Q1 2022 | Putnam High Yield Fund Q&A

High yield struggles amid market turbulence

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High-yield bonds posted negative performance amid changing central bank policy and geopolitical turmoil. However, the asset class outperformed investment-grade credit.

Underweight exposure to food & beverages and retail aided performance versus the benchmark, while security selection in financials, industrials, and chemicals detracted.

We have a generally positive outlook for the market's fundamental environment and supply-and-demand backdrop, tempered by broader economic concerns.

How did the fund perform for the three months ended March 31, 2022?

The fund's class Y shares returned –4.18%, performing in line with the –4.18% result of the benchmark JPMorgan Developed High Yield Index.

What was the market environment like for high-yield bonds during the first quarter of 2022?

It was a volatile period for bond markets in the U.S. and around the world. Hawkish policy pivots from the U.S. Federal Reserve and the European Central Bank in the face of rapidly rising inflation, combined with Russia's invasion of Ukraine, fueled a flight from risk.

Within this environment, credit spreads widened and interest rates rose. [Spreads are the yield advantage high-yield corporate bonds offer over comparable-maturity U.S. Treasuries. Bond prices rise as yield spreads tighten and decline as spreads widen.] The yield on the benchmark 10-year U.S. Treasury rose from 1.63% on January 3 to 2.32% on March 31. In anticipation of Fed policy changes, short-term yields rose even more, causing the yield curve to flatten materially.

Within the high-yield market specifically, the asset class started the year with its worst January return on record [–2.59%]. The market slump persisted in February, with high yield posting a return of –0.88%, as investors continued to forecast an aggressive pace of Fed interest-rate hikes.

In March, oil prices spiked early in the month and interest rates continued to rise. Despite this, high-yield spreads tightened as investors sought to capitalize on more attractive valuations, particularly among mid-tier and higher-quality bonds.

Relative to other asset classes, high-yield credit lagged leveraged loans but outpaced investment-grade [IG] corporate credit and the broad IG fixed income market.

Within the fund's benchmark, all cohorts registered losses. Food & beverages, housing, and retail were the weakest performers, as each group returned about –6%. Energy [–2%] and metals & mining [–3%] held up better and outperformed the benchmark. Commodities such as oil, wheat, and metals experienced large price increases during the quarter on expectations of global shortages resulting from Russia's invasion of Ukraine. From a credit-rating perspective, mid-tier bonds rated B or split B performed the best, reflecting increased demand from investors during March.

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

Lower-than-benchmark exposure to food & beverages and retail, along with favorable overall positioning in gaming, lodging & leisure, added the most value on a relative basis. An allocation to floating-rate bank loans also aided performance. On the downside, security selection in financials, industrials, and chemicals dampened performance versus the benchmark.

What is the team's near-term outlook?

We have a moderately constructive outlook. We have a positive outlook for high-yield market fundamentals and the overall supply-and-demand backdrop. Our view on valuations is more neutral, given the relative tightness of yield spreads in the market as of quarter-end. Spreads widened during the quarter, but remain tight by historical standards. From a fundamental perspective, we continue to closely monitor issuers' balance sheets and liquidity metrics, with an eye toward default risk or a credit-rating downgrade.

As of quarter-end, U.S. economic growth expectations had moderated somewhat. However, we believe U.S. gross domestic product will continue to grow at a rate above the longer-term trend in 2022. Following robust corporate earnings growth in 2021, market expectations for 2022 were adjusted down to the low double-digit range.

As of March 31, the U.S. high-yield default rate remained very low. Including distressed exchanges, the default rate ended the quarter at 0.50%, well below the long-term average of 3.8%.

As for supply/demand dynamics, new issuance of high-yield debt totaled $46.5 billion in the first quarter. This represented a 71% decline from the same period in 2021 and was the lightest quarterly total since the fourth quarter of 2018. About 47% of this year's new issuance was used to refinance existing debt. On the demand side, high-yield funds [mutual funds and exchange-traded funds] experienced outflows of $25.3 billion in the first quarter, which compares with outflows of $10.6 billion during last year's first quarter.

From a valuation standpoint, the average spread of the fund's benchmark widened to 3.99 percentage points over U.S. Treasuries during the first quarter, but this is still significantly below the long-term average of 6 percentage points. The benchmark's yield was 6.3% as of March 31, a sizable increase from 4.7% at the end of 2021. Despite tight spreads, we think the market's income potential is attractive in the face of much lower global yields.

Key risks that we will continue to focus on include geopolitical tensions, the pace of Fed rate hikes, inflation, and potentially negative effects on energy supplies.

How was the fund positioned as of March 31?

Relative to the benchmark, the portfolio had overweight exposure to the higher- and lower-quality areas of the market and an underweight allocation in mid-tier bonds. From an industry perspective, we favored energy, broadcasting, diversified media, technology, and housing. The fund had underweight exposure to retail; food & beverages; gaming, lodging & leisure; automotive; and transportation.

Putnam High Yield Fund (PHAYX)

Annualized total return performance as of 3/31/22

	Class Y shares Inception 12/31/98	**JPMorgan Developed High Yield Index**
Last quarter	–4.18%	–4.18%
1 year	–0.03	0.12
3 years	4.39	4.52
5 years	4.30	4.68
10 years	5.13	5.86
Life of fund	7.14	—
Total expense ratio: 0.76%		

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.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed are those of the portfolio managers as of March 31, 2022, are subject to change with market conditions, and are not meant as investment advice.

Consider these risks before investing: The value of investments in the fund's portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political, or financial market conditions; investor sentiment and market perceptions; government actions; geopolitical events or changes; and factors related to a specific issuer, geography, industry, or sector. These and other factors may lead to increased volatility 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 (a significant part of the fund's investments). 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.

Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could have a negative effect on the fund. You can lose money by investing in the fund.

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Request a prospectus or summary prospectus from your financial representative or by calling 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

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