Q1 2019 | Equity Outlook

The upside of the downturn

The key risks weighing on equity markets may subside in the coming months.

In the current equity market environment, one of our concerns is the potential for a policy error by central banks.

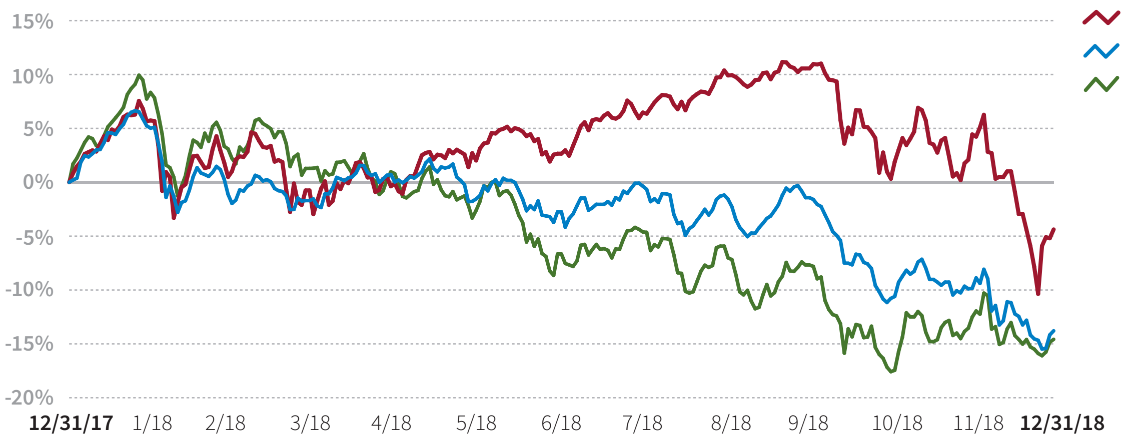
U.S.–China trade and a slowing Chinese economy are challenges to navigate, but they offer the potential for positive outcomes.

Equity investors worldwide greeted the new year with an array of heightened concerns. A difficult fourth quarter brought volatility and annual losses for many major indexes. Among the issues that contributed to the downturn were geopolitical instability, uncertainty about monetary policy, a slowing Chinese economy, and the U.S.–China trade dispute.

Looking ahead, we believe the key risks weighing on equity markets may subside. A resolution of the tariff conflict, even if limited in scope, is quite possible. In China, more aggressive stimulus measures could improve the outlook for both the Chinese economy and global markets. And in the wake of fourth-quarter selloffs, we have the benefit of more attractive valuations for companies whose fundamental prospects are strong.

A challenging year for global equity markets

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



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 begin 2019

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Risk: U.S–China trade conflict

SHEP: The ongoing U.S.–China trade dispute remains among the top concerns for equity investors, despite the "non-escalation" agreement in December that paused hikes in tariffs for 90 days. Higher tariffs undermine confidence among corporate leaders and complicate and delay investments in their businesses. Tariff hikes can also lead to inflationary pressure, reduce demand for products, and shrink profit margins.

Risk: China slowdown

SHEP: A slowing economy in China — which has been such a strong engine of global growth — is a key risk to equities. Growth in the world's second-largest economy has been slowing for several years, and it weakened further in 2018. This has consequences not only for China's trading partners in Asia, but also for the broader global economy. Demand from China has been a significant source of revenue for U.S. and European automobile, consumer, and technology companies, for example.

Opportunity: China stimulus and trade resolution

SHEP: There is a considerable amount of fear in the marketplace. Investor sentiment is about as low as we've seen it since 2011. If the China-related issues conclude in a reasonably positive manner, we could see a significant rebound for stocks across global markets. We believe that a favorable resolution of the tariff conflict is quite possible. Even if an agreement is only partial in scope, equity markets should respond positively.

SAM: In China, we're seeing signs of more aggressive stimulus measures, which could improve the economic outlook for both China and global markets. If trade negotiations proceed smoothly and lead to some type of resolution, even for the short term, this could prompt an equity market rebound. It would be particularly beneficial for fundamentally strong companies that have been punished in the recent market turmoil.

SHEP: It is also worth noting that President Trump views financial markets as a gauge of his success. Now that markets have sold off, he may consider easing up on the aggressiveness in the tariff dispute and may feel more pressure to find a resolution that could help ease investor anxiety.

> "A range of political issues in Europe could continue to dampen equity performance."

Risk: Political uncertainty in Europe

SAM: A range of political issues in Europe have pressured price/earnings multiples, and continued uncertainty in many regions could dampen equity performance. Worries over the budget situation in Italy eased somewhat when the Italian government and the European Commission reached a compromise. However, slow growth, combined with Italy's high debt-to-GDP ratio, is still a potential headwind. In France, the populist uprising and violence from "yellow vests" protesters could continue to be disruptive to the economy and equity markets. And, of course, Brexit remains unresolved, which could be destabilizing for the United Kingdom, with ripple effects throughout Europe.

