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Q2 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

Bonds rally as the Fed hits the pause button

An inverted yield curve raises concerns about a U.S. downturn.

The Federal Reserve's dovish shift on interest rates has boosted Wall Street.

China and the United States inch closer to finalizing a new trade deal.

The outlook for global growth has cooled in 2019. Higher real interest rates, weaker demand from China, political troubles in the eurozone, and trade tensions have kept the lid on economic growth. Still, that downward trend may be easing, and we are likely to see waves of optimism and pessimism about growth in the coming months. The U.S. economy is likely to expand at a more moderate pace compared with 2018. Unemployment has touched multi-decade lows, inflation remains anchored, and the likelihood of a recession remains low.

The Fed pivoted to a dovish stance on interest rates in the first quarter, and this has reassured financial markets and prompted investors to reduce expectations of further hikes. The central bank had raised short-term rates four times in 2018, taking the federal funds rate to a range of 2.25% to 2.50%. The Fed has also announced a more flexible approach to shrinking its balance sheet. Across the Atlantic, the European Central Bank left rates unchanged and ended its multi-trillion dollar bond-buying program. In Britain,

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		●	

the government remained in crisis as Parliament failed to agree on options for the country's withdrawal from the European Union. Across the Pacific, China and the United States appear closer to a trade deal, and any truce would be a positive step for the global economy.

The U.S. Treasury market continued to draw headlines in the first quarter of 2019. Treasury yields tumbled in many parts of the yield curve as the Fed expressed a more cautious view of the U.S. economy. The slide in the 10-year bond yield has taken it below the rate on 3-month Treasury bills — a phenomenon known as an inverted yield curve and which is commonly viewed as a harbinger of recession. Despite this move, we expect global sovereign fixed-income yields to trend higher by the end of this year.

U.S. economy set to cool

The U.S. economic expansion is cooling from last year, under the weight of the Trump administration's shifting trade policies, economic slowdowns in Europe and China, and fading stimulus from the tax cuts of 2017. The economy grew at a 2.2% annual rate in the fourth quarter of 2018, after expanding 3.4% in the third quarter. Jerome Powell, the Fed chairman, said in March the economy "is in a good place." The Fed now expects growth of 2.1% this year, down from the 2.3% it forecast in December, and 1.9% in 2020.

We believe the probability of a recession remains low. We expect to see signs of weakness in areas like business investment and housing. However, the labor market remains strong, real wages are edging higher, and consumer spending is steady. After a lackluster performance in February, the job market bounced back in March. U.S. employers added 196,000 jobs, an indication that many businesses are still looking to hire despite signs that the economy is slowing. The unemployment rate held at 3.8%, according to the Labor Department.

The Fed's 180-degree turn

U.S. and international equity markets rallied after the Fed signaled no interest-rate increase this year, bringing its projections more in line with market expectations. This was an abrupt halt to what had been five consecutive quarters of rate increases. Most Fed officials now expect a single rate increase in 2020 and none in 2021. The Fed had forecast two rate rises for 2019 as recently as December. The central bank also said it will slow the monthly reduction of its Treasury holdings starting from May with a cut from $30 billion to $15 billion and will cease trimming its balance sheet in September.

Fed Chair Jerome Powell said at the March rate-setting meeting that short-term rates could be on hold for "some time" as global risks weigh on the economic outlook and inflation remains below the Fed's 2% target. The Treasury market is already reflecting an environment of steady rates, slowing growth, and lower inflation. As a result, parts of the Treasury yield curve have inverted. Falling long-term bond yields are a sign that investors expect the economy to slow. While the recent inversion in and of itself is not a forecast of a recession, it is a sign that something might be awry, and we would like to see a steeper curve. The yield on the 10-year Treasury traded around 2.41%, while the two-year yield fell to around 2.27% at the end of March 2019. Bond yields move inversely to prices.

ECB to inject stimulus

The eurozone's economy is showing the effects of both local and global developments. The region is flirting with an economic contraction, but we believe there will be some modest growth. Domestic demand appears to be holding up reasonably well. The ECB said it expects its key interest rates "to remain at their present levels" at least through the end of 2019. In March, the central bank announced a new program to stimulate bank lending in the eurozone; the targeted longer-term refinancing operations (TLTRO-III) will provide loans to banks starting in September 2019 and ending in March 2021. Financial lenders will be able to provide better credit conditions to customers, which in turn could stimulate economic growth.

