Q1 2020 | Fixed Income Outlook

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Bonds likely to be range bound in 2020

U.S. Treasury yield curve may steepen as the Federal Reserve keeps rates on hold.

We have a favorable outlook on corporate credit, municipal bonds, and mortgage-backed securities.

We believe recession risks are waning amid accommodative monetary policies.

Global growth will likely stabilize and remain soft as we head into 2020. A recession remains relatively unlikely as central banks around the world lowered interest rates and trade tensions eased. The U.S. economy, now in its 11th year of expansion, will continue to grow at a more moderate pace compared with 2019. The Federal Reserve held interest rates steady in mid-December and signaled no appetite to raise them soon. The central bank had cut rates three times in 2019.

U.S. Treasury yields are also on an uptrend, marking a significant reversal for the bond market. The yield curve was signaling recession over the summer, but the Fed's easing and positive trade developments helped turn the tide. Short duration yields are no longer higher than the rates on the long end, like the benchmark 10-year Treasury note. Within this environment, we think intermediate- and long-term bond yields are likely to drift higher. Elsewhere, the

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	○	●	

European Central Bank (ECB) left its key interest rate at a record low and restarted bond purchases. India, Brazil, China, and other emerging-market central banks have also lowered rates.

Stabilizing global growth and accommodative monetary policies will provide support for the markets, including fixed-income securities that are highly sensitive to positive "risk-on" sentiment. The modest U.S. growth environment should be sufficient to support corporate fundamentals as we head into 2020. We have a favorable outlook on corporate bonds, municipal bonds, and mortgage-backed securities. The dollar — a currency safe-haven — will likely trade within a limited range this year on the back of fluctuations in risk appetite. The Bloomberg Barclays U.S. Aggregate Bond Index advanced 0.18% during the fourth quarter.

Bright spots in the U.S. economy

Growth should settle in at a lower gear next year, and we expect the economy to grow at a pace of 1.75% to 2.00%. The Fed expects growth of 2.0% in 2020, down from the 2.2% rate it forecast for 2019. The job market and consumer spending continue to be resilient. The housing market has also picked up as the Fed shifted to a more accommodative monetary policy stance early in 2019. Activity in the services sector rose slightly in December, but manufacturing activity shrank for a fifth month. The ISM's manufacturing gauge fell to 47.2% in December, its lowest level in more than 10 years, signaling a weak start to the year. Readings below 50 indicate contraction in the economy.

There will be a lot at stake in the 2020 U.S. presidential elections as Republicans and Democrats wrestle to take control of the White House, the Senate, and the House. The outcome is likely to influence everything from Wall Street and the economy to businesses and trade policies. So, the election will be one of the key events we will be following closely this year as it may cause headwinds for financial markets.

The Fed's wait-and-see outlook

Fed chair Jerome Powell and his colleagues have indicated comfort with leaving monetary policy on hold through 2020 while keeping an eye on trade and global growth risks. In December, the Fed penciled in no rate changes this year and saw only one move, an increase, in 2021, followed by a second in 2022. Powell said the "economic outlook remains a favorable one." The Fed cut its benchmark fund rate three times between July and October to a range of 1.50% to 1.75%. The central bank also began buying short-term Treasury bills in October and may continue those purchases into the second quarter of 2020. As a result, we don't expect short-term interest rates to move significantly over the near term. Consequently, we believe the yield curve is likely to continue its recent steepening trend.

Strong market dynamics and the phase-one trade deal between the United States and China sparked a rally in Treasury bond yields in the fourth quarter. Treasury yields had started 2019 in a downward spiral as investors fled risk assets and flocked to safety amid an escalated U.S.–China trade war and weakening economic signals. By the end of last year, the yield on the 10-year note rose to around 1.92% from around 2.7% at the start of 2019. The 2-year note yield, which rose above the 10-year security over the summer, tumbled to around 1.58% at year-end. We expect to see a steepening of the yield curve this year.

ECB's policy dilemma

The eurozone's economy continues to be plagued by slow growth. And with interest rates already at record lows and its balance sheet inflated, the ECB has limited policy tools. The bank launched a massive stimulus package in November including new lending conditions to commercial banks and a second round of QE. The current deposit rate is -0.5%, the lowest on record. The eurozone is forecast to grow 1.1% in 2020 and 1.4% in 2021 from 1.2% last year, according to the ECB. ECB president Christine Lagarde, who succeeded Mario Draghi, has called for a more aggressive approach to public investment spending to stimulate demand and growth prospects, and to rebalance the policy mix.

Politics are also back in focus. British Prime Minister Boris Johnson won a decisive majority in the December general election, paving the way for parliament to trigger a long-delayed split with the European Union. Johnson has promised to complete the U.K.'s protracted exit from the EU by the end of January 2020. Germany, Europe's biggest economy, continues to grapple with rising unemployment and a weakening manufacturing sector. And Italy, the eurozone's third-largest economy, has been broadly stagnant over the past year as the coalition government contends with reining in rising debt levels.

