Q4 2019 | Fixed Income Outlook

D. William Kohli
Chief Investment Officer, Fixed Income

Michael V. Salm
Co-Head of Fixed Income

Paul D. Scanlon, CFA
Co-Head of Fixed Income

Bond rally reflects economic uncertainty

Treasury yields swing as recession fears ebb and flow.

Trade rift and politics continue to weigh on financial markets.

We predict the Fed will cut rates further by the end of 2019.

Global growth has cooled in 2019 as trade conflicts have taken a toll on international manufacturing, investments, and financial markets. Despite multiple headwinds, the likelihood of a recession — while rising — remains relatively low in the shortrun. The U.S. economy is likely to continue expanding at a more moderate pace this year compared with 2018. The Federal Reserve lowered its policy rate twice during the quarter to safeguard the economy against future risks. Fed officials remain divided on the trajectory of future interest rates. Still, we predict there are more cuts to come.

Market worries drove many investors to bonds. Government bond yields in the United States and Europe fell sharply in August, and then rose and fell again in September. Different parts of the U.S. Treasury yield curve inverted during the quarter. The yield on the benchmark 10-year note fell below the 2-year note yield in August for the first time since

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	●		

Not FDIC insured | May lose value | No bank guarantee

2007. Besides the Fed, other central banks around the world addressed market worries by also cutting borrowing costs. The European Central Bank (ECB) lowered one of its policy rates to a record low and rolled out a broader package of monetary stimulus.

Within an environment of declining intermediate- and long-term interest rates, the Bloomberg Barclays U.S. Aggregate Bond Index advanced 2.27% during the quarter. Investment-grade corporate bonds registered a strong return of 3.05% as measured by the Bloomberg Barclays U.S. Corporate Index. Municipal bonds, mortgage-backed securities, and high-yield bonds trailed the aggregate index. Non-U.S. bonds trailed further behind.

President Trump was in the spotlight again as the House of Representatives initiated a formal impeachment inquiry against him. While we are uncertain about the outcome, the whole episode cannot be dismissed as political theater with no important implications for markets. At some point, asset markets — both equity and fixed-income — may have to price in political uncertainty and changes in the policy agenda.

U.S. economy decelerates modestly

This year marks the 10th anniversary of the U.S. economic expansion. The economy grew at a seasonally adjusted 2.0% annual rate in the second quarter of 2019, after expanding 3.1% in the first quarter. The jobless rate is near an historic low, consumer spending remains strong, and housing market activity is picking up. In short, the economy is decelerating modestly. Strength in housing is helping to offset, in part, the weakness from the global trade war and the end of the fiscal stimulus. But the economy is not heading unavoidably into a recession. The Fed now expects growth of 2.2% this year, up from the 2.1% rate it forecast in June 2019.

Meanwhile, job creation remains steady despite some uneven gains this year. Employers added 136,000 jobs in September, and the jobless rate fell to 3.5%. Still, there has been some pullback in manufacturing, which slumped to its lowest level in more than 10 years in September, according to data from the Institute for Supply Management.

Fed sends mixed signals on rates

The Fed in September cut its main interest rate — for a second time this year — by another 25 basis points to a range of 1.75% to 2.00%. And in response to stresses in the short-term borrowing markets, the Federal Open Market Committee (FOMC) also lowered the rate it pays on bank reserves. The interest on excess reserves rate (IOER) now stands at 1.8%, after a 30-basis point cut. Fed chair Jerome Powell, however, said little on the outlook for rates. Recent commentary from FOMC officials suggests there remains a possibility rates will be cut further this year. The Fed also plans to look into whether it should resume "organic growth" in the balance sheet (or holdings of Treasury securities).

Investors tend to seek the stability of bonds when they are worried about growth. The recent rally in bonds has sent yields, which fall as bond prices rise, toward record lows. The Treasury yield curve inverted multiple times during the quarter. The yield on the 10-year note finished the quarter at 1.68%, down from 2% at the end of the second quarter and about a full percentage below where it stood at the end of 2018. In addition, the 1-year, 2-year, and 10-year note yields have been trading below the 3-month yield for months.

ECB turns on stimulus tap

The eurozone's economy continues to be at risk from domestic and global developments. But with interest rates already at record lows and an inflated balance sheet, the ECB has limited policy tools to boost growth. The ECB lowered its rate for deposits to -0.5% in September. The central bank will also restart its quantitative easing (QE) program in November, with 20 billion euros per month of net asset purchases for as long as it deems necessary. ECB president Mario Draghi referred to "downside risks" in the outlook as Germany teeters on the brink of recession, trade tensions linger, and Brexit drags on.

