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THE MACRO REPORT | JUNE 2018

Italy's Political Opera

Italy's Giuseppe Conte was sworn in to power in early June to head a new populist government — made up of an unlikely marriage between the anti-establishment 5-Star Movement (M5S) and the far-right League party. The oath ceremony ended a three-month-long political opera in the eurozone's third largest economy. The inconclusive March elections, the political chaos in forming a government, and the anti-euro leanings of the coalition rattled Italian and global financial markets. The country remains vulnerable to high interest rates, high debt levels, and very low growth.

As Italian markets tumbled, global interest rates continued to trend higher. The yield on the benchmark 10-year U.S. Treasury crossed the 3% psychological barrier, setting a new five-year high. It signaled that higher rates are afoot in the world's biggest bond market as the Federal Reserve tightens monetary policy. Higher oil prices, which have raised concerns about inflation, will be driven by supply factors, including the possibility that OPEC will boost output in the second half of the year.

THIS MONTH

Balancing act in Italy

Interest-rate ripples

Spotlight on oil

For use with institutional investors and investment professionals only.

Balancing act in Italy

A coalition government came to power in June, but its views on the euro, fiscal policy, and the European Union have rattled global financial markets.

Italy's new populist government, consisting of the anti-establishment M5S and the far-right League party, was sworn in to power by President Sergio Mattarella in early June. Giuseppe Conte, who is backed by M5S, became the new prime minister. The government was formed after three months of political deadlock in the eurozone's third-largest economy following inconclusive March 4 elections. In late May, the coalition reached a last-ditch deal amid growing global market turmoil. The coalition has won mandatory confidence votes in Parliament.

An unlikely marriage

Conte and the fringe parties ascended to power after the elections pushed aside mainstream political groups. The coalition between the left and right seemed disconcerting and dubious. But the two found themselves in this unlikely marriage. Early on, there were disagreements over forming a government, and President Mattarella vetoed the coalition's choice of a eurosceptic economist who advocated a "plan B" to leave the euro. The government's views on the euro, fiscal and economic policies, and the European Union, among others, have rattled Italian and global financial markets.

The populists driving the political bus have various economic proposals. If enacted, they would raise the fiscal deficit, lower potential growth, and worsen Italy's debt. Other ideas include the European Central Bank (ECB) writing off its holdings of Italian government securities (BTPs) and leaving the eurozone. There are Italians who describe the euro as a "German cage." The full implementation of the proposals is simply incompatible with membership in the eurozone. The ECB cannot write off its BTP holdings as a gift to the government.

