

Q4 2020 | Equity Outlook

# What would the end of the pandemic mean for the bull market?

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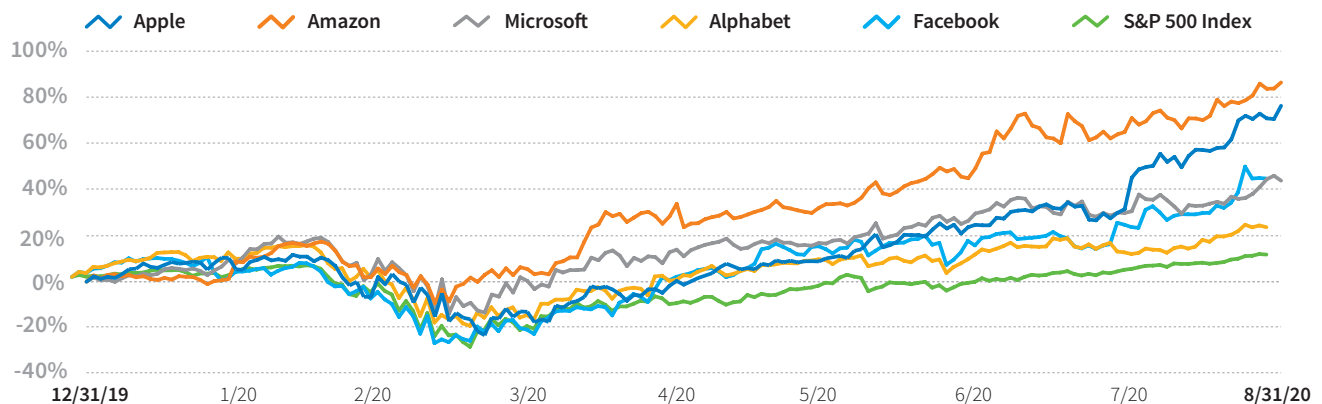
*The active edge in sustainable investing*

Advances in equities continued through another quarter, but experienced investors know that a measure of caution is warranted. Today’s market is considerably one-sided, skewed heavily toward a narrow band of high-growth stocks. We see some trends that are rare for a recessionary environment and that are worth considering as we position portfolios.

We explore what makes this recession unique and why COVID-19 vaccine progress could be disruptive to markets. Members of our equity research team discuss the potential impact of the U.S. presidential election on a range of industries. And our Sustainable Investing team outlines how they seek an “active edge” versus passive ESG peers.

## Large technology stocks lead in a market skewed toward growth

Performance for five largest S&P companies



Sources: S&P Dow Jones Indices, NASDAQ. The companies highlighted above were the five largest companies in the S&P 500 Index as of August 31, 2020. The inclusion of company information should not be interpreted as a recommendation to buy or sell or hold any security. It should not be assumed that investment in the securities mentioned was or will be profitable. Past performance is no guarantee of future results. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index.

## A recession like no other

### Shep Perkins, CFA

Chief Investment Officer, Equities

Portfolio Manager of Putnam Global Equity strategy

As we enter the final quarter of this unforgettable year, the COVID-19 pandemic remains at the forefront of investor concerns. Clearly, a solution to this problem would be extremely beneficial for public health, sentiment, and global economies. However, we believe for U.S. equity markets, such a development won't be as sanguine.

“ With so much equity ownership skewed toward growth, we could see a sharp sector rotation. ”

### If virus fears subside, markets could be volatile

Today's equity market is considerably one-sided. Based on estimates from FundStrat\*, approximately 70% of the S&P 500 Index, as measured by market capitalization, consists of companies that are reasonably well positioned for the current constrained conditions. This includes high-growth, mega-cap “virus beneficiaries” in the technology sector. It also includes bond proxy stocks that are thriving in the low-interest-rate environment and could benefit from a prolonged economic slowdown. Other beneficiaries include those that are ideally suited for a pandemic, such as cleaning/disinfectant products companies, or the housing sector, which is seeing a fundamental boost from the ultra-low interest rates.

