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Q1 2018 | Equity Outlook

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World markets enjoy rising GDP but face distinct issues

The reduction in the U.S. corporate tax rate will clearly provide a boost to profitability, but there are many more ancillary benefits for businesses worldwide.

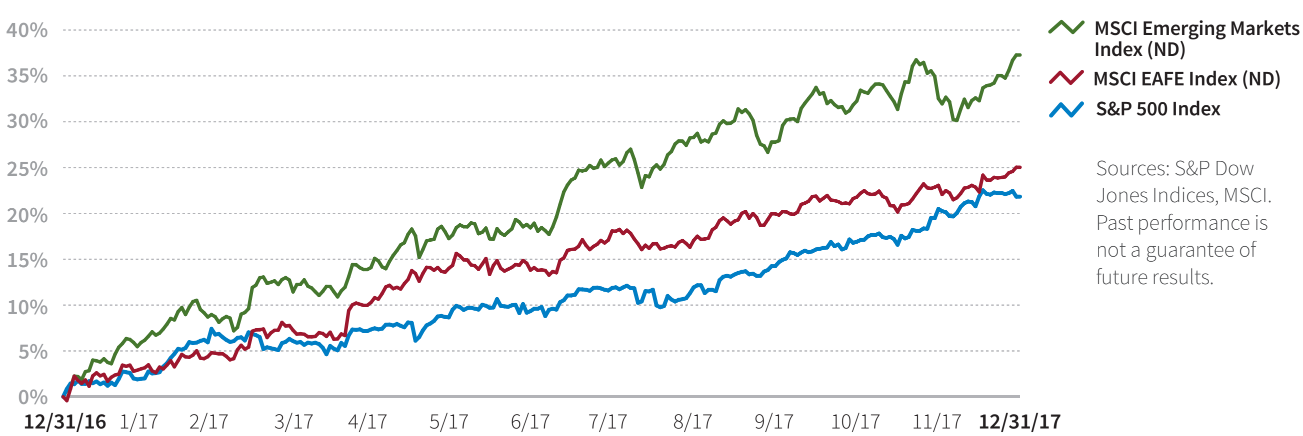
Japan and China offer a complex mix of opportunity and headwinds for equity investors.

As passive assets represent an increasingly larger portion of the equity market, investors should consider them as a potential risk.

When a 21% annual gain for the S&P 500 is among the lowest of major global indexes, it is a remarkable year for equity investors. Throughout 2017, investors in most markets worldwide shrugged off geopolitical and macroeconomic risks, embraced equities, and drove markets considerably higher. Most notable was the performance of emerging-market stocks, which continued to rally throughout the fourth quarter and ended the year with a 37% gain, as measured by the MSCI EM Index. Healthy corporate earnings growth and few signs of recessionary trends in most economies worldwide should allow equities to maintain their strength. However, this type of outperformance raises many questions as we begin 2018. How long can these rallies last, are valuations too stretched, what risks remain, and where are the opportunities in the year ahead?

Emerging markets were 2017 leaders by a wide margin

Total return performance, 12/31/16–12/31/17



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

An already bullish outlook boosted by tax reform

Daniel Schiff
Portfolio Manager
Global Industrials

While we are not blind to the risks in today's equity market, we remain constructive — for reasons that extend far beyond the Tax Cuts and Jobs Act. Although we have not seen a significant market pullback since February 2016, we see many trends that are encouraging for global economic growth, and ultimately, equity performance — for the industrials sector in particular.

A virtuous cycle of spending on the horizon

The reduction in the corporate tax rate will clearly provide a boost to profitability, but there are many more ancillary benefits. For example, I'm not sure investors have considered the cleaner balance sheets we're likely to see in two to three years. Healthier cash flows and improved credit profiles will likely drive a virtuous cycle of increased spending, leading to higher revenues and an acceleration of growth. This would occur on the heels of an eight-year recovery in which earnings growth was derived primarily from cost cutting, share buybacks, and mergers and acquisitions, rather than from organic growth.

