

Mid-year insights: Assessing the risks

In this issue

COVID-19 and investing: Prospects for a second wave

How are businesses faring?

Disruptive change drives small-company growth

We enter the second half of a remarkable year in the midst of a deep economic contraction. Equity markets, however, are demonstrating surprising resilience. Since their lows in March, major indexes have rallied despite dismal economic data, such as record-high levels of unemployment and plummeting consumer spending. While the equity rebound is encouraging, many investors are wary as numerous uncertainties and challenges remain.

We take a look at the potential for a second wave of the coronavirus and its impact on the markets, and we offer insights on how businesses are faring as COVID-19 restrictions are eased. We also discuss how small-cap companies may benefit from the unprecedented challenges of 2020.

Market rebound may have stamina

S&P 500 Index performance after monthly gains of 10% or more

In April 2020, the S&P 500 Index gained 12.7% in a robust rebound. After similar monthly gains in the history of the index, strong returns often continued over the longer term.

Month	S&P 500 Index monthly gain	Return for following 6 months	Return for following 12 months	Month	S&P 500 Index monthly gain	Return for following 6 months	Return for following 12 months
April 2020	12.7%	—	—	December 1991	11.2%	-2.1%	4.5%
October 1974	16.3	18.1%	20.5%	October 1982	11.0	23.0	22.3
January 1987	13.2	16.3	-6.2	October 2011	10.8	11.5	12.7
January 1975	12.3	15.3	31.0	August 1984	10.6	8.7	13.2
January 1976	11.8	2.6	1.2	November 1980	10.2	-5.6	-10.1
August 1982	11.6	23.9	37.3	November 1962	10.2	13.7	17.6

Source: LPL Research, FactSet

COVID-19 and investing: Prospects for a second wave



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

At the midpoint of an already momentous year for financial markets, investors are both encouraged by the rebound in equities and nervous about a potential “second wave” of the COVID-19 pandemic. There are still many unknowns, but one thing is certain — it will not be a surprise if we see a resurgence of COVID-19 cases later this year. The fact that investors are prepared, from a sentiment standpoint, is just one reason we believe that a second wave will not cause a meaningful pullback in equity markets.

“ The fact that investors are prepared is just one reason we believe that a second wave will not cause a meaningful pullback in equity markets. ”

The possible scenarios

Obviously, the most encouraging scenario — for public health and for financial markets — would be the absence of a second wave. It is worth noting that not all pandemics experience a second wave, by which we mean a resurgence that is as bad as or worse than the initial outbreak. One example is the 1968 influenza A (H3N2) pandemic, which caused an estimated 1 million deaths worldwide and about 100,000 deaths in the United States. This pandemic did not have a second wave, but rather experienced a slight uptick in cases in the form of a seasonal influenza. Today, the mean expectation appears to be that we will experience a second wave. Therefore, having no resurgence in cases could result in a market rally.

Another possibility is that we experience a second wave, but it is less severe than the first. For a number of reasons,

we believe a milder resurgence is more likely. We are better prepared from a medical, technological, and social standpoint. Our testing and tracing capabilities are vastly improved. We’ve advanced from 100 tests per day in early March to 600,000 per day and rising. Far more people are taking precautions such as mask wearing, frequent hand washing, and social distancing. We’ve seen advances in contact tracing technology to identify and warn people who have been in contact with an infected person. And it is likely that crowds will continue to be limited, with no large-scale gatherings such as sporting events or concerts.

Preparing for a worst-case resurgence

What if the second wave is worse than the first outbreak? In our view, this is less likely, but we also believe the markets will be able to withstand the shock. One reason is the willingness of the Federal Reserve and Congress to provide support in the form of massive stimulus measures. This is likely to continue if we are forced into another severe lockdown scenario. It also doesn’t hurt that this is a presidential election year, making politicians on both sides of the aisle more likely to advocate for further government stimulus measures.

Businesses are also better prepared in the event of a severe second wave. Companies are not only adapting to a COVID-19 environment, they are innovating in ways they hadn’t considered before the pandemic arrived. With the whole world focused on this challenge, we’re seeing ingenuity and creative solutions that should help many businesses generate healthy earnings and profits over the longer term.

“ Companies are not only adapting, they are innovating in ways they hadn’t considered before the pandemic arrived. ”

Markets have shrugged off second waves

Also important from an investing perspective is the fact that, historically, equity markets have tended to shrug off second waves of pandemics. Typically, bad news must be unexpected in order to severely impact markets. Investors

will not be surprised if COVID-19 cases spike again, and as a result, we may see indifference rather than a steep fall in equity prices.

