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Q3 2020 | Fixed Income Outlook

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Bonds ride the Fed wave as volatility returns

We expect short-term interest rates to remain near record lows this year and yields to stay range bound.

The Fed's facilities have increased liquidity in the markets and, in turn, stabilized bond spreads.

We have a fairly favorable outlook for the fixed-income markets, including investment-grade corporate bonds.

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	●		

Global financial markets proved to be surprisingly resilient during the second quarter. The snapback in investor sentiment and price levels across asset classes was fueled by fiscal and monetary stimulus, along with the first steps of an economic recovery as businesses began to reopen around the world. The S&P 500 Index, a broad measure of stocks, rose 20.54% and the MSCI World Index gained 19.36% during the period. The market's resilience has also benefited bondholders. The rate-sensitive Bloomberg Barclays U.S. Aggregate Bond Index advanced 2.90% during the quarter. The ICE BofA 1–3 Year U.S. Corporate Index advanced 4.39 % for the period.

Interest rates remained range bound. The yield on the benchmark 10-year Treasury Note ended the quarter at 0.66% compared with 0.70% on March 31. Corporate credit — both investment-grade and high-yield — advanced and spreads tightened, mirroring the strength seen across equity markets. The Federal Reserve (Fed) cut interest rates to near zero in mid-March, and unleashed a torrent of bond-buying programs to ensure smooth market functioning. The U.S. Congress has also pumped trillions of stimulus dollars into the economy. Central banks across Europe, Asia, and other regions also rolled out COVID-19 stimulus measures. Against this backdrop, we have a favorable long-term outlook for investment-grade corporate bonds and some sectors within mortgage-backed securities. The commercial mortgage-backed securities (CMBS) market, however, has faced significant headwinds caused by the pandemic.

As we head into the second half of the year, we expect COVID-19 and the economy will continue to dominate headlines. Investors are bracing for a worldwide recession and a second wave of the coronavirus outbreak. Fed Chair Jerome Powell signaled in June that the central bank plans to keep rates near zero for "as long as it takes to provide some relief and stability." Therefore, we expect short-term rates to remain near record lows this year. The U.S. economy has entered a recession — bringing the 11-year expansion to a halt — as the pandemic caused economic activity to slow sharply. A recovery, once it comes, will likely be slow and halting, and punctuated by brief periods of faster growth.

U.S. recovery unlikely to be "V-shaped"

The economy is showing early signs of stabilization. U.S. manufacturing rebounded in June as major parts of the country opened up, ending three months of contraction; consumer spending surged in May although it remains below pre-pandemic levels, and unemployment fell in June. U.S. employers added about 4.8 million jobs in June and the unemployment rate fell to 11.1% from 13.3% in May, according to the Labor Department. However, the economy's position is a bit tricky because of the recent surge in coronavirus infections.

As states ease mobility restrictions, there is a second wave of COVID-19 in a large number of places such as Florida and Texas. This poses a threat to private sector confidence and the pace of the recovery. The interaction between public health policies and the private sector's reaction is at the heart of the outlook for these states and the economy. We don't expect households will return to more normal patterns of consumption while the virus is circulating so freely. The Fed expects the economy to contract by 6.5% this year, before rebounding by 5% in 2021. Policymakers also expect the unemployment rate to be 9.3%, before falling to 6.5% in 2021. We continue to think a "V-shaped" recovery is very unlikely.

