Q1 2018 | Putnam Municipal Bond Funds Q&A

Munis decline but outpace Treasuries and corporates

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Municipal bonds posted an unusual decline in the first quarter as a result of rising municipal bond yields.

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Overall, municipal bond credit fundamentals are stable and defaults continue to remain low and isolated.

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

Municipal bond yields were driven higher by rising U.S. Treasury yields as well as some weakening in bank and insurance company demand. The Bloomberg Barclays Municipal Bond Index posted a total return of -1.11% for the three months ended March 31, 2018, marking the largest first-quarter decline for the index in 15 years. The high-yield tax-exempt market outperformed the broader municipal bond market during the quarter, posting a return of 0.58%, as measured by the Bloomberg Barclays High Yield Municipal Bond Index. The muni curve steepened, with short maturities outperforming intermediate and long maturities.

The period began in the wake of the passage of the Tax Cuts and Jobs Act. While the tax law retained the tax-exempt status of municipal bonds and kept the highest individual tax rate nearly intact, it reduced the corporate income tax rate to 21% from 35%, making municipal bonds a less compelling investment for corporate buyers. Banks, property and casualty insurance companies, and life insurance companies represent nearly one-quarter of muni bond buyers. We are closely monitoring market technicals as waning demand from these investors could impact the market. We did see some selling early in the year from banks and property and casualty companies, though the selling appeared to fade somewhat by the end of the quarter.

Demand from retail investors remained stable during the period. Total municipal mutual fund flows were positive during the quarter. While some individual tax rates saw modest reductions from tax reform, the top marginal tax rate remained relatively unchanged. As a result, we do not anticipate that the changes in tax rates will affect demand for municipal bonds from individual investors. The tax reform law also set a cap on the state and local tax deduction. Demand may increase, particularly among residents in high-tax states such as California and New York, where muni bonds represent a popular tax mitigation strategy. Net flows into municipal bond funds were positive, totaling $6.58 billion for the quarter.

On the supply side, gross municipal bond issuance totaled $63 billion for the quarter, representing a 31% decline from a year earlier. The drop in issuance followed a jump in supply in the fourth quarter as issuers rushed to issue advance refunding deals before the new tax law took effect and eliminated the provision. A refunding occurs when an issuer refinances a bond by issuing a second bond at a lower interest rate to pay off the original, older higher-yielding bond, thereby reducing interest costs. Year-to-date net supply was -$19 billion, which is a positive technical backdrop for the municipal market.

How were the funds positioned in this environment?

Given our outlook for interest rates trending higher, we began the quarter with more of a barbell approach to structuring the portfolios. We had underweight positions to short-term bonds, underweights to intermediate-term bonds with maturities of 5 to 12 years, and overweights to longer-term bonds with maturities of 10 to 20 years. Because the yield curve is very flat, we began moving the portfolio's average maturity slightly shorter as we believe the future return expectations are more advantageous in longer intermediate maturities than longer out the term structure.

Duration positioning, which affects the portfolios' sensitivity to interest rates, was generally neutral to slightly below relative to the Lipper peers. From a credit-quality standpoint, the funds generally held an overweight exposure to bonds rated Aa, A, and BBB. From a sector-positioning perspective, we continued to overweight higher education, essential service utilities, and continuing-care retirement community bonds relative to the funds' Lipper group.

We maintained an underweight position in Puerto Rico-based issuers relative to the funds' Lipper peers. During the period, after Puerto Rico's governor proposed a new, more optimistic budget to the Federal Control board (PROMESA), Puerto Rico bonds rallied strongly; some bonds were up nearly 80%. That said, we continue to believe Puerto Rico's current economic and financial situation remains extremely difficult, and we remain positioned more defensively.

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

With regard to interest rates, the Fed raised the target range for the federal funds rate in March as expected, and also slightly raised its forecast for economic growth. In an environment of steady global economic growth, 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. Inflation has been slowly increasing, and we don't expect inflation to spike any time soon. Our duration positioning remains slightly defensive, and we are favoring 15-year to 20-year maturities. We remain underweight the shortest and longest maturities. We also continue to be overweight bonds rated A and BBB, and rely on our deep team of municipal credit analysts for comprehensive, bottom-up fundamental credit research.

In addition, President Trump continues to push for a $1.5 trillion infrastructure plan, although to date, Congress has only allocated about $21 billion. Although we agree that U.S. infrastructure needs are fairly significant, we remain skeptical that a large, federal infrastructure program will find any traction during 2018 as Washington focuses on trade agreements, geopolitical tensions, and the midterm elections.

More broadly, the municipal bond market continues to adjust to new supply and demand conditions created by tax reform. As individual investors make up over 65% of municipal bond holders, we believe tax reform is unlikely to materially change their demand profile. We continue to monitor banks and insurance company demand and the impact on yields. Munis continue to represent a high-quality, low-default investment choice for individuals seeking to mitigate the burden of income taxes and diversify other portfolio holdings.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 3/31/18

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	-1.16%	-1.11%
1 year	3.53	2.66
3 years	2.34	2.25
5 years	2.80	2.73
10 years	4.45	4.40
Life of fund	6.38	—

Total expense ratio: 0.55%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 3/31/18

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	-0.52%	-1.11%
1 year	5.65	2.66
3 years	3.88	2.25
5 years	4.09	2.73
10 years	5.54	4.40
Life of fund	5.82	6.42

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.

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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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