Q4 2017 | Capital Markets Outlook

Goldilocks environment to persist, but valuations limit upside

The market has learned to take geopolitics, and even North Korea, in stride.

Any benefit to stock prices from tax cuts might be disappointing.

Watch and wait for the effects of central bank balance sheet unwinding.

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

Despite a very brief spell of volatility in August triggered by American and North Korean saber rattling, global equity markets and risk assets have continued to enjoy a stress-free year. The VIX Index, which measures market volatility, briefly touched 17 (its intraday high of the year) on August 17, but then quickly settled back into the low teens, where it has resided for most of 2017.

We believe August volatility receded quickly for two main reasons. First, markets have been trained to dismiss geopolitical risk ever since the Brexit vote in June 2016. Second, there is suddenly a bit of renewed optimism around the potential for meaningful corporate tax reform in the United States.

However, neither of these reasons gives us particular comfort when we think about allocations to equities and other risk assets for the coming quarter.

An accident could trigger conflict in Korea

The amped-up rhetoric regarding North Korea's nuclear weapons program is not particularly troublesome in and of itself, but the continued pace of missile tests and the actual firing of ICBMs over neighboring countries' airspace create the possibility, even if remote, of accidents happening. Nate Silver's *FiveThirtyEight* website recently posted a sobering article written by Oliver Roeder exploring the game theory of a nuclear standoff: "By talking tough, the Trump administration knows, or should know, that there's a higher chance of an accident — that some radarman in Pyongyang will sound the alarm at the first hint of a possible attack ... In many

Tax cut expectations have not affected portfolios of high-tax and low-tax stocks

Sector-beta controlled quintile sorts on tax rates, value-weighted cumulated index (5/31/16 = 100)

Source: Putnam. Data represents cumulative return indices of the top and bottom quintiles of the Russell 1000 Index by trailing 12-month effective tax rates (beta and sector neutral); each line is that quintile's performance relative to the Russell 1000.

game theoretic models, nuclear war only ever happens by accident." Using the phrases "nuclear war" and "by accident" together in the same sentence about a live situation doesn't really seem consistent with the VIX remaining in the single digits.

What tax cuts could mean to equities

As we wrote at the beginning of the year, a substantial cut in the effective corporate tax rate would have a positive impact on U.S. equity prices. More recently, many market commentators have suggested that there is virtually nothing priced into current market levels regarding tax reform or even tax cuts. We have a hard time believing that.

What equity prices suggest about tax-cut expectations

It stands to reason that stocks of highly taxed companies would react more significantly to prospects for lower rates, and so we studied stock prices of companies that pay high rates and compared them with companies that pay low rates to discern whether optimism for tax cuts has had an impact on relative performance. With awareness that isolating companies in the equity market based on effective tax rates is fraught with data challenges, we ranked companies in the Russell 1000 Index by tax rate and isolated the top and bottom 20% of companies (by number). We could then analyze a portfolio that is long high-tax stocks and short low-tax stocks.

Such a portfolio includes some interesting tilts in risk factors and industries, even while the overall beta to the equity market of the two baskets is essentially equal. We found that it would also include industry group overweights to energy, Internet, and health-care providers, along with underweights to REITs and biotechnology stocks. It would also have substantial risk factor tilts; namely, this long/short portfolio would be tilted toward companies that are larger and more profitable, and that yield lower dividends.

Given the industry dispersion and the divergence between large-cap and small-cap stocks in year-to-date performance, trying to use this bottom-up analysis to glean any insights regarding the probability of a favorable tax reform deal in Washington yields murky results at best. In any event, even controlling for these biases, it was very hard to detect any movement relative to the overall volatility in the long and short quintiles around the time of the November 2016 presidential election. If the date of the election were not displayed at the bottom of the chart on the previous page, it would be hard to identify it based on the move in these portfolios alone.

Business leaders show greater optimism

We think a better indicator of how much optimism there is regarding tax reform continues to be the elevated level of the NFIB Small Business Optimism Index: It has sustained its multi-decade highs since the election. This is corroborated by the continued high level of the CEO Confidence Index — as published by *Chief Executive* magazine — which likewise skyrocketed in the immediate aftermath of the election.

The optimism for tax cuts is easiest to see in surveys of CEOs

NFIB Small Business Confidence Index

Sources: National Federation of Independent Businesses, Small Business Confidence Index.

Ultimately, we may see something positive on the corporate tax front, but there is a risk that whatever is enacted will have only a modest impact on stock prices.

