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Q2 2018 | Equity Outlook

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Assessing market themes after a challenging quarter

Tariffs and geopolitical tensions have implications for equity markets, but not all the impacts are negative.

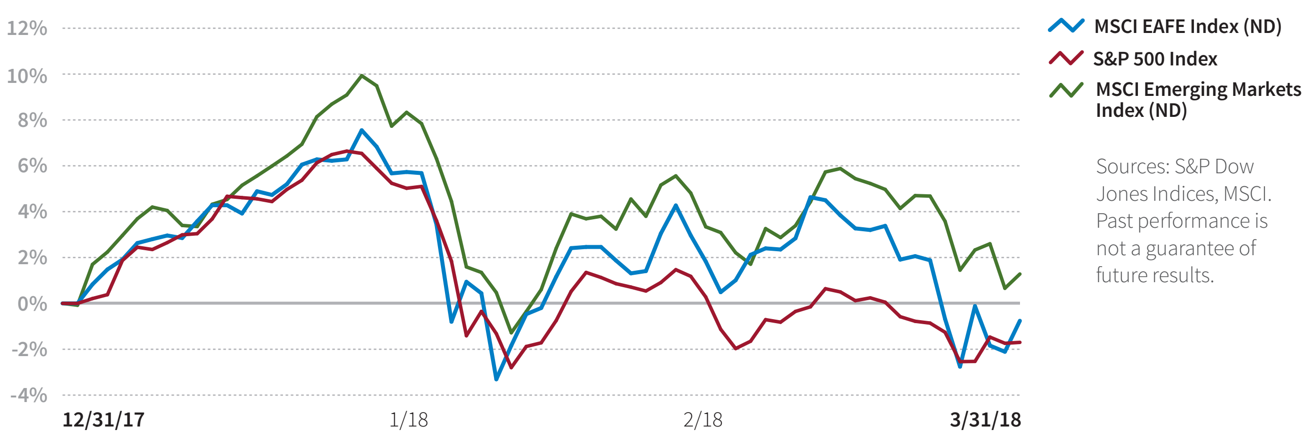
Despite progress with Brexit negotiations, we are cautious about U.K. equities and believe the U.K. economy remains challenged.

For a number of reasons, the U.S. housing market continues to be a bright spot for consumers and equity investors.

After an extended period of record advances and low volatility, global stock markets encountered their share of challenges in early 2018. Stocks began the quarter against a backdrop of optimism, but soon lost ground, beginning with a sharp downturn that pushed the U.S. market into correction territory in early February. This was followed by a series of market ups and downs that, combined with fears of a trade war, resulted in a turbulent quarter for equity investors worldwide. Such disruptions in market momentum can create compelling investment opportunities for portfolios. Looking ahead, we remain focused on business fundamentals and underappreciated earnings growth potential. We are optimistic about GDP growth trends across global markets and believe the likelihood of a recession remains low for most economies.

Volatility hits global markets in first quarter

Total return performance, 12/31/17–3/31/18



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

Trump, tariffs, and trade: The impact on stocks

Elizabeth C. McGuire
Portfolio Manager, Analyst
Materials and industrials

Worries over a potential trade war contributed to equity market turbulence in the first quarter. Investors responded negatively when the Trump administration imposed tariffs on aluminum and steel in early March, followed by a proposal for additional tariffs on Chinese imports. Trade war rhetoric escalated after the close of the quarter, with China announcing tariffs on U.S. goods, further rattling equity markets. While the investor reaction is understandable — free trade has been a key contributor to economic growth — we believe these developments may be less damaging than some headlines suggest. However, we are carefully considering implications for the equity market and specific companies.

Tariffs may increase already surging prices, but inflation isn't always bad

We are cognizant of the inflationary impact of tariffs on U.S. businesses and consumers. Prices for raw materials were already soaring before President Trump's announcements. U.S. steel prices, for example, are at levels we haven't seen since 2011, and are 30% higher year over year, due to economic recovery and growth in markets worldwide. This inflation could accelerate with new tariffs in place and pressure profit margins of U.S. companies. Auto manufacturers, for example, are facing higher costs for imported steel.