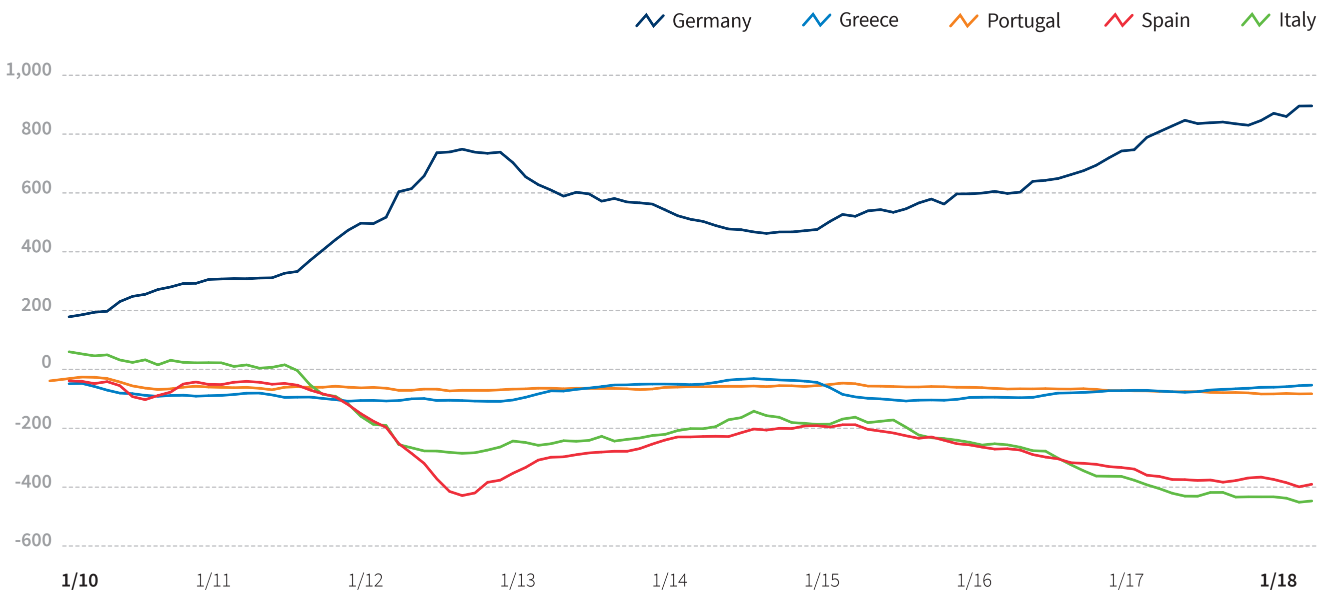
Delicate dance with the EU

So, what will happen? The coalition government will make a show of trying to implement some reforms, and there will be a delicate dance between Rome and its partners in Brussels and Berlin. This will not encourage stability in Italian asset prices. We anticipate the populists will rein in their policy ambitions and the eurozone will throw them a bone by temporarily relaxing fiscal rules. The long-term political stresses will remain; the underlying economic weakness, disillusion with the EU, and resentment toward Germany over migration policy will not dissipate.

The M5S and the League are not natural bedfellows, and it seems likely to us that the government will collapse. Opinion polls suggest the League has gained popular support, creating an incentive for it to seek new elections to increase power.

Italy's TARGET2 deficit is highest among key eurozone economies

(Euro in billions, year-over-year)



TARGET2 (Trans-European Automated Real-time Gross Settlement Express Transfer System) is the euro system's real-time gross settlement system. The claims and liabilities of euro area national central banks vis-à-vis the ECB arising from cross-border payment flows are executed through TARGET2.

Source: European Central Bank, as of May 2018.

Growth and debt woes

Italy needs growth driven by a better economic structure and not by fiscal relaxation. Without that growth, it remains vulnerable to higher interest rates. Rising risk premiums on local debt will slow growth. Italy's economy, unlike that of Portugal, Greece, or Ireland, is large enough to matter to the eurozone. It will not take much to push Italy into a crisis given its debt. The public debt is 130% of gross domestic product, and the debt dynamics are about the relationship between growth and interest rates. Inflation is around 1%, productivity growth is around zero, potential growth is estimated at less than 1%, and realized real growth over the past 20 years was barely above zero.

Italy's size creates a new European dimension to this problem. The Europeans have put in place various policies since the last sovereign debt crisis that enable them to deal with a small country. But they can't deal with Italy. The ECB supervises large Italian banks, and this cuts off, or dramatically reduces, the scope for the traditional route of easing a sovereign debt problem by stuffing bonds onto the books of local banks. Italy also makes it impossible to agree on the next round of eurozone reforms.

Against this backdrop, it's hard to believe that Italian assets — at least BTPs — are fairly priced. We think the default risk on BTPs is materially higher than it is for Greece or the other bonds included in the JPMorgan High Yield Index. The 10-year default probability in Italy is forecast at over 10%. During the last eurozone sovereign debt crisis, we used a country's TARGET2 balance as a stress indicator. These balances aren't the cause of the problem, but they do reflect its dimension. Germany's position is now much larger than it was in 2012, and Italy is running the biggest deficit. We need to think about what is going on in Italy, and how serious a threat it is to the European and global outlook.

Interest-rate ripples

The yield on the 10-year Treasury has crossed the 3% psychological barrier, signaling a steady rise in global rates and posing a challenge for riskier assets.

One way of telling the story of the past month is through interest rates, particularly yields on the benchmark 10-year U.S. Treasury. Rates have risen pretty steadily from the very beginning of April through mid-May. The 10-year bond yield crossed the 3% psychological barrier in April, setting a new five-year high and signaling that higher interest rates are ahead in the world's biggest bond market amid the Federal Reserve's intent on boosting interest rates. Fed officials' most recent forecasts are for two additional rate increases in 2018.

