Q1 2021 | Equity Outlook

# A shot in the arm: The economy and stocks get a boost from vaccines

***In this issue***

*A springboard to 5,000*

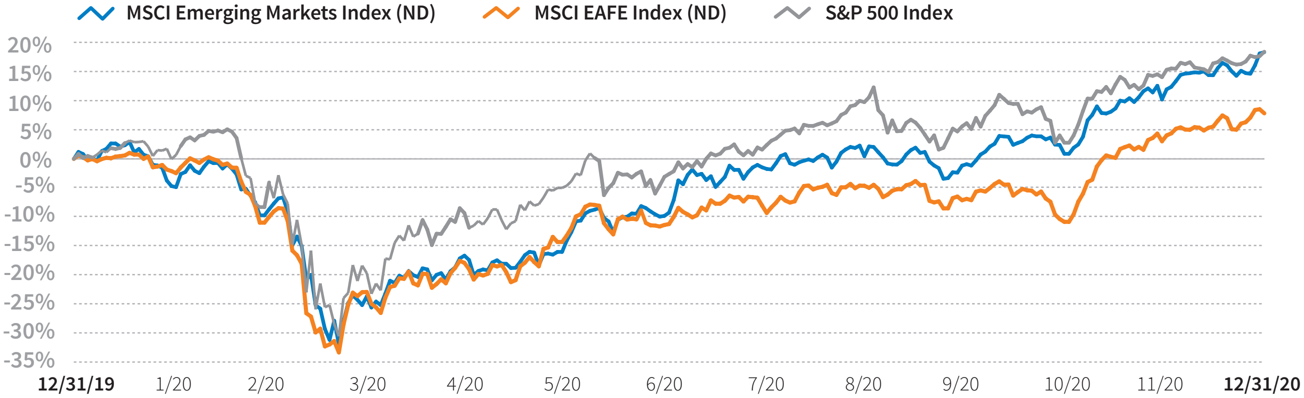
*A turn toward value*

Equity markets proved their resilience in dramatic fashion in 2020. We closed out a record-setting year for many equity indexes just as distribution began for two COVID-19 vaccines with impressive efficacy results. The potential for a post-pandemic recovery bodes well for equities, in our view. There will be limits to how fast the economy can rebound, which should prolong the recovery. Higher interest rates are a key potential headwind.

We explore the catalysts for continued market advances in the year ahead as well as the risks we're monitoring. Also, our value investing managers offer their views on whether 2021 is the year that value stocks finally take a durable lead over their growth counterparts.

## A remarkable year for global equity markets

Total return performance, 12/31/19–12/31/20




Sources: S&P Dow Jones Indices, MSCI

# A springboard to 5,000

**Shep Perkins, CFA**
Chief Investment Officer, Equities
Portfolio Manager of Putnam Global Equity Fund

A year ago, in my outlook for 2020, I suggested that "the path was paved to 5,000 on the S&P 500." A few months later, that idea was looking particularly far-fetched. However, after a brutal first quarter of 2020 and an economic contraction of astounding suddenness and magnitude, we've seen a remarkable rebound. Is the path still paved to that 5,000 milestone? I believe it is, and it may come sooner than I projected a year ago. In early 2020, equity markets hit a pothole — a giant economic pothole that caused hardship in so many ways. However, for many stocks it was also a springboard. On December 8, the S&P 500 Index closed above 3,700 for the first time in its history — one of its many record closes in 2020. For a number of reasons, I believe the S&P 500 is likely to eclipse 5,000 before the end of 2023.

### A historic November

Two significant events occurred in November 2020. First, in the midst of a pandemic, we concluded an extremely divisive U.S. presidential election. Second, we received news that multiple COVID-19 vaccine trials were showing impressive efficacy results. These events are complex and important on many levels. But perhaps most significant for financial markets is that they have removed uncertainty, which is often one of the biggest headwinds to equity performance.

Although Democrats technically control both the House and Senate, the chance of sweeping legislation is low. While we may see some corporate and personal tax increases, the magnitude is likely to be modest. And given the challenging economic conditions we currently face, this is unlikely to be the first order of business for the new administration and Congress. Instead, expect more targeted stimulus packages that focus on those hobbled by the pandemic as well as infrastructure-related investments.

