Q4 2017 | Equity Outlook

What could extend the equity rally?

Valuation levels are not a reason to stay away from equities.

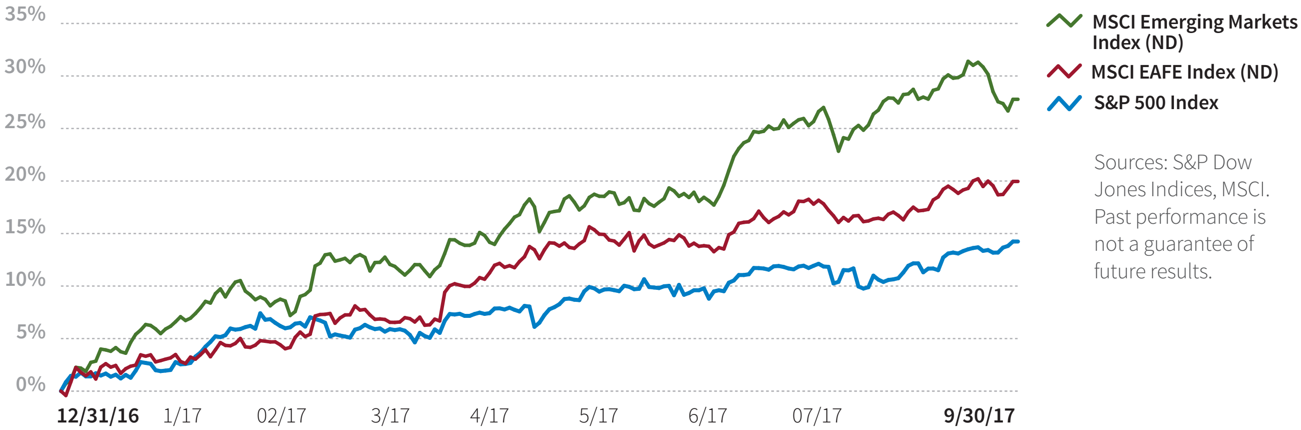
The most encouraging factor for equities today may be the impressive level of synchronized global economic improvement.

For emerging markets, a number of risks remain, which the market does not appear to be pricing into stocks.

In the face of uncertainties that might normally rattle stock markets, equities continued to deliver impressive performance in the third quarter. In the United States, despite a lack of pro-growth legislation, lofty valuations, and market leadership concentrated in a small cohort of growth stocks, U.S. equity indexes moved higher, setting multiple records. Even more unexpected was the performance of markets outside the United States, which were unfazed by distractions such as escalating geopolitical tensions, a contentious European electoral cycle, continued uncertainty over the implications of Brexit, and the risk of a more protectionist U.S. trade policy. International equities delivered solid gains, with the biggest rally coming from emerging markets stocks. The MSCI Emerging Markets Index in September reached its highest level in six years.

Emerging markets maintain their strength

Total return performance, 12/31/16–9/30/17



Sources: S&P Dow Jones Indices, MSCI. Past performance is not a guarantee of future results.

Putting valuations in perspective

Shep Perkins, CFA
Co-Head of Equities
Portfolio Manager of
Putnam Global Equity Fund

As we enter the final quarter of 2017, the narrative for global equity markets is focused heavily on valuation levels. A common belief is that multiples are too high, and that U.S. equities in particular are expensive relative to Europe. I would argue that current price multiples alone are not a reason to stay away from U.S. equities, nor are valuations alone a reason to own European equities.

How expensive are stocks?

Looking first at the United States, I would not describe the U.S. equity market as expensive. Based on the price-to-earnings [P/E] ratio for the S&P 500 Index, valuations are slightly above average. As long as U.S. consumer and business confidence don't plummet and corporate earnings don't contract, above-average multiples should remain with us for some time. This is especially true considering today's low bond yield environment. In fact, relative to fixed income, U.S. equities today are incredibly cheap and arguably undervalued.

