Q1 2019 | Putnam Municipal Bond Funds Q&A

Dovish Fed and tax aversion lift munis

Paul M. Drury, CFA
Portfolio Manager
Industry since 1989

Garrett L. Hamilton, CFA
Portfolio Manager
Industry since 2006

Municipal bonds outperformed Treasuries and nearly kept pace with the taxable bond market for the quarter.

With the new tax law allowing individuals fewer income deductions, retail demand provided support for the asset class.

We believe slower growth and the absence of inflationary pressures may keep the Fed on hold in 2019.

How did municipal bonds perform during the first quarter of 2019?

With the prevailing macroeconomic and geopolitical winds presenting some uncertainty about the pace of global growth, and the Federal Reserve taking a more dovish tone, the market environment was quite hospitable for the asset class. Tax-exempt municipal bonds enjoyed solid performance during the quarter, outperforming Treasuries, and nearly kept pace with the taxable bond market.

The Fed held its short-term benchmark rate steady at a target range of 2.25% to 2.50% during the quarter. However, the Fed's post-meeting statements indicated a softening in its outlook for the economy. In January, Fed Chair Jerome Powell signaled that the impasses over U.S. trade and government budget negotiations and slower growth in Europe and China warranted a "patient" approach to future rate increases. The Fed also referenced "muted inflationary pressure" and downgraded its description of U.S. economic growth from "strong" to "solid." At the March meeting, the Fed acknowledged that U.S. economic growth had slowed from its solid pace in the fourth quarter of 2018 and then surprised investors by saying that no more hikes would be coming in 2019.

Against this backdrop, yields declined across the U.S. Treasury yield curve, with the bellwether 10-year Treasury falling from 2.67% at the beginning of the quarter to 2.39% on March 28, 2019. The drop in interest rates was a tailwind for the municipal market, which took its cue from Treasuries. [Bond prices rise as interest rates fall.]

Technicals, or supply and demand dynamics, were also positive for the municipal market. Fund inflows [a measure of retail investor interest] were noteworthy, with investors pouring a record $22.5 billion into municipal bond funds during the quarter, according to Lipper fund flow data. With the new tax law capping the deductibility of state and local taxes at $10,000 a year, many Americans are facing higher taxes for 2018. As a result, tax-exempt bond funds are seeing renewed demand, which has contributed to rising prices. The surge helped to offset weaker interest from banks following the decline in the corporate income tax rate from 35% to 21%. On the supply front, new municipal bond issuance totaled $75 billion in the first quarter, according to the *Bond Buyer.*

Against this backdrop, the Bloomberg Barclays Municipal Bond Index [the municipal benchmark] finished the quarter with a return of 2.90%. Lower-quality and longer-maturity bonds within municipals outperformed higher-quality and shorter-maturity bonds. The Bloomberg Barclays U.S. Corporate High Yield Index returned 7.26%. In comparison, the Bloomberg Barclays U.S. Aggregate Bond Index and the ICE BofAML U.S. Treasury Bill Index rose 2.94% and 0.62%, respectively.

What was your investment approach in this environment?

Many of our broader investment themes remained in place. They included duration positioning, or interest-rate sensitivity, that was generally neutral relative to the funds' Lipper peer groups; overweight exposure to higher-quality bonds rated A and BBB relative to the benchmark; and a preference for continuing-care retirement community, essential service utilities, and higher-education bonds — all relative to the Lipper groups. The funds also continued to be weighted more toward essential service revenue bonds than toward local general obligation bonds [GOs], which typically rely on the taxing power of state and local governments.

Geographically speaking, the national funds held an overweight in Illinois GOs. We believe that the state's financial profile continued to stabilize, and this is not currently reflected by market spreads. As such, those holdings look attractive from a fundamental and relative value standpoint, in our view.

In February, Puerto Rico reach an important milestone in its financial recovery. Federal bankruptcy Judge Laura Taylor Swain formally approved a major debt restructuring plan for Puerto Rico's sales tax bonds known as "COFINA." The agreement swapped out more than $17 billion in COFINA sales tax revenue bonds, including a senior and subordinate lien, for new bonds in a debt exchange. Senior lien bonds recovered roughly 93 cents on the dollar. Subordinate lien bonds recovered roughly 56 cents on the dollar. The restructured bonds were downsized — to about $12 billion — into one new single lien security.

