Equity markets continued to rally and reach new highs in the closing months of 2019. This was despite many developments that could have sent investors fleeing from stocks. The year also saw its share of volatility, and many issues for investors remain unresolved. What’s in store for equities in 2020? We consider a number of factors that could drive stocks higher.

We explore the prospect — and likely timing — of a 5,000 milestone for the S&P 500 Index. Members of our Sustainable Investing Team discuss businesses in the fashion industry that are innovating to address some environmentally unfriendly processes. And we take a look at whether corporate governance practices can continue to boost the performance of Japanese companies.

Are stocks too expensive? Valuations in line with average S&P 500 price/earnings, trailing 12 months

![Graph showing S&P 500 price/earnings, trailing 12 months with an average of 19.8x]

Source: Putnam research.
S&P at 5,000 may be closer than you think

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

Just after the midpoint of 2019, on July 10, the S&P 500 Index reached 3,000 for the first time. It has risen since then. As the market continues to reach new highs, fear among investors has also increased. Without a doubt, worries have been justified. Many people are concerned about China’s slowing economy and its impact on global economic growth. Also, nearly two years after the start of the U.S.–China trade conflict, we have yet to see a meaningful resolution and we are not likely to see one any time soon. The uncertainty surrounding this issue was the cause of much of the market’s volatility throughout 2019.

A look across global markets features a host of additional uncertainties, such as the seemingly endless challenges of Brexit, Italian debt, and anemic growth in Europe overall. Headlines have also focused on the implications of an inverted yield curve and the potential consequences of the 2020 U.S. presidential election. What has received much less attention are the factors that could drive equity markets meaningfully higher from here. These positive factors are also numerous, and they are why the S&P 500 Index has the potential to reach 5,000 in the next three to five years.

“In March 2009, the S&P 500 Index bottomed at 666. It would be quite impressive if 15 years later it reached 5,000.”

The case for a further climb: Valuation

Many market observers believe equities today are overly priced and therefore are not a risk worth taking given their limited upside potential. The reality is that price/earnings multiples are in line with their average in recent decades. From 1991 to 2007, with the exception of two months, the trailing P/E for the S&P 500 never dipped below 16x. Assuming fourth-quarter estimates are correct, the market is currently trading at 19x 2019 earnings. By these measures, the U.S. stock market valuation seems decidedly average, without much downside from multiple compression.

On the flipside, there is a reasonable case to be made that P/E multiples will expand from current levels. This could be fueled by historically low long-term bond yields. In fact,

Compared with bonds, stocks are historically cheap

Source: Putnam research.
for much of the second half of 2019, the dividend yield on the S&P 500 was higher than the 10-year U.S. Treasury yield. Also, the earnings yield of stocks has been higher than the 10-year bond yield since the turn of the century. The difference between them has been near an extreme recently, which makes equities arguably undervalued. When comparing stocks with bonds, stocks have almost never been cheaper.

What will drive the market now?
What might prevent multiple expansion? One issue is concern about economic growth and how a slowdown, or even a recession, might lead to downward earnings revisions. However, stock market valuations could move higher in an environment where some pressures are alleviated — a trade deal with China coupled with a slight acceleration in global growth, for example.

Not all segments of the market would necessarily see valuations expand. High-quality companies with durable profit streams and dividends have been strong performers and have benefited via multiple expansion from low interest rates. This “bond proxy” cohort is expensive versus history and the valuations would likely contract, with prices falling in the event that bond yields were to rise.

Obviously, growth stocks, and technology stocks in particular, have powered the market over the past five years. Yet, in our view, valuations for many of the large- and mega-cap technology stocks remain attractive. Examples include Facebook, Alphabet (Google), Cisco, Intel, and Apple, which have undemanding valuations and a combined market cap of more than $3 trillion. At the same time, a number of undervalued sectors, such as financials, energy, and basic materials, which together account for 20% of the S&P 500, are priced well below historical averages and could help drive equity market gains in the years ahead.

