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Europe plays catch up

In contrast to late-cycle economic conditions evident in the United States, we think Europe — which typically lags the U.S. cycle — may continue to build growth momentum.

We think global interest-rate normalization will continue, but likely on a slower path.

We continue to prefer various spread sector risks, including credit, prepayment, and liquidity risks, over interest-rate risks.

In the United States, we see an increasing amount of evidence pointing toward late-cycle economic conditions. This does not mean a recession is imminent or likely, although it probably does mean that the odds of a recession are rising. A consoling thought, of course, is that the economy has shown its resilience in recent years. We have weathered fiscal tightening between 2011 and 2013, sharp movements in oil prices, and rising dollar strength in 2014 and 2015. These protracted events caused fluctuations in the economy’s growth rate, but they were not powerful enough by themselves to produce a recession. It is entirely possible, and indeed quite likely, that the current challenges to growth today may also lack power sufficient to cause a contraction.

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		●	

The limitations of corporate profits

The key problem the U.S. economy faces today is that the tightening labor market is constraining corporate profits. Firms attempted to regain healthier margins in the first quarter of 2017 by raising prices, but households rebelled, and consumption growth eased. This is most clear in the auto market, but it has happened in other areas, including residential real estate.

We think that labor market conditions and recent weakness in core inflation make the pace of future monetary tightening uncertain. The weight of opinion on the Federal Open Market Committee (FOMC) is to hike at least once more after June and to begin balance-sheet reduction near year-end, but that opinion could change if the outlook changes. Moreover, as we have indicated in recent quarters, the composition of the FOMC could look different in a few months' time, and that could be enough to tip the center of gravity for policy purposes.

The European powerhouse

Economic data show that Europe is currently the fastest growing of the major advanced economies. Europe typically lags the global cycle, so if normal global dynamics hold, it would not be surprising to see Europe staying strong when the rest of the world slows.

As we investigate evidence of Europe's strength, we see continued heavy dependence on export-led growth. Economic powerhouses like Germany are indifferent where they sell their goods. A pickup in demand anywhere in the world — whether in the United States, China, or other emerging economies — provides an export market for German companies. These companies increase production and investment, and their profitability rises. The German labor market tightens, and wages go up. Domestic consumption edges higher, but generally the current account surplus increases and German capital goes somewhere else in the world.

The new wrinkle on this decades-old story is that the euro is probably weaker than the deutsche mark would be, if it still existed, so euro weakness is helping to keep German exports growing a bit more rapidly and German consumption growing a bit more slowly than would otherwise be the case.

Other European bright spots

With the exception of Greece, Europe's periphery is growing at a decent clip as it recovers from the downturn. This recovery has further to go, which gives the eurozone some added resilience. There are also positive prospects in France, particularly as President Emmanuel Macron has gathered major support in the National Assembly. Coupled with a tailwind of a cyclical recovery in France, this political unity gives Macron a good chance of success in enacting growth-enhancing measures.

The latest revisions to Italy's GDP data paint a better picture of what's going on there. The country remains the laggard among the larger European economies, and the structural challenges it faces are enormous, but we have to acknowledge that Italy looks better. Growth in Q1 is now at 0.4% (quarter-over-quarter, seasonally adjusted), up from 0.2% in the first estimate. Together with an upward revision in GDP for Q4 2016, to 0.3% from 0.2%, the new numbers suggest the economy has some momentum. In our view, it seems likely that Italy can maintain a decent pace of growth for the balance of the year.

Sector views

Securitized debt: Prepayment and credit risks remain attractive

We continue to look for value in areas within interest-only collateralized mortgage obligations (CMOs), although we have been more cautious in our allocation relative to mortgage credit. More generally, we find prepayment risk attractive in an environment where mortgage lending standards have yet to ease materially. Additionally, we find reverse mortgage interest-only securities (IOs) compelling due to their valuations, stable prepayment speeds, and lack of convexity.

In mortgage credit-sensitive areas, we think investors should consider commercial mortgage-backed securities (CMBS). The underlying fundamentals for commercial real estate continue to be stable overall, as employment growth, low interest rates, and a positive GDP trajectory provide a tailwind for the CMBS sector. Nonetheless, we believe the growth in property prices experienced over the past few years will be difficult to maintain going forward. While we do predict some regional mall-related losses, we do not believe it will translate into fundamental losses at the BBB- tranche level.

Among agency credit risk transfer securities (CRTs), valuations in both mezzanine and subordinated tranches are fairer, in our view, but investor participation continues to increase and the underlying collateral has a strong outlook. Additionally, we continue to find value in the legacy residential mortgage backed security (RMBS) market. Improving housing fundamentals are helping homeowners, with loan-to-value ratios falling, homeowner delinquency rates declining, and more borrowers staying current after mortgage modifications.

