Q2 2018 | Putnam High Yield Fund Q&A

High yield shines in bond market gloom

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For the quarter, Putnam High Yield Fund trailed its benchmark, the JPMorgan Developed High Yield Index.

The fund benefited from security selection in gaming, lodging & leisure; energy; and cable & satellite. Conversely, picks in automotive, paper & packaging, and housing dampened relative results.

As of quarter-end, we have a positive outlook for market fundamentals, but have a neutral view toward the supply-and-demand backdrop and valuation.

What was the market environment like for high-yield bonds during the second quarter of 2018?

High-yield bonds returned 0.82% for the quarter, as measured by the JPMorgan Developed High Yield Index, slightly outperforming high-yield bank loans, but outpacing the broad investment-grade fixed-income market by a greater margin.

Overall, despite bouts of volatility, high yield was a relative bright spot in an otherwise weak period for fixed income. The asset class benefited from continued strength in the U.S. economy, growth in corporate profits, and a decidedly positive tone in business confidence.

As the quarter began, the U.S. unemployment rate fell to 3.9% in April, its lowest level since December 2000. This development, coupled with oil prices that approached $70 per barrel, added to investor unease about inflation. Reflecting this concern, the yield on the benchmark 10-year U.S. Treasury reached 3% late in April, its highest level in more than four years, and began to weigh on investor risk appetite. Against this backdrop, high-yield bonds rallied during the first half of April, and then gave back some of that gain in the second half of the month.

After relatively flat performance in May, high-yield bond prices were volatile in June, amid swings in U.S. stocks, Treasuries, and oil prices, but finished the period on a positive note. Investor concerns about global trade were at the forefront of June's market turbulence.

Not FDIC insured | May lose value | No bank guarantee

Within the JPMorgan index, the majority of industry groups generated gains, with retail (+3%), energy (+2%), and cable & satellite (+2%) leading the way. On the downside, automotive (-4%), housing, and diversified media were the weakest performers. From a credit-quality perspective, lower-quality CCC-rated bonds were once again the top performers, although mid-tier B-rated credits also outperformed the index this quarter.

What factors had the biggest influence on the fund's relative performance this quarter?

The fund benefited from security selection in gaming, lodging & leisure; energy; and cable & satellite. By contrast, picks in automotive, paper & packaging, and housing worked against relative results.

What is your outlook for the high-yield market over the coming months?

We evaluate the high-yield market through three lenses: fundamentals, valuation, and "technicals," or the balance of supply and demand. As of period-end, we thought the fundamentals environment was positive, whereas we had a more neutral outlook toward technicals and valuation.

Looking at fundamentals, we think U.S. economic data continue to provide a supportive backdrop for high yield. Gross domestic product expanded at an annual rate of 2.2% in the first quarter of 2018, slower than the 2.9% rate in the fourth quarter of 2017. While consumers reduced their spending in the first quarter, a key measure of business spending rose. Nonresidential fixed investment, which reflects investment in buildings, equipment, software, and more, grew at a robust 6.1% rate. Meanwhile, the U.S. unemployment rate fell to 3.8%, a 17-year low.

U.S. corporate profits were bolstered in the first quarter by the tax cuts enacted at the end of 2017. Earnings for companies in the S&P 500 Index grew by an average annual rate of 24%, while revenues expanded by 8%.

Including distressed exchanges, the U.S. high-yield default rate was 2.1% as of June 29 — modestly higher than it was at the beginning of 2018, but still well below the long-term historical average of about 5%.

Given the stimulus provided by a lower corporate tax rate, along with generally positive sentiment across companies, we think growth for both the U.S. economy and corporate earnings is likely to strengthen over the balance of 2018.

Turning to valuation, high-yield credit spreads — the yield advantage U.S. high-yield bonds offer over comparable-maturity U.S. Treasuries — were at about four percentage points as of quarter-end. Spreads have remained relatively unchanged thus far in 2018. In our view, the asset class is in a range of fair value, given corporate fundamental strength. Against this backdrop, we think performance in 2018 will be driven by coupon income with limited capital appreciation potential. That said, in light of the firm economic backdrop and strong corporate fundamentals, we think high-yield corporate credit remains attractive for investors seeking income.

As for technicals, the majority of year-to-date gross new issuance was used to refinance existing debt — a continuation of a trend we have seen for some time. Year-to-date net new issuance of high-yield bonds — excluding refinancing — totaled about $45 billion, down 28% from the same period in 2017. Meanwhile, net new issuance of bank loans year to date is about 19% ahead of the 2017 level, as loan issuance appears to be cannibalizing bond issuance. High-yield mutual funds and exchange-traded funds reported a year-to-date net outflow of -$23.7 billion through June 29. Overall, it appears that fund outflows have offset the positive impact of lower net new issuance.

How are you positioning the fund in light of this outlook?

From a credit-quality perspective, the fund was about equally weighted versus the benchmark in higher-quality, BB-rated bonds and was underweight in B-rated credits. We also had overweight exposure to select CCC-rated bonds where we had high conviction in the issuer's prospects.

At the industry level, we favored housing and gaming, lodging & leisure. Conversely, we had lower-than-benchmark exposure to transportation, food & beverages, health care, technology, consumer products, and automotive.

Putnam High Yield Fund (PHAYX)

Annualized total return performance as of 6/30/18

Class Y shares Inception 12/31/98	**Net asset value**	**JPMorgan Developed High Yield Index**
Last quarter	0.41%	0.82%
1 year	2.60	2.79
3 years	4.38	5.75
5 years	4.75	5.76
10 years	7.00	8.42
Life of fund	7.44	—

Total expense ratio: 0.78%

Returns for periods of less than one year are not annualized.

Current performance may be lower or higher than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or a loss when you sell your shares. Performance assumes reinvestment of distributions and does not account for taxes. For the most recent month-end performance, please visit putnam.com. Class Y shares before their inception are derived from the historical performance of class A shares (inception 3/25/86), which have not been adjusted for the lower expenses; had they, returns would have been higher. For a portion of the periods, this fund may have had expense limitations, without which returns would have been lower. Class Y shares are generally only available for corporate and institutional clients and have no initial sales charge.

The JPMorgan Developed High Yield Index is an unmanaged index of high-yield fixed-income securities issued in developed countries. You cannot invest directly in an index.

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Consider these risks before investing: Bond prices may fall or fail to rise over time for several reasons, including general financial market conditions, changing market perceptions (including perceptions about the risk of default and expectations about monetary policy or interest rates), changes in government intervention in the financial markets, and factors related to a specific issuer or industry. These and other factors may also lead to increased volatility in the financial markets and reduced liquidity in the fund's portfolio holdings. Lower-rated bonds may offer higher yields in return for more risk. Bond investments are subject to interest-rate risk (the risk of bond prices falling if interest rates rise) and credit risk (the risk of an issuer defaulting on interest or principal payments). Interest-rate risk is generally greater for longer term bonds, and credit risk is generally greater for below-investment-grade bonds. 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. Unlike bonds, funds that invest in bonds have fees and expenses. You can lose money by investing in the fund.

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