

Q1 2019 | Fixed Income Outlook

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Global growth outlook cools amid higher interest rates and market volatility

The U.S. economy will likely slow in 2019 as higher rates and policy uncertainty take a toll on sentiment and investment.

China and the United States wrap up trade talks in Beijing in a bid to ease trade war.

Global bond yields will continue to rise, posing headwinds for financial markets.

The outlook for global growth in 2019 has slipped because of rising real interest rates, trade tensions, and asset market volatility. The U.S. economy is likely to expand at a more moderate pace compared with 2018 as the impact of the 2017 tax cut fades and interest rates trend higher. Still, unemployment has touched multi-decade lows, inflation remains anchored, and the likelihood of a recession remains low.

We believe global interest rates will continue to drift higher in 2019. The Federal Reserve raised short-term rates in December, taking the federal funds rate to a range of 2.25% to 2.50%. Market volatility and the resulting tighter financial conditions have led the Fed to shift recently to a more flexible and dovish tone. Across the Atlantic, the European Central Bank [ECB] left rates unchanged and ended its multi-trillion bond-buying program. Trade disputes between the United States and China escalated and ebbed.

Putnam fixed-income views

Shading in the table indicates the change from the previous quarter

	Underweight	Small underweight	Neutral	Small overweight	Overweight
U.S. government and agency debt	●				
U.S. tax exempt			●		
Tax-exempt high yield				●	
Agency mortgage-backed securities			●		
Collateralized mortgage obligations					●
Non-agency residential mortgage-backed securities				●	
Commercial mortgage-backed securities					●
U.S. floating-rate bank loans					●
U.S. investment-grade corporates				●	
Global high yield				●	
Emerging markets			●		
U.K. government	○			●	
Core Europe government		○		●	
Peripheral Europe government			●		
Japan government		●	○		

Currency strategy

U.S. dollar versus

	Favor other	Neutral	Favor dollar
€ Euro		●	
£ Pound	●		
¥ Yen		●	

President Donald Trump and Chinese President Xi Jinping agreed to hold off on further tariffs until March 1, 2019, to allow time to negotiate a trade agreement.

Fixed-income markets were mixed in the fourth quarter of 2018. The risk appetite for fixed-income sectors waned amid turmoil in U.S. and global equity markets. Short-term Treasury yields rose, and longer-term Treasury yields fell. The widely watched spread between two- and 10-year Treasury yields narrowed to around 21 basis points at the end of 2018. We expect global and U.S. sovereign fixed-income yields to trend higher by the end of 2019. The Fed seems to be at a pause at the moment, considering whether to continue the path of rate increases or to slow the pace or pause.

U.S. economy set to cool

Falling stock prices, weakening global growth, and concerns about President Trump's economic policies have set investors on edge and prompted warnings that the U.S. economic expansion is nearing its end. Indeed, the U.S. economy is heading into 2019 with slowing momentum. Our central scenario is for economic growth to moderate to its pre-2018 range this year amid higher interest rates and shifting fiscal and trade policies. Buoyed by government spending and tax cuts, the U.S. economy grew at a 3.5% annual rate in the third quarter of 2018, after expanding 4.2% in the second quarter. Unemployment has touched multi-decade lows, inflation remains anchored around 2%, and the likelihood of a recession remains low. The labor market remains strong as hiring improved and wage gains accelerated. The unemployment rate was 3.9% in December 2018.

Fed Chair Jerome H. Powell acknowledged at the December rate-setting meeting that the economy is showing signs of "softening." The central bank lowered its 2019 growth forecast from 2.5% to 2.3%. The risks to growth remain asymmetric. Indicating this softening, the Institute for Supply Management's (ISM) closely watched manufacturing index tumbled in December 2018.

In addition, there is little evidence of the kind of rise in corporate investment that would be necessary to keep growth strong in the absence of fiscal stimulus. Investment has been underperforming, and forecasts for investment spending are slipping. We are left with the very real risk that the Fed will be too aggressive, placing too much weight on

the labor market — which is at best a contemporaneous indicator — and not enough on the erosion of the economy's prospects.

Fed ready to pause?

The Fed raised its benchmark rate four times in 2018. The federal funds rate can slow the economy because it closely ties to consumer debt, home equity lines of credit, and other adjustable-rate instruments. The Fed is also gradually reducing its \$4.5 trillion balance sheet following a decade of quantitative easing. Financial markets remain on edge, and investors are starting to bet the Fed could reverse policy as growth slows and start cutting rates before the end of 2019.

