

Q1 2019 | Equity Outlook

Aaron M. Cooper, CFA
Chief Investment Officer, Equities

Simon Davis
Co-Head of Equities

Shep Perkins, CFA
Co-Head of Equities

The upside of the downturn

The key risks weighing on equity markets may subside in the coming months.

In the current equity market environment, one of our concerns is the potential for a policy error by central banks.

U.S.–China trade and a slowing Chinese economy are challenges to navigate, but they offer the potential for positive outcomes.

Equity investors worldwide greeted the new year with an array of heightened concerns. A difficult fourth quarter brought volatility and annual losses for many major indexes. Among the issues that contributed to the downturn were geopolitical instability, uncertainty about monetary policy, a slowing Chinese economy, and the U.S.–China trade dispute.

Looking ahead, we believe the key risks weighing on equity markets may subside. A resolution of the tariff conflict, even if limited in scope, is quite possible. In China, more aggressive stimulus measures could improve the outlook for both the Chinese economy and global markets. And in the wake of fourth-quarter selloffs, we have the benefit of more attractive valuations for companies whose fundamental prospects are strong.

A challenging year for global equity markets

Total return performance, 12/31/17–12/31/18



Market overview

A look at key risks and opportunities as we begin 2019

Simon [Sam] Davis

Co-Head of Equities
Portfolio Manager of Putnam International Equity Strategy
and Putnam Europe Equity Strategy

Shep Perkins, CFA

Co-Head of Equities
Portfolio Manager of Putnam Global Equity Strategy
and Putnam Sustainable Leaders Strategy

Risk: U.S.–China trade conflict

SHEP: The ongoing U.S.–China trade dispute remains among the top concerns for equity investors, despite the “non-escalation” agreement in December that paused hikes in tariffs for 90 days. Higher tariffs undermine confidence among corporate leaders and complicate and delay investments in their businesses. Tariff hikes can also lead to inflationary pressure, reduce demand for products, and shrink profit margins.

Risk: China slowdown

SHEP: A slowing economy in China — which has been such a strong engine of global growth — is a key risk to equities. Growth in the world’s second-largest economy has been slowing for several years, and it weakened further in 2018. This has consequences not only for China’s trading partners in Asia, but also for the broader global economy. Demand from China has been a significant source of revenue for U.S. and European automobile, consumer, and technology companies, for example.

Opportunity: China stimulus and trade resolution

SHEP: There is a considerable amount of fear in the marketplace. Investor sentiment is about as low as we’ve seen it since 2011. If the China-related issues conclude in a reasonably positive manner, we could see a significant rebound for stocks across global markets. We believe that a favorable resolution of the tariff conflict is quite possible. Even if an agreement is only partial in scope, equity markets should respond positively.

SAM: In China, we’re seeing signs of more aggressive stimulus measures, which could improve the economic outlook for both China and global markets. If trade negotiations proceed smoothly and lead to some type of resolution, even for the short term, this could prompt an equity market rebound. It would be particularly beneficial for fundamentally strong companies that have been punished in the recent market turmoil.

SHEP: It is also worth noting that President Trump views financial markets as a gauge of his success. Now that markets have sold off, he may consider easing up on the aggressiveness in the tariff dispute and may feel more pressure to find a resolution that could help ease investor anxiety.

“ A range of political issues in Europe could continue to dampen equity performance. ”

Risk: Political uncertainty in Europe

SAM: A range of political issues in Europe have pressured price/earnings multiples, and continued uncertainty in many regions could dampen equity performance. Worries over the budget situation in Italy eased somewhat when the Italian government and the European Commission reached a compromise. However, slow growth, combined with Italy’s high debt-to-GDP ratio, is still a potential headwind. In France, the populist uprising and violence from “yellow vests” protesters could continue to be disruptive to the economy and equity markets. And, of course, Brexit remains unresolved, which could be destabilizing for the United Kingdom, with ripple effects throughout Europe.

Risk: Monetary policy and inflation

SAM: We are monitoring risks related to U.S. Federal Reserve policy and the potential for inflation. Some data show that U.S. wage growth has been very strong, but there is uncertainty about its sustainability. Many economists believe that it is limited only to certain areas

of the economy, and that wage growth in aggregate has not been as strong. One possible scenario is that inflation becomes more prevalent and widespread than expected. This could cause an inflation shock to the upside and force the Fed to tighten more aggressively. A policy error from central banks, such as becoming too aggressive with rate hikes, remains a risk in the current market environment.