The benefits of U.S. tax reform span the globe

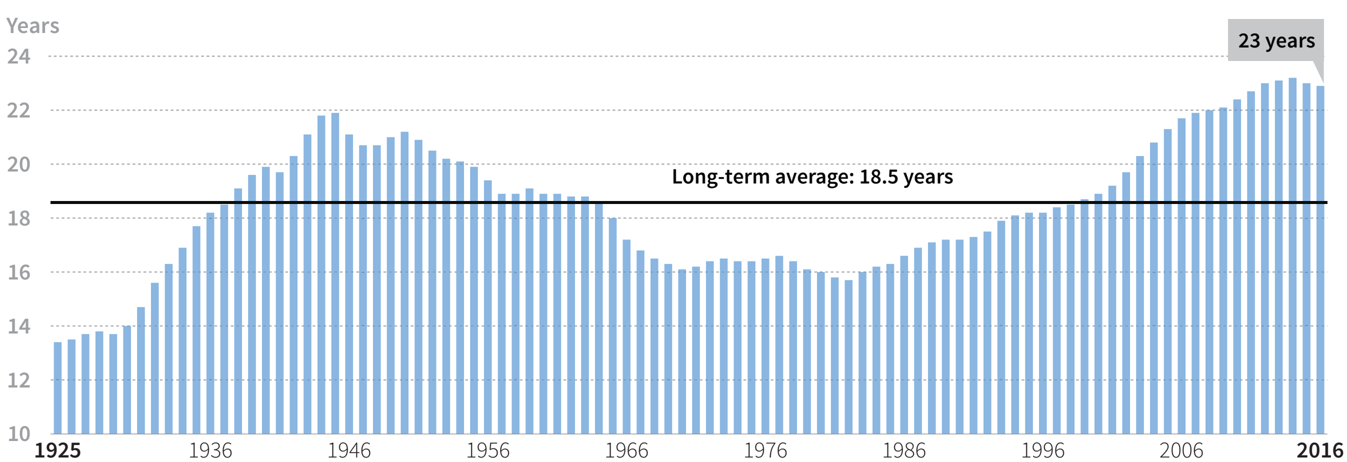
We believe many investors view the Tax Cuts and Jobs Act as a U.S.-centric stimulus, losing sight of our highly interdependent global economic system. U.S. corporate tax reform could be highly stimulative — not just domestically, but for the global economy as a whole. It is likely to benefit overseas suppliers to U.S. businesses — say, a Japanese company selling automation equipment to a U.S. manufacturer that suddenly has more cash to upgrade aged equipment. And the benefits extend beyond "old economy" capital expenditures. We should also see meaningful increases in operational expenditures for service companies by way of greater commitments to research and development, technology, and marketing.

Investment spending poised to accelerate

For the past 15 years, U.S. industrial companies have woefully underinvested in capital equipment. Spending has started to recover as businesses update physical plants with new technologies. However, investment spending as a percentage of GDP remains historically low. Capital spending as a percentage of sales is at its lowest point since the 1980s. And the average age of U.S. manufacturing facilities is well above the long-term average. Businesses recognize the need to shift their focus to internal investment to drive organic growth, reinforcing the notion that we are emerging from a two-year "industrial recession." This potential uptick in spending is likely to be accelerated further by tax reform.

Manufacturing facilities need updating

Average age of U.S. manufacturing facilities exceeds long-term average



Source: Bureau of Economic Analysis, as of 12/31/16.

Japan: Progress and problems

Jeffrey B. Sacknowitz, CFA
Portfolio Manager
International Growth

Japan is a study in contrasts. In the near term, I see improving business profitability, increasing attempts at innovation, and many compelling investment choices. Over the longer term, however, my outlook for Japanese equities is considerably less optimistic — clouded by looming macroeconomic difficulties.

> “We are witnessing the growth of a new generation of business leaders and company managers.”

