Q1 2021 | Fixed Income Outlook

**D. William Kohli**
Co-Chief Investment Officer,
Fixed Income

**Michael V. Salm**
Co-Chief Investment Officer,
Fixed Income

**Paul D. Scanlon, CFA**
Co-Head of Corporate
and Tax-exempt Credit

# Bond investors chase yields amid vaccine rollout

***U.S. Treasury bond yields may trend slightly higher, lifted by expectations of additional fiscal spending.***

***We have a relatively positive medium-term outlook for corporate credit.***

***Vaccines may reduce mobility restrictions, but global economic recovery is likely to remain uneven.***

## 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 | ● | | |

Global financial markets trended higher during the fourth quarter, powered by the emergence of COVID-19 vaccines and continuing stimulus policies. Multiple coronavirus vaccines fueled hopes of returning to more normalcy in the economy, markets, and society as we move through 2021. But those gains and global economic recovery will depend on the rollout of coronavirus vaccines, corporate earnings, and the Federal Reserve's policy stance. The rate-sensitive Bloomberg Barclays U.S. Aggregate Bond Index advanced 0.67% during the quarter. The ICE BofA 1–3 Year U.S. Corporate Index rose 0.74%.

The Fed has pinned short-term interest rates near zero since March 2020. They also launched an array of lending programs and began large-scale purchases of government debt and mortgage securities. Central banks across Europe, Asia, and other regions also rolled out COVID-19 stimulus measures. In late December, the U.S. Congress approved a $900 billion pandemic relief package that would send direct payments to many Americans, provide aid to businesses, and fund distribution of vaccines, among other measures. This comes as COVID-19 cases began to surge in the United States. and globally, and some areas imposed new lockdown measures.

The U.S. Treasury yield curve moved higher and steepened somewhat during the period. The benchmark 10-year note finished the quarter at 0.93% from 1.88% at the beginning of 2020; the 2-year note yield fell to around 0.13% from 1.58%. Low yields on government debt have driven investors in search of better potential returns, including high-yield and investment-grade corporate bonds. We have a relatively positive medium-term outlook for corporate credit. Mortgage credit strategies also gained, supported by a strong housing market. Still, the commercial mortgage-backed securities (CMBS) market — especially retail and hospitality — face a challenging landscape due to the pandemic.

### Fed extends lifeline with bond purchases

The Fed left short-term rates near zero at its December meeting and pledged to continue buying government-backed debt for the foreseeable future. Fed chair Jerome Powell said policy makers would keep their effort to bolster demand going "for some time," as they try to coax the economy back to full strength. The Fed has been buying $80 billion in Treasuries and $40 billion in mortgage bonds monthly since June and plans to maintain those purchases until there is progress in employment and inflation goals. We believe the central bank's backstop remains supportive for credit spreads. The Fed's efforts helped keep the yield on the 10-year Treasury note below 1% last quarter. But in early January, the 10-year yield rose above 1% for the first time since March, reflecting increased bets on additional fiscal spending in Washington.

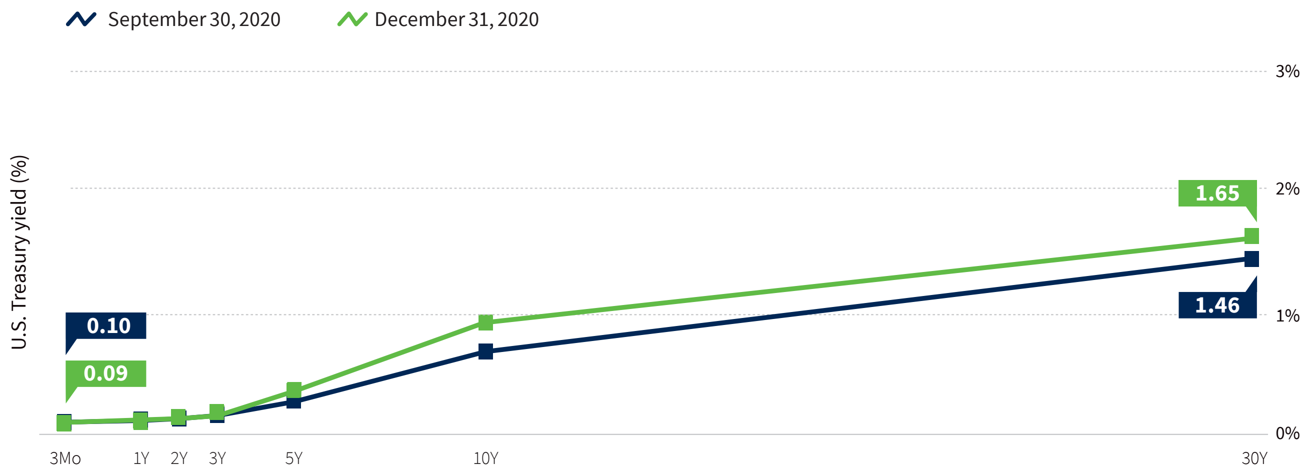
The new pandemic relief package should help bridge the gap for consumers and businesses. President Trump signed the $900 billion stimulus bill into law on December 27. It casts a wide net with a variety of measures aimed at addressing the needs of millions of Americans. We also believe double-digit quarterly GDP growth is possible in late 2021 if vaccine developments stay on track and there are widespread immunizations. The Fed expects the economy to grow 4.2% this year and 3.2% in 2022, and the unemployment rate to fall to 5.0% this year. Still, consumer confidence unexpectedly fell in December to a four-month low amid surging COVID-19 cases and state-imposed mobility restrictions. Against this backdrop, hiring gains cooled in December. The jobless rate held steady at 6.7% from its April peak of 14.8%, a Labor Department report said.