The eurozone's reform agenda and growth continue to struggle against a difficult political backdrop. Political stresses are becoming more evident in places such as France and Italy. In addition, Brexit also poses risks to smaller countries within the eurozone that are most exposed to a breakdown in trade with the United Kingdom. A "no deal" Brexit would affect the United Kingdom and may be enough to tip the barely growing German economy into contraction. However, that is not our base case, and the latest signals from London suggest a soft Brexit is the most likely outcome.

China fine-tunes policies

China, the world's second-largest economy, has stepped up efforts to cushion its cooling economy. The latest measures include tax cuts, a reduction in corporate Social Security contributions, and an increase in local government bond sales to finance infrastructure projects. In early March, the government lowered its growth target. Premier Li Keqiang set the gross domestic product (GDP) growth goal for 2019 at a range of 6% to 6.5% compared with last year's, which was "about" 6.5%.

China's currency — the yuan — is another tool that policy makers can use to manage the economy. For years, there was global pressure on China to move toward a free-floating currency due to concerns regulators were capping the yuan's value against the dollar to benefit exporters. The yuan has stabilized so far this year. The mood on the China trade conflict has changed, and there is considerable optimism that a deal will be signed by President Trump and President Xi Jinping in the near future. Still, it's not likely the deal will provide a lasting boost to confidence and economic activity.

Sector views

Finding value in corporate credit

After fluctuating in a fairly narrow range in January and February, bond yields around the world declined in March. Central banks signaled that they were willing to keep interest rates low for significantly longer. Within this environment, corporate credit — both high-yield and investment-grade — emerging-market debt, and mortgage credit outperformed U.S. Treasuries and other government securities.

Following a sharp downturn in 2018's fourth quarter, investment-grade credit had its best start in 20 years in 2019's first quarter. Our outlook for corporate credit remains favorable as the U.S. economy continues to expand and fundamentals remain generally firm. The spread on corporate bonds, including investment grade, narrowed meaningfully during the first quarter after a challenging fourth quarter. As a result of this big move higher in bond prices, it has become somewhat more difficult to find compelling values in these sectors.

Renewed appetite for mortgage strategies

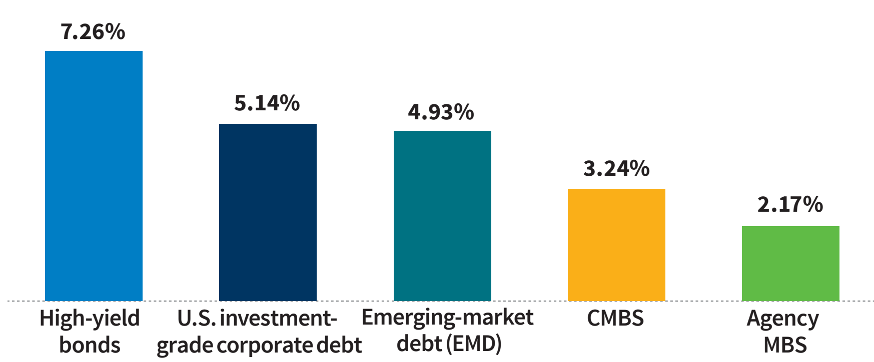
Commercial mortgage-backed securities (CMBS) rallied along with other risk-driven assets. We continue to find relative value in mortgage credit, prepayment risk, and corporate credit. In our view, the yield premiums provided by CMBS, agency IO CMOs, non-agency residential mortgage-backed securities, and high-yield corporate bonds offer relatively attractive risk/reward profiles.

Risk assets rebounded sharply during Q1 and posted strong gains

Excess returns* relative to Treasuries, Q1 19

Source: Bloomberg, as of 3/31/19. 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.



High-yield bonds in demand

High-yield bonds rose 7.30% for the quarter, as measured by the JPMorgan Developed High Yield Index, outpacing both high-yield bank loans and the broad investment-grade fixed-income market. The high-yield market had its strongest start to a calendar year on record in the first quarter. We think the fundamental backdrop for high yield remains supportive, led by a strong labor market and rising employee wages. Additionally, overall default levels have significantly fallen over the past 12 months and are at levels last seen in 2014. In terms of valuations, high-yield spreads have narrowed. As a result, it has become more challenging to find compelling values in the market. We favor higher-quality BB-rated bonds relative to CCC-rated credits.

