Q2 2017 | Capital Markets Outlook

Recalculating the *if* and *when* of stimulus

Equities have risen on optimism rather than on actual economic improvement.

Pro-growth policies expected in the United States have been delayed by political wrangling.

Consider selective profit-taking as markets wait for policy to take shape.

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		●	○

Global allocation insights

Robert J. Schoen
Chief Investment Officer,
Global Asset Allocation

James A. Fetch
Co-Head of
Global Asset Allocation

Robert J. Kea, CFA
Co-Head of
Global Asset Allocation

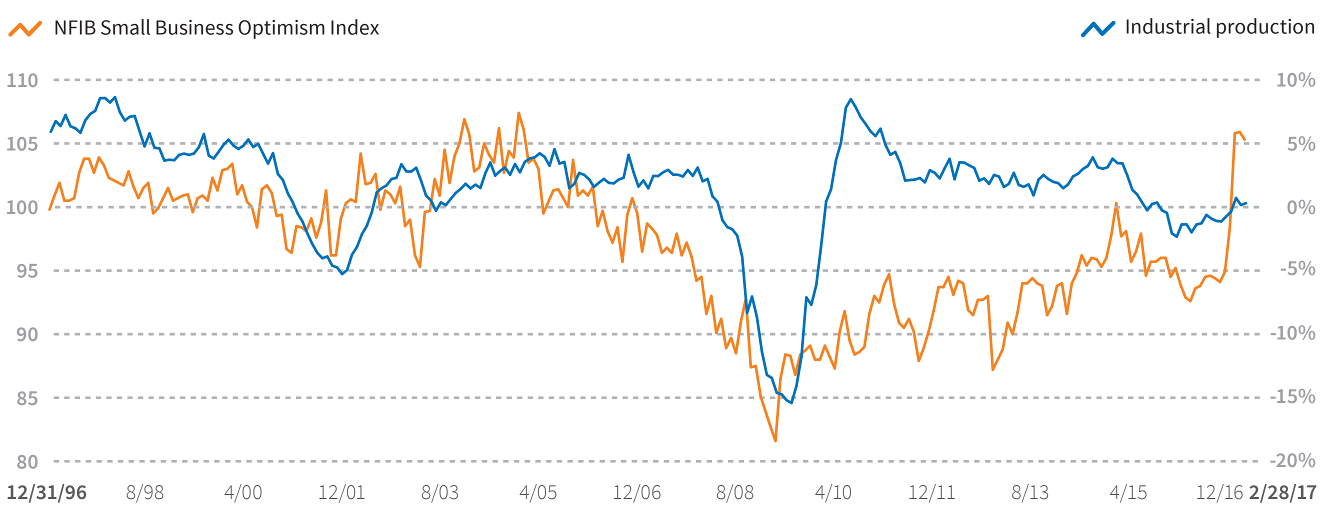
Jason R. Vaillancourt, CFA
Co-Head of
Global Asset Allocation

At the end of 2016, we wrote that the improvement in macroeconomic data in the second half of the year had been underappreciated and underpriced by global equity markets. The election, in and of itself, simply provided the resolution of some uncertainty. It is a subtle distinction, but it is important to separate the event from the outcome in that regard. And while we believed that markets were "catching up" with economic fundamentals early in the post-election rally, during the first quarter markets surpassed levels justified by the rebound in growth that began in the second half of 2016. The markets have even begun to price in a premium on what some have referred to as the Trump Trade.

Distinguishing substance from effervescence

The narrative of the Trump Trade (or what some have referred to as "the reflation trade") is that economic growth will receive an additional boost in coming years from a combination of 1) diminished regulatory burdens on the private sector, 2) lower personal and corporate taxes via comprehensive tax reform, and 3) fiscal stimulus, primarily in the form of infrastructure spending. We believe the current market premium exists due to the divergence between hard data — that is, measurements of actual output, production, and new orders — and soft data, which primarily consist of surveys and sentiment.

