Q4 2021 | Fixed Income Outlook

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Bond markets navigate crosscurrents of rates and inflation

U.S. Treasury yields trend higher as the Fed plans to tiptoe away from asset purchases.

We believe the environment for fixed-income securities remains relatively supportive.

As the clock ticks on debt ceiling talks, we will continue to monitor how short-term bond markets react.

Global financial markets were mixed during the third quarter. Fixed-income markets faced volatility from multiple directions, including the Federal Reserve's announced intention to taper monthly bond purchases, the expiration of the U.S. federal debt limit, the shifting outlook for growth, and the spread of Covid-19 variants. China's real estate woes also kept investors on edge. Markets have taken a slight risk-off turn as the global recovery from the pandemic slows, in our view. The rate-sensitive Bloomberg U.S. Aggregate Bond Index rose 0.05% during the quarter. Global bonds, as measured by the FTSE World Government Bond Index, declined 1.24%. That compares with a gain of 0.58% for the S&P 500® Index.

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		●	○

Central banks around the world have started to raise interest rates or revealed plans to roll back easy monetary policies. In late September, the Fed signaled it was poised to begin scaling back asset purchases as soon as November. Half of the Fed's 18 policymakers expect to lift interest rates from near zero in 2022, according to updated economic projections. The European Central Bank (ECB) also said it would conduct bond purchases under its emergency program at a "moderately lower pace" over the next few months. President Biden's $1.2 trillion bipartisan infrastructure bill — already passed in the U.S. Senate — has been held up in the House of Representatives. How all these factors, including the fate of the U.S. debt ceiling, play out will determine the market's medium- and long-term direction.

Global bond yields have continued their upward trend, pushed higher by the Fed's hawkish surprise on its policy path. The yield on the benchmark 10-year U.S. Treasury note topped 1.5% in late September, its highest since June, and ended the quarter at 1.49%. The yield on the 2-year note ended the period at around 0.28%, up slightly from 0.25% at the end of June. Investment-grade corporate bonds finished the quarter flat. High-yield credit bucked the trend even though yield spreads widened modestly. (Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity Treasuries.)

Fed prepares to curtail asset purchases

Fed Chair Jerome Powell said the bond-buying program may come to an end by the middle of 2022. Officials, however, are also evenly split on whether to raise the federal funds rate in 2022, according to the median estimate of FOMC participants. In June, the dot-plot indicated no rate increases until 2023. But the Fed left the benchmark short-term interest rate anchored near zero, where it has been since March 2020. The U.S. rates market rose following the Fed meeting. The central bank is buying $120 billion a month in Treasury bonds and mortgage-backed securities to hold down long-term rates. We will continue to monitor how the short-term markets, including Treasury bills and repos, react over the next few months. Congress' challenge to raise the federal debt limit made headlines. Lawmakers passed legislation in early October to raise the debt ceiling through early December.