Currency views

The dollar poised to weaken

In March, the Federal Open Market Committee took a dovish turn on interest rates. The Fed scaled back its median interest-rate projection to zero hikes in 2019 and one increase in 2020. The Fed also moved up its balance sheet normalization plan and announced that in May it will begin tapering the amount of proceeds it allows to roll off its balance sheet each month, ending aggregate reductions in September. The pause in the Fed's rate-hike cycle should help alleviate some of the upward pressure on the U.S. dollar. Still, growth outside the United States will need to pick up to allow for a more broad-based dollar depreciation.

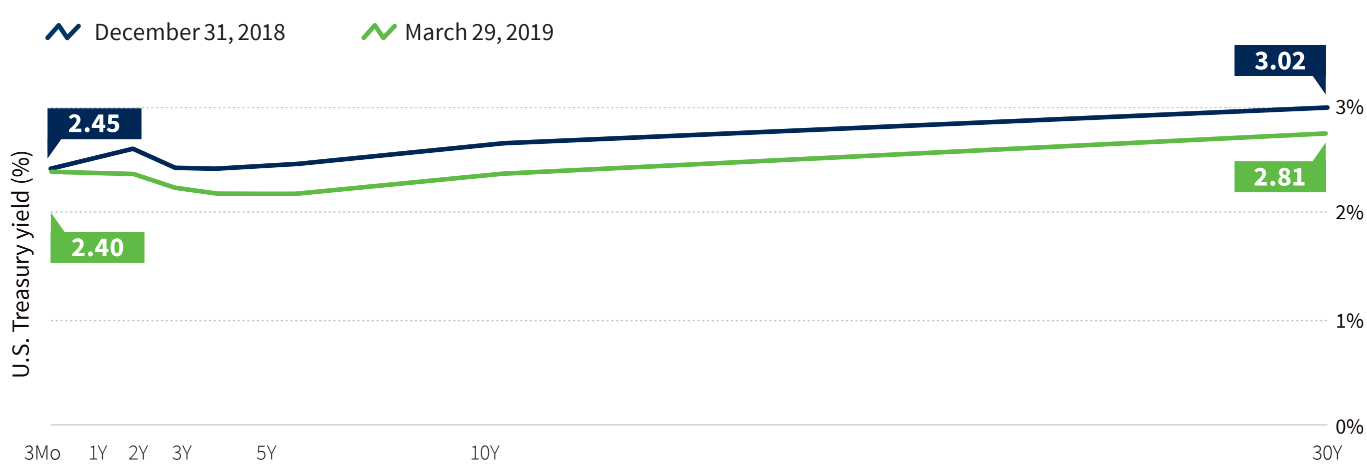
The euro looks steady

The outlook for the euro remains dominated by monetary policy, growth, and political risk premium. At its March meeting, the ECB said it will delay raising interest rates until at least 2020. The ECB plans to provide banks with fresh long-term loans known as TLTROs (targeted longer-term refinancing operations) to keep credit flowing in the eurozone. The stimulus measure — which will start in September — came after the ECB lowered its growth and inflation forecasts. The euro will likely retain its role as a funding currency as the central bank pushes back its guidance for future rate moves.

Brexit weighs on pound

In the United Kingdom, Brexit noise remains high. While considerable work on a deal remains ahead and may continue to cause market volatility, we think a soft Brexit is now the most likely outcome. The pound will continue to be affected by the

Rates continued to fall during Q1 causing parts of the yield curve to slightly invert



Source: U.S. Treasury Department, as of 3/31/19. Past performance is not indicative of future results.

uncertainty around Brexit as investors attach a risk premium to the currency instead of focusing on fundamental economic news.

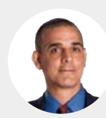
Japan's accommodative policies

The Bank of Japan (BoJ) changed its yield-curve control policy in August. It allows for an elongated policy horizon driven by focusing on the price (level) of rates over quantity. At subsequent meetings, the BoJ continued to endorse this policy. With global growth slowing and Japan's inflation moving lower, it's likely that policy will remain accommodative longer than previously expected. The BoJ kept monetary policy steady in March, and minutes suggest that a growing majority are discussing additional easing.

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 December 31, 2018.

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

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