Raw material inflation, however, can also be good for businesses over the long term. In positioning portfolios in the industrials sector, we are focused on high-quality companies that we believe have pricing power. That is, businesses that can pass inflation on through higher prices for their products without compromising demand. For these companies, we see promising long-term growth prospects, although they may experience short-term earnings weakness due to tariffs.

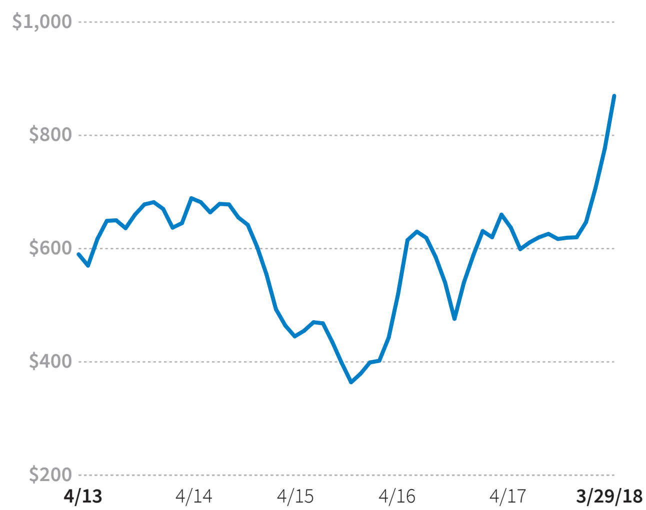
One uncertainty is the effect of inflation on sentiment. Will consumers hold off on purchases if price increases are too steep? While we remain generally bullish about fundamental business strength and global economic trends, these uncertainties could pose a risk to the current recovery cycle.

Trade flows rebalance over time

While tariffs and threats of restrictions are inevitable, trade flows in global markets tend to rebalance over time. In agriculture, for example, investors were unnerved by China's plan to impose tariffs on U.S. soybeans. The world's top buyer of soybeans, China buys approximately 30% of U.S. production, so restrictions would be disruptive in the short term to U.S. farmers. However, while supply chains may change and trade war concerns may cause short-term volatility, the global demand for soybeans will remain intact, and U.S. farmers will find new markets for soybean sales. We believe disruptions from new tariffs are likely to have a negative near-term impact, but it will settle down over time as trade flows rebalance.

Steel prices were already rising before tariffs

Price per short ton in U.S. dollars



Source: S&P Global Platts; U.S. hot rolled coil EXW Indiana.

Working to avoid a "hard Brexit"

Simon Davis
Co-Head of Equities, Portfolio Manager
European core and international core equity strategies

The United Kingdom and European Union have been engaged in months of detailed negotiations on the separation of the United Kingdom from the EU. The EU insists on agreeing to terms before discussing future trading relationships — an important issue for both sides. For obvious economic reasons, the United Kingdom has been concerned about a cliff-edge "hard" Brexit. This refers to the potential consequences of the United Kingdom exiting the EU without a formal withdrawal agreement on March 30, 2019.

In an effort to avoid this cliff-edge departure, the United Kingdom has agreed in principle to pay an exit bill covering ongoing obligations from its EU membership. In addition, it has agreed to abide by EU laws and regulations during a post-Brexit transition period, despite not having the right to vote on or influence these regulations.

Key developments of Brexit

6/23/16	The United Kingdom electorate votes 51.9% to 48.1% to leave the European Union
6/24/16	Prime Minister David Cameron announces his intention to resign
7/13/16	Theresa May becomes the new U.K. Prime Minister
3/29/17	Prime Minister May triggers Article 50; two-year countdown begins to United Kingdom's departure
6/8/17	May calls a General Election in expectation of an increased Conservative Party majority. Labour Party performs much better than expected, resulting in a significantly reduced majority for the Conservatives

In return, EU member leaders provisionally approved a transition period that provides additional time to clarify the terms of any future relationship, and for companies and households to plan accordingly. Some risk remains in the finalizing of this agreement, notably the future of the border dividing Ireland, an issue that is both unresolved and politically contentious.

The current state of the U.K. economy

Although many investors braced for a recession in the immediate aftermath of the Brexit vote, it did not materialize for a few reasons. First, the British pound sterling materially declined, making U.K. exports more competitive and the United Kingdom a more attractive tourist destination. Also, the Bank of England cut interest rates, providing significant liquidity to the economy through the banking system.

