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Q2 2018 | Fixed Income Outlook

Growth remains steady amid higher rates, market swings

The U.S. economy is poised to remain solid in 2018.

The risk of a trade war between the U.S. and China is now elevated.

Eurozone growth is easing to a more reasonable pace.

Global growth prospects are expected to remain solid in 2018. The U.S. economy is poised to pick up some speed this year given indicators for consumer spending, corporate capital expenditure, and fiscal spending. The likelihood of a recession remains low. During the past few months, economic data, both in the United States and overseas, has been stronger than most market observers were expecting several months ago, especially given the fact that interest rates have risen. Despite this strength, we think it is unlikely that the global economy will overheat at this stage of the business cycle and spark a sustained rise in inflation.

In terms of fixed-income markets, this year is turning out to be more challenging than 2017. In recent months, the risk of a global trade war, the trajectory of U.S. interest rates, and geopolitical tensions have caused a series of market ups and downs. Still, we see a stabilizing dynamic at work in the markets. With bond yields trending higher, on days when market-moving

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	●		○

economic data is released, bond investors react and the yield curve adjusts, helping to dampen the impact on risk-sensitive assets. Bond yields will continue to drift higher over the course of 2018, we believe, as rate normalization continues. Global central bankers continue to move along the path of gradual tightening, with the U.S. Federal Reserve at the forefront, normalizing interest rates and gradually reducing the size of its balance sheet. We expect the Fed to continue increasing interest rates throughout 2018.

A key challenge in coming months will be the Trump administration's return to its campaign promise of "America First" trade policies. Despite this backdrop, we believe there is still an environment that fosters risk-taking overall.

U.S. economy to benefit from spending

The underlying story in the economy has not changed. The labor market is one of the best indicators of economic health, and it began 2018 on a strong note as Americans saw wage gains accelerate and hiring improve. In February, President Trump signed into law a far-reaching budget deal that will boost spending by hundreds of billions of dollars. Output is likely to accelerate for the rest of 2018 as the fiscal stimulus kicks in. The Tax Cuts and Jobs Act of 2017, which became law in December, is also likely to create some upward momentum, boost corporate earnings, and prolong the eight-year U.S. economic expansion.

The U.S. dollar weakened against most other major developed market currencies during the quarter, partly on concerns about U.S. trade policy with China and the risk of a global trade war. Also weighing on the dollar was the global economic upswing that has encouraged central bankers in Europe and Asia to take the first steps toward normalizing monetary policy after years of monetary stimulus. Still, the volatility of asset prices, to some extent, is taking a bit more of a back seat now to the real economic story, where growth continues to look stable and steady. But of course, how the trade conflict with China develops will have an important influence, and there are clear downside risks to the outlook.

The risk of a trade war

It is fair to say that trade protectionism and the risk of a trade war rose during the first quarter. President Trump in March proposed tariffs on an estimated $50 billion in imports from China, weeks after slapping tariffs on aluminum and steel and washing machines. The tariffs follow an investigation of the administration into the theft of intellectual property from U.S. companies. In April, China, the world's second-largest economy, retaliated by imposing tariffs on U.S. imports worth around $3 billion. China launched a World Trade Organization complaint against the U.S. action, and while it could be withdrawn, this machinery is now in motion. However, it should be remembered that the tariffs on both sides remain proposals until they are scheduled to go into effect in June, allowing time for negotiations.

At the same time, the U.S. administration is still in the midst of renegotiating the North American Free Trade (NAFTA) agreement. Canada and Mexico were exempted from the imported steel and aluminum tariffs, provided they make concessions in a new NAFTA deal. If the U.S. administration withdraws from NAFTA or imposes another spate of anti-China trade measures, there will be downside risks to the U.S. economy. Despite Trump's firmly held beliefs, tariffs will not close the U.S. trade deficit, absent higher savings (in the public or private sectors) or lower investment.

Europe's dance with rates

The eurozone economy had it best year in a decade in 2017, growing at a 2.5% annual rate, and the jobless rate fell to its lowest level since 2008. However, more recently growth is easing to a more reasonable pace. The eurozone grew by 0.6% in the final three months of 2017, slower than the previous quarter.

The European Central Bank (ECB), which has been providing stimulus to the region through negative interest rates and massive sovereign bond purchases, is adjusting to the economy's stronger pace. The central bank said it would continue purchasing government bonds through at least September 2018, but in reduced monthly amounts. This decision may signal a policy shift by the

ECB that will eventually lead to more rapid tapering of its bond-purchase program. Markets expect QE will end in December 2018, and the ECB may raise the deposit rate in the second quarter of 2019. If everything goes as planned, the best we can expect is that the policy rate will move toward zero at the end of 2019.

