Q4 2020 | Fixed Income Outlook

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Bond investors face Catch-22

We expect bond yields to stay near record lows amid an uneven economic rebound and the November election.

The Fed signals a shift for setting its monetary policy, allowing for a rate environment that will likely be "lower for longer."

We have a fairly favorable outlook for the bond markets, including investment-grade corporate bonds.

Global financial markets trended higher during the third quarter. The rally was fueled by ongoing stimulus policies, signs of economic revival, and progress toward a COVID-19 vaccine. The market's resilience also benefited bondholders. The rate-sensitive Bloomberg Barclays U.S. Aggregate Bond Index advanced 0.62% during the quarter. The ICE BofA 1–3 Year U.S. Corporate Index rose 0.74%.

In August, the Fed announced a new monetary policy framework that will essentially abandon its longtime strategy of preemptively lifting rates to head off higher inflation. The Fed's shift in how it sets rates indicates the central bank will tolerate "lower for longer" interest rates. Central banks across Europe, Asia, and other regions also rolled out COVID-19 stimulus measures.

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	●		

That said, the world's top economies — including the United States, France, Germany, Japan, and the United Kingdom — shrank dramatically in the first half of 2020. This indicates the global economy may struggle to return to pre-pandemic levels of output until a vaccine becomes widely available.

Yields on U.S. government bonds have stalled near all-time lows. The yield on the benchmark 10-year Treasury note ended the quarter at 0.69 % from 1.88% at the beginning of the year. The 2-year note yield tumbled to around 0.13% at quarter-end. The market for high-yield and investment-grade corporate bonds continued to recover as spreads, or the risk premiums over Treasuries, narrowed during the period. We have a fairly favorable outlook for investment-grade corporate bonds, and we are also finding opportunities in high-quality securitized assets, including AAA-rated asset-backed securities. The commercial mortgage-backed securities (CMBS) market, however, is coming back haltingly.

The Fed's new policy and the U.S. economy

Fed officials expect to leave rates near zero for years — through at least 2023 — as they try to coax the economy back to full strength after the pandemic-induced recession. The Fed continues to pump trillions of dollars into the financial system. We believe the central bank's backstop remains supportive for credit spreads and reduces the probability of another liquidity driven sell-off. We think Treasury yields will remain low across the curve for an extended period. The Fed also signaled that it will be more inclined to allow inflation to rise modestly above the 2% target. Chair Jerome Powell said the bank's new strategy could be viewed as "a flexible form of average inflation targeting."

The economy continues its halting recovery from the sharp decline in the second quarter. The service and manufacturing sectors reported solid growth in September, and the unemployment rate declined, but hiring gains cooled. The jobless rate fell to 7.9% in September from 8.4% the prior month, a Labor Department report said. Consumer spending is also rising at a slower pace than pre-pandemic levels. We believe the risk of renewed widespread lockdowns is low. That said, we remain skeptical about a "V-shaped" recovery. A sharp downturn followed by a quick rebound in growth defines the V-shaped recovery.

