Q2 2019 | Equity Outlook

How resilient is the rebound?

Investors may be overlooking a key risk in the current economic environment.

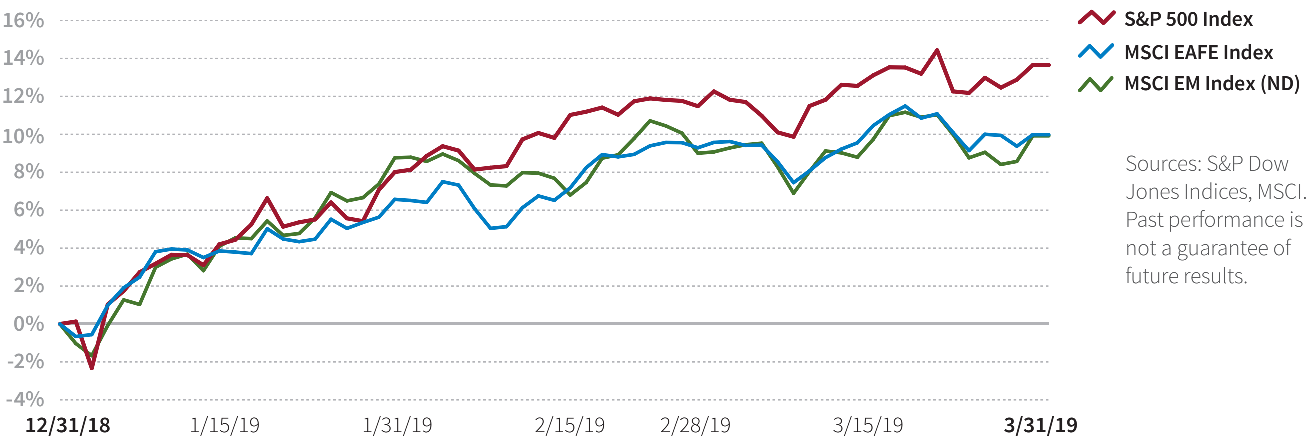
Intensive life cycle analysis helps uncover ESG leaders with promising long-term growth potential.

The start of 2019 brought a rebound for global equities. After a bruising fourth-quarter sell-off, stocks bounced back despite concerns over slowing economic growth and downward earnings revisions. The Federal Reserve's decision to put rate hikes on hold boosted sentiment, as did signs of progress in the global trade conflict.

Is the rebound sustainable? A number of factors could support continued strength, including stimulus measures in China and a resolution in U.S.–China trade negotiations. In fact, with the potential for an uptick in economic growth, inflation is a risk that investors may be overlooking. On the other hand, European GDP has slowed materially and the United Kingdom is struggling with Brexit challenges. Pockets of recession around the globe are possible, which would not be favorable for equities.

World equity markets recover in the first quarter

Total return performance, 12/31/18–3/31/19



Sources: S&P Dow Jones Indices, MSCI. Past performance is not a guarantee of future results.

Market disruption and the risk no one is talking about

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Portfolio Manager of Putnam Global Equity Portfolio
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Investors are not worried about inflation. That is one reason I believe it's a key risk for equities. Given the subdued inflation trends over the past decade, the market has been more concerned about deflation, which can be driven by falling commodity prices, lack of wage growth, efficiency gains from innovation, and global trade. It is logical, with the current environment of slowing global growth and the recent yield curve inversion, to disregard the potential for inflation. However, it is worth considering whether pressures finally may be building.

First, a pickup in economic growth seems probable. Interest rates have pulled back, China is implementing stimulus measures, and we are likely to see a resolution soon for some aspects of the U.S.–China tariff conflict. Second, consider energy prices. After peaking in mid-2018, oil prices fell dramatically later in the year, further dampening inflation concerns. However, production cuts from OPEC could continue to move oil prices higher. At the same time, geopolitical uncertainties, particularly related to U.S. sanctions on Iran and Venezuela, could lead to a minor supply shock and a spike in prices.

From a labor market perspective, there has been a notable pickup in wage inflation in the past six months. It could be that the combination of low unemployment and increasing labor participation has finally reached a tipping point and the economy is finally seeing real labor market tightness.