SHEP: While we believe it is unlikely at this point, a meaningful pickup in reported inflation would be negative for equity markets. Tighter labor markets could push up inflation in the United States, Japan, and Europe, where central banks may determine that interest-rate hikes are necessary. We are less concerned about this risk, particularly as oil prices have declined, easing some inflationary pressure. Also, in the United States, we have seen that the Fed is willing to take a more dovish stance when interest-rate hikes are taking a toll on markets.

“ The Fed is willing to take a more dovish stance when interest-rate hikes are taking a toll on markets. ”

Opportunity: The bright side of down markets

SAM: For many reasons, we can categorize the 2018 market selloff as an opportunity. Valuations are more attractive today. It is quite possible we will benefit from a Goldilocks scenario, in which U.S. economic growth continues at a controlled, healthy pace while the Fed avoids policy mishaps and gradually raises rates in line with growth.

Many market observers believe that the benefits of the stimulus from the Tax Cuts and Jobs Act will last longer than just one year. More importantly, structural tax reform, which reduces corporate tax rates, could be a game changer in terms of competitiveness. It could attract more investment back into the United States, boosting the U.S. economy, and ultimately strengthening global markets as well.

SHEP: All of the key concerns weighing on the equity markets at the close of 2018 have the potential for a positive outcome. And experienced investors recognize the advantages of a market downturn. Through several corrections and the worst of the fourth-quarter declines, many companies have continued to demonstrate fundamental strength and still offer solid long-term growth prospects. In particular, stock prices of many high-quality companies in cyclical sectors collapsed when worries about global growth intensified. We are sifting through the damage to identify those that we believe have been unfairly punished and adding to those positions if appropriate.

Opportunity: Compressed multiples and sectors to watch

SHEP: In the wake of the challenges we encountered last year, price/earnings multiples have compressed. A year ago, equities were more expensive, with valuations near the top of their typical range. Today, those valuations are lower, and many more are below average.

In the recent market pullback, defensive stocks outperformed by a significant margin. This included utilities, telecommunications, and consumer staples. The worst performers were economically sensitive sectors, such as energy, financials, and technology. Going forward, we believe a balanced portfolio of cyclical and defensive names is appropriate. Recently, we have favored energy pipeline companies and technology stocks, while trimming some positions in global industrials.

“ We are sifting through the damage to identify those stocks that we believe have been unfairly punished. ”

Why tariff hikes are bad for equities

Shep Perkins, CFA
Co-Head of Equities

Although we believe that a favorable resolution of the U.S.–China trade conflict is possible, we continue to monitor it as a potential risk for equity investors. Rising tariffs can have a negative impact on equities for a multitude of reasons.

While the impact on U.S. and Chinese companies is obvious, the risk also affects businesses worldwide. As an example, European auto manufacturers are already feeling pain from higher import tariffs on cars produced in the United States.

Among the consequences of tariff hikes are disrupted supply chains. Supply chains have been globalized, so while end products may be made in the United States, sub-components are from all over the globe, with many coming from China and Mexico. Tariffs disrupt this supply chain.

Trade disputes undermine confidence among corporate leaders. The potential for significantly higher tariffs brings a level of uncertainty that can cause businesses to retreat

from investing. For example, as a result of the conflict, businesses may focus on restructuring their supply chains rather than building new factories. This is particularly true when they are uncertain about where those factories should be located due to changing supply chains.

We have already seen the effects of tariffs on corporate earnings. For manufacturers, there are more potential losers than winners, as profit margins are vulnerable to cost increases. This is likely a contributing factor in the recent restructuring and layoff announcements from General Motors and Ford.

Globalization over the past 25 years helped to generally reduce costs, improve margins, and expand markets. Tariffs, on the other hand, are a form of de-globalization and have the opposite effects, namely they raise costs, squeeze profit margins, shrink markets, and lead to inflationary pressure. The impact of higher tariffs is similar to that of taxes. They make products more expensive, resulting in fewer purchases. They raise prices and reduce demand.