China aims to set growth pace

China's economy, the world's second largest, is slowly decelerating with some signs of stabilization. The government adopted various stimulus measures to cushion the economy over the past year. In January 2020, the central bank said it would add an estimated $115 billion into the financial system to reduce bank lending rates to businesses. The move comes after a similar action in September. The economy has weakened with the trade war and a slowing global economy. The official manufacturing Purchasing Managers' Index stayed in contraction territory for most of 2019. We forecast growth next year will be in the 5.5%–6.0% range.

But there was some good news. Easing U.S.–China trade tensions lifted demand for Chinese goods and boosted factory production in December 2019. China and the United States in mid-December agreed to a so-called phase-one trade agreement in their long-running tariff war. The initial deal helped diffuse market uncertainties and forestalled new tariffs. Presidents Trump and Xi Jinping announced they would sign the first phase of the agreement in January, though exact details of the deal have not been released.

Sector views

Trends in mortgage market

We continue to have a generally favorable outlook for mortgage credit. We think the underlying fundamentals for commercial real estate appear stable, supported by a strong employment backdrop, interest rates that remain historically low, and a positive U.S. economic environment. When the Fed shifted back to a more accommodative monetary policy stance early in 2019, the U.S. housing market responded positively. Against the backdrop of mortgage rates that are low by historical standards, we think home price growth suggests the economy is likely to expand at a steady, moderate pace.

We continue to find better relative value in CMBX versus cash bonds. We think the negative sentiment toward the retail industry — though well deserved — overstates the risk of the index. We think the index offers sufficient protection, even at the BBB-rated level. In our view, mall operators may be able to stabilize their revenues by repurposing properties, thereby mitigating or delaying losses.

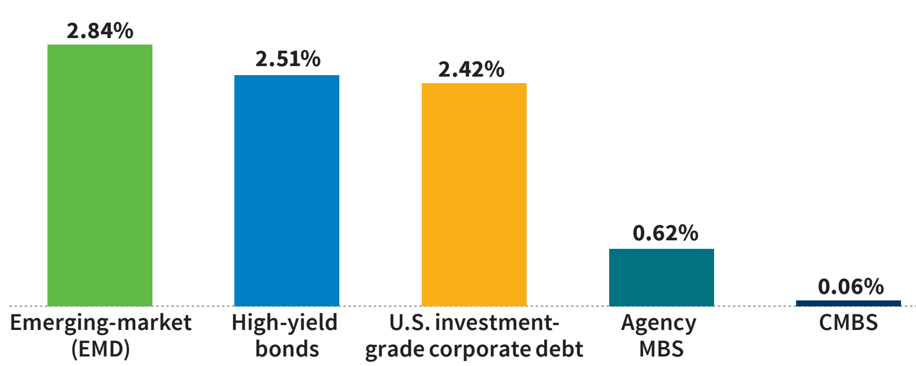
Within cash commercial mortgage-backed securities (CMBS), we have been focusing on mezzanine tranches rated A and BBB- that were issued between 2011 and 2014. Securities in this market category offered a

Risk assets broadly outperformed during Q4, with corporate credit and emerging markets leading the way

Excess returns* relative to Treasuries, Q4 19

Source: Bloomberg, as of 12/31/19. 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. Excess return does not always mean "outperformance."



significant yield premium over many other areas. We have been avoiding mezzanine securities issued in 2015 or later.

Rally in corporate debt

The investment-grade corporate credit class rallied in November, following the October rate cut by the Fed and optimism about the phase-one trade deal with China. For corporate credit, we continue to like the BBB-rated market segment. For several years debt issuance increased as corporations financed mergers and acquisitions. Now, we're beginning to see BBB issuers reduce debt.

