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Q2 2017 | Fixed Income Outlook

Global reflation at a crossroads

We expect global economic reflation will continue to set a positive backdrop for asset markets, including fixed income.

We expect a somewhat faster pace of monetary policy change than markets currently anticipate, at both the U.S. Federal Reserve and the ECB.

We continue to believe that interest-rate-sensitive areas of fixed income hold fewer opportunities for investors than sectors reliant on prepayment, credit, and liquidity risks.

While the post-U.S. election rally appeared to exhaust itself late in the first quarter, the global economic reflation story seems to be very much alive. On the basis of broadly positive macroeconomic data in the United States, Europe, Japan, and a variety of other markets, we maintain an optimistic outlook for a number of fixed-income sectors in the quarter ahead, particularly those sectors that are not heavily exposed to interest-rate risk. That said, as market participants monitor the interest-rate backdrop, as well as the transition from high expectations for growth-friendly policy to actual policy implementation in Washington, we expect volatility and risk aversion are likely to return periodically.

Putnam fixed-income views

	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		●	○

Impressive growth, but no new catalysts in view

We have been impressed by the pickup in global growth across numerous regions, with only a few reservations. We doubt, for example, that Russia is as strong as it looks, and Mexico is not quite as weak as it may appear on the surface, either. Latin America is the only region that appears to be lagging — and that, we think, is because Brazil's recovery has stalled and Mexico, while not as bad as the data suggest, is certainly not doing well.

In some cases, the composition of growth is quite encouraging. In Europe, for example, the fourth-quarter 2016 national accounts show a balanced pattern of growth with investment moderately picking up. In Japan, there has also been a rise in investment and a further increase seems likely, in our view.

However, we are hesitant to look at the recent bounce in growth and get excited about a new era of faster global growth overall.

The dynamics driving the global pickup are, we think, nearing their natural end. Chinese policymakers' overreaction to the slowdown in the winter of 2015–2016 pushed up the Chinese growth rate, allowing commodity prices to strengthen. At the same time, the inventory cycle in global manufacturing turned. These factors are beginning to reverse: China is now tightening policy, and we think the inventory cycle is coming to a close over the next quarter or so.

These dynamics are also at work in the case of U.S. growth. For industrial production to move onto a much stronger path would require a large upward shift in the ratio of new orders to inventory, which we do not think is likely in the near future. We also do not find evidence of a significant acceleration in global demand growth on the horizon. And finally, after seeing the Trump administration in action for a couple of months now, our near-term conclusion is that nothing in terms of fiscal policy — whether that means tax reform or large-scale infrastructure initiatives — will happen early enough to have a meaningful impact on growth in 2017.

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Central banks on the move

With respect to interest rates, we have thought that the Fed could indeed accelerate its rate hikes faster than the market expected, and the Fed's March meeting minutes confirmed this view. The Fed hiked the federal funds rate by a quarter point on March 15, and it has projected that two more hikes are likely this year. For the time being, we think the Fed's anticipated plan does not depend on anything the Trump administration may or may not do in terms of policy. Instead, we observe that today's sustained backdrop of stronger commodity prices is adding to inflation in other segments of the economy, and this may induce the Fed to remain more explicitly on a path toward interest-rate normalization.

In addition, as the minutes of the latest Fed meeting also confirm, the time for making adjustments to the Fed's balance sheet may be fast approaching. We think that the potential unwinding of the Fed's multi-trillion-dollar balance sheet represents a far more important development for asset markets than incremental steps to rate normalization. And importantly, President Trump will have a significant opportunity to reshape the Fed as vacancies on the Fed's board of governors open up over the next year. In our view, there is clearly a risk that the individuals Trump may appoint to the Fed could view the Fed's balance sheet as evidence of undesirable government "interference" in markets. This is something we will be watching very carefully in the coming months.

Turning to Europe, we also think that markets may currently may be underappreciating the possibility of monetary policy changes at the European Central Bank (ECB). The ECB, unlike the Fed, takes its policy cue from headline inflation rather than core inflation. Headline inflation has risen rather substantially in Europe on the back of higher prices across the global commodity complex. While the ECB has said it will continue its quantitative easing program through the end of 2017, that does not mean the bank cannot raise interest rates. Indeed, it is likely to face increased pressure from the financials sector to leave its negative-rate policies behind.

Sector views

Securitized debt: Attractive valuations and healthier U.S. housing fundamentals

In the securitized debt sector, we continue to like the valuations of commercial mortgage-backed securities (CMBS) and non-agency residential mortgage-backed securities (non-agency RMBS). We also continue to find attractive opportunities in a relatively new segment of the securitized debt market: agency credit risk transfer securities (CRTs).