What happens if a recession hits?
Earnings growth is another element that could help power the S&P to that 5,000 milestone. As an example, if we saw annual earnings growth of 8.5% — which is below the 100-year long-term average — and the market’s multiple expanded slightly to just over 20x (20.3x), the S&P 500 would reach 5,000 in five years. What can fuel this type of earnings growth? A reacceleration of global growth and a weakening dollar could be tailwinds, while modestly rising interest rates could boost earnings in sectors such as financials and energy.

“Resilient earnings growth and multiple expansion could power the S&P to that 5,000 milestone.”

Combining resilient earnings growth and multiple expansion could get the market to 5,000 even faster. With earnings growth of 8.5% per year and a 26x P/E multiple, the market would surpass that mark inside of three years. This is hardly the base case, but it’s also not an extreme scenario in the event bond yields remain depressed.

What happens if we add a recession to the equation? It all depends on the timing. A recession late in our five-year time frame — say, in year four — might delay the 5,000 milestone. However, if a recession arrives in 2020 or 2021, we could still see a rebound and reach that 5,000 target within five years.

Due to the nature of equity performance, the road to 5,000 — a gain of almost 60% from recent levels — will certainly include periods of nervousness, downturns, rebounds, and rallies. But it is important to keep the long view in mind, especially to take advantage of periods of inevitable volatility.

S&P potential for 2024
Higher valuations and continued earnings growth could power the S&P 500 to 5,000 by 2024.

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Source: Putnam research.
Fashion industry tackles sustainability challenges

Stephanie Dobson
Assistant Portfolio Manager
of Putnam Sustainable Future and Sustainable Leaders funds

Shelby Centofanti
Equity Associate
Sustainable Investing Team

The youngest generations of consumers are faced with a sustainability conflict. They have embraced “fast fashion” — clothing that is trendy, extremely inexpensive due to low-quality material and low-wage labor, and designed to be thrown away relatively quickly. These same consumers also care deeply about the environment, and fast fashion has some inherent sustainability challenges. What is the solution to this disconnect?

If consumers hold tight to their fashion choices, then companies have an opportunity to change their approaches to produce fashion in more sustainable ways. Fortunately, many companies in the fashion industry are beginning to demonstrate deeper commitments to sustainability, due in large part to consumer demands. This includes the current fast-fashion leaders as well as innovative newer companies that are working to create a better system.

Creativity from fashion innovators

Consumers who are disposing of clothing at high rates may not realize that only 13% of clothing materials are ultimately recycled. To provide consumers with more environmentally friendly choices, many fashion businesses are demonstrating impressive creativity and innovation. Allbirds, a footwear maker, is one example. In addition to its use of sustainable materials for its shoes, the company is committed to going carbon neutral for its entire supply chain. Also, the company’s innovative packaging features 90% post-consumer recycled cardboard. For customer returns that can’t be resold, Allbirds donates the products to Soles4Souls, a charity that distributes them to people in need.

The pros and cons of clothing rentals: an emerging industry

Clothing rental platforms such as The RealReal, Rent the Runway, and Le Tote are disrupting the fashion industry. Their business models are based on recirculating high-quality designer clothing back into the consumer market. This provides consumers with access to the latest trends while also reducing consumption. This approach has sustainability benefits, but it also relies on some less sustainable processes that are often overlooked. One example is the cost of re-shipping and re-packaging clothes, and washing items after every use. Rent the Runway, for example, created the nation’s largest dry-cleaning facility to support its operations.

Traditional retailers step up

Start-ups are not the only businesses offering solutions. Traditional retailers Macy’s and J.C. Penney, for example, have introduced ThredUp departments in their stores. ThredUp is the largest online thrift store, selling high-quality secondhand clothing for up to 90% off retail prices. As of August 2019, ThredUp had redistributed 65 million garments.

Fast fashion: Why should we care?