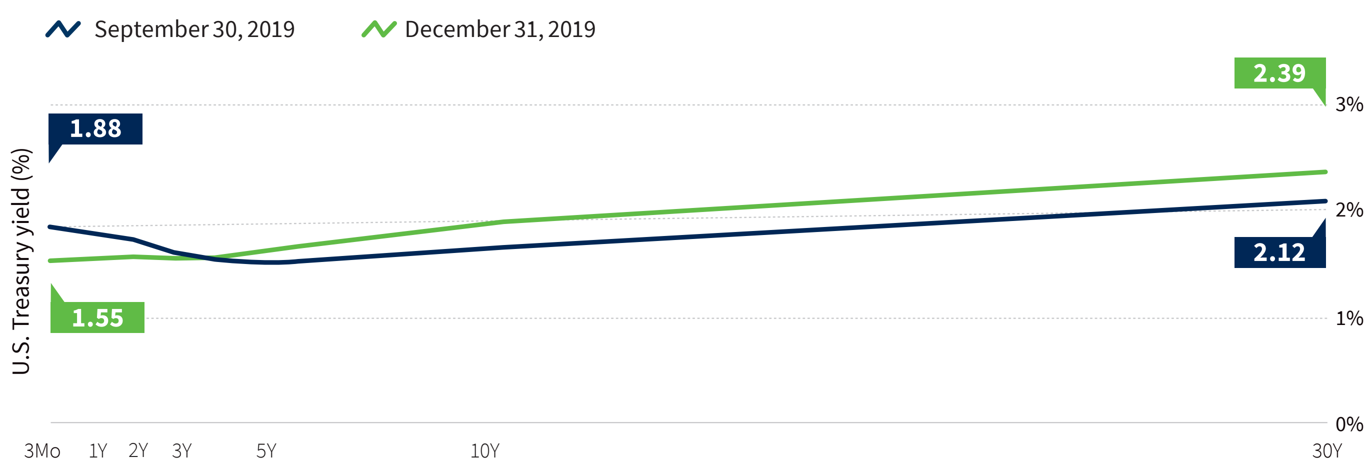
High-yield bonds fairly valued

We continue to have a generally positive outlook for high-yield credit. We think the fundamentals underlying U.S. issuers are skewed slightly positive, buoyed by favorable corporate earnings. High-yield bonds rose 2.89% for the fourth quarter, as measured by the JPMorgan Developed High Yield Index, with most of the advance occurring in December. From a sector perspective, cohorts that underperformed in 2019 — such as lower-rated issuers in energy and other sectors — could continue to rebound if economic growth remains steady and stocks advance.

Looking at defaults, when distressed exchanges are included in calculating the U.S. high-yield default rate, the figure was 2.86% as of December 31. Despite an increase from the end of 2018, the default rate remains low from a historical perspective. The long-term average default rate for high yield is 3.44%, based on annual default rates dating back to 1980.

We think the market's supply-and-demand backdrop is supportive given moderate net new issuance and strong flows into high-yield mutual funds and exchange-traded funds. From a valuation standpoint, high-yield spreads look fairly valued to us in light of underlying fundamental strength and a favorable technical environment. Despite these positives, risks to our outlook include price volatility in oil and other commodities, policy missteps by global central banks, and heightened geopolitical tension.

Rates continued to fall on the front end but rose on the long end as the curve steepened



Source: U.S. Treasury Department, as of 12/31/19. Past performance is not indicative of future results.

Currency views

The dollar likely to be range bound

The dollar's support from its high-yielding status is wavering. The Fed cut rates three times in 2019 and continues to inject liquidity in the very front end of the Treasury yield curve due to funding pressures in the repo market putting downward pressure on the dollar. To see more broad-based U.S. dollar weakness from here, growth in the rest of the world needs to rebound substantially rather than stabilize at soft levels. That is not something we expect. Trade tensions with China create downside economic risks, and major breakthroughs are unlikely ahead of the U.S. elections. So, the dollar is likely to continue to weaken as global growth stabilizes. However, U.S. outperformance and risks to global growth should provide a limit and ultimately keep the dollar range bound.

Euro's highs and lows likely capped

The outlook for the euro remains dominated by monetary policy and growth. The ECB looks to be on hold for the foreseeable future as its president, Christine Lagarde, tries to gain consensus across the governing council and to push for higher fiscal spending. The mandate is on keeping an accommodative policy stance until inflation reaches the ECB's target. That means that interest rates will remain at historic lows and asset purchases will continue for as long as necessary. The eurozone remains reliant on a pickup in global growth. The euro will retain its role as a funding currency and will likely lag other currencies. But there are limits to how low, and how high, the single currency can go.

Higher spending could boost pound

In the United Kingdom, Prime Minister Boris Johnson led the Conservative Party to win an overall majority in the general elections. Sterling continued its run as investors expected this victory to allow passage of the Brexit withdrawal agreement and a more orderly transition period. However, Johnson surprised markets by saying that Britain has no intention of seeking an extension to the transition period beyond December 2020 after it leaves the EU. This has created another "no deal" Brexit risk and has increased the risk premium to hold the currency and U.K. assets. Given the size of the Conservative majority, Parliament can easily reverse this by amending the law. In the near term, the deadline is likely to remain part of the U.K.'s negotiating stance with the EU. The Conservative Party's manifesto calls for higher fiscal spending; that in turn could support economic growth and the sterling.

Japan's yen and fiscal stimulus

The Bank of Japan (BoJ) kept its monetary policy unchanged at the December meeting. Governor Haruhiko Kuroda offered a slightly more upbeat view on recent developments, including the U.S.–China trade truce. But the BoJ reassured markets that it stands ready to ramp up stimulus if overseas risks derail a fragile economic recovery. On the fiscal front, Prime Minister Shinzo Abe launched a ¥26 trillion fiscal stimulus package to support slowing growth and to help Japan "maintain or enhance economic viability" after the 2020 Olympics. About ¥9.2 trillion of it is fresh spending. The yen's moves will be subject to the outlook for global growth and risk appetite.

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 December 31, 2019.

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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