

Q3 2021 | Fixed Income Outlook



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Bond markets in flux on rates and inflation outlook

Long-term U.S. Treasury yields slipped and short-term rates rose, as investors mulled growth and inflation.

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

The Fed has adopted a more hawkish tone on interest rates and higher inflation expectations.

Global financial markets were mixed during the second quarter. Fixed-income assets came under pressure periodically due to concerns that rising inflation and a speedy economic recovery could prompt central bankers to pare back easy money policies. But markets have stabilized as the pandemic shows signs of tailing off in parts of the world and fiscal stimulus continues to buoy growth. The rate-sensitive Bloomberg Barclays U.S. Aggregate Bond Index rose 1.83% during the quarter. Global bonds, as measured by the FTSE World Government Bond Index, rose 0.98%. That compares with a gain of 8.55% 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 | | | ● |

In mid-June, the Federal Reserve signaled that it expects to raise short-term rates by late 2023, sooner than previously anticipated. The Fed also said officials had discussed an eventual tapering of bond-buying programs. Some central banks across Europe and Latin America have already started to lift rates. But the European Central Bank has pledged to maintain easy money policies. Against this backdrop, President Biden is indicating support for a \$1.2 trillion spending package to invest in the nation's infrastructure, adding fuel to the economic recovery. The U.S. economy grew at an annualized rate of 6.4% in the first quarter.

Yields on longer-dated U.S. Treasuries have broadly trended lower this quarter since peaking in March. The yield on the benchmark 10-year Treasury note slipped to 1.45% at quarter-end from 1.74% at the end of March, while the yield on the 30-year Treasury fell from 2.41% to 2.06%. The yield on the 2-year note ended the period at around 0.25%. Investment-grade bonds managed to recover from losses suffered in the first quarter to post positive performance. High-yield corporate credit did even better, as yield spreads continued to narrow. [Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity Treasuries].

Fed signals shift in easy money policies

Fed policymakers expect to make two interest-rate increases by the end of 2023, according to the central bank's updated economic projections in June. But they left the benchmark short-term interest rate anchored near zero, where it has been since March 2020. The Fed also pledged to continue buying about \$120 billion a month in Treasury securities and other government-backed bonds. The Treasury yield curve flattened, and real rates rose following the Fed meeting. Overall, we believe the environment for risk assets remains generally supportive. Considering expectations for sturdier growth, we believe Treasury yields could rise further this year. That said, we think the trend toward higher rates will be gradual as bond investors adjust their growth and inflation outlooks, leading to periods of market volatility.

The Fed expects the economy to grow 7% this year from the 6.5% growth estimate in March. Central bank officials have also raised projections for personal consumption expenditure (PCE) inflation to 3.4% this year — above

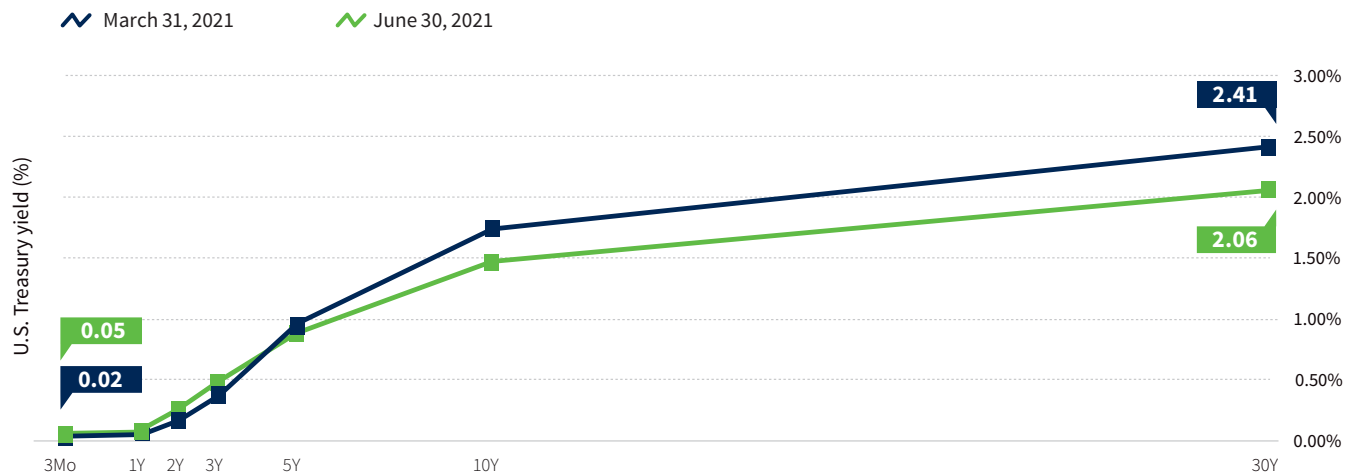
its 2% goal — from 2.4% in March. This comes as the economic recovery is driving consumer prices to the highest levels in nearly 13 years. The consumer price index surged 5.4% in June, the fastest rate since 2008, according to the Labor Department. Fed Chair Jerome Powell said the spike in prices will likely abate and was largely being driven by pandemic-related issues. Against this backdrop, job growth picked up in June, but the unemployment rate rose to 5.9%. The Fed sees the unemployment rate for the year unchanged at 4.5%.