- The fashion industry produces 10% of global carbon emissions and is the second largest consumer of the world’s water.
- Fast fashion has increased consumption. The average American bought 60% more clothing in 2014 than in 1991, and kept those garments half as long.
- Each year, 85% of textiles end up in landfills.
- Microplastics from synthetic clothing leach into the environment and eventually the ocean, contributing to pollution and impacting the food chain.
- The global apparel market is forecast to be worth $1.5 trillion by 2020.
Levi Strauss, another more traditional clothing retailer, has differentiated itself with a sustainable approach to apparel. The company has been a recognized leader in responsible supply chain practices for more than 25 years. It has done impressive work on product life-cycle assessments — calculating the resource use and impact of a single item of clothing over its entire life cycle. The company purposely designs products that are durable and built to last, a notable contrast to the fast-fashion approach. Levi Strauss also provides education to consumers on how to extend the life span of clothing. In all of its U.S. stores, the company collects denim from any brand, in any condition, to be recycled.

Stock stories: Leaders and innovators addressing the challenge

**Inditex**
- One of the world’s largest fashion retailers; eight brands, 7,000 stores in 96 markets
- Sustainability goal: By 2025, no longer send anything to landfills from its headquarters, logistics centers, stores, or factories
- Is investing in new technologies for more sustainable fashion products
- Makes it easy for customers to drop off their used Inditex garments for reuse or recycling

**Levi Strauss**
- A holding in Putnam Sustainable Leaders Fund
- Project FLX manufacturing process reduces time/costs and eliminates thousands of chemicals usually needed for denim finishing
- Goals by 2020: 100% sustainably sourced cotton; less water to produce 80%+ of Levi products
- By 2020, produce 80% of products in “worker well-being” factories, which support financial empowerment, health and family well-being, and equality and acceptance for apparel workers

**H&M**
- A multinational retailer known for its fast-fashion clothing. Operates in 62 countries with over 4,500 stores
- Aiming for 100% recycled or sustainably sourced materials over the next 10–20 years
- Launched the world’s largest retail garment collecting system in 2013
- Collected 20,649 tons of textiles for reuse or recycling in 2018; a 16% increase year over year; equal to 103 million T-shirts

**Patagonia**
- Goal is to be carbon neutral across entire business, including its supply chain, by 2025
- Aims to become carbon positive — taking more carbon out of the atmosphere than it puts in
- Goal of using only renewable or recycled materials in all products by 2025
- Its “Worn Wear” program encourages reuse, repair, and recycling to extend the life of products

As of 9/30/19, Levi Strauss represented 0.74% of Putnam Sustainable Leaders Fund assets and was not held in Putnam Sustainable Future Fund. H&M, Inditex, J.C. Penney, Le Tote, Macy’s, and The RealReal were not held in either fund.
Is shareholder-friendly Japan taking a step backward?

Vivek Gandhi, CFA
Portfolio Manager of Putnam International Equity Fund

In 2007, Steel Partners, a New York hedge fund, attempted a hostile takeover of Japanese condiment maker Bull-Dog Sauce. Steel Partners sought to repeal Bull-Dog’s poison pill scheme. It failed on legal grounds, but not on merits. In ruling against the takeover attempt, the Japanese lower court described Steel Partners as an “abusive acquirer” and a “vulture investor.” Forbes magazine said the ruling reflected “the prevailing distaste in corporate Japan for foreign invaders that threaten the long-cherished coziness of its management ranks.”

At the time, Japanese companies in aggregate suffered from poor returns on capital and low profit margins for a multitude of reasons. Among them was the fact that company managements were not held accountable for looking after shareholder interests.

Abenomics brings big changes

Fast forward to 2012, when Prime Minister Shinzo Abe came to power and made corporate governance reform a central part of his economic policy platform. Since then, Japanese stocks have outperformed most major non-U.S. markets. Improved profitability helped boost the stocks, and corporate governance took great strides forward. Managements became more accountable to shareholders, and share buybacks and dividends surged.

Among the key improvements were the creation of a Stewardship Code in February 2014, followed by a Corporate Governance Code later that year. Japanese investors today have significant powers. Beyond the codes, the government has announced additional measures to protect and promote minority shareholders’ interests.

Are Japan’s improvements sustainable?

