Q2 2021 | Fixed Income Outlook

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Bond markets restless amid inflation hype

U.S. Treasury yields trended higher, lifted by forecasts of stronger economic growth and inflation.

The Fed may start tapering bond purchases as soon as the first half of 2022, depending on Covid-19 cases and economic activity.

High-yield bonds and different parts of the mortgage market offer attractive investment opportunities.

Global financial markets were mixed during the first quarter. The bond markets experienced bouts of volatility, as yields jumped and demand eroded, reflecting expectations that Covid-19 vaccines and new stimulus money will boost the U.S. economy, lifting growth and inflation. The rate-sensitive Bloomberg Barclays U.S. Aggregate Bond Index fell 3.37% during the quarter. The ICE BofA 1–3 Year U.S. Corporate Index rose 0.02%. That compares with a gain of 6.17% for the S&P 500 Index.

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	○	●	

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The Federal Reserve has pinned short-term interest rates near zero since early 2020. Fed officials in March highlighted an improved outlook for U.S. growth but signaled they expect to maintain ultralow interest rates through 2023. U.S. fiscal stimulus, including President Biden's $1.9 trillion package, has added tailwinds to the economy. Central banks across Europe, Asia, and other regions have also maintained easy money policies. Covid-19 cases have ebbed and flowed across the globe, with some governments reopening and others reimposing lockdown measures.

Long-term U.S. Treasury yields have risen sharply in recent months. The yield on the benchmark 10-year Treasury note surged as high as 1.78% in March before falling to 1.74% at quarter-end. That rate was below 1% for much of 2020. The yield on the 2-year note ended the period at around 0.16%. Higher long-term interest rates placed a degree of pressure on the credit market, including investment-grade bonds and emerging-market debt. Within this environment, high-yield credit outpaced the broad investment-grade debt market, aided by better-than-expected corporate earnings and higher oil prices.

Fed downplays the risk of inflation

The Fed has left the federal funds rate at 0.00% to 0.25% since March 2020. The Fed also pledged to continue purchasing at least $120 billion of Treasury bonds and mortgage-backed securities monthly. Fed Chair Jerome Powell in March said the measures "will ensure that monetary policy will continue to deliver powerful support to the economy until the recovery is complete." Concerns about the potential inflationary impact of additional stimulus on top of an already-recovering economy have led to speculation that the Fed may lift short-term rates or start tapering its bond-buying program. Powell, however, has said any pickup in inflation will be transitory.

The Fed expects the economy to grow 6.5% this year and 3.3% in 2022, and the unemployment rate to fall to 4.5% by the end of 2021. Central bank officials have also raised projections for inflation rate for personal-consumption expenditures (PCE) to 2.4% this year and 2% in 2021. But the Fed hasn't said how long it would allow inflation to run above 2%. Against this backdrop, consumer confidence in March soared to a one-year high. Job growth picked up in March, and the jobless rate fell to 6% after peaking at almost 15% in April 2020.

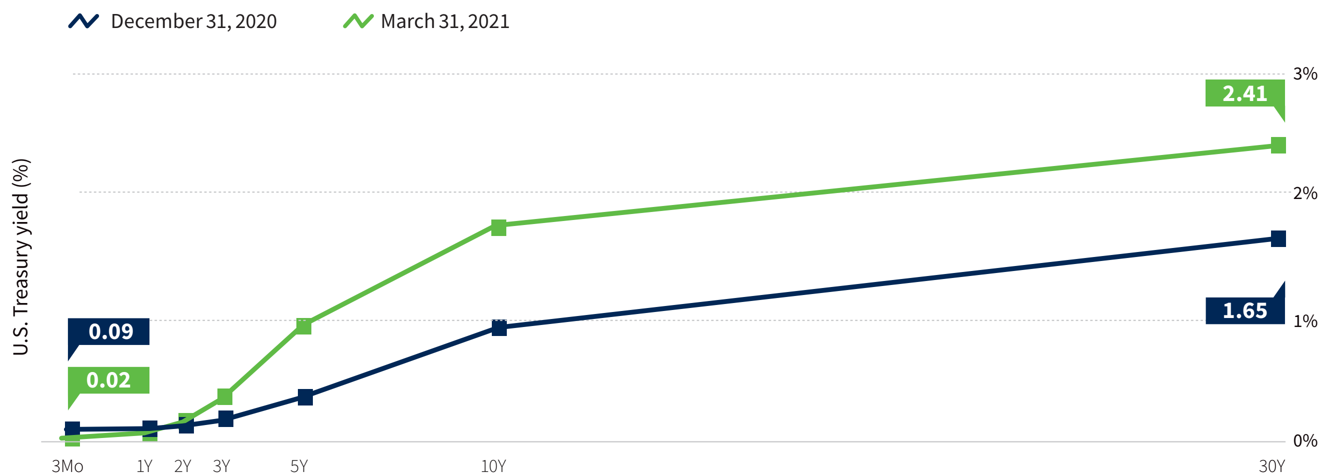
We believe the Fed may announce tapering in the second half of 2021 if Covid-19 cases don't take a turn for the worse and economic activity improves. Tapering of asset purchases – which is a form of monetary tightening - could start as soon as the first half of 2022. As for raising the policy rate, the Fed might stay patient until there is substantial progress in the labor market. The Treasury yield curve has steepened in response to no hike projections in 2023. The Fed can control the front-end of the curve but not the back end.

