Q3 2018 | Putnam High Yield Fund Q&A

High yield outperforms amid broader fixed-income weakness

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High-yield bonds had a solid third quarter, handily outpacing the broad investment-grade fixed-income market.

The fund benefited from security selection in industrials, retail, and health care. Conversely, positioning in technology, picks in metals & mining, and underweight exposure to transportation dampened performance versus the benchmark.

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 third quarter of 2018?

High-yield bonds returned 2.42% for the quarter, as measured by the JPMorgan Developed High Yield Index, outpacing high-yield bank loans and topping the broad investment-grade fixed-income market by an even greater margin. The asset class benefited from continued strength in the U.S. economy, growth in corporate profits, and a decidedly positive tone in business confidence.

In July, high yield registered its strongest performance in a year, bolstered by trade talks between the United States and Europe, strong second-quarter corporate earnings, and the lightest net new issuance since April 2009. The asset class continued to show strength in August, aided by a robust 4.2% annualized growth rate for U.S. gross domestic product [GDP] in the second quarter of 2018. Stronger business investment, fueled by solid earnings, drove U.S. GDP growth. U.S. corporate earnings rose 25% in the second quarter, boosted by a lower corporate tax rate, but the pace may have moderately slowed in the third quarter.

In September, high-yield bond credit spreads reached their tightest level in a decade at 3.65 percentage points over comparable-maturity U.S. Treasuries. [Bond prices rise as spreads tighten.] Reduced pressure on emerging-market currencies, positive trade developments (except with China), and rising oil prices aided the asset class.

As expected, the Federal Reserve raised its target for short-term interest rates to a range of 2% to 2.25% at its September policy meeting, the third hike this year and the eighth in the past three years. U.S. Treasury yields rose across the curve during the third quarter, as investors anticipated that the Fed would continue to hike interest rates at a steady pace. At the same time, accelerating economic growth increased the potential for inflation to pick up.

Immediately after the quarter ended, oil prices reached multiyear highs, with West Texas intermediate crude hitting $75.30 per barrel on October 1. Brent crude, the global benchmark, was even higher, at $84.98 per barrel. Both benchmarks climbed on the view that U.S. sanctions against Iran and lower output from producers such as Venezuela and Libya will cause supply deficits.

Within the JPMorgan index, all cohorts generated gains, with cable & satellite (+4%), telecommunications (+3%), and health care (+3%) leading the way. On the downside, retail (0%), automotive (+1%), and diversified media (+1%) were the weakest performers. From a credit perspective, lower-quality CCC-rated and split B-rated bonds delivered the best results, reflecting investor confidence amid the solid fundamental backdrop. However, bonds across all rating tiers posted solidly positive performance this quarter.

For the quarter, the fund modestly lagged its benchmark, the JPMorgan Developed High Yield Index. What factors had the biggest influence on relative performance?

On the plus side, we benefited from security selection in industrials, health care, and retail. By contrast, overall positioning in technology, picks in metals & mining, and underweight exposure to transportation dampened 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 quarter-end, we thought the fundamental environment was positive, whereas we had a more neutral outlook toward technicals and valuation.

Despite global trade and political tensions, we think the fundamental backdrop for high yield remains supportive, led by a strong labor market and rising employee wages. Including distressed exchanges, the U.S. high-yield default rate was 2% as of September 30, still well below the long-term historical average of about 5%. We think default rates could remain below average for the next year or two, and possibly longer, for two key reasons: the relative financial health of high-yield issuers overall, and the fact that many have refinanced and extended bond maturities into the future.

Turning to valuation, although high yield is not compellingly cheap, we think the asset class is in a range of fair value, given corporate fundamental strength. As a result, we believe near-term performance will be driven by coupon income with limited capital appreciation potential. That said, in light of the supportive economic environment and strong corporate fundamentals, we think high-yield bonds remain an attractive option for investors seeking income.

As for technicals, gross high-yield new-issue activity totaled $168.3 billion year to date through September, which is 34% lower than the same period last year. And net new volume totaled a meager $63.3 billion year to date. At this rate, full-year net new issuance would be roughly half what it was between 2013 and 2015. Much of the new issuance has been used to refinance outstanding debt at lower rates, enabling issuers to extend maturities and improve their financial flexibility. Meanwhile, net new issuance of bank loans year to date is about 23% ahead of the 2017 level, as loan issuance appears to be cannibalizing bond issuance.

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

In terms of credit quality, the fund had underweight allocations versus the benchmark in BB-rated and B-rated bonds, and overweight exposure to select CCC-rated credits where we had high conviction in the issuer's prospects. We are looking to trim our CCC exposure, given strong performance and also with an eye toward reducing overall portfolio risk. As of quarter-end, we had a roughly 6% allocation to bank loans, which may help the fund benefit from rising interest rates.

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

Putnam High Yield Fund (PHAYX)

Annualized total return performance as of 9/30/18

Class Y shares Inception 12/31/98	**Net asset value**	**JPMorgan Developed High Yield Index**
Last quarter	2.08%	2.42%
1 year	2.48	3.16
3 years	6.95	8.34
5 years	4.69	5.72
10 years	8.03	9.58
Life of fund	7.45	—

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.

The views and opinions expressed are those of the portfolio managers as of September 30, 2018, 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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