Tighter labor market conditions, combined with a boost in global economic growth, could surprise the market with a considerable amount of inflationary pressure. This would weigh on equity markets for several intertwined reasons. For one, interest rates would rise and the "Fed put"— the Federal Reserve's willingness to keep the federal funds rate low — would be jeopardized. The Fed would be inclined to hike rates, and higher rates naturally slow the economy. This, in combination with higher wage pressure, would squeeze corporate profits. Moreover, as rates rise, market price/earnings multiples would be more likely to contract than expand as bonds and fixed income securities become more attractive relative to stocks. High-growth stocks would be particularly vulnerable in this environment, as their elevated P/Es have the farthest to compress. Lower corporate earnings and a falling market P/E is a painful combination for equities.

> "Innovation creates a huge opportunity, with no guarantees. The winners could be the new disruptors or the entrenched players that embrace innovation."

Disruption in the supermarket

Constant innovation is a potential opportunity for equity investors. The market potential can be huge as companies develop better, faster, cheaper — and groundbreaking — products and services that can be adopted globally. Most of these innovations have higher margins and low capital intensity, especially software. Of course, there are high risks too. As many innovative growth companies command high valuations, they are assuming some level of success that is sustainable. Yet, this is far from certain. Also, innovation can be disruptive in a negative way for existing businesses. This threat of technological disruption has weighed on long-standing firms whose stocks have shifted from growth to value. And it has hurt stocks of some traditional value-oriented firms that are losing market share to innovative growth companies.

Grocery retailing is not known to be a dynamic growth segment of the market. But technology disruption has arrived for this traditionally sleepy, low-margin business. Recent changes are significant — and they bring opportunities and challenges for equity investors. Examples of disruption include online ordering/in-store pickup, two-hour grocery delivery services, driverless delivery programs, and online grocery purchases even in cities without a physical grocery store presence. These innovations have boosted e-commerce sales considerably and are coming from new entrants to the grocery industry as well as existing players.

This brings challenges to legacy grocery companies, primarily increased supply due to new entrants and price discounting by these new players to attract business. It seems likely that both incumbents and challengers will increase their investment, the former to protect their positions and the latter in an attempt to gain market share. Online grocery shopping represents a negligible share of the market today. It has the potential to grow in much the same way online apparel shopping has, and to capture double-digit share in the coming years. Innovation has the potential to create substantial opportunity, with no guarantees. The winners could be the new disruptors or the entrenched players that embrace innovation.

Still many questions around tariffs and trade

In this report one year ago, we first cited "Trump, tariffs, and trade" and U.S.–China tensions as a risk in equity markets. News headlines suggest we are closer to a favorable resolution for some aspects of the trade conflict. A partial solution could limit further tariff increases and possibly reverse some of the tariffs put in place last year. However, this outcome is uncertain, and more aggressive tariff measures could be enacted.

There is reason for some optimism, as President Trump's negotiating stance seems in part dictated by stock market momentum. Stock market weakness due to the lack of any trade deal may prompt him to capitulate to some degree. At the same time, China is not in a particularly strong negotiating position. According to some data, China's economy experienced a pronounced decline in 2018 — much slower than the country's reported 6.5% GDP growth would suggest. Auto sales, for example, were down close to 20% at the end of the year. The Chinese government has enacted a series of stimulus measures, a sign that the economy is indeed weak. Ironically, a combination of a weak U.S. stock market and a struggling Chinese economy could help cement some type of deal, most likely geared toward the U.S. trade deficit.

Even if some agreements are reached, the U.S.-China trade relationship is complex. There are many unresolved issues relating to manufacturing competitiveness, intellectual property, and cybersecurity, which could lead to export controls on critical technology and defense items. We expect the underlying trade friction to be sustained for years, not months.

Market scorecard

Select equity index performance as of 3/31/19

Index name	Q1 2019	1 year	3 years	5 years	10 years
Russell 1000 Growth Index	16.10%	12.75%	16.53%	13.50%	17.52%
Russell 2000 Index	14.58	2.05	12.92	7.05	15.36
S&P 500 Index	13.65	9.50	13.51	10.91	15.92
MSCI World Index (ND)	12.48	4.08	10.68	6.78	12.38
Russell 1000 Value Index	11.93	5.67	10.45	7.72	14.52
MSCI Europe Index (ND)	10.84	-3.72	6.56	1.04	8.95
MSCI EAFE Index (ND)	9.98	-3.55	7.27	2.33	8.96
MSCI EM Index (ND)	9.92	-7.28	10.68	3.68	8.94

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.