ECB pledges higher pace of bond purchases

The European Central Bank (ECB) said in March it plans to increase its bond purchases in the second quarter of 2021 to contain the impact of global rising yields in the eurozone. While policy makers committed to front load purchases, it kept the Pandemic Emergency Purchase Program (PEPP) at 1.85 trillion euros until at least the end of March 2022. Yields in the eurozone had trended higher since February – following a rise in U.S. Treasury and global government bond yields – leading to worries that it could derail the region's economic recovery. The ECB's decision to accelerate bond buying has pushed European yields lower, widening the spread between European and U.S. sovereign bond yields. Germany's10-year bond yields, seen as the benchmark for Europe, tumbled to -0.313% as of early April after climbing in February.

ECB President Christine Lagarde said the Covid-19 pandemic continues to pose a risk to the eurozone's economy. Consumers in the region also remain cautious about the outlook, as some countries in the EU remain in lockdown and others have strict social-distancing restrictions still in place. In addition, the rollout of Covid-19 vaccines has been slow. This could add further pressure on the 19 eurozone economies. The ECB in March forecast that gross domestic product (GDP) in the eurozone would rise by 4% this year and 4.1% in 2022.

Rates remained anchored on the front end as intermediate and long-term rates rose and the curve steepened



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

China leaves benchmark lending rates unchanged

Recovery in the world's second largest economy has picked up speed, boosted by domestic consumption and foreign demand for Chinese-made goods. The official manufacturing purchasing managers index, a gauge of factory activity, hit a three-month high of 51.9 in March, according to data by the National Bureau of Statistics. The official nonmanufacturing PMI also surged in March. China's economy expanded by 2.3% in 2020 as the government rolled out a raft of stimulus measures, including tax relief and cuts in banks' reserve requirements. The government set its target for 2021 growth at "above 6%."

The People's Bank of China (PBoC) in March kept its benchmark lending rate unchanged. The one-year loan prime rate (LPR) was at 3.85%, while the five-year LPR remained at 4.65%. PBoC Governor Yi Gang reiterated a pledge that policymakers want to balance providing support for growth while reducing financial risks. The central bank still has room to pump liquidity into the economy. Chinese bonds continue to attract investors. The 10-year government bonds yielded around 3.2% compared with about 1.7% for the 10-year U.S. Treasury. The yuan has surged in strength in recent months against the dollar and other major currencies.

Sector views

Corporate debt: Investment grade and high yield

In investment-grade credit, it appears that a significant amount of good news has been priced in by the market. As of period-end, IG corporate spreads had tightened considerably, making valuations in this sector less attractive. Consequently, security selection and sector rotation will be of utmost importance as we navigate this market. [Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity U.S. Treasuries.]

Relative to other asset classes, high-yield bonds modestly lagged high-yield bank loans but outpaced the broad investment-grade fixed-income market. Looking first at high-yield bonds, we have a constructive intermediate-term view of corporate fundamentals and the market's supply-and-demand backdrop, although we expect the ongoing global health crisis to have an effect. Also, even though bond spreads retightened following their sizable widening in March 2020, and compressed further on favorable vaccine news, we think valuations remain relatively attractive.

