A world of investing.®

Putnam INVESTMENTS

Q2 2020 | Capital Markets Outlook

Robert J. Schoen
Chief Investment Officer,
Global Asset Allocation

James A. Fetch
Co-Head of
Global Asset Allocation

Jason R. Vaillancourt, CFA
Co-Head of
Global Asset Allocation

Markets wrestle with policy versus the pandemic

We have become accustomed to referring to financial and economic statistics in terms of where they stand "in the post-World War II period." That changed abruptly as the COVID-19 pandemic swept across the world, disrupting it like WWII. The nature of this global shock has three important dimensions: 1) the obvious epidemiological issues, 2) a sudden seizing up of financial market liquidity conditions, similar to the Global Financial Crisis, and 3) a "sudden stop" in economic activity to slow contagion. And if those problems were not enough for the world, Saudi Arabia and Russia decided in early March to start a global price war in the oil market. By the end of the first quarter, the price of WTI (West Texas Intermediate) crude oil fell below $20 a barrel.

As regular readers will know, we came into 2020 with a clear defensive posture in our asset allocation. That continues to be the case as we enter the second quarter. We will end this outlook with some comments on what we are watching over the coming weeks that might alter that view.

Asset allocations

Shading in the table indicates the change from the previous quarter

	Underweight	Neutral	Overweight
EQUITY	●		
U.S. large cap	●		
U.S. small cap	●		
U.S. value	●		
U.S. growth	●		
Europe	●		
Japan	●		
Emerging markets	●		
FIXED INCOME		●	
U.S. government		●	
U.S. investment-grade corporates	○	●	
U.S. mortgage-backed			●
U.S. floating-rate bank loans	○	●	
U.S. high yield	○	●	
Non-U.S. developed country		●	
Emerging markets	●		
COMMODITIES	●	○	
CASH			●

Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro		●	○
£ Pound	○	●	
¥ Yen	●	○	

An unprecedented market impact

The financial damage done to risk assets beginning in late February is staggering. The onset of a bear market (-20%) in the S&P 500 took only 16 trading days. That was nearly twice as fast as the second fastest onset, which happened in September 1929. The one-day decline of almost 12% on March 16 was the third worst in the history of the index. We experienced 27 consecutive trading days without back-to-back positive returns. As the slope of the curve in new cases and deaths began to rise exponentially in Europe and the United States, funding markets ground to a halt. Rates for corporate paper spiked, and overnight funding dried up. Safe-haven assets such as gold and long-dated Treasuries sold off as margin calls and forced liquidation caused investors to sell what they could, as opposed to what they wanted to.

All of this behavior had strong echoes of what occurred in the autumn of 2008. Fortunately, policy makers were able to dust off that crisis-era playbook and quickly implement new facilities to unclog the plumbing of funding markets during the second half of March, with the Fed promising unlimited QE and having their "whatever it takes" moment.* As of this writing, the full effect of those programs has not yet completely normalized the short end of credit curves, nor has it completely reversed, for example, the spikes in the LIBOR-OIS spread† or spreads in the corporate paper market. However, our estimate is that the Fed, ECB, and BoE are likely to expand their balance sheets by more than $6 trillion. With that, we expect these stresses to normalize relatively quickly over the coming weeks.

Policy has responded, but the effect is unclear

Governments have also recognized the severity of the various measures to slow the spread of the virus. The hit to GDP growth rates and employment around the world, resulting from locking down borders and forcing many service industries to close, has required fiscal stimulus measures on par with wartime economies. The U.S. fiscal package is equivalent to almost 10% of GDP. Other countries have responded in kind.

The key question for financial markets remains whether these stimulus efforts are large enough to offset the enormous downside shock to activity and employment. Already, U.S. government leaders are discussing a fourth measure, focused on infrastructure spending, which could add another $2 trillion of stimulus along with future debt.