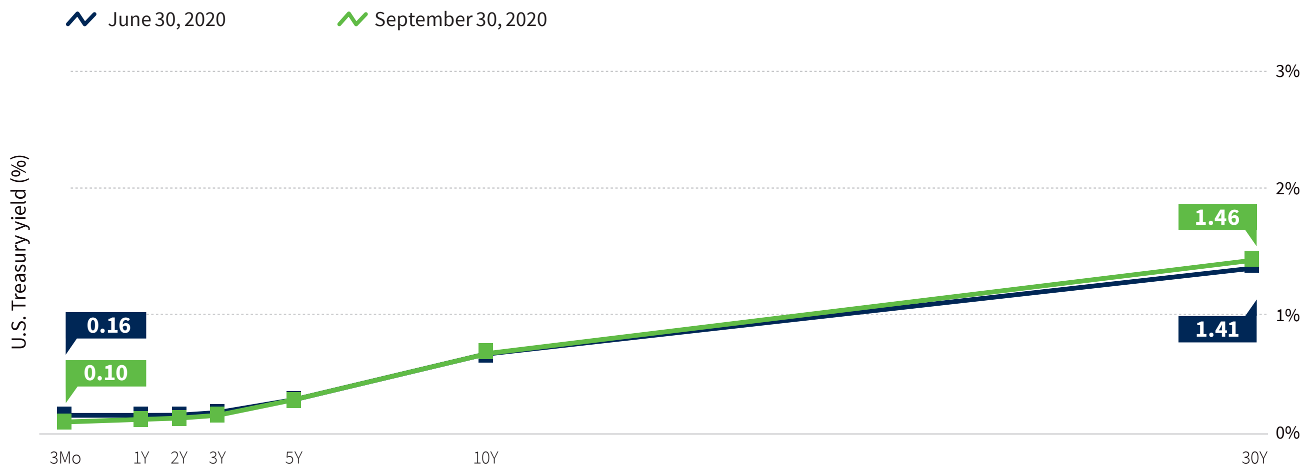
Politics will take center stage over the next few months. The presidential election campaigns have kicked into full gear ahead of the November 3 vote amid fresh uncertainty after President Trump tested positive for COVID-19. Investors are also bracing for gridlock on a new fiscal stimulus package. Democrats and Republicans have been at an impasse over the next virus relief bill. Our view is the economy and risky assets will struggle in the absence of a new round of stimulus. Against this backdrop, the Fed expects the economy to contract by 3.7% this year, before bouncing by 4% in 2021.

EU adopts groundbreaking stimulus plan

The recovery has been slower in many parts of Europe because of the resurgence of the virus. The weakening of service sectors in September came as a number of European countries, including the United Kingdom, France, and Spain, tightened restrictions in response to accelerating infection rates. Manufacturing, however, is bounding back in some countries. In Germany, the region's largest economy, the private sector continued to recover as foreign demand provided a boost to manufacturing. The European Union (EU) predicts the bloc's economy will shrink by 8.7% this year and grow by 6.1% in 2021.

In July, the EU agreed to create a €750 billion recovery fund, including selling collective debt. The European Central Bank (ECB) is also doing its bit to help, with an expansion and extension of its quantitative easing program at least until June 2021. The bond purchases by the ECB have kept yields on government debt in the region pinned extremely low, especially for riskier borrowers such as Italy. In the United Kingdom, finance minister Rishi Sunak unveiled another £30 billion stimulus package aimed at stemming the growing jobs crisis and lifting the economy out of its worst slump in centuries.

Rates stayed mostly range bound during the quarter across a relatively flat curve, as investor sentiment remained risk-on



Source: U.S. Treasury Department. Past performance is not indicative of futures results.

China's bond market attracts investors

China's recovery makes it an outlier as the pandemic weighs on the rest of the globe. The economy, which contracted 6.8% in the first quarter, grew 3.2% in the second quarter from a year earlier as lockdown measures ended, and policymakers stepped up stimulus measures. Manufacturing and services sectors have shown signs of recovery, but private consumption and retail sales remain weak. China has rolled out a raft of measures, including tax relief and cuts in banks' reserve requirements. The economic momentum and easing concerns about U.S. tariffs have spilled over to the currency and the bond markets.

Relatively high interest rates, plus a broader sell-off in the dollar, have buoyed the yuan. The People's Bank of China — which tightly controls the currency's movements — appears more comfortable in letting the currency join a broader rally against the dollar. A widening gap between interest rates in the United States and higher rates available in China is also boosting government bonds. Foreign purchases of Chinese bonds hit a record in the second quarter as investors sought higher yields. The benchmark 10-year bond yielded around 3.16%.