### ECB steps up cocktail of relief measures

Many parts of Europe face the threat of a double-dip recession because of rising virus cases, new restrictions, and slower consumer and business spending. Growth slipped back into contraction in the last three months of 2020 and is likely stay weak or even negative in the first quarter of 2021, in our view. Germany, France, the United Kingdom, and other countries have tightened or extended lockdowns. Germany, the region's largest economy, expanded a record 8.2% in the third quarter, fueled by private consumption, equipment investment, and a strong pickup in exports.

The European Central Bank (ECB) unleased new stimulus measures in December for the 19-nation eurozone economy. It extended its emergency bond-buying program by 500 billion euros and plans to provide new ultracheap loans for banks. The move brings the ECB's asset-buying program to 1.8 trillion euros and its total monetary stimulus to more than 3 trillion euros in 2020. The ECB extended its program by nine months to March 2022. The region's fixed-income markets received a major boost from the news. The borrowing costs of heavily indebted nations like Italy and Spain have fallen. Yields on Italian government debt, the riskiest among the eurozone's economies, hovered near multi-year lows.

# Rates rose on the long end of the curve toward the second half of the period




Source: U.S. Treasury Department. Past performance is not indicative of future results.

## China's economy defies the odds

China's economy is rebounding even as other major economies continue to struggle with the pandemic. The government has been largely successful in containing COVID-19, has embarked on an aggressive vaccination drive, and has stepped up stimulus measures. The economy grew 4.9% in the third quarter of 2020 from a year earlier after expanding 3.2% in the second quarter. Recovery has been widespread, including exports, private sector investment, and manufacturing. But consumer spending has been relatively subdued. China has rolled out a raft of stimulus measures, including tax relief and cuts in banks' reserve requirements.

The People's Bank of China has also provided extra liquidity in the market to contain rising bond yields. In November, there were a series of defaults involving state-owned companies in China — normally a safe pick for investors. Still, bond investors looking for yield have turned to Chinese government bonds since their yields are higher than U.S. or European yields. The benchmark 10-year bond yielded around 3.2%. The yuan also strengthened against the dollar last year, and the central bank has been trying to slow the appreciation.

# Sector views

### Corporate debt: Investment grade and high yield

Investment-grade corporate bonds outpaced the broad investment-grade fixed-income market, but trailed high-yield corporate credit during the quarter. We have a relatively positive medium-term outlook for corporate credit. While acknowledging the ongoing risks associated with COVID-19, we believe there are factors that will be supportive for the U.S. corporate credit market. These include demand for comparatively higher yields in the face of much lower yields globally. Also, investors are aware that the Fed is prepared to provide further support to the market via its bond purchase facilities if necessary. Reflecting investor demand for risk, spreads on corporate securities continued to tighten during the final three months of 2020. [Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity U.S. Treasuries. Bond prices rise as spreads tighten and decline as spreads widen.]