However, in terms of economic performance, we have witnessed a marked difference in the United Kingdom relative to the EU and the rest of the world. The U.K. economy has slowed compared with its pre-referendum growth rate, driven by a few trends. One is reduced household purchasing power, as wages have not kept pace with inflation brought on by the decline in sterling. Also, corporate and consumer confidence and investment have been impaired due to uncertainties surrounding Brexit.

Approaching U.K. equities with caution

The outlook for the U.K. economy remains challenged, in our view, both in absolute terms and relative to other regions. Central government debt remains high, limiting fiscal flexibility, and the Bank of England is likely to raise interest rates, given the inflationary pressure building in the economy. While aggregate figures remain resilient, evidence is emerging of distress in consumer-facing sectors. For example, we have witnessed some high-profile bankruptcies in the retail and leisure sectors.

Politics remains a key variable due to the slim majority of the Conservative Government, internal divisions within that party, and growing support for the left-wing Labour Party, with its policies of higher taxation and re-nationalization. We believe, from a longer-term perspective, value is emerging selectively across the U.K. equity universe. However, in our portfolios, we continue to maintain underweight exposure to the United Kingdom. Within our UK holdings, we favor high-quality exporters, which benefit from the depreciation of the pound.

Housing remains a bright spot for the consumer sector

Walter D. Scully, CPA
Portfolio Manager, Analyst
Global consumer and research strategies

Stocks in the consumer sector have been driven by many positive forces in recent years. One of the most significant has been the U.S. housing market — a pillar of strength and a segment of the economy that is still recovering from one of its greatest busts in history. Following the peak of the housing bubble in 2006 and the subsequent market collapse, U.S. home prices declined for six years. Since 2012, however, housing has made a remarkable recovery, with average home prices now higher than their 2006 levels. Despite this advance, we may not have reached the late innings of this recovery, and housing remains a notable bright spot for U.S. consumers and equity investors.

Inventory is tight, boosting housing wealth

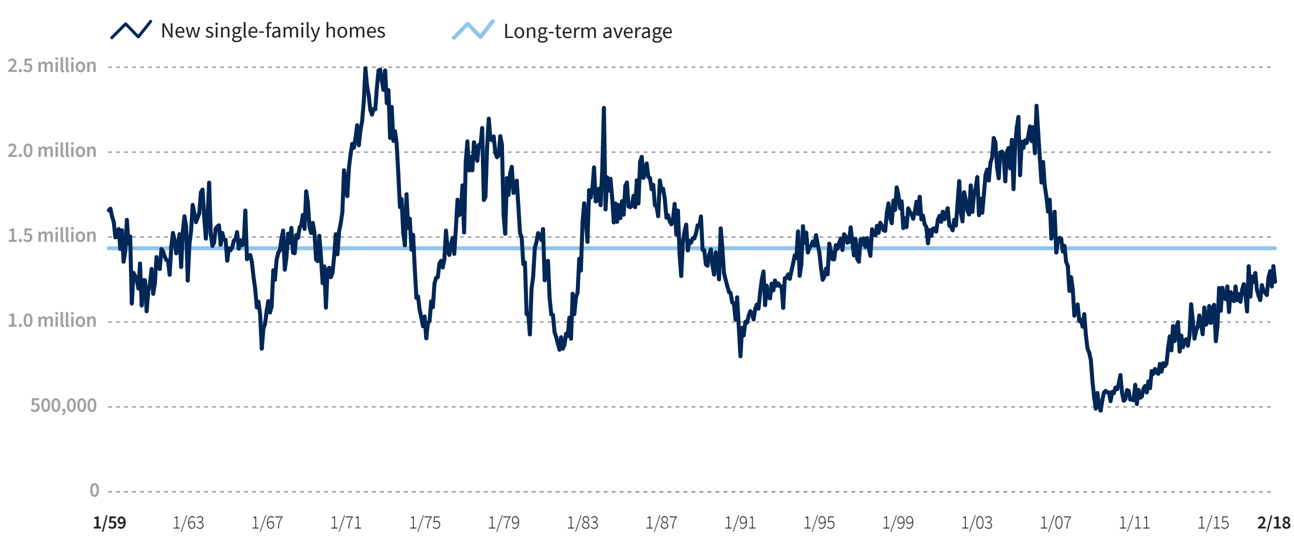
Following the 2006 collapse, we saw new home construction plummet — from 2.2 million new homes being built annually to just under 500,000 in 2009. Early this year, the annual rate for new home starts reached 1.3 million. We have certainly risen from the lows, but we are not near the previous peak. Also, while new home construction has grown, inventory remains tight. Arguably, there is actually a housing shortage, which has helped to drive up home prices and boost aggregate housing wealth.

