Q3 2019 | Fixed Income Outlook

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Bonds rally as the Fed signals possible rate cut

Global growth is set to moderate amid trade rifts and waning business confidence.

We predict the Fed will cut interest rates by the end of 2019.

China and the United States reach a tentative peace accord on trade.

The global economy has cooled in 2019 as the fallout from the ongoing trade rifts, waning business confidence, and financial market volatility have kept the lid on expansion. Despite multiple headwinds, we expect growth for the remainder of the year will hover around its long-term trend of 2% to 3%. The U.S. economy is also likely to expand at a more moderate pace compared with 2018. Still, unemployment has touched multi-decade lows, inflation remains anchored, and the likelihood of a recession remains low.

The Federal Reserve struck a more dovish tone in its June policy statement, and chair Jerome Powell said that the case for easier monetary policy had strengthened. We predict the Fed will cut its policy rate by 50 basis points by the end of 2019. The central bank had raised short-term rates four times in 2018, taking the federal funds rate to a range of 2.25% to 2.50%. The Treasury yield curve has been flattening for some time. The yield on the benchmark 10-year note — widely used

Putnam fixed-income views

Shading in the table indicates the change from the previous quarter

	Underweight	Small underweight	Neutral	Small overweight	Overweight
U.S. government and agency debt	●				
U.S. tax exempt			●		
Tax-exempt high yield				●	
Agency mortgage-backed securities			●		
Collateralized mortgage obligations				●	
Non-agency residential mortgage-backed securities				●	
Commercial mortgage-backed securities					●
U.S. floating-rate bank loans					●
U.S. investment-grade corporates				●	
Global high yield				●	
Emerging markets			●		
U.K. government				●	
Core Europe government					●
Peripheral Europe government			●		
Japan government		●			

Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro		○	●
£ Pound	○		●
¥ Yen	●	○	

in setting borrowing costs for consumers and businesses worldwide — fell below 2% for the first time since November 2016.

At the G-20 meeting, President Trump and Chinese President Xi Jinping made headway on stabilizing tariffs as they continue to work on long-term trade issues. At the same time, the European Central Bank (ECB) opened the door to interest-rate cuts for the eurozone. The elections for the European Parliament in May shook up domestic politics in a few countries, including Germany and Italy. And Britain is in the middle of choosing a leader to become the country's next prime minister amid a failure to agree on options for its withdrawal from the European Union.

U.S. economy set to moderate

The U.S. economic expansion is cooling from last year under the weight of the Trump administration's restrictive trade policies, economic slowdowns in Europe and China, and fading stimulus from the tax cuts of 2017. The Fed's Powell said in June that the central bank "will act as appropriate" to sustain economic expansion, fueling market speculation of a rate cut this year. The economy grew at a 3.1% annual rate in the first quarter of 2019, after expanding 2.2% in the fourth quarter. The Fed now expects growth of 2.1% this year, down from the 2.3% rate it forecast in December 2018.

Meanwhile, job creation remains solid despite some uneven gains this year. The pace of hiring rebounded in June following the sharp decline in May. The government reported that employers added 224,000 jobs, exceeding economists' expectations. The jobless rate ticked up slightly to 3.7% as more Americans looked for work. Still, there has been some pullback in the manufacturing and retail sectors. And wages are increasing, but not at a faster rate. We remain cautious about the outlook as it would not take much to tip the economy into a weaker path.

Fed rate cut in the cards

U.S. and international financial markets rallied on Fed statements that it may lower interest rates in the near term. Powell said the "case for somewhat more accommodative policy has strengthened." This represents a shift after the central bank raised short-term rates four times in 2018, taking the federal funds rate to a range of 2.25% to 2.50%. At the same time, the Fed balance sheet will continue to be reduced through September 2019. That balance had ballooned to $4.5 trillion under its quantitative easing policies during the financial crisis.

The Fed may cut rates at its meeting on July 30–31. The Treasury market is already reflecting an environment of falling rates, slowing growth, and lower inflation. The yield on the 10-year Treasury traded around 2.00%, while the two-year yield fell to around 1.75% at the end of June 2019. The spread between the two-year yield and the 10-year yield, a popular gauge of the curve's steepness, has narrowed but has yet to invert. Bond yields move inversely to prices. History shows that an inverted yield curve, where shorter-dated bonds yield more than longer-dated ones, typically presages a recession.

