

Q3 2019 | Putnam Municipal Bond Funds Q&amp;A

# Municipals rise on falling rates and strong technicals



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*Municipal bonds continued their streak of solid quarterly performance.*

*Stable credit fundamentals and positive supply/demand technicals remained supportive of the asset class during the quarter.*

*We continued to look for what we viewed as attractively priced opportunities to shorten our yield-curve positioning.*

## How did municipal bonds perform during the third quarter of 2019?

Municipal bonds continued their streak of solid performance, with the Bloomberg Barclays Municipal Bond Index rising 1.58% for the quarter. This brings year-to-date and one-year performance to 6.75% and 8.55%, respectively. This performance came as market volatility increased with the U.S.–China trade dispute and slowing global growth contributing to recession fears. August was noteworthy for the sell-off in risk assets when U.S.–China trade talks hit an impasse. U.S. Treasuries and municipal bonds rallied as investors sought lower-risk strategies.

As widely expected, the Federal Reserve reduced its benchmark rate by a quarter percentage point on July 31, 2019. Chair Jerome Power described the reduction as a “mid-cycle adjustment” to help get the economy moving again. He added that the adjustment didn’t represent the “beginning of a lengthy cutting cycle.” The Fed also announced the termination of its balance sheet reduction two months early on August 1. With investors weighing the possibility of a global slowdown, the pace of the Fed’s interest-rate hikes came into question, adding to market volatility.

The Fed introduced a second rate hike in September to help keep the U.S. economy on solid footing. Fed policymakers remained open to another rate cut later this year should market conditions warrant it. However, members seemed split on whether or not to lower short-term rates further.

As investors positioned for a period of easing monetary policy, yields declined across the U.S. Treasury yield curve. The bellwether 10-year Treasury fell from 2.00% at the beginning of the quarter to 1.67% on September 30, 2019. The drop in interest rates was a tailwind for the municipal market. [Bond prices generally rise as interest rates fall.] 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 2.27% and 0.56%, respectively.

### **Were technical [supply/demand] factors supportive of municipal bonds?**

Supply/demand technicals, as well as stable credit fundamentals, were supportive of the asset class during the quarter. The level of supply continued to climb due to refundings and new issuance in the low-rate environment. [Refundings occur when municipalities issue new bonds at the prevailing lower rates to pay off their existing, more expensive debt.] According to Bond Buyer, municipal issuance for the third quarter and year to date stood at \$103 billion and \$275 billion, respectively.

Fund flows, a measure of investor demand for municipal mutual funds, continued to trend higher as well. The cap on state and local tax [SALT] deductions was a driver of this demand, as was overall investor concern about the state of the U.S. and global economy. According to Lipper, inflows for the third quarter totaled \$25 billion, bringing the year-to-date total to \$69 billion.

With supportive technicals and low interest rates prevailing, municipal bond yields declined to near-record lows during the quarter. This contributed 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.]

### **How were the funds positioned in this environment?**

Many of our broader investment themes remained in place. Duration positioning, or interest-rate sensitivity, was generally neutral relative to the funds' Lipper peer groups. The funds' yield curve positioning continued to reflect a bulleted portfolio structure focused on longer intermediate-term securities with maturities of 10 to 15 years. As part of this strategy, the funds held underweight exposures to long maturity holdings compared with their benchmarks.

With regard to credit positioning, we favored higher-rated bonds over lower-rated, high-yield bonds due to the credit spread compression in the municipal bond market. Accordingly, the funds held an overweight exposure to higher-quality bonds rated A and BBB and an underweight exposure to non-rated bonds relative to the fund's Lipper peer group. The fund's overweight in bonds rated BBB was especially beneficial, as they outperformed the market when the Fed's outlook became more dovish. From a sector positioning perspective, we favored higher education, power, charter schools, land secured, tobacco, and select state general obligation bonds [GOs] relative to the funds' Lipper peer groups.

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. In August 2019, Fitch Ratings upgraded its outlook to stable for Illinois and affirmed the state's BBB rating. This positive development came on the heels of a lawsuit that was filed in July 2019. It argued the state's pension bond sale in 2003 and tax-exempt debt issued in 2017 were debt refinancings prohibited by the Illinois constitution. Illinois GOs sold off modestly following the announcement. However, on August 29, Sagamon Circuit Court denied the petition on lack of merit. Illinois GOs rallied following the favorable ruling.

**Putnam Tax Exempt Income Fund (PTEYX)**

Annualized total return performance as of 9/30/19

Class Y shares Inception 1/2/08	Net asset value	Bloomberg Barclays Municipal Bond Index
Last quarter	1.85%	1.58%
1 year	8.93	8.55
3 years	3.57	3.19
5 years	3.91	3.66
10 years	4.45	4.16
Life of fund	6.38	—
Total expense ratio: 0.55%		

**Putnam Tax-Free High Yield Fund (PTFYX)**

Annualized total return performance as of 9/30/19

Class Y shares Inception 1/2/08	Net asset value	Bloomberg Barclays Municipal Bond Index
Last quarter	2.23%	1.58%
1 year	9.19	8.55
3 years	4.35	3.19
5 years	5.28	3.66
10 years	6.06	4.16
Life of fund	5.88	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.

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. ICE Data Indices, LLC (ICE BofAML), used with permission. ICE BofAML permits use of the ICE BofAML indices and related data on an "as is" basis; makes no warranties regarding same; does not guarantee the suitability, quality, accuracy, timeliness, and/or completeness of the ICE BofAML indices or any data included in, related to, or derived therefrom; assumes no liability in connection with the use of the foregoing; and does not sponsor, endorse, or recommend Putnam Investments, or any of its products or services.

In late July, Puerto Rico Governor Ricardo Rossello resigned amid protests demanding his exit after leaked texts indicated possible wrongdoing in his political circle. He appointed Pedro Pierluisi as his successor, but Puerto Rico's Supreme Court ruled in August that this move was unconstitutional due to a lack of legislative confirmation. Puerto Rico Justice Secretary Wanda Vazquez then became governor. 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, our portfolios remained underweight in their exposure to Puerto Rico's municipal bonds during the period compared with their Lipper peer groups.

**What is your outlook for interest rates and the municipal bond market for the balance of 2019?**

We believe the U.S.–China trade war is creating headwinds for the U.S. economy. U.S. GDP growth declined from 3.1% in the first quarter of 2019 to 2.1% in the second quarter. Global growth is also showing the effects of the trade war, with Germany and the United Kingdom, as well as China, experiencing weaker growth. Given the growth-dampening effects of the trade conflict and mild inflation, we believe the Fed could reduce short-term interest rates two more times over the next 12 months. Our base case is for slower U.S. and global growth, but we don't believe a U.S. recession is imminent.

Although unfunded pension liabilities remain a concern for some municipalities, defaults for investment-grade municipal bonds have been rare and isolated in the lowest ratings tiers. The asset class also has demonstrated a low correlation to equities in recent years. This suggests that they could help play a defensive role in a diversified investment portfolio during periods of equity market volatility.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed here are those of the portfolio managers as of September 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.

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