The Fed seems to be struggling a bit to get its message across. In December, Fed officials signaled two rate hikes in 2019 before capitulating to volatile markets. Powell said in January that low inflation would allow the Fed to be "patient" in deciding whether to continue raising interest rates, a message welcomed by jittery investors. It's clear the Fed is beginning to take seriously the issues that are now worrying the markets: weaker global growth, the widening consequences of the China-U.S. trade war, and financial market volatility.

Falling long-term bond yields are a sign that bond investors expect the economy to slow. Higher rates also create headwinds for fixed-income assets. The yield on the benchmark 10-year note traded around 2.69%, while the two-year yield held at around 2.48% at year-end 2018. Bond yields move inversely to prices.

ECB's interest-rate conundrum

The eurozone's economic indicators continue to disappoint. Growth is slowing, inflation is below market expectations, and domestic consumption remain sluggish. The core inflation measure watched by the European Central Bank rose by 1.1% year on year in December, the same as in November and in October, defying ECB expectations that it would be moving up by now. With the overall economic outlook not changing very much, it is looking more and more likely that 2019 will pass without an interest-rate hike by the ECB. The central bank ended its quantitative easing (QE) program in December. Starting this year, the ECB bond buying will happen in the form of reinvesting funds from maturing bonds it holds.

In addition, the eurozone's reform agenda and growth continue to struggle against a difficult political backdrop. Political stresses are becoming more evident in places such as France, Spain, and Italy. These stresses keep bubbling up, reflecting popular dissatisfaction with the status quo. There were protests in France over higher taxes on diesel and gasoline. In Spain, the success of the far-right party Vox in Andalusia (southern Spain) elections sent shock waves through the country's political establishment. Italy continues to contend with high debt levels and a shrinking economy. In December, the European Union reached a deal with Italy on its 2019 budget, which allows the eurozone's third-biggest economy to avoid disciplinary action.

China's cooling economy

China, the world's second-biggest economy, is slowing amid deleveraging and trade tensions with the United States. Beijing has stepped up efforts to ease monetary policy and bank lending restrictions to lift growth. We believe the authorities have the policy tools, including control of the currency, to offset shocks to the economy. China's currency, the renminbi, had depreciated to its weakest level in a decade against the dollar in October 2018 amid worries about trade tensions and domestic growth. The yuan appreciated slightly in January 2019, fueled by hopes that China and the United States will reach a trade deal and the U.S. Fed may halt interest-rate hikes.

China and the United States wrapped up three days of trade talks in Beijing in January 2019. So far, both parties have given few details about the outcome. The Sino-U.S. trade war creates policy options for the Chinese government. China can calibrate what kind of concessions

they are prepared to offer with an eye on the domestic economy. However, as the economy gets bigger and more sophisticated, the policy challenges will mount. And the chance of a policy mistake will rise. China's government is used to having control over the economy and being able to fine-tune economic outcomes as closely as they fine-tune political outcomes. But their ability to do this is shrinking over time.

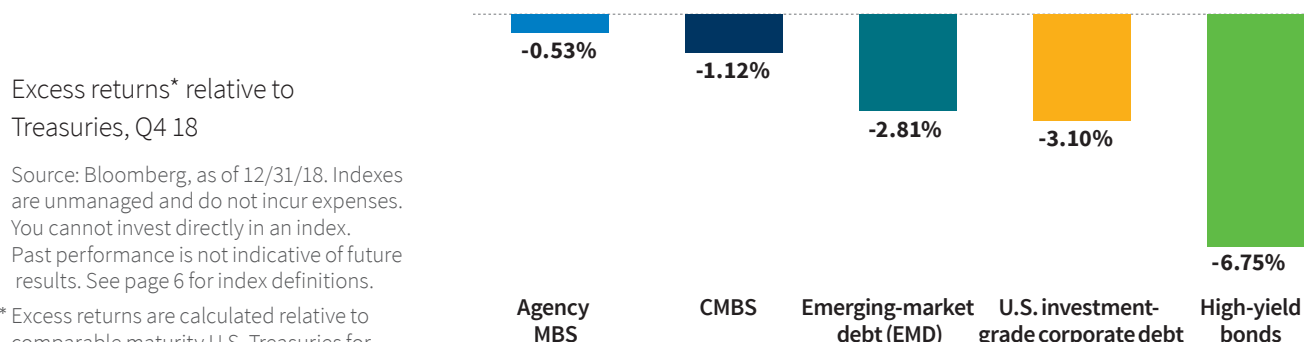
Sector views

Conservative approach to credit strategies

For some time, we have held the view the Fed was attempting to normalize interest rates, and that it would continue to raise its target for short-term rates as long as the markets seemed to be accommodating these increases. Given the volatility that pervaded markets in the fourth quarter, we now think the Fed is likely to pause, perhaps until the second half of 2019.

