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Q1 2018 | Fixed Income Outlook

Solid growth makes central bank policy the key question

With global economic growth likely to continue, the response of central banks becomes a key question.

New leadership at the Fed has signaled policy continuity, but markets may face adjustment to a new chair's communication style.

We believe fundamental conditions continue to be supportive for risky assets, but we are monitoring central banks for possible overreaction to inflation forecasts.

The acceleration in global growth witnessed in 2017 should continue well into 2018, we believe, but likely with significant changes in its components. The U.S. economy has been on a solid pace and appears poised to do even better. The economies of Europe and Japan may improve relative to that of the United States as 2018 unfolds. Meanwhile, the United Kingdom may be headed toward a softer version of Brexit as a consequence of recent developments in the country's efforts to separate from the European Union. Overall, we expect reasonably solid global growth, continued policy tightening by the Fed, relatively benign inflation, and a generally supportive environment for risk-driven assets. We also think bond yields may continue to drift higher over the course of 2018 as rate normalization continues.

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			●

The Fed will be a key focus of investor attention as a new chair takes office and new governors join the Federal Open Market Committee. While we don't anticipate significant policy changes, we see the potential for misunderstandings in communication as the market adjusts to the tone and language of a new leader.

U.S. growth may accelerate with help from tax cuts

GDP expanded at a 3.3% annualized rate in the third quarter, the fastest pace in three years. The combination of personal consumption spending and corporate fixed investment spending has grown by approximately 2.5%. We see more of the same ahead in 2018 with no obvious downside risks to this pattern.

The Tax Cuts and Jobs Act of 2017 that became law in December is also likely to create some upward momentum. At the margin, corporate tax reforms could buoy the equity markets by raising after-tax earnings, and investment projects that are currently not viable could become worthwhile with a lower tax rate. Of course, the effect may be small because the cost of capital is already low, but it should have a measurable positive impact on growth.

The household tax cuts in the tax package will likely have little impact on consumption because they are, in net terms, very small and geared toward high-income households. But the rally in equity markets creates a wealth effect, and this will boost consumption growth in 2018. The labor market is key to household income and spending, and it continues to improve, albeit at a slower pace.

Europe may improve modestly

The eurozone's strong performance was among the biggest surprises of 2017. The region's growth is also well-balanced. Germany's export powerhouse is benefiting from the global recovery, and France is enjoying a cyclical recovery boosted by rising business confidence in the light of the Macron reform agenda. There are also signs of a rise in corporate investment.

We're paying particularly close attention to European sovereign bonds. In our view, a key policy issue for the ECB early in 2018 will be that the eurozone economy may continue to grow at a faster-than-forecast rate. If this occurs, inflation could begin to rise in the eurozone well before that happens in the United States or the United Kingdom. Increasing inflation could, in turn, lead to upward pressure on interest rates, which could affect not only European bonds, but other asset markets as well.

China turns to restructuring

China avoided a sharp downturn in 2017, but in 2018 the pace of domestic reform may accelerate, with greater emphasis placed on forcing the restructuring of state-owned enterprises (SOEs). The outcome of this restructuring effort depends on whether President Xi Jinping, who has consolidated political power, can overcome the strong links between SOEs, the ruling party, the People's Liberation Army, and a handful of leading Chinese families. Restructuring could slow the economy, and anything that destabilizes internal debt markets creates the risk of a bigger downturn. China also faces the problem of capital outflows. Although outflows stabilized in 2017, the possible appreciation of the dollar in 2018 under tighter Fed policy could cause new pressure.

Inflation remains below expectations

The trajectory of inflation provided many surprises in 2017. Core inflation was weaker than expected by many central banks, especially the Fed and the ECB. In 2017, the Fed's preferred core personal consumption expenditures (PCE) inflation measure dropped sharply, reaching 1.4% in the past few months. Among eurozone countries, core inflation fell to 0.9% over the past two months, defying ECB and market expectations that a new range of 1.1% to 1.2% would hold.

Our internal views show actual inflation rising in 2018, but only minimally, with no risk of deflation. We do not think that higher inflation is a major risk for central banks to address. Still, it's important to remember that central banks target forecasts of inflation rather than actual inflation, and so long as the forecasts show inflation increasing, policy is oriented in that direction.

The biggest risk is the Fed moving too aggressively

Monetary policy clearly is in transition, which is difficult to manage. With the real economy likely to do a bit better in 2018, the Fed has legitimate concerns about the possibility that inflation will tick higher. But the longer-term trends in the economy suggest that higher rates are risky. The impact of demographics, the persistent effects on consumer behavior resulting from the financial crisis, the global disinflationary impulse from the pattern of global competition and technological innovation, as well as high levels of corporate debt — for all these reasons, we think the capacity of the economy to deal with much higher interest rates is limited. So, we think the Fed is going to be playing a risky game in 2018.

