Q2 2018 | Putnam Municipal Bond Funds Q&A

Funds advance as muni market bounces back

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Municipal bonds posted gains in the second quarter.

Tax reform drives banks to reduce municipal bond assets.

Summer reinvestment demand is generally constructive for municipals.

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

Municipal bonds posted gains in the second quarter as demand improved following a U.S. Treasury-led selloff in the first quarter. The Bloomberg Barclays Municipal Bond Index posted a total return of 0.87% for the three months ended June 29, 2018. The high-yield tax-exempt market outperformed the broader municipal bond market, posting a return of 3.06%, as measured by the Bloomberg Barclays High Yield Municipal Bond Index.

The period marked a rebound from weakness in the first quarter, when demand from institutional investors dropped. For the first time since the credit crisis, banks reduced their municipal bond assets as corporate tax cuts enacted in December 2017 made munis less appealing. Muni assets held by banks dropped $16 billion in the first quarter [Federal Reserve].

After a period of modest outflows during tax season, flows turned back to positive in mid-May. In the second quarter, demand picked up from households in many high-tax states, including California, New York, and Minnesota. The Tax Cuts and Jobs Act of 2017 capped the state and local tax deduction [SALT] at $10,000. With the change in the SALT deduction, we believe the attractiveness of municipal bonds has increased, especially in certain high-tax locations. In general, demand remains solid.

Not FDIC insured | May lose value | No bank guarantee

Likely driven by the flattening yield curve, Fed tightening, and geopolitical tensions, investors pulled assets from equities at the end of the quarter and moved into "safer" investments, including municipal bonds and Treasuries [BofAML].

New municipal bond issuance totaled $96 billion in the second quarter, down 12% from a year ago, according to the Bond Buyer. At $161 billion for the year to date, total issuance remains below historic norms. A drop in available supply is favorable for investors.

Municipal and U.S. Treasury yields were volatile during the quarter. The 10-year Treasury bond yield surpassed 3.0% in May, reaching its highest level since 2011. By the end of the month, bond yields declined. Munis outperformed Treasuries on a total return basis on both the short and long end of the curve in May.

How were the funds positioned in this environment?

Duration positioning, which affects a portfolio's sensitivity to interest rates, was generally neutral to slightly below the average of Lipper peers. From a credit quality standpoint, the funds generally held overweight exposure to bonds rated Aa, A, and BBB relative to peers. From a sector-positioning perspective, we continued to overweight higher education, essential service utilities, and continuing care retirement communities bonds relative to Lipper peers. This strategy was positive for performance results.

For all portfolios, we maintained an underweight position in Puerto Rico-based issuers. Puerto Rico's current economic and financial situation remains extremely difficult and could further challenge the debt-restructuring process, in our view.

Credit fundamentals remain stable, and defaults remain low and isolated to the lowest rated bonds. Market technicals remain positive, and valuations are reasonable. That said, with the Fed actively hiking short-term interest rates, we remain somewhat cautious on extending portfolio duration.

What is your outlook for the municipal bond market for the months ahead?

The Federal Reserve raised rates in June, and it is anticipated that there will be two more rate hikes this year. We expect to see a continued normalization of short-term interest rates and continued flattening of the yield curve, with short-term rates rising more than long-term rates.

While inflation edged higher during the quarter, our economists do not anticipate a spike in inflation in the near term.

Our duration positioning remains slightly defensive, and we are favoring 15-year to 20-year maturities. We favor an underweight to the shortest and longest maturities and an overweight to bonds rated A and BBB. As always, we rely on our deep team of municipal credit analysts for comprehensive, bottom-up fundamental credit research.

The U.S. economy will maintain its upward trajectory, we believe, supported by stronger business and consumer spending. Additionally, the labor market remains strong. These conditions should allow the Fed to continue normalizing interest rates. In our view, this scenario will likely lead to short-term rates rising more than long-term rates. We also anticipate that the Fed will continue reducing its balance sheet as planned.

We believe municipal bonds offer a high-quality, low-default investment option for investors seeking attractive tax-free income and diversification opportunities.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 6/30/18

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	0.69%	0.87%
1 year	2.25	1.56
3 years	2.98	2.85
5 years	3.64	3.53
10 years	4.46	4.43
Life of fund	6.36	6.40

Total expense ratio: 0.55%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 6/30/18

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	1.31%	0.87%
1 year	4.45	1.56
3 years	4.67	2.85
5 years	5.21	3.53
10 years	5.56	4.43
Life of fund	5.82	6.40

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 June 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.

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