

Q4 2017 | Fixed Income Outlook



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Global growth quickens without inflation

The U.S. and global economy continue to grow in a synchronized fashion that has, in past cycles, helped foster faster growth, although an acceleration is not yet clear in the data.

The U.S. Federal Reserve and the European Central Bank continue to move toward tighter policy though inflation readings continue to disappoint.

We believe fundamental conditions continue to be supportive for a variety of credit, prepayment, and liquidity risk strategies.

U.S. economic data remained positive during the third quarter and consistent with an economy growing steadily at around 2.0% to 2.5%. Our outlook is for more of the same. Beyond the United States, the global economy is growing in a synchronized fashion and firing on many cylinders. While synchronized cycles can build on themselves and there is a possibility of growth moving to the upside, we haven't yet seen enough data to suggest that such a transition is at hand.

The trends and the events of the third quarter have not altered the trajectory that we see for the economy. The major issues remain the geopolitical confrontation over North Korea's missile and nuclear

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		○	●

weapons development program and its potential to disrupt trade and growth; the persistence of low inflation and its implications for central bank policies; and the developing debate over U.S. fiscal policy and, more specifically, possible actions on the debt ceiling, tax reform, and the federal budget.

The hurricanes stir up economic data and political decisions

Aside from these themes, Hurricanes Harvey, Irma, and Maria deserve mention because of the destruction and suffering they have caused and the consequences for economic data, as well as for politics. Harvey-related flooding that badly affected southern Texas has raised gasoline prices and will have some effects on headline inflation and consumer spending. Hurricane Irma's effects are more difficult to analyze cleanly because there is relatively little industrial production based in Florida. While there will be a reduction in third-quarter GDP because of the two storms (Puerto Rico, severely damaged by Hurricane Maria is not included in U.S. GDP figures), this should be more than offset by a bigger bounce back in the fourth quarter and the first quarter of 2018, when money will be spent on reconstruction.

With regard to politics, the human suffering caused by the hurricanes has prompted a response from Washington, and in this context the painful debate on the debt ceiling and government funding for the next fiscal year has been avoided for now through a deal that pushes deadlines out to December. However, this does not mean these issues have been resolved. In our view, the prospects for growth-enhancing tax reform remain low because of the divisions in the Republican Party over these policies and the crowded agenda confronting Congress.

Central banks take steps toward additional monetary tightening

Given the positive global economic growth profile, both the Fed and the European Central Bank (ECB) seem set to move — the Fed by beginning balance sheet reduction in October and increasing rates again in December, and the ECB by outlining its plans to taper its bond purchasing program. However, much is still unclear because both central banks show a considerable attachment to the Phillips curve and the expectation that as the labor market tightens, wages ought to rise, and inflation ought to move higher. A series of negative inflation surprises in the United

States call this expectation into question. Moreover, if the economy is gradually coming to the end of this phase of the cycle, and inflation pressures continue to diminish, the central banks may become frustrated in their inability to normalize monetary policy.

Inflation may be weaker than the Fed thinks

The Fed has been clear that it views the recent negative inflation surprises in U.S. data as temporary and transitory, but we find it difficult to be confident in this view. When we look at a major component of core inflation — housing — we find indications of price weakness that are difficult to dismiss as temporary. Over the past several years, the single-family and multi-family housing markets have moved closer to equilibrium as demand for housing for purchase has recovered and new rental supply has become available. As a result, pressure on rents has eased, and indeed in some places rents are now falling, and it is rents that drive the housing statistics that are used to calculate the Consumer Price Index.

With regard to lodging — a smaller component of the CPI — hotel rates have not been rising despite high occupancy. It appears that Airbnb and other online travel services have increased the supply of rental rooms quite dramatically, as if a vast number of hotels had been built very quickly, contributing to new price competition. This is a very powerful effect, and one that is difficult to dismiss as transitory.

A December rate increase remains likely while balance sheet reduction may be blunted

Given other dynamics at work, we expect inflation to move higher in the short run, and this will be convenient for a Fed that wants to hike rates again in December. Looking toward 2018, however, we expect core inflation to remain in a narrow range, at a level that is consistent with the Fed's target, and which therefore may not warrant the three rate hikes that a majority of Federal Open Market Committee (FOMC) members projected at the September Fed meeting. Similarly, we are not convinced the Fed will make much progress in reducing its balance sheet. In October, the Fed will begin by allowing a total of \$10 billion of Treasuries and agency mortgages to mature without reinvesting the proceeds, increasing this amount by \$10 billion per quarter, until getting to the level of \$50 billion per month. The Fed aims to bring down the amount of securities it acquired during several rounds of quantitative easing, although it

has not committed itself to a target size for the balance sheet. The announced, slow pace of “quantitative tightening” means the issue of final balance sheet size will not need to be addressed for quite a while.

