Q3 2018 | Fixed Income Outlook

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Global economic outlook is favorable, but rates and trade create headwinds

The U.S. economy is poised to pick up some speed in the second half of 2018.

Escalating trade tensions between the United States and its major trading partners pose risks.

The European Central Bank is poised to wind down its bond-buying program by year's end.

The outlook for global growth is stable — albeit less synchronized — for the remainder of 2018, we believe. The U.S. economy is poised to expand at a stronger pace this year, buoyed by government spending and corporate investment. The likelihood of a recession remains relatively low. More strikingly, we are starting to see some convergence in global growth rates — especially between the United States and the eurozone — in the second half of this year. The growth gap had widened during the first half of 2018.

For fixed-income markets, this year is turning out to be more challenging than 2017. Higher interest rates, the long-feared trade war, rising inflation, higher oil prices, and political risks have weighed on the global bond market. The Federal Reserve raised rates twice this year — in March and in June 2018 — and signaled that it is on track to raise short-term rates at least once more this year. The yield on the benchmark 10-year Treasury crossed the 3% psychological barrier

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	●		

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in April, setting a new five-year high, and the yield curve has flattened. Higher rates typically create some challenges for fixed-income assets.

Bond yields will continue to drift higher over the course of 2018, in our view, as rate normalization continues in the United States and globally. A more hawkish Fed also stepped up the pace of its balance sheet reductions in April, and this is expected to continue through October, when the pace will reach its highest level. Across the Atlantic, the European Central Bank plans to wind down its bond purchase program by the end of 2018. But, the ECB remained dovish and said it did not expect to raise interest rates, which are at historic lows, until the fall of 2019 at the earliest.

The risk that the trade conflict between the United States and its major trading partners will escalate continued to plague markets and investor sentiment. In July, the United States and China imposed punitive tariffs on each other's imports. The European Union, Mexico, and Canada have similarly retaliated against President Trump's steel and aluminum tariffs. While the volume of trade targeted is too small to influence the economic trajectory much, the possibility of an expanded and more damaging trade war looms.

U.S. economy a bright spot

The American economy headed into the second half of 2018 with strong momentum and the longest streak of job growth on record. The labor market remains robust as hiring improved and wage gains accelerated. Employers added 213,000 net new jobs in June as more people flocked to the job market, reflecting healthy gains in a broad range of industries such as manufacturing and construction. The unemployment rate rose slightly to 4% in June from an 18-year low of 3.8% in May.

The economy grew at an annual rate of 2.2% in the first quarter of 2018 due to lower consumer and business spending. Still, corporate investment picked up in the second quarter, although most of the increase has been in extractive industries where high prices and a relaxation of environmental regulations have boosted profit margins. We expect U.S. growth to be stronger in the second half than in the first six months of 2018, supported by the latest fiscal stimulus and corporate investment.

The risks to growth, however, seem asymmetric to the downside. The tariffs imposed by President Trump, along with the threats of more tariffs and trade restrictions, are unsettling financial markets. There is clear historical evidence that uncertainty is bad for investment. The administration's hard line on trade policies has prompted retaliatory measures by major trading partners, including China, the European Union, and Mexico. China, the world's second-biggest economy, has imposed $34 billion in retaliatory tariffs on American goods. Canada, a member of the North American Free Trade Agreement (NAFTA), which is still being renegotiated, announced retaliatory tariffs against almost $13 billion of U.S. products. The European Union has announced similar measures.

Fed and interest-rate hikes

The Federal Reserve raised rates in March and in June 2018, and signaled that two additional rate increases in 2018 are likely. U.S. government and global bond yields trended higher. The yield on the benchmark 10-year Treasury has continued to hover near the 3% psychological barrier, signaling that higher rates are ahead in the world's biggest bond market. The 2-year yield also hit its highest level since 2008, and the yield curve has been on a flattening trend. Debt yields also rose pretty much in lockstep with oil prices. That is not surprising because of the clear influence energy has on headline inflation.

The strong economic recovery in the United States and a more determined Fed means U.S. rates are likely to rise gradually. This upward drift, however, may continue to be interrupted by rallies when markets fear that higher rates may constrain growth. The Fed's June increase pushed the federal funds target to 1.75%–2.00%. These increases add to the costs of consumer debt, particularly credit cards, home equity lines of credit, and other adjustable-rate instruments. We believe there is increased risk of overtightening as the Fed steps up the pace of balance sheet reductions and interest-rate hikes in the second half of this year. Short-term rates have kept pace with balance sheet reductions. It's not at all clear to us that the Fed is paying enough attention to developments at the front end of the yield curve, which are certainly rippling through the economy and asset markets.