In fixed-income markets, we continue to favor mortgage credit, prepayment risk, and corporate credit. However, because we are in the later stages of both the economic and credit cycles, we are taking a somewhat more conservative approach than previously. We are doing this by purchasing securities with less price sensitivity to changes in yield spreads, while also seeking greater credit protection by investing at more senior levels in a deal's credit structure. After asset prices dropped in the fourth quarter, yields are higher across many market sectors. We think this may give us the ability to generate greater income in our portfolios.

Risk assets came under tremendous pressure during the quarter



Source: Bloomberg, as of 12/31/18. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index. Past performance is not indicative of future results. See page 6 for index definitions.

* Excess returns are calculated relative to comparable maturity U.S. Treasuries for each index.

The portfolio's exposure to commercial mortgage-backed securities via the CMBX — an index that references a basket of CMBS issued in a particular year — hurt results during the fourth quarter as the index's average yield spread widened substantially. The prices of credit-sensitive securities decline as yield spreads widen. Investments in agency credit risk-transfer securities and pay-option adjustable-rate mortgage-backed securities were further detractors after delivering generally steady performance during the first nine months of the year.

Fundamental backdrop for high-yield bonds look positive

High-yield securities struggled during the fourth quarter as investors shifted away from riskier categories. High-yield bonds declined 4.65% during the fourth quarter, as measured by the JPMorgan Developed High Yield Index, trailing high-yield bank loans as well as the broad investment-grade fixed-income market.

As we enter 2019, we have a positive outlook for market fundamentals and think valuations are more attractive in the sector. The fundamental backdrop for high-yield bonds remains supportive, led by corporate profit growth, a strong labor market, and rising employee wages. Including distressed exchanges, the U.S. high-yield default rate was 1.9% as of December 31, 2018, below the long-term historical average of about 3.5%. We think default

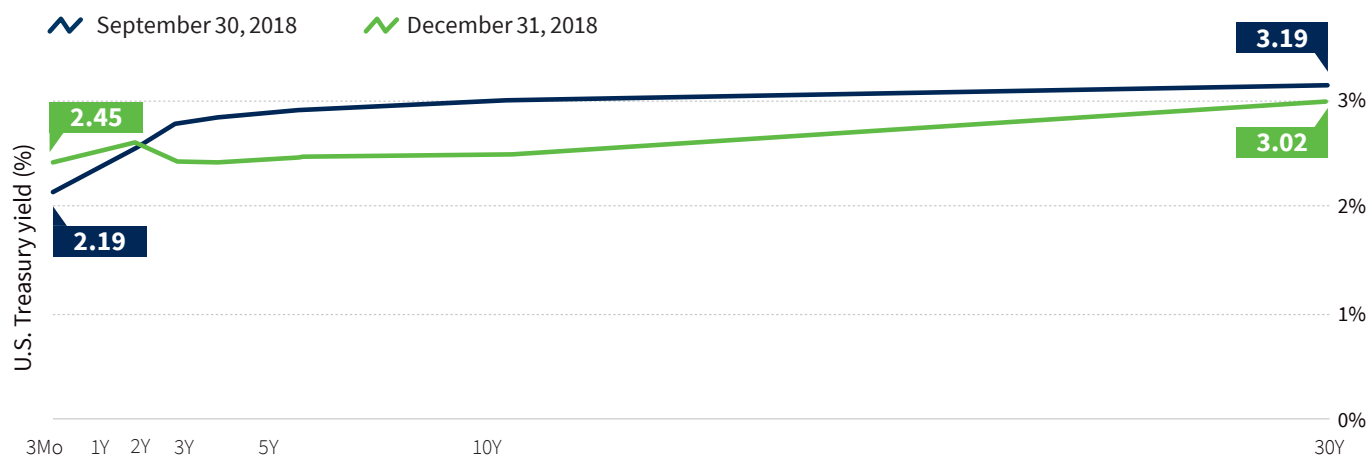
rates could remain below average for the next year or two, and possibly longer, for two key reasons: the relative financial health of high-yield issuers overall, and the fact that many have refinanced and extended bond maturities into the future.

Currency views

The dollar may stabilize

At its December meeting, the Federal Open Market Committee (FOMC) hiked rates by 25 basis points. The FOMC also lowered its median expectation for interest-rate hikes in 2019 from three to two. Powell emphasized the FOMC will rely on data to decide on rate increases but would continue to follow plans to reduce its balance sheet. The market was expecting a significantly more dovish outcome, and risky assets weakened following these statements. Since then, Powell and other Fed speakers have softened their tone and implicitly signaled a pause to the rate-hike cycle. Powell has also indicated that balance sheet policy could change if conditions warrant. This should help to alleviate some of the upside pressure on the U.S. dollar coming from Fed policy.

