Simon Davis
Co-Head of Equities

Q4 2018 | Equity Outlook

Aaron M. Cooper, CFA
Chief Investment Officer, Equities

Shep Perkins, CFA
Co-Head of Equities

Seeking opportunity in uncertainty

The potential for inflation to rise faster than expected is a key risk for global equity markets.

In Europe, we see the potential for a rebound in economic growth and would expect European stocks, especially value stocks, to follow.

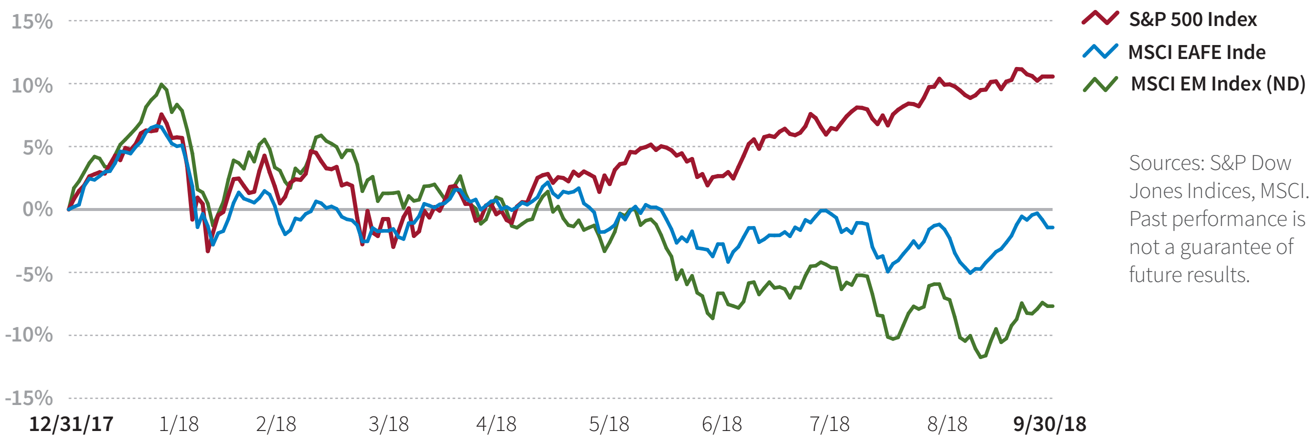
The escalating U.S.–China trade conflict is a risk, but also an opportunity as select stocks are being unfairly punished.

While most world markets advanced in the third quarter, U.S. stocks saw their biggest quarterly gain in nearly five years, boosted by rising wages, low unemployment, continued economic growth, and positive investor sentiment despite an escalating U.S.–China trade conflict. Outside the United States, emerging markets struggled with weaker currencies, rising interest rates, and worries over a slowing Chinese economy.

For equities in the months ahead, we believe rising inflation is a key potential risk, fueled by tightening labor markets and elevated energy prices. The escalating tariff conflict also threatens to disrupt market momentum, although we are seeking opportunities among stocks that we believe are being unfairly punished. We are monitoring developments in a number of markets, with a focus on their vulnerability in a rising-rate environment and political uncertainties that could lead to increased volatility.

U.S. stocks lead global equity markets in 2018

Total return performance, 12/31/17–9/30/18



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

Market overview

A look at key risks and opportunities as we enter the final quarter of 2018.

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: Inflation shock

SHEP: While many market observers expect inflation to remain muted, the potential for it to rise faster than expected is a key risk for today's equity markets. We are seeing much tighter labor market conditions as unemployment has declined globally, especially in the United States. In mid-September, the number of Americans filing for unemployment benefits dropped to a 49-year low. And while we have not seen meaningful wage growth yet, it has picked up in recent months. This labor market backdrop — combined with a solid U.S. economy, corporate tax cuts, strong consumer confidence, and government stimulus — could trigger a significant uptick in inflation.

> "An escalating tariff conflict could put 'sand in the gears' of global trade."