Sector views

Securitized debt: Attractive opportunities despite crosswinds

Within mortgage credit, we think commercial mortgage-backed securities could benefit from employment growth, low interest rates, and a continuation of the current economic expansion. Significant press coverage has described challenges to brick-and-mortar retailers by online shopping. While we recognize the challenges, we're also encouraged by the fact that many mall operators are attempting to repurpose their space to attract new types of tenants. Consequently, we don't believe this shift in consumer preference will necessarily lead to widespread weakness in the commercial real estate market.

We believe the non-agency RMBS market continues to be supported by an improving housing market and shrinking supply. The tax reform plan that was passed in December is a modest negative for the housing market due to the new limitations on interest deductibility. More broadly, however, existing home prices have been rising steadily since 2012, while the supply of available homes has dropped to levels not seen since 2005. As a result, we think the supply-and-demand dynamics are quite favorable for home prices, particularly as millennials begin to reach prime ages for household formation. Also, we continue to like agency credit risk-transfer securities on the basis of fundamentals and underlying collateral, but have become more cautious from a valuation perspective.

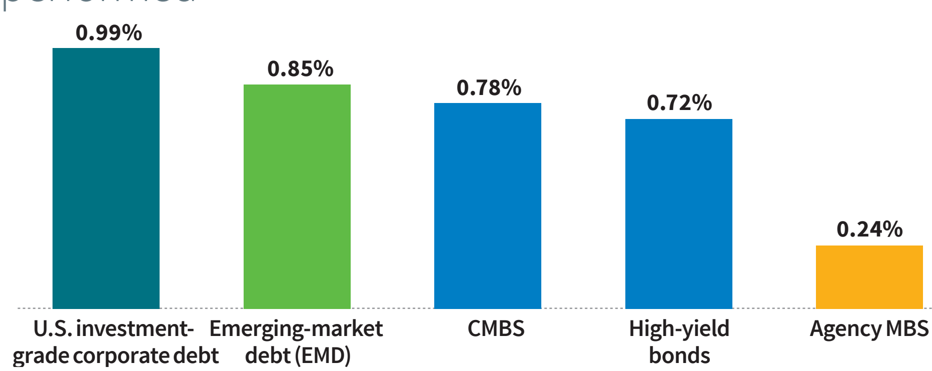
High yield: Fair valuations constrain upside

High-yield issuers' credit metrics improved over the course of 2017, in our view, and we think corporate fundamentals are likely to remain strong. Issuer defaults have begun to creep higher, with forecasts for a 2% to 2.5% total default rate in 2018, which is still low based on longer-term history. At the same time, recovery rates have also risen. As for technicals, we are not anticipating a significant spike in new supply. In light of new provisions governing corporate interest deductibility passed as part of U.S. tax reform, it's possible that new-issue supply could decline. If this happens, we think it could be beneficial for existing bonds, assuming the demand for yield persists.

Risk assets generally outperformed

Excess returns relative to Treasuries, Q4 17

Source: Bloomberg, as of 12/31/17. 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.



The asset class is not compellingly cheap, but is in a range of fair value, in our view, given corporate fundamental strength. Against this backdrop, we think performance in 2018 will be driven by coupon income with limited capital appreciation potential.

Bank loans: With sustained gains, credit cycle rolls on

We have a positive fundamental outlook for bank loans and a neutral view on valuation and technicals. As the U.S. economy continues to expand, corporate fundamentals — sales, earnings, cash flow, and debt management — are likely to remain strong, providing a supportive environment. As of December 31, the average discounted spread over LIBOR in the S&P/LSTA Leveraged Loan Index was about 4.2 percentage points, below where it began the year and also lower than the long-term average. Roughly 70% of the loans in the index were trading at or near par (face value). In our view, these data portray a loan market where valuations are not overly attractive but also are not exceptionally rich. With a relatively high percentage of outstanding loans trading at par, there appears to be limited near-term capital appreciation potential. The default rate may rise modestly in 2018, but we believe it will remain below the long-term average range of 3% to 3.5%. Importantly, we believe strong sales and earnings among loan issuers, coupled with a record pace of refinancing, may extend the current credit cycle for at least a few more years.

