a current account deficit representing approximately 7% of GDP. This is a record level for peace time. Typically, this deficit has been funded by foreign direct investment and by portfolio flows from abroad into British sovereign debt, or gilts.

In the wake of the referendum, however, foreign direct investment is likely to weaken as firms wait to see how the United Kingdom's trading relationship with the EU is resolved. Portfolio flows have held up well so far, but may be at risk if central banks and other investors turn more negative on gilts following rating agency downgrades in the wake of the Brexit vote.

The bottom line is that difficulty in funding the current account deficit could, in an adverse scenario, lead the Bank of England to raise rates to protect the pound and attract overseas flows. However, higher rates would hurt the already fragile British economy.

SHEP PERKINS

When we look at other major currencies over the past calendar quarter, we see that the U.S. dollar has strengthened, but the yen has strengthened even more. Meanwhile, over the same period, the Chinese yuan has weakened to new lows. These trends tighten financial conditions in the United States and Japan and have a deflationary effect more generally. It also means that the largest, the third-largest, and the sixth-largest economies of the world — the United States, Japan, and the United Kingdom — all face headwinds that will likely result in slower growth in the immediate future. In addition, a weaker currency in China undermines domestic and foreign investor confidence, which is critical given China's financial situation.

The major political risk is a fragmenting Europe

SAM DAVIS

The example set by Brexit — both the vote itself and the political stances taken as leaders negotiate the separation terms — may strengthen other anti-EU parties across Europe. These parties could agitate for their own referenda, leading to heightened political uncertainty throughout the region. In turn, these political issues could have an economic impact and renew investor concerns about fragmentation of the eurozone and the future of the single currency. This could set in motion a sell-off in European equity markets and rising bond yields in peripheral markets.

SHEP PERKINS

We believe that uncertainty regarding the terms of Brexit is likely to expand across the EU, which could restrict investment and risk taking. In concrete terms, this means that factories may not be built, houses may not be purchased, and the brakes may be applied to economic growth. Also, we foresee that M&A activity is likely to stall, and investors may shun equities for the perceived safety of bonds and gold.

Lower yields and policy responses could create opportunities and new risks

SHEP PERKINS

We have already seen bond yields fall, and we have sketched a scenario in which they could fall further. While lower interest rates can be stimulative for economic growth, they are less so when rates begin where they currently sit — at negative levels in Europe and Japan, and near record low levels in the United Kingdom and the United States.

Low rates also spell trouble for banks. Major cracks are beginning to form in the European and Japanese banking sectors. Profits are under intense pressure because of the low rates, and new loan demand is tepid. Finally, lower rates generally make safer stocks act more like bonds, which makes them susceptible to price declines if interest rates increase.

Where we see potential for policy responses

SAM DAVIS

While it is essential for investors to keep risks in mind, it is also important to consider the possibility of a major monetary or fiscal policy response. On the monetary front, we see limited ability for the European Central Bank (ECB) to greatly expand its quantitative easing program or reduce rates further into negative territory. We believe that doing so would have a detrimental impact on the German financial system, in particular.

While monetary policy accommodation is unlikely from the ECB, Japan is another consideration. The introduction of so-called "helicopter money" — or direct infusions of cash to consumer and businesses — in Japan is becoming a distinct possibility, in our view, as authorities there are reaching the limit of what more orthodox policies can achieve. While this is unlikely to change the economic trajectory of Japan, it could create new investment opportunities in a variety of Japan-based companies.

On the monetary front, we see limited ability for the European Central Bank (ECB) to greatly expand its quantitative easing program or reduce rates further into negative territory.

With regard to fiscal policy, the potential menace of nationalist movements could prompt coordinated action in Europe. We are monitoring developments surrounding the EU's Stability Pact, which guides fiscal policy. We see potential for a decision to loosen the restrictions on deficit spending in France, for example, allowing it to boost its economy through infrastructure investment prior to critical elections next year. The current French government is facing the nationalist threat of the increasingly popular far right National Front political party.