ECB pledges to keep policy steady

The European Central Bank (ECB) said in June it plans to maintain its “very accommodative” monetary stance. The ECB left the policy rate unchanged but has increased the pace of asset purchases while keeping the Pandemic Emergency Purchase Programme (PEPP) at 1.85 trillion euros until at least March 2022. Eurozone government bond yields ticked higher during the second quarter amid expectations of rising inflation, the Fed's more hawkish tone on rates, and worries about the ECB's stance on policy. Germany's 10-year bond yields, seen as the benchmark for Europe, rose to a high of -0.074% in mid-May before settling at -0.203% at the end of June.

The ECB in June also forecasted a stronger growth outlook and higher inflation in the region. The eurozone economy is expected to grow 4.6% this year compared with a 4% forecast in March. Inflation is expected to spike at 1.9% in 2021, driven by temporary upward factors, before returning to 1.5% in 2022. ECB President Christine Lagarde said in June that policymakers are more optimistic about the recovery even as the pandemic continued to weigh on the bloc's economy. Lagarde added that it was too soon to discuss tapering bond purchases and that premature tightening in rates poses risks to growth and inflation. In our view, if there are no Covid-19-related hiccups in the fall and inflation stays elevated, the ECB Governing Council will probably start debating the end of PEPP in or after March 2022.

Rates sold off on the front end as intermediate- and long-term rates rallied and the curve flattened



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

China seeks more targeted and flexible monetary policy

The world's second-largest economy is rebounding strongly from the impact of the Covid-19 pandemic, boosted by exports. But the recovery in the consumer spending and factory activity has slowed. The official manufacturing purchasing managers' index (PMI), a gauge of factory activity, eased slightly to 50.9 in June versus 51.0 in May, data from the National Bureau of Statistics showed. The official nonmanufacturing PMI also dropped in June. China's economy grew a record 18.3% in the first quarter of 2021 compared with the same quarter last year.

The People's Bank of China (PBoC) has kept its benchmark lending rate unchanged. The central bank said in June it plans to make policy more targeted and flexible while keeping the economy's leverage ratio stable. PBoC Governor Yi Gang said consumer inflation will likely stay below the government's target this year and monetary policy must remain stable. Chinese bonds continue to attract international investors. The 10-year government bonds yielded around 3.075% compared with about 1.308% for the 10-year U.S. Treasury. In recent weeks, the central bank has tried to slow the yuan's appreciation against the dollar and increase its flexibility.

Sector views

Corporate debt: Investment grade and high yield

Investment-grade bonds managed to recover from losses suffered in the first quarter to post positive performance. Within this environment, we have a positive outlook for the fundamentals and overall supply-and-demand backdrop underlying investment-grade corporate credit. Our view on valuation is more neutral, however, given the relative tightness of yield spreads as of quarter-end. Now that the U.S. economy has largely reopened, investors will have a keen eye on corporate earnings during the next few quarters. Market participants will also be watching for any shift in tone by the Fed, should inflation continue to move higher.

High yield rallied in June, along with stocks and Treasuries, amid growing confidence that inflation will likely prove transitory. Relative to other asset classes, high-yield bonds outpaced high-yield bank loans and the broad investment-grade (IG) fixed-income market, but modestly lagged IG corporate credit. We have a positive outlook for high-yield market fundamentals and