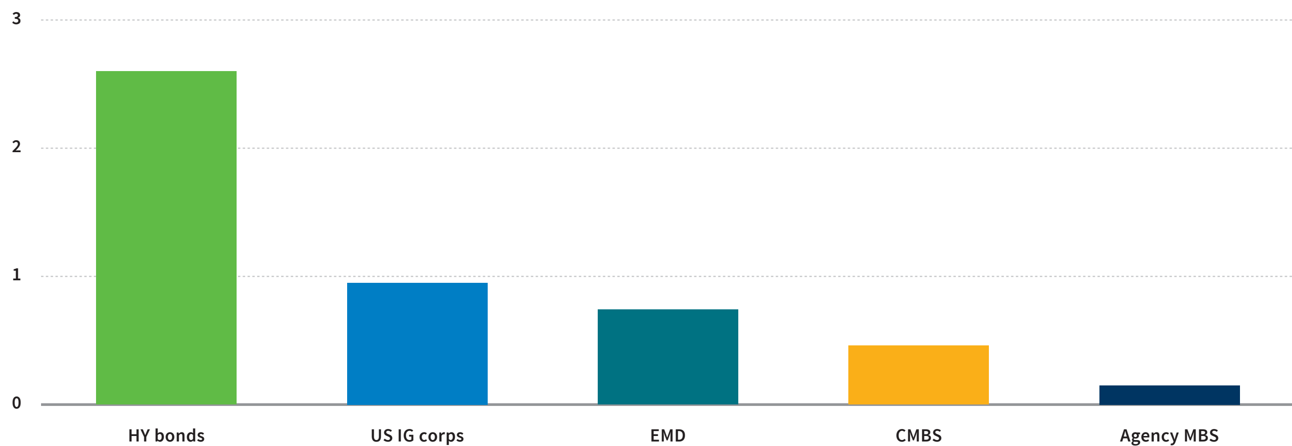
Trends in the mortgage market

Within the commercial mortgage-backed securities [CMBS] market, while there continues to be a degree of negative sentiment toward certain property types, the availability of Covid-19 vaccines has sparked optimism that social-distancing measures could be meaningfully eased by the middle of 2021. As a result, we continue to have conviction in our CMBX exposures. [CMBX is a group of tradeable indexes that each reference a basket of 25 CMBS issued in a particular year.] We believe current valuations fairly compensate investors for existing risk levels and provide an attractive risk premium.

Fundamental credit analysis and security selection are particularly important in the current CMBS market environment. While some parts of the CMBS market will likely continue to struggle, there are CMBS backed by what we consider to be strong underlying collateral that

During Q1 risk assets had solid excess returns despite rising rates and inflation concerns

Excess returns* relative to Treasuries, Q1 2021



Source: Bloomberg, as of 3/31/21. 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 suffered amid widespread fear of the sector. We think many of these bonds represent attractive investment opportunities.

Within residential mortgage credit, against the backdrop of robust home sales and a rebound in mortgage originations, we continue to find value across numerous market segments. In prepayment-sensitive areas of the market, we view agency IO collateralized mortgage obligations favorably, as well as inverse IOs backed by jumbo loans and more seasoned collateral. Overall, we consider prepayment-related opportunities as attractive sources of diversification.

In non-U.S. sovereign debt in both developed and emerging markets, we think the economic recovery will be strongest in countries with large service sectors and effective vaccine distribution. We also prefer countries that can contain government expenditures despite political pressures to raise them.

Currency views

U.S. dollar may come under downward pressure

The United States is set to see its twin deficits widen amid rising fiscal spending and a consumer boom. Deficits have been an indicator of dollar direction over past cycles because these deficits need to be funded or the dollar needs to fall. With front-end rates pinned close to zero, flows into U.S. fixed-income markets are likely to be hedged, leaving the dollar in need of unhedged flows into equities or via inbound mergers and acquisitions. The Fed remains sidelined for now, but the market has priced in earlier hikes and may continue to do so, which should be supportive of the dollar. The global recovery has lagged the United States but should accelerate in the latter half of the year, and investors may look for better opportunities outside the United States, eventually putting downward pressure on the dollar.

Euro to trend moderately higher

Europe is experiencing continued weakness in the near term as lockdowns and poorly managed vaccine rollouts delay its recovery. The ECB has voiced concern over the slowing economy and has increased asset purchases accordingly. This has resulted in euro area rates lagging the move up in global rates and in a weaker euro. It is likely the move to front load bond purchases was a trade-off at the expense of more buying later, suggesting peak dovishness from the ECB. The euro's valuation has improved as the U.S. dollar strengthened, and valuations could improve further over the short run. But we expect the euro to trend moderately higher against the dollar as European conditions improve (local lockdowns ease and vaccinations accelerate) amid a global economic recovery.

Upside for British pound over the medium term

Amid a virus resurgence, continued lockdowns, and potential trade frictions with the European Union, we have seen some short-term economic pain. However, the United Kingdom remains positioned well for a domestic and global recovery, fueled by one of the better-run vaccination campaigns. There will be near-term risks and medium-term upside for sterling.

Japan's yen is likely to appreciate

The Bank of Japan (BoJ) remains largely sidelined, with limits on further monetary policy easing. In March, the BoJ tweaked the guidance around ETF purchases and allowed more flexibility in bond yields. The yield on the 10-year Japanese government bond (JGB) will be allowed to fluctuate +/- 25 basis points in each direction around its 0% target. The new band will provide room for temporary deviations while ensuring bond yields remain low (in absolute terms and relative to other markets). The yen has already seen a large repricing on the back of the global recovery and could grind weaker as it progresses. Still, yen strength on risk shocks is likely to be more pronounced going forward.

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 March 31, 2021.

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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