The giant leap of optimism obscures a small step for output

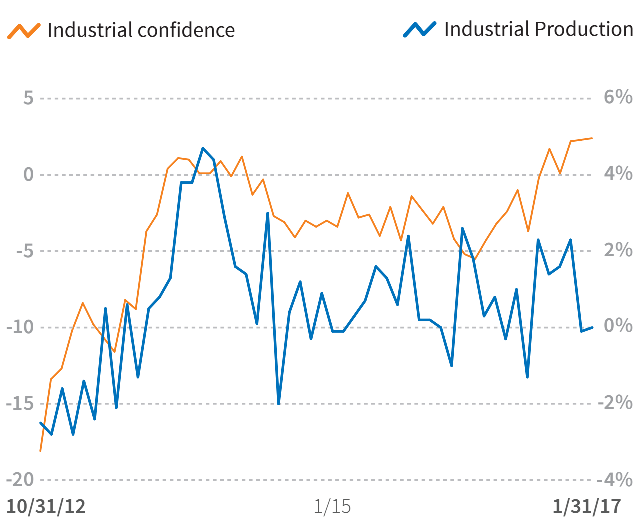


Sources: Putnam, National Federation of Independent Businesses, U.S. Federal Reserve (U.S. industrial production, year-over-year percentage change). Data is for the period 12/31/96–2/28/17.

Investors trying to discern the trajectory of future earnings growth are reminded of classic advice: "Watch what I do, not what I say," e.g., follow the hard data rather than the surveys.

Placing greater confidence in hard data rather than soft does not mean to dismiss the role of animal spirits, that is, the emotions or sentiments that can motivate investment behavior, as articulated by John Maynard Keynes in *The General Theory of Employment, Interest, and Money*. Far from it. The optimism evident in the market rally can easily lead to tangible effects like greater spending and hiring by corporate CEOs and CFOs. However, optimism is often fickle, and even when it persists, there can be a long lag between the onset of optimism and when the real economic impact becomes tangible. Sentiment can also be viewed skeptically because this unusual divergence between hard and soft data, in both magnitude and duration, is not solely a U.S. phenomenon. There are many developed countries around the world, including Germany, that recently have shared this conundrum.

German business confidence has outpaced economic fundamentals



Sources: Putnam, European Commission, German Ministry of Economics and Labor (German industrial production, year-over-year percentage change). Data is for the period 10/31/12–2/28/17.

Can the Trump train run on time?

With respect to pricing President Trump's reflationary policies, risky assets play the role of oddsmaker and serve as a discounting mechanism for the future value of incremental cash flows. Markets are assigning a probability of whether the policies are implemented — an *if* question — and then weighting the probability of a "yes" answer, in order to discount the future cash flow benefit of such an outcome. This second point addresses the question of *when* reflation might have tangible effects.

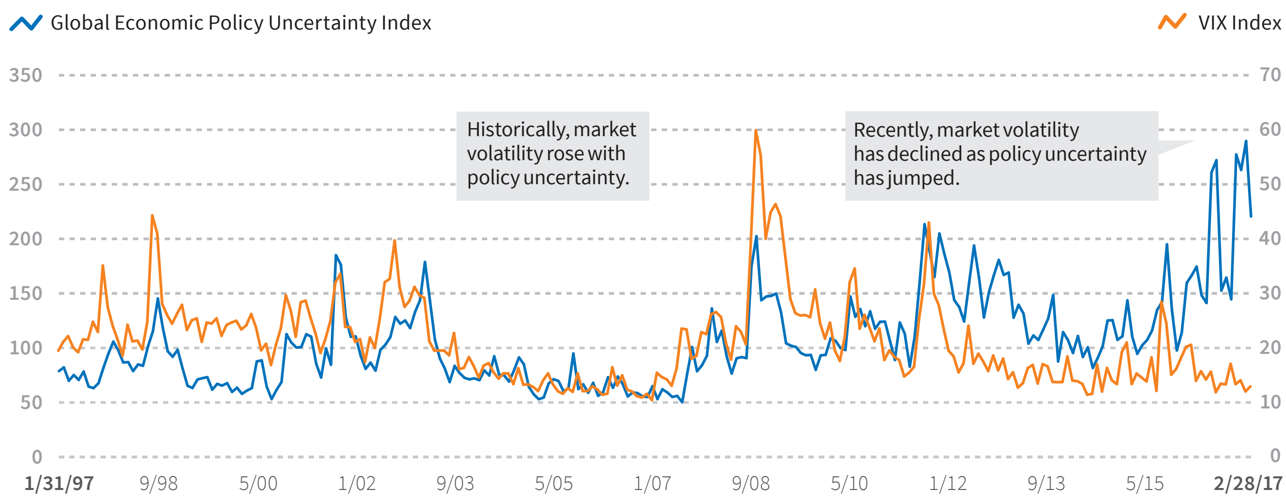
As we watched the drama unfold around Congress' consideration of the American Health Care Act (the Republican replacement for the Affordable Care Act), we were essentially seeing the timeline expand for enactment of the reflationary policies of the Trump campaign. An earnings boost that arrives in 2018 is worth less than an immediate boost. By definition, then, as the effort to repeal the ACA has faltered, we must lower the expected value of both the *if* and the *when*. The equity market actually began moderating expectations when, on March 21, we experienced the first decline of more than 1% in the S&P 500 Index in 109 trading days — the longest such streak since 1995. If expected tax and infrastructure initiatives stall in Congress, the market will need to adjust more.