A proactive Fed

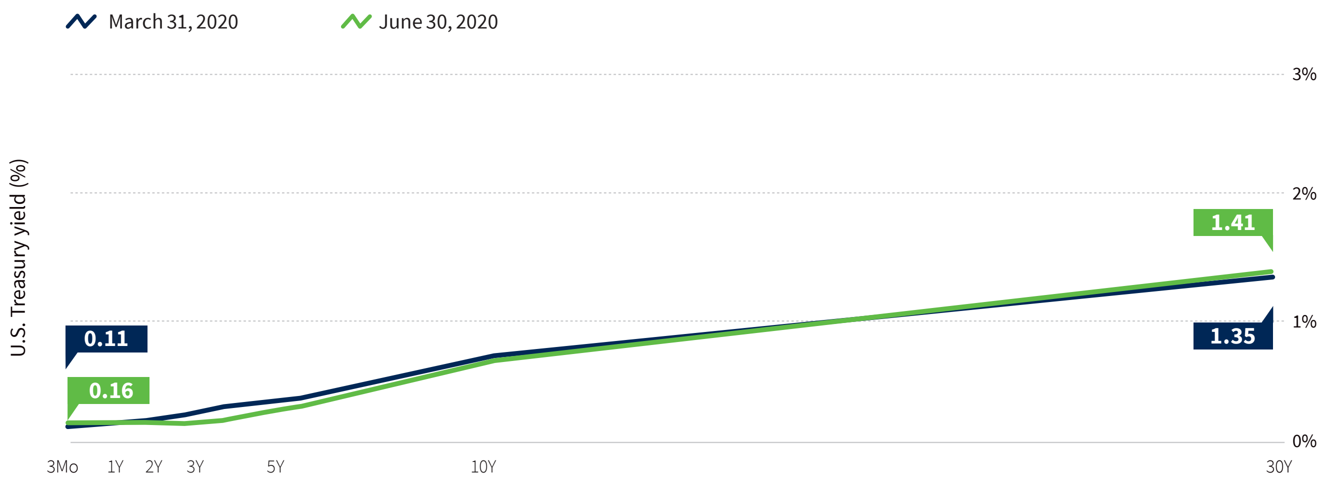
Since March, the Fed has cut its short-term rates to a target range of 0% to 0.25% and has pumped trillions of dollars into the financial system. The central bank has introduced a range of emergency lending programs to purchase debt of companies, cities, and states in a bid to encourage banks to keep lending and prevent a market collapse. In June, Fed officials signaled plans to keep interest rates near zero through at least 2022. Minutes released from the June meeting indicate officials remain worried about the bounce in consumer spending, business activity, and unemployment.

Given the overwhelming policy response, we think Treasury yields will remain low across the curve for an extended period. The 10-year Treasury yield plunged to an all-time low of 0.31% on March 9 and ended the quarter at 0.66%, after starting the year at 1.88%. The 2-year note yield tumbled to around 0.16% at quarter-end. As the economy enters the second half of the year, we believe the Fed will need to step in with more policy support as the initial phase of growth fades. Whether that will be through more explicit yield-curve control or an expansion of its quantitative easing (QE) program isn't yet clear. With QE, the Fed will buy Treasury bonds and other securities to keep borrowing costs low and help markets function properly.

European Central Bank expands bond buying program

Cyclically, the eurozone looks to be in a decent place. Although no one is out of the woods yet, recoveries are slowly underway. Germany agreed on a sweeping €130 billion stimulus package designed to spur short-term consumer spending and get businesses investing again. There are also some encouraging signs in France, but Spain is lagging quite badly. The virus data also continues to be better in Europe. Reopening has seen isolated pockets of resurgence, but they have so far been

Rates were mostly range bound during the quarter across a relatively flat curve, amid widespread risk-on sentiment



Source: U.S. Treasury Department. Past performance is not indicative of futures results.

contained. The European Union (EU) is still working on the details of its burden sharing program that includes a €500 billion recovery fund.

The European Central Bank (ECB) is also doing its bit to help, with an expansion and extension of its quantitative easing program at least until June 2021. In early June, the central bank increased its Pandemic Emergency Purchase Program by €600 billion. That comes on top of €750 billion of government bond purchases announced in March. These steps are more aggressive than expected, and while they are not game changers, they are helpful. In the United Kingdom, the Bank of England and the government are ramping up stimulus measures to lift the economy from one of its worst downturns. The central bank increased the target for its bond-buying program to £745 billion.

