Q4 2020 | Putnam Municipal Bond Funds Q&A

Municipals rally on stimulus and vaccine hopes

Paul M. Drury, CFA
Portfolio Manager
Industry since 1989

Garrett L. Hamilton, CFA
Portfolio Manager
Industry since 2006

Municipal bonds outperformed U.S. Treasuries and the broader taxable market for the quarter.

The municipal bond market has experienced an increase in downgrades but remains sound overall, in our view.

We believe technicals are favorable for the asset class and should prove to be a tailwind into 2021.

How did municipal bonds perform during the fourth quarter of 2020?

Against a backdrop of stabilizing U.S. fundamentals and positive supply/demand technicals, the municipal bond market achieved its third successive quarterly gain. The Bloomberg Barclays Municipal Bond Index [the municipal benchmark] rose 1.82%, outperforming U.S. Treasuries and the broader U.S. fixed-income markets. November was an especially solid month, with the municipal benchmark climbing 1.51%. Announcements by Pfizer/BioNTech and Moderna regarding the efficacy of their vaccines and the formal start of a Biden transition boosted investor sentiment. Furthermore, with Congress working on another stimulus package, one that investors believed would include more aid to state and local governments, confidence in municipal bonds increased. The asset class closed 2020 with a gain of 5.21%.

As the fourth quarter progressed, however, a resurgence in cases of COVID-19 and renewed measures to contain the spread threatened the pace of economic improvement. Just days before quarter-end, Congress passed and President Trump signed a $2.3 trillion coronavirus stimulus and short-term spending package into law. However, aid to state and local governments did not make it into the coronavirus relief bill. President-elect Biden stated that he would pursue the funding in 2021.

In its final policy meeting of 2020, the Federal Reserve kept its key overnight interest rate near zero. The Fed also remained committed to its massive bond-buying program and to channeling cash into the financial markets. It indicated the measures would stay in place until its maximum employment and price stability goals were met. The central bank also revised its outlook for economic growth up to 4.2% and its outlook for the unemployment rate down to 5% for 2021. This helped to rally sentiment. However, some uncertainty returned as the year came to a close. The January 2021 U.S. Senate runoff election in Georgia and its implications for the balance of power in the U.S. Senate was one source. The emergence of a new variant of the coronavirus was another.

What factors contributed to munis' strong technicals?

With the outlook and confidence generally improving, fund flows, a measure of investor demand for mutual funds, were positive during the quarter. The prospect for higher taxes to meet budget shortfalls helped to sustain interest in the asset class, in our view. The relative value that municipal bonds offer was another factor. Additionally, we believe investors were drawn to municipal bonds for their historically low-default frequency and the diversification benefits they offer relative to other more volatile asset classes. Supply was very strong in October as municipal borrowers refinanced existing, higher-coupon debt, but supply then tapered off in November and December.

Despite the extreme volatility created by the pandemic-induced sell-off and subsequent recovery, the municipal bond market finished 2020 much as it began from a technical perspective. Tax-exempt supply was relatively steady on a year-over-year basis and was met by solid demand. As such, we believe the technical backdrop is favorable for the asset class and should prove to be a tailwind into 2021.

How were the funds positioned in this environment?

With regard to credit positioning, we focused on lower-rated investment-grade bonds and select high-yield bonds. We believe the lower tiers of the investment-grade market, particularly those rated BBB, and parts of the high-yield universe represent some of the best income and return opportunities. However, we're extremely discriminating given the ongoing economic uncertainty. From a sector or industry positioning perspective, we favored long-term care, private higher education, land secured, charter schools, and transportation, as well as other revenue sectors relative to the funds' Lipper peer groups.

Duration positioning, a measure of the portfolios'/funds' interest-rate sensitivity, was generally neutral relative to the level of the Lipper peer groups at quarter-end. The funds' yield curve positioning was defined by an overweight in bonds with maturities of 10 to 20 years. As part of this strategy, the funds generally held an underweight exposure to long maturity holdings compared with the Lipper peer groups.

