Q2 2020 | Putnam Municipal Bond Funds Q&A

Municipals recover amid stimulus and reopening

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Unprecedented policy initiatives help allay investor fears about pandemic.

The greatest risk and opportunity are in lower-quality securities, in our view.

We believe that direct aid to states and municipalities is warranted and necessary given the challenges posed by the pandemic.

How did municipal bonds perform during the second quarter of 2020?

After a challenging start in April, municipal bonds rallied in May and June. Unprecedented policy initiatives designed to ease the economic impact of the pandemic allayed investor fears about the spread of COVID-19. On April 9, the Fed authorized the Municipal Liquidity Facility [MLF] to provide aid to cash-strapped state and local governments. On April 27, Fed officials increased the scope and duration of the MLF's programs to include a broader group of counties and cities. With regard to fiscal initiatives, Congress passed a new pandemic relief-package totaling $484 billion to aid small businesses and hospitals in April. As COVID-19 came to be better understood and infection rates declined, states began to gradually open during the quarter. With the outlook improving, municipal bond fund flows turned positive, with weekly inflows increasing while supply remained low. These technicals helped to support municipal bond prices.

Against this backdrop, the Bloomberg Barclays Municipal Bond Index [the municipal benchmark] closed the quarter with a return of 2.72%. May was especially rewarding, with the benchmark rising 3.18%. The ICE BofA U.S. 3-Month Treasury Bill Index and the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.02% and 2.90%, respectively, for the quarter. Year to date through June 30, 2020, the municipal benchmark return was 2.08%.

High-yield and lower-investment-grade credit spreads narrowed from the worst levels but were still significantly wider than pre-pandemic levels at quarter-end. Yields on higher-quality bonds remained near record lows. On the credit spectrum, higher-yielding, lower-quality municipal bonds outpaced higher-quality municipal bonds for the quarter. Securities with intermediate-term maturities outperformed securities with long- and short-term maturities. Revenue bonds outperformed general obligation bonds [GOs]. Within revenue-based bonds, the top-performing sectors for the quarter were electric, water and sewer, and tobacco, while housing and special tax-backed bonds were the biggest underperformers.

What strategies or holdings influenced the funds' performance during the quarter?

From a valuation perspective, municipals started to look very attractive to us in early to mid-April. We took advantage of the market volatility and selectively added to the funds' positioning in investment-grade municipal bonds. We also extended duration in April to a point where we felt we were longer than the majority of the funds' Lipper peers. We achieved this mostly by adding higher-quality, longer-term securities. As the market recovered in May and June, the funds benefited from the rally versus our peers given their overweight positioning in lower-investment-grade securities and relatively long duration stance. As the higher-quality segment of the municipal bond market generally normalized in May, we slowly moderated our long duration posture, becoming more neutral relative to the funds' Lipper peers.

At quarter-end, the funds generally held an overweight exposure to higher-quality bonds rated A and BBB. We also held a neutral exposure to lower-rated, high-yield bonds relative to their Lipper peer groups. Duration positioning, a measure of the portfolios' interest-rate sensitivity, was slightly longer than that of the Lipper peer groups at quarter-end. The funds' yield-curve positioning was focused on longer intermediate-term securities with maturities of 15 to 20 years. As part of this strategy, the funds held underweight exposures to long maturity holdings compared with the benchmark. The funds continued to hold an overweight exposure to revenue bonds versus GOs.

Within our state strategy, we believe the financial profile of the state of Illinois continues to stabilize. This was not completely reflected by market spreads, in our view. Thus, we believe these holdings look attractive from a fundamental and relative value standpoint.

We remain cautious about Puerto Rico due to its uncertain economic recovery and a perceived lack of institutional credibility across the Commonwealth's government. As such, the funds remained underweight in their exposure to uninsured Puerto Rico municipal debt.

What is your current assessment of the health of the municipal bond market?

We believe state and local governments have ample reserves to prepare for potential revenue declines. Those that lack reserves will have some flexibility to balance their budgets using one-time measures. They can also reduce expenses, borrow on a short-term basis from either the market or the MLF, and, in some cases, raise revenues by increasing taxes or fees. In our view, most states and local governments would only see prolonged fiscal stress should economic activity fail to stabilize over the next 12 to 18 months. Our exposure to state and local governments is limited to credits with diverse tax bases and, in our view, the ability to enact broad revenue enhancements or expense cuts.

What is your outlook for the municipal bond market as the third quarter begins?

The Fed is projecting that it will hold short-term interest rates near zero until 2022. That said, we believe Fed officials stand ready to revisit their non-traditional policy tools should the economy deteriorate further.

We believe the strength of the economic recovery and the pace of normalization will shape the performance of the municipal market in the months ahead. At this point, the greatest risk and opportunity are in lower-quality securities, in our view.

Much of the issuance within the municipal market is used to finance public infrastructure, which includes toll roads, subways, bridges, ports, airports, colleges, and convention centers. It is critical that people be mobile and be able to congregate for these enterprises to generate revenue. Lack of mobility or severely reduced usage by the public could have trickle down effects on state and local municipalities.

We believe it will take time for the market to digest the longer-term impact of COVID-19. While we don't see a systemic risk to the municipal market, we are seeing credit fundamentals broadly deteriorating. That said, credit spreads remain wide. We believe this market environment plays to our team's strengths of fundamental credit analysis.

At period-end, we were waiting for more detail about Federal aid for municipalities. We believe that direct aid to states and municipalities is warranted and necessary given the challenges posed by the pandemic.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 6/30/20

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	3.05%	2.72%
1 year	3.16	4.45
3 years	4.09	4.22
5 years	3.79	3.93
10 years	4.35	4.22
Life of fund	6.30	—

Total expense ratio: 0.56%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 6/30/20

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	4.18%	2.72%
1 year	1.14	4.45
3 years	4.13	4.22
5 years	4.39	3.93
10 years	5.38	4.22
Life of fund	5.71	6.35

Total expense ratio: 0.61%

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

The ICE BofA 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.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed here are those of the portfolio managers as of June 30, 2020, 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. 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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