China's stimulus firepower

As mobility restrictions have eased in China, economic activity has been gathering momentum. A raft of recent data has shown the upturn, including manufacturing activity and consumer spending. The manufacturing purchasing managers index climbed to a three-month high of 50.9 in June from 50.6 in May, according to the National Bureau of Statistics. The separate non-manufacturing PMI, a gauge of services and construction activity, jumped to a seven-month high. Still, keep in mind the actual level of activity remains far below pre-virus levels and the recovery in demand remains slow. Increased spending will also continue to increase debt levels. The Chinese economy shrank 6.8% in the first quarter from a year earlier.

Chinese policymakers have also adopted accommodative measures to boost growth. In April, the People's Bank of China (PBoC) cut its benchmark lending rate to reduce borrowing costs for companies. The one-year loan prime rate was lowered to 3.85% from 4.05% previously. The yuan has strengthened to levels last seen in March, and PBoC has so far sent strong signals that it does not want to see pronounced currency volatility. Periodic bursts of renminbi weakness have the potential to send shock waves around the global financial system.

Sector views

Trends in the mortgage market

COVID-19 created significant headwinds for the commercial mortgage-backed securities (CMBS) market because commercial real estate is in the "eye of the storm." Uncertainty about the duration of social distancing measures makes for a challenging backdrop, particularly for hotel and retail properties. We believe most properties that were functioning well prior to the crisis and have reasonable levels of equity will survive, buoyed by government support, operator reserves, and/or debt-service modifications.

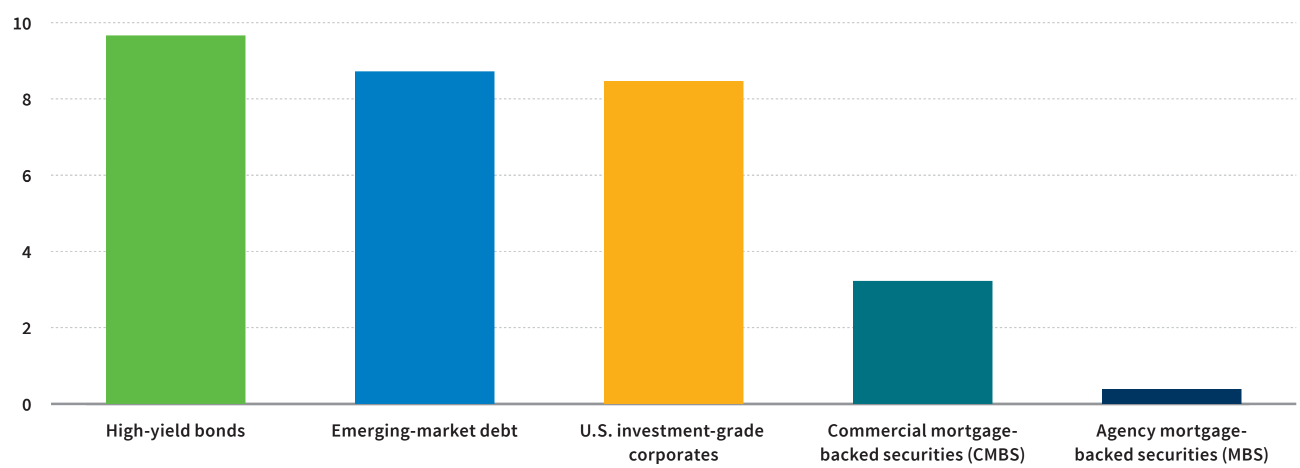
We continue to have conviction in our CMBX positions, which we believe offer value at the single A and BBB levels for indexes representing 2012–2014 issuance. CMBX is an index that references a basket of CMBS issued in a particular year. Within CMBS cash bonds, spreads on debt we view as AA/A rated have tightened, but we feel compelling opportunities still exist within the mezzanine tranches. In addition, we think the relatively large sell-off in newer vintages has presented additional value in that part of the market.