In the United Kingdom, the economy appears stable, even as the country is in the midst of Brexit negotiations. We also expect a hike by the Bank of England in May. Europe is seeing more inflation than expected, and this is not priced in to rates currently. This could produce some volatility in euro-based sovereigns and corporate bonds. We expect rate normalization to continue, though monetary policy on the whole remains mostly accommodative.

China: President Xi and the economy

President Xi Jinping's supporters have succeeded in their attempt to lift the constitutional provision on the length of time a president can serve. The expansion of the two-term limit, which was in place for nearly two decades, was ratified by the National People's Congress in March 2018. This is a departure from the economic and political reforms of Deng Xiaoping, who had emphasized separating the Party from the everyday machinery of the government. Xi and his supporters claim they want to strengthen the Communist Party's leadership. This could create risks for the economy over the long term because this type of authoritarian government leads to capital being misallocated, creating bad assets on the books of the financial system.

China's macroeconomic data has deteriorated a little. However, it's hard to interpret the data flow in January and February because of the changes in the timing of the Lunar New Year. The government has set a GDP growth target of around 6.5%, the same as in 2017. China also trimmed its fiscal deficit target for 2018. While, it's not clear whether the growth and deficit targets are achievable, it is clear that keeping the growth target the same as last year means the government is not interested in risking slower growth by advancing economic reforms more rapidly.

Sector views

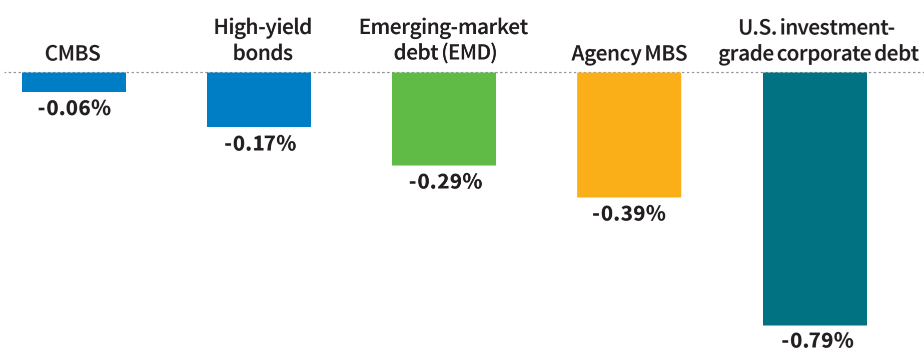
Credit strategies remain attractive in the current environment

Surprisingly, as bond yields rose during the quarter, spreads remained relatively stable. [Spreads are the yield advantage offered by riskier types of bonds over comparable-maturity Treasuries.] Spreads for investment-grade and high-yield corporate credit, as well as mortgage credit, finished the period near their lows for the current market cycle. We think this is justified by the fundamentals underlying these market sectors, namely solid economic growth, rising corporate profits, and a strong housing market. We believe the fundamental backdrop continues to support risk-taking in these sectors, and we think this is particularly true in structured mortgage credit. As a result, we continue to have a

Risk assets reversed course and generally underperformed

Excess returns relative to Treasuries, Q1 18

Source: Bloomberg, as of 3/31/18. 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.



positive outlook for securitized mortgage products, such as CMBS, agency IO CMOs, CRTs, and non-agency residential mortgage-backed securities.

High yield: Supported by favorable fundamentals

We evaluate the high-yield market through three lenses: fundamentals, valuation, and technical (the balance of supply and demand). As of quarter-end, we thought the fundamental environment and technical backdrop were positive, and valuation was neutral. Looking at fundamentals, 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. Recovery rates have risen.