Recently, however, doubts have emerged about the sustainability and direction of these shareholder-friendly measures. In late 2019, Japan’s parliament passed the Foreign Exchange and Foreign Trade Act (FEFTA). The law requires foreign investors buying national-security-related stocks to seek prior permission to buy shares after they have reached 1% ownership. FEFTA seems to have fallen prey to some industry lobbies and false claims that certain companies are related to national security. Many investors are concerned that FEFTA will reduce investor activism, which could reverse the tide of improving shareholder friendliness.

However, there are still many reasons to believe Japan will continue to move forward in support of shareholders. For one, registered domestic and foreign institutional investors will likely be exempted from FEFTA, so they can continue their dialogue with managements to improve governance.

The most important reason for optimism is that Japanese managements and boards have finally internalized the change. As a result of the Stewardship Code, they have witnessed the positive effects of improving governance. Many measures have become part of Japanese corporate psyche and will likely remain there.

With regard to Bull-Dog, it is anyone’s guess as to what would have happened if Steel Partners had been successful in its takeover. However, since then, Bull-Dog’s profits have mostly gone sideways, and in March 2019, they were lower than they were in 2005.

Japan has outperformed most major non-U.S. markets

![Graph showing Japan, United States, and Europe stock market performance from November 12, 2011, to November 19, 2019. Japan has consistently outperformed the United States and Europe over this period.](image-url)
An active, research-driven approach to investing in 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.

The power of independent research

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.

Top 10 holdings as of 9/30/19:

**Putnam Global Equity Fund:** NRG Energy (4.28%); Amazon (2.96%); Assured Guaranty (2.96%); Nomad Foods (2.71%); Unilever (2.53%); Asahi Group Holdings (2.25%); Cenovus Energy (2.15%); Microsoft (2.06%); Advance Auto Parts (2.03%); Compass Group (1.84%). Holdings represent 25.77% of the portfolio.

**Putnam Sustainable Leaders Fund:** Microsoft (6.77%); Apple (4.08%); Visa (3.80%); Amazon (3.36%); Unilever (3.21%); Adobe (2.90%); Alphabet (2.79%); Danaher (2.58%); Home Depot (2.58%); Bank of America (2.47%). Holdings represent 34.54% of the portfolio.

**Putnam Sustainable Future Fund:** Salesforce.com (4.01%); Danaher (3.76%); McCormick & Co. (3.42%); Mastercard (3.38%); Chipotle Mexican Grill (3.14%); Vail Resorts (3.02%); Unilever (2.92%); Adobe (2.54%); Novozymes (2.44%); BD Medical (2.43%). Holdings represent 31.06% of the portfolio.

Holdings will vary over time.

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

The views and opinions expressed are those of the authors: Shep Perkins, CFA; Stephanie Dobson; Shelby Centofanti; and Vivek Gandhi, CFA, as of November 30, 2019, are subject to change with market conditions, and are not meant as investment advice.
Consider these risks before investing: The value of investments in the fund’s portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political, or financial market conditions; investor sentiment and market perceptions; government actions; geopolitical events or changes; and factors related to a specific issuer, geography, industry, or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund’s portfolio holdings. Growth stocks may be more susceptible to earnings disappointments, and the market may not favor growth-style investing. Value stock may fail to rebound. Risks associated with derivatives include increased investment exposure (which may be considered leverage) and, in the case of over-the-counter instruments, the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. Investments in small and/or midsize companies increase the risk of greater price fluctuations. International investing involves currency, economic, and political risks. Emerging-market securities have illiquidity and volatility risks. The fund’s investment strategy of investing in companies that exhibit a commitment to sustainable business practices may result in the fund investing in securities or industry sectors that underperform the market as a whole or underperform other funds that do not invest with a sustainable focus. From time to time, the fund may invest a significant portion of its assets in companies in one or more related industries or sectors, which would make the fund more vulnerable to adverse developments affecting those industries or sectors. In evaluating an investment opportunity, we may make investment decisions based on information and data that is incomplete or inaccurate. Due to changes in the products or services of the companies in which the fund invests, the fund may temporarily hold securities that are inconsistent with its sustainable investment criteria. You can lose money by investing in the fund.