Only about 30% of the market is oriented toward cyclically sensitive stocks in sectors such as industrials, financials, and consumer discretionary. So what happens if we see meaningful progress toward eliminating the virus, such as an approved vaccine or evidence of herd immunity? The consensus view is that equity markets would rally even

further, but we could see disruption in the overall index averages in the equity markets — possibly in the form of a sharp sector rotation as so much of equity ownership today is skewed toward growth.

“ Second-quarter earnings announcements brought a scenario of ‘haves’ and ‘have-nots.’ ”

Moreover, if pandemic worries subside, we believe investors will anticipate a sustained and robust economic recovery over the next few years. This, in turn, could lead to inflationary concerns and eventually higher interest rates, further pressuring the growth and quality sectors that are widely favored today, in our view.

### Earnings extremes

Although it's not unprecedented to see a strong stock market early in an economic downturn, we've seen other trends that are rare for a recessionary environment. Second-quarter earnings announcements brought a scenario of “haves” and “have-nots.” Some businesses experienced extremely strong year-over-year growth while others saw their revenues decline by staggering amounts. This contrast is unusual in the midst of a deep recession, when typically most businesses struggle to varying degrees. Obviously, leisure-related industries, such as hotels, casinos, airlines, cruise lines, and concert venues have been hit hard. But auto parts and home improvement retailers have experienced phenomenal results. Also, construction activity has rebounded meaningfully, and U.S. pending home sales have skyrocketed. Many of these trends are the result of pandemic-related shifts in business practices and consumer behavior, as well as ultra-low interest rates, making this a recession like no other in history, in our view.

\* FundStrat Insight is an independent research firm.

### Multiples and interest rates: A vulnerable equity market?

Also worth noting in today’s market are rapidly expanding price/earnings multiples. The adage that “stock prices follow earnings” seems true, in our view, only in terms of direction but not at all in magnitude. Apple’s stock price, for example, has soared fourfold in the past four years, yet earnings have increased just 50%. And over the past five years, the company’s compounded annual revenue growth has been less than 4% per year. Apple’s P/E multiple has expanded from 13 times 2016 forward earnings to a record 34x today.

“ The adage that ‘stock prices follow earnings’ seems true only in terms of direction but not at all in magnitude. ”

Many factors could be contributing to Apple’s multiple expansion, such as an appreciation for a company’s resilience and pent-up earnings potential given the challenging 2020 environment. However, we believe another key driver is the low-interest-rate environment

spurred by a hyper-accommodative Federal Reserve. This drives investors to equities from low-yielding bonds, and it increases the present value of future growth through a lower discount rate.

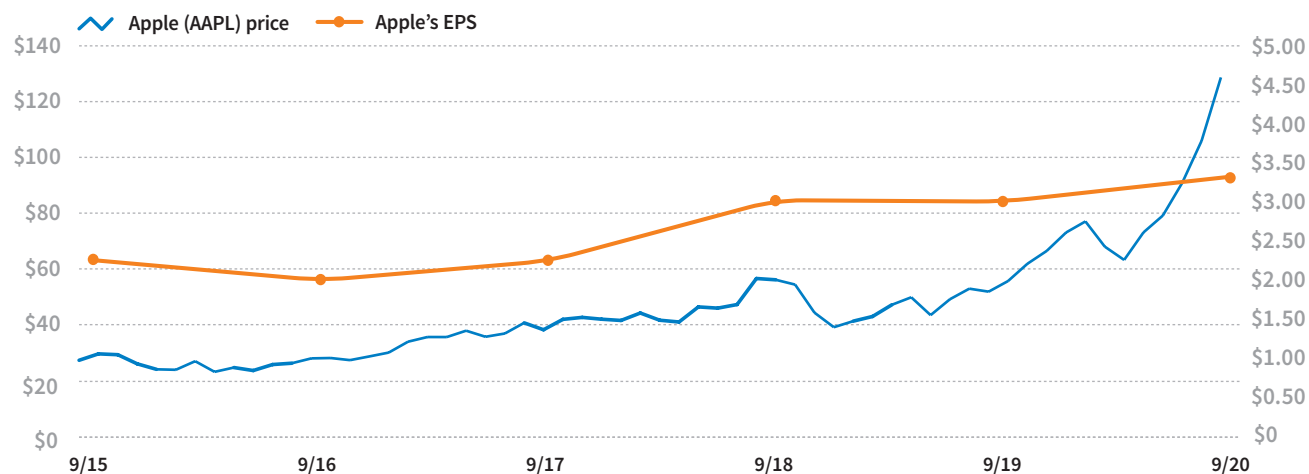
“ Pandemic-related shifts have made this a recession like no other in history, in our view. ”