Politics are also back in focus. New British Prime Minister Boris Johnson says the United Kingdom plans to leave the European Union without an agreement if EU officials refuse to negotiate a new deal. The ongoing impasse — ahead of the October 31 deadline — has frayed the nerves of investors and dampened business activity. The U.K. economy unexpectedly contracted in the second quarter of 2019. In Italy, Prime Minister Giuseppe Conte has formed an unlikely new coalition government that includes the Five Star Movement and the Democratic Party. The alliance still has to contend with overhauling the economy and reining in rising debt levels.

China tries more stimulus

China, the world's second-largest economy, has adopted a string of fiscal and monetary measures to cushion its cooling economy. This includes billions of dollars in infrastructure spending and tax cuts for companies. In early September, the central bank also reduced the amount of money commercial banks are required to set aside (reserve requirement ratio) to promote lending. The economy grew 6.2% in the second quarter of 2019, the slowest pace in 27 years, as the trade war took a toll. We are now less sanguine about the resilience of global financial markets and financial flows should a more serious Chinese downturn materialize.

The exchange rate has also come into play, and this is making us a bit nervous. The trade tensions with the United States escalated over the summer when Beijing allowed its tightly controlled currency to weaken against the dollar to its lowest level in more than 10 years. This yuan weakening is a message to Washington about the trade war. Months of trade negotiations between Beijing and Washington have resulted in deadlock.

Sector views

Finding value in mortgages

Despite some recent signs of weakness, we think the U.S. economy is still in good shape overall. As a result, we believe the yield pickup offered by U.S. corporate and mortgage credits relative to lower- and even negative-yielding international alternatives may remain attractive to investors.

We continue to have a favorable outlook for mortgage credit. We think the underlying fundamentals for commercial real estate appear stable. Supports include a growing labor market, interest rates that remain historically low, and a positive U.S. economic backdrop. We also think the pricing of securities in the sector continues to reflect overly negative sentiment toward retail properties. The U.S. housing market has picked up, aided by the substantial decline in the 10-year Treasury yield — a key benchmark for mortgage rates.

Corporate debt fairly valued

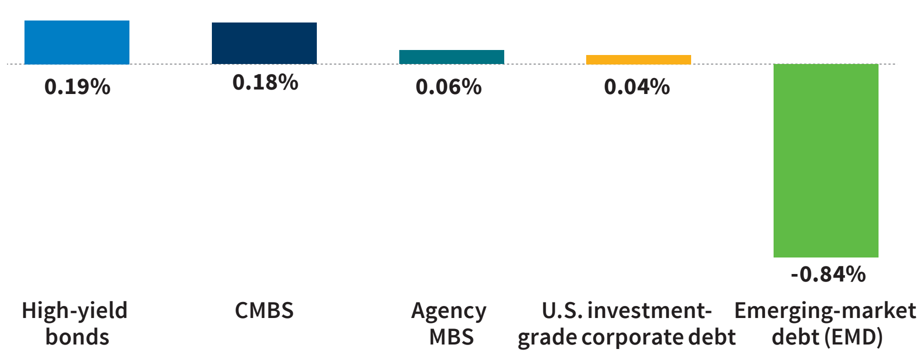
Investment-grade corporate bonds outperformed U.S. government and agency debt, mortgage credit, high-yield credit, and emerging-market debt. Generally speaking, after a strong run during the past 12 months, we think corporate credit is fairly valued. Fundamentals within investment-grade corporate credit remain stable; however, some of

Emerging markets lagged during Q3, while other risk assets modestly outperformed

Excess returns* relative to Treasuries, Q3 19

Source: Bloomberg, as of 9/30/19. 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. Excess return does not always mean "outperformance."



the economic deceleration may flow through third-quarter earnings. As a result, in our security selection process, we are continuing to remain selective and are pruning certain cyclic names. Our corporate credit holdings — which included high-yield, investment-grade bonds, and convertible securities — performed well due to favorable sector and security selection.