SAM: The job market is tightening across developed markets, driving up labor costs, particularly in the areas of transportation and logistics. At the same time, oil prices have risen meaningfully. Although energy is not factored into the core inflation rate, higher oil prices do have a secondary impact on prices of goods and services. In combination with a tight labor market, it could cause inflation to surprise on the upside. As a result, the Federal Reserve could tighten faster than anticipated, which would likely have a negative impact on equity markets even outside the United States. Rising rates can be beneficial for stocks early on, but there is an inflection point after which it becomes problematic. Another issue to consider is that we remain in uncharted territory with the reversal of quantitative easing. As central banks take on the unprecedented challenge of shrinking their bloated balance sheets, it is difficult to determine how that will play out in the markets.

SHEP: Bond proxy stocks, many of which we believe are overvalued, could come under pressure should we see an unexpectedly sharp spike in interest rates. Growth stocks could also struggle, and in general, price/earnings multiples tend to contract in a higher rate environment. From a corporate earnings standpoint, inflation could lead to higher costs and a squeeze on profit margins, elevating the potential for an earnings recession.

Opportunity: Equity recovery in Europe

SAM: Europe is an area of potential opportunity for equity investors. In recent months, we have seen growing confidence in the durability and sustainability of the region's macroeconomic recovery. Economic indicators have stabilized and corporate profitability has improved, while weakened currencies provide a further growth tailwind. If economic data begins to strengthen and interest rates rise in a measured way, European equities should outperform. European value assets represent the greatest opportunity, in our view. The European equity market has a strong value bias, represented by businesses in traditional sectors such as financials, energy, and materials — all of which tend to outperform in an improving macro environment that includes rising rates. European bank stocks have sold off fairly aggressively in 2018, and investors have largely ignored the potential boost they would receive from higher rates. Also, European bank valuations appear even more attractive when considering improvements in the banks' financial condition as they have cut costs, built up capital, and maintained solid asset quality.

Risk: Global trade conflict

SAM: Any discussion of today's equity market risks must include the escalating tariff conflict between the U.S. and China. There is potential for this issue to put "sand in the gears" of global trade and have a more chilling effect than is currently priced into global equity markets. Investors initially had a fairly benign view of the friction. However, it has moved from being viewed as a short-term negotiating tactic by the Trump administration to a more serious ideological dispute. In September, Trump announced tariffs on $200 billion worth of goods imported from China, and is prepared to place tariffs on the remaining $267 billion worth of imports. The tariffs will start at 10% and climb to 25% by January 2019.

Opportunity: Trade friction mispricings

SAM: While a trade war is a significant risk, it is also quite possible that the damaging effects of the U.S.–China trade friction have been overestimated. In our research team's work, we are seeing evidence in the case of specific assets, such as domestically focused Chinese companies that have been sold off irrationally and are completely immune to trade issues. There are stocks elsewhere that have been overly punished by trade conflict fears. Japanese industrial companies, for example, have declined sharply due to their perceived exposure to global supply chains, and these mispricings represent an opportunity for long-term investors.

While we do not expect trade headwinds to be positive for the Chinese economy, the negative impact may not be as massive as some fear. By loosening credit, allowing the currency to weaken, and taking other measures to stabilize the economy, the Chinese government is working to soften the blow of a trade-related slowdown. While it could take some time before we see the results of these stimulus measures, we are monitoring the situation for ongoing risks and opportunities.

Opportunity: Non-U.S. markets

SHEP: We have seen a considerable bifurcation this year in terms of performance between U.S. and international equities. U.S. equities, especially growth stocks, had outperformed all other regions, and the underperforming international markets represent a potential opportunity. Some of the issues that have weighed on the international markets could emerge in the United States, giving non-U.S. equities an opportunity to take the lead. If the dollar starts to weaken, emerging markets could find their footing, and we could see improved performance from Europe and Japan as well.

