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Q3 2017 | Equity Outlook

Aaron M. Cooper, CFA
Chief Investment Officer, Equities

Simon Davis
Co-Head of Equities

Shep Perkins, CFA
Co-Head of Equities

Positive fundamentals may be tested by policy uncertainty

International markets may continue to attract investors in the second half of 2017, particularly in Europe, which lags the U.S. economic cycle.

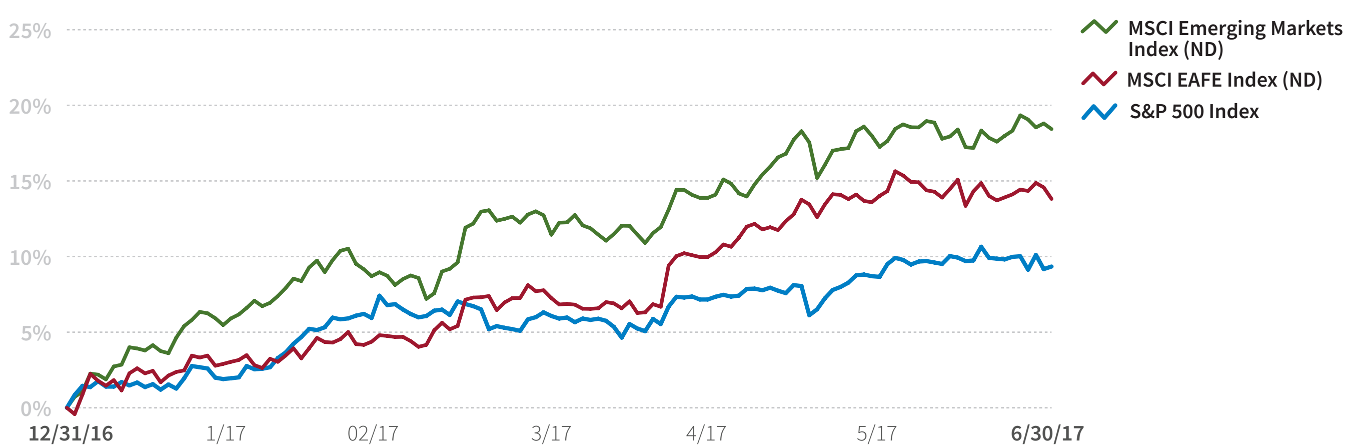
In the United States, a number of favorable trends remain in place and are likely to keep politics from derailing market momentum.

The latest twists and turns of Brexit have caused many to overlook stocks that we think are fundamentally strong.

For U.S. equity investors, the second quarter offered a number of familiar themes: relatively low volatility, new record highs for major indexes, and a modest advance for stocks. Along with these positive trends, however, came a decidedly lower level of optimism about progress from Washington in implementing pro-growth, business-friendly policies. Non-U.S. stocks across the developed and emerging markets outperformed their U.S. counterparts for much of the second quarter. Emerging-market stocks, in particular, continued to build on their momentum, as global interest rates remained low and the U.S. dollar's strength ebbed.

Emerging markets lead the way at the midpoint of 2017

Total return performance, 12/31/16–6/30/17



Market scorecard

Select equity index performance as of 6/30/17

U.S. value lags in a solid quarter for most equity markets

Index name	Q2 2017 (cumulative)	1 year	3 years (annualized)	5 years (annualized)	10 years (annualized)
MSCI Europe Index (ND)	7.37%	21.11%	-0.24%	8.82%	0.62%
MSCI EM Index (ND)	6.27	23.75	1.07	3.96	1.91
MSCI EAFE Index (ND)	6.12	20.27	1.15	8.69	1.03
Russell 1000 Growth Index	4.67	20.42	11.11	15.30	8.91
MSCI World Index (ND)	4.03	18.20	5.24	11.38	3.97
S&P 500 Index	3.09	17.90	9.61	14.63	7.18
Russell 2000 Index	2.46	24.60	7.36	13.70	6.92
Russell 1000 Value Index	1.34	15.53	7.36	13.94	5.57

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.

U.S. equities

During a quarter in which political turmoil was a dominant theme, investors in the U.S. equity market largely shrugged off headlines and media noise. Other than two brief downturns in mid-April and mid-May, equities advanced with relatively little volatility. However, increased focus on political controversy stalled pro-growth initiatives, and investors became considerably more skeptical about the administration's ability to make progress in areas such as deregulation, infrastructure spending, and corporate tax reform.