ECB mulls fresh stimulus

The eurozone's economy is at risk from global developments and inflation remains low despite years of unprecedented stimulus. But with interest rates already at a record low and an inflated balance sheet, the ECB has limited policy tools to boost growth. In June, the ECB pledged to delay the time frame before any rate increase to the middle of 2020. Policy makers are now mulling additional monetary stimulus, including a reduction in the already negative policy rate. The central bank has already rolled out a new program to stimulate bank lending; the targeted longer-term refinancing operations (TLTRO-III) will provide loans to banks starting in September 2019 and ending in March 2021.

The recent political shift has also dampened the region's reform agenda and growth prospects. In the United Kingdom, Germany, Italy, and France — powerhouse economies in the region — voters have shown increasing support for nationalists and populist parties. German Chancellor Angela Merkel, Western Europe's longest-serving head of government, will not seek a fifth term when her current term expires in 2021. Germany's economy, the largest in Europe, has slowed as global growth cools, Brexit drags on, and trade tensions linger between the United States and China.

China's next move

China, the world's second-largest economy, has stepped up fiscal stimulus and monetary easing to cushion its cooling economy. This includes billions of dollars in infrastructure spending and tax cuts for companies. The country's growth pace is easing amid the fallout from the trade rift and slowing investments at home. The government is targeting growth of 6% to 6.5% this year, a deceleration from 6.6% in 2018 and 6.8% in 2017. We don't expect China to return to the rapid rates of growth that supported global demand in the years following the financial crisis. Meanwhile, Premier Li Keqiang reiterated in July that the government will not competitively devalue the yuan.

At the G-20 summit in June, Trump said he would set aside plans for new tariffs on Chinese imports and also ease restrictions on Huawei, the Chinese telecommunications giant, by allowing it to buy technology that isn't deemed a security risk. China, in turn, agreed to buy more U.S. farm goods. However, current high trade barriers — including 25% tariffs on some of China's exports to the United States — will remain in effect until both sides are able to renegotiate a trade deal.

Sector views

Corporate credit spreads may tighten

In the second quarter, a sizable decline in global interest rates was the biggest development. Spreads — the yield advantage bonds offer over comparable-maturity U.S. Treasuries — tightened across asset classes, driven by dovish Fed commentary and easing trade tensions. Within this environment, corporate credit, mortgage credit, and prepayment risk generally performed well. In corporate credit, we think spreads as of June 30 represented fair value, based on generally supportive business fundamentals. In an environment where the Fed and other central banks have adopted a more dovish tone, we think spreads could remain steady or tighten slightly in the months ahead.

Favorable outlook for mortgage strategies

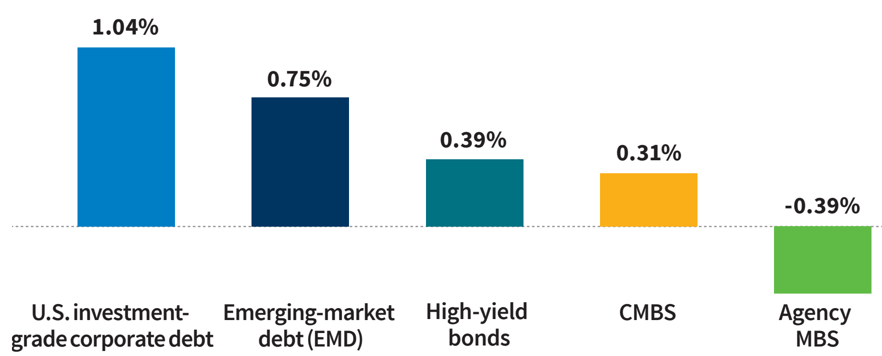
We continue to have a generally favorable outlook for mortgage credit, including commercial mortgage-backed securities (CMBS). We think the underlying fundamentals for commercial real estate appear stable, supported by a growing labor market, interest rates that remain historically low, and a positive U.S. economic backdrop. That said, we think these favorable factors will be partially offset by higher capital costs and low capitalization rates. (Capitalization rate is the rate of return on a commercial investment property based on the income that the property is expected to generate.) Elsewhere, within residential mortgage-backed securities (RMBS), we

Most risk assets modestly outperformed during Q2

Excess returns* relative to Treasuries, Q2 19

Source: Bloomberg, as of 6/30/19. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index. Past performance is not indicative of future results. See page 6 for index definitions.

