Q1 2019 | Putnam High Yield Fund Q&A

High yield rallies in best-ever first quarter

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Following heavy selling pressure in 2018's fourth quarter, high-yield bonds posted their best-ever start to a calendar year in 2019's first quarter.

The fund benefited from favorable positioning in financials and gaming, lodging & leisure. On the downside, an underweight allocation to the strong-performing consumer products sector hampered performance versus the benchmark.

We have a positive outlook for market fundamentals but think valuations are less attractive following the quarter's strong advance.

What was the market environment like for high-yield bonds during the first quarter of 2019?

High-yield bonds rose 7.30% for the quarter, as measured by the JPMorgan Developed High Yield Index, handily outpacing both high-yield bank loans and the broad investment-grade fixed-income market.

Following a sharp downturn in 2018's fourth quarter, the high-yield market had its strongest start to a calendar year on record in the first quarter. Investor sentiment improved following comments from Federal Reserve Chair Jerome Powell that mild inflation would give the central bank greater flexibility to set policy in 2019. Market participants also welcomed Powell's announcement that the Fed was not on a "pre-set" path to push its benchmark rate higher, after hiking rates every quarter in 2018. Better-than-expected corporate earnings, a rebound in oil prices, and progress in U.S.-China trade talks were additional factors fueling the recovery.

Energy is the largest sector in the JPMorgan Developed High Yield Index. Consequently, oil prices have a major impact on the high-yield market. During the quarter, U.S. oil prices rose by 32% to $60 per barrel — their biggest quarterly gain since 2009. Prices advanced gradually but steadily during the quarter, as investors became increasingly confident that the global oversupply problems in late 2018 were mostly resolved. The Organization of Petroleum Exporting Countries [OPEC] and Russia made good on promises to cut production.

Within the JPMorgan index, all cohorts posted solid gains, led by consumer products (+9%), cable & satellite, housing, and health care, each of which advanced 8%. Industries that lagged the index included more economically sensitive cohorts, such as automotive and transportation, as well as the more defensive diversified media group. Each of these cohorts returned about 5%. Gains were positive and in a tight range across credit-quality tiers, with B and BB-rated bonds producing the best results.

The fund performed roughly in line with its benchmark for the quarter. What factors had the biggest influence on relative performance?

On the plus side, we benefited from favorable overall positioning in financials and gaming, lodging & leisure, along with overweight exposure to housing. Conversely, underweight allocations in consumer products and food & beverages, as well as adverse positioning in telecommunications, hampered performance versus the benchmark.

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 March 31, we thought the fundamental environment continued to be positive, whereas we had a more neutral outlook toward valuation and technicals.

Despite uncertainty surrounding the ultimate outcome of U.S.-China trade negotiations, we think the fundamental backdrop for high yield remains supportive, led by a strong labor market and rising employee wages. Gross domestic product, the broadest measure of goods and services produced across the economy, was revised downward to a 2.2% annual rate in 2018's fourth quarter. We did not find this surprising, however, because we expect growth to moderate as the immediate benefits of a lower corporate tax rate recede. That said, we do not believe a recession is likely in 2019.

After-tax corporate profits, without inventory valuation and capital consumption adjustments, declined 1.7% in 2018's fourth quarter from the third quarter. This was the first quarter-over-quarter decline in profits since the final quarter of 2017. Profits rose 11.1% in 2018's fourth quarter from a year earlier, which was the largest year-over-year gain since the first quarter of 2017. The broad trend depicted by these data suggest that profits started 2018 strongly but eased as the year progressed. Looking ahead, we think earnings will continue to expand at a reasonably solid clip, but not at the same robust pace we saw in 2018.

Looking at defaults, when distressed exchanges are included in calculating the U.S. high-yield default rate, the figure was 1% as of March 31. Defaults declined materially during the past 12 months and are now at a level last seen in 2014. We think defaults are likely to remain low for an extended period given the relative financial health of high-yield issuers and the fact that many have refinanced and extended bond maturities into the future.

Turning to valuation, by quarter-end, high-yield spreads had retraced most of their recent widening back to the tight level we saw prior to 2018's fourth quarter. As a result, it has become more challenging to find compelling values in the market. From an income perspective, the average yield of the fund's benchmark was 6.83% as of March 31. [Yield spreads are the yield advantage high-yield corporate bonds offer over comparable-maturity U.S. Treasuries. Bond prices rise as spreads tighten and fall as spreads widen.]

The market's technical backdrop improved during the quarter, aided by a combination of modest net new issuance and a return to strong fund inflows. Specifically, net new volume [net of refinancing-related new issuance] was $24.9 billion year to date, 30% above the net volume in the first quarter of 2018. Meanwhile, flows into retail and exchange-traded funds totaled $12.2 billion, compared with outflows of –$20 billion during the same period last year.

How have you positioned the fund in light of this outlook?

During the period, we reduced risk in the portfolio by continuing to decrease our exposure to CCC-rated credits, while maintaining an overweight allocation to higher-quality BB-rated bonds.

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

Putnam High Yield Fund (PHAYX)

Annualized total return performance as of 3/31/19

Class Y shares Inception 12/31/98	**Net asset value**	**JPMorgan Developed High Yield Index**
Last quarter	7.10%	7.30%
1 year	4.25	5.64
3 years	7.36	9.01
5 years	3.80	4.75
10 years	9.71	11.61
Life of fund	7.39	—

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.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed are those of the portfolio managers as of March 31, 2019, are subject to change with market conditions, and are not meant as investment advice.

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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