Meanwhile, U.S. inflation accelerated in May to the fastest pace in more than six years, reinforcing the Fed's outlook for interest-rate hikes. The consumer price index rose 0.2%

from April and 2.8% from a year earlier, partly reflecting higher fuel prices. The Fed's preferred gauge of core prices was up 1.8% in April from a year earlier. While it is likely that core inflation will breach the Fed's 2% target later this year, policy makers seem quite comfortable with that outlook for 2018. Oil prices rose quite sharply this year, driven by a growing global economy, production cuts by OPEC, and increased geopolitical tensions.

The ECB's balancing act

Across the Atlantic, the European Central Bank (ECB) in June decided to end its €2.6 trillion bond purchase program by the end of 2018. The bank said it did not expect to raise interest rates, which are at historic lows, until the fall of 2019 at the earliest. The looming trade war, with the United States and Europe announcing tit-for-tat tariffs on products, have raised concerns about growth in the region. ECB President Mario Draghi and other policy makers have singled out protectionism as a threat to the eurozone's outlook.

One of the big stories in the first half was the deceleration in the eurozone. Economic growth slowed to 0.4% in the first quarter — the weakest in six quarters — after expanding 0.7% at the end of 2017. Manufacturing eased, and the euro strengthened. Fortunately, this material downshift appears to be coming to an end as growth indicators stabilize, domestic demand steadies, and consumer confidence rises. Inflation in Europe hit 2% in June for the first time in more than a year, supported by higher oil prices. The pickup in the inflation rate was just above the ECB's target.

Still, political turmoil in Italy — the eurozone's third-largest economy — is likely to complicate the ECB's policy decisions this year. Prime Minister Giuseppe Conte took power in early June to head a new populist government made up of the anti-establishment 5-Star Movement and the far-right League party. The populists have various economic proposals, and if enacted, they would raise Italy's fiscal deficit, lower potential growth, and worsen Italy's public debt. Italy needs growth driven by a better economic structure. Without that growth, it remains vulnerable to higher interest rates. Given the new coalition's program, we think the default risk on Italian government securities (BTPs) is materially higher than it is for Greece or the other bonds included in the JPMorgan High Yield Index.

Cross currents in emerging markets

The jump in global interest rates, a stronger dollar, rising oil prices, and trade jitters have caused havoc across emerging markets. We expect bond yields in emerging markets to continue rising over the coming months. The Fed will be a primary focus for the remainder of 2018 as rate increases and balance sheet reduction are widely expected to be implemented at a faster pace, and these will continue to have impact on emerging markets.

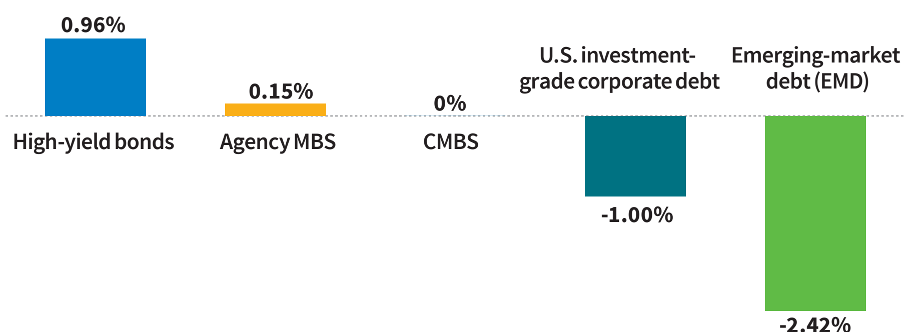
Political risks also weighed on some key emerging-market economies, including Mexico, Argentina, and Brazil. President Trump's protectionist trade policies targeting U.S. trading partners, including Mexico, continues to weigh on Mexican asset markets. Also, the leftist Andrés Manuel López Obrador was elected president in a landslide victory that swept aside the previous ruling party, which has governed the country for most of the past 70 years. In Argentina, the central bank raised rates to double digits to defend a battered peso, which had been weakened by capital flight. In Brazil, political uncertainty ahead of the October presidential elections weighed on bonds.

