Q1 2022 | Putnam Municipal Bond Funds Q&A

Inflation and hawkish Fed weigh on municipals

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Persistently high inflation and rising interest rates created headwinds and negative results for the asset class during the quarter.

Our strategies have positioned the funds with a slightly defensive bias, but not completely risk-off.

We believe the credit outlook is currently the most favorable factor supporting the asset class.

How did municipal bonds perform during the first quarter of 2022?

Municipal bonds encountered headwinds due to fears that persistently high inflation might prompt the Federal Reserve to pare back pro-growth monetary policies faster than expected. Inflation concerns were stoked by supply chain disruptions, rising labor costs, and higher commodity prices. Geopolitical and economic uncertainties surrounding Russia's invasion of Ukraine in late February also unnerved investors.

The Fed faces the difficult task of tempering inflation without slowing economic growth or causing unemployment to rise. In January 2022, the Fed indicated it was on track to start a series of rate hikes in March 2022 and end its bond-buying stimulus program. The war in Ukraine and ensuing sanctions on Russia elevated commodity prices. This further complicated the Fed's balancing act and shifted expectations for the number and degree of interest-rate hikes higher. At its final meeting for the quarter in March, Fed policymakers raised their benchmark rate by a quarter percentage point and signaled their intent to take further measures to curb the highest inflation in 40 years. The markets subsequently began pricing in a higher probability that the Fed would raise interest rates by a half percentage point at one or more of its 2022 meetings.

These factors led to significant outflows from municipal bond funds, resulting in increasingly difficult market technicals. For the three months ended March 31, 2022, the Bloomberg Municipal Bond Index return was –6.23%.

How were the funds positioned at the end of the first quarter?

Our strategies have positioned the funds with a slightly defensive bias, but not completely risk-off. At quarter-end, the funds held an overweight exposure to bonds rated A and BBB relative to the benchmark. From a sector- or industry-positioning perspective, we favored continuing-care retirement community, higher education, and charter school bonds relative to the funds' Lipper peer groups. Duration positioning, a measure of the funds' interest-rate sensitivity, was generally neutral relative to the level of their Lipper peer groups at period-end.

Regarding our strategy for state debt, the funds held an overweight exposure to Illinois relative to their Lipper peer groups. We believe Illinois's financial profile continues to stabilize, and its flexibility and credit fundamentals have improved since the onset of the Covid-19 pandemic in the United States.

We remain cautious about investing in bonds issued by Puerto Rico due to what we believe are its seemingly fragile economy, weak demographic trends, poor-quality infrastructure, volatile political environment, and history of fiscal mismanagement. As such, the funds remained underweight in their exposure to uninsured Puerto Rico municipal debt relative to their Lipper peer groups. We continue to monitor Puerto Rico's ongoing restructuring efforts for potential opportunities.

What is your current assessment of the health of the municipal bond market?

Municipal bonds had a difficult start to 2022 as positive seasonal factors waned, fund flows turned negative, and the market adjusted to a quicker pace of policy normalization. However, municipal credit fundamentals remain strong, in our view. Unprecedented fiscal support, tax revenue outperformance, and strong economic growth expectations have put most state and local governments in the best fiscal shape for more than a decade. State and local tax collections also were up 13.6% in 2021 compared with 2020. Finally, municipal defaults are in line with long-term averages and remain isolated to the lowest-rated cohorts. As such, we believe the credit outlook is currently the most favorable factor supporting the asset class.

What is your outlook as we enter the second quarter of 2022?

Higher-than-expected inflation and strong labor reports during the first quarter have seemingly cemented the Fed's pivot to a more hawkish stance. The market has quickly repriced to reflect a faster path of policy normalization. In our view, the Fed is likely to continue the path of policy normalization. This process could contribute to heightened market volatility but also present investors with attractive opportunities.

We expect pandemic-related supply chain pressures will begin to ease and U.S. economic activity will slow in the second half of 2022. We think the combination could contribute to slower growth and lower inflation, which could lead to a slower pace of policy normalization than is currently priced in.

In our view, the technical environment is likely to remain challenged, as investors respond to tightening monetary policy. The volatility-induced outflow cycle is no longer a potential risk but a current reality. Municipal bond funds saw $23 billion in outflows during the first quarter. However, valuations at this level are more attractive, and future returns look more promising for longer-term investors, in our opinion.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 3/31/22

	Class Y shares Inception 1/2/08	Bloomberg Municipal Bond Index
Last quarter	–6.58%	–6.23%
1 year	–4.37	–4.47
3 years	1.79	1.53
5 years	2.81	2.52
10 years	3.07	2.88
Life of fund	6.05	—

Total expense ratio: 0.55%

Source: Bloomberg Index Services Limited.

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 3/31/22

	Class Y shares Inception 1/2/08	Bloomberg Municipal Bond Index
Last quarter	–6.58%	–6.23%
1 year	–3.04	–4.47
3 years	2.94	1.53
5 years	3.95	2.52
10 years	4.38	2.88
Life of fund	5.57	5.98

Total expense ratio: 0.60%

Source: Bloomberg Index Services Limited.

Returns for periods of less than one year are not annualized.

Current performance may be lower or higher than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or a loss when you sell your shares. Performance assumes reinvestment of distributions and does not account for taxes. For the most recent month-end performance, please visit putnam.com. Class Y shares before their inception are derived from historical performance (Tax Exempt Income Fund, class A inception 12/31/76; and Tax-Free High Yield Fund, class B inception 9/9/85), which have not been adjusted for the lower expenses; had they, returns would have been higher. For a portion of the periods, these funds may have had expense limitations, without which returns would have been lower. Class Y shares are generally only available for corporate and institutional clients and have no initial sales charge.

The Bloomberg Municipal Bond Index is an unmanaged index of long-term fixed-rate investment-grade tax-exempt bonds. It is not possible to invest directly in an index.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed here are those of the portfolio managers as of March 31, 2022, are subject to change with market conditions, and are not meant as investment advice.

Consider these risks before investing: Capital gains, if any, are taxed at the federal and, in most cases, state levels. For some investors, investment income may be subject to the federal alternative minimum tax. Income from federally tax-exempt funds may be subject to state and local taxes. Bond investments are subject to interest-rate risk (the risk of bond prices falling if interest rates rise) and credit risk (the risk of an issuer defaulting on interest or principal payments). Interest-rate risk is generally greater for longer-term bonds, and credit risk is generally greater for below-investment-grade bonds. Unlike bonds, funds that invest in bonds have fees and expenses.

The fund may invest significantly in particular segments of the tax-exempt debt market, making it more vulnerable to fluctuations in the values of the securities it holds than a more broadly invested fund. Interest the fund receives might be taxable. The value of investments in the fund's portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political, or financial market conditions; investor sentiment and market perceptions; government actions; geopolitical events or changes; and factors related to a specific issuer, geography, industry, or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings.

Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could have a negative effect on the fund. You can lose money by investing in the fund.

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