High-yield bonds and bank loans: Expecting yields to grind tighter

Outside of March 2017, the high-yield bond market has had a good run year to date, and our outlook is for continued strength and further yield compression. While this outlook for the asset class is positive, we are slightly more cautious on the fundamentals. With respect to high-yield valuations and “technicals,” or the balance of supply and demand, our view is neutral.

Looking more closely at fundamentals, first-quarter U.S. corporate earnings were the strongest since 2011. High-yield issuers have improved in terms of various credit metrics, and we expect continued strength in corporate fundamentals. However, our outlook is tempered to a degree by the various uncertainties surrounding the ability of the Trump administration to implement key aspects of its policy agenda, particularly tax reform and major U.S. infrastructure investment. Additionally, we are cautious on the energy sector due to ongoing supply/demand dynamics and questions surrounding OPEC, which have driven oil prices to \$45 per barrel.

Considering valuation, high-yield credit spreads — the yield advantage high-yield bonds offer over comparable-maturity U.S. Treasuries — continued to compress during the period, and the average bond price within the index was close to par, or face value. As a result, the asset class is not compellingly cheap, but is in a range of fair value, in our view, given corporate fundamental strength.

As for technicals, new issuance of high-yield bonds totaled \$148.5 billion for the year-to-date period through May 31, 2017, which was 19% higher than the same period in 2016. However, 65% of newly issued bonds year to date were used to refinance existing debt, as corporations sought to capitalize on tight spread levels to refinance and extend their maturities. According to data from JPMorgan, the amount of new issuance excluding refinancing is at its lowest level since 2011. Meanwhile, high-yield retail fund flows were negative for the year-to-date period (-\$9.1 billion), compared with inflows of \$7 billion for the first five months of 2016.

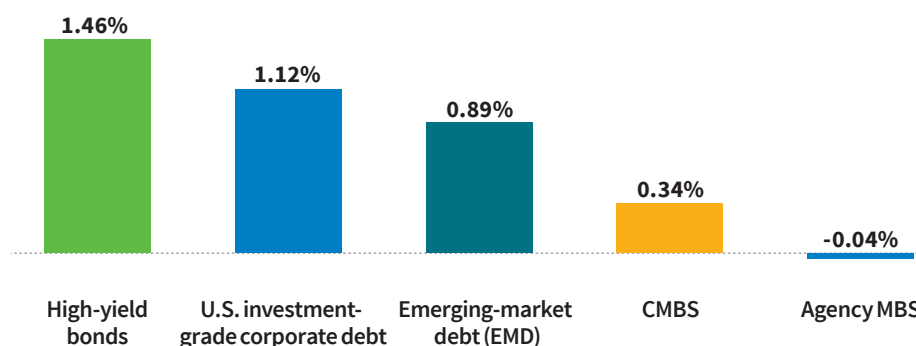
Turning to bank loans, issuance was the second-highest total on record for the first five months of the year. As with high-yield bonds, a significant amount of this new issuance — roughly half in the case of bank loans — represented refinancing activity. While the yield curve has flattened at the long end, short-term interest rates have generally risen through the first half of 2017. With 3-month LIBOR (London Interbank Offered Rate) at roughly 125 basis points at period-end, bank loans have continued to offer slightly more attractive coupon income to investors. Moreover, as 3-month LIBOR and the federal funds rate are highly correlated, we think that any future Fed policy tightening will only enhance the attractiveness of bank loans for investors seeking income that is hedged against interest-rate risk.

Corporate credit and EM debt continue to lead

Excess returns relative to Treasuries, Q2 17

Source: Bloomberg, as of 6/30/17.

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.



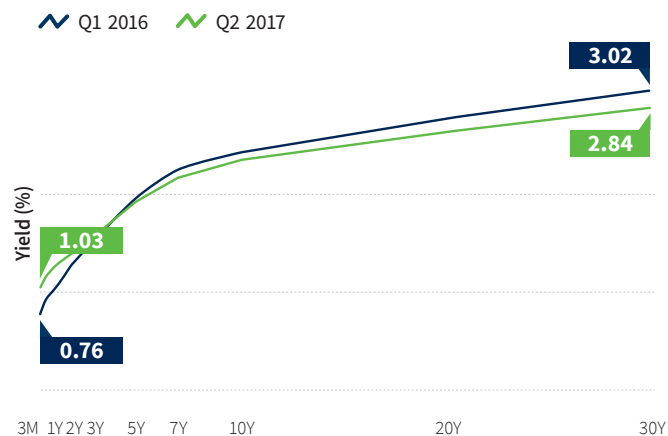
Investment-grade bonds: Solid fundamentals and strong demand

Demand for investment-grade bonds in the second 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 continuing path toward interest-rate normalization may lend further support to fundamentals.