In our view, prepayment-sensitive areas of the market are the direct beneficiary when there are increased frictions in the housing finance industry. There are ongoing risks from high unemployment, weaker projected home-price appreciation, lower home turnover, and reduced homeowner mobility. Even as the use of mortgage forbearance grows, cash flows to investors from agency mortgages are guaranteed by government-sponsored enterprises. We continue to have confidence in the fund's holdings of interest-only collateralized mortgage obligations and inverse interest-only (IO) securities backed by more seasoned collateral.

Within residential mortgage credit, we believe existing home prices may decline 2% year over year during the current recession.

Risk assets rebounded sharply during Q2, with corporate credit and emerging-market debt leading the way

Excess returns* relative to Treasuries, Q2 2020



Source: Bloomberg, as of 6/30/20. 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."

Corporate debt: Investment grade and high yield

Investment-grade corporate bonds and high-yield credit advanced 9% and 9.7%, respectively, during the quarter as investors reembraced risk. Spreads on corporate credit holdings tightened dramatically during the quarter after widening in March. We have a fairly positive intermediate-term view on corporate credit because of still attractive valuations and the market's supply-and-demand backdrop. Earnings during the next two quarters will be lower than prior years, but many companies have bolstered liquidity and flexibility in response to the uncertainty. We continue to have conviction in the "crossover corridor" of investment-grade and high-yield credits. Current spread levels on these securities are attractive compared with the underlying risks.

For the high-yield market, we have a similarly constructive outlook. Over the past several months, the high-yield market has seen some accelerated defaults as companies that were stumbling before the COVID-19 situation were pushed into default. We also saw a large number of investment-grade companies get downgraded to high yield. Between the high-yield defaults and the downgrades of investment grade, the by product has been a high-yield cohort that is higher quality than before. The biggest risk is the still-to-be-determined impact of the pandemic on growth, corporate earnings growth, and cash flows. Although high-yield spreads tightened after widening in March, valuations remain relatively attractive. In our view, spreads continue to offer a broad range of attractive relative-value investment opportunities. Moreover, we think the market's yield remains compelling due to lower global yields. From a fundamental perspective, we are closely watching sectors vulnerable to the disruption caused by the coronavirus. We are monitoring the impact on energy, gaming, lodging & leisure, retail, and other cohorts.

Currency views

The dollar is an expensive safe haven

The dollar's support from its high-yielding status has largely disappeared. The Fed has cut rates to zero, unveiled an unlimited QE package, and backed other financing measures. Growth looks to be troughing, and mobility restrictions are slowly being lifted. Investors may look to other currencies with more compelling valuations and better prospective recoveries. It could result in a weaker dollar. The presidential elections are likely to create headwinds. The dollar remains an expensive safe haven for capital during higher levels of uncertainty. Therefore, currencies such as the Swiss franc and the yen are more attractive.

Euro likely to rally in near term

The outlook for the euro remains dominated by relative monetary policy, growth, and political risk premium. The ECB has expanded its asset purchases through various programs, including buying bonds. The single currency has rallied in recent weeks. We expect the euro will continue to appreciate in the near term, supported by the lifting of lockdowns in Europe and Asia with better results than in the United States.

British pound capped by EU trade talks

Neither the idiosyncratic story driven by Brexit nor the ongoing negotiations on future trade relations has affected trading of the British pound. The currency has been at the mercy of global risk appetite and implications of the virus on prospective economic growth. Brexit's transition period cannot be extended beyond the end of this year, increasing the probability of a harder exit from the EU. This should keep the pound as an underperformer.

Yen likely to appreciate

The Bank of Japan continues to expand measures designed to encourage lending, but it has left its yield-curve control and interest rates unchanged. With the rate differential in currency forwards now fully reflecting the rate cuts by the Fed, purchases of hedged foreign bonds will likely replace unhedged purchases. This will place less downside pressure on the yen. As purchases of foreign equity abates and outward direct investment slows, we should see the yen appreciate.

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.

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* As of June 30, 2020.

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.

Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

You cannot invest directly in an index.

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The views and opinions expressed are those of the authors: D. William Kohli, Michael V. Salm, and Paul D. Scanlon, CFA, as of June 30, 2020, are subject to change with market conditions, and are not meant as investment advice.

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