In our opinion, this represents a key risk for the equity market. If interest rates rise, P/E multiples are more likely to contract. We believe high-growth stocks would be particularly vulnerable, as their elevated multiples have the farthest to compress. Since the global financial crisis, each time rates moved higher, equity market volatility intensified. Many investors remember the 2013 “Taper Tantrum,” when emerging-market stocks corrected.

The equity market has benefited from low inflation expectations and no deflation, which is a near-perfect Goldilocks scenario. If we were to move out of this range and inflationary pressures increase, especially if the economy gains strength, we could see rising interest rates — a risk we are monitoring in the closing months of 2020.

### Share prices are outpacing earnings

Apple’s share price has soared while Apple’s earnings growth has been less robust



Sources: NASDAQ and SEC filings. Stock price adjusted for 4:1 split on 8/28/20. 2020 EPS is a forecast. The company highlighted above represents the largest company in the in the S&P 500 Index as of August 31, 2020 (Apple Inc.). The inclusion of company information should not be interpreted as a recommendation to buy or sell or hold any security. It should not be assumed that investment in the securities mentioned was or will be profitable. Past performance is no guarantee of future results. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index.

## 2020 election analysis

As we approach the 2020 U.S. presidential election, Putnam's investment professionals consider the potential impact each candidate could have on an array of industries.

### INFRASTRUCTURE

#### Elizabeth C. McGuire

Analyst, materials and industrials

With either a Biden or a Trump administration, we believe that a large federal infrastructure bill is likely to be passed in 2021. This has been a focus for governing officials for a while for a number of reasons. They include high-profile bridge collapses as well as a D+ grade on the American Society of Civil Engineers' 2017 Infrastructure Report Card. Now, our crumbling infrastructure will be combined with the need for post-COVID economic stimulus, increasing the likelihood of an infrastructure bill, in our opinion.

Biden's current proposal is to spend \$2 trillion on infrastructure over four years. This includes more traditional spending on roads, bridges, and waterways, as well as "green" spending in areas such as electric vehicle charging stations and sustainable homes. Trump has floated a \$1 trillion amount, with a heavy focus on traditional road and bridge work.

#### Congress matters too

Congressional races are also important. We believe a Biden administration with a Democratic House and Senate would result in the quickest passage of an infrastructure bill, and one that would include a higher spending total and a greater focus on "green" projects. For stocks, we believe construction materials and equipment companies would benefit most directly, as might electric vehicle suppliers. Indirectly, to the extent that an infrastructure program creates more jobs, consumer stocks should also benefit.

### PIPELINES

#### William C. Rives, CFA

Analyst, Portfolio Manager of Putnam Research strategy

Oil and gas pipelines and midstream infrastructure face a challenging outlook regardless of who is elected, although a Biden victory could bring additional long-term difficulties.

Conditions are not good for the pipeline industry, in our view. Some of the largest U.S. pipeline projects, costing billions, have been canceled due to regulatory uncertainty. Existing pipelines are also being challenged and could face temporary or permanent shutdowns.

The biggest headwind has been the ability of environmentalists to use courts to delay projects until it doesn't make economic sense to continue them. In our view, conditions will not change if Trump wins in November, since many of the issues are not driven by federal policy.