SAM: In a number of regions, improving corporate governance should be a significant driver of equity performance. This is most notable in Japan, where valuations remain attractive, in my view, and many companies are still working to implement change. Examples include improving the efficiency of their balance sheets, returning cash to shareholders in the form of share buybacks or dividends, and focusing on profit generation and cost cutting. Since Prime Minister Shinzo Abe took office in 2012, the Japanese government has made great progress in encouraging businesses to improve their profitability and capital efficiency, but we are likely to see more advances in the months and years ahead.

> "Innovation from companies across the global equity universe continues to boost return potential for investors."

Opportunity: Innovation

SHEP: The outperformance of growth stocks over value stocks, which has been most prominent in the United States, is due in large part to innovation. Growth companies are taking market share from more traditional value-oriented businesses thanks to impressive advances in technology, especially software solutions. Innovative products and services typically have global appeal, giving growth companies a huge addressable market and a meaningful advantage over companies with legacy products that are more expensive and have less appealing long-term growth prospects. Even in the face of market fluctuations and macroeconomic headwinds, innovation from companies across the global equity universe continues to boost the return potential for investors.

Italy's policy standoff

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

Italy continues to generate political risks for equities. The Italian governing coalition consists of two major populist parties that have combined to form a relatively fragile alliance. The coalition is working to enact a budget that risks pushing debt to an unsustainable level and that would conflict with the rules of the European Commission and fiscally conservative nations of the European Union (EU). It raises fears of sovereign risk within the eurozone and a potential "Italexit" — a play on the term "Brexit" — in reference to a departure of Italy from the EU.

We believe these issues pose a threat to Italian assets and potentially to the integrity of the EU. The populist government's combative stance toward EU policies has triggered a sell-off in Italian sovereign bonds and pressured Italy's bank stocks. Italy is a large economy with a debt of more than $2.5 trillion, and if a crisis were to unfold there, it would have far-reaching effects — greater than the impact of the crisis in Turkey today or in Greece during 2012.

The parties are proposing policies that imply fiscal expansion through a flat tax reform, pension reforms, and minimum income guarantees. We find it difficult to see how the government, in the face of dwindling economic growth and budget surpluses, can manage this without expanding the nation's debt-to-GDP position.

Early in the fourth quarter, pressure on Italian assets intensified after the government announced a budget deficit target that EU authorities believe would break the EU rules on fiscal discipline.

The proposed budget-deficit target of 2.4% of gross domestic product would contravene both the Italian constitution and European Commission requirements. Given these factors, the populist coalition will have to decide whether to fight for the policy that got them elected or accept a diluted policy. Recent rhetoric from the populist coalition has not been supportive of a compromise, with the finance minister going so far as to suggest a change to the constitution. However, a constitutional change is unlikely, as it is more in keeping with Italian political precedent to find a muddle-through compromise.

Although Italian and European equity markets have already begun to price in some of these risks, we have concerns about the continued pressure on Italian assets and the impact to global markets if the situation were to deteriorate.

Market scorecard

Select equity index performance as of 9/30/18

Index name	Q3 2018	1 year	3 years	5 years	10 years
Russell 1000 Growth Index	9.17%	26.30%	20.55%	16.58%	14.31%
S&P 500 Index	7.71	17.91	17.31	13.95	11.97
Russell 1000 Value Index	5.70	9.45	13.55	10.72	9.79
MSCI World Index (ND)	4.98	11.24	13.54	9.28	8.56
Russell 2000 Index	3.58	15.24	17.12	11.07	11.11
MSCI EAFE Index (ND)	1.35	2.74	9.23	4.42	5.38
MSCI Europe Index (ND)	0.80	-0.30	7.71	3.70	4.85
MSCI EM Index (ND)	-1.09	-0.81	12.36	3.61	5.40

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.

U.S. consumer stocks have been strong, but will it last?