Sector views

Corporate debt: Investment grade and high yield

We have a moderately constructive outlook overall. We anticipate periods of volatility across all risk markets as we approach the U.S. elections. Reflecting investor demand for risk, investment-grade corporate bonds outpaced the broad investment-grade fixed-income market but trailed high-yield corporate credit during the quarter. Accordingly, more defensive areas of the market lagged, including U.S. government securities and agency mortgage-backed bonds. Credit spreads tightened during the three months. Our corporate credit holdings — primarily high-yield bonds and convertible securities — added the most value this quarter. Emerging-market [EM] debt also performed well, but gained only about half as much as high-yield credit, in U.S.-dollar terms, during the three-month period.

We have a relatively positive medium-term outlook for corporate credit. While there are risks, there are factors that will be supportive of the U.S. corporate credit market. These include demand for comparatively higher yields in the face of much lower yields globally. Investors know the Fed stands ready to provide further support to the market via its bond purchase facilities if necessary. That has provided an important boost to market sentiment. The central bank has so far invested only a small portion of the $750 billion earmarked for corporate debt purchases. Also, even though high-yield spreads retightened following their sizable widening in March, we think valuations remain relatively attractive.

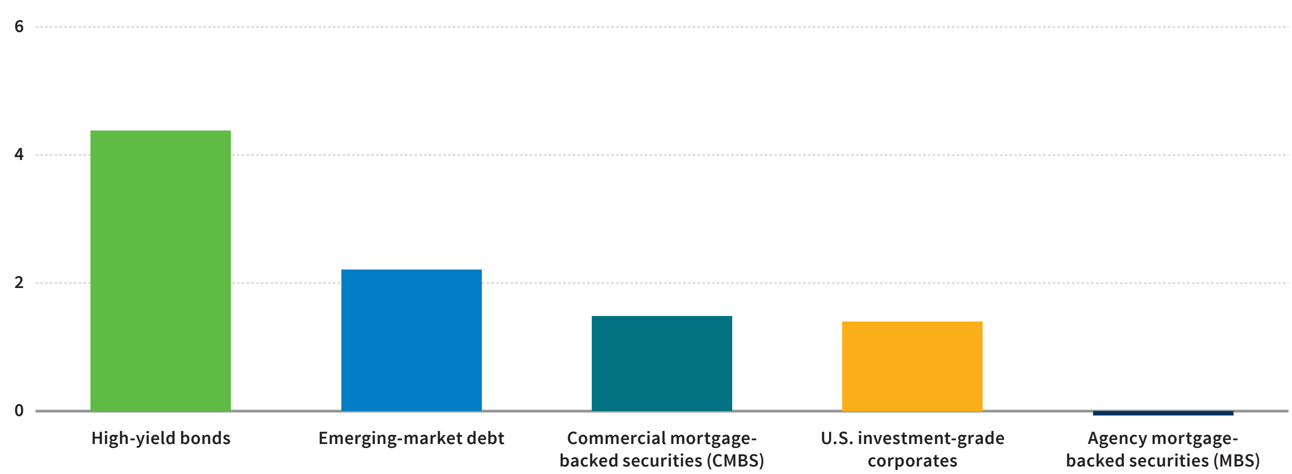
In high-yield credit, we are closely watching sectors vulnerable to the disruption caused by the pandemic, including energy, gaming, lodging & leisure, and retail. Within these groups, we are focusing on the health of issuers' balance sheets and liquidity metrics, as well as the risk of defaults or credit-rating downgrades.

Trends in the mortgage market

COVID-19 created significant headwinds for the CMBS market due to the negative impact on commercial real estate. That said, during the quarter, we began to see some improvement in higher-rated cash bonds. We continue to

Risk assets continued to rebound during Q3, and corporate credit and EM debt again led the way

Excess returns* relative to Treasuries, Q3 2020



Source: Bloomberg, as of 9/30/20. 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. Excess return does not always mean "outperformance."

have conviction in our CMBX positions, which we believe fairly compensate investors for current risk levels. (CMBX is an index that references a basket of CMBS issued in a particular year.)