#### Biden win could bring longer-term challenges

We believe the near-term impacts of a Biden administration would be manageable. There is the potential for Biden to eliminate fracking permits on federal land, but this is not a major source of production. Other issues are more significant. Biden wants to eliminate carbon from the power sector by 2035. The power sector represents roughly one third of U.S. natural gas demand, and this could be a headwind for natural gas pipeline volumes. Biden also supports expanded electric vehicle adoption, which could pressure oil pipeline volumes.

### OIL AND GAS

#### Ryan W. Kauppila

Analyst, global natural resources

The politicization of energy and climate issues that accelerated under President Obama has continued under the Trump administration. Campaign rhetoric suggests more of the same under Biden, who declared in a March debate: "No ability for the oil industry to continue to drill, period." There is little evidence that either party wants to use free-market tools to address de-carbonization (e.g., a carbon tax). Rather, the preferred policy choices are myriad supply- and demand-side decrees such as rules around federal drilling permits, biofuels regulations, and highly complex fuel efficiency mandates.

#### Potential for international oil price inflation

In aggregate, Trump's deregulation efforts and tax policies have lowered the costs of U.S. production and the slope of global oil and gas supply curves, negatively impacting both prices and the returns achieved for producers. The consensus view today is that Biden's anti-hydrocarbon

mantra would translate into a similarly challenging period for energy equities. However, I suspect the supply impact will overwhelm any demand attrition over the near and medium term. We could see a surprising inflationary period for international oil prices under a Biden administration. From an equity investing perspective, that would likely be negative for the returns of U.S. producers, but beneficial for producers outside the United States, in our opinion.

## HEALTH CARE

### Michael J. Maguire, CFA

Analyst, Portfolio Manager of Putnam Global Health Care strategy

It's not easy to find areas where politicians from both sides of the aisle are in agreement. Medicare Advantage, the privatized version of Medicare coverage, has been a resounding success in the view of Republicans and Democrats. Because of this and our aging population, we believe many managed care insurance companies are well positioned for growth, regardless of the election outcome. Medicare Advantage is likely to stay intact, but a Biden administration may seek to expand the benefits, such as lowering the eligibility age. Democrats are also more likely to seek increases in government funding for Medicaid. This could weigh on managed-care stocks because margins are typically lower with government coverage.

### The most complex challenge: Drug pricing

Both parties agree that drug pricing is a significant problem. Drugs are getting more expensive, and the co-pay structure is poorly designed. Both Biden and Trump are likely to focus on this issue, putting pressure on retail pharmacies, drug manufacturers, wholesalers, and pharmacy benefit managers. We believe this incredibly complex challenge will continue long after the election. We also find bipartisan support when it comes to medical innovation. From gene therapies to targeted oncology, highly innovative assets tend to be viewed favorably from a legislative and regulatory perspective, in our view.

## TECHNOLOGY

### Robert B. Gray

Analyst, technology

A common belief is that only Biden would be negative for "big tech." However, there is bipartisan support for regulation of businesses such as Amazon, Apple, Facebook, and Google. With internet regulation, many issues are at

play, such as consumer data/privacy, the role of social media in elections, and free speech. In our view, the most significant regulatory risk is around competition, and anti-trust-related regulation could have negative consequences for large internet companies. However, we believe the path to comprehensive regulation will be long and complicated.

### Cable: Rate regulation and net neutrality

For cable companies, a key area of focus is net neutrality. This is the principle that internet service providers must treat all communications equally, and they may not intentionally slow down, block, or charge for prioritization of specific types of online content. We fully expect Biden to push for reinstatement of the net neutrality rules overturned by Trump. The impact on cable companies would be immaterial, we believe, as they already largely abide by net neutrality principles.

A Biden administration could be more stringent, perhaps seeking to regulate pricing for internet service. In our view, however, this is a low probability event. We believe that for both the cable and internet industries under either administration, calls for regulation are not likely to result in significant near-term disruptions.