Slow and steady may be the best pace

Heightened uncertainty in Washington remains a key risk for equities as we enter the second half of 2017. In our view, however, a number of favorable trends remain in place and are likely to keep politics from derailing market momentum. Corporate earnings strength may be the most potent positive force. Investors have shown an impressive ability to look beyond headline distractions and focus on healthy fundamentals and the stronger-than-expected financial results we've seen from many U.S. businesses.

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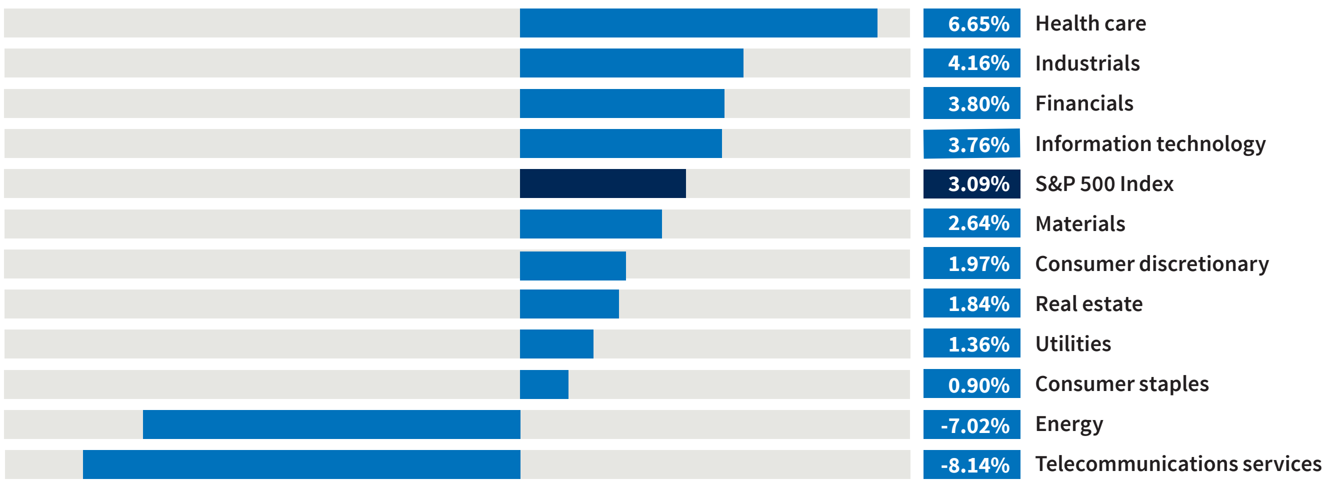
Corporate earnings performance has been moderately better than expected, with a return to growth, on a year-over-year basis, in the first quarter of 2017. Second-quarter growth is expected to be solid, and corporations continue to be reasonably conservative with their free cash flow. Also boosting prospects for earnings is the belief that corporate tax reform is one victory that could emerge from the Trump administration agenda.

Despite a backdrop of political drama, many areas of the economy have been quite uneventful — a scenario that we believe could continue to fuel the market in the months ahead. Along with a slow and steady advance for equities, we have seen moderate improvements in wage growth, employment, consumer confidence, and consumer spending. While moderate changes may not generate headlines, they tend to bode well for stock market performance and investor sentiment.

Another difficult quarter for energy and telecommunications

S&P 500 sector total returns for 3 months ended 6/30/17



Source: S&P Dow Jones Indices.

Sectors to watch in the wake of large-cap growth dominance

As prospects for growth stimulus dimmed in the second quarter, investors again began to focus on a narrow band of large-cap growth stocks, particularly in the technology sector. Other notable areas of growth outperformance have been the health-care and consumer discretionary sectors. Large-cap technology stocks, and the growth stock universe as a whole, have outperformed value stocks — especially in financials, energy, and consumer staples — by a considerable margin. Despite a still uncertain macroeconomic picture, we are focused on opportunities in value stocks, given their underperformance and more reasonable valuations relative to growth stocks.

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The financials sector is one area where we see potential for the remainder of 2017. The sector struggled a bit in the second quarter due to declining enthusiasm about legislative success in Washington as well as stubbornly low long-term interest rates. We believe, however, that continued tightening in the labor market and rising wages could lead to higher inflation and interest rates, which would be beneficial for businesses in the financials sector. Additional support could come in the form of progress on the deregulation front — an area of the Trump agenda that may not involve overly complex Congressional battles.

The risk of uncertainty: Fed's next steps, political distractions

Another calming influence on the equity market has been a deliberate, communicative, and fairly predictable Federal Reserve. However, we see potential risks for equities in the context of Fed policy. While its three interest-rate hikes since December were widely expected, much less certain is the effect on markets when the Fed begins the process of shrinking its balance sheet. Investors have become quite accustomed to the Fed's accommodation, and we are in unprecedented territory as the Fed works to reduce a balance sheet that has grown to more than $4 trillion — the result of its purchases of Treasuries and mortgage-backed securities to help stimulate economic growth.