Investment-grade bonds: Tighter spreads make valuations less attractive

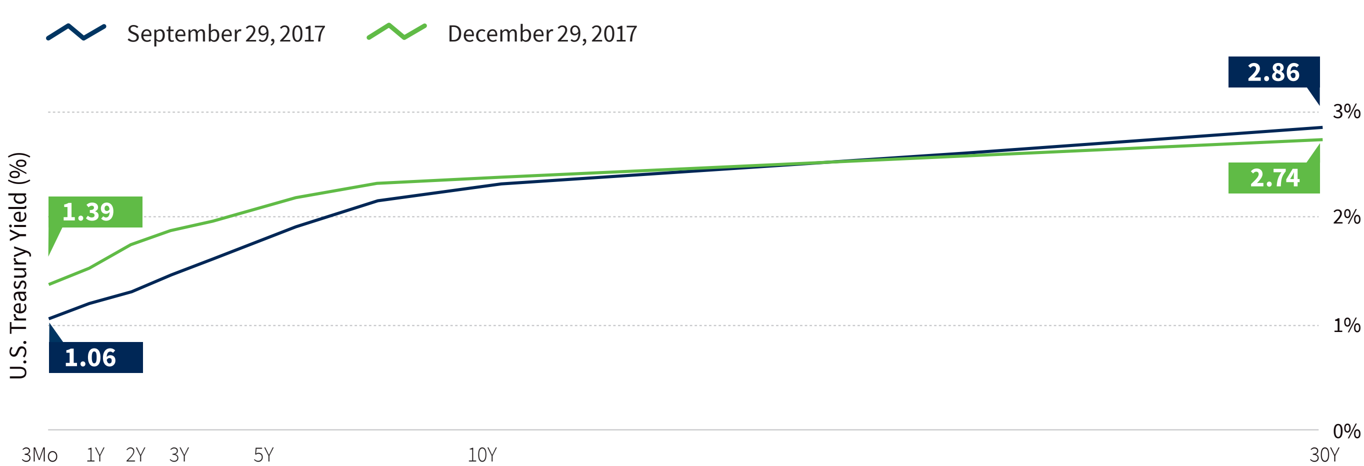
We continue to have a constructive outlook for investment-grade credit despite the fact that valuations are not as attractive as they were a year ago. We plan to continue emphasizing bonds issued by banks and other types of financial services companies. Many of these firms have strengthened their balance sheets, and their earnings have become much less volatile, in our view.

Emerging-market debt: Favorable economic environment offset by risks

We are cautiously optimistic as we look to the year ahead. We believe the acceleration in global growth will continue well into 2018, fueled by many developing countries. At the same time, there will be modest downside risks to growth in China in 2018 given the imbalances in the economy. We are cognizant that the deep financial and trade links between China and emerging markets, especially Latin America and Asia, render the latter vulnerable to a hard landing.

We think any flare-up in geopolitical risks, including in North Korea, Russia, and the Middle East, could weigh on emerging-market debt. Separately, Brazil and Mexico will hold presidential elections in 2018. Electoral cycles and changes in governments could result in economic and financial policies that are not favorable to investors. There is some headwind risk that investors will reallocate funds from emerging-market assets.

Rates rose across most of a flattening yield curve in Q4



Source: U.S. Treasury Department, as of 12/31/17.

Municipal bonds: Monitoring the effects of stimulus

We will be closely monitoring the debt ceiling debate, a budget resolution for the next fiscal year, and the confirmation of President Trump's nomination of Jerome Powell as the next Federal Reserve chair. As always, we will continue to rely on in-depth research and our experienced market insights to evaluate new and existing holdings for attractive income and return potential.

Currency views

The dollar may rally a bit longer

The U.S. dollar outlook continues to be most heavily influenced by the Fed and Congress' surprising ability to deliver a tax reform package. At its December meeting, the Fed hiked rates by 25 bps, as largely expected by the markets. The market is pricing another 50–60 bps in hikes in 2018, a level still a little below the Fed's economic projections, or "dots" outlook, but this gap has closed quite a bit over the past several months. With Jerome Powell approved by the Senate Banking Committee to be the next Fed Chair, it suggests policy continuity over the medium term. Over the coming months, the tactical U.S. dollar rally may continue, though it has already started to wane as the dollar is quite rich.

The euro appears stable

The outlook for the euro remains dominated by relative monetary policy, better-than-expected growth, and a diminished euro political risk premium. The ECB continues to balance the doves, who point to tame core inflation rate, with the hawks, who call for tapering and then ceasing asset purchases. The euro has already moved considerably, so much of the near-term direction will be based on whether the ECB is dovish or hawkish relative to the Fed.

Brexit negotiations to influence the pound

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 in negotiations, this volatility is likely to persist. The statements from the Bank of England have been surprising. The BOE has hiked rates for the first time in ten years (by 25 bps) and backpedaled on expectations that only a couple of hikes would be necessary over the coming three years, putting the fate of the pound firmly back on to Brexit negotiations.

Yen to remain soft as capital leaves Japan

With Prime Minister Abe's landslide victory in the October election, the tail risk of the end of "Abenomics" has been dramatically reduced. 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 was no need to raise rates just because foreign rates rise. The dollar-yen rate will remain a function of Fed policy and the long end of the U.S. Treasury yield curve. With financial market volatility low, the yen should continue to soften as capital leaves Japan to be invested in higher-yielding assets abroad.

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 80 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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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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