We’re optimistic that key aspects of the current trade conflict will be resolved and that tariffs will be repealed or, at least, the pending new hikes will be rescinded. But in the event this does not play out and tariffs are ratcheted up and used more broadly, it would be punitive for equity markets.

Market scorecard

Select equity index performance as of 12/31/18

Index name	Q4 2018	1 year	3 years	5 years	10 years
MSCI EM Index (ND)	-7.46%	-14.57%	9.25%	1.65%	8.02%
Russell 1000 Value Index	-11.72	-8.27	6.95	5.95	11.18
MSCI EAFE Index (ND)	-12.54	-13.79	2.87	0.53	6.32
MSCI Europe Index (ND)	-12.72	-14.86	2.10	-0.61	6.15
MSCI World Index (ND)	-13.42	-8.71	6.30	4.56	9.67
S&P 500 Index	-13.52	-4.38	9.26	8.49	13.12
Russell 1000 Growth Index	-15.89	-1.51	11.15	10.40	15.29
Russell 2000 Index	-20.20	-11.01	7.36	4.41	11.97

Sources: S&P Dow Jones Indices, MSCI, Russell. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index. Past performance is not a guarantee of future results. Returns for periods greater than one year are annualized. See page 6 for index definitions.

What's next for small caps?

William J. Monroe, CFA

Portfolio Manager, Putnam Small Cap Growth Strategy

Small-cap growth stocks took quite a hit in the fourth-quarter downturn, and investors may wonder if there is any good news for the asset class as we begin 2019. The Russell 2000 Growth Index — which had advanced by 15.7% by the close of September — plummeted 21.6% in the final quarter of 2018.

Small-cap stocks are still somewhat expensive by traditional price-earnings measures, but we believe there are many opportunities in the wake of the steep decline. Also, some of the basic characteristics of these stocks provide an advantage in the current economic environment.

Small-cap companies are often more domestically focused than large-cap companies. Therefore, they may have less exposure to international markets, which have experienced some of the sharpest recent slowdowns in economic activity. Also, these U.S.-focused companies continue to benefit from new, lower corporate tax rates. Finally, small domestic companies tend to be less exposed to the U.S.–China trade conflict and other geopolitical issues.

The technology sector offers attractive opportunities for growing small companies. The newer business model known as SaaS — software as a service — has enabled small businesses to compete with the larger, entrenched technology providers. We're invested in many small companies that have more advantaged technology than the old incumbents. Moreover, the recurring-revenue nature of their businesses models makes them much higher quality than a typical younger company. Despite the downturn, these companies remain in high-growth mode, and we believe they will continue to take market share of large-enterprise spending.

Macroeconomic conditions have been a consideration in some of our allocation decisions. For example, we slightly reduced our portfolio's exposure to the industrials sector. We may be entering a period of disrupted trade, in which small U.S. companies may have more difficulty landing

contracts with large international businesses. Also, we are more cautious about industrial or materials companies with exposure to emerging markets.

“ The newer business model known as SaaS — software as a service — has enabled small businesses to compete with the larger, entrenched technology providers. ”

We also see advantages for small companies in the consumer discretionary sector. For example, almost all large-cap retailers have been struggling with the “Amazon effect” — the competitive threat from online retailers. In the small-cap space, we have identified a number of businesses that offer unique, niche products and services that are not typically offered by online retailers and may ward off the threat of competition.

With the increase in interest rates, we have reduced positions in companies that have balance sheet leverage. We do not believe they would have issues in terms of paying their debt, but they might be limited in their ability to grow through M&A in a rising-rate environment.

Active management, fundamental research, and new insights to capture the growth potential of equities

Equity investing at Putnam features a tenured and talented team of portfolio managers backed by an integrated group of research analysts with worldwide reach. Our research organization is structured to focus fundamental analysis on the factors that matter most in global equity markets.

Aaron M. Cooper, CFA

Chief Investment Officer, Equities
Investing since 1999
Joined Putnam in 2011

Simon Davis

Co-Head of Equities
Investing since 1988
Joined Putnam in 2000

Shep Perkins, CFA

Co-Head of Equities
Investing since 1993
Joined Putnam in 2011

Kate Lakin

Director of Equity Research
Investing since 2008
Joined Putnam in 2012

MSCI EAFE Index (ND) is an unmanaged index of equity securities from developed countries in Western Europe, the Far East, and Australasia.