High-yield bond spreads tighten

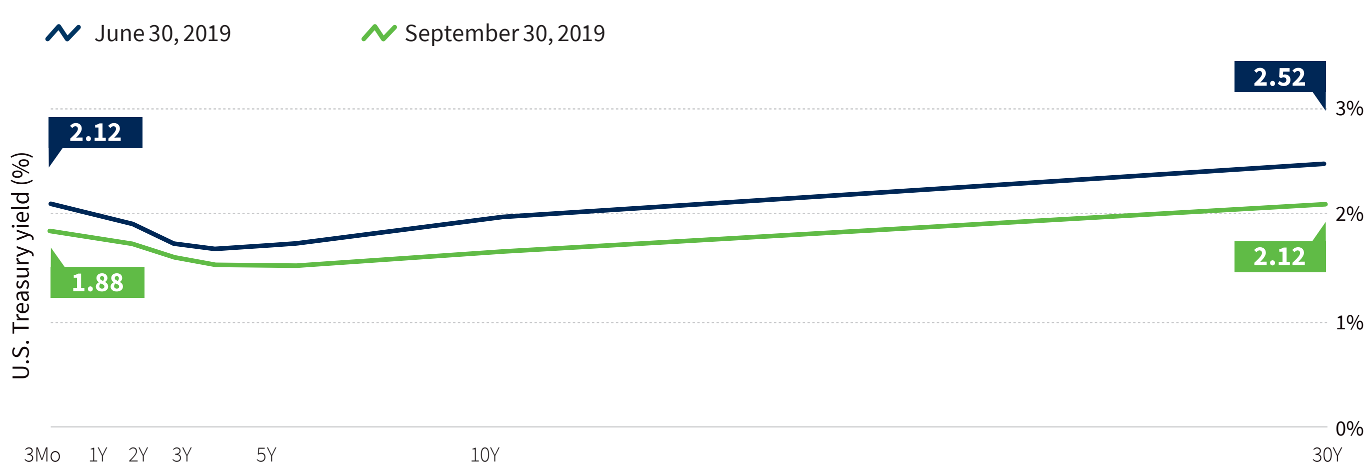
High-yield bonds gained 0.91% for the third quarter, as measured by the JPMorgan Developed High Yield Index. They trailed high-yield bank loans and the broad investment-grade fixed-income market. As of September 30, the fundamental environment remained reasonably supportive, but we had a more neutral outlook toward valuation and the technical backdrop. As for valuation, high-yield spreads ended the quarter at 4.75 percentage points above comparable maturity Treasuries. For the year to date through September 30, spreads had tightened by almost one percentage point. Energy has been a difficult sector in the market, and the overall market has favored higher quality names.

Supply trends have contributed to the improvement in issuer quality. During the 2007 to 2019 period, issuance of split B/CCC-rated bonds declined from about 38% of total new-issue volume to roughly 16%, according to Standard & Poor's. A dramatic reduction in issuance to fund leveraged buyouts and mergers/acquisitions was a major reason for this downtrend in lower-quality issuance. In 2007 and 2008, upward of 50% to 60% of new-issue volume went to fund leveraged buyouts, and mergers and acquisition deals. By April 2019, this volume had dwindled to roughly 15%.

Term-structure securities bound by rates

In parts of the market where we target prepayment risk, we don't think our allocations to agency interest-only collateralized mortgage obligations (CMO) will have the benefit of rising interest rates in the near term. Consequently, we are focusing on security selection in this area of the market. Finally, our term-structure outlook is that rates in the United States are likely to be rangebound at this stage of the economic cycle. In light of macroeconomic events, duration will be somewhat similar to the rate-sensitive Bloomberg Barclays U.S. Aggregate Bond Index in the near future.

Rates continued to fall across the yield curve during Q3



Source: U.S. Treasury Department, as of 9/30/19. Past performance is not indicative of future results.

Currency views

The dollar to remain supported

The dollar's support from its high-yielding status is wavering. The Federal Reserve lowered its policy rate twice during the quarter to a range of 1.75% to 2.00% to cushion the economy against a slowdown. However, Fed officials are less dovish than expected by the markets and continue to signal a high level of dependency on data. The Fed also remains divided on how to set future policy. Growth outside the United States will need to pick up to allow a more broad-based dollar depreciation. The trade rift between the United States and China has created downside risks, with breakthroughs unlikely ahead of the elections in 2020. So, the dollar will likely remain supported against most other currencies except for the Japanese yen, the Swiss franc, and maybe the euro.

Euro depreciation may be capped

The outlook for the euro remains dominated by monetary policy, growth, and the currency's political risk premium. The ECB recently cut its deposit rate, introduced tiering of reserves to limit the impact of negative rates on the banking system, enhanced forward guidance, and restarted the QE program. The emphasis is on keeping policy easy until inflation reaches the ECB's target. This promises low rates and asset purchases for as long as necessary. The euro will likely retain its role as a funding currency. However, there are limits to how low the single currency can go as other central banks shift to a more dovish tone.

