Q4 2017 | Putnam Diversified Income Trust Q&A

Multisector strategy fuels positive results

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Improving trends across global economies created a favorable environment for risk-driven strategies.

The fund posted positive performance, led by mortgage-credit strategies. On the downside, currency strategies detracted.

We believe the acceleration in global growth seen in 2017 will likely continue in 2018.

What was the fund's investment environment like during the fourth quarter of 2017?

Improving economic growth and the continuation of a positive trend for corporate profits bolstered investor sentiment during the quarter. U.S. gross domestic product [GDP] registered two consecutive quarters of 3% or better annualized growth in the second and third quarters of 2017. Consumer spending was solid overall, as was business investment, and exports grew, reflecting a strengthening global economy. The unemployment rate reached a 17-year low of 4.1%. A closely watched measure of corporate profits — after-tax profits, without inventory valuation and capital consumption adjustments — increased 9.8% compared with a year earlier. All told, we think these trends point to a steadily growing economy ahead of the $1.5 trillion tax cut that was approved by Congress in late December, with a portion of that amount likely to influence the economy this year.

The yield on the benchmark 10-year U.S. Treasury stayed in a fairly tight range, ending the quarter at 2.40%. Rates rose modestly across the yield curve, with short-term yields rising more than longer-term yields in anticipation of a further increase in the target for short-term rates by the Federal Reserve. In December, the Fed hiked its benchmark rate by a quarter percentage point to a range of 1.25% to 1.5%, the fifth such increase in the past two years. The central bank also reiterated its forecast for raising rates potentially three times in 2018.

After strengthening modestly early in the quarter, the U.S. dollar weakened in November and December, on doubts that the Fed will be able to maintain its pace of rate increases this year in the face of low inflation. U.S. consumer prices have stayed stubbornly weak despite other signs of economic expansion. The most recent data on U.S. inflation showed that the personal-consumption expenditures price index — the Fed's preferred price gauge — had risen at a 1.8% annual rate, still below the central bank's long-elusive 2% target. Inflation remains low in the eurozone, Japan, and most other developed economies.

Overseas, the 19-country eurozone economy grew at an annualized rate of 2.4% in 2017's third quarter, a slowdown from the 2.6% growth rate recorded in the second quarter. Despite the third-quarter deceleration, the eurozone economy appears on course for its strongest year since 2007. Meanwhile, Japan's economy grew at an annualized pace of 1.4% in the July to September quarter, marking the country's seventh-straight quarter of growth — its longest streak since 2001.

For the first time in a decade, the world's major economies appear to be growing in sync. This parallel growth trend has been fueled by low interest rates and other stimulus measures by central banks, along with the gradual fading of crises that over the years ricocheted from the United States to Greece, Brazil, and elsewhere.

Eurozone and United Kingdom government bonds were among the top performers during the past three months with, for example, the Bloomberg Barclays Pan Euro Aggregate Bond Index returning 2.22% in U.S.-dollar terms. In U.S. corporate credit, investment-grade bonds modestly outpaced their high-yield counterparts.

Which holdings and strategies fueled the fund's performance for the quarter?

Our mortgage credit strategies were the primary contributor by a wide margin, led by an allocation to agency credit-risk transfer securities [CRTs]. The sector rebounded from an August-to-September selloff driven by hurricanes in Texas and Florida, as investors concluded that initial damage fears were overblown. Furthermore, CRTs continued to benefit from strong overall demand, as investors continued to embrace the sector's relatively high yields backed by robust collateral and rising residential real estate prices.

Positions in mezzanine commercial mortgage-backed securities [CMBS] also notably contributed. Our holdings of cash bonds performed well. Additionally, our long exposure to the BBB-rated tranche within the CMBX — an index that provides access to CMBS issued in a particular year — recovered in November and December following weakness in prior months.

Our holdings of high-yield corporate bonds also helped, aided by a benign default backdrop, a continuation of the positive trend in corporate earnings, and an improving U.S. economy. The yield spread of the JPMorgan Developed High Yield Index tightened by 0.11% for the quarter, as prices rose modestly.

Strategies targeting prepayment risk modestly contributed this period. Our positions in reverse-mortgage interest-only securities continued to benefit from regulatory changes announced by the Department of Housing and Urban Development [HUD] in August. The market cheered the new regulatory backdrop, believing it would reduce the incentives for holders of such mortgages to refinance.

By way of background, a reverse mortgage is a special type of loan that lets homeowners who are age 62 or older borrow money against the existing equity in their home. The U.S. government insures reverse mortgages under its Home Equity Conversion Mortgages [HECM] program. We focused on opportunities among HECM MBS that were issued by Ginnie Mae.

What about detractors?

Our currency strategies worked against performance in the fourth quarter. Our positioning was hampered by long exposure to the Norwegian krone, which weakened versus the U.S. dollar, and by a short position in the New Zealand dollar, which strengthened against the greenback in December.

What is your near-term outlook?

We believe the acceleration in global growth seen in 2017 will likely continue in 2018, but with significant changes in its components. We think U.S. GDP may strengthen somewhat from its recent level, but we also think growth in Europe and Japan may improve relative to the United States as 2018 unfolds. As a result, we think the euro and possibly the yen may strengthen versus the dollar later in the year. Meanwhile, the United Kingdom may be headed toward a softer version of Brexit as a consequence of recent developments in the country's efforts to separate from the European Union. Overall, we expect reasonably solid global growth, continued policy tightening by the Fed, relatively benign inflation, and a generally supportive environment for risk-driven assets. We also think bond yields may continue to drift higher over the course of 2018 as rate normalization continues.

In our view, the Fed will be a key focus of investor attention in 2018, especially during the first half, as a new chair takes office and new governors join the Federal Open Market Committee. While we don't anticipate significant policy changes under the new Fed chair, we do see the potential for miscommunication as the market adjusts to the tone and language of a new leader.

Given this outlook, what market sectors do you find to be most attractive?

We think prepayment risk remains attractive because relatively tight mortgage-lending standards may continue to curb refinancing activity. We also continue to like reverse-mortgage interest-only securities, given their stable prepayment profile and attractive spreads.

Within corporate credit, high-yield valuations are not as attractive as they were a year ago, but continue to look fair to us, in light of our positive outlook for corporate fundamentals, the U.S. economy, and default trends.

Within mortgage credit, we think CMBS could benefit from employment growth, low interest rates, and a continuation of the current economic expansion. While we expect some degree of losses related to regional malls, we're also encouraged by the fact that many malls are attempting to repurpose their space to attract new types of tenants. We believe the non-agency residential MBS market continues to be supported by an improving housing market and shrinking supply. We continue to like agency CRTs on the basis of fundamentals and underlying collateral, but have become more cautious from a valuation perspective.

Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 12/31/17

Class Y shares Inception 7/1/96	**Net asset value**	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	1.20%	0.39%
1 year	6.70	3.54
3 years	3.05	2.24
5 years	3.68	2.10
10 years	4.13	4.01
Life of fund	6.35	6.23

Total expense ratio: 0.75%

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 10/3/88), 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 Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities. You cannot invest directly in an index.

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