## The active edge in sustainable investing

### Katherine Collins, CFA, MTS

Head of Sustainable Investing  
Portfolio Manager, Putnam Sustainable Leaders  
and Sustainable Future strategies

### Stephanie Dobson

Portfolio Manager, Putnam Sustainable Leaders  
and Sustainable Future strategies

The challenges of 2020 have given us an opportunity to test our processes and performance in an extreme set of conditions. During this time, sustainable investing strategies have fared well, as has our active investment approach. We believe that active, fundamental research is key to unlocking differentiated insights and creating alpha for all strategies. The potential benefits are even more clear for sustainable investing, where underlying environmental, social, and governance (ESG) data is still evolving, and context matters greatly.

### Focus on inclusion is key to alpha and impact

As active managers, we take an inclusionary approach and seek out companies where a leading sustainability strategy is fueling financial outperformance. One example is First Republic Bank, where a strong culture leads to lower employee turnover, higher referral rates, and more sustainable loan growth.

Within the sustainable investment landscape, many passive strategies take an exclusionary approach that eliminates exposure to certain types of businesses, while other

As of 6/30/20, First Republic represented 2.02% of the Sustainable Futures strategy and 1.00% of the Sustainable Leaders strategy, respectively. First Republic is highlighted as a firm that has a strong company culture and is relevant to the ESG investment opportunity being discussed. The current investment opportunity and firm presented was selected without regard to whether such opportunity or relevant security was or will be profitable and is intended to help illustrate the investment process. A security may be selected for a strategy based on factors other than the ESG themes highlighted herein, and the analysis should not be interpreted as a recommendation to buy or sell or hold any security. It should not be assumed that investment in the security or investment opportunity mentioned was or will be profitable. Holdings are for a representative account and are shown for illustrative purposes only. Each account is managed individually. Accordingly, account characteristics may vary. No assurance can be given that the investment objective will be achieved or that an investor will receive a return of all or part of his or her initial investment. Actual results could be materially different from the stated goals.

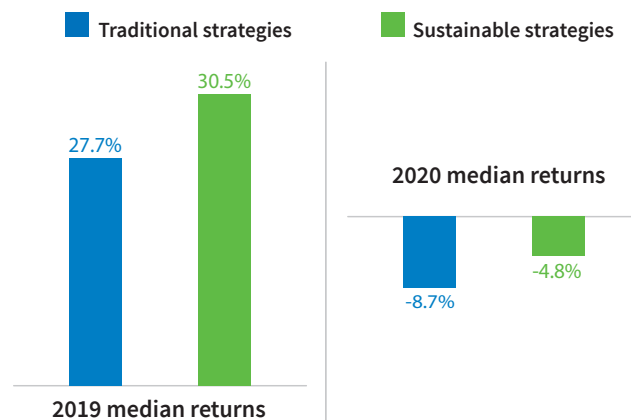
For use with institutional investors and investment professionals.

passive strategies take a “best-in-class” approach that aims for sector-neutral portfolio construction by owning stocks with the highest sustainability ratings within each sector or industry. For example, one of the largest passive ESG exchange-traded funds (ETFs) available today holds shares in, two of the world’s largest publicly traded hydrocarbon producers. Several of the other top passive ESG ETFs hold shares in other large global hydrocarbon producers. This is because the investment process for passive ETF portfolios is typically based on excluding certain business involvements and incorporating assessments of ESG practices.

In contrast, our forward-looking fundamental approach, focused on long-term trends and company-specific business analysis, helped us to identify companies like, a global power company proactively transitioning power generation from hydrocarbons to renewable energy. The stocks of many large hydrocarbon producers have underperformed in recent years in part due to the industry’s transition to lower cost renewable energy sources. Of course, an active approach does not always lead to such divergence in performance, but this example illustrates the potential benefit of investing in companies that are leading sustainability trends like the shift to renewable energy.

## Sustainable strategies have outperformed during the measurement period

U.S. sustainable strategies outperformed their traditional peers in 2019 and in the first half of 2020.



Source: Morgan Stanley. Data as of 6/30/20. Definition of traditional strategies derived from analysis of more than 11,000 mutual funds and exchanged-traded U.S.-domiciled funds that do not prioritize ESG criteria. See [Morgan Stanley’s report: Sustainable Reality—Analyzing Risk and Returns of Sustainable Funds](#).

