Q4 2018 | Putnam Municipal Bond Funds Q&A

Munis outperform stocks and bonds amid volatility

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Municipal bonds began to rally in early November and delivered positive performance in the fourth quarter.

Investor demand for tax-free income and reduced municipal bond supply supported municipal bond prices.

The funds were generally overweight longer intermediate bonds and higher-quality bonds.

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

In a quarter memorable for its roller-coaster volatility, municipal bonds delivered positive performance and outperformed the broader fixed-income markets, Treasuries, and equity markets. Investors encountered a constant barrage of headlines about U.S.–China trade tensions, rising interest rates, slowing global growth, and geopolitical tensions. They responded by selling higher-risk equity and fixed-income investments and buying more conservative fixed-income investments and other sanctuary assets. The month of December was especially challenging for stocks, which saw their worst performance for the month since the 1930s.

With the flight to quality, municipal bond yields moved lower in tandem with Treasury rates in November and December. Although mutual fund flows were negative during the quarter, investor demand for tax-free income and reduced municipal bond supply coming to market helped to create positive technicals. These conditions supported municipal bond prices and contributed to their relative outperformance. Against this backdrop, the Bloomberg Barclays Municipal Bond Index rose 1.69%, while the Bloomberg U.S. Aggregate Bond Index and ICE BofAML U.S. Treasury Bill Index returned 1.64% and 0.58%, respectively.

At its November meeting, the Federal Reserve held interests rates steady. In its statement, the Fed's outlook was little changed from its commentary in September 2018 aside from observing that "business investment had moderated from its rapid pace earlier in the year." At its highly anticipated December meeting, the Fed introduced its fourth rate hike of 2018 as expected, increasing its benchmark rate a quarter of a percentage point to a target range of 2.25% to 2.50%. Fed Chair Jerome Powell stated that he sees growth and inflation moderating in the future and signaled a more patient approach to future rate increases. Powell added that there were a number of "cross-currents emerging" warranting a reduction in hikes in 2019 from three to two.

Securities with intermediate-term maturities outperformed securities with shorter- and longer-term maturities. Higher-quality municipal securities led lower-quality municipal securities.

What is contributing to the reduced supply in the municipal bond market?

We attribute the municipal bond market's lower supply during the quarter and for all of 2018 to the positive tailwind provided by the Tax Cuts and Jobs Act [TCJA]. The 2017 tax legislation eliminated tax-exempt advanced refundings, which contributed to sharp decline in new-issue supply. An advanced refunding occurs when an issuer refinances a bond before its call date with a second bond at a lower interest rate. The issuer pays off the original, older higher-yielding bond, thereby reducing interest cost. For 2018, new municipal bond issuance totaled $389 billion, representing a 24.4% drop from the same period a year earlier, according to the *Bond Buyer.* A decline in available supply typically helps to support prices. During the quarter, it also provided a counterweight to weaker demand from banks.

Fund flows, a measure of retail investor interest, were negative in October, November, and December. Weaker demand from banks contributed to lower inflows, creating an imbalance relative to outflows. One positive factor helping to counteract the weaker bank demand was the TCJA's elimination of deductions taken by high-income earners. This made the tax-exempt status of municipal bonds more attractive to retail buyers, especially in high-tax states such as New York and California.

How were the funds positioned during the quarter?

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 an overweight position in bonds with longer intermediate maturities while underweighting shorter intermediate and long maturity holdings.

Consequently, the funds' yield-curve positioning had more of a bulleted portfolio structure focused on the intermediate portion of the curve at quarter-end. This positioning resulted in an average maturity of approximately 15 years. Additionally, we used market weakness in October and November to adjust duration in the portfolios to capture positive seasonal conditions in December and early January. [Duration affects the portfolios' sensitivity to interest rates.] Consequently, the funds' duration positioning moved to a generally neutral to a slightly longer stance during the period.

From a credit-quality standpoint, the funds held an overweight exposure to higher-quality bonds. We continued to look for what we view as attractively priced opportunities to move higher up the credit-quality spectrum. This defensive positioning was positive for the funds' performance as higher-yielding, lower-quality bonds underperformed lower-yielding, higher-quality bonds. With municipal credit fundamentals seemingly stable, credit spreads remain at or near post-crisis lows.

Geographically speaking, the national funds held a modest overweight in Illinois general obligation [G.O.] bonds. They outperformed the broader municipal bond market due to their relatively higher yields and steady demand, which helped to offset price declines from modestly higher interest rates. Illinois G.O. bonds remain an attractive opportunity, in our view, as we believe the state's financial profile stabilized during the period and is not currently reflected by market spreads.

The funds also continued to hold an underweight position in Puerto Rico-based issuers relative to their Lipper peers. Puerto Rico's current economic and financial conditions remain extremely difficult as the island recovers from Hurricane Maria. The majority of Puerto Rico's bonds are in default and are not currently making coupon payments. We believe that the eventual recovery value and economic return of investing in such debt will be determined by the ongoing negotiations between the

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 12/31/18

Class Y shares Inception 1/2/08	Net asset value	Bloomberg Barclays Municipal Bond Index
Last quarter	1.30%	1.69%
1 year	0.91	1.28
3 years	2.50	2.30
5 years	4.09	3.82
10 years	5.60	4.85
Life of fund	6.32	—

Total expense ratio: 0.55%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 12/31/18

Class Y shares Inception 1/2/08	Net asset value	Bloomberg Barclays Municipal Bond Index
Last quarter	0.46%	1.69%
1 year	1.32	1.28
3 years	3.64	2.30
5 years	5.81	3.82
10 years	8.49	4.85
Life of fund	5.75	6.35

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.

Commonwealth, the federal control board, and creditors, as well as the long-term economic growth of the island. The uncertainty and volatility of these factors cause us to remain cautious and prefer an underweight position. That said, many Puerto Rico bond prices jumped during 2018 as the market appears to have priced in the potential of higher recoveries.

What is your outlook for interest rates and the municipal bond market as 2019 begins?

In our view, the Fed is not on a preset course and remains pragmatic and data dependent. Tighter monetary policy, the trade war, and the winding down of the stimulus provided by the TCJA could dampen U.S. growth in 2019, in our view. As such, we believe slower growth and stable inflation may contribute to a moderation in the Fed's pace of tightening. There were seven rate hikes during 2017 and 2018 as the Fed normalized interest rates.

We are constructive in our outlook for municipals in 2019. As to the general health of the municipal bond market, we believe credit fundamentals appear to be stable. Employment conditions remain favorable, in our view, as the unemployment rate is close to or at a generational low. Income and sales tax receipts at the state level, as well as local property taxes, continue to grow, albeit somewhat slower than over the past few years. The number of municipal borrowers defaulting in 2018 was the lowest that we have seen in the past five years.

There will always be pockets of weakness and select issues in the municipal market that make headlines from time to time, such as pension challenges. However, while 2019 could be another volatile year in the financial markets, we believe municipals could perform relatively well against such a backdrop. We'll continue to monitor municipal technicals on a daily basis to capture opportunities that arise from supply and/or demand imbalances.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed here are those of the portfolio managers as of December 31, 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 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. 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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