Q1 2017 | Putnam Municipal Bond Funds Q&A

Solid U.S. growth and technical conditions support municipals market

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Industry since 1989

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Industry since 2006
(Photo not available)

Given the favorable economic backdrop, higher-yielding municipal bonds saw nearly $2 billion of inflows.

New issue supply was generally light during the first quarter, as refunding supply fell nearly 50% year over year, contributing to rising prices and a slight narrowing of credit spreads.

We continue to monitor developments in Washington, D.C., as they relate to policy changes, including tax reform.

How did municipal bonds perform during the first quarter of 2017?

With the U.S. economic backdrop continuing to improve during the first quarter of 2017, municipal bonds delivered positive results. Consumer confidence remained high, the unemployment rate fell to 4.5% in early April, and inflation remained just below 2%. In response to the solid backdrop, the Federal Reserve announced its first 2017 rate increase on March 15, elevating its benchmark federal funds rate to the range of 0.75% to 1%.

For the three months ended March 31, 2017, the Bloomberg Barclays Municipal Bond Index rose 1.58%, outperforming the Bloomberg Barclays U.S. Aggregate Bond Index and the BofA Merrill Lynch U.S. 3-Month Treasury Bill Index, which returned 0.82% and 0.10%, respectively. Long-maturity bonds lagged intermediate- and short-maturity bonds given the more hawkish statements by the Fed that contributed to a steepening of the municipal bond yield curve. The high-yield tax-exempt market outperformed the broader municipal bond market during the quarter, climbing 4.06%, as measured by the Bloomberg Barclays High Yield Municipal Bond Index. Credit spreads [the difference in yield between higher- and lower-quality municipal bonds] narrowed during the quarter, contributing to slightly better returns for lower-quality investments than for higher-quality investments.

What contributed to the narrowing of credit spreads?

Given the favorable economic backdrop, the higher-yielding, lower investment-grade sector of the municipal bond market saw nearly $2 billion of inflows. On the other side of the technical [supply/demand] equation, new-issue supply continued to be relatively light. As such, demand slightly outpaced supply, contributing to rising prices and a narrowing of credit spreads between BBB-rated and AAA-rated bonds. Viewed in a longer-term context, the tighter spreads seemed relatively fair to us — especially considering that defaults among municipal issuers continued to remain low and isolated.

Within the tax-free high-yield municipal market, tobacco bonds performed well in the first quarter, as the refinancing of a large vintage 2007 deal helped buoy prices. The situation in Puerto Rico, however, continues to be challenging. The prices of those bonds abruptly fell in March when the Oversight Board approved Puerto Rico's budget, which had revenue expectations that were much lower than forecasted. We remain underweight Puerto Rico municipal bonds across the portfolios.

Our team of credit analysts, portfolio managers, and traders regularly analyze the merits and relative value of bonds throughout the municipal universe and are prepared to take advantage of price swings in an effort to capture better returns in the portfolios.

Please describe technical conditions across the broader tax-exempt market during the quarter.

Overall, market technicals were generally supportive of municipal bond prices during the quarter. On the supply side, new-issue supply fell 12% year over year during the first quarter of 2017. Refunding [refinancing] volume fell hard as many issuers moved to the sidelines ahead of the March Fed meeting as well as developments in Washington, D.C. Year-to-date gross issuance for the quarter stood at $87 billion compared with $100 billion in the first quarter of 2016.

We are closely monitoring the composition of demand for municipal bonds. Today, banks and insurance companies hold approximately 25% of outstanding municipal bonds compared with about 70% held by mutual funds and direct retail holdings. Banks have more than doubled their exposure since 2009. We believe this trend is due to the high-quality, low-default attributes of municipal bonds and the opportunity that they afford to help diversify away from corporate bonds. However, demand from banks and insurance companies has eased in recent months, given that tax reform is a top priority for the Trump administration and both Republican-controlled houses of Congress. Changes to corporate tax rates could impact demand from banks and/or insurance companies. We continue to actively monitor the market for such changes.

What is your current assessment of the potential for tax reform, and how might you steer the portfolios given that possibility?

Tax reform is one of the main policy agenda items for the new administration along with health care, border security, and infrastructure. President Trump is seeking to lower overall individual tax rates as well as corporate tax rates, but final details are pending. And, as one of my colleagues mentioned, details matter in legislation. However, we expect tax reform will be equally difficult to achieve given competing interests, which accounts for why there hasn't been major tax reform in the past 30 years.

In sum, we believe it is too early to boldly position the portfolios in anticipation of tax reform. That said, we are taking some limited steps to protect the portfolios by focusing a little more on municipal bonds with 20-year maturities versus the 30-year maturities in which banks have typically invested. We will continue to follow the development of government policy closely to see if tax reform materializes, and how the details of tax reform may shape the outlook for municipal bonds.

The United States is approaching full employment, and the economic outlook is improving. What are your thoughts about Fed policy for 2017?

The market also appears to be focused on how much fiscal stimulus might come from the new administration and how those initiatives will affect the pulse of the U.S. economy. Should additional fiscal stimulus augment U.S. growth, the Fed might be inclined to tighten a little faster, or, conversely, tighten more slowly if fiscal policy proves less stimulative.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 3/31/17

Class Y shares Inception 1/2/08	Net asset value	Bloomberg Barclays Municipal Bond Index
Last quarter	1.29%	1.58%
1 year	0.36	0.15
3 years	3.68	3.55
5 years	3.33	3.24
10 years	4.19	4.33
Life of fund	6.46	—

Total expense ratio: 0.55%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 3/31/17

Class Y shares Inception 1/2/08	Net asset value	Bloomberg Barclays Municipal Bond Index
Last quarter	2.30%	1.58%
1 year	1.03	0.15
3 years	5.48	3.55
5 years	4.82	3.24
10 years	4.60	4.33
Life of fund	5.83	6.54

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, this fund 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 March 31, 2017, 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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