Q1 2018 | Putnam Diversified Income Trust Q&A

Multisector strategy advances in changing environment

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(Photo not available)

Increasing risk-aversion created a more challenging market environment in February and March.

Global interest-rate positioning and mortgage-credit holdings bolstered the fund's performance, while currency strategies detracted.

A supportive international environment may provide further opportunities to pursue global interest-rate and currency strategies.

What was the fund's investment environment like during the first quarter of 2018?

Following a strong start in January, the majority of risk-driven asset classes declined in February and March, as market volatility and investor risk-aversion returned after being largely absent from the market for the past two years.

At the onset of 2018, stocks and credit-sensitive bonds performed well amid an improving outlook for global economic growth, positive sentiment surrounding U.S. tax reform, and continued strength in corporate earnings. The yield on the benchmark 10-year U.S. Treasury rose by 0.26% in January, ending the month at 2.72%, as optimism about a synchronized global recovery spread.

The environment shifted in late January due to interest-rate jitters, collapsing strategies predicated on market volatility remaining low, and uncertainty about inflation expectations and a corresponding response from the Federal Reserve. Stocks reached correction territory in February, declining by roughly 12% from their January highs, with declines worsening when the Trump administration announced that it would impose tariffs on imports of steel and aluminum, sparking widespread fear of a trade war.

The yield on the 10-year Treasury posted its largest quarterly increase since the end of 2016. Data showed wages and consumer prices rose in January, encouraging more investors to sell government bonds and driving the yield on the 10-year Treasury more than half a percentage point higher in less than two months. But the rise in yields stalled in March. Strong January wage data were revised lower in the following month's labor report. Subsequent weaker-than-forecast inflation data suggested the tax cuts were unlikely to spur growth that matched the move in market expectations. Rising bond yields also attracted buyers. After reaching 2.94% on February 21 — its high for the period — the 10-year yield finished the quarter at 2.74%.

Heightened risk-aversion and rising yields pushed most credit-sensitive and U.S. government fixed-income categories into the red for the quarter. Among the bright spots were foreign developed-market sovereign bonds, which advanced 4.42% in U.S.-dollar terms, and floating-rate bank loans, which gained 1.45%.

The U.S. dollar weakened against other major currencies during the quarter, partly dampened by concerns about U.S. trade policy with China and the risk of a global trade war. Also weighing on the dollar was a global economic upswing that has encouraged central bankers in Europe and Asia to take the first steps toward normalizing monetary policy after years of expansive support. Indications that the European Central Bank [ECB] and the Bank of Japan are on course to phase out their stimulus programs and eventually raise interest rates boosted the yen and the euro by 5.9% and 2.7%, respectively, against the dollar.

The fund held up well despite the challenging backdrop. Which holdings and strategies fueled its positive performance?

Our interest-rate positioning was the biggest contributor for the quarter. The fund's duration in the United States was below zero, meaning it was positioned to benefit if market interest rates rose, which is exactly what happened. Tactical positioning in Europe also aided performance. Most notably, a short position in the United Kingdom during the first half of the quarter proved beneficial as bond yields there rose. A shift to long exposure in the U.K. during the second half of the quarter also helped, as rates trended lower during that time.

Our mortgage credit holdings provided a further boost to performance, led by investments in mezzanine commercial mortgage-backed securities [CMBS]. We held CMBS that were issued between 2011 and 2014, and the yield spreads for these bonds stayed in a fairly tight range versus widening spreads in the broader market. [Bond prices fall as spreads widen.]

An allocation to agency credit-risk transfer securities [CRTs] was also additive for the quarter. CRTs benefited 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. Additionally, credit-rating agencies upgraded various CRT tranches, recognizing the improved outlook for their underlying collateral.

Strategies targeting prepayment risk solidly contributed this period. Our positions in reverse-mortgage interest-only [IO] securities continued to benefit from regulatory changes announced by the Department of Housing and Urban Development in August. Higher longer-term Treasury yields aided the performance of our positions in agency interest-only collateralized mortgage obligations [IO CMOs]. Refinancing activity was subdued due to rising mortgage rates and stringent bank underwriting standards, which constrained lending activity. As a result, prepayment speeds on the mortgages underlying our IO CMO positions stayed below market expectations.

Elsewhere, holdings of high-yield corporate credit, convertible securities, and emerging-market [EM] debt modestly aided performance. These sectors performed well in January, but high-yield spreads widened considerably over the balance of the quarter as volatility increased. EM debt was also hampered by heightened volatility in February.

What about detractors?

Our currency strategies worked against performance in the first quarter. Our positioning was hampered by short exposure to the Japanese yen and the British pound, both of which strengthened against the U.S. dollar. Long exposure to the weakening Australian dollar also dented results. By contrast, a short position in the Swedish krona proved additive and partially offset the overall negative impact of our strategies.

What is your near-term outlook?

Recent U.S. and global economic data have been stronger than most market observers were expecting several months ago, especially given the fact that interest rates have risen. Despite this strength, we think it is unlikely that the global economy will overheat at this stage of the business cycle and spark a sustained rise in inflation. As an example of our view, we believe the U.S.

unemployment rate, which has held at 4.1% since October — its lowest level since December 2000 — results partly from demographic and structural factors. Consequently, we don't think the current level of employment will cause the economy to overheat.

During the quarter, we also saw a stabilizing dynamic at work in the markets. With bond yields trending higher, on days when market-moving economic data were released, bond investors would react and the yield curve would adjust, helping to dampen the impact on risk-sensitive assets.

Treasury yields also stabilized, plateauing in March and ending the quarter slightly below where they peaked. We think yields may continue to drift higher over the course of 2018, as rate normalization continues.

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

Surprisingly, as bond yields rose during the quarter, spreads remained relatively stable. [Spreads are the yield advantage offered by riskier types of bonds over comparable-maturity Treasuries.] Spreads for investment-grade and high-yield corporate credit, as well as mortgage credit, finished the period near their lows for the current market cycle. We think this is justified by the fundamentals underlying these market sectors, namely solid economic growth, rising corporate profits, and a strong housing market. We believe the fundamental backdrop continues to support risk-taking in these sectors, and we think this is particularly true in structured mortgage credit. As a result, we continue to have a positive outlook for securitized mortgage products, such as CMBS, agency IO CMOs, CRTs, and non-agency residential mortgage-backed securities.

Overseas, the eurozone economy had its best year in a decade during 2017, growing at a 2.4% annual rate, and the jobless rate fell to its lowest level since 2008. The ECB said it would continue purchasing government bonds through at least September 2018, but in reduced monthly amounts. This decision may signal a policy shift by the ECB that will eventually lead to more rapid tapering of its bond-purchase program. In the United Kingdom, the economy appears stable, even as the country is in the midst of Brexit negotiations. And in Asia, growth in Japan and China appears to us to be better than investors were anticipating several months ago. In our view, this favorable international backdrop is creating more opportunities to pursue various global interest-rate and currency strategies.

As of March 31, the fund's total duration was positive at about 2.7 years, driven by tactical yield-curve strategies in Europe. We continued to de-emphasize interest-rate risk in the United States, where the fund's duration remained below zero.

Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 3/31/18

Class Y shares Inception 7/1/96	**Net asset value**	**ICE BofAML U.S. Treasury Bill Index**	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	1.91%	0.34%	-1.46%
1 year	6.22	1.04	1.20
3 years	3.77	0.53	1.20
5 years	3.31	0.35	1.82
10 years	4.81	0.40	3.63
Life of fund	6.37	—	6.13
Total expense ratio: 0.75%			

Returns for periods of less than one year are not annualized.

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