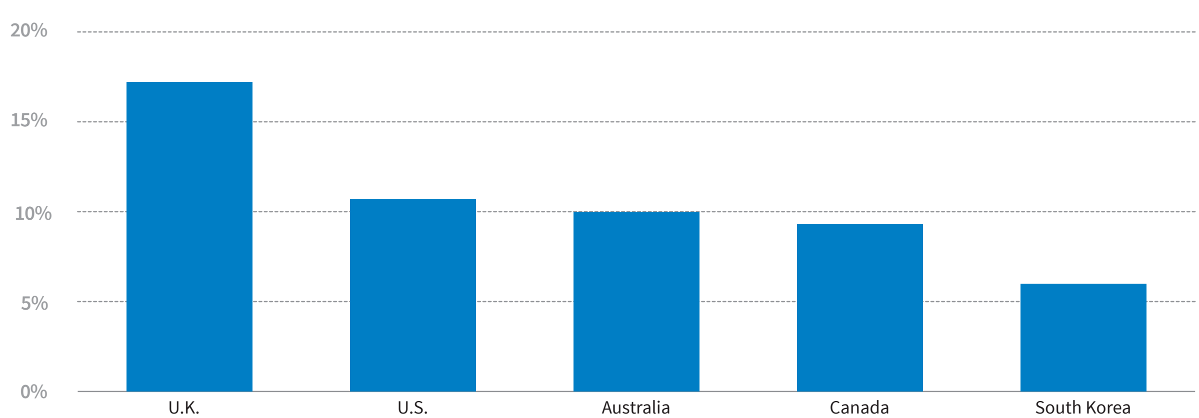
* In July 2012, the president of the European Central Bank helped resolve the European bank crisis by declaring that the ECB would do "whatever it takes to preserve the euro."

† The LIBOR-OIS spread is the difference between the rates on LIBOR (bank lending) and overnight indexed swaps (a swap of variable-rate and fixed-rate obligations), and is a measure of the perceived health of the banking system.

Figure 1:

Even massive stimulus may not offset an unprecedented economic shock

Fiscal stimulus as % of GDP

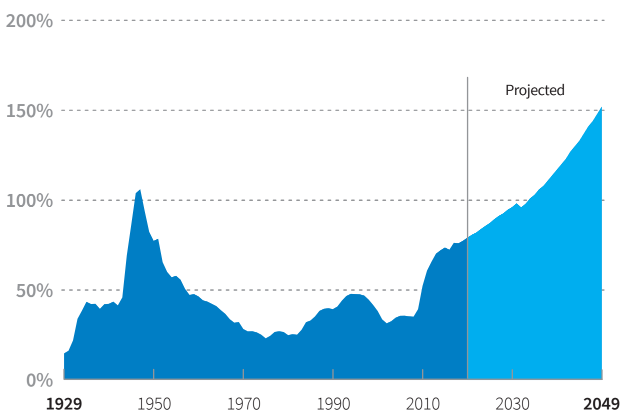


Sources: Putnam, Bloomberg, and Strategas Reseearch Partners. Data reflects announced programs as of March 31, 2020.

Figure 2:

U.S. debt was projected to grow even before the emergency stimulus

Federal debt held by the public as a % of GDP



Source: Congressional Budget Office, March 12, 2020.

This uncertainty is clouded by many unknowns regarding the virus itself. We do not yet know if countries that were initially successful in their more draconian containment strategies will experience a second wave of infections as they "get back to work." Analyzing the strategies is complicated. There is a large dispersion in the specific measures put in place across countries and varied lags in their timeline.

While the size of the fiscal response in the United States is extremely large and reasonably well targeted, there remains the critical open question about whether its rollout is fast enough and constructed correctly. Its goal is to stem job losses in large pockets of service sector jobs and small businesses feeling the most impact from "stay at home" orders. With 9.9 million Americans filing first time unemployment claims in the last two weeks of March, the early evidence is not encouraging. Until either a promising treatment is found or a vaccine is widely available, the idea of daily life returning to "normal," let alone opening borders and resuming flights, seems wildly hopeful in the near term.

