Rate-sensitive municipals succumb to market pressures

How did municipal bonds perform during the third quarter of 2023?

The asset class began the quarter positively, with recession fears easing and many investors embracing a soft-landing narrative for the U.S. economy. Better-than-expected economic data also contributed to the rally. In August, municipal bonds, along with other interest-rate-sensitive bonds, sold off. The credit-rating agency Fitch Ratings downgraded the U.S. government’s credit rating from AAA to AA+. Municipal bond yields rose, moving in sync with U.S. Treasury yields. This weighed on the asset class, as municipal bond prices move inversely to yields. Markets continued to experience weakness in September, as concerns mounted about U.S. monetary policy, rising U.S. Treasury yields, surging oil prices, and weaker consumer demand.

Combating inflation remained a top priority for the Federal Reserve. At the end of July, the Fed raised rates by 0.25%, which brought the federal funds rate to 5.25%–5.50%. This was the highest range in 22 years. At its annual conference in August, the Fed stated it would “proceed carefully” and continue making data-driven decisions on a meeting-to-meeting basis. As part of this process, the Fed mentioned it would try to balance the risk of doing too much and slowing growth against the risk of doing too little and reigniting inflation.

The Fed left its benchmark rate unchanged at the September meeting, but its commentary took on a more hawkish tone. The Fed suggested another interest-rate hike was possible before the end of 2023. Policymakers also indicated the need to keep interest rates high well into 2024 to ensure inflation drops back down to its 2% target rate and that, when rates eventually come down,
it may happen more slowly than previously projected. Yields on U.S. Treasuries rose, and prices fell further, as investors ratcheted up their expectations for the Fed’s terminal interest rate. This amplified recession concerns and weighed on interest-rate-sensitive investments from bonds to high-growth technology stocks.

For the three months ended September 30, 2023, the Bloomberg Municipal Bond Index returned –3.95%. Short-term municipal bonds outperformed their intermediate- and long-term cohorts. From a credit perspective, investment-grade bonds outperformed high-yield bonds during the quarter, which aided performance due to our preference for higher-quality bonds.

**What was your strategy during the third quarter?**

We closely monitored our credit positioning throughout the quarter. We remained somewhat cautious on lower-rated cohorts and are currently not adding significantly to high yield due to the uncertainty surrounding slowing U.S. economic growth. Regarding positioning, the funds had an overweight exposure to both the lower tiers of the investment-grade universe [A and BBB] and the highest-rated portions of the high-yield universe compared with their Lipper peer groups.

Given the shape of the municipal bond curve, we favored bonds at the longer end of the curve for our long-term portfolios. For short- and intermediate-term portfolios, the funds had a barbell strategy. This meant holding more bonds in the very front end of the yield curve and in the longer-intermediate portion of the yield curve.

We targeted a modestly long-duration position in the portfolios relative to the funds’ Lipper peer groups. [Duration is a measure of a fund’s interest-rate sensitivity.] The funds were invested in a wide range of sectors, including retirement community, private higher education, housing-backed, essential service utilities, and state-backed bonds.

We continue to find opportunities across the municipal bond market, uncovering value in rating, sector, and coupon dislocations.

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

Municipal credit fundamentals remain stable, in our view. Higher employment and increasing wages have bolstered tax receipts in the past few years. We continue to monitor the housing market, including home values, an important factor in property tax revenues.

Total state and local tax collections fell 7.0% in the first half of 2023 compared with the first half of 2022. At the same time, total tax revenues are nearly 16% above their five-year average. Also, state and local governments’ rainy-day funds and financial reserves are close to 30-year highs. Municipal defaults through September are down 28% versus the average of the past five years and continue to represent a very small percentage of the market. As such, we believe the credit outlook remains favorable, though we continue to actively evaluate credit conditions.

In the second half of 2023, we expect economic growth to continue to slow as the economy responds to the past 18 months of higher, Fed-driven, short-term interest rates.

**What do you see on the horizon that could influence your management of the funds?**

Interest-rate volatility, a hawkish Fed, and inflationary pressures could remain headwinds for rate-sensitive investments in the near term, in our view. Following the market’s reaction to the Fed’s summary of economic projections and dot plot from its September meeting, 10-year U.S. Treasury yields reached their highest levels since October 2007. Given how resilient U.S. growth has been, we believe the Fed may need to keep interest rates higher for longer to allow the effects of its policy to trickle through the economy.

We regard any market volatility as an investment opportunity and continue to be vigilant for dips in the market that can present attractive entry points. Current valuations are attractive, in our view. At the close of quarter-end, taxable equivalent yields were close to 7.00%, suggesting municipal bonds were relatively cheap on a long-term basis.

Fundamentals across most municipal sectors remain stable, in our view. Generally speaking, defaults remain low and are contained to the non-rated subsectors. That said, we believe security selection and sector exposure decisions matter, especially if the U.S. economy slows.
Putnam Tax Exempt Income Fund (PTEYX)
Annualized total return performance as of 9/30/23

<table>
<thead>
<tr>
<th>Class Y shares</th>
<th>Bloomberg Municipal Bond Index</th>
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<tbody>
<tr>
<td>Last quarter</td>
<td>–4.37%</td>
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<tr>
<td>1 year</td>
<td>3.16</td>
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<tr>
<td>3 years</td>
<td>–2.36</td>
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<tr>
<td>5 years</td>
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<td>10 years</td>
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<td>Life of fund</td>
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Total expense ratio: 0.58%
Source: Bloomberg Index Services Limited.

Putnam Tax-Free High Yield Fund (PTFYX)
Annualized total return performance as of 9/30/23

<table>
<thead>
<tr>
<th>Class Y shares</th>
<th>Bloomberg Municipal Bond Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Last quarter</td>
<td>–4.63%</td>
</tr>
<tr>
<td>1 year</td>
<td>3.27</td>
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<tr>
<td>3 years</td>
<td>–1.60</td>
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<td>5 years</td>
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<td>10 years</td>
<td>3.37</td>
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<tr>
<td>Life of fund</td>
<td>5.15</td>
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</table>

Total expense ratio: 0.62%
Source: Bloomberg Index Services Limited.

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 of class A shares for Tax Exempt Income Fund (inception 12/31/76) and class B shares for Tax-Free High Yield Fund (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 Municipal Bond Index is an unmanaged index of long-term, fixed-rate, investment-grade tax-exempt bonds.

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The views and opinions expressed here are those of the portfolio managers as of September 30, 2023, are subject to change with market conditions, and are not meant as investment advice.

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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; 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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