Yields then broke through 3.1% on May 17, 2018. Rates were rising pretty much in lockstep with oil prices. That is not surprising because of the clear influence energy has on headline inflation. In fact, real rates were rising and not the inflation break-even rates (the break-even rate is applied to bonds and refers to the difference between the yield on a nominal fixed-rate bond and the real yield on an inflation-linked bond, such as a Treasury inflation-protected security). We think this oddity reflects trading patterns and liquidity; people were selling nominals, and it takes time for the break-even trade to happen when there are fewer active trading desks and smaller hedge funds.

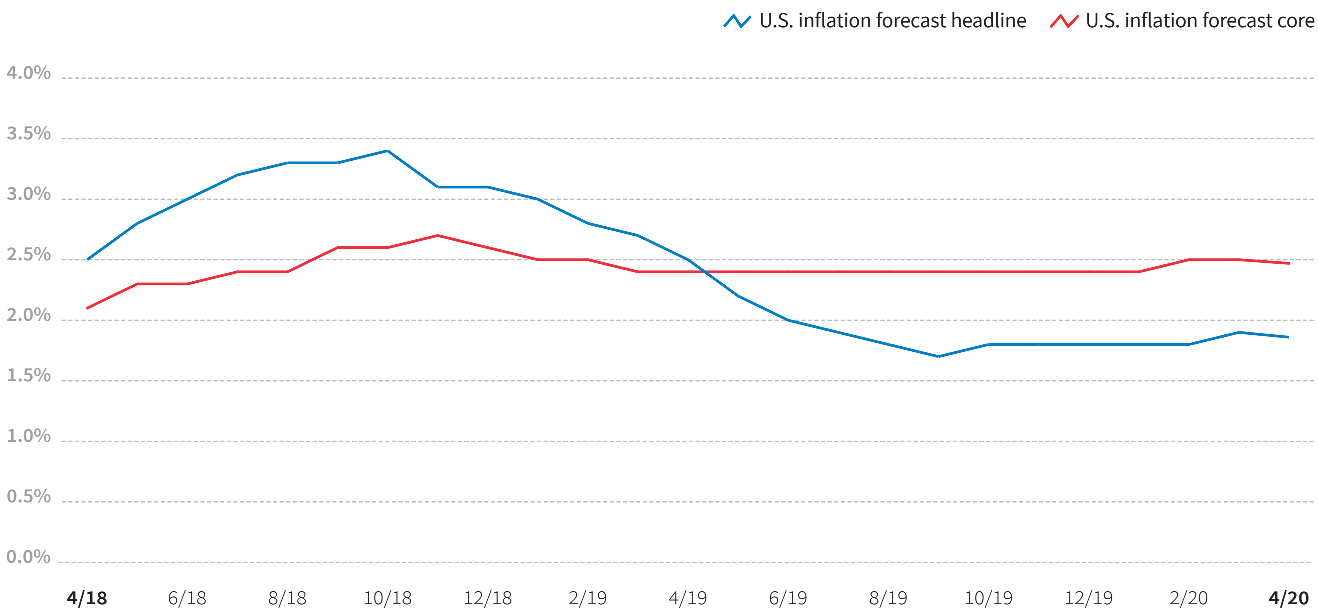
As yields pushed through 3%, we had a number of conversations about whether this was the decisive move in long-term rates, the key break in the great bond bear market, or just the first stop on the march to 4%, 5%, or 6% yields. We continue to resist this idea for two main reasons, both of which came into play in the month.

Rising yields do matter

The first is that a rising real interest rate is a challenge for risky asset markets. There are circumstances in which yields and returns on risky assets can rise together such as when yields are being pulled up by strong returns on private capital. But for this to happen, more real sector investment is needed. When yields are pushed up by other factors, risky assets tend to decline. That's exactly what happened in May; within hours of the real yield on the 10-year Treasury hitting a new multi-year high of 0.945%, the stock market was tumbling.

U.S. headline and core inflation trends

(% year-over-year)



Source: Putnam, as of June 2018.