In a global context, we still consider China to be a greater risk

SHEP PERKINS

China, in my view, remains the biggest risk and the most likely source for a major upset in global markets. Although other issues have moved China out of the headlines, recent data suggest that its economy continues to struggle under the weight of mountainous debt, including slower loan growth and sharply rising bad loans. In addition, reduced electricity demand and year-over-year declines in beer and noodle sales indicate weakness in the Chinese consumer sector. Also, the manufacturing Purchasing Managers' Index [PMI] is declining and below 50, and data show negative business trends in Macau, another important barometer of consumer prosperity and propensity to spend. I expect fear regarding issues in China will resume and intensify in the latter half of 2016.

Portfolio strategy favors a barbell approach, focused on high dividends and sustainable earnings growth

SAM DAVIS

In the aftermath of the referendum, we have held off thus far making major changes to Putnam International Equity Fund. To bolster positions for uncertain markets and the numerous risks we have outlined, we want to ensure that we have a core of stable, high-dividend-paying companies. We will also look to take advantage of a selection of cheaply valued, more cyclical names that potentially stand to benefit from currency movements and the eventual clearing of political and economic clouds.

SHEP PERKINS

The global portfolio, Putnam Global Equity Fund, is currently positioned conservatively, with a big underweight to the financials sector and to global cyclicals such as autos and metals. The portfolio currently has almost no direct exposure to emerging markets. It has an overweight to consumer staples, such as food and beverage companies like Smuckers [The J.M. Smucker Company, United States], Budweiser [Anheuser-Busch InBev, Netherlands], and the European consumer goods conglomerate, Orkla [Norway].[1] I have used the volatility in Europe to add to positions in what I believe are solid, stable businesses with sales in Europe and beyond. Many suggest that "defensives" are expensive, which is true versus their own history, but compared with bond yields, they have never been cheaper. In a relative-yield world, they are attractive.

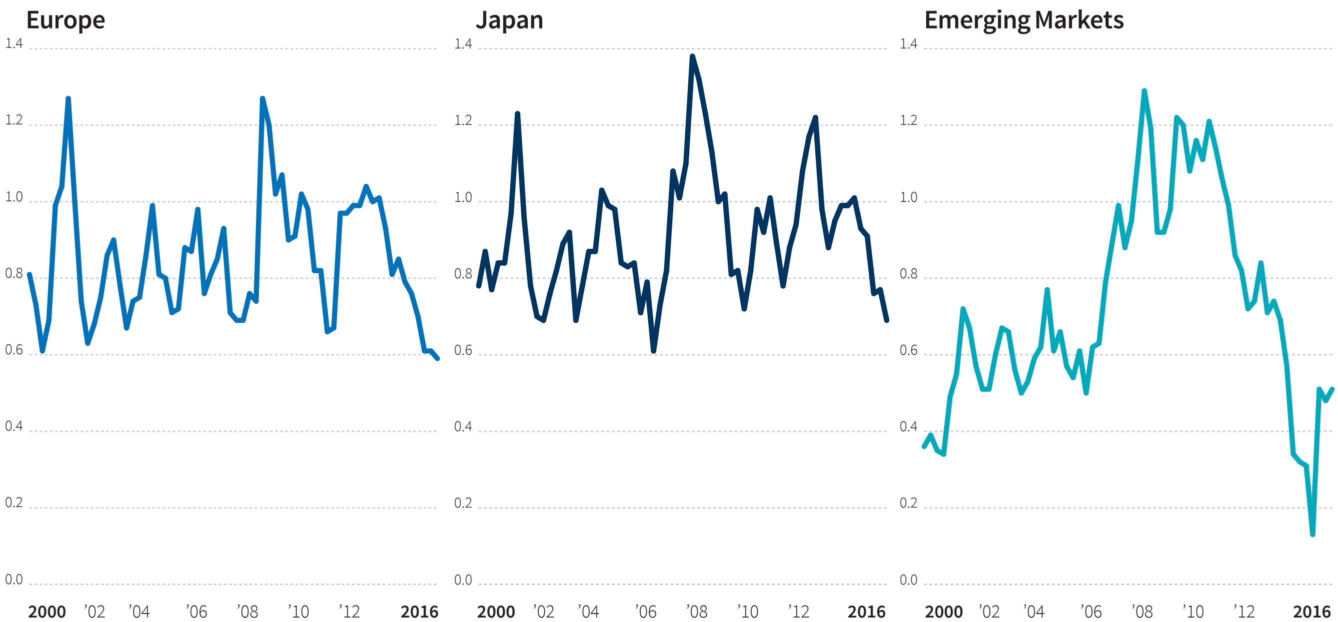
Putnam Global Equity Fund, sector weightings as of 6/30/16