How green is your beverage container?

Alexander Rickson, CFA
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Putnam Sustainable Investing team

Packaging is big business — valued at nearly $900 billion globally. Historically, the principal goal of the industry was simple: provide protection for packaged goods in the most cost-effective manner. Today, there is much greater emphasis on sustainability and the environmental consequences of low recycle rates and poor waste management systems.

There is much debate about which is the most environmentally friendly form of packaging. While some uses of plastic are clearly valuable, there has been increasing analysis of the negative impact of single-use plastics, such as flimsy shopping bags and straws. Some countries are trying to curtail their use via a variety of measures. Businesses have also begun to respond, with some committing to 100% recyclable plastic packaging in the years to come.

> “It is estimated that three-quarters of all aluminum ever mined is still in use today.”

Heavy research into light containers

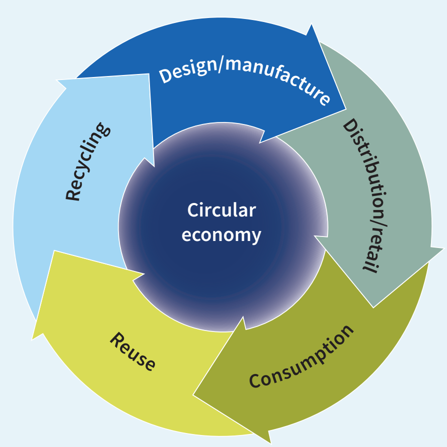
Analysis of the $60 billion beverage container market provides insight into the complexities of sustainability research. Exploring the efficiency of something as simple as a single-use bottle or can means in-depth research in areas such as transportation of raw materials and finished products, production processes, weight, form factor, recycling potential, and end-of-life scrappage value. This life cycle analysis forms the core of many carbon footprint studies and considers all steps in a product life cycle to identify ways to mitigate environmental impact and reduce all-inclusive economic costs.

So what's best for beverages?

While reusing a container is clearly the best solution, it is not always practical. With this in mind, and based on our analysis of glass, aluminum, and plastic containers, we found distinct advantages with aluminum. It is fully recyclable with no loss in quality; it already has high recycling rates; and it benefits from a low weight-to-volume ratio, which reduces transportation costs. These attractive properties give aluminum a high scrappage value, which incentivizes collection and reuse. In fact, it is estimated that three-quarters of all aluminum ever mined is still in use today. As a result, a typical can contains 70% recycled content, while a can made from fully recycled metal uses just 5% of the energy needed to produce a can made from virgin material.

The circular economy: Accelerating recycling and reuse

Life cycle analysis research supports the concept of a circular economy, in which the ultimate goal is to accelerate recycling and reuse in order to minimize or even eliminate the need for virgin raw materials.



Source: Putnam research.

Glass suffers from being the heavyweight option, which amplifies distribution-related emissions. Although glass can be fully recycled, it usually must be mixed with virgin materials to achieve desired quality and color. For plastic, the disadvantages are low scrappage values, which contribute to poor recycling rates and significant negative end-of-life externalities. For example, unlike glass, plastic will break down and pollute in ways that have significant environmental implications. Furthermore, its recyclable content is low, and material degradation means that plastic beverage bottles need to be made from virgin material.

"Exploring the efficiency of something as simple as a single-use bottle or can requires in-depth research."

Good for the planet, good for investors

How does this research translate into investment opportunities? We have found companies with meaningfully faster growth than that of their business peers — due in large part to their sustainability initiatives. Examples include making improvements in metal packaging and production lines, and working closely with suppliers and customers to increase recycling rates and reduce the energy intensity of aluminum production.

The advantages of aluminum

Based on a number of measures, we believe aluminum is the most appealing option for single-use beverage containers.

	Glass	Aluminum	Plastic*
Weight	High	Low	Low
Energy required (raw materials)	Medium	High	Very high
Energy required (bottle only)	High	Low	Low
Transport cost	High	Low	Low
Recycle potential	Full	Full	Low
Amount recycled	Medium	High	Low
Negative end-of-life	Low	Low	High

* Plastic example for Polyethylene Terephthalate (PET).
Source for size of packaging market: Smithers PIRA Long-term Strategic Forecast Report to 2028.
Source: Putnam research, 3/31/19.

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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.

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

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