The second reason is that the equilibrium global real interest rate remains low. This is partly because of all the global supply and demand factors, including large current account surpluses in advanced, aging economies, and limited corporate demand for investable funds given current patterns of technological advance. These are not permanent features of the world economy. Although they are easing a little, they remain key factors. The low interest rates they have produced have encouraged debt accumulation.

Debt dynamics and higher rates

The debt accumulation creates a sensitivity to increases in interest rates. If debt is used to finance the installation of productive assets, then rising debt service costs don't matter all that much. But if not, then the real resources needed to service debt can harm economic prospects and generate financial stress as defaults happen and assets are written down. Those forces then tend to push rates down.

This is exactly what happened in May. As U.S. yields rose, a number of emerging-market economies began to suffer. This is also what happened in Italy. As the risk premium on Italian debt rose to unsupportable levels, given the country's debt level and economic prospects, German bond (or Bund) yields began to fall, pulling Treasury yields lower.

The strong economic recovery in the United States and a more determined Fed means U.S. rates could rise gently, even if this upward drift continued to be interrupted by rallies amid strains from the economy adjusting to higher rates. Bund yields will continue to be held back by high savings levels, a sluggish economy, and a cautious central bank.

Spotlight on oil

The global supply and demand balance of oil is improving, while OPEC mulls boosting output in the second half of 2018.

Oil prices rose quite sharply from the middle of April until the last few days of May. Prices are currently a little higher compared with where they were a month ago. Global oil prices will be driven by supply factors because the demand side of the equation appears to be quite steady.

In the United States, where it's a bit easier to analyze demand trends, there's no sign that higher gasoline prices have hampered driving habits. It's possible that demand from China looks a bit stronger than it really is because there may be some large purchases from China for inventories. But we doubt this can explain much of the recent spike in prices.

On the supply side, however, there were a host of factors that influenced prices. There is mounting difficulties with output from Venezuela. There is also the risk that the United States will step up sanctions on the country, further limiting supply. Then, there is the likelihood that exports from Iran will decline, following the withdrawal of the United States from the multinational nuclear agreement. Still, it's not clear how much exports from Iran will drop. We also have periodic outage problems in Nigeria and worries about output from Iraq. In addition, U.S. shale output is rising in reaction to the run-up in prices.

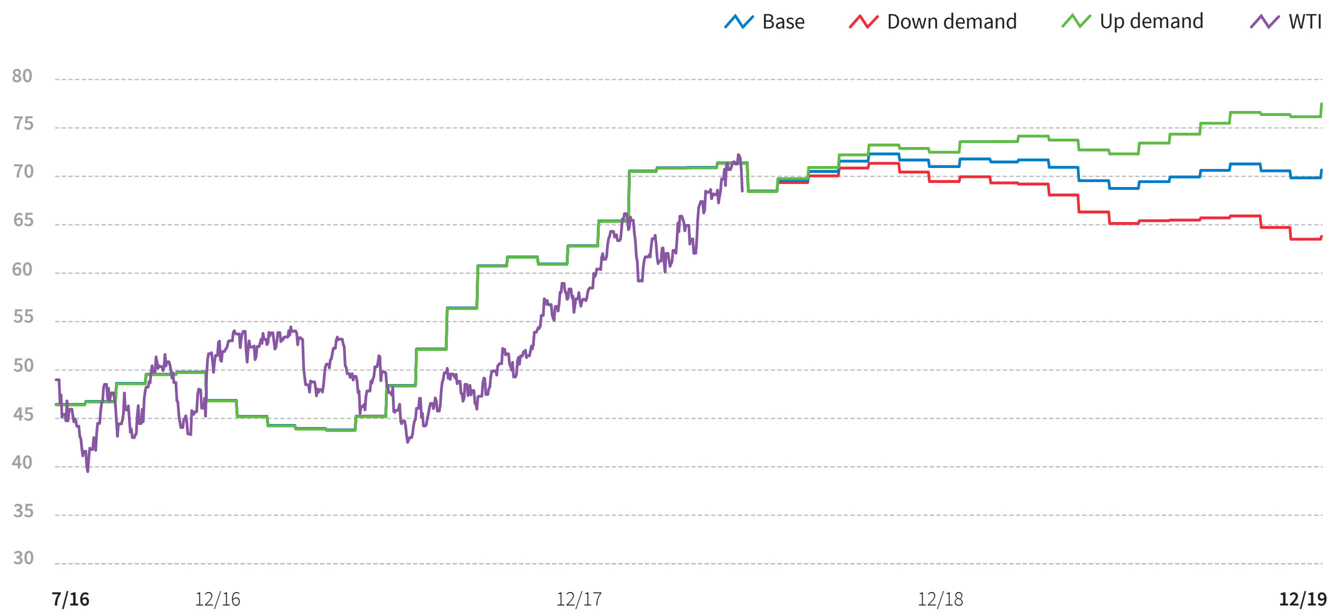
There are debates in the market about the effects of sanctions on Iranian oil production and about the extent of decline in Venezuela's output. These exact numbers do matter. The output discipline of the Organization of Petroleum Exporting Countries (OPEC) and non-OPEC producers led by Russia have been very strong in recent months. In late May, however, Saudi Arabia and Russia signaled a change and indicated their willingness to boost oil output in the second half of the year.