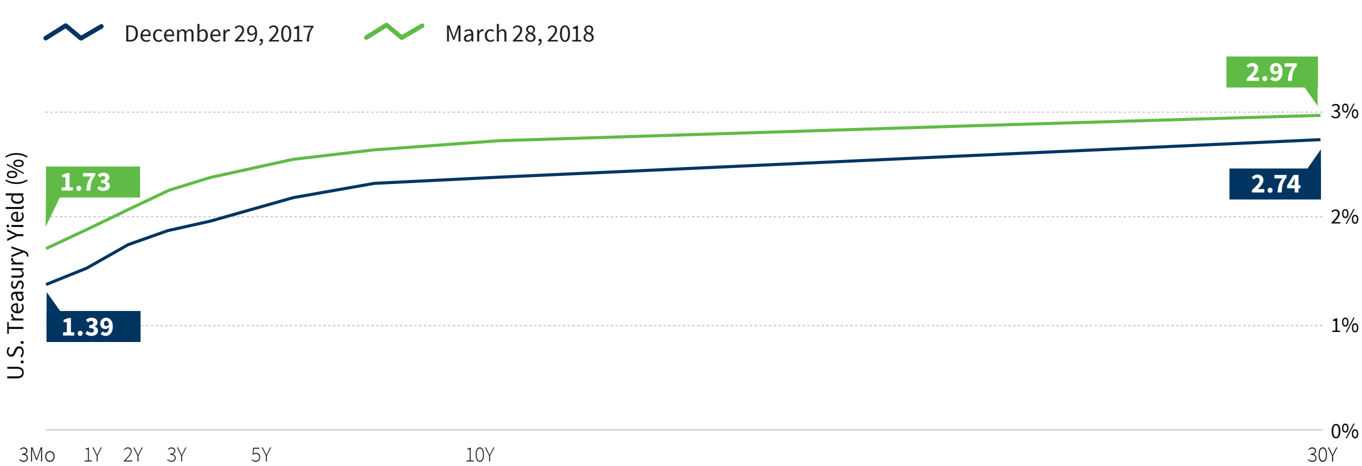
Regarding valuation, high-yield credit spreads — the yield advantage high-yield bonds offer over comparable-maturity U.S. Treasuries — widened slightly in the first quarter, but remain below the long-term average. It is worth noting that the overall credit quality of the high-yield market, by most measures, is higher quality than the average high-yield cohort. The average bond price within the index was close to par value, i.e., face value. As a result, the asset class is in a range of fair value, in our view, given corporate fundamental strength. Against this backdrop, we think performance will be driven by coupon income with limited capital appreciation potential. Regarding technicals, we are not anticipating a significant spike in new supply. In light of new provisions governing corporate interest deductibility passed as part of the U.S. tax reform, it's possible that new-issue supply could sharply decline. If this happens, we think it could benefit existing bonds, assuming the demand for yield persists.

Bank loans: Benefiting from strong fundamentals and the rising-interest-rate environment

Loans performed well in the early months of 2018 amid a volatile backdrop for risk-driven assets. Rising interest rates bolstered the asset class, as loan coupons — their stated interest rates — adjusted higher. Bank-loan coupons are linked to the London Interbank Offered Rate [LIBOR], a widely used benchmark for short-term lending among banks that tends to move in step with the federal funds rate. In late February, three-month LIBOR eclipsed 2% for the first time since the 2007–2008 financial crisis. We think it's possible that the Federal Reserve could increase the fed funds rate four times during 2018. If that occurs, LIBOR also would continue to rise, and coupons on existing loans would, in turn, adjust higher from current levels.

More broadly, we think the loan market continues to be supported by a favorable fundamental backdrop. The U.S. economy continues to expand, aided by a reacceleration in global growth. Corporate fundamentals — sales, earnings, cash flow, and debt management — have continued to strengthen, in our view, providing a supportive environment for risk-based assets, including bank loans. The loan default rate rose to 2.5% during the

Rates continued to rise across the yield curve in Q1



Source: U.S. Treasury Department, as of 3/31/18. Past performance is not indicative of future results.

first quarter but remained 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.

Currency views

Shifting outlook for dollar

The outlook for the U.S. dollar has shifted. The drivers now include structural factors as well as the cyclical aspects of Fed policy and the newly minted tax reform, which we believe should provide some mild positives for growth and have limited impact on an already benign trajectory for rising inflation. The Fed delivered a rate hike in March, and new Chair Powell cautioned not to put too much weight on the dot plot projection given that it is conditional on economic forecasts that are liable to revision. Concerns that the Powell-led Fed will have a more hawkish reaction function were misplaced. We believe the U.S. dollar will be influenced by the Fed, but also by valuation, which is still rich, and by the twin deficits: the current account and budget. Both of these deficits are set to start widening and will require greater levels of capital to fill the gap. Over the coming months, U.S. dollar rallies are likely to be sold, in our view.

The euro appears stable

The outlook for the euro remains dominated by relative monetary policy, robust growth, and diminished political risk premium. The European Central Bank has been leaning dovish as growth has come off the boil and core inflation remains benign. Inflation should start to increase in the coming months, with headline inflation rising before core. Growth should stabilize at lower levels, while still strong. The euro has already moved considerably, but little is priced for the ECB, so much of the near-term direction will be based on how dovish or hawkish the ECB actually is relative to the Fed.

Hawkish Bank of England to influence pound

In the United Kingdom, political concerns have declined. The EU summit produced a transition agreement that will apply from March 2019 through 2020, and the probability of a soft Brexit continues to increase. The Bank of England has again surprised the markets by suggesting more hikes may be needed than are currently priced. With inflation high, monetary policy will look to lean hawkish and supportive of the currency.

Yen may gain against dollar

In Japan, with the re-appointment of Bank of Japan Governor Kuroda, continuation of ultra-accommodative monetary policy is set to continue in its current form. Governor Kuroda continues to underscore that the inflation outlook remains subdued, that prices are rising gradually, and that the economy is moving out of the deflationary situation. An immediate change to the yield curve control policy seems premature as inflation hasn't reached its objective, but a change is being considered and may be likely over the coming year. Structural forces will start to play in favor of the yen versus the dollar.

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* As of March 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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