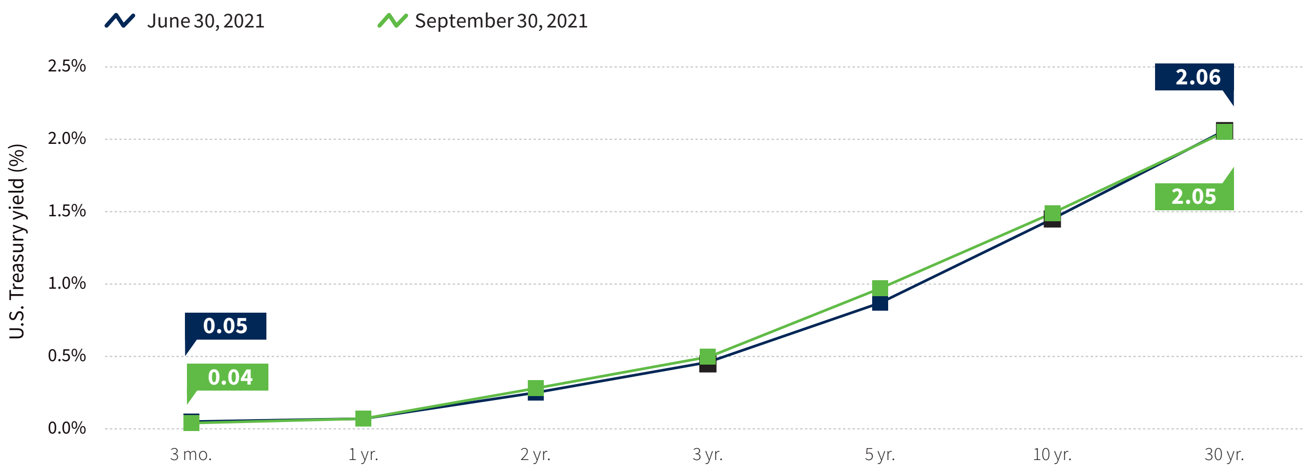
The Fed expects the economy to grow 5.9% this year from the 7.0% estimate in June. Central bank officials have also raised projections for personal consumption expenditure (PCE) inflation to 4.2% this year — above its 2% goal — from 3.4% in June. Economic recovery, pandemic-related labor shortages, and supply bottlenecks have been driving price gains. Consumer prices rose 5.3% for the 12 months ending in August, down slightly from 5.4% in July, according to the Labor Department. Against this backdrop, job growth slowed in September, but the unemployment rate fell to 4.8%. The Fed sees the unemployment rate for the year at 4.8%.

ECB slows bond purchases but holds rates steady

In September, the European Central Bank left its policy rate unchanged. But the ECB opted to slow the pace of bond purchases under its pandemic emergency purchase program in the final three months of this year. The program has been buying about 80 billion euros of mostly government bonds each month. ECB president Christine Lagarde, however, downplayed inflation risks, noting that the current increase in inflation is expected "to be largely temporary."

The Bank of England (BoE) has also signaled its intention to gradually unwind crisis-era aid. BoE Governor Andrew Bailey said interest rates could increase as soon as this year, even before its bond-buying program expires. The aggressive tone by the BoE led to a sell-off of government bonds and a sharp rise in yields across Europe during the third quarter. It also places the BoE among the more hawkish central banks in the developed world. The yield on U.K. 10-year notes rose above 1% — for the first time since March 2020 — to about 1.163% in early October. Germany's 10-year bond yields, seen as the benchmark for Europe, rose to -0.148% in early October from -0.605% at the beginning of the year.

Treasuries rallied to start the quarter, but reversed course as the taper discussion heated up later in the quarter



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

China seeks to avoid "flood like" stimulus

China's crackdown on property developers, technology behemoths, and other private companies has weighed on domestic and global markets. This comes in the wake of a debt crisis facing real estate company Evergrande Group. New restrictions on travel have also hurt consumer spending, while manufacturing has been bit by rising costs, production bottlenecks, and electricity shortages. The official manufacturing Purchasing Managers' Index (PMI) was at 49.6 in September versus 50.1 in August, data from the National Bureau of Statistics showed. China's economy grew 7.9% in the second quarter from a year ago, compared with a record 18.3% in the first quarter.

In August, People's Bank of China (PBoC) Governor Yi Gang said the central bank will keep monetary policy stable. And in early September, Deputy Governor Pan Gongsheng said the bank plans to avoid "flood like" stimulus. At the same time, the central bank ramped up support to small businesses by providing lost-cost funding to banks. The PBoC cut the reserve requirement ratio, the amount banks need to hold on reserve, in July. However, the central bank has kept the loan prime rate and policy rates steady since lowering them in early 2020. China's benchmark sovereign bond yield has seesawed in recent weeks, with the 10-year notes yielding around 2.92% in early October.