Debt grows while population shrinks

Let's discuss the cautionary tale first. Over the longer term, the combination of Japan's high debt level, aging population, and rapidly shrinking workforce gives me cause for serious concern. Japan's national debt has risen steadily and sharply for 25 years, with today's debt-to-GDP ratio in the range of 250%. Even in an economy with a growing population, this debt level would represent a massive burden. With the added strains of Japan's increasing elderly population and fewer workers to support the retirees and the debt, that burden becomes unsustainable, in my view.

Since almost all of Japan's debt is held internally, the problem has been allowed to endure and worsen over time. This differs from a more traditional "external debt crisis," which tends to come to a more ugly, but rapid conclusion. The "internal" nature of the debt burden also makes it much more difficult to predict when this will likely become a crisis for the Japanese economy, what might trigger it, and the extent of the damage it could cause for financial markets. From our perspective as investment managers, we are constantly on alert, actively managing and positioning our portfolios to focus on companies that would be less vulnerable to this potential debt debacle. Given signs of an improving economy, combined with ultra-low interest rates, we believe the immediate risks of a crisis are low.

Dynamic and profitable: A healthy shift for Japanese businesses

While the long-term macroeconomic risks are top-of-mind, we also see many opportunities in a business environment that is evolving in positive ways. For many decades, Japanese companies have been poorly managed. They were unwilling or unable to innovate, to shed unprofitable businesses that were no longer strategic, or to disrupt their conservative, conglomerate-style business models. The result has been extremely low returns on investment in Japan. However, since Prime Minister Shinzo Abe took office in December 2012, the Japanese government has taken a series of steps to encourage businesses to focus more on profit generation and balance sheet management, and to remove at least some of the negative stigma associated with companies shedding underperforming business lines.

While the changes have been slow to take hold, we are starting to see signs that some companies are improving their profitability and capital efficiency. Their returns on equity are rising rapidly as they shed bad assets and cut costs. We are also witnessing the growth of a new generation of business leaders and company managers who came of age during the economic "lost quarter-century" in Japan. Many of these new leaders are professionally trained in management and tend to be more dynamic and more willing to make difficult business decisions.

With this, we are seeing rapidly rising profits for many Japanese businesses, which has led to significantly better overall returns on equity and returns on investment, albeit still at lower levels than other advanced countries. As these more efficiently managed companies begin to use their healthier cash flows and growing profits to generate better returns for shareholders, it should lead to more attractive investment opportunities for us.

The shift to passive strategies presents risks for all investors

David L. Diamond, CFA
Portfolio Manager
U.S. Small Cap Value

Since the early 2000s, equity investors have seen a variety of structural changes in market dynamics. Among the most dramatic has been an increase in passive strategies — a trend that I believe presents risks that many investors may not fully appreciate or understand.

Across equity markets, the percentage of passive investments — ETFs and other portfolios that are not actively managed but simply track an index — has risen dramatically. As this passive money pours into stocks, it creates a disruption in the traditional flow and balance of equity market activity. In my view, the downside of this disruption could become painfully clear with the next significant market correction.

The risk of a selloff that's blind to fundamentals

For quite some time, we have had a one-dimensional market. Stocks have been performing well with historically low volatility, and we are in the midst of the second-longest U.S. bull market in history. At the same time, passive assets represent an increasingly larger portion of the market. This is capital that is essentially blind to fundamentals. These assets don't move based on research and judgements about earnings growth, balance sheets, or valuations. Much of today's equity flows are based on quantitative models or computer-driven trading, with price momentum as a primary driver of outperformance.

Historically, when equity markets experienced a correction, active managers conducting rigorous research would seize on buying opportunities based on fundamentals. This helped create a balance that may be missing in today's market. With a much smaller pool of "active" money — fewer active managers to buy in a selloff — an equity market correction could be considerably more severe, particularly for small- and mid-cap stocks, which tend to be less liquid. And if the downturn is too sharp, even active managers may dismiss some buying opportunities in an attempt to mitigate further risk. Small- and mid-cap stocks with the highest proportion of passive ownership could be hit the hardest in a downturn as investors make indiscriminate reductions in ETF and index holdings.

