Q3 2020 | Putnam Municipal Bond Funds Q&A

Municipals rally on stimulus prospects

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Municipal bonds outperform U.S. Treasuries and the broader taxable market for the quarter.

We believe the lower tiers of the investment-grade market and parts of the high-yield market currently represent some of the best income and return opportunities.

We're extremely selective and are avoiding concentrated bets from a sector, credit-quality, and geographical standpoint.

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How did municipal bonds perform during the third quarter of 2020?

The municipal bond market continued to recover from the unprecedented volatility experienced during the height of the COVID-19 pandemic in March and April 2020. With Congress working on another stimulus package, one that investors believed would include more aid to state and local governments, confidence in the asset class increased.

The Fed's expectation to keep short-term interest rates near zero until the end of 2023 also fueled interest. With yields on certificates of deposits and U.S. Treasuries near zero, investors sought out other alternatives. Although municipal bond yields were lower as well, their after-tax income advantage remained compelling. In other cases, investors perceived high-quality tax-free bonds as an attractive alternative to the volatile equity market. With weekly inflows increasing, municipal bond fund flows were positive for the quarter. This created a supply/demand imbalance that helped push bond prices higher. As a result of these technical factors, municipal bonds outperformed U.S. Treasuries during the quarter.

Against this backdrop, the municipal and U.S. Treasury yield relationship, referred to as the municipal/Treasury [M/T] ratio, narrowed during the quarter. This was especially noteworthy at the front end of the yield curve. [The M/T ratio is one of the tools we use to determine the relative richness or cheapness of municipal bonds compared with U.S. Treasuries. The higher, or cheaper, the ratio, the more attractive municipal bonds are relative to U.S. Treasuries.] Although the ratio tightened during the quarter, it still remains attractive from a historical perspective, in our view.

On the credit spectrum, higher-yielding, lower-rated municipal bonds outpaced higher-rated municipal bonds for the quarter. Revenue bonds outperformed general obligation bonds [GOs]. Within revenue-based bonds, the top-performing sectors for the quarter were electric, water and sewer, and tobacco, while housing and special tax-backed bonds were the biggest underperformers.

For the three months ended September 30, 2020, the Bloomberg Barclays Municipal Bond Index [the benchmark] closed the quarter with a return of 1.23%. The Bloomberg Barclays U.S. Aggregate Bond Index and the ICE BofA U.S. 3-Month Treasury Bill Index returned 0.62% and 0.04%, respectively, for the quarter. Year to date through September 30, 2020, the benchmark return was 3.33%.

What strategies or holdings influenced the funds' performance during the quarter?

We believe the lower tiers of the investment-grade market and parts of the high-yield market represent some of the best income and return opportunities at this time. However, we're extremely selective given the ongoing economic uncertainty and are avoiding concentrated bets from a sector, credit quality, and geographical standpoint.

The funds generally held an overweight exposure to bonds rated A and BBB at quarter-end. The funds also held an overweight to bonds rated BB and a neutral exposure to lower-rated, high-yield bonds relative to their Lipper peer groups. However, the combined, overall exposure to lower-rated, high-yield bonds was underweight relative to the Lipper peer groups. The funds held an overweight exposure to revenue bonds versus general obligation bonds [GOs]. Duration positioning, a measure of the portfolios' interest-rate sensitivity, was neutral relative to the benchmark.

Within our strategy for state debt, we continue to hold an overweight exposure to Illinois. We believe these holdings look attractive from a fundamental and relative value standpoint. In June, Illinois accessed the Fed's Municipal Liquidity Facility [MLF] for one-year GO notes to help remove any near-term liquidity stress. We believe Illinois's financial outlook, which continues to stabilize, was not completely reflected by market spreads.

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, the funds remained underweight in their exposure to uninsured Puerto Rico municipal debt.

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

As the third quarter came to a close, we were waiting for more detail about additional federal aid for municipalities. We believe that direct aid to state and local governments is warranted and necessary given the fiscal challenges posed by the pandemic. While the lack of additional stimulus would not be optimal, we believe most state and local governments have the flexibility to navigate budget gaps. Those initiatives include balancing their budgets using one-time measures, reducing expenses, borrowing on a short-term basis from either the market or the MLF, and raising revenues by increasing taxes or fees. In our view, most states and local governments would only see prolonged fiscal stress should economic activity fail to stabilize over the next 12 to 18 months. Our exposure to state and local governments is limited to credits with diverse tax bases and, in our view, the ability to enact broad revenue enhancements or expense cuts.

What is your outlook for the municipal bond market as the fourth quarter begins?

Municipal bond credit fundamentals have broadly weakened due to the growth-dampening effects of the pandemic. However, defaults remain low and isolated to the lower tier of the high-yield market and sectors most affected by the pandemic. And while we do not expect widespread defaults within the investment-grade universe, credit downgrades are possible.

The path ahead remains unclear due to the uncertain course of the pandemic, but there are encouraging signs. Economic activity has picked up from depressed levels, supported by a vibrant housing market, and there are signs of improvement in business investment. However, while unemployment has continued to decline, it has a long way to go to meet the central bank's maximum employment goal.

In August 2020, the Fed adopted a new strategy to hit its 2% inflation target over time, not every year — implying that it would tolerate higher inflation for some time. In September 2020, the Fed provided forward guidance that shifted its policy from providing stability and relief to supporting economic expansion. Fed Chair Jerome Powell announced that the Fed would hold rates close to zero until core inflation reached 2% on a sustained basis.

Against this backdrop, we believe our highly experienced team of municipal investment professionals with over 15 years of experience on average gives us perspective and the ability to navigate different types of market environments. Furthermore, as a manager of a family of municipal bond funds for over 40 years, we believe our experience gives us an advantage in an asset class that is generally less liquid as well as the ability to find less widely followed opportunities in these unprecedented times.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 9/30/20

Class Y shares Inception 1/2/08	Net asset value	Bloomberg Barclays Municipal Bond Index
Last quarter	1.54%	1.23%
1 year	2.84	4.09
3 years	4.16	4.28
5 years	3.86	3.84
10 years	4.12	3.99
Life of fund	6.30	—

Total expense ratio: 0.56%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 9/30/20

Class Y shares Inception 1/2/08	Net asset value	Bloomberg Barclays Municipal Bond Index
Last quarter	2.49%	1.23%
1 year	1.41	4.09
3 years	4.26	4.28
5 years	4.58	3.84
10 years	5.21	3.99
Life of fund	5.75	6.34

Total expense ratio: 0.61%

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 BofA U.S. Treasury Bill Index is an unmanaged index that tracks the performance of U.S.-dollar-denominated U.S. Treasury bills publicly issued in the U.S. domestic market. Qualifying securities must have a remaining term of at least one month to final maturity and a minimum amount outstanding of $1 billion. You cannot 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 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. 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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