Brexit fog looms over the pound

In the United Kingdom, Brexit still determines the direction of the pound sterling. Political uncertainty remains high. Parliament has passed legislation that requires Boris Johnson's government to extend the United Kingdom's exit deadline to avoid a no-deal Brexit on October 31. Pushing the required deadline to the end of January 2020 means the fog is unlikely to lift any time soon. And as such, the country is also highly likely to face an election, with the polling day as soon as late November. All of this is likely to delay any policy action by the Bank of England until at least the first quarter of 2020. Sterling will be subject to swings in the polls for the general election.

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 90 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.

D. William Kohli
Chief Investment Officer, Fixed Income
Global Strategies
Investing since 1988
Joined Putnam in 1994

Michael V. Salm
Co-Head of Fixed Income
Liquid Markets and Securitized Products
Investing since 1989
Joined Putnam in 1997

Paul D. Scanlon, CFA
Co-Head of Fixed Income
Global Credit
Investing since 1986
Joined Putnam in 1999

* As of September 30, 2019.

Japan's yen and near-term stimulus

The Bank of Japan (BoJ) and its governor Haruhiko Kuroda have indicated that more accommodative policy is an option amid soft global growth, trade risks, and the recent increase to the value-added tax. At its September meeting, the BoJ mulled several policy options, including lower rates, a higher QE program, and accelerating the increase in the monetary base. So, there are glimmers of hope for changes in policy — in line with other global central banks — as early as October. However, the impact on the yen is likely to be limited and temporary. As other central banks have cut rates and as markets have priced in lower rates, the interest-rate spreads with Japan have narrowed. That has reduced Japan investors' tendency to seek higher yields abroad. We expect the yen to remain strong.

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.

For informational purposes only. Not an investment recommendation.

This material is provided for limited purposes. It is not intended as an offer or solicitation for the purchase or sale of any financial instrument, or any Putnam product or strategy. References to specific securities, asset classes, and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations or investment advice. The opinions expressed in this article represent the current, good-faith views of the author(s) at the time of publication. The views are provided for informational purposes only and are subject to change. This material does not take into account any investor's particular investment objectives, strategies, tax status, or investment horizon. The views and strategies described herein may not be suitable for all investors. Investors should consult a financial advisor for advice suited to their individual financial needs. Putnam Investments cannot guarantee the accuracy or completeness of any statements or data contained in the article. Predictions, opinions, and other information contained in this article are subject to change. Any forward-looking statements speak only as of the date they are made, and Putnam assumes no duty to update them. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties. Actual results could differ materially from those anticipated. Past performance is not a guarantee of future results. As with any investment, there is a potential for profit as well as the possibility of loss.

The information provided relates to Putnam Investments and its affiliates, which include The Putnam Advisory Company, LLC and Putnam Investments Limited®.

Prepared for use in Canada by Putnam Investments Inc. [Investissements Putnam Inc.] (o/a Putnam Management in Manitoba). Where permitted, advisory services are provided in Canada by Putnam Investments Inc. [Investissements Putnam Inc.] (o/a Putnam Management in Manitoba) and its affiliate, The Putnam Advisory Company, LLC.

Consider these risks before investing: International investing involves certain risks, such as currency fluctuations, economic instability, and political developments. Additional risks may be associated with emerging-market securities, including illiquidity and volatility. Lower-rated bonds may offer higher yields in return for more risk. Funds that invest in government securities are not guaranteed. Mortgage-backed securities are subject to prepayment risk. Derivatives also involve the risk, in the case of many over-the-counter instruments, of the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. Bond investments are subject to interest-rate risk, which means the prices of the funds' bond investments are likely to fall if interest rates rise. Bond investments also are subject to credit risk, which is the risk that the issuer of the bond may default on payment of interest or principal. Interest-rate risk is generally greater for longer-term bonds, and credit risk is generally greater for below-investment-grade bonds, which may be considered speculative. Unlike bonds, funds that invest in bonds have ongoing fees and expenses. You can lose money by investing in a mutual fund.

In the United States, mutual funds are distributed by Putnam Retail Management.

A world of investing.®

Putnam INVESTMENTS

If you are a U.S. retail investor, please request a prospectus, or a summary prospectus if available, from your financial representative or by calling Putnam at 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

Putnam Retail Management

Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

TL002_RE 318712 10/19