Global political climate remains at risk

We also continue to be concerned about political risk in Europe. While the election in the Netherlands provided temporary relief from a wave of populism, it is not the end of the story. In France, opinion polls have been showing lower risk of Marine Le Pen winning the presidential election in May. This trend has helped to narrow the yield spread between French and German government bonds, a reflection of that perceived diminished risk. But polls got Brexit and Trump wrong, so should we really trust them now? Greek yields have also been widening again, highlighting the risk that the promised funding for Greece as a quid pro quo for some difficult structural reforms does not follow the same path as it did for Ireland and Portugal.

Policy uncertainty has risen above crisis levels while markets remain complacent

Global Economic Policy Uncertainty Index vs. the S&P 500 Volatility Index (VIX)



Sources: Putnam, Economic Policy Uncertainty Index, CBOE. Data is for the period 1/31/97–2/28/17.

Europe is not the only question mark. South Korea may be in the midst of political transition. President Park Geun-hye was impeached in December and removed from office, and the prime minister is now serving as president until an election scheduled for May. Leading the polls is an opposition candidate who would take a different, more conciliatory approach with North Korea than the current government. In Japan, Prime Minister Shinzo Abe is now mired in controversy surrounding a government land grant to a planned school at which his wife served as honorary principal.

As we begin the second quarter, we start the clock ticking on the two-year countdown to the United Kingdom's exit from the European Union. In a recent investor forum, former British Prime Minister David Cameron said that while he was optimistic that both sides would behave in an economically rational manner, they had to get the politics right for that to be the case. Both sides need to be able to demonstrate to their constituents a clear "win" in the outcome. Any grandstanding or antagonizing could jeopardize a good deal, and a bad deal would certainly be capable of stomping out the green shoots that appear to be taking hold in the European economy.

Politics will also continue to dominate the headlines in the United States as Congress in April approaches the end of the continuing resolution passed last December to keep the government funded. It will be important to continue to monitor the Republican party for signs of fracture between the establishment, moderates, and fiscal hawks. After the health-care mess, intra-party turmoil could make advancing other agenda items more difficult.

So while the economy's stronger pulse gives us confidence of a continued earnings recovery in several areas — particularly financials, materials, and large multinationals — we have concerns about all risk assets for the time being while we evaluate how some of these big global policy issues are likely to play out. We expect to see better entry points in the near future.

Market trends

Index name (returns in US$)	1Q 17	12 months ended 3/31/17
EQUITY INDEXES		
Dow Jones Industrial Average	5.19%	19.91%
MSCI EAFE (ND)	7.25	11.67
MSCI Emerging Markets (ND)	11.44	17.21
MSCI Europe (ND)	7.44	9.76
MSCI World (ND)	6.38	14.77
Nasdaq	12.09	22.77
Russell 1000	6.03	17.43
Russell 2000	2.47	26.22
Russell 3000 Growth	8.63	16.27
Russell 3000 Value	2.99	19.97
S&P 500	6.07	17.17
Tokyo Topix	5.27	15.68
FIXED INCOME INDEXES		
BB Government Bond*	0.68%	-1.34%
BB MBS*	0.47	0.17
BB U.S. Aggregate Bond*	0.82	0.44
BofA Merrill Lynch 91-day T-bill	0.10	0.36
CG World Government Bond ex-U.S.	2.02	-4.79
JPMorgan Developed High Yield	2.59	17.68
JPMorgan Emerging Markets Global Diversified	3.87	8.92
JPMorgan Global High Yield	2.87	17.80
S&P LSTA Loan	1.16	9.72
COMMODITY INDEX		
S&P GSCI	-5.05	8.45

* BB is an abbreviation for Bloomberg Barclays.

Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell indexes. Russell® is a trademark of Frank Russell Company.