Equity markets don't typically respond well to uncertainty, and at the mid-point of 2017, we have plenty to consider. In addition to the Fed's next steps, many wonder what's next for a presidential administration that is notorious for its unpredictability. It is likely that the market's resilience will continue to be tested by investigations and potential scandals, as well as global geopolitical concerns.

Non-U.S. equities

Looking forward to the second half of 2017, we think the disappointments of U.S. policy change will become increasingly less relevant to the markets. Although we anticipate the White House will attempt to resuscitate parts of its original policy agenda — such as tax reform and plans for large-scale infrastructure investment — we think it is unlikely that anything comprehensive will be accomplished quickly in the current political environment. Against this backdrop of stalled U.S. policy, we expect international markets will remain attractive for investors, both for their distance from U.S.-based uncertainties and for what we consider their compelling fundamentals and valuation profiles.

Also, where the markets have occasionally tripped up on non-U.S. uncertainties — as with the United Kingdom's volatile political transformation as it lurches toward Brexit — we find reason for optimism. Historically, the U.K. economy has managed political uncertainty fairly well, and the country has strong policy mechanisms to help stabilize its economy. In the short term, we expect political uncertainty may take a toll on U.K. domestic markets, but in the medium term, some of today's oversold U.K. companies, particularly U.K. multinationals, may emerge from the temporary crisis looking remarkably strong.

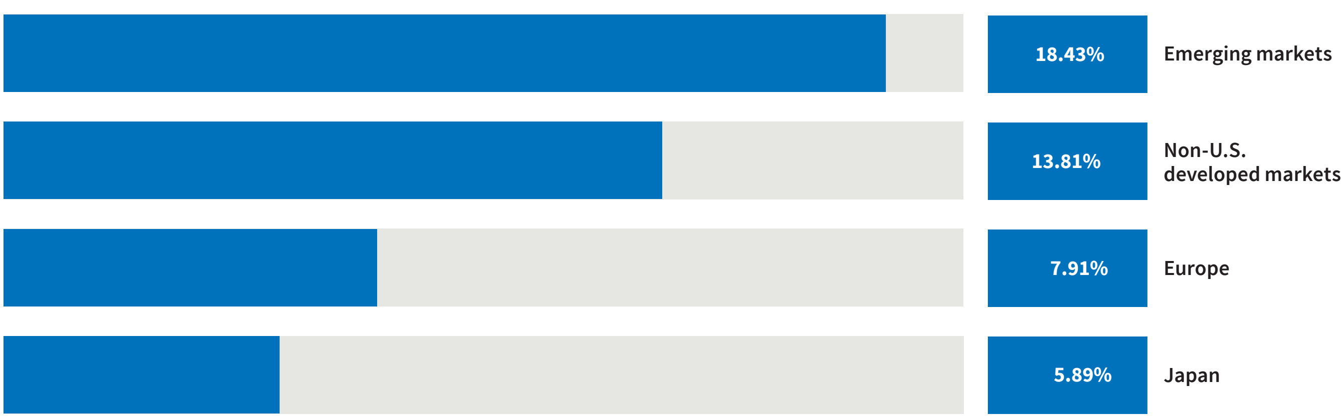
Europe slowly accelerates

In the first half of the second quarter, all eyes were on the unfolding political situation in France, where the general election promised to deliver either a stunning blow to EU institutions or a resounding victory for foundational EU principles. With far-right French presidential candidate Marine Le Pen vanquished by political centrist Emmanuel Macron, European markets have risen on the improved prospects for a more unified European Union and the promise of economic reforms in France.

Economically, the European Union has recently exhibited more signs of a slow but steady advance. Industrial production and employment indicators have risen, while inflation outside the United Kingdom has largely remained controlled. Meanwhile, assessments of economic activity in key markets such as Germany are brighter. All of these indicators feed into positive expectations for the European economy, funneling attention toward the earnings potential of EU-based businesses.

A solid first half for international equity markets

Total return performance, 12/31/16 – 6/30/17



Source: MSCI, as of 6/30/17. Index sources: MSCI Emerging Markets; MSCI EAFE; MSCI Europe; MSCI Japan.

With far-right French presidential candidate Marine Le Pen vanquished by political centrist Emmanuel Macron, European markets have risen on the improved prospects for a more unified European Union and the promise of economic reforms in France.