MSCI Emerging Markets Index (ND) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

MSCI Europe Index (ND) is an unmanaged index of Western European equity securities.

MSCI World Index (ND) is an unmanaged index of equity securities from developed countries.

Russell 1000 Growth Index is an unmanaged index of those companies in the large-cap Russell 1000 Index chosen for their growth orientation.

Russell 1000 Value Index is an unmanaged capitalization-weighted index of large-cap stocks chosen for their value orientation.

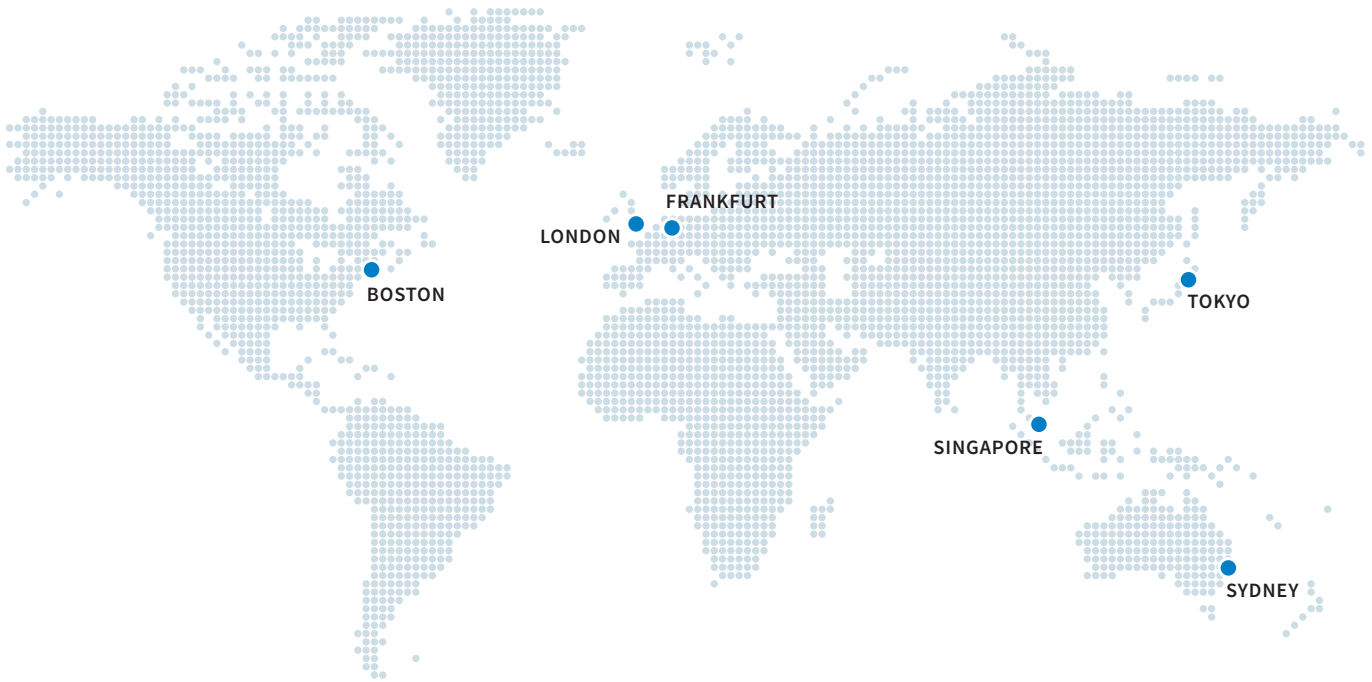
Russell 2000 Index is an unmanaged index of the smallest 2000 securities in the Russell 3000 Index.

S&P 500 Index is an unmanaged index of common stock performance.

Indexes assume reinvestment of all distributions and do not account for fees. It is not possible to invest directly in an index.

Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Russell® is a trademark of Frank Russell Company.

The views and opinions expressed are those of the authors Simon Davis; Shep Perkins, CFA; William Monroe, as of December 31, 2018, are subject to change with market conditions, and are not meant as investment advice.