Equity insights

Aaron M. Cooper, CFA
Chief Investment Officer, Equities

Simon Davis
Co-Head of Equities

Shep Perkins
Co-Head of Equities

U.S. equities: Earnings continue to recover

Looking ahead, we anticipate an environment in which politics may be the most significant force that drives — or disrupts — the U.S. equity market's momentum. The first quarter's relatively brief downturn could be an indication of the biggest risk for U.S. equities — that investors will become discouraged by setbacks and a lack of concrete, measurable progress for President Trump's pro-growth agenda.

Despite political uncertainties, we see reasons for optimism, including improving fundamentals for U.S. businesses. Earnings growth has been positive, and we expect it will continue, particularly in light of higher levels of consumer and business confidence. In addition, unlike the struggles with health-care reform, we may see less resistance to pro-business initiatives on the Trump agenda, such as tax reform, deregulation, and infrastructure spending.

Earnings growth takes on added importance when considering today's elevated equity valuations. While we wouldn't describe price-to-earnings multiples as alarmingly high, we believe equities are far from cheap. In our view, however, corporate profitability and stocks can move higher even with stretched valuations, and we believe the financial and industrial sectors in particular remain attractive. Finally, sentiment appears to be positive with respect to Federal Reserve policy, as investors viewed the Fed's recent interest-rate hikes as validation of economic strength rather than a precursor to the end of a growth cycle.

Non-U.S. equities: Positive signs in many markets

The improved economic backdrop in Europe in the fourth quarter of 2016 led to better year-end corporate earnings results — and, we expect, it may lead to bigger earnings surprises in the months ahead. A wide variety of companies in Europe's cyclical industries, as well as in the financials sector, should benefit from domestic economic reflation, and we expect that European exporters will continue to benefit from foreign exchange dynamics and relative economic stability in China and the emerging markets. As we have discussed in prior quarters, politics in Europe continue to pose a threat to the integrity of the European Union.

In the United Kingdom, where on March 29 Prime Minister Theresa May triggered the two-year clock for Brexit negotiations, the U.K.'s plan to depart the EU has yet to be felt as a headwind in the U.K. economy. That said, we note that U.K. consumers are in a worse place today than they were a year ago as higher inflation has collided with relatively stagnant wages. However, we currently see a variety of compelling valuation opportunities in the United Kingdom.

Turning to Japan, we continue to regard investing in Japanese equities as a highly sensitive play on the global economic recovery. Unlike the United States or Europe, domestic demand in Japan is not strong enough to drive a sustained economic recovery that could meaningfully impact the government's high debt levels. In the absence of strong domestic demand, Japan must look to external demand to help drive economic growth. For this reason, among others, we continue to believe the exporting sector holds some of the more interesting near-term opportunities for investors in Japanese stocks.

China has recently posted some better-than-expected economic results, which helped boost global markets in the first quarter. Importantly, as well, China maintains a clear interest in keeping the semblance of economic stability in advance of the 19th National Congress of the Chinese Communist Party, which will occur in the fall of 2017. After applying significant stimulus, China has more recently been dialing back some of the excesses in its economy, particularly in the financial and real estate sectors. In general, the risk here is that a structured slowdown would cool the economy — and hence global demand — more than the markets or policymakers anticipate.

Fixed income and currency insights

D. William Kohli
Chief Investment Officer,
Fixed Income

Michael V. Salm
Co-Head of
Fixed Income

Paul D. Scanlon, CFA
Co-Head of
Fixed Income

Fixed income: Rising tide of economic growth creates numerous strategy choices

While the post-election rally appeared to exhaust itself late in the first quarter, the global economic reflation story seems to be very much alive. On the basis of broadly positive macroeconomic data in the United States, Europe, Japan, and a variety of other markets, we maintain an optimistic outlook for a number of fixed-income sectors in the quarter ahead, particularly those sectors that are not heavily exposed to interest-rate risk. That said, as market participants monitor the interest-rate backdrop, as well as the transition from high expectations for growth-friendly policy to actual policy implementation in Washington, we expect volatility and risk aversion are likely to return periodically.

With respect to interest rates, we think the Fed may act somewhat more quickly than the market currently expects. The Fed hiked the federal funds rate by a quarter point on March 15, and it has projected that two more hikes are likely this year. For the time being, we think the Fed's anticipated plan does not depend on anything the Trump administration may or may not do in terms of policy. Instead, we observe that today's sustained backdrop of stronger commodity prices is adding to inflation in other segments of the economy, and this may induce the Fed to remain more explicitly on a path toward interest-rate normalization.