Some investors have been tempted to compare this virus-related downturn to the global financial crisis of 2008/2009, which had massive ripple effects and called into question the foundation of the global financial system. Today, the financials sector, the epicenter of the earlier crisis, has been able to withstand the pressures. Today's crisis has had a greater impact on consumer and energy companies, resulting in a number of high-profile bankruptcies, such as Neiman Marcus, J.C. Penney, and Hertz. However, the market has been largely unfazed by them.

“ A worse-than-expected second wave could be dwarfed by positive news related to a vaccine or other new medications. ”

Innovation in virus studies

In addition to the progress we've already seen, there are a number of promising new developments for tracking and possibly combatting COVID-19. For example, municipal wastewater studies may offer an effective solution for containing the virus. This analysis can detect the genetic material of the virus in wastewater, providing “advanced notice” of regions or populations that might be prone to an outbreak. Also encouraging is a recent study that found virus-fighting T cells in people who have not been exposed to COVID-19, meaning they may already have immunity due to exposure to other coronaviruses.

For investors, a worse-than-expected second wave could be dwarfed by positive news related to a vaccine or other new medications that could lessen the impact of the virus. We expect more data from the biopharmaceutical industry over the summer months and into the fall.

1999: Eliminating the worst-case scenario

Looking back 20 years ago, we have an example of the equity markets' reaction when a worst-case-scenario does not materialize. As the year 2000 approached, programmers realized that computers might interpret 00 as 1900 rather than 2000. This led to widespread fears about damaged or malfunctioning computer systems.

The greatest concerns centered around system failures for airlines, nuclear power plants, and telecommunications. Markets were volatile, but rallied in late 1999 as investors became confident that the issues had been resolved.

- In 1999, the CBOE Volatility Index averaged between 20 and 30, similar to current levels.
- In the fourth quarter of 1999, the S&P 500 gained 15%, and it ended 1999 with an annual return of 21%.
- Following an uneventful January 1, equities had a massive rally for most of the 2000 first quarter, including a near-25% jump in the Nasdaq until the stock market peak in mid-March.

How are businesses faring?



Kate Lakin

Director of Equity Research
Portfolio Manager of Putnam Research Fund
and George Putnam Balanced Fund

Businesses enter the second half of 2020 with great uncertainty around the outlook for economic recovery and COVID-19. Analysts across our global equity research team are gaining insights from their ongoing discussions with company management teams, their stress-test analyses of earnings and balance sheets, and collaboration with our fixed-income colleagues.

Tapping the bond markets for liquidity

In periods of severe volatility and stress, businesses are faced with short-term liquidity risk and in some cases solvency risk. Many equity investors may not realize just how key a role the corporate bond market plays in determining how some businesses will manage the impact of the COVID-19 crisis. Working closely with our fixed-income colleagues, our equity analysts have spent a considerable amount of time conducting liquidity analyses. We have stress-tested earnings and balance sheets, projecting various cash flow scenarios over the next few years. For example, how long would an airline's cash supply last if travel remains down significantly for the remainder of 2020? And still down meaningfully throughout 2021?

“Some of the companies hardest hit by shutdowns have been able to access the debt markets for liquidity.”

Interestingly, some of the companies hardest hit by the pandemic-related shutdowns have been able to access the debt markets for liquidity. After the chaotic dislocation in March, we saw record primary issuance in the corporate asset class. Three notable companies that received funding are Boeing, concert promoter Live Nation, and Carnival

Cruise Line. Although they were at the epicenter of the crisis, the corporate market was willing to support them. We believe this is because of the market's view of the durability of these businesses over the longer term, despite the recent massive decline in revenues and earnings.

Of course, the debt market is also discerning, and not all companies will have access to liquidity. Those less likely to get funding are companies that were challenged even before the pandemic, such as a number of retailers and distressed hospitality providers. If the long-term viability of a business was a concern prior to February 2020, the credit markets are less likely to support it. As a result, we expect the pandemic to accelerate market consolidation, allowing the strong to take share and potentially exit in even stronger positions.