Risk: Monetary policy and inflation

SAM: We are monitoring risks related to U.S. Federal Reserve policy and the potential for inflation. Some data show that U.S wage growth has been very strong, but there is uncertainty about its sustainability. Many economists believe that it is limited only to certain areas of the economy, and that wage growth in aggregate has not been as strong. One possible scenario is that inflation becomes more prevalent and widespread than expected. This could cause an inflation shock to the upside and force the Fed to tighten more aggressively. A policy error from central banks, such as becoming too aggressive with rate hikes, remains a risk in the current market environment.

SHEP: While we believe it is unlikely at this point, a meaningful pickup in reported inflation would be negative for equity markets. Tighter labor markets could push up inflation in the United States, Japan, and Europe, where central banks may determine that interest-rate hikes are necessary. We are less concerned about this risk, particularly as oil prices have declined, easing some inflationary pressure. Also, In the United States, we have seen that the Fed is willing to take a more dovish stance when interest-rate hikes are taking a toll on markets.

> “The Fed is willing to take a more dovish stance when interest-rate hikes are taking a toll on markets.”

Opportunity: The bright side of down markets

SAM: For many reasons, we can categorize the 2018 market selloff as an opportunity. Valuations are more attractive today. It is quite possible we will benefit from a Goldilocks scenario, in which U.S. economic growth continues at a controlled, healthy pace while the Fed avoids policy mishaps and gradually raises rates in line with growth.

Many market observers believe that the benefits of the stimulus from the Tax Cuts and Jobs Act will last longer than just one year. More importantly, structural tax reform, which reduces corporate tax rates, could be a game changer in terms of competitiveness. It could attract more investment back into the United States, boosting the U.S. economy, and ultimately strengthening global markets as well.

SHEP: All of the key concerns weighing on the equity markets at the close of 2018 have the potential for a positive outcome. And experienced investors recognize the advantages of a market downturn. Through several corrections and the worst of the fourth-quarter declines, many companies have continued to demonstrate fundamental strength and still offer solid long-term growth prospects. In particular, stock prices of many high-quality companies in cyclical sectors collapsed when worries about global growth intensified. We are sifting through the damage to identify those that we believe have been unfairly punished and adding to those positions if appropriate.

Opportunity: Compressed multiples and sectors to watch

SHEP: In the wake of the challenges we encountered last year, price/earnings multiples have compressed. A year ago, equities were more expensive, with valuations near the top of their typical range. Today, those valuations are lower, and many more are below average.

In the recent market pullback, defensive stocks outperformed by a significant margin. This included utilities, telecommunications, and consumer staples. The worst performers were economically sensitive sectors, such as energy, financials, and technology. Going forward, we believe a balanced portfolio of cyclical and defensive names is appropriate. Recently, we have favored energy pipeline companies and technology stocks, while trimming some positions in global industrials.

> “We are sifting through the damage to identify those stocks that we believe have been unfairly punished.”

Why tariff hikes are bad for equities

Shep Perkins, CFA
Co-Head of Equities

Although we believe that a favorable resolution of the U.S.–China trade conflict is possible, we continue to monitor it as a potential risk for equity investors. Rising tariffs can have a negative impact on equities for a multitude of reasons.

While the impact on U.S. and Chinese companies is obvious, the risk also affects businesses worldwide. As an example, European auto manufacturers are already feeling pain from higher import tariffs on cars produced in the United States.

Among the consequences of tariff hikes are disrupted supply chains. Supply chains have been globalized, so while end products may be made in the United States, sub-components are from all over the globe, with many coming from China and Mexico. Tariffs disrupt this supply chain.

Trade disputes undermine confidence among corporate leaders. The potential for significantly higher tariffs brings a level of uncertainty that can cause businesses to retreat from investing. For example, as a result of the conflict, businesses may focus on restructuring their supply chains rather than building new factories. This is particularly true when they are uncertain about where those factories should be located due to changing supply chains.

We have already seen the effects of tariffs on corporate earnings. For manufacturers, there are more potential losers than winners, as profit margins are vulnerable to cost increases. This is likely a contributing factor in the recent restructuring and layoff announcements from General Motors and Ford.

Globalization over the past 25 years helped to generally reduce costs, improve margins, and expand markets. Tariffs, on the other hand, are a form of de-globalization and have the opposite effects, namely they raise costs, squeeze profit margins, shrink markets, and lead to inflationary pressure. The impact of higher tariffs is similar to that of taxes. They make products more expensive, resulting in fewer purchases. They raise prices and reduce demand.