All options are on the table

There were many reasons for this policy swerve. President Donald Trump has publicly complained on Twitter about OPEC policy and rising oil prices. And Saudi Arabia, the world's largest oil exporter, intends to cement its close relationship with Trump and his anti-Iranian policies. OPEC also has no interest in pushing prices up to levels that will threaten demand or encourage even faster growth in shale output from the United States. News reports that OPEC could lift oil output pushed prices lower in late May.

Oil's supply and demand improves

(US$ per barrel)



U.S. West Texas Intermediate crude (WTI)

Sources: U.S. Energy Information Administration, Bloomberg, Putnam, as of May 2018.

The Saudis and the Russians are apparently still arguing about how much to raise oil output in the second half of the year. And since the production shortfall from Venezuela and Iran remains unknown, we can't forecast with confidence the supply outcome. Right now, we think prices are in line with our fair value estimates. Whether that estimate edges up or down will be influenced by the size of the output increase that OPEC agrees. It's worth noting that our fair value estimate was driven by an appreciating U.S. dollar, and not by a shift in underlying market dynamics.

Right now, we think prices are in line with our estimate of fair value.

Finding a fair value

There are two important points in determining oil's fair value. First, the probability of much higher oil prices has fallen. Market watchers eyeing $90 or $100 per barrel for Brent crude were always too bullish. Now, however, we have a clear signal from OPEC that there is a ceiling on prices. Secondly, prices were close to fair value at the end of May. Our fair value model isn't a forecasting tool. We can't claim that prices could be $5 lower or higher, and not be consistent with our fair value.

Today's prices are broadly consistent with the balance of supply and demand. It will take a major shift in these supply and demand dynamics to push prices to a significantly different level.

The Putnam Global Risk Appetite (RA) Index is a proprietary quantitative model that aims to measure investors' willingness to invest in risky assets, including equities, commodities, high-yield bonds, and other spread sectors. With a composite view of risk-appetite signals across a broad mix of asset types, Putnam's RA Index provides a framework for discussing investor preferences and can signal trend changes in broad market sentiment.

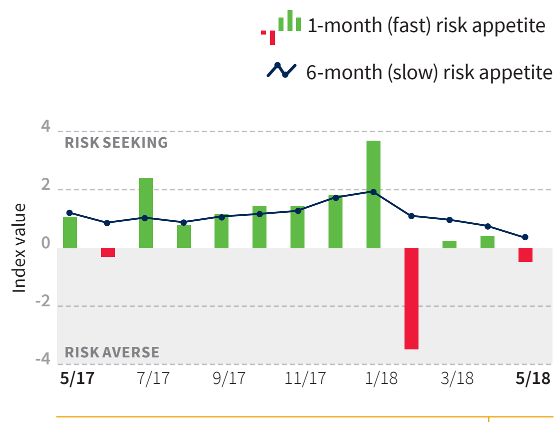
Risk appetite continued to waver

SHORT-TERM TREND

Appetite for riskier assets was weak in May.