A closer look at Europe

I also believe it's important to take a careful look at the "Europe-is-cheaper" view of many market observers. In our analysis of valuations in the U.S. and European markets, we find that more than half of the discrepancy in average P/E multiples can be attributed to differences in industry weightings. European equities appear cheaper, but the MSCI Europe Index generally has higher weightings in lower-multiple sectors such as energy and financials, while the S&P 500 Index has larger weightings in the higher-multiple technology sector.

In our analysis, we modeled MSCI Europe industry multiples, applying S&P 500 industry weights, and this brought valuations closer into alignment, narrowing the P/E spread by more than half. Additionally, Amazon, a high P/E (200+ times), mega-cap constituent in the consumer discretionary sector, has no equivalent in Europe. It alone accounts for another 10% of the difference in the valuation spread between the United States and Europe.

Excluding energy industry group weightings had a similar effect. Within the energy sector, there is a considerable valuation difference between European energy companies — which are typically large, integrated businesses — and the U.S. energy sector, which has some integrated companies, but also many more exploration and production companies, which tend to trade at high earnings multiples.

It's much more than multiples

Seeking broad exposure to Europe as a whole based on valuation levels is misguided, in my view. That's not to dismiss Europe with a broad brush; fundamental research can uncover many attractive opportunities among European equities today. The European Union has recently exhibited more signs of a slow but steady economic advance, and industrial production and employment indicators have risen. Assessments of economic activity in key markets such as Germany and France as well as peripheral Europe also have been brighter, which is likely to boost the earnings potential of EU-based businesses.

> "Relative to fixed income, U.S. equities today are incredibly cheap and arguably undervalued."

Global economies improving in sync

Robert M. Brookby
Portfolio Manager of Putnam Growth Opportunities Fund and Putnam Multi-Cap Growth Fund

In many ways, for equity investors, 2017 has defied expectations. U.S. economic growth, which most of us expected to accelerate, has been underwhelming. Inflation and interest rates were both expected to increase, but inflation has been stagnant and the 10-year Treasury yield is on track to end the year lower than where it began.

Cyclical stocks have underperformed significantly. There is geopolitical risk, disappointment in President Trump's legislative agenda, and discomfort with rising equity valuations. Yet global equity markets have moved steadily higher.

What can extend the advance?

It is natural to look toward 2018 and wonder how the market can advance further without catalysts such as an acceleration in GDP, progress with tax reform, or a sector rotation. Corporate profitability has been strong and could continue to drive equity performance. Wall Street's forecasts are for 10% earnings growth in 2018, and there has been constructive guidance from businesses.

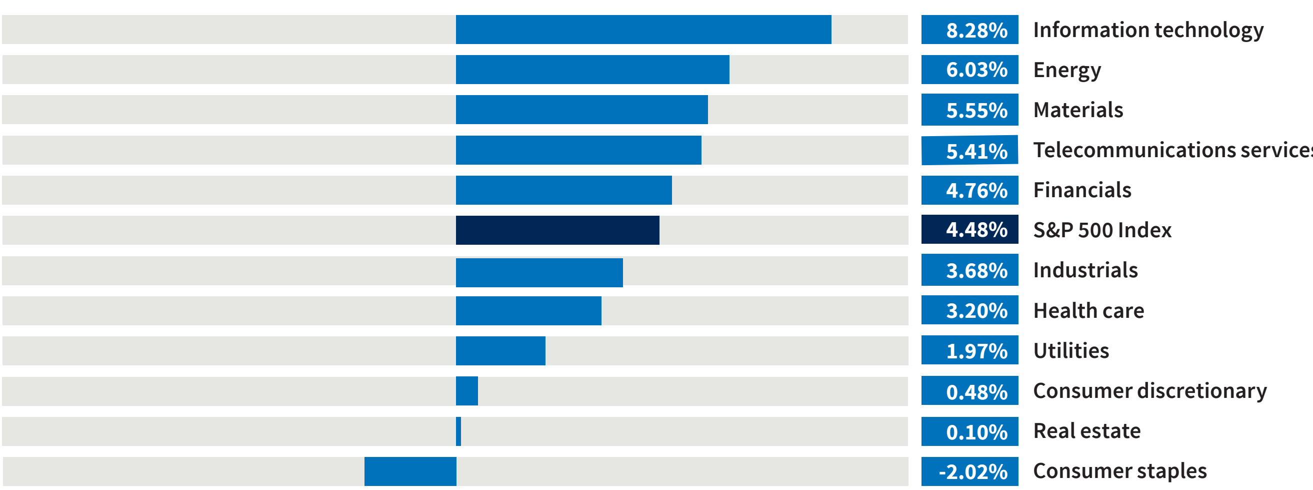
> "Positive data from most regions worldwide may be a catalyst for equities as we look to 2018."