Sector views

Corporate debt: Investment grade and high yield

Looking first at corporate credit, we have a positive outlook for the fundamentals and overall supply-and-demand backdrop of high-yield bonds. Our view on valuation is more neutral, however, given the relative tightness of yield spreads as of quarter-end. Within the high-yield market, we are continuing to closely monitor issuers' balance sheets and liquidity metrics, with an eye toward default risk or a credit-rating downgrade.

Relative to other asset classes, high-yield bonds outperformed the broad investment-grade fixed-income market and investment-grade corporate credit, but slightly lagged high-yield bank loans. We have a positive outlook for high-yield market fundamentals and the overall supply-and-demand backdrop. Our view on valuation is more neutral, given the relative tightness of yield spreads in the market as of quarter-end. Our optimism is driven by the sizable percentage of Americans who have received Covid-19 vaccines, along with continued government stimulus. We were encouraged that, as of September 30, U.S. cases of, and hospitalizations from, Covid continued to steadily decline. Within this environment, we remain focused on the health of issuers' balance sheets and liquidity metrics, with an eye toward default risk or a credit-rating downgrade. Concerns about defaults have meaningfully retreated this year, given the liquidity in the market. In our view, many troubled issuers have been given the lifeline they need to continue operating.

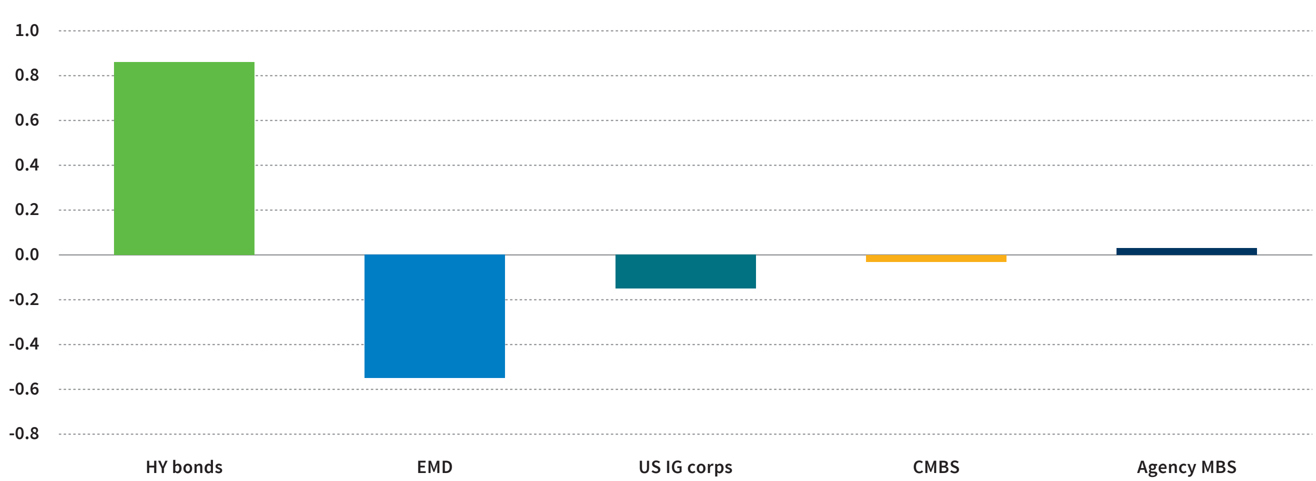
Trends in the mortgage markets

In the commercial mortgage-backed securities market, we believe there are attractive risk-adjusted investment opportunities available amid an improving fundamental backdrop. We continue to find value among issues that have been on the market for a few years. At the same time, we are also investing in newer issues backed by relatively long leases and what we consider to be strong underwriting.

Within residential mortgage credit, given low mortgage rates, high demand, and a declining inventory of available homes, we think home prices are likely to continue rising.

In Q3, risk assets generally posted weaker excess returns as a number of concerns crept into the market

Excess returns* relative to Treasuries, Q3 2021



Source: Bloomberg, as of 9/30/21. 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."