We're optimistic that key aspects of the current trade conflict will be resolved and that tariffs will be repealed or, at least, the pending new hikes will be rescinded. But in the event this does not play out and tariffs are ratcheted up and used more broadly, it would be punitive for equity markets.

Market scorecard

Select equity index performance as of 12/31/18

Index name	Q4 2018	1 year	3 years	5 years	10 years
MSCI EM Index (ND)	-7.46%	-14.57%	9.25%	1.65%	8.02%
Russell 1000 Value Index	-11.72	-8.27	6.95	5.95	11.18
MSCI EAFE Index (ND)	-12.54	-13.79	2.87	0.53	6.32
MSCI Europe Index (ND)	-12.72	-14.86	2.10	-0.61	6.15
MSCI World Index (ND)	-13.42	-8.71	6.30	4.56	9.67
S&P 500 Index	-13.52	-4.38	9.26	8.49	13.12
Russell 1000 Growth Index	-15.89	-1.51	11.15	10.40	15.29
Russell 2000 Index	-20.20	-11.01	7.36	4.41	11.97

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 7 for index definitions.

What's next for small caps?

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

Small-cap growth stocks took quite a hit in the fourth-quarter downturn, and investors may wonder if there is any good news for the asset class as we begin 2019. The Russell 2000 Growth Index — which had advanced by 15.7% by the close of September — plummeted 21.6% in the final quarter of 2018.

Small-cap stocks are still somewhat expensive by traditional price-earnings measures, but we believe there are many opportunities in the wake of the steep decline. Also, some of the basic characteristics of these stocks provide an advantage in the current economic environment.

Small-cap companies are often more domestically focused than large-cap companies. Therefore, they may have less exposure to international markets, which have experienced some of the sharpest recent slowdowns in economic activity. Also, these U.S.-focused companies continue to benefit from new, lower corporate tax rates. Finally, small domestic companies tend to be less exposed to the U.S.–China trade conflict and other geopolitical issues.

The technology sector offers attractive opportunities for growing small companies. The newer business model known as SaaS — software as a service — has enabled small businesses to compete with the larger, entrenched technology providers. We're invested in many small companies that have more advantaged technology than the old incumbents. Moreover, the recurring-revenue nature of their businesses models makes them much higher quality than a typical younger company. Despite the downturn, these companies remain in high-growth mode, and we believe they will continue to take market share of large-enterprise spending.

One example of a SaaS company in our portfolio is Everbridge. This company offers services to help businesses with critical event management. For example, it provides incident response technology, preparedness training, and alert systems for communicating during emergencies in real time with employees and community residents.

Macroeconomic conditions have been a consideration in some of our allocation decisions. For example, we slightly reduced our portfolio's exposure to the industrials sector. We may be entering a period of disrupted trade, in which small U.S. companies may have more difficulty landing contracts with large international businesses. Also, we are more cautious about industrial or materials companies with exposure to emerging markets.

> "The newer business model known as SaaS — software as a service — has enabled small businesses to compete with the larger, entrenched technology providers."

We also see advantages for small companies in the consumer discretionary sector. For example, almost all large-cap retailers have been struggling with the "Amazon effect" — the competitive threat from online retailers. In the small-cap space, we have identified a number of businesses that offer unique, niche products and services that are not typically offered by online retailers and may ward off the threat of competition.

One example in our portfolio is Five Below, a chain of roughly 650 stores that sells a range of products, all priced under $5. The company's merchandise is targeted to young teens and includes items that make the most sense as in-store purchases. Five Below delivered strong earnings growth in 2018, and we believe it can continue. The company's aggressive expansion strategy includes plans to triple its store count.

With the increase in interest rates, we have reduced positions in companies that have balance sheet leverage. We do not believe they would have issues in terms of paying their debt, but they might be limited in their ability to grow through M&A in a rising-rate environment.

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

Aaron M. Cooper, CFA
Chief Investment Officer, Equities
Investing since 2000
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

EQUITY RESEARCH

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, and we have recently taken steps to enhance our capabilities. We have made strategic additions while structuring research to analyze compelling long-term investment opportunities around the globe.

Our research team thrives in an entrepreneurial environment, opportunistically focused on developing differentiated insights. Our process encourages collaboration as well as out-of-the-box critical thinking. We balance tenure with sector rotation and new hires to sharpen analytical skills and encourage new ideas.

> “Putnam is built with the scale to research global markets while giving analysts the scope to dig deep enough to achieve real conviction in their recommendations.”

AARON COOPER

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; and William Monroe, CFA, as of December 31, 2018, are subject to change with market conditions, and are not meant as investment advice.

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