Stocks are drifting as central banks drain liquidity

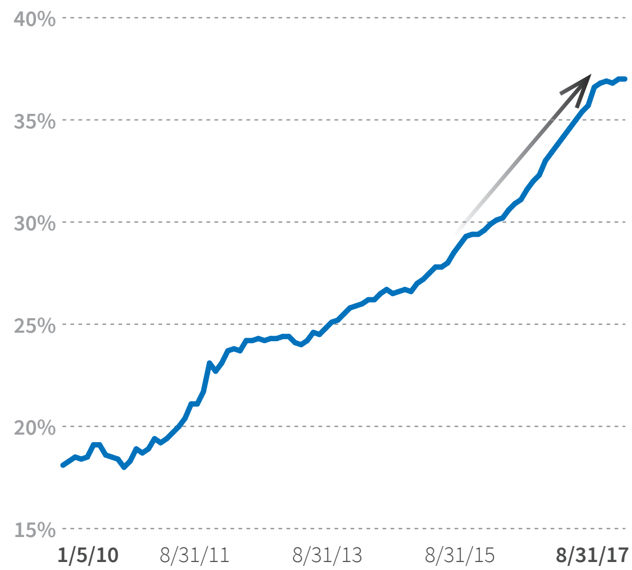
In the meantime, the major global central banks in aggregate have started the process of balance sheet normalization. It began with the Fed, and soon the European Central Bank (ECB) is also likely to provide clarity on winding down its asset purchase program. The Bank of England has recently sounded hawkish notes as well, leaving the Bank of Japan as the sole major monetary authority with a foot still on the accelerator. The following chart shows the aggregate balance sheets of these four major central banks relative to the combined GDP of their respective countries.

Given the substantial uptick in the growth rate of the liquidity backstop during 2015 and 2016, it is hard to imagine that the simultaneous growth in short volatility strategies is unrelated.

Of course, the lack of realized volatility is part of the story. However, given the current message of caution coming from most of our forecasting models, we feel that the impending announcements of active central bank balance sheet reduction is worthy of our attention. We will know soon enough whether this bull market is self-sustaining without the help of ever-growing liquidity. Also, given the reasonably high year-over-year earnings comparisons that companies will be facing at the beginning of 2018, the cost of waiting is relatively low.

Central banks have slowed balance sheet growth

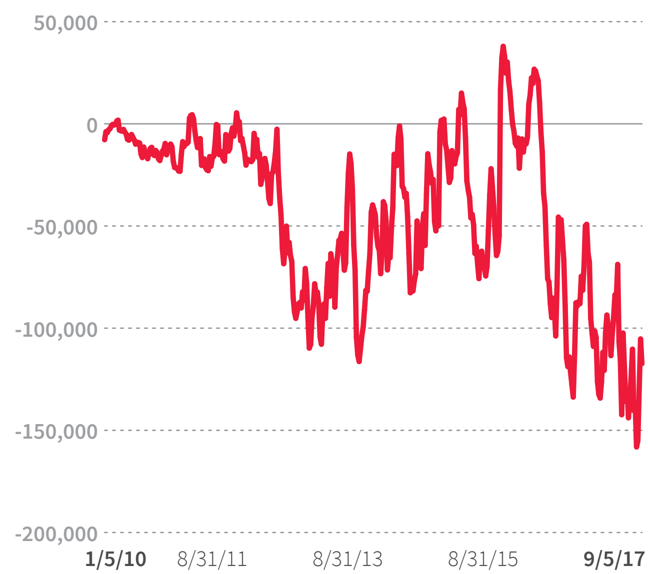
Central bank (U.S., euro area, U.K., and Japan) balance sheets as percentage of GDP



Source: Bloomberg.

Markets are short volatility

Net positioning by non-commercial traders in CBOE VIX Futures



Source: Commodity Futures Trading Commission.

Market trends

Index name (returns in US$)	3Q 17	12 months ended 9/30/17
EQUITY INDEXES		
Dow Jones Industrial Average	5.58%	25.45%
MSCI EAFE (ND)	5.40	19.10
MSCI Emerging Markets (ND)	7.89	22.46
MSCI Europe (ND)	6.45	22.30
MSCI World (ND)	4.84	18.17
Nasdaq	6.17	24.08
Russell 1000	4.48	18.54
Russell 2000	5.67	20.74
Russell 3000 Growth	5.93	21.87
Russell 3000 Value	3.27	15.53
S&P 500	4.48	18.61
Tokyo Topix	4.55	16.29
FIXED INCOME INDEXES		
BB Government Bond*	0.38%	-1.56%
BB MBS*	0.96	0.30
BB U.S. Aggregate Bond*	0.85	0.07
BofA Merrill Lynch 91-day T-bill	0.26	0.66
CG World Government Bond ex-U.S.	2.57	-3.14
JPMorgan Developed High Yield	2.05	9.65
JPMorgan Emerging Markets Global Diversified	2.63	4.61
JPMorgan Global High Yield	2.24	9.93
S&P LSTA Loan	1.02	5.29
COMMODITY INDEX		
S&P GSCI	7.22%	1.79%

* 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.