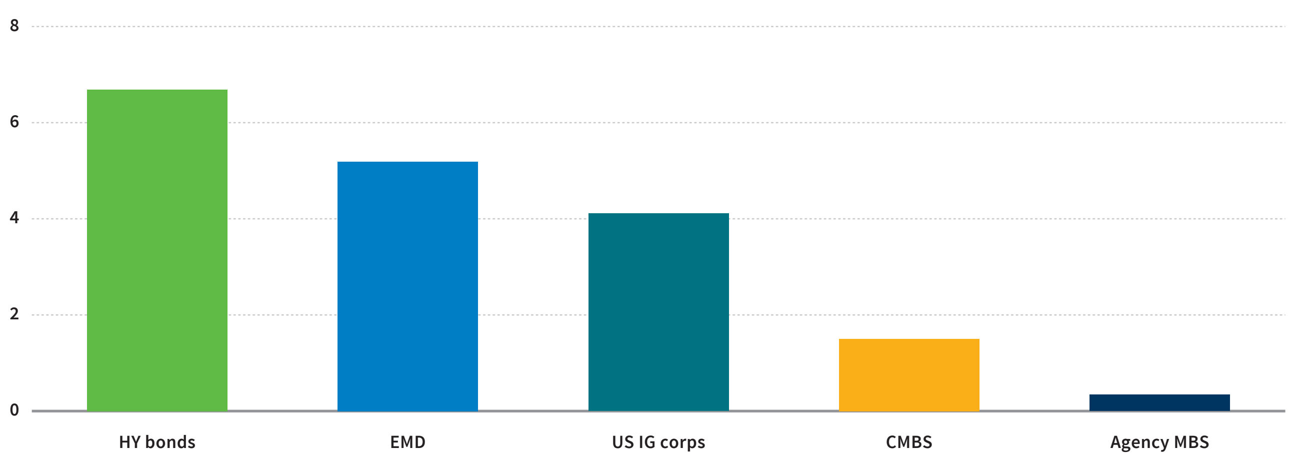
Although we expect the ongoing global health crisis to affect the high-yield market, we have a fairly positive intermediate-term outlook for corporate fundamentals and the market's supply-and-demand backdrop. Also, even though high-yield spreads re-tightened following their sizable widening in March, we think valuations remain relatively attractive. Reflecting consistent investor demand for risk, high-yield bonds outpaced high-yield bank loans, investment-grade corporate bonds, and the broad investment-grade fixed-income market for the quarter overall.

### Trends in the mortgage market

Within the CMBS market, we believe borrowers with access to capital will continue to make investments in properties that were performing well before the pandemic hampered their revenue streams. As a result, we continue to have conviction in the portfolio's CMBX exposure. [CMBX is a group of tradeable indexes that each reference a basket of 25 CMBS issued in a particular year.] We believe current valuations fairly compensate investors for existing risk levels and provide an attractive risk premium.

## Risk assets enjoyed strong performance during Q4

Excess returns* relative to Treasuries, Q4 2020




Source: Bloomberg, as of 12/31/20. 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. Excess return does not always mean "outperformance."

Fundamental credit analysis and security selection are particularly important in the current CMBS market environment. While some parts of the CMBS market will likely continue to struggle, there are CMBS backed by what we consider to be strong underlying collateral that have suffered amid widespread fear of the sector. We think many of these bonds represent attractive investment opportunities.

Within residential mortgage credit, we believe the dislocations that occurred in March have been mitigated by U.S. monetary and fiscal policy and the gradual reopening of the economy. Against the backdrop of robust home sales and a rebound in mortgage originations, we continue to find value across numerous segments of the residential mortgage-backed market.

In prepayment-sensitive areas of the market, we've seen that prepayment speeds stabilized after rising during the summer. This gave investors greater confidence in their ability to build models that anticipate speeds going forward, even if they remain at higher levels. [Mortgage refinancing and early repayment of outstanding mortgages drives prepayment speeds.]

# Currency views

### U.S. dollar likely to remain weak

The dollar's support from its high-yielding status has disappeared as the Fed slashed rates to zero. The central bank's new policy framework means a lower-for-longer short-term policy rate and continued asset purchases until there is "substantial further progress" on its employment and inflation goals. Despite optimism on vaccines and the sizeable pandemic relief package, these goals still look to be more than a year out and should keep real yields low (and potentially lower) in the United States. As such, the dollar will likely remain weak.

### Euro to trend higher amid global recovery

Europe looks set to see a double-dip recession in the fourth quarter after better-than-expected growth in the third quarter as some countries reintroduce lockdowns. The ECB has voiced concern over the anticipated slowdown and has increased asset purchases. The European Recovery Fund remains a fundamental game changer for the eurozone over the medium to long term. This and the ECB's asset purchases should keep bond spreads tighter in peripheral countries, ensuring loose monetary policy across the region. The euro's valuation is no longer as appealing, but it is not a deterrent. As such, we expect the euro to trend higher against the dollar as the global economy recovers.

### Upside for pound over the medium term

The U.K. parliament has approved the post-Brexit trade agreement with the European Union (EU). It is pending final EU implementation. Although the trade deal appears to be quite thin, it is better than no deal, and any remaining risk premium for a no-deal outcome can be priced out. Amid a virus resurgence, new lockdowns, and potential trade frictions with the EU, we expect some short-term economic pain. Still, we believe the U.K. is positioned well for a domestic and global recovery, fueled by vaccine news and vaccinations this year. There will be near-term risks and medium-term upside for sterling in our view.