Given that prices have already risen substantially, we are aware that affordability has become a constraint for many prospective buyers. Against this backdrop, even with tighter yield spreads, we are finding value in investment-grade securities backed by non-agency residential loans. We also see value in legacy residential mortgage-backed securities and lower-quality segments of the agency credit-risk transfer market.

We believe prepayment-sensitive areas of the market serve as important sources of diversification. In our view, interest-only collateralized mortgage obligations (IO CMOs) and other types of prepayment-related securities offer attractive risk-adjusted return potential at current price levels if refinancing activity recedes and mortgage prepayment speeds slow.

In emerging markets, we are seeking opportunities in countries we think are better positioned to benefit from a global recovery and are less exposed to domestic policy risks.

Currency views

The U.S. dollar is likely to appreciate as rates trend higher

Expectations about the U.S. and global recovery continue to be marked down as the impact of higher prices, concerns around the Delta variant, and slower consumption rein in excessive optimism on growth. The Fed has signaled its tapering of asset purchases is coming. Tapering likely will formally commence in November and is expected to take place over the following eight months. The latest median expectations from the FOMC highlight almost seven rate hikes through the end of 2024, a somewhat hawkish innovation and supportive of the U.S. dollar. But compared with prior cycles, this is a relatively moderate pace. As a result, labor market data and future job gains will be pivotal for the Fed. The path of rate hikes makes dollar appreciation against currencies backed by resolutely dovish central banks such as the Japanese yen, the Swiss franc, and, potentially, the euro, more likely.

Euro may weaken as ECB mulls policy

At its last meeting, the ECB recalibrated its pandemic emergency purchase program (PEPP) to a “moderately lower pace” of asset purchases and pushed other major decisions to December. European growth data remains solid but has likely peaked and is stabilizing at lower levels as inflation starts to move higher. This is likely to make other issues on the ECB’s agenda — the future of the PEPP, which is currently set to last until March 2022, and whether to expand its asset purchase program (APP) — more contentious in December. Growth concerns are likely to dominate over the short term. The euro might continue to weaken under the current central bank policy. But the magnitude of the descent may be limited if there are hawkish signals from the ECB.

We are less bullish on the British pound

The United Kingdom remains positioned well for domestic and global recovery, fueled by one of the better-run vaccination campaigns. The BoE has moved to a more hawkish stance earlier than expected. The Coronavirus Job Retention Scheme (CJRS), due to end on September 30, will provide some insight into the tightness of the labor market and when the BoE may raise rates. The U.K. has also been affected by energy supply issues and a jump in inflation. Despite a more hawkish central bank, stagflation concerns have dominated and weighed on the pound. Until these concerns abate, we are less bullish on the pound.

Japan’s yen could strengthen on risk appetite

The Bank of Japan (BoJ) remains largely sidelined, with limits on further monetary policy easing. As short-term rates make hedged international bonds highly attractive, this should represent the bulk of flows into global, especially U.S., bond markets. The yen had seen a large repricing due to the global recovery and has reached the upper end of the range since peaking in April. The ruling Liberal Democratic Party held party leader elections on September 29. Fumio Kishida was appointed as the next prime minister. This outcome is expected to have limited impact on the yen-dollar exchange rate. From here, the risk for the yen is more balanced than before and may be skewed to yen strength, depending on global risk appetite.

The Fixed Income Outlook represents the insights of the collaborative process of our 100+ member team and of our senior leadership.

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As of September 30, 2021.

Agency mortgage-backed securities are represented by the Bloomberg 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 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 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 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.

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FTSE World Government Bond Index (WGBI) measures the performance of fixed-rate, local-currency, investment-grade sovereign bonds.

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 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 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 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 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 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 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.

The Bloomberg U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities.

The ICE BofA 1-3 year U.S. Corporate Index is an unmanaged index of U.S. investment-grade corporate debt with a remaining term to maturity of less than 3 years.

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