Q1 2018 | Putnam High Yield Fund Q&A

Sector gains pause as caution outweighs fundamentals

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For the quarter, Putnam High Yield Fund performed in line with its benchmark, the JPMorgan Developed High Yield Index.

The fund benefited from security selection in retail and technology, as well as underweight exposure to the lagging food & beverages group. Conversely, selection in metals & mining, financials, and energy dampened relative results.

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

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

High-yield bonds returned -0.83% for the quarter, as measured by the JPMorgan Developed High Yield Index, trailing high-yield bank loans, but outpacing the broad investment-grade fixed-income market.

High yield performed well for most of January, amid solid gains for stocks and oil. However, a steady climb in the yield of the benchmark 10-year U.S. Treasury, fueled by optimism about a synchronized global economic recovery, began to weigh on sentiment toward month-end. The asset class did poorly in February amid the most severe selloff for stocks since January 2016 and an intra-month four-year high for 10-year Treasury yields. In March, high yield suffered a second consecutive monthly loss, as the Federal Reserve forecast that it may need to accelerate the pace of future rate increases to keep the economy from overheating in coming years. Softer readings on global economic growth, steep losses in technology stocks, and the threat of a trade war with China also weighed on high-yield bonds.

U.S. oil prices fluctuated in a range of about $60 to $65 per barrel during the quarter. Prices reached a three-year high in January before falling back on fresh indications of burgeoning U.S. shale oil production. Crude rose again in March, bolstered by declining stocks outside the United States and rising tensions between the United States and Iran, but moved lower later in the month due to trade concerns and rising production in Russia.

Within the index, most cohorts generated losses, with cable & satellite TV, automotive, and food & beverages underperforming the most. On the plus side, broadcasting, transportation, and retail posted gains. From a credit-quality perspective, lower-quality bonds outperformed the market, aided by positive sentiment in January. Higher-quality BB-rated bonds lagged the JPMorgan index.

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

At the sector/industry level, the fund benefited from security selection in retail and technology, along with underweight exposure to food & beverages. On the downside, selection in metals & mining, financials, and energy worked against relative results.

What is your view on tax reform as it relates to the high-yield market?

Overall, we think the Tax Cuts and Jobs Act is positive for U.S. corporations. While analysis of the law's intricacies continues to emerge, we think a lower corporate tax rate — it dropped from 35% to 21% — will bolster cash flows. At the same time, the new tax law caps interest deductibility at 30% of earnings before interest, taxes, depreciation, and amortization, which, in our view, will sap cash flows for more heavily indebted, lower-rated debt issuers.

Based on our preliminary analysis, a large majority of companies in the high-yield and bank-loan markets will benefit from tax reform. The firms that may be disadvantaged are lower-rated issuers — those with credit ratings of CCC or lower — and we think the impact will likely occur over a two- to five-year period.

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 and technical backdrop were positive, and valuation was neutral.

Looking at fundamentals, we think corporate fundamentals are likely to remain strong. Issuer defaults have begun to creep higher, with forecasts for a 2% to 2.5% total default rate in 2018, which is still low based on longer-term history. At the same time, recovery rates have risen.

Regarding valuation, high-yield credit spreads — the yield advantage high-yield bonds offer over comparable-maturity U.S. Treasuries — widened slightly in the first quarter, but remain below the long-term average. Also, the average bond price within the index was close to par [face value]. As a result, the asset class is not compellingly cheap, but is in a range of fair value, in our view, given corporate fundamental strength. Against this backdrop, we think performance will be driven by coupon income with limited capital appreciation potential.

As for technicals, we are not anticipating a significant spike in new supply. In light of new provisions governing corporate interest deductibility passed as part of U.S. tax reform, it's possible that new-issue supply could sharply decline. If this happens, we think it could be beneficial for existing bonds, assuming the demand for yield persists.

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

As always, we plan to maintain broad diversification across market sectors. From a credit-quality perspective, the majority of the fund's holdings at period-end were in split BB-rated or B-rated bonds, which occupy the middle tier of high-yield credit quality. We increased the fund's allocation to select CCC-rated credits where we had high conviction in the issuer's prospects.

At the sector/industry level, we favored gaming, lodging & leisure, housing, chemicals, utilities, and financials. Conversely, we had an underweight in retail — which we plan to continue — due to fundamental concerns about the industry, along with increased competitive pressure. The fund also had lighter-than-benchmark exposure to services, technology, food & beverages, transportation, health care, consumer products, and telecommunications.

Putnam High Yield Fund (PHAYX)

Annualized total return performance as of 3/31/18

Class Y shares Inception 12/31/98	**Net asset value**	**JPMorgan Developed High Yield Index**
Last quarter	-0.89%	-0.83%
1 year	4.08	4.21
3 years	4.31	5.59
5 years	4.35	5.32
10 years	7.18	8.53
Life of fund	7.49	—

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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