The compromise agreement will help Puerto Rico save more than $400 million annually that will be available for public services such as health, education, and pension payments. While the ruling brings clarity, and the bond restructuring is a positive step to help resolve Puerto Rico's debt crisis, the uncertainty of the island's road to economic recovery causes us to remain cautious.

The funds remain significantly underweight Puerto Rico if held.

What is your outlook for interest rates and the municipal bond market?

We believe slower growth and the absence of inflationary pressures may keep the data-dependent Fed on hold in 2019. This bodes well for municipal bond prices for the foreseeable future, in our view.

Although unfunded pension liabilities remain a concern for some municipalities, defaults for investment-grade municipal bonds have been rare and remain relatively low for non-investment-grade municipal bonds. The asset class also has demonstrated a low correlation to equities in recent years, suggesting that they could help play a defensive role in a diversified investment portfolio during periods of equity market volatility.

With their low default rate, competitive tax-adjusted returns, and stable credit fundamentals, we believe municipals represent a high-quality investment option for income-oriented investors. We'll continue to monitor the market on a daily basis to capture opportunities that arise from supply and/or demand imbalances. We'll also continue to adjust the portfolio's interest-rate sensitivity accordingly as our views change.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 3/31/19

Class Y shares Inception 1/2/08	Net asset value	Bloomberg Barclays Municipal Bond Index
Last quarter	3.03%	2.90%
1 year	5.06	5.38
3 years	3.00	2.71
5 years	3.95	3.73
10 years	5.38	4.72
Life of fund	6.35	—

Total expense ratio: 0.55%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 3/31/19

Class Y shares Inception 1/2/08	Net asset value	Bloomberg Barclays Municipal Bond Index
Last quarter	3.40%	2.90%
1 year	5.31	5.38
3 years	3.98	2.71
5 years	5.48	3.73
10 years	7.88	4.72
Life of fund	5.81	6.39

Total expense ratio: 0.59%

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 historical performance (Tax Exempt Income Fund, class A inception 12/31/76; and Tax-Free High Yield Fund, class B inception 9/9/85), which have not been adjusted for the lower expenses; had they, returns would have been higher. For a portion of the periods, these funds 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 Municipal Bond Index is an unmanaged index of long-term fixed-rate investment-grade tax-exempt bonds. It is not possible to invest directly in an index.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed here are those of the portfolio managers as of March 31, 2019, are subject to change with market conditions, and are not meant as investment advice.

Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

Consider these risks before investing: Capital gains, if any, are taxed at the federal and, in most cases, state levels. For some investors, investment income may be subject to the federal alternative minimum tax. Income from federally tax-exempt funds may be subject to state and local taxes. 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. Unlike bonds, funds that invest in bonds have fees and expenses. The fund may invest significantly in particular segments of the tax-exempt debt market, making it more vulnerable to fluctuations in the values of the securities it holds than a more broadly invested fund. Interest the fund receives might be taxable. 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 lead to increased volatility and reduced liquidity in the fund's portfolio holdings. You can lose money by investing in the fund.

The Bloomberg (BBG) Barclays U.S. Corporate High-Yield Index covers the U.S. dollar-denominated, non-investment-grade, fixed-rate, taxable corporate bond market and includes securities with ratings by Moody's, Fitch, and S&P of Ba1/BB+/BB+ or below.

The Bloomberg (BBG) Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities.

The ICE BofAML U.S. Treasury Bill Index is an unmanaged index that tracks the performance of U.S.-dollar-denominated U.S. Treasury bills publicly issued in the U.S. domestic market. Qualifying securities must have a remaining term of at least one month to final maturity and a minimum amount outstanding of $1 billion. You cannot invest directly in an index.

A world of investing.®

Putnam INVESTMENTS

Request a prospectus or summary prospectus from your financial representative or by calling 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

Putnam Retail Management

Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

TL041 316490 4/19