Q3 2017 | Putnam Diversified Income Trust Q&A

Multisector strategy drives solid results

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(Photo not available)

The bond market continued to benefit from investor willingness to take risk in order to access higher yields.

Corporate credit holdings, currency strategies, and positions in emerging-market debt drove results, while interest-rate and yield-curve positioning detracted.

We think the Fed's gradual approach to reducing its bond portfolio may help keep rate volatility contained.

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

The trend of elevated risk appetite continued during the third quarter.

Globally, investors grappled with geopolitical risk, highlighted by heated rhetoric surrounding North Korea's nuclear program. In the United States, Hurricanes Harvey and Irma caused suffering and economic disruption in Texas and Florida, respectively. Despite these developments, investors focused on a broader macro landscape that revealed a rising trajectory, with second-quarter U.S. gross domestic product revised upward to 3.1% and a labor market that continued to register reasonably positive gains.

The benchmark 10-year U.S. Treasury yield ended the quarter at 2.33%, slightly above where it started. The yield declined during August into early September amid heightened U.S.–North Korea tension. The yield moved higher during the remainder of September, however, as the Federal Reserve indicated that it still saw the potential for raising rates once more this year and three times in 2018.

At its mid-September policy meeting, the Fed left the target for short-term interest rates unchanged at a range of 1% to 1.25%. The central bank announced that it would begin in October to shrink its massive portfolio of Treasuries and agency mortgage-backed securities [MBS] that it accumulated after the 2008 financial crisis.

Overseas, second-quarter growth in the 19-nation eurozone came in at a 2.6% annual rate, a faster pace than the European Central Bank [ECB] had expected at the beginning of the year. The eurozone's strength has been one of the positive surprises for the global economy this year, as it outpaced the United States in the first quarter and accelerated further in the three months ended June 30, 2017.

ECB monetary policy remains supportive, but an announcement by ECB President Mario Draghi signaled that the bank could announce a plan in October to gradually end its program of bond purchases. However, Mr. Draghi also warned that the bank's next steps would partly depend on the strength of the euro, which has surged by about 12% against the U.S. dollar since the beginning of the year.

U.S. crude oil prices rebounded in the third quarter, fueled by unexpectedly strong demand, signs of ebbing U.S. production, and refinery disruptions resulting from Hurricane Harvey. The price for a barrel of West Texas Intermediate, the U.S. crude benchmark, ended the period at $51.67, representing a 10.5% advance for the quarter.

Emerging-market [EM] debt was among the top performers of the past three months, with the JPMorgan Emerging Markets Bond Index returning 2.63%. In U.S. corporate credit, high-yield bonds outpaced investment-grade corporates as yield spreads continued to tighten.

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

Our positions in corporate credit meaningfully contributed, aided by a benign default backdrop in the high-yield market, along with supportive corporate fundamentals and a generally healthy U.S. economy. The yield spread of the JPMorgan U.S. Developed High Yield Index tightened by 0.28% for the quarter, as prices rose modestly.

Our currency strategies were another notable positive. Long positions in the Swedish krona and the euro were the most additive. However, the contribution from these positions was partially offset by short exposure to the Norwegian krone, which appreciated during the quarter.

EM debt also aided performance, led by investments in Argentina. Argentine bonds benefited from a primary vote ahead of congressional elections in October that gave a boost to the market-friendly agenda championed by the country's president. Positions in Brazil rallied when the country's senate passed a labor reform bill in July. Holdings in Russia and Mexico also contributed.

Exposure to prepayment risk provided a further boost to results, driven by our holdings of reverse-mortgage interest-only securities [reverse-mortgage IOs]. These securities posted strong returns late in the period after the Department of Housing and Urban Development [HUD] announced changes that we think reduce the incentives for holders of existing reverse mortgages to refinance. Adverse results from a strategy that sought to exploit the yield differential between current mortgage rates and longer-term Treasuries partially detracted from the overall positive performance of our prepayment-related positions.

What about detractors?

The fund's interest-rate and yield-curve positioning was the primary detractor this period. Although we took a tactical approach to our rate strategy throughout the quarter, performance was hampered by the fact that the fund's duration — its sensitivity to interest-rate changes — was below zero in August — a period when Treasury yields steadily declined. Had yields risen, our duration strategy would have helped performance.

What is your near-term outlook?

The Fed had signaled for months that it was planning to begin reducing its $4.5 trillion bond portfolio, and in September announced that it would start the process in October. The Fed's plan is to allow a specific amount of securities to mature each month (or pay down, in the case of MBS): $6 billion in Treasuries and $4 billion in MBS. It would then allow the amount of maturities to increase each quarter, ultimately reaching a maximum of $30 billion per month for Treasuries and $20 billion per month for agency MBS. We expect that the Fed will reduce its holdings in a gradual and predictable manner in an effort to avoid interest-rate spikes or other market strains.

The Fed stopped adding to its investments more than three years ago, but it has been reinvesting the proceeds of maturing bonds to keep its holdings steady. These reinvestments have helped keep a lid on long-term interest rates, and letting securities mature without reinvesting could put upward pressure on rates. That said, we think the incremental nature of the plan suggests that rate volatility may be limited, at least initially.

Turning to bond yields, we think yields are too low given generally favorable global economic conditions. Although we don't believe yields are likely to rise significantly this year, partly due to strong global demand for U.S. bonds, we do think they'll be higher by the end of 2018. There are a lot of unknowns: potentially significant changes to the Fed's Board of Governors in 2018; the timing of when the ECB will begin to taper its bond-purchase program; tax reform in the United States; tighter monetary policy in other countries, such as Canada and the United Kingdom; and the ongoing potential for geopolitical flare-ups. So, while there are a variety of cross-currents that could impact the trajectory of bond yields both in the United States and overseas, we think the overall trend will be for yields to rise next year.

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 IOs, 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 commercial mortgage-backed securities 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 are 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 credit risk-transfer securities 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 9/30/17

Class Y shares Inception 7/1/96	**Net asset value**	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	1.63%	0.85%
1 year	9.24	0.07
3 years	1.79	2.71
5 years	4.22	2.06
10 years	4.05	4.27
Life of fund	6.37	6.28

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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