Eyes on credit markets and public health

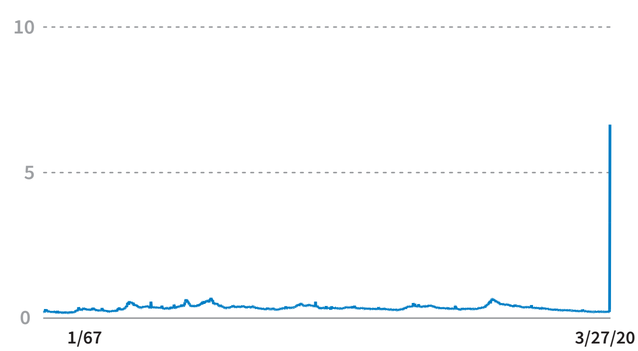
However, markets are forward-looking, and so our playbook for the second quarter is as follows. We believe that, first, funding markets need to be fixed and liquidity in the credit markets needs to normalize. The evidence on this front in the final trading days of March was encouraging. Next, the stimulus to the corporate sector, small businesses, and unemployed workers needs to be deployed. Congress and the Administration took a frustratingly long time to act, but with the signing of the CARES Act on March 27, that process looks to be in motion as well. Still, seeing how much economic, earnings, and default pain is priced into risk assets is like viewing a mosaic rather than a clear picture.

We enter the second quarter with a reasonable amount of investor capitulation and a washout of sentiment. That is a necessary but insufficient condition to add risk back to the portfolios. We also expect that this credit cycle, even if its timeline is more compressed than previous cycles, will likely follow the pattern in which credit markets recover before equity markets. Finally, with so many of the world's pharmaceutical and biotech companies now working tirelessly to defeat this common enemy, we believe any progress on the medical side of what is ultimately a medical problem will also be a signal that risks may have shifted back toward a more balanced posture.

Figure 3:

U.S. unemployment soars as workers must "stay at home"

Jobless claims in millions, 1967–2020



Source: Putnam.

Visit putnam.com for continuing market updates, expert insights, and investment commentaries.

Find us

For informational purposes only. Not an investment recommendation.

This material is provided for limited purposes. It is not intended as an offer or solicitation for the purchase or sale of any financial instrument, or any Putnam product or strategy. References to specific asset classes and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations or investment advice. The opinions expressed in this article represent the current, good-faith views of the author(s) at the time of publication. The views are provided for informational purposes only and are subject to change. This material does not take into account any investor's particular investment objectives, strategies, tax status, or investment horizon. Investors should consult a financial advisor for advice suited to their individual financial needs. Putnam Investments cannot guarantee the accuracy or completeness of any statements or data contained in the article. Predictions, opinions, and other information contained in this article are subject to change. Any forward-looking statements speak only as of the date they are made, and Putnam assumes no duty to update them. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties. Actual results could differ materially from those anticipated. Past performance is not a guarantee of future results. As with any investment, there is a potential for profit as well as the possibility of loss.

Consider these risks before investing: International investing involves certain risks, such as currency fluctuations, economic instability, and political developments. Investments in small and/or midsize companies increase the risk of greater price fluctuations. Bond investments are subject to interest-rate risk, which means the prices of the fund's bond investments are likely to fall if interest rates rise. Bond investments also are subject to credit risk, which is the risk that the issuer of the bond may default on payment of interest or principal. Interest-rate risk is generally greater for longer-term bonds, and credit risk is generally greater for below-investment-grade bonds, which may be considered speculative. Unlike bonds, funds that invest in bonds have ongoing fees and expenses. Lower-rated bonds may offer higher yields in return for more risk. Funds that invest in government securities are not guaranteed. Mortgage-backed securities are subject to prepayment risk. Commodities involve the risks of changes in market, political, regulatory, and natural conditions. You can lose money by investing in a mutual fund.

In the United States, mutual funds are distributed by Putnam Retail Management.

A world of investing.®

Putnam INVESTMENTS

Investors should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing. For a prospectus, or a summary prospectus if available, containing this and other information for any Putnam fund or product, call your financial representative or call Putnam at 1-800-225-1581. Please read the prospectus carefully before investing.

Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

Putnam Retail Management

TL001_RE 320804 4/20