Q4 2017 | Putnam Municipal Bond Funds Q&A

Tax reform leaves municipal tax exemption intact

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We do not believe the changes in tax rates will materially affect demand for municipal bonds from individuals.

We found value in bonds with maturities of 15 to 20 years.

Positioning in Puerto Rico, Illinois, and New Jersey was advantageous for the funds.

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

Amid myriad crosswinds, the Bloomberg Barclays Municipal Bond Index returned 0.75% for the three months ended December 31, 2017. The high-yield tax-exempt market outperformed the broader municipal bond market during the quarter, climbing 1.83%, as measured by the Bloomberg Barclays High Yield Municipal Bond Index. Securities with longer maturities outperformed securities with shorter maturities.

The Tax Cuts and Jobs Act became law during the quarter. The legislation includes tax cuts for individuals and corporations, the elimination of certain taxes, and changes to some popular tax deductions, but left the municipal bond tax exemption intact. Overall, the tax bill appears constructive for the municipal bond market, in our view.

However, volatility picked up in the fourth quarter in response to the tax reform debate. In November, anticipation of heavier municipal bond supply due to the proposed elimination of advance refundings within the tax bill contributed to a selloff. [Refunding occurs when an issuer refinances a bond by floating a second bond at a lower interest rate to pay off an older higher-yielding bond, thereby reducing interest costs.] In December, issuers rushed to close deals before the new tax law took effect in 2018. Total municipal bond new issue volume for the month was $62.5 billion — surpassing the previous record of $52.7 billion in December 1985, which was just before the last comprehensive tax overhaul took effect. The flood of new issuance was well received by investors, and the municipal bond market rallied as strong demand helped buoy prices.

What are your thoughts about the new tax legislation, and its effects on the municipal bond market?

First, the change is taking place at great speed. Given the scale of the Tax Cuts and Jobs Act and that it was passed effectively in about three months suggests to us that the legislation is likely to have unintended consequences for the U.S. economy. What those consequences will be and their effects on the municipal market will become more apparent in time.

That said, we believe one overarching takeaway for our investors is that the tax-exempt status of municipal bonds remains intact. This deduction has been challenged in the past, but it has remained — to the benefit of investors. Also, the highest individual tax rate is basically unchanged. As such, we do not believe the changes in tax rates will materially affect demand for municipal bonds from individuals. The reduction in corporate taxes, however, may influence demand from banks, property and casualty insurers, or other corporate buyers. Demand from banks especially bears watching, as they have more than doubled their investment in municipal bonds during the past 10 years. We believe that any significant interruption in bank demand could weigh on prices of long-maturity municipal bonds.

The legislation, in our view, will have a more meaningful impact on the supply side of the technical equation. The elimination of advance refundings could eliminate up to 20% of the municipal market's annual supply — a fairly significant portion of the municipal bond supply.

Some unique investment opportunities emerged this past December when issuers flooded the municipal market with new supply. We added what we viewed as stable credits with solid yields at attractive prices, which improved the portfolio's overall positioning, in our opinion.

How were the funds positioned in this environment?

Given our outlook for interest rates trending higher, the portfolios began the quarter with more of a barbell approach to structuring the portfolios — overweighting short-term bonds, underweighting intermediate-term bonds with maturities of 5 to 12 years, and overweighting longer-term bonds with maturities of greater than 12 to 20 years.

Duration positioning, which affects the portfolios' sensitivity to interest rates, was generally neutral relative to the benchmark index. From a credit-quality standpoint, the funds held an overweight exposure to higher-quality bonds rated BBB and A. From a sector positioning perspective, we placed greater focus on higher education, essential service utilities, and continuing-care retirement community bonds relative to the funds' Lipper groups. These strategies were positive for performance results.

We 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, in our view.

During the quarter, the portfolios had overweight positions in State of Illinois and City of Chicago credits. After a two-year impasse, we believe the 2018 fiscal-year budget may 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, Illinois municipal debt rallied, which aided the funds' performance during the period.

New Jersey also faces a heavy debt burden and large unfunded pension liabilities. However, the November 2017 gubernatorial election of Phil Murphy provided one-party control for the first time in eight years, which we believe should facilitate legislative action to stabilize New Jersey's finances. At period-end, all three major rating agencies had a stable outlook for New Jersey. The funds' positioning in New Jersey municipal debt contributed to performance during the quarter.

What is your outlook for Fed rate policy as 2018 begins?

As widely expected, the Federal Reserve announced a rate hike of a quarter percentage point at its December 2017 meeting, setting its benchmark rate at a target range of 1.25% to 1.50%. In its commentary, the Fed maintained its expectation for three rate hikes in 2018 but also raised its forecast for economic growth from 2.1% to 2.5% for the year — most likely in response to tax cuts.

We expect that strengthening global economic growth will facilitate the continued normalization of short-term interest rates and continued flattening of the yield curve, with short-term rates rising more than long-term rates. From a fiscal policy perspective, the market appears to be focused on how much stimulus might come from Washington, 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.

Looking ahead, we will be closely monitoring the debt ceiling debate; a budget resolution for the next fiscal year; and the confirmation of President Trump's nomination of Jerome Powell as the next Federal Reserve chair. As always, we will continue to rely on in-depth research and our experienced market insights to evaluate new and existing holdings for attractive income and return potential.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 12/31/17

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	1.28%	0.75%
1 year	6.09	5.45
3 years	3.16	2.98
5 years	3.05	3.02
10 years	4.49	4.46
Life of fund	6.45	—

Total expense ratio: 0.55%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 12/31/17

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	1.50%	0.75%
1 year	8.64	5.45
3 years	4.74	2.98
5 years	4.42	3.02
10 years	5.38	4.46
Life of fund	5.89	6.51

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.

The views and opinions expressed here are those of the portfolio managers as of December 31, 2017, are subject to change with market conditions, and are not meant as investment advice.

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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