

Q4 2018 | Fixed Income Outlook



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Trade war and rising rates create headwinds for global economy

The U.S. economy is poised to expand further this year, but growth will likely ease in 2019.

China and the United States are locked in a spiraling trade war.

We believe global yields will rise, but without disrupting asset markets.

The outlook for global economic growth is easing because of protectionist tariffs, weakness in emerging markets, and rising oil prices. While the U.S. economy is expanding at a strong pace this year, buoyed by government spending and tax cuts, growth will likely slow in 2019. Unemployment has touched multi-decade lows, inflation remains anchored, and the likelihood of a recession is relatively low. The United States, Mexico, and Canada reached a new trade deal that is a lot like NAFTA but with a few upgrades. However, trade tensions between the United States and China, the world's two biggest economies, have worsened.

For fixed-income markets, this year has turned out to be more challenging than 2017. Rising interest rates, tariffs and the trade conflicts, higher oil prices, and political risks have weighed on bonds. The Federal Reserve has raised its benchmark interest rate three times in 2018 and continues to project one

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	○	●	

more hike before the end of the year, as well as three in 2019. That would push the federal funds rate above 3.00%. More importantly, the Fed removed a single word, “accommodative,” from its September 2018 rate statement, signaling to investors the economy can hold its own with little help from the central bank. While the yield on the benchmark 10-year Treasury has crossed the 3% psychological barrier, short-term rates have risen faster, resulting in a flatter yield curve. Higher rates typically create some challenges for fixed-income assets.

We believe bond yields will continue to drift higher over the course of 2018 and 2019 as interest-rate normalization continues in the United States and globally. The Fed has also stepped up the pace of its balance sheet reductions this year. Across the Atlantic Ocean, the European Central Bank (ECB) confirmed that it will cut bond buying in half in October 2018 and anticipates that new purchases will be halted by the end of the year. These moves will start the ECB on a tightening path similar to the Fed’s.

U.S. economy on a winning streak

The U.S. economy is heading into 2019 with significant momentum and the longest streak of job growth on record. The labor market remains strong as hiring has improved and wage gains have accelerated. The unemployment rate of 3.7% is the lowest since December 1969. The dollar has surged as rates moved higher and investors sought the safety of U.S. assets, including Treasuries, amid some turmoil in global fixed-income markets.

The economy grew at an annual rate of 4.2% in the second quarter of 2018, its best performance in nearly four years, boosted by robust consumer spending, solid business investment, and tax cuts. Consumer confidence hit an 18-year high in September, according to a recent survey from the Conference Board. But there are signs of some nervousness about the upward move in prices; consumers are sensitive to changes in prices of items they frequently purchase, and the recent increase in retail gasoline prices will not have gone unnoticed.

The Fed estimates GDP growth will ease slightly to 2.5% in 2019 from 2018. This is largely in line with our expectations for growth to slow next year as the effects of the fiscal stimulus abate. We continue to see the risks to growth as asymmetric. It is possible we are in the early stages of higher capital spending and productivity growth. That

would allow economic expansion and strong wage gains without rising inflation and without the Fed shifting to a more aggressive path. However, that remains unlikely. Either the economy will slow, as fiscal stimulus wears off and higher rates restrain growth or, if fast growth continues, real rates will rise to the point they cause financial market instability.

Fed ends “accommodative” monetary policy era

The Fed raised rates in March, June, and September 2018, and signaled that another rate increase in 2018 was likely. The yield on the 10-year Treasury touched 3.26% in October 2018, its highest level since 2011. The two-year-note yield also hit its highest level in more than 10 years. Not surprisingly, the yield curve has been on a flattening trend. The U.S. economic recovery and a more determined Fed mean U.S. rates are likely to rise steadily. In addition, some Fed officials have indicated that it’s likely the funds rate may be temporarily set above what they call the “neutral” rate that is neither restrictive nor stimulative.

What’s driving the higher rates appears to be continued strong economic growth and some creeping signs of inflation. Inflation measures have moved above the Fed’s 2% target. In the 12-months through September, the consumer price index rose 2.3%, while the Fed’s preferred inflation gauge — the personal consumption expenditures (PCE) price index that excludes food and energy — hit 2% in August. FOMC officials will have two more months of inflation data before the December rate meeting.

Japan’s central bank remains cautious

While the Fed has been raising rates, Japan’s central bank has been relatively dovish on monetary policy. Japan’s economy is growing at a slow but fairly steady pace, but it is not fast enough for the Bank of Japan (BoJ) to alter monetary policy over the near term. The yields on Japanese government bonds, or JGBs, are influenced by the BoJ, global interest rates, and the upward pressure on Treasury yields. But equally, the BoJ’s stance on rates will keep Treasury yields lower than they would otherwise be.

