Q2 2019 | Putnam Emerging Markets Equity Fund Q&A

Emerging markets remain cautious on trade truce

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Industry since 1993

The Fed's dovish turn improves investor appetite for risk assets.

The outcome of U.S.–China trade talks, elections may create headwinds.

Our largest allocations include Hong Kong and Saudi Arabia.

What was the market environment during the second quarter of 2019?

Emerging-market equities gained during the quarter. Investor appetite for risk assets, such as developing-market stocks, has ebbed and flowed because of the U.S.–China trade rift and growing fears the dispute would accelerate a global economic slowdown. China and the United States, the world's two largest economies, have imposed tariffs on billions of dollars' worth of one another's goods since the start of 2018, battering financial markets and souring business and consumer sentiment.

At the Group of 20 meeting in June, President Trump and Chinese President Xi Jinping made headway on stabilizing tariffs as they continue to work on long-term trade issues. This is important because almost all emerging markets are fairly dependent on the trajectory of China's economy as a result of their trade and financial links. China is one of the largest buyers of commodities, capital goods, and technology globally, and a slowdown in China will slice the expected growth rates of many emerging economies. China's central bank has taken steps to encourage more bank lending and boost infrastructure spending to support cooling growth.

The Federal Reserve held interest rates steady during the quarter and signaled a possible cut if the U.S. economic outlook doesn't improve. Earlier this year, the central bank surprised investors by signaling it was done raising interest rates for now. The Fed's shift in monetary policy has opened the door for central banks in emerging markets to reduce interest rates. Since April, Russia, India, Malaysia, and the Philippines all have lowered rates. The U.S. dollar has also weakened, creating a more favorable environment for emerging economies because lower rates make it easier to service dollar-denominated debt.

The majority of our strategy's outperformance so far this year has come from bottom-up stock selection, specifically opportunities in Taiwan's and China's clean technology companies, which are tied to domestic growth and less affected by macroeconomic factors. The benchmark MSCI Emerging Markets Equity Index [ND] finished the quarter up 0.61%.

How did the fund perform?

Putnam Emerging Markets Equity Fund outperformed its benchmark, the MSCI Emerging Markets Equity Index, for the quarter. The fund rose 1.98%. Our stock picks in different countries and sectors drove most of the performance, followed by sector allocations and currency strategy. Our country allocation strategy was negative for the quarter.

What strategies detracted from return? What strategies helped?

From a country perspective, a slight overweight allocation in Taiwan, an underweight allocation in Indonesia, and a notable underweight position in China relative to the benchmark contributed most to returns. But overweight allocations in India, Russia, and the United Arab Emirates detracted most from results. Our stock selections were strongest in Taiwan, Indonesia, and Hong Kong and weakest in India, Russia, and the United Arab Emirates.

In terms of sectors, positions in industrials, financials, and information technology were the top contributors to performance. Consumer discretionary, energy, and health care detracted most during the quarter. Regarding currency, significant underweight positions in the Chinese renminbi and the South Korean won more than offset underweight exposures to the Thai baht and South African rand.

What is the outlook for the third quarter and for 2019?

There are risks on the horizon. Global growth continues to slow, the outcome of the U.S.–China trade talk remains uncertain, and there are elections in some emerging economies. The United States will ease restrictions on China, including taking steps to allow telecommunications giant Huawei to buy technology from American companies. The trade truce in itself will not resolve the underlying differences between Beijing and Washington, but it may give officials another chance to reach a permanent accord. Meanwhile, China is also stepping up measures to prevent too swift a slowdown. However, there is the risk of policy errors should the Chinese government disappoint in the size and timing of these measures just as the rest of the world is also slowing.

Elections have also injected volatility in emerging-market assets. Turkey held a re-run of the race for mayor of Istanbul in late June 2019. The main Turkish opposition party won the mayoral elections, in a blow to President Recep Tayyip Erdogan. Argentina will hold presidential elections in October 2019, and that has the potential to rattle equity markets. In Argentina, we believe the choice is clear: Press ahead with difficult reforms under President Mauricio Macri, or default and return to the dark days of former President Cristina Fernández de Kirchner. Political developments in Europe, including Brexit and fragmentation following the European Parliament elections, will also affect financial markets this year.

Considering these uncertainties, we believe our top-down macroeconomic perspective on emerging markets — which complements our bottom-up company research — is more important than ever for an investment strategy focused on finding attractive opportunities. We remain defensively positioned in the broader emerging markets portfolio. We continue to focus on countries that have sizable and strong domestic markets, and that are developing their intellectual property and brands. We also favor economies that can benefit from domestic growth and investment, as well as countries with reformist agendas.

As of quarter-end, the fund's largest allocations included Hong Kong, Canada, and Saudi Arabia. The fund had the biggest underweight positions in South Korea, China, and Thailand. We have started to reduce our underweight position in China, anticipating more aggressive stimulus measures. However, we do not feel the need to jump into Chinese assets more aggressively at this point. From a sector perspective, the portfolio is most overweight relative to the benchmark in industrials, consumer discretionary, and consumer staples. The portfolio is most underweight in the materials, communication services, and health care sectors.

Putnam Emerging Markets Equity Fund (PEMYX)

Annualized total return performance as of 6/30/19

Class Y shares Inception 9/29/08	**Net asset value**	**MSCI Emerging Markets Index [ND]**
Last quarter	1.98%	0.61%
1 year	-1.87	1.21
3 years	10.59	10.66
5 years	3.17	2.49
10 years	5.43	5.81
Life of fund	4.37	5.39

Total expense ratio: 1.58%

What you pay: 1.07%

"What you pay" reflects Putnam Management's decision to contractually limit expenses through 12/30/19.

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. For a portion of the periods, this fund 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 MSCI Emerging Markets Index (ND) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. You cannot invest directly in an index.

The views and opinions expressed are those of Daniel J. Graña, CFA, Portfolio Manager of Putnam Emerging Markets Equity Fund, as of June 30, 2019. They are subject to change with market conditions and are not meant as investment advice.

Consider these risks before investing: International investing involves currency, economic, and political risks. Emerging-market securities carry illiquidity and volatility risks. Investments in small and/or midsize companies increase the risk of greater price fluctuations. From time to time, the fund may invest a significant portion of its assets in companies in one or more related industries or sectors, which would make the fund more vulnerable to adverse developments affecting those industries or sectors. Growth stocks may be more susceptible to earnings disappointments, and value stocks may fail to rebound. Risks associated with derivatives include increased investment exposure (which may be considered leverage) and, in the case of over-the-counter instruments, the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. 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. You can lose money by investing in the fund.

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