Risk-off market sentiment caused most of the yield curve to rally and flatten during Q4



Source: U.S. Treasury Department, as of 12/31/18. Past performance is not indicative of future results.

The euro also looks steady

The outlook for the euro remains dominated by monetary policy, growth, and political risk premium. Expectations for higher inflation have been pushed back because of recent low oil prices. Some aspects of core inflation have proven weaker than expected. While the ECB ended its asset purchase program in December, it also revised down its growth and inflation forecasts. This, in turn, justified expectations that the ECB would delay its first-rate hike until after the summer of 2019, or early 2020. The delay in the rate hike should limit how much the single currency can rally on a weaker dollar.

Brexit weighs on the pound

In the United Kingdom, Brexit noise remains high. Prime Minister May survived a no-confidence vote. This step prevents another challenge to her leadership for the next 12 months. The European Court of Justice determined the United Kingdom can revoke the Article 50 process, the step it took to initiate Brexit. This decision significantly reduces the likelihood of Brexit occurring without a new arrangement between the United Kingdom and the European Union. While considerable work on an arrangement remains ahead and may continue to cause market volatility, a soft Brexit is now the most likely outcome. While this uncertainty remains, the pound's appreciation will likely be limited.

Japan adjusts policy

The Bank of Japan (BoJ) changed its yield curve control (YCC) policy in August. It allows for an elongated policy horizon driven by focusing on the price (level) of rates over quantity. At subsequent meetings, the BoJ continued to endorse this policy. With Japan's growth and inflation moving lower, it's likely that policy will remain accommodative even longer than previously expected. The risk to this outlook is if the YCC and negative interest rate (NIRP) become more damaging to regional banks. This could alter the flow of credit to the real economy, a risk that could lead to further tweaks in YCC.

Putnam's veteran fixed-income team offers a depth and breadth of insight and an independent view of risk.

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 90 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.

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* As of December 31, 2018.

Agency mortgage-backed securities are represented by the Bloomberg Barclays U.S. Mortgage Backed Securities Index, which covers agency mortgage-backed pass-through securities (both fixed rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Commercial mortgage-backed securities are represented by the Bloomberg Barclays U.S. CMBS Investment Grade Index, which measures the market of commercial mortgage-backed securities with a minimum deal size of \$500 million. The two subcomponents of the U.S. CMBS Investment Grade Index are U.S. aggregate-eligible securities and non-eligible securities. To be included in the U.S. Aggregate Index, the securities must meet the guidelines for ERISA eligibility.

Emerging-market debt is represented by the Bloomberg Barclays EM Hard Currency Aggregate Index, which is a flagship Emerging Markets debt benchmark that includes USD, EUR, and GBP denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The index is broad-based in its coverage by sector and by country, and reflects the evolution of EM benchmarking from traditional sovereign bond indices to Aggregate-style benchmarks that are more representative of the EM investment choice set.

Eurozone government is represented by the Bloomberg Barclays European Aggregate Bond Index, which tracks fixed-rate, investment-grade securities issued in the following European currencies: euro, Norwegian krone, Danish krone, Swedish krona, Czech koruna, Hungarian forint, Polish zloty, and Swiss franc.

High-yield bonds are represented by the JPMorgan Developed High Yield Index, an unmanaged index of high-yield fixed-income securities issued in developed countries.

Japan government is represented by the Bloomberg Barclays Japanese Aggregate Bond Index, a broad-based investment-grade benchmark consisting of fixed-rate Japanese yen-denominated securities.

Tax-exempt high yield is represented by the Bloomberg Barclays Municipal Bond High Yield Index, which consists of below-investment-grade or unrated bonds with outstanding par values of at least \$3 million and at least one year remaining until their maturity dates.

U.K. government is represented by the Bloomberg Barclays Sterling Aggregate Bond Index, which contains fixed-rate, investment-grade, sterling-denominated securities, including gilt and non-gilt bonds.

U.S. floating-rate bank loans are represented by the S&P/LSTA Leveraged Loan Index, an unmanaged index of U.S. leveraged loans.

U.S. government and agency debt is represented by the Bloomberg Barclays U.S. Aggregate Bond Index, an unmanaged index of U.S. investment-grade fixed-income securities.

U.S. investment-grade corporate debt is represented by the Bloomberg Barclays U.S. Corporate Index, a broad-based benchmark that measures the U.S. taxable investment-grade corporate bond market.

U.S. tax exempt is represented by the Bloomberg Barclays Municipal Bond Index, an unmanaged index of long-term fixed-rate investment-grade tax-exempt bonds.

You cannot invest directly in an index.

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