The yield curve flattened as rates rose on the front end and fell on the long end

Expectations for growth and inflation ticked down in the second quarter



Source: U.S. Department of the Treasury, as of 6/30/17.

Emerging-market debt: High investor interest despite political shocks

Domestic political shocks continued to occur across the emerging markets throughout the first half of 2017. In South Korea, for example, the president was removed from office on corruption charges. In Turkey, the government held a referendum on a constitutional change that many observers see as a sign marking Turkey’s illiberal future. In South Africa, President Jacob Zuma came under intense political pressure for deeply

embedded corruption. And in Brazil, President Michel Temer, the former Vice President who took office last year following the impeachment of Dilma Rousseff, appeared to become embroiled in his own corruption scandal. These developments, which matter for the economic outlook for these countries in many ways, didn’t do much to deter investors.

We believe a variety of forces are aligned that may enhance the attractiveness of the asset class for many investors. Significantly, we think political risk has declined across the developed markets. The recent elections in Europe support this view, and we think these election results suggest the region will maintain its commitment — in the near term, at least — to accommodative monetary policy.

Overall, we maintain a bias in the fund toward dollar-denominated sovereign debt and have a greater sense of caution with respect to emerging local debt and foreign currency exchange risk. Interest rates have largely fallen in the United States so far in 2017, and we do not see inflation rising to a level that would prompt more aggressive action from the Federal Reserve. That is good news for emerging-market sovereigns with dollar-based debt obligations.

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

From January to May 2017, investor sentiment generally improved, especially for higher-yielding municipal bonds. The pace of new issuance was generally light, and demand slightly outpaced supply — contributing to rising prices and a narrowing of credit spreads of lower investment-grade as well as high-yield municipal bonds. Viewed in a longer-term context, the tighter spreads seemed relatively fair to us, especially considering that defaults among municipal issuers remained low and isolated.

In late May, President Trump presented his tax plan, which was light on details. However, such as it is, the proposed plan would reduce the overall number of individual tax brackets to three, eliminate targeted tax breaks, and repeal the alternative minimum tax, among other things. The good news for tax-sensitive investors is that the tax-exempt status of municipal bonds was not addressed in the recently announced tax outline. Treasury Secretary Steven Mnuchin publicly affirmed the administration’s preference to keep the interest deductibility of state and local bonds. Furthermore, we do not believe the currently

proposed lowering of the highest personal income tax bracket from 39.6% to 35% will materially affect demand for municipal bonds.

The new administration has stated that tax reform remains a major policy goal. However, we have not seen major tax reform in over 30 years, and we believe it will continue to be difficult to achieve today given the current political climate. As such, we believe it is too early to boldly reposition tax-exempt portfolios. That said, we continue to closely monitor tax policy developments in Washington to see what form the final tax plan takes, and how it may shape the outlook for municipal bonds.

Currency: Don't look to the dollar for leadership

The U.S. dollar outlook continues to be most heavily influenced by the Fed, as expectations for fiscal policy have been pushed beyond the investment horizon. The Fed hiked rates by 25 basis points at its June meeting, gave an outline for the mechanics of winding down the balance sheet, and chose to look through the recent softness in inflation data, describing its causes as temporary. This stance is relatively hawkish compared with market pricing and our own beliefs. With no urgency to hike rates aggressively, it is likely that the Fed will start to pare back the balance sheet gradually, but economic data and financial conditions will play a larger role in determining the pace, leaving the expensive dollar as more of the laggard than the leader among currencies.

The outlook for the euro is dominated by relative monetary policy and political risk. The ECB continues to balance the doves, who point to a tame core inflation rate, with the hawks, who call for removal of emergency-level accommodation and tapering of asset purchases. This balance is likely to persist until September or October, when the ECB will communicate to the market what it will do at year-end when the purchase program expires. Over the medium term, the euro should continue to appreciate.

In the United Kingdom, the results of the snap election have left the Conservative government in a much weaker position as they are forced to form a minority coalition with Northern Ireland's DUP (Democratic Unionist Party). The market has taken this to mean that the Conservatives will be forced to take a softer stance and remain in the single market and customs union, but in actuality, the likelihood of a hard Brexit has increased. In this context, the Bank of England kept rates unchanged, but three

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dissents in the vote suggest that its tolerance of inflation is limited. Since much of the recent U.K. inflation spike has been caused by currency weakness, it appears likely that the currency will not be allowed to fall much further. Given the risks associated with Brexit, the pound should be weak, but not excessively.

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 for the foreseeable future. This will keep the dollar-yen rate a function of Fed policy and the pace of policy relative to market pricing. Over the medium term, however, the return distribution is asymmetric because the yen is fundamentally cheap. A more dovish Fed stance could cause the yen to appreciate more swiftly.

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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