Merrill Lynch, Pierce, Fenner & Smith Incorporated ("BofAML"), used with permission. BofAML permits use of the BofAML indices and related data on an "as is" basis, makes no warranties regarding same, does not guarantee the suitability, quality, accuracy, timeliness, and/or completeness of the BofAML indices or any data included in, related to, or derived therefrom, assumes no liability in connection with the use of the foregoing, and does not sponsor, endorse, or recommend Putnam Investments, or any of its products or services.

Equity insights

Aaron M. Cooper, CFA
Chief Investment Officer, Equities

Simon Davis
Co-Head of Equities

Shep Perkins
Co-Head of Equities

Global equity markets continue to shrug off risks

In several ways, 2017 has defied expectations. In the United States, economic growth, which was expected to accelerate, has been underwhelming. Inflation and interest rates were expected to increase, but inflation has been stagnant and the 10-year Treasury yield is on track to end the year lower than where it began. Cyclical and value stocks have underperformed significantly. There is disappointment over a stalled legislative agenda in Washington, discomfort with rising equity valuations, and narrow market leadership from a handful of large-cap growth stocks. Yet U.S. equities have moved steadily higher, setting multiple records, with the S&P 500 Index breaking 2,500 for the first time in September.

Even more unexpected, however, is the performance of markets outside the United States, which have also been largely unfazed by uncertainties. They have performed well despite the distraction of escalating geopolitical tensions, a contentious European electoral cycle, continued uncertainty over the implications of Brexit, and the risk of a more protectionist U.S. trade policy. The biggest rally occurred in emerging markets stocks. The MSCI Emerging Markets Index in September reached its highest level in six years.

Putting valuations in perspective: Is Europe compellingly cheap?

As we enter the final quarter of 2017, the chief issue for global equity markets is valuation levels. A common belief is that multiples are too high, and that U.S. equities in particular are expensive relative to Europe. In our analysis of valuations in the U.S. and European markets, we find that more than half of the discrepancy in average P/E multiples can be attributed to differences in industry weightings. European equities appear cheaper, but the MSCI Europe Index generally has higher weightings in lower-multiple sectors such as energy and financials, while the S&P 500 Index has larger weightings in the higher-multiple technology sector. Additionally Amazon, a high P/E (200+ times), mega-cap constituent in the consumer discretionary sector, has no equivalent in Europe. It alone accounts for another 10% of the difference in the valuation spread between the United States and Europe. This observation does not mean that Europe offers nothing. Fundamental research can uncover many attractive opportunities among European equities today. But seeking broad exposure to Europe based solely on valuation levels may be misguided.

Positive synchronization across global economies may help extend the rally

It is natural to look toward 2018 and wonder how equities can advance further without certain catalysts, such as greater acceleration in economic growth. However, the markets have enjoyed some positive trends that could continue to support stock performance. The first is corporate earnings growth. In the United States, S&P 500 companies just saw a second consecutive quarter of double-digit growth for the first time since 2011. Wall Street's forecasts are for 10% growth in 2018, and there has been constructive guidance from businesses overall.

The most encouraging factor for equities today may be the impressive level of synchronized global economic improvement. Global equity markets often stumble as a result of serious economic woes in a specific region, such as the eurozone debt problems of 2010 and 2012 or the China slowdown fears in 2016. Today, however, we have decent economic conditions in the United States, improvement in Europe, and impressive growth in China. Global economic variables are more in sync now than at almost any other time since the Great Recession.

Sectors to watch: Value and cyclicals

Throughout 2017, the bulk of U.S. equity performance has been in growth stocks at the expense of value stocks. While it is not unusual for the styles to diverge, there has been a dramatic bifurcation this year. The highest P/E stocks continue to outperform the lowest P/E stocks — consistently and by a considerable margin. As we assess the macroeconomic and earnings environment, we find the most relative value in cyclical sectors. In areas such as energy and industrials, many fundamentally strong companies with exposure to key growth trends are trading at below-market multiples. Another sector that stands out is financials. These companies have struggled recently, but with improving global macroeconomic trends and the potential for rising interest rates, we believe they are poised for improvement.

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: Short-term dynamics favor Fed rate move in December

U.S. economic data remained positive in the third quarter and consistent with an economy growing steadily at around 2.0% to 2.5%. The major issues as we enter the fourth quarter continue to be the geopolitical confrontation over North Korea's missiles and nuclear weapons program and its potential to disrupt trade and growth; the persistence of low inflation and its implications for central bank policies; and the developing debate over U.S. fiscal policy and, more specifically, possible actions on the debt ceiling, tax reform, and the federal budget.