Economies look better across the globe

Beyond earnings, the most encouraging factor for equities today may be the impressive level of synchronized global economic improvement. Regional equity markets often stumble as a result of serious economic woes elsewhere — recall the Eurozone debt problems of 2010 and 2012 or the China slowdown fears in 2016. Today, however, we have decent economic conditions in the United States, improvement in Europe, and impressive growth in China and many other emerging markets. Global economic variables are more in sync now than at almost any other time since the Great Recession. Positive economic data from most regions worldwide has been a key feature of 2017, and may serve as a catalyst for equities as we look to 2018.

Sector snapshot

S&P 500 sector total returns for 3 months ended 9/30/17



Source: S&P Dow Jones Indices. Past performance is not a guarantee of future results.

Looking ahead after growth trounces value

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

U.S. equities have exhibited a fairly dramatic momentum trend — what has worked just keeps working. Assets continue to flow into the stocks that have done well, in many cases with little regard for unsustainably high valuations. Although many of the top performers continue to offer strong fundamentals, I believe many are also priced for perfection and are likely due for a correction. In my view, this is a key risk factor for equities as we close out 2017.

Another surprising trend relates to the performance of growth versus value. Throughout 2017, the bulk of U.S. equity performance gains have been in growth stocks at the expense of value stocks. While it is not unusual for the styles to diverge, there has been a dramatic bifurcation this year. The highest P/E stocks continue to outperform the lowest P/E stocks — consistently and by a considerable margin.

Sectors to watch: Cyclicals

There may be more opportunities among value stocks today than we have seen since the global financial crisis — and not simply because they have underperformed. As we assess the macroeconomic and earnings environment, we find the most relative value in cyclical sectors. Cyclicality is quite inexpensive today, and this is where we will focus much of our research in the closing months of 2017. In areas such as energy and industrials, many fundamentally strong companies with exposure to key growth trends are trading at below-market multiples. However, the sector that stands out most is financials. Companies in the sector have struggled with persistently low interest rates, but with improving global macroeconomic trends, they are among the most attractively valued in my view.

> “Many stocks are priced for perfection in today’s market, which could be a key risk factor for equities as we close out 2017.”

Market scorecard

Select equity index performance as of 9/30/17

Emerging markets and Europe are third-quarter leaders

Index name	Q3 2017 (cumulative)	1 year	3 years (annualized)	5 years (annualized)	10 years (annualized)
MSCI EM Index (ND)	7.89%	22.46%	4.90%	3.99%	1.32%
MSCI Europe Index (ND)	6.45	22.30	4.36	8.36	1.08
Russell 1000 Growth Index	5.90	21.94	12.69	15.26	9.08
Russell 2000 Index	5.67	20.74	12.18	13.79	7.85
MSCI EAFE Index (ND)	5.40	19.10	5.04	8.38	1.34
MSCI World Index (ND)	4.84	18.17	7.69	10.99	4.22
S&P 500 Index	4.48	18.61	10.81	14.22	7.44
Russell 1000 Value Index	3.11	15.12	8.53	13.20	5.92

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.