The vaccine news, however, brings a much stronger gravitational pull to the market. With an end to the pandemic in sight, investors are anticipating a sustained and robust economic recovery over the next few years. This potentially benefits cyclically sensitive stocks in sectors such as industrials, financials, and consumer discretionary. Moreover, what's not widely contemplated is that buoyant economic conditions should also propel sales growth for many companies in the technology and communications sectors. Accelerating revenue growth often underpins higher stock prices. This backdrop — reduced political uncertainty combined with a post-pandemic recovery — could be a springboard that has the potential to unlock animal spirits and drive equities even higher. And this time it could be all equities, not just growth-oriented ones.

> "The vaccine news brings a much stronger gravitational pull to the market."

### Limitations may extend the rebound

There will be limits to how fast the economy can rebound in 2021 and into 2022, which could mean we'll see a prolonged recovery. This is also positive. For example, we are already seeing capacity constraints in shipping, trucking, and rails as freight volumes increase. In addition, after nine months of stalled capital expenditures, corporate boards will begin to allocate capital more ambitiously.

We are also likely to see increased merger-and-acquisition activity as companies that were hesitant to make large strategic moves in the midst of the pandemic will now revisit them. This includes private equity firms, which have upwards of $5 trillion to invest on the heels of record capital raises. Increased M&A activity can have a two-pronged effect: It lifts valuations across broad segments of the market and results in quicker valuation rebounds when stocks pull back as they're viewed as "targets."

### Stockpiles of cash and low-yielding bonds

Also supporting our bullish outlook is the record amount that is invested in cash proxies — a trend that was exacerbated by the COVID-19 pandemic. Market participants who are now holding super-low-yielding fixed-income investments may be looking to move those assets to equities as the economic outlook brightens. Investors have come to recognize that the bulk of the S&P 500 is made up of high-quality growing companies, which has made them resilient in times of economic turbulence, with 2020 being a textbook example.

While absolute equity valuations may be on the high side relative to history, in our view, stocks remain extremely cheap when compared with bonds. This was the case a year ago, and it became more pronounced in 2020, due to the sharp decline in 10-year Treasury yields. The S&P 500 dividend yield is 1.52%, well above that of long duration government bonds. And the spread between the S&P 500 earnings yield and the 10-year Treasury remains near all-time wide levels. Over time, this spread has been near zero as the growth in S&P 500 dividends offsets the volatility inherent in equities, whereas bond coupons are static and bond prices are less volatile. In fact, over the past 20 years, 10-year U.S. corporate bond returns have outpaced those of the S&P 500 Index.

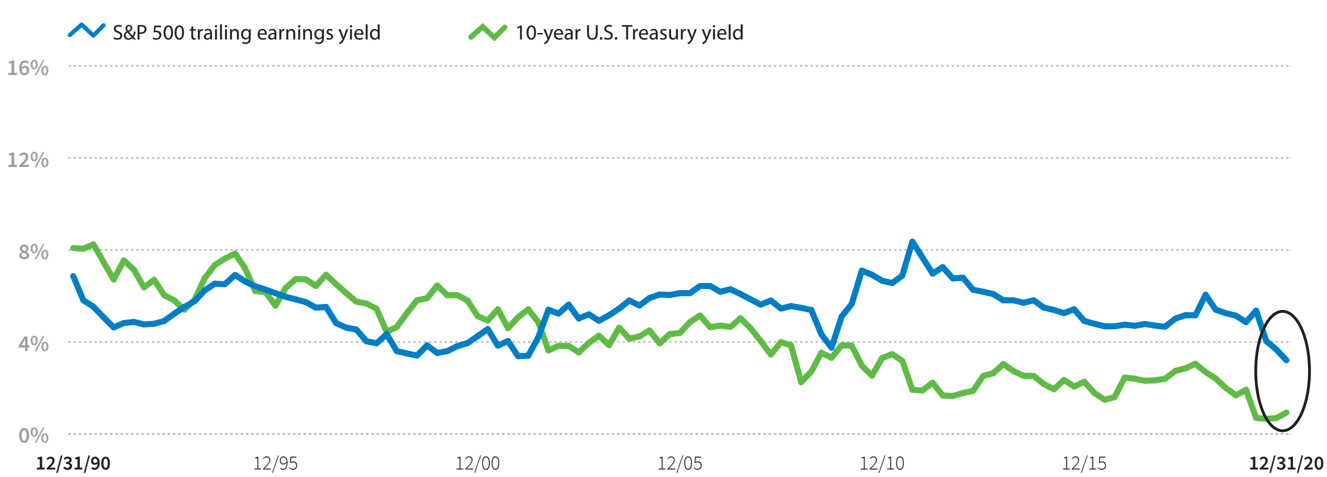
International and emerging-market equities also look attractive versus fixed-income investments. Globally, we're seeing $17 trillion in debt with negative yields as well as historically low yields on sovereign bonds in many developed and emerging markets. We believe that these extraordinarily low rates, now combined with a weakening U.S. dollar versus other currencies, are bullish for non-U.S. equities.

