

## Q4 2023 | Putnam Municipal Bond Funds Q&A

# Municipal bonds rally with Treasuries, as central bank comments turn dovish



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*We believe the spreads for bonds rated AA, A, and BBB continue to represent the best opportunities in the municipal market.*

### How did municipal bonds perform during the fourth quarter of 2023?

Global markets ended 2023 with strong returns across the board, as market participants reacted positively to more dovish central bank rhetoric, particularly from the Federal Reserve. Treasury yields rallied meaningfully across the curve into year-end, and municipal bonds moved in sync with this Treasury rally. Long-term municipal bonds outperformed their short-term counterparts. The Bloomberg Municipal Bond Index posted a total return of 7.9% during the fourth quarter. For 2023, the Bloomberg Municipal Index was up 6.4%, while the high-yield municipal index ended the year up 9.2%.

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

Fundamentals continue to be generally stable across most municipal sectors, but we also believe security selection and sector exposure matters in this environment.

Tax receipts for state and local governments fell 7% in the first half of 2023 compared with the same time period a year earlier. This decline primarily came from the effects of the inflated 2022 base of comparison. Also, capital gains tax receipts were lower due to weaker market performance. Viewed from a longer term perspective, overall state and local tax revenues remain 17% above their five-year average through Q3 2023.

Muni defaults in 2023 ran 20% below the previous 5-year average. Defaults remain low and are generally contained in the non-rated subsector. We would note that even during recessions, state and local tax revenue performance is resilient. We believe the muni sector is better positioned for a recession than it has been in previous economic cycles due to unprecedented levels of reserves.

In 2023, \$29 billion flowed out of municipal bond mutual funds. While the category was still in outflows during the year, the pace moderated from 2022's record levels. At the end of 2023, new issue supply was down 3% year over year. In our view, seasonal technical conditions have generally remained constructive into early January.

The taxable equivalent yield (TEY) of the Bloomberg Municipal Bond Index ended the year at 5.43%. Yields have rallied significantly since the end of October, while still remaining somewhat attractive on a long-term basis. AAA Muni/U.S. Treasury ratios, a commonly used valuation metric, ended the year richer on both a short- and longer-term basis. Long-maturity (30-year) ratios remained the cheapest cohort. At the same time, we believe the muni-Treasury ratios do not tell the entire story as credit spreads, even for highly rated AA bonds, are attractive. We feel the spreads for bonds rated AA, A, and BBB continue to represent the best opportunities in the municipal market.

### What is your investment strategy for early 2024?

While the funds have an emphasis on investment-grade bonds, they can invest across the entire municipal landscape, including high-yield bonds, to leverage Putnam's municipal credit research expertise. We continue to see value in the lower tiers of investment grade — A and BBB — as well as the higher tiers within high yield. In contrast, we are more cautious on lower rated cohorts and are currently not adding significantly to high yield.

In terms of interest-rate risk, we are targeting a modestly long duration position across our strategies, but it is important to emphasize that we slightly shortened our previous duration positioning in late December and early January. We recognized how far the market ran during the recent November and December 2023 rally. Compared to each funds' peer group, the portfolios remain modestly long duration, as we believe interest rates will likely fall further as the Fed's posture turns from restrictive to accommodative.

### Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 12/31/23

	Class Y shares Inception 1/2/08	Bloomberg Municipal Bond Index
Last quarter	8.89%	7.89%
1 year	7.57	6.40
3 years	-0.45	-0.40
5 years	2.31	2.25
10 years	3.19	3.03
Life of fund	5.88	—

Total expense ratio: 0.58%

Source: Bloomberg Index Services Limited.

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

Annualized total return performance as of 12/31/23

	Class Y shares Inception 1/2/08	Bloomberg Municipal Bond Index
Last quarter	8.82%	7.89%
1 year	8.26	6.40
3 years	-0.12	-0.40
5 years	2.70	2.25
10 years	4.25	3.03
Life of fund	5.34	5.80

Total expense ratio: 0.77%

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 December 31, 2023, are subject to change with market conditions, and are not meant as investment advice.

**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; 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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