Managing risk through shifting market dynamics

Like most risks, it is impossible to predict how harshly passive strategies might impact the equity markets. But it is a risk we are constantly monitoring and assessing, working with quantitative analysts and data scientists to understand the impact of passive exposure and to develop strategies for managing it as part of our portfolio construction process. We have screens that rank stocks by passive exposure across our investment universe. Like balance sheet metrics and other fundamental screens, this is another important data point we consider.

Market scorecard

Select equity index performance as of 12/31/17

Index name	Q4 2017 (cumulative)	1 year	3 years (annualized)	5 years (annualized)	10 years (annualized)
Russell 1000 Growth Index	7.86%	30.21%	13.79%	17.33%	10.00%
MSCI EM Index (ND)	7.44	37.28	9.10	4.35	1.68
S&P 500 Index	6.64	21.83	11.41	15.79	8.50
MSCI World Index (ND)	5.51	22.40	9.26	11.64	5.03
Russell 1000 Value Index	5.33	13.66	8.65	14.04	7.10
MSCI EAFE Index (ND)	4.23	25.03	7.80	7.90	1.94
Russell 2000 Index	3.34	14.65	9.96	14.12	8.71
MSCI Europe Index (ND)	2.21	25.51	6.69	7.37	1.34

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. See page 6 for index definitions.

Can China avoid a hard landing?

Daniel J. Graña, CFA
Portfolio Manager
Emerging-Market and Asian ex-Japan Equities

President Xi Jinping secured his second term in office at the culmination of the 19th Congress of the Communist Party in October. The Congress ended with the Politburo Standing Committee, the Party's decision-making body, having no obvious successor to Xi. This points to the possibility that Xi may hold on to power for a third five-year term in 2022.

Picking up the pace of reforms

Xi has emerged as China's most powerful ruler since Mao Zedong and Deng Xiaoping. He can pursue reforms that affect strong vested interests. For example, he has pledged to escalate economic and financial reforms, and we believe there will be an increased pace of change going forward. However, Xi is not a believer in unfettered free markets. China's one-party state will continue to pursue a government-directed path of economic development.

> "Tech stocks remain a bright spot among many investment choices in the Chinese equity markets."

Among the challenges facing the government will be the frothy property market, the seemingly ever-rising financial leverage of the economy, and the capital inefficient state-owned enterprises (SOEs). The SOEs are critical for Xi's vision of economic development, and policies that foster more efficient behemoths and less fragmented industries would benefit the economy.

Pivoting from growth-enhancing policies

We expect growth to decelerate in 2018 as China has pivoted from growth-enhancing policies to those that rein in credit expansion and encourage more environmentally friendly development that includes closures of polluting facilities. Over the long term, to avoid a hard landing, economic growth that is less dependent on credit is necessary.

The government has the incentives and policy tools to curb rising property prices and deal with debt risks to prevent an uncontrolled slowdown. The economy does not rely on foreign flows, the domestic savings rate is high, and credit underwriting standards that underpin the housing market do not concern us.

While the rapid buildup of financial leverage in the broader economy concerns us, debt is more sustainable in China because it is domestically funded. These factors reduce the risk of a sharp downturn in the economy. Should the government prove unwilling to accept the near-term pain of financial deleveraging, our concerns about the debt trajectory would rise.

The rise of the tech giants

Slower growth has not stopped investors from piling into Chinese technology companies, which have given Silicon Valley's top tech stocks a run for their money. China's tech boom is being fueled by the rapid growth of e-commerce, digital payment services, and innovations in financial technology. Millions of Chinese shoppers are using payment apps to make purchases using their smartphones instead of cash or bank cards.

Chinese tech companies are leading the way in financial technology to enable consumers to purchase investment products and secure consumer loans. The Chinese banking system is largely dominated by SOEs that are focused on corporate- and government-related lending. This facilitates the entry of Chinese tech companies into financial services for consumers.

We believe the growth of these Chinese tech stocks will last much longer than what has been priced in the markets. As a result, tech stocks remain a bright spot among many investment choices in the Chinese equity markets.

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 1999
Joined Putnam in 2011

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

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

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.

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