However, the liability that the Fed would like to extinguish — the excess reserves of commercial banks — may not be easy to reduce. Banks earn decent returns on these excess reserves, and it is not at all clear that they have attractive alternatives in which they could put this money. The Fed could try a different approach by seeking to lower the amount of cash circulating in the economy, but this may not be easy to do either. If the Fed’s liabilities do not fall, its assets cannot fall.

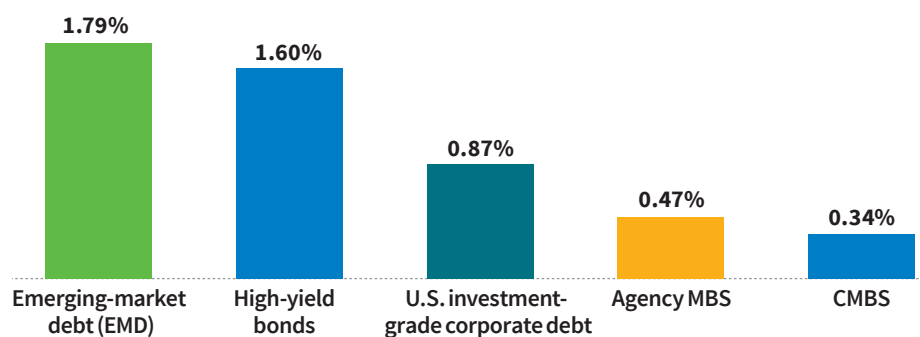
The ECB has a communications challenge

Meanwhile, the ECB continues to struggle with the fact that European growth has been stronger than it had been expecting and that inflation, while edging higher, remains well below the target. ECB President Mario Draghi did not use his Jackson Hole speech to preannounce any policy changes, but we know that the ECB needs to start tapering at the turn of the year. Continuing the purchases at the current pace would leave them without enough German government bonds to buy. Since the markets know that the ECB needs to begin tapering, the euro has begun to rise, creating an additional question about when the ECB will begin commenting on the euro to discourage its appreciation. The euro’s rise will likely cause concern in the ECB’s Governing Council that it is pushing down inflation without the ECB even having to taper its bond purchases. Given the appreciation of the euro so far, the ECB might be forced to play its hand somewhat differently. There isn’t scope to continue quantitative easing at its current pace, but perhaps the taper will be somewhat shallower than seemed likely in recent months.

EM debt and corporate credit lead fixed-income sectors

Excess returns relative to Treasuries, Q3 17

Source: Bloomberg, as of 9/30/17. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index. Past performance is not indicative of future results.



Sector views

Securitized debt: Mortgages benefit from general stability

In mortgage credit-sensitive areas, we favor an allocation to commercial mortgage-backed securities (CMBS). The underlying fundamentals for commercial real estate continue to be stable overall as employment growth, low interest rates, and a positive GDP trajectory provide a tailwind for the CMBS sector. With concern about the business outlook for retail shopping malls in the news, we anticipate some losses in regional mall-related credit. However, malls are showing some ability to repurpose their space to capture new types of tenants. Ultimately, we do not believe these issues will translate into fundamental losses at the BBB- tranche level.

Within agency credit risk transfer (CRT) securities, we are more cautious on valuations compared with last year, but credit metrics remain very high and underlying collateral performance is strong. Additionally, we continue to find value in the legacy RMBS market. Improving housing fundamentals are helping homeowners, with loan-to-value ratios falling, homeowner delinquency rates declining, and more borrowers staying current after mortgage modifications.

We also continue to find value in areas within interest-only collateralized mortgage obligations (CMO), although we have been more cautious in our allocation relative to mortgage credit. Despite low interest rates, prepayment speed uncertainty is not currently a major concern as we have been in this type of rate environment for quite some time. More generally, we find prepayment risk attractive in an environment where mortgage lending standards have yet to ease materially.

High yield and bank loans: Fundamentals are positive while spreads have tightened

We continue to have a constructive general view on the high-yield asset class. The fundamental landscape continues to be stable and buoyed by solid corporate earnings. There is also cause for optimism that high-yield issuers stand to benefit from pro-growth reforms expected in Washington, including deregulation and fiscal stimulus. However, the timing of policy implementation remains in question. Despite our positive general view, we are somewhat more cautious on the energy sector due to ongoing supply/demand concerns and uncertainty around OPEC production. Also, from a valuation standpoint, although credit spreads are measurably tighter year over year, they continue to look fair on the back of good fundamentals. High yield also benefits from a relatively favorable technical environment due to low net new issuance volumes.

