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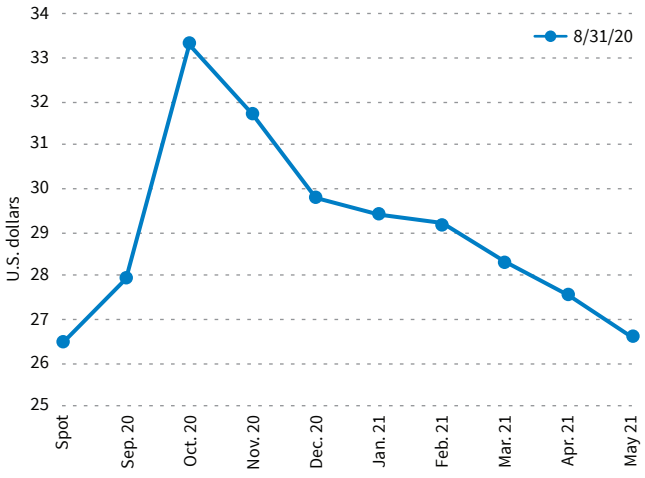
VIX futures hint at post-election uncertainty

We believe VIX futures are showing increased uncertainty about stock prices after Election Day, November 3.

In our view, volatility markets are pricing in a large likelihood of a drawn-out election, possibly until inauguration day.

Political and market risks can change daily, and we continue to research derivatives markets for changes in pricing trends.

VIX futures curve



Sources: Putnam Investments, Bloomberg Finance L.P., as of 8/31/20. Past performance is not a guarantee of future results.

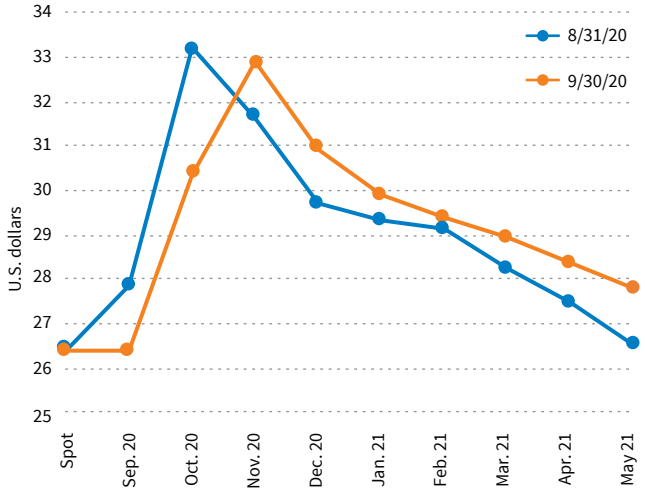
In "normal" markets, the VIX futures curve historically has an upward slope, and it inverts during risk-off episodes (VIX is the CBOE Volatility Index, and it is a measure of expected volatility in the next 30 days). However, our research indicates that when there are well-known catalysts (e.g., elections, Federal Reserve meetings), the curve can experience a "kink" to price in that idiosyncratic risk. To the left is the VIX futures curve from the end of August 2020.

Note that a VIX futures contract converges to the value of the VIX on the day the contract expires. In this case, the October VIX future contract, which expires on October 21, will converge to the value of VIX on that date. The price of the VIX on October 21 is itself an expectation of the volatility in the thirty days from October 21 to November 20. Since that period includes Election Day (November 3), the kink occurs at the October maturity.

Probability of delayed election result

However, with growing uncertainty around the actual election (counting ballots amid the COVID-19 pandemic), the declaration of a winner (the possibility of a court challenge as in 2000) and a potential messy transfer of power (President Trump has made statements that indicate he would not accept the election results), we believe the volatility markets are starting to price these risks further into the future, rather than on Election Day. (Note, we recognize that the prices of futures can change rapidly with changes in campaigns and election polling, and could move significantly in coming days and weeks.) Below are the VIX futures curves as of the end of August 2020 and of September 2020.

VIX futures curve



Sources: Putnam Investments, Bloomberg Finance L.P., as of 9/30/20. Past performance is not a guarantee of future results.

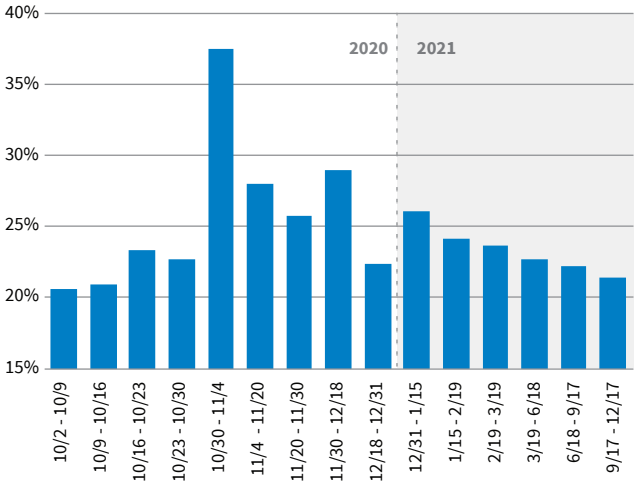
Notice that the kink has now moved to the November futures contract (election aftermath), with even the December future priced higher than the October future (compare points on the 9/30/20 line). This was a result of the October future falling significantly and the November and December (and even January) futures all moving higher. This shifting of the kink from October to November is a recent phenomenon:

Oct. VIX future minus Nov. VIX future

Sources: Putnam Investments, Bloomberg Finance L.P. Past performance is not a guarantee of future results.