Serving clients around the globe

At Putnam, we have built a global market presence that offers local market expertise. Our dedicated institutional specialists focus on building relationships and providing solutions aligned with client objectives.

United States

Putnam Investments
100 Federal Street
Boston, MA 02110
Phone: 617-292-1000

Germany

Putnam Investments Limited
Niederlassung Deutschland
Siemensstrasse 8, D-63263
Neu-Isenburg
Phone: +49 (0) 6102 56059 00

Australia

Putnam Investments Australia
Pty Limited
Level 13
167 Macquarie Street
Sydney, NSW 2000
Phone: +612 8083 9900

Japan

Putnam Investments Securities Co., Ltd.
Kamiyacho MT building
18th Floor
4-3-20 Toranomon, Minato-ku
Tokyo, 115-0001
Phone: +81 3 5404 5800

United Kingdom

16 St. James's Street
London, SW1A 1ER
Phone: +44 (0) 207 907 8200

Singapore

The Putnam Advisory Company, LLC
Singapore Branch
8 Marina View #28-01
Asia Square Tower 1
Singapore 018960

Visit putnam.com for continuing market updates, expert insights, and investment commentaries.

Find us



This material is a general communication being provided for informational and educational purposes only. It is not designed to be investment advice or a recommendation of any specific investment product, strategy, or decision, and is not intended to suggest taking or refraining from any course of action. The opinions expressed in this material represent the current, good-faith views of the author(s) at the time of publication. The views are provided for informational purposes only and are subject to change. This material does not take into account any investor's particular investment objectives, strategies, tax status, or investment horizon. Investors should consult a financial advisor for advice suited to their individual financial needs. Putnam Investments cannot guarantee the accuracy or completeness of any statements or data contained in the material. Predictions, opinions, and other information contained in this material are subject to change. Any forward-looking statements speak only as of the date they are made, and Putnam assumes no duty to update them. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties. Actual results could differ materially from those anticipated. Past performance is not a guarantee of future results. As with any investment, there is a potential for profit as well as the possibility of loss.

This material or any portion hereof may not be reprinted, sold, or redistributed in whole or in part without the express written consent of Putnam Investments. The information provided relates to Putnam Investments and its affiliates, which include The Putnam Advisory Company, LLC and Putnam Investments Limited®.

Issued in the United Kingdom by Putnam Investments Limited®. Putnam Investments Limited is authorized and regulated by the Financial Conduct Authority (FCA). For the activities carried out in Germany, the German branch of Putnam Investments Limited is also subject to the limited regulatory supervision of the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht - BaFin). Putnam Investments Limited is also permitted to provide cross-border investment services to certain EEA member states. In Europe, this material is directed exclusively at professional clients and eligible counterparties (as defined under the FCA Rules, or the German Securities Trading Act (Wertpapierhandelsgesetz) or other applicable law) who are knowledgeable and experienced in investment matters. Any investments to which this material relates are available only to, or will be engaged in only with, such persons, and any other persons (including retail clients) should not act or rely on this material.

Prepared for use with wholesale investors in Australia by Putnam Investments Australia Pty Limited, ABN, 50 105 178 916, AFSL No. 247032. This material has been prepared without taking account of an investor's objectives, financial situation, and needs. Before deciding to invest, investors should consider whether the investment is appropriate for them.

Prepared for use in Canada by Putnam Investments Canada ULC (o/a Putnam Management in Manitoba). Where permitted, advisory services are provided in Canada by Putnam Investments Canada ULC (o/a Putnam Management in Manitoba) and its affiliate, The Putnam Advisory Company, LLC.

This material is prepared by Putnam Investments for use in Japan by Putnam Investments Securities Co., Ltd. ("PISCO"). PISCO is registered with Kanto Local Finance Bureau in Japan as a financial instruments business operator conducting the type 1 financial instruments business, and is a member of Japan Securities Dealers Association. This material is prepared for informational purposes only, and is not meant as investment advice and does not constitute any offer or solicitation in Japan for the execution of an investment advisory contract or a discretionary investment management contract.

A world of investing.®

For use with institutional investors and investment professionals.

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



TL003_IN 314843 1/19