### Japan's yen likely to appreciate

The Bank of Japan (BoJ) remains largely sidelined with limits on further monetary policy easing. It is focused on ensuring bond yields remain low and inflation hits its 2% target. The BoJ said in December it will look at ways to make its policy more effective and sustainable in April. Policymakers are likely to fine-tune their market operations and asset purchases. With higher real rates in Japan, short-term rates make buying of hedged foreign bonds more attractive than unhedged purchases. As purchases of foreign equity abates and outward direct investment from Japan slows, we should see a stronger yen.

**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.

**D. William Kohli**
Co-Chief Investment Officer, Fixed Income
Global Strategies
Investing since 1988
Joined Putnam in 1994

**Michael V. Salm**
Co-Chief Investment Officer, Fixed Income
Liquid Markets and Securitized Products
Investing since 1989
Joined Putnam in 1997

**Paul D. Scanlon, CFA**
Co-Head of Corporate & Tax-exempt Credit
Investing since 1986
Joined Putnam in 1999

* As of December 31, 2020.

**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.

**Duration** measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

**The Bloomberg (BBG) Barclays U.S. Aggregate Bond Index** is an unmanaged index of U.S. investment-grade fixed-income securities.

**The ICE BofA 1-3 year U.S. Corporate Index** is an unmanaged index of U.S. investment-grade corporate debt with a remaining term to maturity of less than 3 years.

**ICE Data Indices, LLC (ICE BofA)**, used with permission. ICE BofA permits use of the ICE BofA 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 ICE BofA 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.

You cannot invest directly in an index.

This material is prepared for use by institutional investors and investment professionals and is provided for limited purposes. This material is a general communication being provided for informational and educational purposes only. It is not designed to be investment advice or a recommendation of any specific investment product, strategy, or decision, and is not intended to suggest taking or refraining from any course of action. The opinions expressed in this material 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 material. Predictions, opinions, and other information contained in this material 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.

 The information provided relates to Putnam Investments and its affiliates, which include The Putnam Advisory Company, LLC and Putnam Investments Limited®.

Issued in the United Kingdom by Putnam Investments Limited®. Putnam Investments Limited is authorized and regulated by the Financial Conduct Authority (FCA). For the activities carried out in Germany, the German branch of Putnam Investments Limited holds a permit as a financial investment broker in accordance with Sec. 34f para. 1 sentence no. 1 of the German Trade Ordinance and is registered under the registration number D-F-16077N8-19 in the publicly available broker register. Putnam Investments Limited is also permitted to provide cross-border investment services to certain EEA member states. In Europe, this material is directed exclusively at professional clients and eligible counterparties (as defined under the FCA Rules, or the German Securities Trading Act (Wertpapierhandelsgesetz) or other applicable law) who are knowledgeable and experienced in investment matters. Any investments to which this material relates are available only to or will be engaged in only with such persons, and any other persons (including retail clients) should not act or rely on this material. Furthermore this material is only intended for the recipient receiving it directly from Putnam Investments Limited and should not be forwarded to, or relied upon by, the recipient's underlying clients.

Prepared for use with wholesale investors in Australia by Putnam Investments Australia Pty Limited, ABN, 50 105 178 916, AFSL No. 247032. This material has been prepared without taking account of an investor's objectives, financial situation and needs. Before deciding to invest, investors should consider whether the investment is appropriate for them.

Prepared for use in Canada by Putnam Investments Canada ULC (o/a Putnam Management in Manitoba). Where permitted, advisory services are provided in Canada by Putnam Investments Canada ULC (o/a Putnam Management in Manitoba) and its affiliate, The Putnam Advisory Company, LLC.

This material is prepared by Putnam Investments for use in Japan by Putnam Investments Securities Co., Ltd. ("PISCO"). PISCO is registered with Kanto Local Finance Bureau in Japan as a financial instruments business operator conducting the type 1 financial instruments business, and is a member of Japan Securities Dealers Association. This material is prepared for informational purposes only, and is not meant as investment advice and does not constitute any offer or solicitation in Japan for the execution of an investment advisory contract or a discretionary investment management contract.

**Consider these risks before investing:** International investing involves certain risks, such as currency fluctuations, economic instability, and political developments. Additional risks may be associated with emerging-market securities, including illiquidity and volatility. Lower-rated bonds may offer higher yields in return for more risk. Portfolios that invest in government securities are not guaranteed. Mortgage-backed securities are subject to prepayment risk. Derivatives also involve the risk, in the case of many over-the-counter instruments, of the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. Bond investments are subject to interest-rate risk, which means the prices of the portfolios' 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.

A world of investing.®

For institutional investors and investment professional use.

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

TL002_IN 320918 1/21