The CRT market has grown substantially since these securities were introduced in 2013. CRTs provide investors with credit exposure to the U.S. residential mortgage market, helping to fill a void that has emerged from a lack of new supply in the non-agency RMBS sector. Against the backdrop of improving U.S. housing fundamentals, declining homeowner delinquency rates, and more stringent underwriting standards in recent years, we believe this area of the securitized sector will offer compelling opportunities for investors going forward.

High-yield bonds and bank loans: Continued low defaults, positive fundamentals

After ending 2016 on a strong note, the high-yield rally continued in January and February, fueled by investor optimism despite few specifics on the Trump administration's plans for tax reform, deregulation, and infrastructure spending. Rising stock prices, solid economic data, strong earnings, plateauing U.S. Treasury yields, and modest net new issuance also aided the asset class.

March was a volatile period for high yield, as the asset class declined for most of the month before recovering in the final week. The market was buffeted by hawkish rhetoric from the Federal Reserve, a sharp decline in oil prices, rising stock market volatility, heavy new supply, and a failed effort by the U.S. House of Representatives to repeal the Affordable Care Act (ACA). Later in the month, however, oil prices rebounded, which took pressure off the high-yield sector.

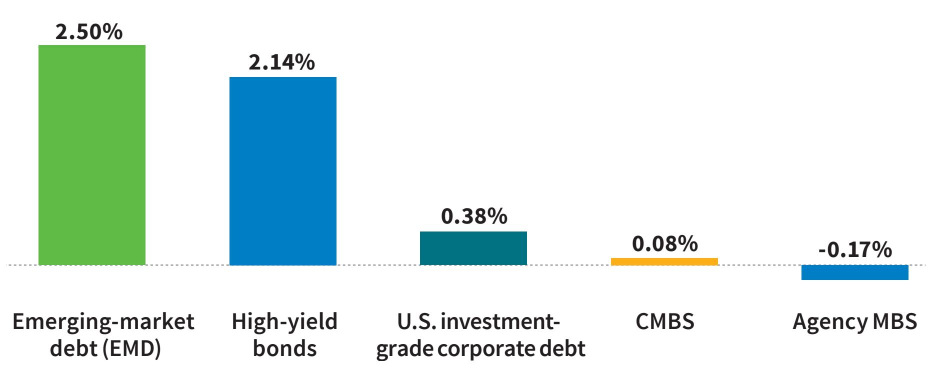
In the coming months, we expect high-yield bonds to continue to generate attractive returns in an environment of constructive fundamentals and well below-average defaults. In addition, we continue to like the prospects of high-yield credit in an environment of rising rates and inflation, even if returns are subdued as higher rates encourage investors to shift to other areas of the market.

After ending 2016 on a strong note, bank loans registered more modest gains in January and February, as loan refinancing intensified and the rally in stocks and credit ebbed. Loans came under pressure in March amid the selloff in high-yield bonds and weakening demand for floating-rate instruments. Overall, we believe that maintaining broad diversification across market sectors is the optimal way to pursue bank-loan exposure. As of the start of the second quarter, we generally found the middle tier of high-yield credit quality to offer the most attractive opportunities.

If the Fed continues to increase short-term interest rates, and three-month LIBOR follows suit, we think bank-loan coupons will continue to adjust higher and

Emerging-market debt and high yield continued to perform well

Excess returns relative to U.S. Treasuries, Q1 17



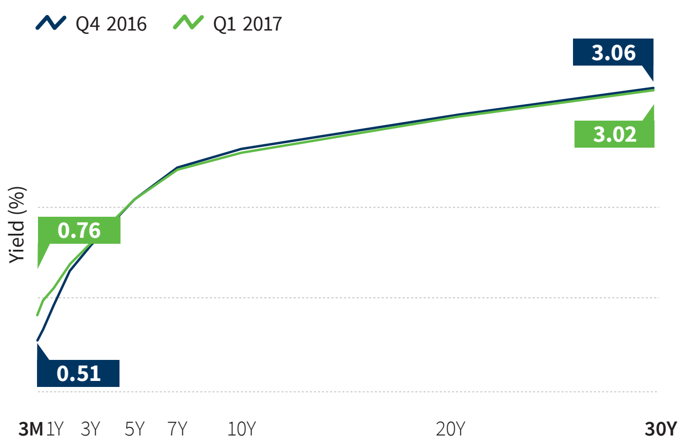
Source: Bloomberg, as of 3/31/17.

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.

investor demand will likely remain strong. However, with an increasing percentage of outstanding loans trading at par (face value) or higher, and refinancing expected to continue at a robust rate, there appears to be limited near-term capital appreciation potential. As a result, we think the bulk of returns from floating-rate exposures is likely to come from coupon income.

Rates rose on the front end of the yield curve

Investors generally showed a healthy appetite for riskier assets during the first quarter



Source: U.S. Department of the Treasury, as of 3/31/17.