Shifts in manufacturing

Another trend we are watching is the potential for more manufacturing facilities to move to the United States. As the COVID-19 crisis resulted in equipment shortages and supply chain delays and disruptions, more businesses began to consider the benefits of moving manufacturing plants to the United States. This may not necessarily bring an abundance of new jobs, since so much of manufacturing is automated, and it would likely be limited to critical industries. However, a notable development was the announcement in May that Taiwan Semiconductor Manufacturing [TSMC], one of the world's largest producers of silicon chips, plans to build a manufacturing facility in Arizona, bringing 1,600 jobs. Di Yao, Portfolio Manager of Putnam Global Technology Fund, notes “It's quite a breakthrough to see a major Asian-based technology company make such a large investment in the United States after decades of moving in the opposite direction.” Di also believes TSMC will at least double its current U.S. manufacturing capacity over time.

Retail sector recovery: Sifting through the nuances

The retail sector has highlighted the benefits of our fundamental research in the current environment. Megan Craigen, our retail analyst, has had ongoing conversations with members of company management teams, and she understands the nuances and details of issues affecting the businesses. This is especially important as recovery prospects, plans for reopening, and consumer sentiment vary widely from state to state.

The retail sector has been a study in contrasts during the COVID-19 crisis. We have seen a considerable disparity between staples and discretionary. Staples retailers such as warehouse clubs, discount chains, and home improvement stores have done tremendously well. On the other hand, retailers selling non-essential products such as clothing have seen dramatic declines in revenues. For retail chains, suburban locations are generally faring better than urban locations, and demand for do-it-yourself products has surged. Also, beginning in March, as people felt the need to stock up in preparation for quarantines, demand surged for many essential items. We expected this trend would be short-lived, but demand continues to be strong on a year-over-year basis in areas such as packaged food and home and personal care.

Even as non-essential retailers have begun to reopen brick and mortar locations, concerns related to COVID-19 and the need for social distancing are likely to continue

throughout 2020. For this reason, we believe companies with strong online businesses and high penetration of online sales will be best positioned. In addition, the closures have caused considerable disruption across retail, which will result in a highly promotional environment as companies work through excess inventory. As the dust settles in 2021 and beyond, we believe the stronger players, such as The TJX Companies (owner of TJ Maxx and Marshalls), Burlington, and Target, will take considerable share as weaker retailers are forced to permanently close stores or cease to exist.

“As the dust settles in 2021 and beyond, we believe the stronger retail players will take considerable share.”

Coke and Pepsi: The impact of COVID-19 may differ

Deep fundamental research is key to understanding the implications of COVID-19 on businesses. As Josh Fillman, one of our consumer sector analysts, observes, even if two companies appear to be similar, the impact of the crisis may differ significantly.

Consider Coca-Cola and Pepsi. Only 50% of Coke's revenues are from at-home consumption, versus 80% for Pepsi. This was obviously an advantage for Pepsi during the height of the crisis. While both brands sell their products off-premise, each has almost no competition at a given stadium, restaurant, or theater. In the grocery aisle, however, they compete for market share against one another and other brands.

Even as we emerge from pandemic-related shutdowns, we expect different volume trends for the two companies. Capacity in dining

facilities will still be reduced, especially outside the United States, where drive-through options are less prevalent. We expect fewer consumers will dine out due to ongoing virus concerns and a desire to cut costs. We believe Pepsi will continue to benefit from higher levels of at-home consumption and a prolonged shift to at-home consumption of packaged foods, which make up 56% of Pepsi's earnings.

The companies are similar. The impact is different.

Revenue by destination	Coca-Cola	PepsiCo
At-home consumption	50%	80%
Off-premise consumption	40%	10%
On-the-go consumption	10%	10%

Disruptive change drives small-company growth



William J. Monroe, CFA
Portfolio Manager
Putnam Small Cap Growth Fund

While it is well-established that the COVID-19 pandemic is a global health crisis, we are just beginning to see evidence of the economic toll it is taking on businesses. For many small-cap U.S. companies, the near-term outlook remains highly uncertain. However, I am optimistic about prospects for the asset class over the longer term. Indeed, we have already seen signs of resilience, and in some cases recovery, since the market bottom and the height of the business shutdowns.

As investors, we believe the negative shock of the COVID-19 pandemic will reveal the strengths and weaknesses of many business models. At the same time, it should also accelerate the pace of disruptive change that many small companies help to promote.

