

Q1 2015 » Putnam Perspectives

Fixed-Income Outlook

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Key takeaways

- U.S. economic data continue to be robust and should lend further support to domestic asset market fundamentals.
- The biggest threats to continued U.S. strength are the dollar's rise and a worsening of economic conditions overseas.
- We favor prepayment risk and liquidity risk, and we expect to downplay energy-related credit and interest-rate risk.

It may be a new year, but some old themes are still dominant. Oil prices are weak and the dollar is rising against literally all other currencies, and U.S. Treasuries continue to have a bid on the long end of the curve. If these trends continue, they have the potential to produce shockwaves around the world. The U.S. economy is a comparative beacon of good health, while the eurozone, Japan, and a large swath of emerging markets that rely disproportionately on energy exports are experiencing genuine pain and facing the possibility of new crises.

Putnam fixed-income views

Arrows in the table indicate the change from the previous quarter.

Fixed-income asset class	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		●			

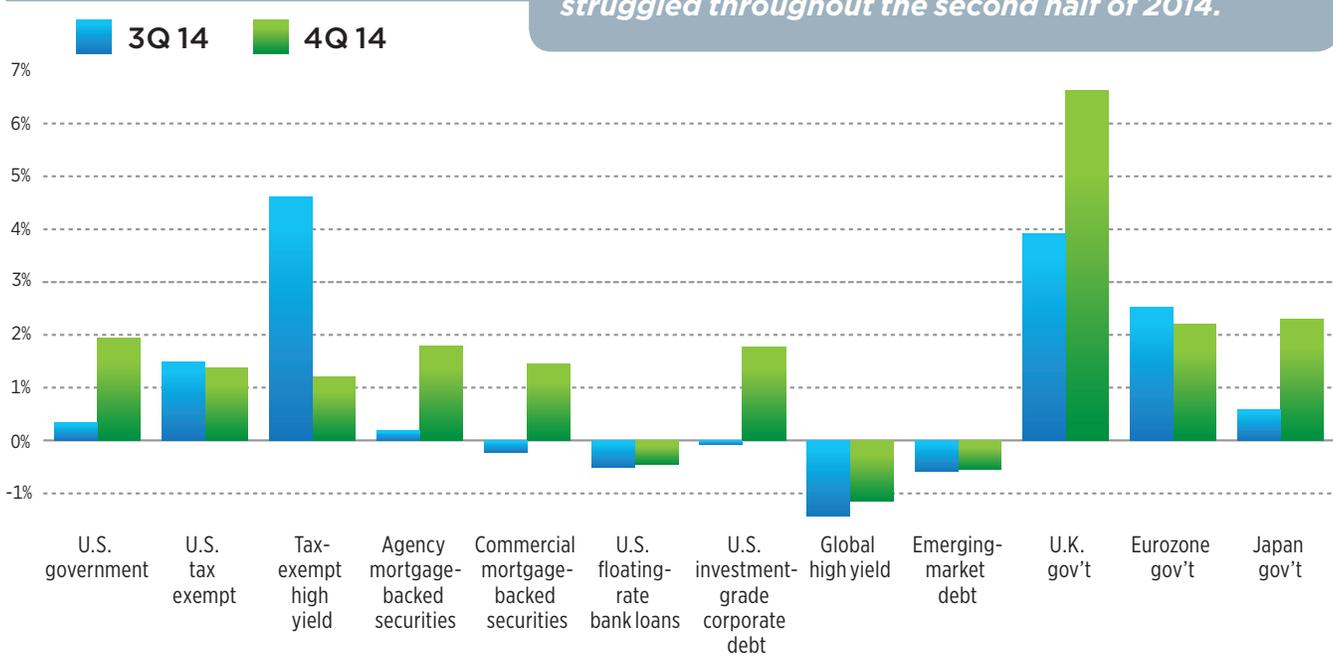
Familiar challenges remain

Greece's exit from the eurozone, for example, may now be back on the table, though concerns over a contagion effect in Europe appear to be muted this time around. In Japan, recent elections may signal another win for Abenomics — not to mention for the nuclear power and defense industries, which Prime Minister Shinzo Abe plans to reinvigorate — but deflation and the potential for slack demand from emerging markets may continue to pose severe problems. In Russia, the state's latest experiment in military aggression is contributing, through the European sanctions it precipitated, to dismal economic results. A face-saving exit by Russia from Ukraine could be in the cards in 2015. At the same time, China is decelerating, and while

CURRENCY: U.S. DOLLAR VERSUS	EURO €	POUND £	YEN ¥
OUR VIEW:	Favor dollar <i>(unchanged from last quarter)</i>	Favor dollar <i>(unchanged from last quarter)</i>	Favor dollar <i>(unchanged from last quarter)</i>

Not FDIC insured | May lose value | No bank guarantee

Figure 1. Fixed-income asset class performance



Sources: Barclays, JPMorgan, Bank of America Merrill Lynch research, as of 12/31/14. Past performance is not indicative of future results.

we do not expect a crisis, it seems clear that Chinese policymakers no longer have the ability to fine-tune economic growth.

Meanwhile, quantitative easing (QE) is over in the United States, and markets are handicapping the timing of the first short-term rate hike. Europe, by contrast, is on the verge of announcing a sovereign bond-buying program; considered optimistically, this may help stave off deflation by expanding the money supply and depreciating the euro. The trouble for Europe, though, may be whether a QE program now — years after the crisis began and once all the design problems of European-style QE can be worked out — can definitively improve the health of the region’s real economy.