Investment-grade bonds: Solid fundamentals and strong demand

Demand for investment-grade bonds in the first quarter of 2017 was robust, particularly from large investors such as global government agencies, supranational entities, and sovereign funds. Thus, while corporate spreads have tightened since the start of the year, we think fundamentals and demand will continue to bolster this market segment.

Looking forward, we think that strong U.S. corporate fundamentals may support the profit margins of investment-grade companies. Moreover, for the financials sector, the combination of potentially less onerous regulation and the Fed's path toward interest-rate normalization may lend further support to fundamentals.

Emerging-market debt: A more benign environment

Across the emerging markets, economic conditions continue to look positive. Sustained strength in China's economy has lent support across virtually all Asian emerging markets. The flood of capital that had been leaving China has now dried up — in no small part, we think, because Chinese authorities have been successful in restricting the channels through which capital had been leaving.

Adverse political developments remain — as in the case of Turkey and South Africa, which are struggling — and needed fiscal reforms in Brazil are running into political opposition, which in turn is slowing the recovery there. Overall, though, easing interest-rate pressures from the developed markets, positive real growth, and diminished fears about Trump-led trade restrictions have caused capital flows into emerging markets to re-accelerate. This has buoyed assets across the emerging markets, and we expect this upward lift may persist in the coming months.

Municipal bonds: Fundamentals are sound, but policy-driven volatility is on the horizon

We are closely monitoring the composition of demand for municipal bonds. Today, banks and insurance companies generate about 25% of total demand in the municipal bond market compared with about 70% of demand coming through mutual funds and direct holdings. Since 2010, banks and insurance companies have doubled their exposure to tax-exempt bonds. We believe this trend is due to the high-quality, low-default attributes of municipal bonds and the opportunity that they afford to help diversify away from corporate bonds.

However, demand from banks and insurance companies has eased in recent months, given that tax reform is a top priority for the Trump administration and both Republican-controlled houses of Congress. We believe that the drop in interest from banks and insurance companies is explained in part by the fact that companies across the entire corporate tax spectrum have bought municipal bonds, and those with lower tax rates can more easily part with the tax benefit. In the individual market, by contrast, it is people with the highest incomes who own municipal bonds and who are less inclined to part with the tax benefit.

While we acknowledge that tax reform is one of the main policy agenda items for the Trump administration, we believe it is too early to re-position municipal bond portfolios in anticipation of tax reform. That said, we will continue to follow the development of government policy closely to see if tax reform materializes and how the details of tax reform may shape the outlook for municipal bonds.

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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Currency: The dollar may neither lead nor lag

Within currency, the U.S. dollar outlook has become more clouded given the uncertainty associated with President Trump's policies, in particular, the ability of Congress to repeal and replace the ACA and repercussions this has for tax reform. As such, the more relevant driver of the dollar has been and remains the Fed. After ramping up its rhetoric and encouraging the market to price in a rate hike in March, the Fed released very subtle changes in the Statement of Economic Projection (SEP) "dots," helping to subsequently weaken the U.S. dollar. The Fed will continue to hike rates, but economic data and financial conditions will play a larger role in determining the pace, leaving the dollar as neither the leader nor laggard among currencies.

The outlook for the euro is dominated by relative monetary policy and the issue of political risk. The ECB left policy unchanged at its March meeting but signs of dissent among the hawks and doves seem to be occurring earlier than the market had expected. It is highly likely that during 2017 the ECB will need to reduce the exceptional degree of policy accommodation in place, albeit at a cautious pace, barring an exceptional outcome in the French elections that could add to instability. This should put a floor under the euro and ultimately help it rise.

The United Kingdom has invoked Article 50 of the EU treaty and initiated the long legal process of leaving the EU. In this negotiation, the EU has incentive to discourage other member countries from thinking that leaving the union is more attractive than staying in it. And while some agreement will be reached that is not catastrophic, negotiations are likely to begin on a discouraging note and become more practical over subsequent quarters. Also, as U.K. inflation has climbed due to a weaker currency and higher energy and food prices, the Bank of England saw its first dissenter calling for a rate hike. However, growth data is once again rolling over as real incomes and real spending are getting hit, and this will likely keep the Bank of England on the sidelines. This should keep the pound weak.

The Bank of Japan (BOJ) kept its "yield curve control" settings unchanged, and Governor Haruhiko Kuroda gave no signal the bank would consider exiting its extremely loose monetary policy this year, which leaves the yen as the G4 funding currency of choice. Supporting this thesis are signs that a wage-price spiral remains absent in Japan. Without any upturn in wage growth, Japan's national CPI is likely to keep undershooting the BOJ's target. In the short run, the dollar-yen rate has traded in a range, and it is likely to remain range-bound.

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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