* Excess returns are calculated relative to comparable maturity U.S. Treasuries for each index.



continue to find value among legacy RMBS, where we think a steadily shrinking market and stable investor base provide a supportive supply-and-demand backdrop.

High-yield bonds in demand

High-yield bonds rose 2.60% for the second quarter, as measured by the JPMorgan Developed High Yield Index. The asset class outpaced high-yield bank loans but trailed the broad investment-grade fixed-income market. Despite global trade uncertainty, we think the fundamental backdrop for high yield remains supportive, aided by favorable corporate earnings, a strong labor market, and solid U.S. economic growth. Defaults declined materially during the past 12 months and are now at a level last seen in 2014. We think defaults are likely to remain low for an extended period.

The market's technical backdrop improved this year, aided by a combination of modest net new issuance and a return to strong fund inflows. New volume (net of refinancing-related new issuance) was $46.6 billion year to date, slightly higher than in the same period in 2018. Meanwhile, flows into retail and exchange-traded funds totaled $12 billion, compared with outflows of $24.5 billion during the same period last year. Turning to valuation, in June, high-yield spreads partially retraced the widening in May and remain tighter than where they began the year. Overall, we think spreads look fairly valued.

Currency views

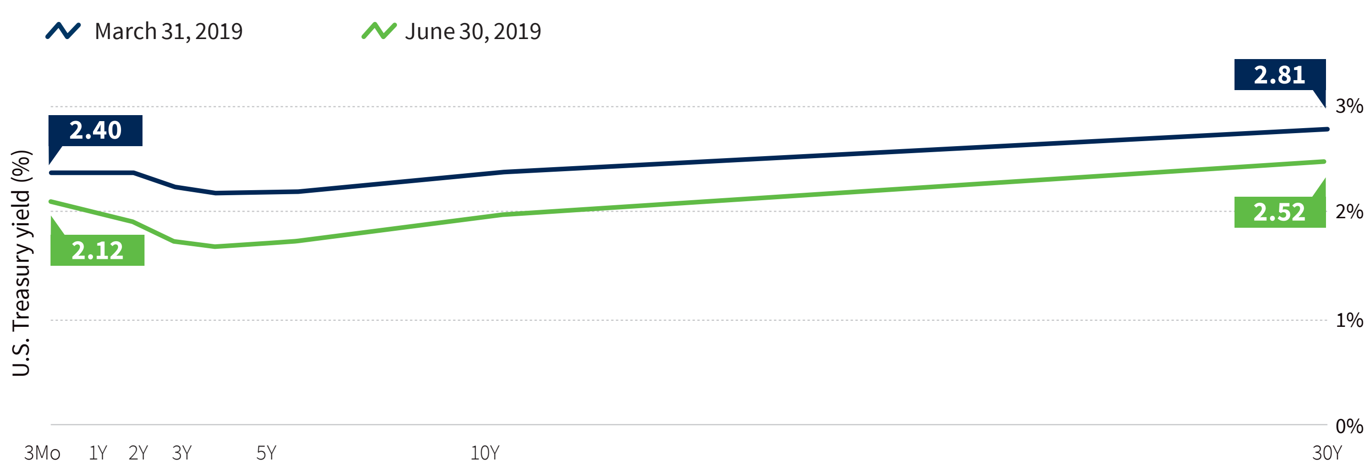
The dollar may waver

The Fed signaled in June that it may lower interest rates to sustain economic expansion. The end of the Fed's rate-hike cycle will alleviate some of the upward pressure on the U.S. dollar. The dollar's support from its high-yielding status is wavering. Still, growth outside the United States will need to pick up to allow a more broad-based dollar depreciation. Growth projections have bounced around this year, and the fallout from the trade rift between the United States and China has dampened the outlook. So, the dollar will likely remain supported against most other currencies except the Japanese yen and the Swiss franc.

Euro weakness could be capped

The outlook for the euro remains dominated by monetary policy, growth, and political risk premium. At its June meeting, the ECB held interest rates. ECB President Mario Draghi also signaled the bank could roll out fresh stimulus as soon as July. This would set the stage for a possible rate cut in September as policy makers step up their efforts to revive the eurozone economy. The euro will likely retain its role as a funding currency. But there are limits to how low the single currency can fall as other global central banks shift to a more dovish tone.

