Q3 2018 | Putnam Emerging Markets Equity Fund Q&A

Tighter global rates, trade tensions impair emerging markets

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Industry since 1993

It was a difficult quarter for emerging-market equities as borrowing became more expensive and trade more uncertain.

Tight global monetary policies are likely to constrain capital flows to emerging markets.

Elections in India and South Africa in 2019 could provide a surprise for investors.

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

It was a difficult quarter. Rising U.S. interest rates, global trade risks, and higher oil prices negatively affected many emerging-market assets, including that of Turkey and Argentina. The Fed raised short-term rates in September for the third time in 2018 and signaled that it is on track to hike one more time by year-end. The dollar has appreciated against most emerging-market currencies due to a tighter U.S. monetary policy. 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 September rate hike took the federal funds rate to a range of 2% to 2.25% and was the eighth increase since the Fed began normalizing policy in December 2015. The yield on the two-year U.S. Treasury bill traded above 2.8%, and the benchmark 10-year Treasury yield rose steadily to above the psychologically important 3% level during the quarter. The Fed is shrinking its balance sheet at the same time, 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.

At the same time, the United States and China, the world's two largest economies, launched new tariffs as tensions escalated. President Trump's trade policies have caused some pullbacks in the markets as the United States added tariffs to $200 billion in Chinese goods. Economic upheavals in Argentina and Turkey also hampered investor appetite for riskier emerging-market equities during the quarter.

How did the fund perform?

Putnam Emerging Markets Equity Fund underperformed its benchmark, the MSCI Emerging Markets Index [ND], for the quarter. The fund declined 4.71% compared with a decline of 1.09% for the MSCI Emerging Markets Index. Security selections within different countries and sectors drove most of the underperformance. However, our currency strategy was a positive contributor for the quarter.

What strategies detracted from returns? What strategies helped?

From a country perspective, overweight allocations in India and Taiwan and an underweight position in China relative to the benchmark detracted most from performance. Overweight allocations in Mexico and Greece and an underweight in South Africa added to results. In terms of sectors, overweight positions in information technology, industrials, and consumer discretionary detracted most from results. But the utilities, real estate, and telecommunications services sectors were positive contributors for the quarter. Regarding currency, an overweight allocation in the Mexican peso, the lack of exposure to the Turkish lira, and an underweight allocation in the Brazilian real helped performance.

While we chose many of the right countries, our sector allocations were slightly negative. Most damaging was security selection within a country and within a sector. The portfolio's tilt toward particular factors, such as small cap, growth, and price, proved to be painful, especially when the risk-off trade in emerging-market assets accelerated during the quarter. 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 fundamental research analysts are skewed toward mid- and small caps, allocation and security selection were negative contributors.

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

While emerging-market equities offer attractive returns for investors over the long term, this diverse asset class carries specific risks as illustrated by the volatility so far in 2018. Trade tensions are escalating between the United States and China, which is an anchor for other emerging markets. Higher rates and tighter monetary policies by the Fed and the European Central Bank are expected to further constrain asset flows to emerging-market equities. The Fed is expected to raise interest rates at least one more time before year-end 2018, and to continue to slowly unwind its post-crisis stimulus program. Should the Fed grow more hawkish, we believe it could further hurt global markets.

The challenges are likely to provide headwinds into 2019. As such, it is especially important to combine insights from bottom-up company research and our top-down country analysis. Many emerging-market economies are vulnerable to tighter Fed policy, heightened trade protectionism, sanctions, and a slowdown in China. However, the vulnerability varies from economy to economy, with some in better shape than others. Also, stimulus from the Chinese government to offset trade pressures will become more apparent, which will help market concerns about emerging-market countries dependent on China trade. As we move into 2019, we should have more clarity about the endpoint and timing of the rate-hiking cycle by the Fed, which should cap further dollar strength and ease pressure on emerging-market assets.

Emerging markets will need to find new sources of growth, but only a brave few are pursuing tough structural reforms. All others will be at the mercy of the developed markets' central banks, China's economic trajectory, commodity markets, and volatility caused by tweets from President Trump. Political developments in emerging markets — Mexico and Brazil — and among developed markets — Italy and the United Kingdom — have potentially far-reaching consequences. Possible negative results from the Brazilian presidential election will likely make for a difficult next few months from an absolute return basis for emerging-market economies. However, elections in India and South Africa in 2019 could provide a surprise for investors.

Putnam Emerging Markets Equity Fund (PEMYX)

Annualized total return performance as of 9/30/18

Class Y shares Inception 9/29/08	**Net asset value**	**MSCI Emerging Markets Index [ND]**
Last quarter	–4.71%	–1.09%
1 year	–2.34	–0.81
3 years	12.68	12.36
5 years	4.73	3.61
10 years	4.41	5.40
Life of fund	4.40	5.56

Total expense ratio: 1.81%

What you pay: 1.03%

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.

The views and opinions expressed are those of Daniel J. Graña, CFA, Portfolio Manager of Putnam Emerging Markets Equity Fund, as of September 30, 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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Request a prospectus or summary prospectus from your financial representative or by calling 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

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