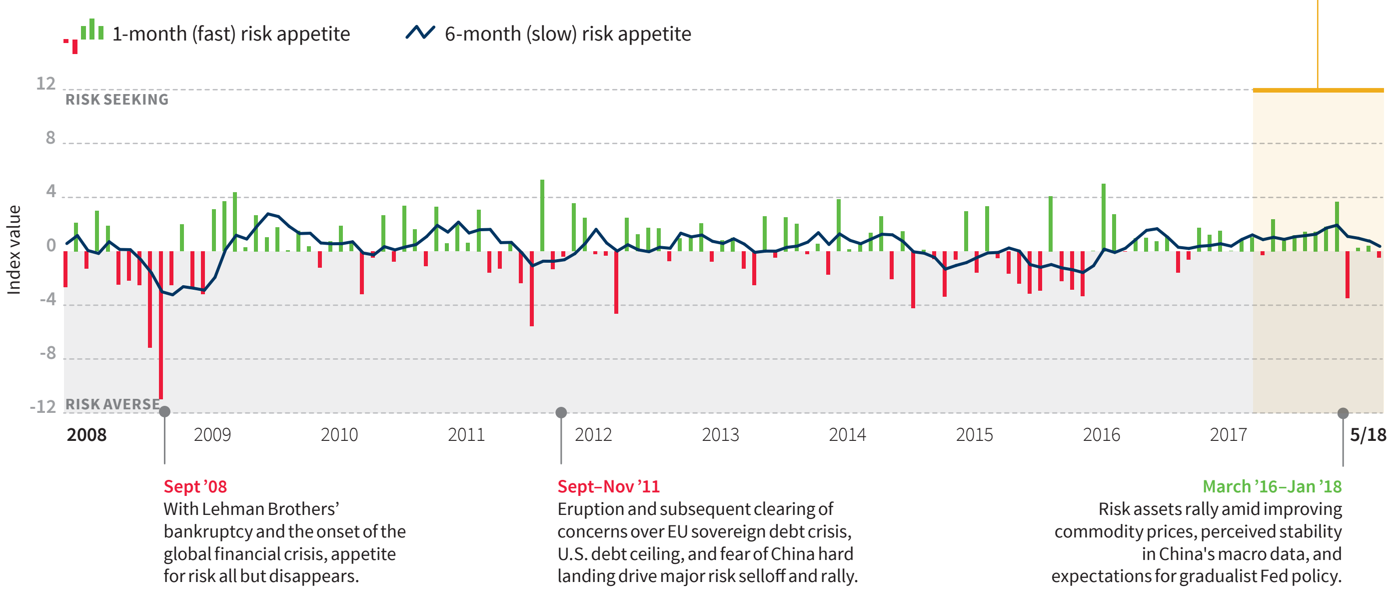
Risk ON OFF

- Equities and bonds in the United States were the overall winners
- Demand for safe-haven assets benefited the U.S. dollar and Treasuries
- International equities mostly declined, with steep losses among emerging markets



LONG-TERM CYCLE

This 10-year illustration captures the cyclicality of investors' appetite for risk.



Source: Putnam. Data as of May 31, 2018. To create the Global Risk Appetite Index, we weigh the monthly excess returns of 30 different asset classes over 3-month T-bills relative to the trailing 2-year volatility of each asset class. The higher the excess return and the lower the volatility, the greater the risk appetite; conversely, the lower the excess return and the higher the volatility, the stronger the risk aversion.

The Putnam Global GDP Nowcast Index is a proprietary GDP-weighted quantitative model that tracks key growth factors across 25 economies. This index and individual country indexes are used as key signals in Putnam's interest-rate and foreign-exchange strategies.

Global economy grows modestly

SHORT-TERM TREND

Growth stabilized in May

▲ 3.36%

Among G10 countries, the United States, the United Kingdom, New Zealand and Canada posted better economic data. New Zealand and Canada's purchasing managers index (PMI) rose, signaling improving business activities. Consumer prices and regional surveys remained positive in the United States. Growth moderated in developing countries. Turkey's economy deteriorated. China's growth held steady.