Rates continued to fall across the yield curve during Q2



Source: U.S. Treasury Department, as of 6/30/19. Past performance is not indicative of future results.

Brexit weighs on pound

In the United Kingdom, Brexit has been delayed until the end of October. Prime Minister Theresa May announced her resignation in May, and the focus is currently on her successor. Boris Johnson and Jeremy Hunt are the leading contenders, and both candidates have increased calls for a no-deal Brexit. At the same time, renegotiating the Brexit deal by the end of October seems unlikely. The winning candidate may need to extend the deal or push for a no-deal plan, which could be overruled by the House of Commons. That might lead to a constitutional crisis. The Bank of England continues to highlight the need for rate hikes on a soft Brexit. The pound will be affected by swings in the U.S. dollar and by the uncertainty around Brexit.

Japan's yen could march higher

The Bank of Japan (BoJ) adopted forward guidance in April that pledges to keep current ultra-low rates at least until the spring of 2020. Given the dampened outlook for global growth and the potential for raising the value-added tax, the BoJ's monetary policy will remain accommodative. As central banks across the world begin to lower rates — or drop hints at additional easing — and markets price in cuts, interest-rate spreads with Japan have narrowed. This has reduced the search for higher yields abroad. Also, the risks to global growth and risky assets are tilted to the downside. We expect the yen to remain strong.

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* As of June 30, 2019.

Agency mortgage-backed securities are represented by the Bloomberg Barclays U.S. Mortgage Backed Securities Index, which covers agency mortgage-backed pass-through securities (both fixed rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Commercial mortgage-backed securities are represented by the Bloomberg Barclays U.S. CMBS Investment Grade Index, which measures the market of commercial mortgage-backed securities with a minimum deal size of $500 million. The two subcomponents of the U.S. CMBS Investment Grade Index are U.S. aggregate-eligible securities and non-eligible securities. To be included in the U.S. Aggregate Index, the securities must meet the guidelines for ERISA eligibility.

Emerging-market debt is represented by the Bloomberg Barclays EM Hard Currency Aggregate Index, which is a flagship Emerging Markets debt benchmark that includes USD, EUR, and GBP denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The index is broad-based in its coverage by sector and by country, and reflects the evolution of EM benchmarking from traditional sovereign bond indices to Aggregate-style benchmarks that are more representative of the EM investment choice set.

Eurozone government is represented by the Bloomberg Barclays European Aggregate Bond Index, which tracks fixed-rate, investment-grade securities issued in the following European currencies: euro, Norwegian krone, Danish krone, Swedish krona, Czech koruna, Hungarian forint, Polish zloty, and Swiss franc.

High-yield bonds are represented by the JPMorgan Developed High Yield Index, an unmanaged index of high-yield fixed-income securities issued in developed countries.

Japan government is represented by the Bloomberg Barclays Japanese Aggregate Bond Index, a broad-based investment-grade benchmark consisting of fixed-rate Japanese yen-denominated securities.

Tax-exempt high yield is represented by the Bloomberg Barclays Municipal Bond High Yield Index, which consists of below-investment-grade or unrated bonds with outstanding par values of at least $3 million and at least one year remaining until their maturity dates.

U.K. government is represented by the Bloomberg Barclays Sterling Aggregate Bond Index, which contains fixed-rate, investment-grade, sterling-denominated securities, including gilt and non-gilt bonds.

U.S. floating-rate bank loans are represented by the S&P/LSTA Leveraged Loan Index, an unmanaged index of U.S. leveraged loans.

U.S. government and agency debt is represented by the Bloomberg Barclays U.S. Aggregate Bond Index, an unmanaged index of U.S. investment-grade fixed-income securities.

U.S. investment-grade corporate debt is represented by the Bloomberg Barclays U.S. Corporate Index, a broad-based benchmark that measures the U.S. taxable investment-grade corporate bond market.

U.S. tax exempt is represented by the Bloomberg Barclays Municipal Bond Index, an unmanaged index of long-term fixed-rate investment-grade tax-exempt bonds.

You cannot invest directly in an index.

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