The funds held an overweight exposure to revenue bonds versus general obligation bonds. The funds' exposure to state and local governments was limited to those with, in our view, diverse tax bases and the ability to enact broad revenue enhancements or expense cuts. As part of our strategy for state debt, we held an overweight exposure to Illinois. We believe Illinois' financial flexibility and credit fundamentals were not completely reflected by market spreads.

The funds remained underweight in their exposure to uninsured Puerto Rico municipal debt compared with their Lipper peer groups. In the funds that held Puerto Rican debt, the exposure represented less than 0.5% of total net assets and was predominantly composed of pre-refunded bonds. We remain cautious on Puerto Rico due to its seemingly fragile economy, weak demographic trends, poor-quality infrastructure, volatile political environment, and history of fiscal mismanagement. We continue to monitor the Commonwealth's ongoing restructuring efforts for potential opportunities.

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

The sudden onset of the recession in March 2020 due to pandemic-related shutdowns and business closures was unparalleled. That said, many states entered this recession in their best fiscal shape in over a decade. Additionally, a major source of funding for local municipalities is property taxes, which are based on home values. Nationwide, home values climbed more than 6.6% year over year through December 2020, according to Zillow, a real-estate marketing company. This is a very different scenario from the 2008–2009 Great Recession, which had a negative impact on property values and, by extension, property taxes. Consequently, we believe most states have ample reserves to address a decline in revenues. In our opinion, even states that were less well prepared still have quite a bit of financial flexibility and avenues to raise capital through the credit markets. So, while the municipal bond market has experienced an increase in downgrades, the asset class remains sound overall, in our view.

What is your outlook as 2021 begins?

Municipal bonds demonstrated resilience in 2020, faring better than many analysts anticipated. Credit spreads, while still wider than the pre-pandemic levels, significantly retraced from the extreme levels that occurred during the historic sell-off. And while we are seeing credit fundamentals broadly weakening, we still believe that defaults will remain low.

In our view, the municipal bond market is poised for continued recovery in 2021, with the greatest opportunities in the lower parts of the investment-grade universe as well as the high-yield sectors. As always, we will continue to balance the pursuit of tax-free income with prudent risk management as we search for the most attractive opportunities in the tax-exempt bond market.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 12/31/20

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	2.73%	1.82%
1 year	4.83	5.21
3 years	4.66	4.64
5 years	4.12	3.91
10 years	4.91	4.63
Life of fund	6.33	—

Total expense ratio: 0.56%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 12/31/20

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	4.05%	1.82%
1 year	4.52	5.21
3 years	5.13	4.64
5 years	5.01	3.91
10 years	6.14	4.63
Life of fund	5.82	6.35

Total expense ratio: 0.63%

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 Barclays 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.

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

The ICE BofA U.S. Treasury Bill Index is an unmanaged index that tracks the performance of U.S.-dollar-denominated U.S. Treasury bills publicly issued in the U.S. domestic market. Qualifying securities must have a remaining term of at least one month to final maturity and a minimum amount outstanding of $1 billion. You cannot invest directly in an index.

ICE Data Indices, LLC (ICE BofA), used with permission. ICE BofA permits use of the ICE BofA indices and related data on an "as is" basis; makes no warranties regarding same; does not guarantee the suitability, quality, accuracy, timeliness, and/or completeness of the ICE BofA indices or any data included in, related to, or derived therefrom; assumes no liability in connection with the use of the foregoing; and does not sponsor, endorse, or recommend Putnam Investments, or any of its products or services.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed here are those of the portfolio managers as of December 31, 2020, are subject to change with market conditions, and are not meant as investment advice.

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.

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 or 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.

Request a prospectus or summary prospectus from your financial representative or by calling 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

Putnam Retail Management

Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

TL041 324049 1/21