Q3 2021 | Putnam Municipal Bond Funds Q&A

Inflation and rate fears weigh on municipals

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How did municipal bonds perform during the third quarter of 2021?

Municipal bonds began the quarter on solid ground but encountered headwinds in the final weeks of the quarter. Mixed economic data, a spike in Covid-19 cases due to the Delta variant, and higher interest rates eroded earlier gains, resulting in relatively flat performance for the three months ended September 30, 2021.

On the positive side, the American Rescue Plan [ARP], which provided a windfall of $350 billion in direct aid to states and local governments, proved to be a considerable tailwind for the asset class. This aid, coupled with the fact that state budgets have generally outperformed conservative forecasts, has improved the outlook for some of the largest credits in the municipal bond market. Furthermore, local municipalities have benefited from a strong housing market and higher revenue from local property taxes.

Supply/demand technicals were another tailwind. Year-to-date 2021 total municipal bond issuance through September 30, 2021, was slightly below that of 2020. Meanwhile, demand was strong. Municipal bond fund inflows, a measure of investor demand, totaled $29 billion for the third quarter, with year-to-date inflows totaling nearly $89 billion through September 30, 2021 — the second highest on record.* We believe a potential increase in the corporate income tax rate, currently being discussed by Congress, could help spur additional municipal bond buying by taxable institutional investors, such as U.S. banks and insurance companies. Similarly, an increase in personal tax rates could stimulate further demand by individual investors.

* Source: Lipper, a Refinitiv company.

At the Federal Reserve's Jackson Hole symposium in August 2021, Fed Chair Jerome Powell offered no timetable on asset-purchase tapering. Sounding a more dovish note, Powell stated the timing of tapering is not meant to signal the timing of future rate hikes and that the Fed will continue to take a cautious approach to raising interest rates. In September 2021, the Fed's messaging became more hawkish when it stated it might begin tapering purchases as early as November 2021. Interest rates moved higher in response to the announcement and in response to inflation fears, which diminished the performance of rate-sensitive fixed income securities. The inflation concerns were stoked by the prospect of higher prices due to supply chain disruptions, rising labor costs, and higher commodity prices.

How were the funds positioned in this environment?

At quarter-end, the funds held an overweight exposure to investment-grade bonds rated A and BBB relative to the benchmark. The funds also held a neutral exposure to lower-rated, high-yield bonds relative to their respective Lipper peer groups. From a sector- or industry-positioning perspective, we favored continuing-care retirement communities, land development, and charter school bonds relative to the funds' Lipper peer groups. Duration positioning, a measure of the funds' interest-rate sensitivity, was generally neutral to modestly short relative to the level of their respective Lipper peer groups at period-end. Our yield-curve strategy was defined by an overweight position in bonds with maturities of 10 to 20 years relative to the Lipper peer groups at quarter-end. As part of this strategy, the funds generally held an underweight exposure to the longest-maturity bonds compared with the benchmark.

Regarding our strategy for state debt, the fund held an overweight exposure to Illinois relative to the Lipper peer group. We believe Illinois's financial profile continues to stabilize, and its flexibility and credit fundamentals have improved since the onset of the Covid-19 pandemic in the United States. During the quarter, we decreased the overweight position slightly as credit spreads tightened due to improving municipal credit fundamentals and strong market technicals. [Credit spreads reflect the difference in yield between higher- and lower-rated municipal bonds.]

We remain cautious about Puerto Rico due to what we believe are its seemingly fragile economy, weak demographic trends, poor-quality infrastructure, volatile political environment, and history of fiscal mismanagement. As such, the fund remained underweight in its exposure to uninsured Puerto Rico municipal debt relative to its Lipper peer group. We continue to monitor the Commonwealth's ongoing restructuring efforts for potential opportunities. In the funds that held Puerto Rico debt, the positions represented less than 0.05% of total net assets and holdings were predominantly pre-refunded bonds.

What is your outlook as we enter the fourth quarter of 2021?

The recent infusions under the ARP, fiscal stimulus, and a pickup in economic activity should help many state and local governments enter their 2022 budget sessions with enough cash on hand to help absorb the economic stress of the pandemic, in our view. In August 2021, the Senate passed a $1 trillion bipartisan infrastructure bill to repair the nation's deteriorating roads and bridges, fund new broadband and climate initiatives, and modernize the power grid. The House subsequently passed a budget reconciliation blueprint, and a vote for the passage of a $550 billion bipartisan infrastructure bill was still pending at quarter-end. Depending on the details of the infrastructure bill, it would likely be a positive development for many municipal borrowers, particularly state and local governments, transit agencies, airports, and other entities that typically finance transportation infrastructure. In our view, federal grants for these projects would reduce the need for municipal borrowers to issue debt to cover these essential services. This could increase fiscal flexibility for these borrowers while avoiding higher tax burdens.

The current uncertainties surrounding the path of inflation and the course of the pandemic could lead to increased interest-rate volatility. The pandemic-related supply chain and labor market disruptions have been more persistent than initially expected, leading to delays and output shortages that could be with us for some time. The near-term result is an elevated inflation backdrop that will likely weigh on consumer sentiment and erode demand or encourage the Fed to tighten monetary policy more quickly. In either case, our near-term outlook is for slower growth than previously expected and modestly elevated inflation.

Municipals were one of the best-performing fixed income classes during the first half of 2021. Given this result, we believe municipal bond returns in the second half of 2021 are unlikely to match the relatively strong results of the first half. With current valuations at relatively rich levels versus history, we would view any rate volatility or a market sell-off as a potential buying opportunity. We believe the lower tiers of the investment-grade municipal market, particularly BBB-rated securities, and the BB-rated part of the high-yield market represent some of the best income and return opportunities today, but we are being extremely selective.

Defaults, despite pandemic-related challenges, remained low and within long-term ranges during the period. Even with Covid-19 challenges in 2020, the default rate represented less than 0.25% of the overall municipal bond market, according to Municipal Market Analytics. Defaults within the investment-grade-rated universe were a rare occurrence.

We continue to believe municipals offer a high-quality, tax-free strategy to garner income in today's historically low-rate environment.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 9/30/21

	Class Y shares Inception 1/2/08	**Bloomberg Municipal Bond Index**
Last quarter	–0.55%	–0.27%
1 year	4.40	2.63
3 years	5.36	5.06
5 years	3.59	3.26
10 years	4.21	3.87
Life of fund	6.26	—

Total expense ratio: 0.58%

Source: Bloomberg Index Services Limited.

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 9/30/21

	Class Y shares Inception 1/2/08	**Bloomberg Municipal Bond Index**
Last quarter	–0.51%	–0.27%
1 year	8.60	2.63
3 years	6.34	5.06
5 years	4.58	3.26
10 years	5.69	3.87
Life of fund	5.82	6.24

Total expense ratio: 0.63%

Source: Bloomberg Index Services Limited.

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 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 September 30, 2021, 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. The value of investments in the fund's portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political, or financial market conditions; investor sentiment and market perceptions; government actions; geopolitical events or changes; and factors related to a specific issuer, geography, industry, or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings.

Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could have a negative effect on the fund. You can lose money by investing in the fund.

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