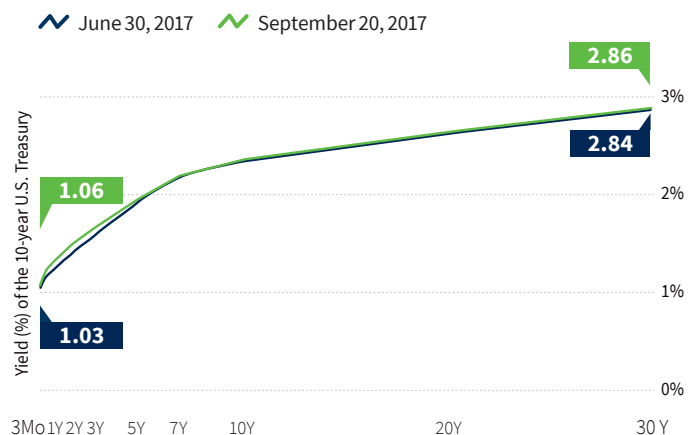
Investment-grade bonds: Fundamentals continue to look solid

We remain constructive on the U.S. investment-grade corporate bond market on account of its improving fundamentals, favorable technical conditions, and fair valuation. Regarding fundamentals, 2Q17 earnings results generally outperformed expectations with notable strength in energy and technology, albeit with continued weakness in telecommunications.

Our outlook is for continued improvement in fundamentals, subject to unknown government policy initiatives. Regarding technicals, our outlook is still for elevated new issue supply, tempered by the decline in pending M&A transactions. U.S. spreads will likely continue to be supported by a solid fundamental backdrop, international flows, and ECB corporate buying programs over the near term. We continue to find current spread levels to be appropriate versus underlying fundamental risk. At the same time, we think it will be challenging for corporate spreads to perform as strongly as they did in 2016.

The yield curve moved modestly higher

Inflation expectations remained subdued



Source: U.S. Treasury Department, as of 9/30/17.

Emerging-market debt: General improvement offset by risk to U.S.-China trade

The dynamics influencing emerging markets (EM) have not changed much during the third quarter and remain driven by the interaction of global conditions, commodity prices, and local political forces. The majority of the focus has been on North Korea and the rising geopolitical tensions between the reclusive communist state and the developed world. There is still a lot of uncertainty around how North Korea will ultimately affect the global economy, and trade relations between the United States and China in particular, but we can no longer dismiss the possibility of a potentially catastrophic outcome. For now, though, markets do not appear to be too concerned, and EM shows no obvious signs of weakness. Within individual countries, Latin America has seen improvements lately, partly due to an improving economy in Mexico and partly due to Brazil, where the political crisis has eased and attention is returning to the tentative economic reforms that are slowly moving forward.

Municipal bonds: Technicals remain positive

From January to September 2017, investor sentiment generally improved, especially for higher-yielding municipal bonds. The pace of new issuance was generally light, and demand slightly outpaced supply, contributing to rising prices and a narrowing of credit spreads of lower-investment-grade and high-yield municipal bonds. Viewed in a longer-term context, spreads are at or close to the narrowest point since the credit crisis. That said, overall credit fundamentals remain stable, supply/demand dynamics are favorable, and defaults remain low and isolated.

The new administration has stated that tax reform remains a major policy goal. However, we have not seen major tax reform in over 30 years, and we believe it will continue to be difficult to achieve any such reform today given the competing demands on the current administration.

Currency: Tightening policies will contribute to relative strength

The U.S. dollar outlook continues to be most heavily influenced by the Fed and rising expectations that some fiscal policy boost could be expected in early 2018. Beyond that, market pricing for rate-hike expectations remains low as the future composition of the Fed is highly uncertain. What seems likely is that the new chair will keep policy accommodative and the dollar will remain on a weaker footing over the medium term. Over the coming months, Fed nominees should be vetted and appear before Congress for confirmation. As this process resolves uncertainty, coupled with an improvement in sentiment from a fiscal boost, the dollar could become tactically stronger, especially against the yen.

The outlook for the euro remains dominated by relative monetary policy. The ECB continues to balance policy doves, who point to a tame core inflation rate, with hawks, who call for the removal of emergency measures, i.e., tapering, and then ceasing, asset purchases. This balance is likely to persist until October or December, when the ECB will communicate to the market what it will do at year-end when the purchase program expires. The euro has already moved considerably, so much of the

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near-term direction will be based on perceptions relative to this baseline view. Over the medium term, the euro should continue to appreciate.

In the United Kingdom, the discussions over Brexit remain fluid and quite noisy, contributing significant volatility to the British pound. Unless there is a breakthrough, this should be expected to persist. The statements from the Bank of England (BoE) have been surprising, as the focus has shifted from maintaining accommodative policy in the face of Brexit to treating the impact from a reactionary standpoint. As such, the BoE has set the market up for a series of rate hikes likely beginning in November

and continuing throughout 2018, which should keep the pound supported against the U.S. dollar, barring a major political mistake.

Bank of Japan (BoJ) Governor Haruhiko Kuroda continues to underscore that the inflation outlook remains subdued and, as such, the market should not expect any change in BoJ policy, adding that there is no need to raise rates just

because global rates rise. With financial market volatility low, the yen should continue to soften as capital leaves Japan to be invested in higher-yielding assets abroad. The continued support of Prime Minister Shinzo Abe is key and should be thought of as a base case. Abe has called a snap election; if his Liberal Democratic Party suffers losses, it is more likely that Governor Kuroda will not be reappointed, and the fundamentally cheap yen will quickly strengthen.

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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