What's next for emerging markets?

Daniel J. Graña, CFA
Portfolio Manager of Putnam Emerging Markets Equity Fund

In a year that has brought many unexpected outcomes for global equities, emerging market performance certainly stands out. As has been the case for most markets in 2017, investors chose to focus on positive factors, such as the potential for pro-growth U.S. fiscal plans, rather than risks to emerging markets, such as the possibility of a push for more protectionist trade measures from the Trump administration. The worst-case scenarios have not played out, and EM returns have been robust.

A more balanced outlook

I continue to find attractive opportunities at the individual stock level, but my macro outlook has become more balanced. I believe that investors are underappreciating some negative scenarios that could evolve for emerging markets. A number of risks remain, which the market does not appear to be pricing into stocks.

Potential headwinds: China and interest rates

The confirmation in September that the U.S. Federal Reserve will begin trimming its balance sheet increases the possibility of rising interest rates. This could be challenging for emerging markets, as they would be forced to pay higher interest rates on their dollar-denominated debt. Slower economic growth in China is another potential risk. For some time, we have seen economic stability in the country in advance of the leadership transition that will take place in October. As China withdraws stimulus, we are likely to see GDP growth soften.

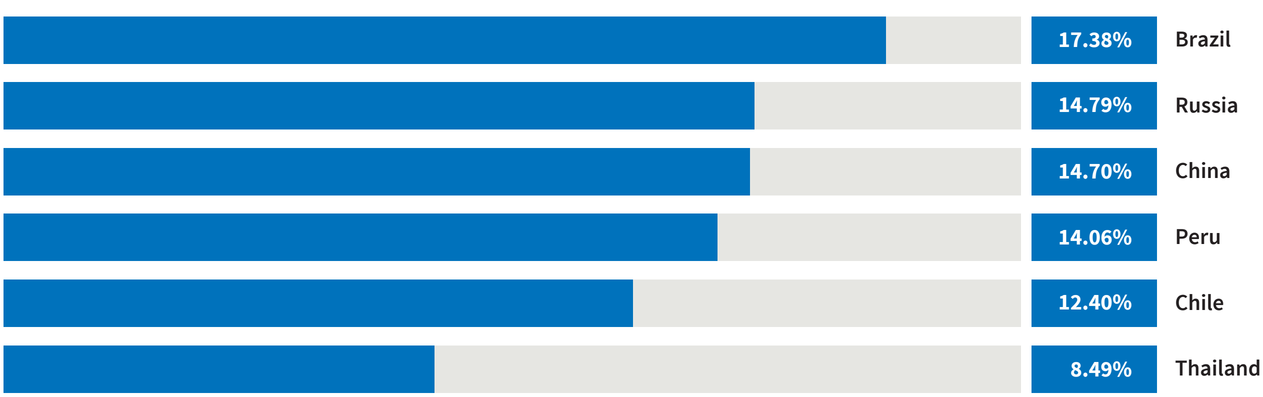
> "Worst-case scenarios have not played out, but risks remain."

Why trade policy risk may reappear

Also, U.S. trade policy remains a risk. The failure to make progress in other areas of the Trump agenda, such as health care, infrastructure spending, and corporate tax reform, may prompt the administration to pivot its focus to trade policy, many aspects of which do not require approval from Congress. As we have seen throughout 2017, potential risks do not necessarily become realized risks, but fundamental, bottom-up company research remains essential.

A strong quarter for many emerging markets

Total return performance, 6/30/17–9/30/17



Source: International market performance is represented by Morgan Stanley Capital International (MSCI) World Country Indices, which are free float-adjusted market capitalization-weighted indices that are designed to measure the equity market performance of developed markets.

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Chief Investment Officer, Equities
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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

Sam Cox
Co-Director of Equity Research
In the investment industry since 2002
Joined Putnam in 2014

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

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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 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.

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