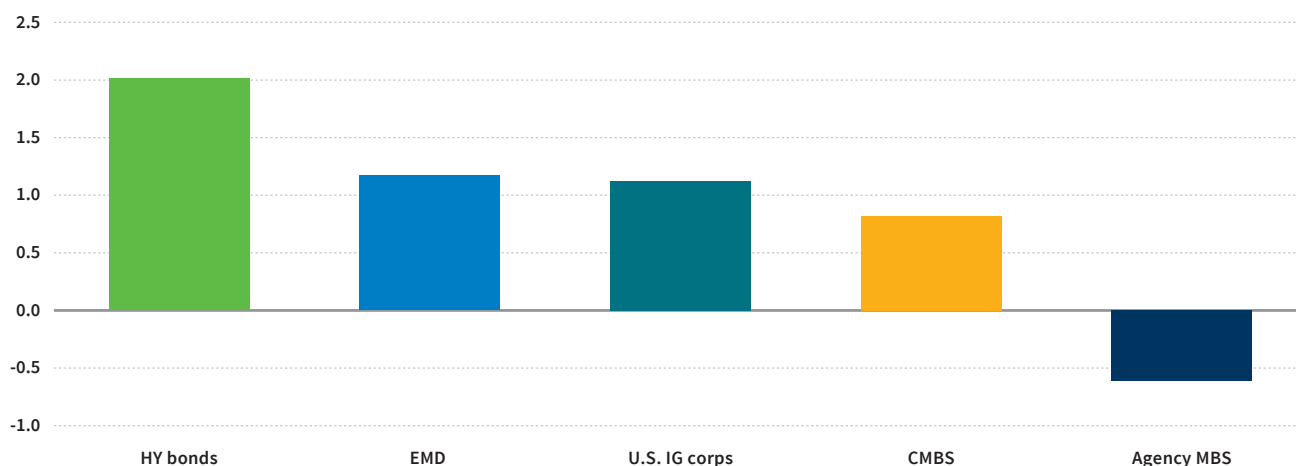
the overall supply-and-demand backdrop. Our view on valuation is more neutral, given the relative tightness of yield spreads in the market as of quarter-end. Our optimism is grounded in the rapidly growing percentage of Americans receiving Covid-19 vaccines, sustained government stimulus, and the continuing recovery of the U.S. economy. That said, we continue to closely monitor issuers' balance sheets and liquidity metrics, with an eye toward default risk or a credit-rating downgrade. Risks to our generally constructive outlook include any new developments with Covid-19, volatility in commodity prices, and policy missteps from global central banks. Expectations for defaults have meaningfully improved this year, given the liquidity in the market.

Trends in the mortgage market

In the commercial mortgage-backed securities (CMBS) market, we believe there are attractive risk-adjusted investment opportunities available amid an improving fundamental backdrop. In our view, borrowers with access to capital will continue to make investments in properties that were performing well before the pandemic hampered their revenue streams.

During Q2, risk assets posted solid excess returns amid widespread reopenings

Excess returns* relative to Treasuries, Q2 2021



Source: Bloomberg, as of 6/30/21. 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."

Near-term inflation expectations are significantly higher than they were prior to the pandemic. We think commercial properties can better absorb inflation pressures compared with other market sectors, such as corporate credit. Consequently, if inflation rises, we believe areas of the CMBS market may offer compelling relative-value opportunities.

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. Even with tighter spreads, we have continued to find opportunities in investment-grade securities backed by non-agency residential loans, along with 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. To us, the prepayment sector offers potential benefits in the event of an economic slowdown, changes in fiscal policy, and/or rising interest rates. In our view, many prepayment-sensitive investments offer attractive risk-adjusted return potential at current price levels. In terms of investment selection, we are focused on securities backed by reverse mortgages, jumbo loans, and more seasoned collateral.

Currency views

U.S. dollar likely to rise as Fed mulls rate hike

The United States is set to see its twin deficits widen amid rising fiscal spending and consumer demand for goods and services. Deficits have been an indicator of dollar direction over past cycles because these deficits need to be funded or the dollar needs to fall. With front-end rates pinned close to zero, flows into U.S. fixed-income markets are likely to be hedged. As hedged ratios increase, it leaves the dollar in need of unhedged flows into equities or via inbound mergers and acquisitions. At the June meeting, the Fed unexpectedly pivoted to a more hawkish tone on its policy rate. Labor market data and future job gains will be pivotal for the Fed as it charts a plan for ending the easy money policies. This makes dollar appreciation against currencies backed by resolutely dovish central banks such as the yen, the Swiss franc, and, potentially, the euro, more likely.

Neutral outlook for the euro

European data continues to improve as lockdowns are eased and vaccine rollouts improve. The ECB in June said its PEPP will continue at a “significantly” higher pace and avoided a hawkish surprise. The central bank is in the process of finalizing its strategic review, which is expected to result in a 2% inflation target. Other big questions on the ECB’s table include the future of the PEPP, which is currently set to last until March 2022, and whether to expand the asset purchase program. In the near term, improving growth should continue to be supportive of the euro. But over the longer term, the ECB’s decisions could weigh on the currency, suggesting a more neutral outlook for the euro against the dollar. The euro is likely to act as a funding currency for better growth stories elsewhere.

British pound likely to trend higher

We believe the United Kingdom remains positioned well for a domestic and global recovery, fueled by one of the better-run vaccination campaigns. The Bank of England continues a glide path of less dovishness. But with the Coronavirus Job Retention Scheme (CJRS) set to end on September 30 this year, it is unlikely the central bank will offer any significant support for the currency. This will leave the pound’s movements more reliant on global forces. We expect to see near-term risks and medium-term upside for the sterling.

Japan’s yen likely to depreciate amid global recovery

The Bank of Japan (BoJ) remains largely sidelined with limits on further monetary policy easing. The yen had seen a large repricing on the back of the global recovery but has been range bound since peaking in April. From here, the currency is likely to grind weaker as the global recovery broadens. Yen strength during economic shocks is likely to be more pronounced going forward, in our view.

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 June 30, 2021.

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.

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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 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.

The Bloomberg Barclays 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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