As France and much of Europe benefit from the macroeconomic bounce, we see relatively fertile ground for adding to select equity positions. In the United States, by contrast, we see more classic signs of late-cycle economic conditions: Consumer credit is slowing while delinquencies are rising; auto sales are depressed; the labor market is near full employment; and policymakers are tightening interest rates. In Europe, therefore, where we prefer to focus on stock-specific stories that exhibit promising catalysts for change, we think the lagging nature of Europe's cyclical recovery relative to the United States enhances the potential of European equities to perform well.

"Brexit means …" more political uncertainty

Whereas politics in France bolstered the case for investors to bulk up their non-U.S. stock exposures, politics in the United Kingdom have delivered a more volatile ride for investors. In yet another surprise political outcome in the United Kingdom, the U.K. general election in June resulted in a hung parliament, with no party winning the necessary majority to govern alone. Following this upset for Prime Minister Theresa May's Conservative Party, the pound sterling fell almost 2% against the U.S. dollar and domestically focused U.K. companies temporarily sold off.

Amid the political confusion, formal Brexit negotiations began on June 19. While it is difficult to forecast what will come next in this process, we think a "softer" approach to Brexit will probably be adopted by Prime Minister May. The election result has been viewed as a repudiation of her "hard" Brexit stance, and she has since struck a more conciliatory tone in her approach to Brexit negotiations.

As investors, we are particularly attuned to the positive earnings momentum that we see in a variety of U.K.-based multinationals. For those companies that have revenue exposure to the United States, for example, earnings converted back into pounds are now worth more. In addition, we think that the Bank of England is likely to keep interest rates low for the foreseeable future — unless inflation, which has been running high on the back of higher import costs, threatens to outpace expectations. Moreover, while business confidence has weakened, we believe a looser fiscal stance by the government — including a renewed commitment to social welfare programs, which garnered popular support for the U.K. Labour Party in the June election — is likely to bolster economic prospects.

Overall, if the May government continues to take a more pragmatic approach to Brexit, allowing U.K. companies to maintain their access to important export markets as well as to non-U.K. labor sources, this should be an important tailwind. Lastly, while short-term political fallout may cloud the perspective of many, we think the fundamental strength of a variety of U.K. businesses will not go unnoticed down the road.

Emerging markets soar

A steady drumbeat of political shocks across the emerging markets has done little to deter investors so far in 2017. The president of South Korea was forced from office. Turkey convulsed with a military coup attempt and subsequent consolidation of power. Economic crisis deepened in Venezuela, driven by both oil market weakness and political corruption. And in Brazil, Michel Temer, the VP-turned-president, appeared to become caught up in a corruption scandal. But as of the end of June, emerging-market stocks, as measured by the MSCI Emerging Market Index [ND], had risen by 18.43% year to date — outpacing virtually every other equity asset class.

We anticipate that the strength in non-commodity-exposed emerging markets — such as India, South Korea, Taiwan, and Argentina — may continue, if certain conditions remain in place. Generally speaking, the U.S. dollar's relative stasis can give some breathing room to emerging-market stocks, as can relatively low developed-market interest rates. Despite higher risks, we believe yield-seeking investors will continue to pour money into both the equity and debt markets of the world's emerging economies if the currency, interest-rate, and policy backdrops remain supportive.

China's perennial risks

Economic stability in China is the consensus expectation, at least until it passes through its next political transition during the 19th National Congress of the Communist Party of China this fall. The market's expectation of stability is based on Chinese policymaker's willingness to supply continued stimulus to the Chinese economy. But we expect volatility to be a rising risk in China and in those countries and markets that are tied to China's economic fortunes.

China poses key risks, but we anticipate these are unlikely to fully emerge until after China undergoes a political transition this fall.

Indeed, we are already seeing the precursors of this volatility emerge. For example, corporate borrowing and inter-bank interest rates have risen in China on the back of new concerns regarding borrowers' ability to pay their debts. For years, China's real estate bubble has continued to grow, and no sustained measures have been adopted to curb the excesses involved in this unbridled market advance. Now, further attempts are being made to control some of the underlying problems. But the quandary for Chinese policy, as we see it, is that any cooling driven by policy could be too much — that is, it could slow the economy more than anyone can anticipate. This carries the risk of either triggering the "hard" economic landing that market observers have formerly considered but in recent quarters have tended to forget, or resulting in a sharp policy reversal from a mode of modest tightening to a mode of aggressive easing.

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.

Aaron M. Cooper, CFA
Chief Investment Officer, Equities
Investing since 1999
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

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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 Japan Index (ND) is a free float-adjusted market capitalization index that is designed to measure equity market performance of the large- and mid-cap segments of the Japan market.

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.

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Putnam Investments | One Post Office Square | Boston, MA 02109 | putnam.com

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