The world’s third-largest economy, Japan grew an annualized 3.0% in the second quarter of 2018, its fastest pace since 2016. Capital spending has risen, consumption indicators have improved, and the labor market has firmed, with the unemployment rate falling to 2.4% in August 2018. But the improved economic performance was offset by

worsening business confidence in the third quarter. The BoJ's closely watched "tankan" survey, which measures sentiment among large manufacturers, fell in September from three months ago amid worsening global trade tensions. Inflation is on the rise, albeit at a painfully slow pace. September inflation surprised on the upside as the BoJ's preferred core measure — prices in Tokyo — were 0.7% higher than a year earlier. But the central bank's inflation target is still an awfully long way away.

China's growth and trade gamble

China, the world's second-biggest economy, is showing signs of slowing amid deleveraging and escalating trade tensions with the United States. Beijing has stepped up efforts to ease monetary policy and bank lending restrictions to lift growth. We believe the authorities have the policy tools, including control of the currency, to offset shocks to the economy. In October 2018, the U.S. Treasury Department stopped short of declaring China a currency manipulator in its semiannual report on foreign-exchange rates, averting an escalation of the trade war. It is still worth noting that the yuan has slid more than 5% against the dollar in the past six months, raising market speculation that China has been deliberately weakening its currency as trade tensions with the United States worsen.

President Trump has slapped tariffs on \$250 billion in Chinese goods, and China has retaliated with tariffs on about \$110 billion of U.S. products. On top of the escalating trade war, Trump recently accused China of meddling in the 2016 elections as well as in the upcoming midterms in November. Negotiations between the Trump administration and China have so far yielded few results.

China has little incentive to offer anything substantive. One reason is China has already floated a deal, supported by Treasury Secretary Steven Mnuchin, that was rejected. Second, whatever the United States has done so far has not changed the cost-and-benefit calculus as Beijing weighs its options. Third, China's hopes of negotiating a free trade pact with Canada or Mexico was dealt a sharp setback by a provision in USMCA (the revised NAFTA) that aims to forbid such deals with "non-market" countries. China qualifies as a "non-market" country because its state-driven economic model doesn't allow for capital to move freely in and out of the country due to capital controls. Lacking an incentive, China is sending signals they are not prepared to roll over and accede to U.S. demands.

Sector views

Credit strategies supported by growth as developing markets struggle

Globally, we think economic growth remains on track, led by the United States. As a result, we believe the stage is set for bond yields to rise. We don't think rising yields will be a major disruption to asset markets. In our view, investors appear to be more comfortable with the idea that risk-driven assets can perform reasonably well even if rates move higher.

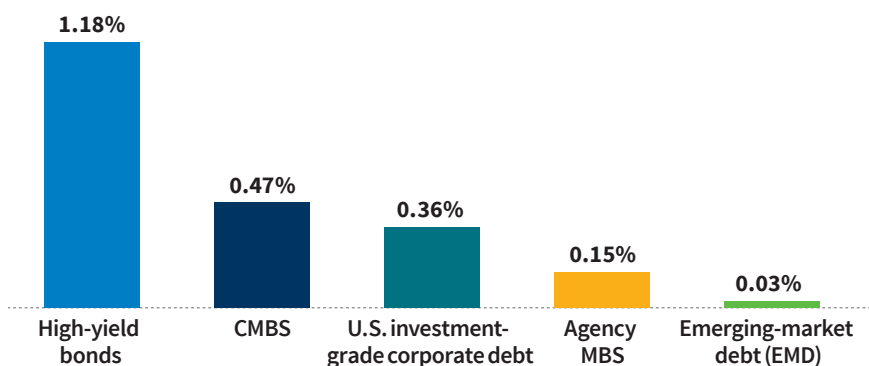
In fixed-income markets, we continue to favor mortgage credit, prepayment risk, and corporate credit, but are taking a somewhat more conservative approach than previously. We are doing this by purchasing securities with less price sensitivity to changes in yield spreads, while also seeking

Risk assets performed well during the quarter

Excess returns* relative to Treasuries, Q3 18

Source: Bloomberg, as of 9/30/18. 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.

* Excess returns are calculated relative to comparable maturity U.S. Treasuries for each index.



greater credit protection by investing at more senior levels in a deal's credit structure. Our corporate credit holdings — primarily high-yield bonds — were the biggest contributor to third-quarter returns. The asset class performed well amid improving U.S. economic growth; strong second-quarter earnings reports; softening trade tensions between the United States, Europe, and Mexico; and the lightest net new issuance since April 2009. Mortgage-credit strategies also aided performance.

Emerging markets: Hampered by economic, political risks

Bonds issued by the government of Argentina sold off in late August after the country's president petitioned the International Monetary Fund to expedite \$50 million in emergency funding. Uncertainty surrounding upcoming elections in Brazil hampered the performance of that country's debt. Emerging-market debt rebounded in September, as investors sought to capitalize on newly attractive valuations created by the volatility in August.