Performance was mixed across risk assets

Excess returns* relative to Treasuries, Q2 18

Source: Bloomberg, as of 6/30/18. 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.



China, the world's second-biggest economy, is showing signs of slowing and is vulnerable to private capital outflows. The government has cracked down on borrowing to curb rising debt levels in the country. The knock-on effect of the trade dispute with the United States may heighten the downside risks for the Chinese economy.

Sector views

Credit strategies show continuity tempered with greater conservatism

We favor mortgage credit, prepayment risk, and corporate credit, but are taking a more conservative approach. We are purchasing shorter-duration securities and seeking greater credit protection by investing at more senior levels in an issue's credit structure. Within mortgage credit, we believe commercial mortgage-backed securities will benefit from employment growth, relatively low rates, and economic expansion. Moving on to the residential sector, we favor agency credit risk-transfer securities because of strong housing fundamentals. However, we are cautious about increasing exposure due to high valuations. We find prepayment risk attractive. And the valuations and spreads on reverse-mortgage interest-only securities are also attractive.

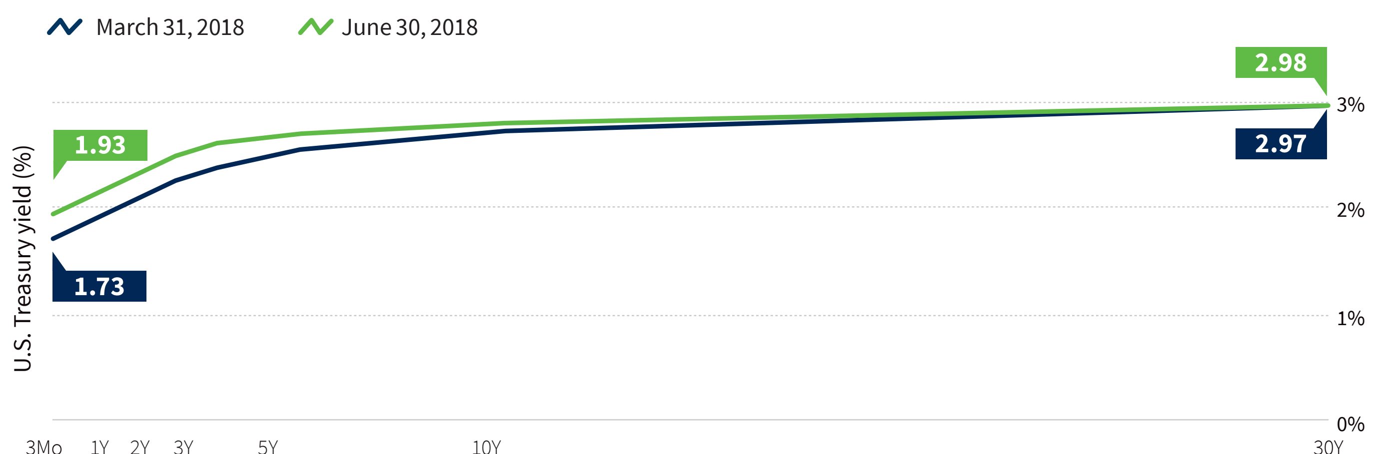
In emerging markets, we managed risk by reducing exposure to volatile markets, such as Russia. We plan to focus on investments that we believe offer value. After a decade of greater borrowing by emerging-market governments and companies, dollar-denominated bonds in developing economies are coming under increasing pressure as U.S. interest rates rise and the U.S. dollar strengthens. A stronger dollar makes it more difficult for countries with large amounts of dollar-denominated bonds to repay that debt as it matures. Trade tensions worsen the outlook for countries that rely on exports. The dilemma now facing policy makers in less-developed countries is whether to try to keep pace with the Federal Reserve as it raises interest rates. Higher rates could help stem capital outflows from emerging markets but could also crimp domestic growth.

High yield: Economic and corporate fundamentals a bright spot

We evaluate the high-yield market through three lenses: fundamentals, valuation, and technicals, or the balance of supply and demand. The fundamental environment has been positive, while we have a more neutral outlook toward technicals and valuation. U.S. economic data is favorable, and the unemployment rate fell to a 17-year low. Growth for the U.S. economy and corporate earnings is likely to strengthen over the remainder of 2018.