> “The U.S. housing market is still recovering from one of its greatest busts in history.”

The growth in housing wealth — combined with the Tax Cuts and Jobs Act and strong advances in the equity markets — has been extremely positive for household balance sheets. Hiring has picked up, wages have been

New home construction still below long-term average

Annual single-family housing starts



Source: Putnam, based on U.S. government data.

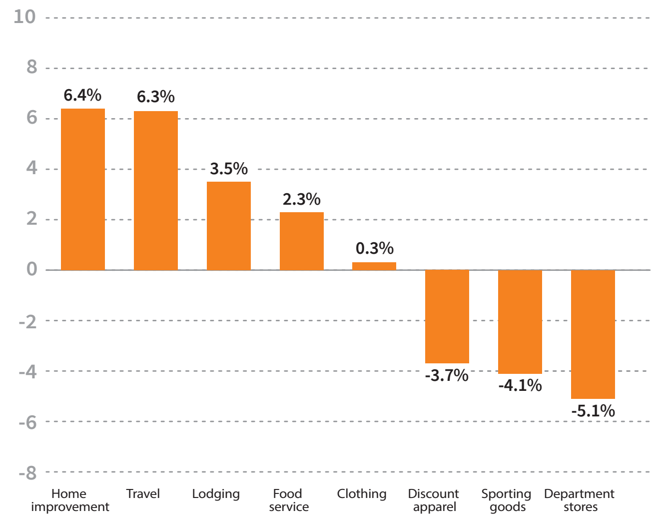
rising, and consumer sentiment has improved. These trends are likely to prompt more spending and help to boost the profitability of companies in the consumer sector. And while home prices have been increasing, they are still affordable, especially as household income rises. And while rising interest rates are certainly a risk to consider, rates are rising from abnormally low levels, and mortgage rates remain below their long-term average.

It's not just about new homes

Beyond housing starts, inventory, and home affordability, another trend to consider is home improvement. When housing wealth grows, even homeowners who choose to stay put tend to invest more in home improvement. In our meetings with the management teams of home improvement retailers, we've learned that 51% of U.S. homes in 2016 were over 40 years old. Industry experts are projecting this to increase to 54% by 2020. The older the home, the greater the demand for home improvement products, services, and supplies. This bodes well for many stocks in the consumer sector, particularly home improvement retailers and their suppliers.

Home improvement on the rise

Consumer spending trends; year-over-year change, Q3 17



Sources: U.S. Census Bureau, U.S. Bureau of Economic Analysis, Home Depot.

Market scorecard

Select equity index performance as of 3/31/18

Index name	Q1 2018	1 year	3 years	5 years	10 years
Russell 1000 Growth Index	1.42%	21.25%	12.90%	15.53%	11.34%
MSCI EM Index (ND)	1.28	24.76	8.76	5.00	3.00
Russell 2000 Index	-0.08	11.79	8.39	11.47	9.84
S&P 500 Index	-0.76	13.99	10.78	13.31	9.49
MSCI World Index (ND)	-1.34	13.52	7.95	9.69	5.89
MSCI EAFE Index (ND)	-1.70	14.60	5.49	6.46	2.72
MSCI Europe Index (ND)	-1.98	14.49	4.79	6.37	2.06
Russell 1000 Value Index	-2.83	6.95	7.88	10.78	7.78

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.

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.

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Investing since 2002
Joined Putnam in 2014

Kate Lakin
Co-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.

The views and opinions expressed are those of the authors (Elizabeth C. McGuire, Simon Davis, and Walter D. Scully, CPA) as of March 31, 2018, are subject to change with market conditions, and are not meant as investment advice.

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