LONG-TERM CYCLE

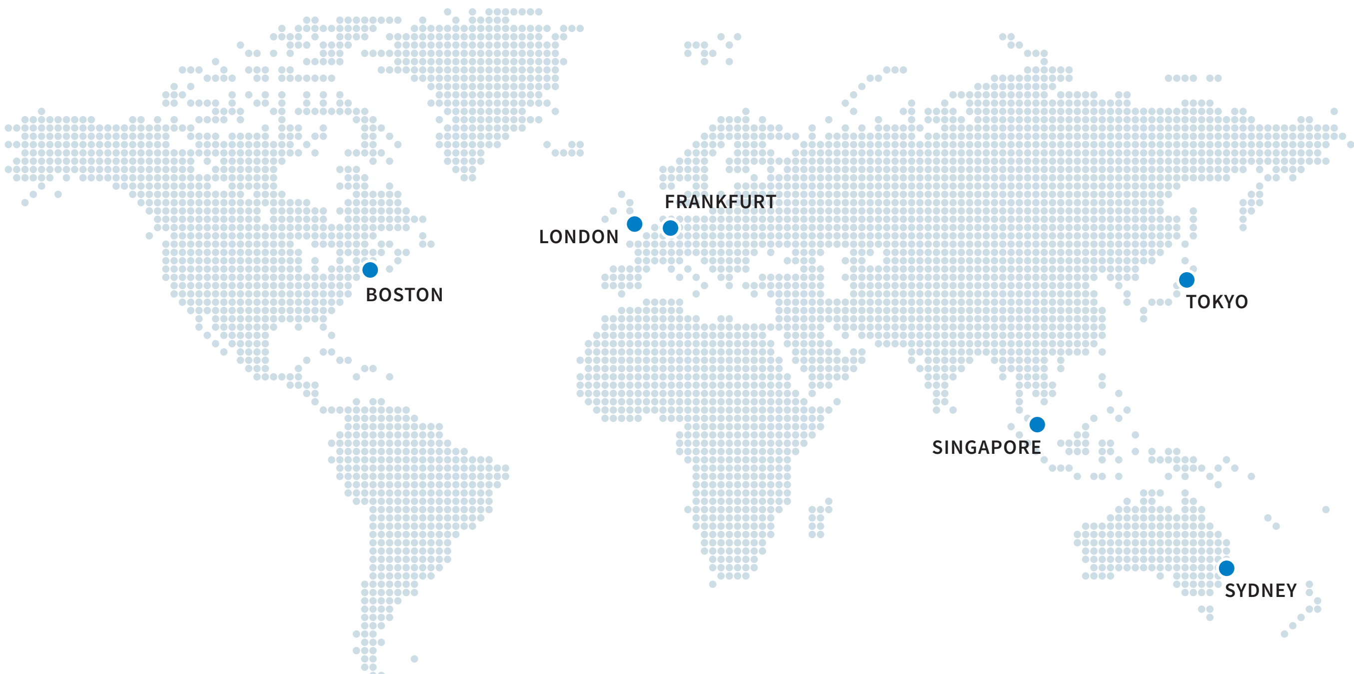
This six-year illustration captures GDP gyrations since the financial crisis.

Sept '12–Dec '13
Global growth swings dramatically, under pressure from sovereign debt crises and darkening global growth prospects amid fitful recoveries.

Jan '14–Oct '16
Global growth settles into a more subdued pattern of modestly disappointing results.

Nov '16 to Dec'17
More synchronous performance across global markets emerges to lift the trajectory of global growth.

Source: Putnam. Data as of May 31, 2018. We base our Global GDP Nowcast on a tailored methodology that captures daily data releases for the most essential growth characteristics for each of 25 countries — including purchasing managers' index data, industrial production, retail sales data, labor market metrics, real estate price indexes, sentiment indicators, and numerous other factors. The mix of factors used for each market may change over time as new indicators become available from data sources or if certain factors become more, or less, predictive of economic growth.



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The Macro Report is written by members of Putnam's Fixed Income team. With backgrounds in applied economics, currency and interest-rate analysis, and sovereign and local bond market dynamics, this group conducts macroeconomic research in support of Putnam's global fixed-income strategies.

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