> “Extraordinarily low interest rates, now combined with a weakening U.S. dollar, are bullish for non-U.S. equities.”

### Capitalize on the volatility

The months ahead will also bring volatility to equity markets. As the economy rebounds, it could put upward pressure on prices, leading to inflation. Already, commodity prices are universally higher, and in many cases, sharply so. Also, in 2021, central banks are likely to move away from their hyper-accommodative monetary policies, and there will be very high government deficits that need to be financed. The key risk is that a sharp rebound in economic activity from COVID-19-depressed levels lifts interest rates from the ultra-low levels we've seen in 2020. However, I would argue that even if the yield on the 10-year Treasury doubles from current levels, stocks would continue to look attractive versus bonds. Rising rates will cause volatility in the equity market, but we view this as a buying opportunity as we don't think higher inflation will be sustained.

## Compared with bonds, stocks are historically cheap




Sources: S&P 500 Trailing Earnings Yield: S&P Dow Jones Indices. Data for 9/30/20 and 12/31/20 are estimates. 10-year U.S. Treasury yield: Federal Reserve.

# A turn toward value

**Darren A. Jaroch, CFA**
Portfolio Manager of Putnam Equity Income Fund and Putnam International Value Fund

**Lauren B. DeMore, CFA**
Assistant Portfolio Manager of Putnam Equity Income Fund and Putnam International Value Fund

**Darren:** While 2020 brought us many unpredictable events, we still had some familiar trends. For example, investors once again started asking, "Is it time for value stocks to take the lead?" It almost made 2020 feel like any other year. We began to see a rotation into value stocks late in the year. Value started outperforming growth in September, and in November, the Russell 1000 Value Index delivered its highest-ever monthly return, handily outperforming its Russell 1000 Growth Index counterpart.

The rotation took a dramatic turn on a single day — November 9 — when Pfizer announced impressive efficacy results for its COVID-19 vaccine trials. On that day, the S&P 500 Index's value stocks outperformed its growth stocks by the biggest margin in records going back to 1993, according to Dow Jones Market Data.

Value stocks tend to take the lead coming out of a recession. However, the 2020 recession — no surprise — was different from any we've seen. In April, when the equity market began to rebound after its steep sell-off, momentum growth stocks outperformed dramatically and continued to do so throughout the summer while value stocks lagged. The gap between the most expensive and least expensive stocks was stretched to some of its highest-ever levels. Now, as we look at this latest rally in value stocks, we are being asked whether it is durable. For a number of reasons, we believe it is.

**Lauren:** To understand why we believe the value rally has long-term potential, it helps to look at the value stock surge in November. News of an effective COVID-19 vaccine had a profound effect on investor sentiment. Suddenly, the idea of leaving our homes for shopping, dining, travel, and entertainment felt like a distinct possibility. While the pandemic has been a financial hardship for many, there are also many households that built up significant savings in 2020. As we enter 2021, we see considerable demand for leisure spending as well as more assets in savings accounts that are ready to be deployed.

Among the biggest headwinds for value stocks in 2020 were sharp declines in inflation expectations, interest rates, and bond yields. We expect a reversal of this in 2021. Inflation is likely to pick up as spending and demand resumes — both from consumers and from businesses that had held back on capital expenditures due to the pandemic.

### The case for financials
### Lauren DeMore

The financials sector, which was the epicenter of earnings uncertainty in 2020, is now fertile ground for a rally, in our view. This is the case for bank stocks especially, which underperformed the S&P 500 by about 35% in 2020. Going into 2021, banks should be able to outperform based on technical drivers alone — the potential for inflation and higher interest rates. Throughout 2020, historically low rates put pressure on net interest margins — the difference between interest earned and interest paid on loans and deposits. Also, banks took an unprecedented level of reserves against their loan books in anticipation of loans that could go bad over the next couple of years. In 2021, we'll get visibility on the adequacy of those reserves, which will provide a floor for earnings expectations. We believe this visibility will give investors more confidence in the return profiles of banks. Also, from a higher-level sentiment perspective, the broader market has been trading at all-time highs and looking past the damage of COVID-19 for broad segments of the economy. At some point, this optimistic view will need to extend to banks, especially as investors recognize how inexpensive these stocks are.

