Q3 2017 | Putnam Municipal Bond Funds Q&A

Positive results continue, and Illinois bonds benefit from budget plan

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Generally stable municipal credit fundamentals, positive supply/demand dynamics, and low defaults contributed to rising municipal bond prices.

Given the constructive economic backdrop, higher-yielding municipal bonds outperformed higher-quality municipal bonds.

Illinois bonds strongly outperformed during the quarter, as the state legislature passed the first budget in two years.

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

Municipal bonds gained ground during the third quarter despite geopolitical tensions, bringing the year-to-date total return to 4.66%. The pace of new issuance was generally light during the quarter — falling 23% from levels seen in the third quarter of 2016, and demand outpaced supply. This dynamic contributed to rising prices and a narrowing of credit spreads of lower investment-grade as well as high-yield municipal bonds. [Credit spreads reflect the difference in yield between higher- and lower-quality municipal bonds.] Viewed in a longer-term context, spreads are at or close to their narrowest point since the credit crisis. That said, overall credit fundamentals remained stable, supply/demand dynamics were favorable, and defaults remained low and isolated.

At its July policy meeting, testimony from Federal Reserve Chair Janet Yellen suggested that the markets should expect inflation to hold below 2% for a prolonged period. With inflation running below its 2% target, the Fed left its benchmark federal funds rate unchanged at that meeting. Municipal bonds, along with other rate-sensitive investments, rallied following these more dovish announcements. In September, Yellen's comments at the Fed's policy meeting were somewhat more hawkish, although the Fed left interest rates unchanged. The central bank signaled that, despite recent low levels of inflation, it expects one more rate increase by year-end, and envisioned three more increases in 2018. The Fed also reaffirmed its commitment to begin in October reducing its balance sheet, which includes over $4 trillion in U.S. Treasury bonds and mortgage-backed securities that it purchased in the years following the 2008 financial crisis.

For the three months ended September 30, 2017, the Bloomberg Barclays Municipal Bond Index rose 1.06%, outperforming the BofA Merrill Lynch U.S. 3-Month Treasury Bill Index, which returned 0.26%. Long-maturity municipal bonds outperformed intermediate- and short-maturity municipal bonds due to the Fed's "wait and see" approach with regard to inflation as well as the potential for fiscal policy stimulus. This contributed to a flattening of the municipal bond yield curve. The high-yield tax-exempt market outperformed the broader municipal bond market during the quarter, climbing 1.50%, as measured by the Bloomberg Barclays High Yield Municipal Bond Index.

What was your investment approach in this environment?

During the quarter, the municipal bond yield curve flattened, benefiting performance, as the funds' hold more long-term bonds than short- and intermediate-term bonds. The funds' duration positioning was in line with the median of their Lipper peer groups. We maintained an overweight exposure to lower-investment-grade municipal bonds and placed greater focus on higher education, essential service utilities, and continuing-care retirement community bonds relative to the funds' Lipper groups.

We also maintained an underweight position in Puerto Rico-based issuers relative to the funds' Lipper peers. This underweight exposure added to performance during the period. Puerto Rico was devastated by the recent hurricanes, which makes its current economic and financial situation even more difficult and could further challenge the debt restructuring process.

Turning to the economic backdrop in Illinois, on July 6, 2017, the Illinois legislature overrode the governor's veto of a new budget plan, which includes a major income tax increase. After a two-year impasse, the 2018 fiscal-year budget is expected to help relieve some pressure from the credit agencies, which had warned that Illinois' credit rating was in jeopardy of falling into junk bond status. While challenges remain, investors welcomed news of the override and a balanced budget. Illinois municipal debt rallied, which aided the funds' performance during the quarter, as the portfolios had overweight positions in the State of Illinois and City of Chicago credits.

What is your market outlook for the balance of 2017?

We anticipate steady improvement in the U.S. economic backdrop and see evidence of a continued, synchronous pickup in the global economic environment. From a fiscal policy perspective, the market appears to be focused on how much stimulus might come from the new administration, and how those initiatives may affect the pulse of the U.S. economy. Should additional stimulus augment U.S. growth, we believe the Fed might be inclined to tighten a little faster, or, conversely, tighten more slowly if fiscal policy proves less stimulative.

Just before the close of the quarter, Republican leaders released a broad framework of a tax plan, which included major changes to the tax code. While the expanded plan for tax reform did eliminate some tax breaks, it did not mention the municipal tax exemption. Furthermore, we do not believe the currently proposed lowering of the higher personal income tax bracket from 39.6% to 35% will materially affect demand for municipal bonds from individuals.

Looking ahead, we will be closely monitoring the evolution of the tax plan. We are still in the early stages of discussion with many details that still need to be hashed out, including how to pay for the cuts. We will be following the debt ceiling debate and a budget resolution for the next fiscal year as well as the nomination of a Federal Reserve chair, as Janet Yellen's current term is due to expire in February 2018. These and other issues have the potential to create headline risk and increase market volatility in the coming months.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 9/30/17

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	1.31%	1.06%
1 year	1.09	0.87
3 years	3.30	3.19
5 years	3.00	3.01
10 years	4.45	4.52
Life of fund	6.46	—

Total expense ratio: 0.55%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 9/30/17

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	2.10%	1.06%
1 year	1.65	0.87
3 years	4.98	3.19
5 years	4.48	3.01
10 years	5.13	4.52
Life of fund	5.89	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, 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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