Within residential mortgage credit, we believe the agency credit-risk transfer securities (CRT) sector directly benefits from the efforts of the government and government-sponsored enterprises such as Fannie Mae and Freddie Mac to keep people in their homes. We also believe the dislocations that occurred in March were mitigated by U.S. monetary and fiscal policy and the gradual reopening of the economy. As a result, we continue to find value in various segments of the CRT market, as well as the non-agency residential mortgage-backed market.

We are also continuing to find value in prepayment-sensitive areas of the market despite a recent increase in refinancing activity. Agency interest-only (IO) and inverse interest-only securities in the collateralized mortgage obligation (CMO) space continue to be our focus, particularly securities with lower coupons and more seasoned collateral, as well as reverse mortgages and those with jumbo loan balances.

Currency views

The dollar is losing its luster amid slide

The dollar's support from its high-yielding status has disappeared as the Fed slashed rates to zero and unveiled an unlimited quantitative easing (QE) package. The Fed's new policy framework also means a lower-for-longer short-term policy rate. The death of Supreme Court Justice Ruth Bader Ginsburg and the race to confirm a successor suggests an agreement on a near-term fiscal package could be delayed. The global recovery and the COVID-19 pandemic will continue to be key themes for the dollar, but the election will be the dominant theme. The candidates' platforms cast very different outlooks for fiscal policy and globalization. The dollar will likely be volatile as polls swing and until a clear winner emerges in the presidential vote.

The euro is on an uptrend

The outlook for the euro remains dominated by monetary policy, growth, and political risk premium. The ECB is concerned about the euro's strength since it could weaken growth and the inflation target. The ECB could increase asset purchases via the Pandemic Emergency Purchase Programme (PEPP), but it is not clear this will be negative for the euro. The European Recovery Fund is a fundamental game changer for the eurozone over the medium to the long term. This and the ECB's massive asset purchases should keep bond spreads tighter in peripheral countries. As COVID-19 cases trend higher in some economies, there is a tempering of upside expectations for the euro. Still, we expect the currency to trend higher.

British pound to remain volatile

The government has proposed trade legislation that would violate the withdrawal agreement with the EU. The bill, which has to be approved by the U.K. Parliament before becoming law, would contravene an international treaty. It is unclear whether this is purely a negotiating tactic to placate backbenchers in the Conservative Party or to pressure the EU for additional concessions. It is a risky move by Prime Minister Boris Johnson. This makes the next several months highly volatile for the pound. A no-deal Brexit scenario would see the pound depreciate over the medium term, and a last-minute deal would see the pound rally in the near term until other factors begin to dominate its direction.

Japan's yen likely to appreciate

Yoshihide Suga was elected the new prime minister following a vote in Parliament in mid-September. Suga, who will head the ruling Liberal Democratic Party, is expected to continue former Prime Minister Shinzo Abe's policies. Abenomics represented Japan's attempt to break away from two decades of lackluster growth and deflation. Suga will face a more difficult environment. The Bank of Japan is largely sidelined with limits on additional monetary easing and remains focused on ensuring that bond yields remain low. As purchases of foreign equity abates and outward direct investment from Japan slows, we should see the yen climb higher.

Putnam's veteran fixed-income team offers a depth and breadth of insight and an independent view of risk.

Successful investing in today's markets requires a broad-based approach, the flexibility to exploit a range of sectors and investment opportunities, and a keen understanding of the complex global interrelationships that drive the markets. That is why Putnam has more than 90 fixed-income professionals* focusing on delivering comprehensive coverage of every aspect of the fixed-income markets, based not only on sector, but also on the broad sources of risk — and opportunities — most likely to drive returns.

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* As of September 30, 2020.

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.

Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

The Bloomberg (BBG) Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities.

The ICE BofA 1-3 year U.S. Corporate Index is an unmanaged index of U.S. investment-grade corporate debt with a remaining term to maturity of less than 3 years.

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