Q3 2018 | Putnam Municipal Bond Funds Q&A

Dwindling bank demand, higher rates weigh on munis

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Duration positioning across the funds remained fairly neutral relative to the benchmark index.

We still see value in the asset class, even in a rising-rate environment.

Not FDIC insured | May lose value | No bank guarantee

How did municipal bonds perform during the third quarter of 2018?

Municipal bonds delivered slightly negative performance for the quarter due to rising interest rates and weaker demand from banks. Since the corporate tax cuts enacted in December 2017 made it less attractive for banks to hold tax-free bonds, municipal assets held by banks declined $26.7 billion through June 30, 2018. Interest rates remained range bound during part of the third quarter — in July and early August — despite concerns about trade protectionism and geopolitical concerns tied to President Trump's European visit and NATO meeting. However, geopolitical risks, including trade tensions between the United States and China, escalated during the second half of the quarter. Investors moved into "safer" investments such as Treasuries. Munis experienced a slow, steady selloff, and their yields moved higher as a result of the higher Treasury rates due to stronger U.S. economic indicators and expectations for a continuation of the Federal Reserve raising short-term interest rates.

The Bloomberg Barclays Municipal Bond Index [the benchmark index] posted a return of -0.15% for the third quarter, underperforming Treasuries, as measured by the ICE BofAML U.S. Treasury Bill Index, which returned 0.49%. As the market priced in the likelihood of a September interest-rate hike by the Fed, the short to intermediate end of the municipal yield curve flattened, while the intermediate to long end of the curve steepened. Higher-yielding and lower-investment-grade bonds outperformed higher-credit-quality bonds during the quarter.

The municipal bond market continued to adjust to fluctuating supply/demand dynamics created by the Tax Cuts and Jobs Act of 2017. On the supply side, new municipal bond issuance totaled $84 billion for the quarter, down 9% from a year ago, according to the *Bond Buyer.* On a year-to-date basis, total issuance stood at $247 billion, representing a 15% drop from the same period a year earlier. A decline in available supply helps to support prices.

Fund flows, a measure of retail investor interest, were positive in July, August, and September and helped to offset the lack of interest from banks. The asset class also saw reduced demand from institutional investors that were less interested in extending portfolio durations.

How were the funds positioned in this environment?

Duration positioning across the funds was slightly short relative to the benchmark index during the quarter. Yields have risen year to date, and benchmark rates are near levels that are more consistent with our longer-term outlook. While we expect interest rates to rise gradually over the balance of the Fed's hiking cycle, there may be short-term periods that feel more abrupt. It is our view that interest rates have reached levels where income return is sufficient to more than offset our outlook for potential capital depreciation over the course of the Fed's rate-hiking cycle. In other words, we still see value in the asset class, even in a rising-rate environment.

With the flattening of the yield curve, we saw better relative value in bonds with maturities of 15 to 20 years. As such, we favored overweighting positioning in bonds with longer intermediate maturities while underweighting shorter intermediate and long maturity holdings. Consequently, the funds' yield-curve positioning had more of a portfolio structure focused on the middle of the curve. This positioning contributed to an average maturity of approximately 15 years across our long-term municipal bond funds.

From a credit-quality standpoint, the funds held an overweight exposure to higher-quality bonds rated A and BBB. We continue to look for opportunities to move higher up on the credit quality spectrum. While municipal credit fundamentals remain stable, credit spreads remain at or near post-crisis lows. From a sector-positioning perspective, we continue to favor higher continuing-care retirement facilities, essential service utility, and state-backed bonds relative to the funds' Lipper group.

Geographically speaking, the funds hold a modest overweight in Illinois general obligation [G.O.] bonds, which performed well for the quarter. Illinois G.O. bonds outperformed the broader municipal bond market during the quarter due to ample spreads and steady demand, which helped to cushion the bonds against modestly higher interest rates. Illinois G.O. bonds remain an attractive opportunity in our view, as we believe the credit stabilized during the past year, which is not currently reflected by market spreads.

The funds also continue to hold an underweight position in Puerto Rico-based issuers relative to their Lipper peers. Puerto Rico's current economic and financial situations remain extremely difficult, especially after the catastrophic damage inflicted by Hurricane Maria. That said, Puerto Rico bond prices have risen dramatically during 2018 as the market has priced in the potential of higher recoveries.

What is your near-term outlook for the municipal bond market?

In late September, as expected, the Fed raised its benchmark short-term rate by a quarter of a percentage point to a target range of 2.00% to 2.25%. In its statement, Fed policymakers cited strong economic growth and forecasted that the U.S. economy would see at least three more years of growth. As part of that communication, the Fed also eliminated the word "accommodative" from its comments about monetary policy.

With regard to our outlook for interest rates over the next three to six months, we believe the Fed will introduce its fourth and final rate hike of 2018 in December. As noted above, our expectation is for a gradual increase in interest rates. We believe such a path and pace over the balance of the hiking cycle will provide the time necessary for fixed-income investors to buttress their portfolios with ample income return that should offset the potential for capital depreciation.

We continue to find value in the asset class as municipals are a high-quality, low-default sector that has a low correlation versus other fixed-income alternatives.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 9/30/18

Class Y shares Inception 1/2/08	Net asset value	Bloomberg Barclays Municipal Bond Index
Last quarter	–0.03%	–0.15%
1 year	0.89	0.35
3 years	2.55	2.24
5 years	3.85	3.54
10 years	4.97	4.75
Life of fund	6.32	—

Total expense ratio: 0.55%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 9/30/18

Class Y shares Inception 1/2/08	Net asset value	Bloomberg Barclays Municipal Bond Index
Last quarter	0.06%	-0.15%
1 year	2.36	0.35
3 years	4.15	2.24
5 years	5.72	3.54
10 years	6.22	4.75
Life of fund	5.78	6.34

Total expense ratio: 0.60%

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.

The views and opinions expressed here are those of the portfolio managers as of September 30, 2018, 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 greater for longer-term bonds, and credit risk is greater for below-investment-grade bonds. Unlike bonds, funds that invest in bonds have fees and expenses. The funds may invest significantly in particular segments of the tax-exempt debt market, making them more vulnerable to fluctuations in the values of the securities they hold than more broadly invested funds. Interest the funds receive might be taxable. Bond prices may fall or fail to rise over time for several reasons, including general financial market conditions, changing market perceptions of the risk of default, changes in government intervention, and factors related to a specific issuer. These factors may also lead to periods of high volatility and reduced liquidity in the bond markets. You can lose money by investing in the funds.

The ICE BofAML U.S. 3-Month Treasury Bill Index is an unmanaged index that seeks to measure the performance of U.S. Treasury bills available in the marketplace. You cannot invest directly in an index.

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