Turning to valuation, high-yield credit spreads — the yield advantage U.S. high-yield bonds offer over comparable-maturity U.S. Treasuries — were at about four percentage points as of quarter-end. Spreads have remained relatively unchanged thus far in 2018. In our view, the asset class is in

Rates continued to rise across the yield curve in Q2



Source: U.S. Treasury Department, as of 6/30/18. Past performance is not indicative of future results.

a range of fair value given corporate fundamental strength. Against this backdrop, we think performance in 2018 will be driven by coupon income with some capital appreciation potential. But given the firm economic backdrop and strong corporate fundamentals, high-yield corporate credit remains attractive for investors seeking income.

As for technicals, the majority of year-to-date gross new issuance was used to refinance existing debt — a continuation of a trend we have seen for some time. Year-to-date net new issuance of high-yield bonds, excluding refinancing, totaled about $45 billion, down 28% from the same period in 2017. High-yield mutual funds and exchange-traded funds had net outflows of $23.7 billion through June 29. Overall, it appears fund outflows have been offset the positive impact of lower net new issuance.

Bank loans: Steady fundamental and technical conditions

The loan market continues to be supported by a favorable fundamental backdrop. U.S. economic and corporate earnings growth are likely to strengthen further this year. Within this environment, loan issuers have slowly grown their revenues and translated that growth into stronger earnings and cash flows. With the exception of specific issuers in certain parts of the market, defaults remain generally subdued.

The majority of year-to-date gross new issuance was used to refinance existing loans — a continuation of a trend we have seen for some time. Year-to-date net new issuance of bank loans, excluding refinancing, totaled about $167 billion, up 19% from the same period in 2017. Meanwhile, loan mutual funds and exchange-traded funds reported a year-to-date net inflow of $11.9 billion through June 29. Additionally, collateralized loan obligations (CLOs) have been a strong source of loan demand. Year to date, about $153 billion in CLOs have been issued, with roughly half this total representing new CLOs.

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 views

U.S. dollar on an upward trend

The U.S. dollar remains supported by a steady dose of hawkish Fed expectations, while other global central banks have flinched. The more structural aspects of a weaker U.S. dollar (the twin deficits — the fiscal deficit and current account deficit — and reserve diversification of foreign central banks) remain intact but will only act as a headwind to a stronger U.S. dollar broadly. A recent flare up in Italian politics serves as a reminder that the dollar still benefits when flight to quality occurs. Given the risks of U.S. trade policy and European politics, the dollar is still subject to abrupt appreciation pressures. However, with the dollar being richly valued and the economic cycle in its later strategies, dollar rallies are likely to be sold.

Italy may cause headwinds for the euro

The outlook for the euro remains dominated by relative monetary policy, robust growth, and euro political risk premium. The ECB announced in June it will end asset purchases in December, and it enhanced its forward guidance for the first-rate hike to take place after summer

of 2019. This has helped to perpetuate the monetary policy divergence theme relative to the Fed. Inflation — headline and core — should start to pick up in the coming months and growth should stabilize. Politics in Italy, which is led by a populist coalition, will remain a headwind for the euro, as Italy is too big to fail, and fiscal promises are likely to generate political backlash from Brussels. If a palatable political path is established, the single currency should stabilize and appreciate.

The pound is likely to remain weak

In the United Kingdom, political concerns have fallen as quickly as they re-emerged. The EU summit accomplished a transition agreement that will apply from the end of March 2019 to the end of 2020. The probability of a soft Brexit continues to increase. The Bank of England expectations remain in flux as inflation data had been soft, but signs of a growth pickup are emerging. Sterling is likely to remain weak until growth, both domestic and global, begins to improve.

Yen may drift higher on politics, current account surplus

At its most recent meeting, the Bank of Japan kept its yield curve control settings unchanged and pledged to “continue current powerful monetary easing persistently,” while also lowering its inflation forecasts. Structural forces will start to play in favor of the Japanese yen. The large current account surplus coupled with a very weak yen suggest that the U.S. dollar should drift lower versus the yen over the medium term. Additionally, if mounting scandals force Prime Minister Abe to step down ahead of the ruling LDP leadership contest in September and Abenomics comes into question, it’s likely the yen would appreciate significantly.

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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