U.S. economic growth, and the Fed's response to it, has placed pressure on international markets, particularly in developing countries. Assets have flowed out of emerging markets and into the United States in search of better risk-adjusted returns. The dilemma facing policy makers in less-developed countries is whether to try to keep pace with the Fed as it raises interest rates. Higher rates could help stem capital outflows from emerging markets but could also crimp domestic growth.

Currency views

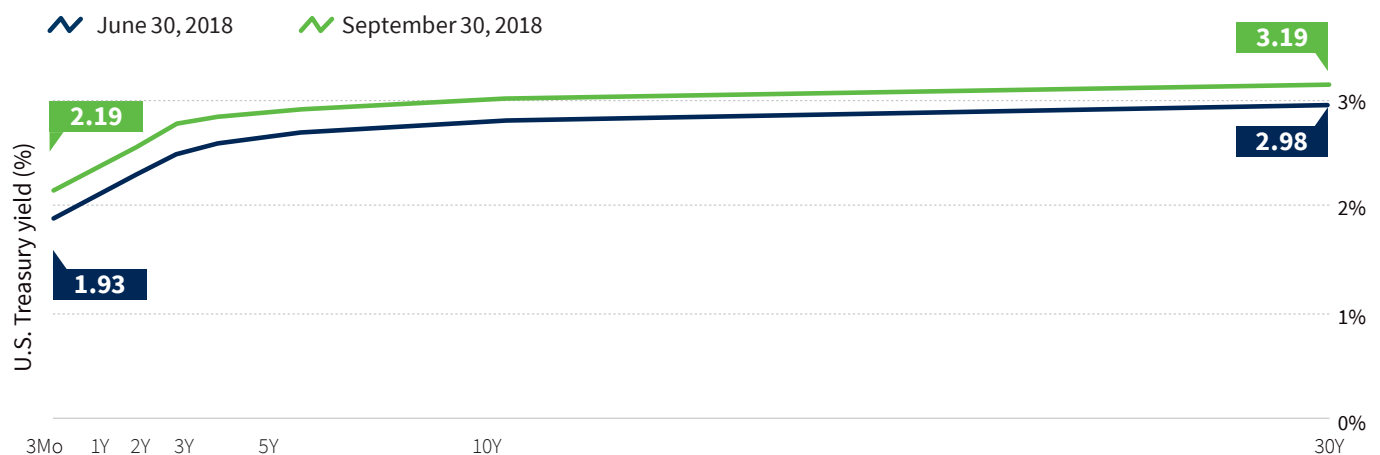
U.S. dollar buoyed by rate hikes

In the United States, growth remains stable and inflation firm. Globally, growth has cooled, and inflation pressure is more subdued, although it appears we are seeing signs of bottoming, particularly in Europe. In these conditions, the U.S. dollar remains supported by a steady dose of hawkish Fed expectations at a time when other global central banks remain cautious. The more structural aspects of a weaker U.S. dollar story (the twin deficits of the federal budget and the U.S. current account, along with reserve diversification) remain intact and will likely dominate over the medium term but will only act as a headwind to a stronger U.S. dollar broadly.

Euro outlook tied to Italian politics

The outlook for the euro remains dominated by relative monetary policy, growth, and the euro political risk premium. Inflation should start to pick up in the coming months (headline has, and core should follow) and growth should continue to stabilize at lower but robust levels, both of which should limit the downside in the single currency. The continued disruption from Italian politics and budget negotiations will remain a headwind to significant upside for the euro as Italy is too big to fail and fiscal promises are likely to generate political backlash from Brussels.

Rates continued to rise across the yield curve during Q3



Source: U.S. Treasury Department, as of 9/30/18. Past performance is not indicative of future results.

The pound's appreciation likely capped

In the United Kingdom, Brexit noise remains high. A relatively “soft” Brexit remains the most likely outcome. However, the possibility of no deal remains. This uncertainty is on the radar of Bank of England Governor Mark Carney, who has stated that the variance around possible Brexit outcomes had risen. But he also emphasized that it was not prudent for the Monetary Policy Committee to wait for “perfect certainty” on Brexit before adjusting monetary policy. With that, the bank hiked rates by 25 bps to 0.75%. The British pound will likely be limited in terms of its upside as the market will continue to discount the Bank of England’s modal path of rate hikes, with Brexit uncertainty requiring a higher risk premium.

Japan's yen may trend higher

The BoJ changed its yield curve control policy in August, allowing for an elongated policy horizon driven by focusing on the price level of rates over quantity. In the medium term, structural forces will start to play in favor of the yen as the large current account surplus and favorable valuation suggest that the dollar-yen rate should drift lower, but it is subject to trade higher over the coming months.

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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