Q4 2018 | Putnam Emerging Markets Equity Fund Q&A

Emerging markets hampered by rising rates and cooling growth

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Industry since 1993

Slowing global growth and higher rates will create headwinds.

An escalation of the trade war between China and the United States is inevitable.

China's economy will continue to cool as authorities mull new policy tools.

What was the market environment during the fourth quarter of 2018?

It was a bruising quarter and 2018 for emerging markets. Falling stock prices, weakening global growth, rising interest rates, and concerns about President Donald Trump's trade and economic policies set investors on edge. Emerging-market equities fared far worse than U.S. markets, with China's technology stocks leading the field. The benchmark MSCI Emerging Markets Equity Index (ND) finished the quarter and the year down 7.46% and 14.57%, respectively. Volatility also increased across equity markets — consistent with late-cycle market and interest-rate movements.

The Federal Reserve raised its benchmark interest rate in December for the fourth time in 2018. The rate hike took the federal funds rate to a range of 2.25% to 2.50%, the ninth increase since the Fed began normalizing policy in December 2015. Emerging markets were also punished by a stronger dollar, which exacerbated stock losses for U.S. investors. Developing economies with high levels of dollar-denominated debt were hit hard since a stronger dollar makes it difficult for these countries to repay their bonds. The Fed is also shrinking its balance sheet, and other global central banks are stepping back from some of the easy policies they adopted in the 2008 financial crisis. That has raised the cost of capital for many developing countries.

Trade tensions between the United States and China, the world's two largest economies, escalated and ebbed during the quarter. In December 2018, President Trump and Chinese President Xi Jinping agreed to hold off on further tariffs until March 1, 2019, to allow the two sides to negotiate a trade agreement. However, the trade war and a slowdown in demand has negatively impacted manufacturing in many developing economies. Elsewhere in emerging markets, Brazilians elected as their next president Jair Bolsonaro, a far-right lawmaker who is unabashedly pro-American.

How did the fund perform?

Putnam Emerging Markets Equity Fund underperformed its benchmark, the MSCI Emerging Markets Equity Index, for the quarter. The fund declined 9.13%. Security selections within different countries and sectors drove most of the underperformance, followed by country allocations and currency strategy.

What strategies detracted from return? What strategies helped?

From a country perspective, underweight allocations in China, South Africa, and Indonesia relative to the benchmark detracted most from performance. An overweight allocation in Taiwan, an out-of-benchmark allocation in Saudi Arabia, and an underweight allocation in South Korea added to results. In terms of sectors, positions in materials, consumer discretionary, and energy detracted most from results. But consumer staples, health care, and communication services were positive contributors for the quarter. Regarding currency, an overweight allocation in the Mexican peso and an underweight position in the Turkish lira detracted the most.

The portfolio's tilt toward small cap, growth, and price momentum proved to be painful, especially when the risk-off trade in emerging-market assets accelerated during the quarter after the Fed raised interest rates. In numerous cases, small-cap and mid-cap holdings beat expectations or positively surprised in other ways, but the stocks still fell on the day of the surprise. Given that the majority of emerging-market ideas from the analysts are skewed toward mid- and small caps, allocation and security selections were negative contributors.

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

Global economic growth is slowing. Higher U.S. interest rates, a stronger dollar, and financial market volatility could pressure some developing economies. The U.S. economy is also likely to moderate in the first half of 2019 from the fast pace set during the second and third quarters of 2018 as the impact of the year-end 2017 corporate tax cut fades. Fed Chair Jerome H. Powell in December acknowledged the U.S. economy is showing signs of "softening." While the Fed's next interest-rate move is uncertain, the hikes so far have undermined and, in some cases, reversed capital flows to emerging markets.

We believe an escalation of the trade war between China and the United States is inevitable. While financial markets expect some sort of an agreement with China, we believe the Trump administration is likely to disappoint. As a result, we expect more market volatility in 2019 as the United States and China resume tussling over trade tariffs. The implications of a trade war are clear; it will affect global manufacturing, consumer prices, and business investment.

Economic growth in China, an anchor for other emerging markets, is cooling after decades of rapid expansion. The People's Bank of China has slashed the amount of money that banks are required to hold in reserve. This is the latest in a series of policy changes the government has taken to support growth. Chinese authorities have also allowed the renminbi to weaken. This has negative implications for emerging-market currencies and commodity prices.

Political developments in emerging markets and in Europe, including Italy's fiscal woes and a disorderly Brexit, will also affect financial market movements this year. In Brazil, Bolsonaro was sworn in as the country's new president in January 2019, inheriting an economy hobbled by low growth and high debt. India and South Africa will hold elections in 2019.

Putnam Emerging Markets Equity Fund (PEMYX)

Annualized total return performance as of 12/31/18

Class Y shares Inception 9/29/08	**Net asset value**	**MSCI Emerging Markets Index [ND]**
Last quarter	–9.13%	–7.46%
1 year	–17.37	–14.57
3 years	7.76	9.25
5 years	1.94	1.65
10 years	7.32	8.02
Life of fund	39.79	—

Total expense ratio: 1.58%

What you pay: 1.07%

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 fund's expense ratio is taken from the most recent prospectus and is subject to change. What you pay reflects Putnam Management's decision to contractually limit expenses through 12/30/19.

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.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed are those of Daniel J. Graña, CFA, Portfolio Manager of Putnam Emerging Markets Equity Fund, as of December 31, 2018. 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. 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. Stock prices may fall or fail to rise over time for several reasons, including general financial market conditions, changing market perceptions, changes in government intervention in the financial markets, and factors related to a specific issuer, industry or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings. 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. You can lose money by investing in the fund.

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