In our opinion, this means volatility markets are now pricing in a large likelihood of a drawn-out election, possibly all the way up to inauguration day. However, the movement of the kink from the October future to the November future does not mean that markets are expecting the aftermath to be riskier than the election itself, in our view. We believe that one subtlety lost in the VIX futures curve being monthly is that the market is pricing in a big discount in risk prior to the election (which may be dragging down the overall level of the October future):

S&P 500 forward implied volatility (as of 9/30/20)



Sources: Putnam Investments, Bloomberg Finance L.P. Past performance is not a guarantee of future results.

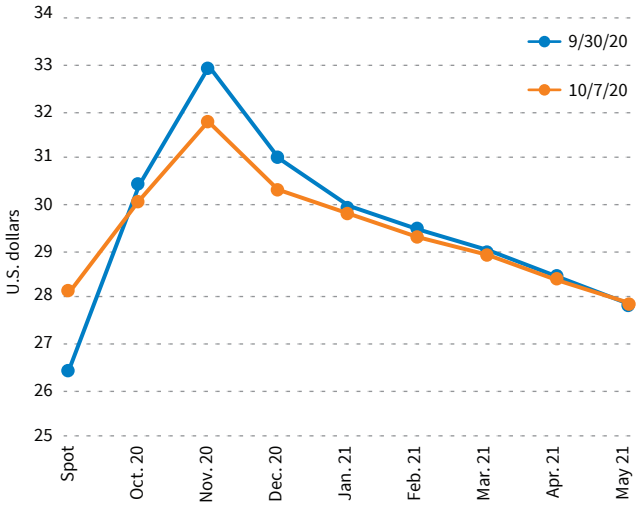
With weekly options generally more popular and liquid than ever, we can calculate expected volatility on a more granular basis. We can see from the chart on the previous page that the implied volatility is still highest around the election, but definitely elevated post-election up to inauguration day (except during the weeks around Christmas, which are typically pretty calm for markets, and, to a lesser extent, during the week of Thanksgiving).

We believe that, given these dynamics, an election resolution that is not drawn out would lead to a quick compression in post-election implied volatility.

Effects of the first debate and the president's COVID-19 illness

There have been several market-moving events since September 30, including the public's reaction to the first presidential debate, the president being diagnosed with COVID-19, and the president tweeting an end to fiscal stimulus negotiations. These events have generally been perceived as negative for President Trump and positive for former Vice President Biden and the Democrats. Polls and prediction markets have shown Biden widening his lead with a higher probability of a "blue wave" scenario (Democrats regain the White House and both chambers of Congress). We believe a more clear-cut election victory for Biden would mean less uncertainty: less dispute regarding the outcome and a less contentious transfer of power. The reaction from volatility markets was exactly along these lines:

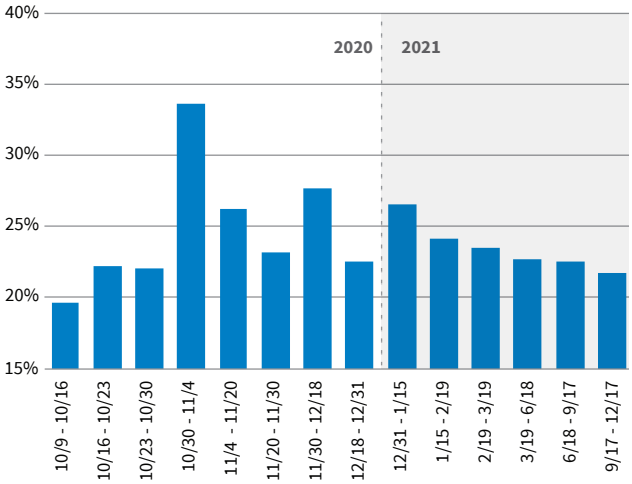
VIX futures curve (early October)



Sources: Putnam Investments, Bloomberg Finance L.P. Past performance is not a guarantee of future results.

The overall shift downward in the VIX futures curve represents lower expected risk at all horizons, but the decrease was by far the biggest in the November and December contracts. In our view, the market reacted to the week's news by lowering the probability of a chaotic election aftermath, but that is not to say, though, that the market removed that possibility altogether:

S&P 500 forward implied volatility (as of 10/7/20)



Sources: Putnam Investments, Bloomberg Finance L.P. Past performance is not a guarantee of future results.

When we view volatility in greater detail, we still see a volatility premium priced in after the election, especially in the first few weeks of December, a period that includes the meeting of the Electoral College on December 14, 2020. When compared with the same data at the end of September, there are still outsized risks around the election and its immediate aftermath, we believe, but markets now expect less volatility. It's important to remember also that these conditions can take a different course with changes in the political situation.

Read more about the Global Asset Allocation Team's current views in the Capital Markets Outlook at Putnam.com.

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