**Darren:** Key ingredients for a prolonged value rally are some inflation and modestly higher interest rates. While the 10-year Treasury yield is still a long way from where it was at the start of March 2020, a look at some non-U.S. markets provides perspective. China, for example, has largely returned to a more normal growth trajectory and has seen interest rates return to their pre-pandemic levels. We believe this is a preview of what we're likely to see in developed markets that are currently still grappling with the pandemic.

As for inflation, few investors are expecting it since it has been so low for so long. However, it's important to note the Federal Reserve's recent decision to employ "average inflation targeting." The fact that inflation has been so much lower than the 2% Fed target means the Fed will almost certainly allow inflation to run hotter for some time.

**Lauren:** Earnings trends are also key. In 2020, uncertainty about earnings potential and significant write-downs for companies across the value universe contributed to the underperformance of value stocks. In 2021, we believe the earnings backdrop will be much more favorable, and we don't expect meaningful downgrades to earnings expectations. Assuming the distribution of COVID-19 vaccines goes well and the pandemic's damage to the economy is not greater than expected, we have a solid setup for value stocks in 2021.

**Darren:** There will be debate over whether multiple waves of the COVID-19 pandemic will result in more permanent economic damage. So far, the market has looked fully past that, anticipating a return to normal in the second half or final quarter of 2021. We have the prospect of herd immunity, pent-up demand from consumers who are eager to go out and spend their savings, and the potential for more fiscal stimulus for those who are struggling. We also have the clarity that came with the U.S. election results, which indicate that massive legislative changes are unlikely. Over the past 10 years, we've seen many head fakes in the value market leadership story. Does the 2020 value rally have legs? We believe the prospects are good.

### Our view on airlines
### Darren Jaroch

Few industries have more leverage to a return to normal than travel. There is a pent-up demand for "experiences," and vacation planning is likely to be a priority for many consumers. We added to our position in **Southwest Airlines** a few times during 2020. Reasons for our conviction include:

- **Balance sheet is its savior.** Coming into the COVID-19 pandemic, Southwest was the strongest airline from a balance sheet perspective. The stock never underperformed as dramatically as network carriers like Delta Air Lines and United Airlines.

- **Ready to go on the offensive.** The network carriers all took federal government help and tapped all of their credit lines. While they work to de-lever their balance sheets, Southwest should be able to gain market share. Network carriers will need to eliminate routes and optimize their networks for a much different environment.

- **Less exposure to business travel.** While we can't have family vacations via Zoom, we can continue to conduct most business meetings without traveling. Southwest focuses on leisure travel, which we believe will recover much more quickly.

- **Better for tentative consumers.** Southwest is a low-cost U.S. carrier, which will be beneficial if U.S. consumers remain tentative about spending or traveling internationally in a post-COVID world.

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

**EQUITIES AT PUTNAM**

**Shep Perkins, CFA**
Chief Investment Officer, Equities
*Investing since 1993*
*Joined Putnam in 2011*

**Kate Lakin**
Director of Equity Research
*In the investment industry since 2008*
*Joined Putnam in 2012*

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Fundamental research has always been an important driver of security selection for Putnam. Our firm is built with the scale to research global markets while also allowing analysts to achieve thorough conviction in their recommendations. Our research organization thrives in an entrepreneurial and collaborative environment, where out-of-the-box critical thinking is encouraged, and analysts are focused on developing differentiated insights.

**S&P 500 Index** is an unmanaged index of common stock performance. You cannot directly invest in an index.

**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.

You cannot directly invest in an index.

As of 9/30/20, Southwest Airlines represented 1.13% of Putnam Equity Income Fund assets and was not held in Putnam International Value Fund.

The views and opinions expressed are those of the authors: Shep Perkins, CFA; Lauren B. DeMore, CFA; and Darren A. Jaroch, CFA as of December 31, 2020, are subject to change with market conditions, and are not meant as investment advice.

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