Q2 2019 | Putnam Municipal Bond Funds Q&A

Falling rates and strong demand extend muni rally

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Municipal bonds posted three months of positive performance and outperformed Treasuries.

The asset class saw significant mutual fund inflows, as investors sought their attractive tax-free yields, perceived lower volatility, and stable credit fundamentals.

Municipals have demonstrated a low correlation to equities in recent years, suggesting that they could help play a defensive role during periods of equity market volatility.

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

Municipal bonds enjoyed solid performance, posting three months of positive results for the quarter. This performance came at a time of increased market volatility and heightened concerns about trade tensions. The month of May was noteworthy for the sell-off in risk assets when U.S.–China trade talks hit an impasse, and both countries imposed a new round of tariffs. The Trump administration then surprised investors when it threatened tariffs on Mexico in response to illegal immigration into the United States.

The Federal Reserve held its short-term benchmark rate steady at a target range of 2.25% to 2.50% throughout the quarter given a tight U.S. labor market, mild inflation, and the growth-dampening effects of the trade tariffs. The Fed's commentary also became increasingly dovish. At the Fed's June 2019 meeting, policy makers removed "patience" from their statement and acknowledged that "uncertainties" have increased in the economic outlook. In turn, Fed observers looked for an interest-rate reduction as early as July 2019. Risk assets then rallied in the final weeks of the quarter.

As investors positioned for a period of easing monetary policy, the municipal bond curve continued to flatten during the period. The flattening was the result of increased demand for longer-maturity bonds, which pushed their prices higher and yields lower. Consequently, municipals outperformed Treasuries.

In addition to falling U.S. Treasury yields, supply/demand dynamics helped to support municipal bond prices during the quarter as well. The Fed's dovish statements increased the appeal of longer-duration fixed-income assets. [Duration is a measure of an investment's sensitivity to interest rates.] Additionally, with the Tax Cuts and Jobs Act of 2017 capping the deductibility of state and local taxes at $10,000 per year, many Americans faced higher taxes for 2018. As a result, municipal bonds saw significant mutual fund inflows during the second quarter, as investors sought their attractive tax-free yields, perceived lower volatility, and stable credit fundamentals. On the other hand, supply has underwhelmed, rising only 1% year-over-year through June 30, 2019. The combination of record demand and modest supply helped to push municipal bond valuations near multi-year highs by the end of the period.

Given their supportive technicals and prevailing low interest rates, municipal bond yields declined to near-record lows during the quarter — contributing to their tight ratio to U.S. Treasury yields. [The ratio of AAA-rated municipal yields versus similar maturity U.S. Treasury yields measures the relative value of tax-free municipals versus taxable bonds. A lower ratio implies that municipal bond yields are somewhat rich versus comparable U.S. Treasuries.]

Against this backdrop, the Bloomberg Barclays Municipal Bond Index [the municipal benchmark] finished the quarter with a return of 2.14%. Lower-rated investment-grade municipal bonds rated BBB were the best performing credits, outpacing higher-yielding, lower-quality and higher-quality municipal bonds. In comparison, the Bloomberg Barclays U.S. Aggregate Bond Index and the ICE BofAML U.S. Treasury Bill Index rose 3.08% and 0.67%, respectively.

How did the changing rate environment affect your strategy?

The flattening of the municipal yield curve and what we viewed as relatively rich valuations made us slightly more cautious in our positioning. That said, stable credit fundamentals and positive supply/demand technicals supported the asset class at period-end. With the municipal yield curve flat by historical standards, we reduced the fund's exposure to long maturity bonds and redeployed the proceeds into shorter and intermediate maturity bonds. In our opinion, these bonds have a much more favorable risk/return profile.

The funds' yield curve positioning continued to reflect a bulleted portfolio structure focused on longer intermediate-term maturities but to a lesser degree than at the beginning of the period. That said, the funds still held an overweight position in bonds with longer intermediate maturities and an underweight exposure to long maturity holdings compared with the funds' benchmark.

With municipal credit fundamentals stable, credit spreads remained at or near post-2008-crisis lows — contributing to the relative outperformance of lower investment-grade municipal bonds during the period. The funds held an overweight exposure to higher-quality bonds rated A and BBB relative to the funds' Lipper peer group. We continued to look for what we viewed as attractively priced opportunities to move higher up the credit-quality spectrum. In our sector strategy, we favored continuing-care retirement communities, utilities, higher education, charter schools, and select state and local general obligation bonds [GOs] relative to the funds' Lipper peer group.

In our state strategy, the funds held overweight positions in GOs relative to their benchmarks, which helped results. We believe that the Land of Lincoln's financial profile continues to stabilize, and this is not currently reflected by market spreads. As such, the Illinois GO holdings looked attractive from a fundamental and relative value standpoint, in our view.

With regard to Puerto Rico, we remain cautious due to the Commonwealth's uncertain economic recovery and a perceived lack of institutional credibility across Puerto Rico's government. Accordingly, our portfolios remained underweight in their exposure to Puerto Rico's municipal bonds during the period compared with their Lipper peer groups.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 6/30/19

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	2.48%	2.14%
1 year	6.92	6.71
3 years	2.87	2.55
5 years	3.91	3.64
10 years	5.21	4.72
Life of fund	6.38	—

Total expense ratio: 0.55%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 6/30/19

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	2.83%	2.14%
1 year	6.88	6.71
3 years	3.65	2.55
5 years	5.30	3.64
10 years	7.28	4.72
Life of fund	5.85	6.41

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.

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

Given the prevailing crosscurrents at period-end, we believe the Fed will cut its benchmark federal funds rate twice during the second half of 2019 and possibly again in early 2020 if market conditions warrant it. The markets are pricing in even more accommodation over this time period. Historically, when the market anticipates interest-rate reductions, the Fed has followed through. In our view, the central bank will interpret continued softening in U.S. growth as proof that lower inflation is persisting. On the other hand, should the Fed choose not to act, we believe increased volatility in higher-risk assets could push them to cut rates.

Municipal fundamentals remain positive, contributing to a relatively healthy municipal bond market, in our view. Tax receipts continue to surprise to the upside in many of the states that have experienced more news coverage as they address pension funding challenges. 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. This suggests a possbility that they could help play a defensive role in a diversified investment portfolio during periods of equity market volatility.

We believe a minor headwind for the asset class in the months ahead is rich valuations after a six-month rally in the municipal bond market. The rich valuations, for the time being, are being supported by strong investor demand. We'll continue to monitor the municipal bond market on a daily basis to uncover opportunities that surface amid supply and/or demand imbalances. We'll also continue to adjust the portfolio to reflect the team's best ideas to enhance income as well as total return prospects in an evolving interest-rate environment.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed here are those of the portfolio managers as of June 30, 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. 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 or 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.

The Bloomberg (BBG) Barclays Municipal Bond Index is an unmanaged index of long-term fixed-rate investment-grade tax-exempt bonds. You cannot invest directly in an index.

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