Consumer discretionary	15.84%
Consumer staples	14.38%
Financials	13.59%
Health care	11.43%
Information technology	11.23%
Industrials	6.78%
Telecommunication services	6.74%
Utilities	6.46%
Materials	6.01%
Energy	5.05%
Cash and net other assets	2.49%

Allocations will vary over time.

Valuations are attractive outside the United States

Price/Cash flow relative to the United States (S&P 500 Index)



Source: Bloomberg, 6/30/16.

Prepared for risk, we also see reasons for optimism

SHEP PERKINS

On a positive note, it is worth considering that we are approaching the one-year anniversary of the dramatic sell-off in emerging-market currencies. As a result, a number of multi-national companies currently in our portfolios, such as Unilever [Netherlands], Japan Tobacco, Budweiser, and Google [Alphabet, United States][1], could benefit, in our opinion, from an acceleration of growth in emerging markets.

SAM DAVIS

We see potential opportunities in the United Kingdom and Europe, but also in Japan, in both domestic names and exporters, notwithstanding the strengthening of the yen. In Putnam International Equity Fund, unlike in Putnam Global Equity Fund, we tend to favor select emerging markets, such as India, where potential tax reforms could provide a boost to the corporate sector.

Regarding China, government stimulus has supported growth over recent quarters. As a result, fears of a hard landing have dissipated, capital outflows have slowed through tighter capital controls, and the currency has been allowed to gently depreciate versus the U.S. dollar — all of which have created a more stable situation. That said, we believe that the stimulus impact is likely to wane gradually from here, overcapacity remains a problem in key old-economy sectors, such as the industrials, and record levels of credit growth pose longer-term risks for the Chinese financial system. In Putnam International Equity Fund, our holdings in China are largely concentrated in consumer-facing and new economy stocks.

It is perhaps worth noting that the impact of Brexit highlights why, in our view, active investment management makes sense versus passive strategies. Brexit could radically change the earnings growth outlook for U.K. banks, for example, given the likelihood of slower economic growth, weaker employment, and rising credit costs. Passive funds have no choice but to continue to own the U.K. banking sector despite its poorer prospects, while active managers have the flexibility to allocate their portfolio capital to take advantage of possible opportunities offered by market dislocation.

[1] As of 6/30/16, the following companies represent percentages of total holdings in Putnam Global Equity Fund: Alphabet, 3.08%; Japan Tobacco, 2.02%; The J.M. Smucker Company, 1.28%; Orkla, 0.78%; Anheuser-Busch InBev, 0.86%; and Unilever, 1.11%. The following companies represent percentages of total holdings in Putnam International Equity Fund: Alphabet, 1.04%; Japan Tobacco, 2.14%; Anheuser-Busch InBev, 2.02%; and Unilever, 1.83%. Portfolio holdings and allocations will vary over time.

The views and opinions expressed are those of the authors, Simon Davis and Shep Perkins, Co-Heads of International Equities, as of June 30, 2016, are subject to change with market conditions, and are not meant as investment advice.

Consider these risks before investing: International investing involves currency, economic, and political risks. Emerging-market securities carry illiquidity and volatility risks. Investments in small and/or midsize companies increase the risk of greater price fluctuations. Growth stocks may be more susceptible to earnings disappointments, and value stocks may fail to rebound. Risks associated with derivatives include increased investment exposure (which may be considered leverage) and, in the case of over-the-counter instruments, the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. Stock prices may fall or fail to rise over time for several reasons, including general financial market conditions and factors related to a specific company or industry. You can lose money by investing in the fund.

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