Past performance is not a guarantee of future results.

### Considering companies of all sizes

As active managers, we sometimes seek opportunities in smaller, faster-growth companies that are creating innovative and impactful solutions. Many passive strategies rely at least in part on third-party ESG ratings, which tend to favor larger-cap companies. Larger companies have more resources to devote to ESG disclosure, which tends to lead to higher scores. Smaller companies with fewer resources, yet with products or services that might be tied to powerful sustainability themes, often have lower, or incomplete, scores from third-party data providers.

This dynamic can also be seen with newer companies, and especially with recent IPOs. We believe our ability as active managers to incorporate timely and unstructured ESG information before it is reflected in third-party scores is essential. Without this approach, our shareholders might miss out on the potentially strong performance of smaller or newly public companies that focus on sustainability solutions.

### We learn from the past, but are focused on the future

A company’s disclosure on greenhouse gas emissions over the past five years is likely not the determining factor for financial performance (or environmental progress) over the next five years. Our approach allows us to use valuable historical and external ESG data as context for considering future prospects.

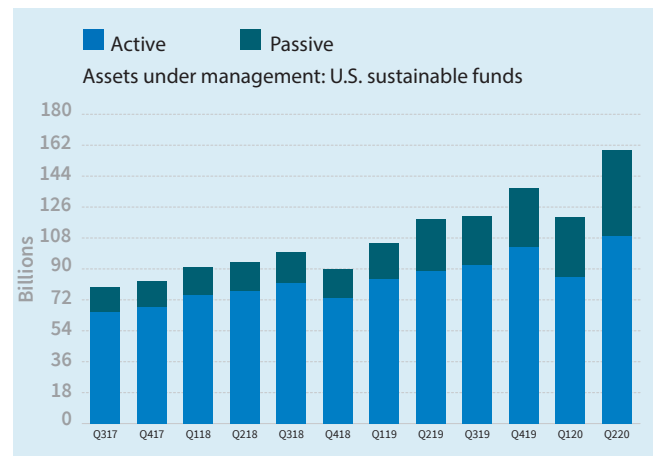
With an understanding of history, we can analyze future potential in areas like commitment to improvements in resource intensity, strength of corporate culture, and ability to invest future cash flows wisely. All of these elements are harder-to-quantify, forward-looking ESG characteristics that are not easily captured by third-party data, but we believe can meaningfully impact future fundamental performance.

“ We analyze harder-to-quantify, forward-looking ESG characteristics that are not easily captured by third-party data, but can impact future performance. ”

We believe that thoughtful fundamental analysis is required to identify the relevant and financially material sustainability issues that may impact the future performance of a given company. By taking an integrated fundamental approach to research, we identify companies where sustainability leadership and innovative solutions may contribute to long-term financial success. Our active portfolios therefore pursue excellence in financial performance that we believe is intrinsically linked to excellence in sustainability performance.

### Active sustainable flows are growing

Inflows into active U.S. sustainable portfolios have accelerated in 2020, driving active AUM to more than \$100 billion.



Sources: Morningstar Direct, Morningstar Research. Data as of June 2020. Past performance is not a guarantee of future results.

**Active management, fundamental research, and new insights to capture the growth potential of equities**

Equity investing at Putnam features a tenured and talented team of portfolio managers backed by an integrated group of research analysts with worldwide reach. Our research organization is structured to focus fundamental analysis on the factors that matter most in global equity markets.

**Shep Perkins, CFA**

Chief Investment Officer, Equities  
Portfolio Manager, Global Equities

**Kate Lakin**

Director of Equity Research

**S&P 500 Index** is an unmanaged index of common stock performance.

You cannot directly invest in an index.

The views and opinions expressed are those of the authors: Shep Perkins, CFA; Elizabeth C. McGuire; William C. Rives, CFA; Ryan W. Kauppila; Michael J. Maguire, CFA; Robert B. Gray; Katherine Collins, CFA, MTS; and Stephanie Dobson, as of August 31, 2020, are subject to change with market conditions, and are not meant as investment advice.



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