Walter D. Scully, CPA
Portfolio Manager of Putnam Global Consumer Strategy and Putnam Research Strategy

Megan M. Craigen
Analyst, Equity Research
U.S. consumer sector

In a year marked by slowing growth across many industries and regions, the U.S. consumer sector has been a notable exception. Businesses in the sector have delivered financial performance at levels we haven't seen since before the 2008 global financial crisis. In September, consumer confidence reached an 18-year high, while unemployment has been declining and wages are rising. As U.S. equities continued to rally in their ninth year of a bull market, stock market wealth has contributed to consumer spending and sentiment. Another boost for consumers comes from housing wealth. New home construction has grown and inventory remains tight, which has helped to drive up home prices.

U.S. retailers have been remarkably strong, with top-line growth for many businesses exceeding expectations. Walmart announced its best results in over a decade with comparable-store sales growth of 4.5% for the latest quarter.

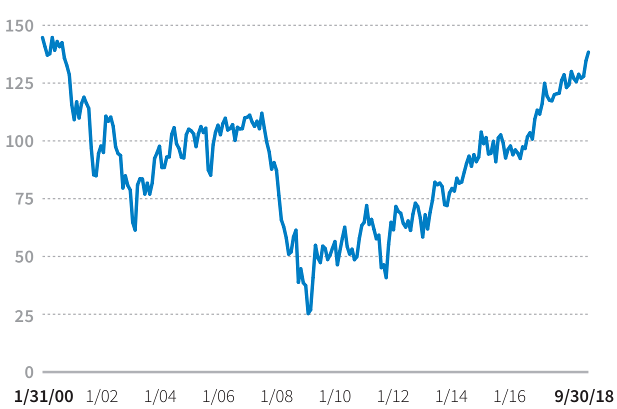
The question for investors is whether this strength is sustainable, and we believe there are reasons for both optimism and caution. Our caution is most applicable to retail stocks, where valuations may be stretched. We believe many recent performance drivers for retail stocks are temporary. Tax reform, for example, boosted income for many individuals in the form of one-time bonuses. Comparable store sales benefited from extremely cooperative weather after difficult weather in the prior quarter. Also, the U.S.–China trade dispute could cause headwinds given the likelihood that tariffs will result in higher prices that would discourage consumers.

On the other hand, some longer-term trends could extend outperformance in the U.S. consumer sector. Tax reform benefits for corporations may take longer to play out, as businesses plan to reinvest tax savings to support long-term growth — in the form of new facilities, equipment, or expanded workforces, for example. Also, the trade conflict could be supportive for businesses as price inflation can improve profitability. Housing wealth should continue to benefit stocks in several industries. While interest rates may be rising for home buyers, they are doing so from historically low levels.

What is fueling U.S. consumer stocks?

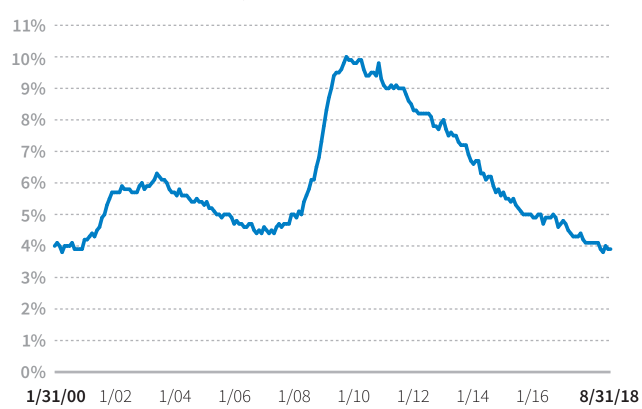
Declining unemployment and rising confidence

Consumer Confidence Index



Source: The Conference Board

U.S. national unemployment rate



Source: U.S. Bureau of Labor Statistics

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

Sam Cox
Co-Director of Equity Research
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 Simon Davis; Shep Perkins, CFA; Megan M. Craigen; and Walter D. Scully, CPA, as of September 30, 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

A world of investing.®

For use with institutional investors and investment professionals.

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

TL003_IN 313907 10/18