We also think the market currently may be underappreciating the possibility of monetary policy changes at the European Central Bank (ECB). The ECB, unlike the Fed, takes its policy cue from headline rather than core inflation. Headline inflation has risen rather substantially in Europe on the back of higher prices across the global commodity complex. While the ECB has said it will continue its quantitative easing program through the end of 2017, that does not mean the bank cannot raise interest rates. Indeed, it is likely to face increased pressure from the financials sector to leave its negative-rate policies behind.

Turning to the corporate debt markets, we note that spreads — the yield advantage of corporate bonds over comparable maturity U.S. Treasuries — are tight to historical averages, particularly among investment-grade bonds. Demand in this area has been quite robust, particularly from large investors such as global government agencies, supranational entities, and sovereign funds. Thus, while spreads are tight, we think fundamentals and demand will continue to help bolster this segment. We also expect high-yield bonds to continue to generate attractive returns in an environment of constructive fundamentals and below-average defaults. Of course, high-yield spreads have compressed significantly in recent quarters, and the average bond price within the index has moved close to par. As a result, valuations at the end of the first quarter of 2017 were not as attractive as they were in 2016. Nevertheless, we continue to like the prospects of high-yield credit in an environment of rising rates and inflation, even if returns are subdued as higher rates encourage investors to shift to other areas of the market.

In securitized debt, we continue to like the prospects of commercial mortgage-backed securities (CMBS) and non-agency residential mortgage-backed securities (non-agency RMBS). We also continue to find attractive opportunities in a relatively new segment of the securitized debt market: agency credit risk transfer securities (CRTs). The CRT market has grown substantially since these securities were introduced in 2013. CRTs provide investors with credit exposure to the U.S. residential mortgage market, helping to fill a void that has emerged from a lack of new supply in the non-agency RMBS sector. Against the backdrop of improving U.S. housing fundamentals, declining homeowner delinquency rates, and more stringent underwriting standards in recent years, we believe this area of the securitized sector will continue to offer compelling opportunities for investors going forward.

Currency

Within currency, the U.S. dollar outlook has become more clouded given the uncertainty associated with President Trump's policies, in particular, the ability of Congress to repeal and replace the Affordable Care Act (ACA) and repercussions this has for tax reform. As such, the more relevant driver of the dollar has been and remains the Fed. After ramping up its rhetoric and encouraging the market to price in a rate hike in March, the Fed released very subtle changes in the Statement of Economic Projection (SEP) "dots," helping to subsequently weaken the U.S. dollar. The Fed will continue to hike rates, but economic data and financial conditions will play a larger role in determining the pace, leaving the dollar as neither the leader nor laggard among currencies.

The outlook for the euro is dominated by relative monetary policy and the issue of political risk. The ECB left policy unchanged at its March meeting but signs of dissent among the hawks and doves seem to be occurring earlier than the market had expected. It is highly likely that during 2017 the ECB will need to reduce the exceptional degree of policy accommodation in place, albeit at a cautious pace, and barring an exceptional outcome in the French elections that could add to instability. This should put a floor under the euro and ultimately help it rise.

The United Kingdom has invoked Article 50 of the EU treaty and initiated the long legal process of leaving the EU. In this negotiation, the EU has incentive to discourage other member countries from thinking that leaving the union is more attractive than staying in it. While some agreement will be reached that is not catastrophic, negotiations are likely to begin on a discouraging note and become more practical over time. Also, as U.K. inflation has climbed due to a weaker currency and higher energy and food prices, the Bank of England saw its first dissenter calling for a rate hike. However, growth data is once again rolling over as real incomes and real spending are getting hit, and this will likely keep the Bank of England on the sidelines. This should keep the pound weak.

The Bank of Japan (BOJ) kept its Yield Curve Control settings unchanged and Governor Haruhiko Kuroda gave no signal the bank would consider exiting its extremely loose monetary policy this year, which leaves the yen as the G4 funding currency of choice. Supporting this thesis are signs that a wage-price spiral remains absent. Without greater wage growth, Japan's national CPI is likely to keep undershooting the BOJ's target. In the short run, the dollar-yen rate has traded in a range, and it is likely to remain range-bound.

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

Find us

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 | One Post Office Square | Boston, MA 02109 | putnam.com

Putnam Retail Management

TL001_RE 305673 4/17