Our three-step approach to managing through volatility

As the virus evolved from an emerging threat to a global crisis, we implemented a three-step approach to managing our small-cap growth portfolio. Steps one and two sought to mitigate downside risk for the portfolio, while the third step was aimed at finding growth opportunities. First, we analyzed the liquidity and debt levels of our holdings to determine which companies could weather this severe shock. Our investment approach going into the crisis was beneficial, as we were already focused on businesses with strong margins, strong returns, and cash-generating ability. We did not find many companies in our portfolio with debt levels that were high enough to hamper future growth prospects, in our view.

Detecting longer-term structural weakness

Our second step was to conduct deeper analysis to determine which companies might be structurally weaker in a year or two as a result of the pandemic. It is worth noting that far fewer companies declare bankruptcy than is commonly believed. However, future returns on capital and growth prospects can be diminished if

liquidity and debt levels force a company to cut costs too deeply. For example, if an airline cannot fly its planes, which were acquired through loans, the business faces serious challenges. Many stocks in the travel and leisure industries have been punished severely. However, in many cases, the long-term impact is not obvious. Will a regional casino operator, for example, be able to successfully conduct business with fewer patrons? If “yes,” then this presents a compelling opportunity. Our top priority is determining the answers to questions such as this as we manage our portfolio.

Seeking growth drivers

Step three in our process is finding companies that will be structurally stronger as a result of the pandemic. While the nature of every crisis is different, they do have one thing in common. Crises tend to accelerate the pace of change, often out of necessity. In our fundamental research, we always consider disruptive change, as it is often the force that enables small companies to compete against their larger peers. We are already finding that the Covid-19 pandemic has enhanced the growth potential of many small companies, and we are seeking to add them to our portfolio.

Small companies that may benefit from disruptive change

1Life Healthcare, Livongo Health, and Teledoc.

These companies specialize in remotely connecting patients and health-care professionals. We believe the adoption rate of telemedicine has advanced by several years as a result of the sudden COVID-19 lockdown and the need for social distancing.

Q2 Holdings and Chegg.

Changes brought on by the pandemic should also benefit businesses with cloud-based software offerings. One example is Q2 Holdings, which enables small and mid-sized financial institutions to offer mobile banking services. Chegg, a name most college students may recognize, provides online learning services. Previously offered as a supplement to in-person college learning, Chegg’s services have become more valuable as a result of pandemic quarantines.

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.

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

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.

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

You cannot directly invest in an index.

Top 10 holdings as of 3/31/20:

Putnam Small Cap Growth Fund: Cable One (3.80%); Everbridge (3.28%); Quidel (3.28%); Mercury Systems (3.00%); Hamilton Lane (2.66%); Novanta (2.61%); Amedisys (2.55%); Trex (2.53%); Palomar Holdings (2.26%); Kinsale Capital Group (2.02%). Holdings represented 27.99% of the portfolio.

Putnam Research Fund: Microsoft (5.96%); Amazon (4.21%); Alphabet (3.41%); Apple (3.31%); Activision Blizzard (2.42%); Procter & Gamble (2.20%); Fidelity National Information Services (2.09%); Home Depot (1.90%); Facebook (1.86%); Adobe (1.59%). Holdings represent 28.95% of the portfolio.

Putnam Global Equity Fund: NRG Energy (5.01%); Amazon (4.42%); Microsoft (4.03%); Nomad Foods (3.31%); Assured Guaranty (2.55%); Union Pacific (2.39%); ServiceNow (2.22%); Visa (2.20%); Nestle (2.19%); Walmart (2.12%). Holdings represented 30.44% of the portfolio.

George Putnam Balanced Fund: Microsoft; Amazon; U.S. Treasury 2.75 08/15/2042; Alphabet; Apple; U.S. Treasury 1.63 10/31/2023; U.S. Treasury 1.75 06/30/2022; U.S. Treasury 1.75 09/30/2022; U.S. Treasury 2.13 12/31/2022; U.S. Treasury 1.88 11/30/2021. Holdings represented 21.15% of the portfolio.

The views and opinions expressed are those of the authors: Shep Perkins, CFA; Kate Lakin; and William J. Monroe, CFA, as of May 31, 2020, are subject to change with market conditions, and are not meant as investment advice.

Visit putnam.com for continuing market updates, expert insights, and investment commentaries.

Find us



For informational purposes only. Not an investment recommendation.

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.

A world of investing.®



Investors should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing. For a prospectus, or a summary prospectus if available, containing this and other information for any Putnam fund or product, call your financial representative or call Putnam at 1-800-225-1581. Please read the prospectus carefully before investing.