Given the positive global economic growth profile, both the Fed and the European Central Bank (ECB) seem set to move — the Fed by beginning balance sheet reduction in October and increasing rates again in December, and the ECB by outlining its plans to taper its bond purchasing program. The Fed has been clear that it views the recent negative inflation surprises in U.S. data as temporary and transitory. Although we find it difficult to be confident in this view, we expect inflation will move higher in the short run. Looking toward 2018, however, we expect core inflation to remain in a narrow range, at a level that's consistent with the Fed's target, and which therefore may not warrant the three rate hikes that a majority of Federal Open Market Committee (FOMC) members projected at the September Fed meeting.

Multiple fixed-income sectors continue to offer opportunity

We remain constructive on the U.S. investment-grade corporate bond market on account of its improving fundamentals, favorable technical conditions, and fair valuation. Our outlook is for continued improvement in fundamentals, subject to unknown government policy initiatives.

In mortgage credit-sensitive areas, we favor an allocation to commercial mortgage-backed securities (CMBS). The underlying fundamentals for commercial real estate continue to be stable overall as employment growth, low interest rates, and a positive GDP trajectory provide a tailwind for the CMBS sector. We anticipate some losses in regional mall-related credit. However, malls are showing some ability to repurpose their space to capture new types of tenants. Ultimately, we do not believe these issues will translate into fundamental losses at the BBB-tranche level.

We continue to have a constructive general view on the high-yield asset class. The fundamental landscape of U.S. high-yield issuers continues to be stable and buoyed by solid corporate earnings. There is also cause for optimism that high-yield issuers stand to benefit from pro-growth reforms expected in Washington, including deregulation and fiscal stimulus. However, the timing of policy implementation remains in question. Despite our positive general view, we are somewhat more cautious on the energy sector due to ongoing supply/demand concerns and uncertainty around OPEC production. From a valuation standpoint, although credit spreads are measurably tighter year over year, they continue to look fair on the back of good fundamentals.

Currency: Central bank tightening and leadership uncertainty create new concerns

The U.S. dollar outlook continues to be most heavily influenced by the Fed and rising expectations that some fiscal policy boost could be expected in early 2018. Beyond that, market pricing for rate-hike expectations remains low as the future composition of the Fed is highly uncertain. What seems likely is that the new chair will keep policy accommodative and the dollar will remain on a weaker footing over the medium term. Over the coming months, Fed nominees should be vetted and appear before Congress for confirmation. As this process resolves uncertainty, coupled with an improvement in sentiment from a fiscal boost, the dollar could become tactically stronger, especially against the yen.

The outlook for the euro remains dominated by relative monetary policy. The ECB continues to balance policy doves, who point to a tame core inflation rate, with hawks, who call for the removal of emergency measures (i.e., tapering and then ceasing asset purchases). This balance is likely to persist until October or December, when the ECB will communicate to the market what it will do at year-end when the purchase program expires. The euro has already moved considerably, so much of the near-term direction will be based on perceptions relative to this baseline view. Over the medium term, the euro should continue to appreciate.

In the United Kingdom, the discussions over Brexit remain fluid and quite noisy, contributing significant volatility to the British pound. Unless there is a breakthrough, this should be expected to persist. The statements from the Bank of England (BoE) have been surprising, as the focus has shifted from maintaining accommodative policy in the face of Brexit to treating the impact from a reactionary standpoint. As such, the BoE has set the market up for a series of rate hikes likely beginning in November and continuing throughout 2018, which should keep the pound supported against the U.S. dollar, barring a major political mistake.

Bank of Japan (BoJ) Governor Kuroda continues to underscore that the inflation outlook remains subdued, and, as such, the market should not expect any change in BoJ policy, adding that there is no need to raise rates just because global rates rise. With financial market volatility low, the yen should continue to soften as capital leaves Japan to be invested in higher-yielding assets abroad. The continued support of Prime Minister Abe is key and should be thought of as a base case. Abe has called a snap election; if his Liberal Democratic Party suffers losses, it is more likely that Governor Kuroda will not be reappointed, and the fundamentally cheap yen will quickly strengthen.

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

Find us

This material is for informational and educational purposes only. It is not a recommendation of any specific investment product, strategy, or decision, and is not intended to suggest taking or refraining from any course of action. It is not intended to address the needs, circumstances, and objectives of any specific investor. Putnam, which earns fees when clients select its products and services, is not offering impartial advice in a fiduciary capacity in providing this sales and marketing material. This information is not meant as tax or legal advice. Investors should consult a professional advisor before making investment and financial decisions and for more information on tax rules and other laws, which are complex and subject to change.

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.

Diversification does not guarantee a profit or ensure against loss. It is possible to lose money in a diversified portfolio.

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.