Robust components of U.S. growth

More risk-averse investors may wonder if U.S. growth is truly all that strong and whether the case for investing in risk assets is really warranted. For our part, we see the data pointing to a balanced and healthy economy. In a revised GDP report for the third quarter of 2014, the government announced the U.S. economy was growing at an annualized rate of 5% — its most impressive stride since before 2008. In other words, the last time the rate of economic growth was like it is today, residential construction, home prices, and consumer debt were all growing by leaps and bounds. Thankfully, the growth is different this time. Rather than being built primarily on the housing market, U.S. growth components today reflect a diverse and healthy pattern of sustainable underlying trends.

One of the bright spots in current economic growth is that consumption growth is in line with growth in incomes, suggesting that consumers are not over-spending or relying on the virtual wealth of home equity appreciation to fuel their purchases. Corporate investment is also quite strong, and over recent quarters has consistently proven to be better than our models have forecasted. Equally as important, the United States is growing without importing an excess of goods. With the trade deficit not widening and an employment picture looking strong in a variety of respects, today's impressive headline growth appears to be built on a solid foundation.

A season for rate hikes? Factors that could give the Fed pause

If everything is going so well in the post-QE era and, domestically at least, macro conditions continue to normalize, one would think the start of the long-awaited tightening cycle could be near. At their closely watched meeting this past December, Fed officials modified their policy statement by adding that they “can be patient” on the timing of rate increases. Questions about the timing of an increase are likely to dominate the public discourse until the central bank implements its first rate hike. We think the Fed’s patience will likely be in abundance given perceived threats to growth posed by a collapsing oil price, meteoric dollar strength, and deteriorating growth of both non-U.S. developed and emerging markets.

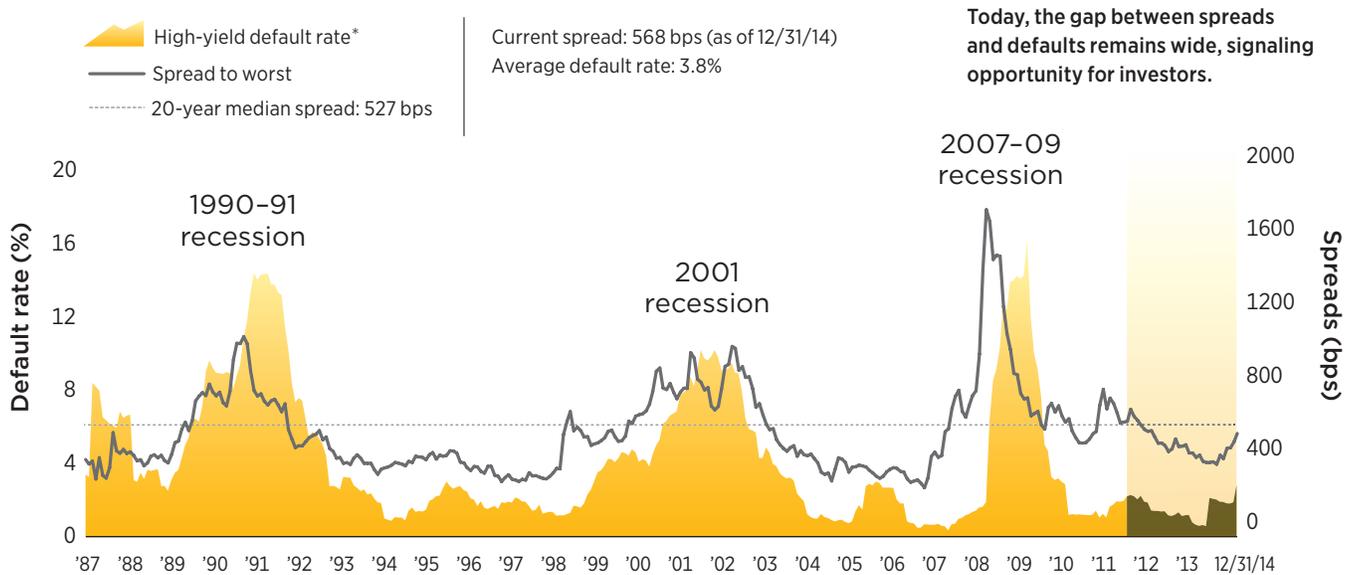
Figure 2. Short-term rates rose in anticipation of the Fed’s expected policy



Source: U.S. Department of the Treasury, as of 12/31/14.

Figure 3. High-yield spreads and defaults generally move in tandem over credit cycles

Spreads and defaults moved modestly higher in 2014.



* Current default rate includes distressed exchanges.

Sources: JPMorgan, High Yield Market Monitor, as of 12/31/14; Putnam Investments.

The risk of dollar strength

A rising dollar produces a set of important economic and financial market effects. It will put pressure on the earnings of U.S. corporations, which is partly a matter of accounting but partly a result of increased competition from cheaper imports. A strong economy is by no means inconsistent with a weak equity market. For foreign investors, a rising dollar adds to the return from U.S.-denominated assets and can make prospective returns attractive.

We also know that a rising-dollar environment has in the past caused stresses in emerging markets. While it is true that emerging markets, in many cases, are not as vulnerable in terms of fiscal health or governing policy as they may have been in the past, China is a highly leveraged economy with a more or less fixed exchange rate. We would argue that a massive amount of capital has been invested in China on the assumption that the exchange rate would be steady or even appreciate versus the dollar. Now that assumption appears to have been a misguided.

The risk of sustained oil weakness

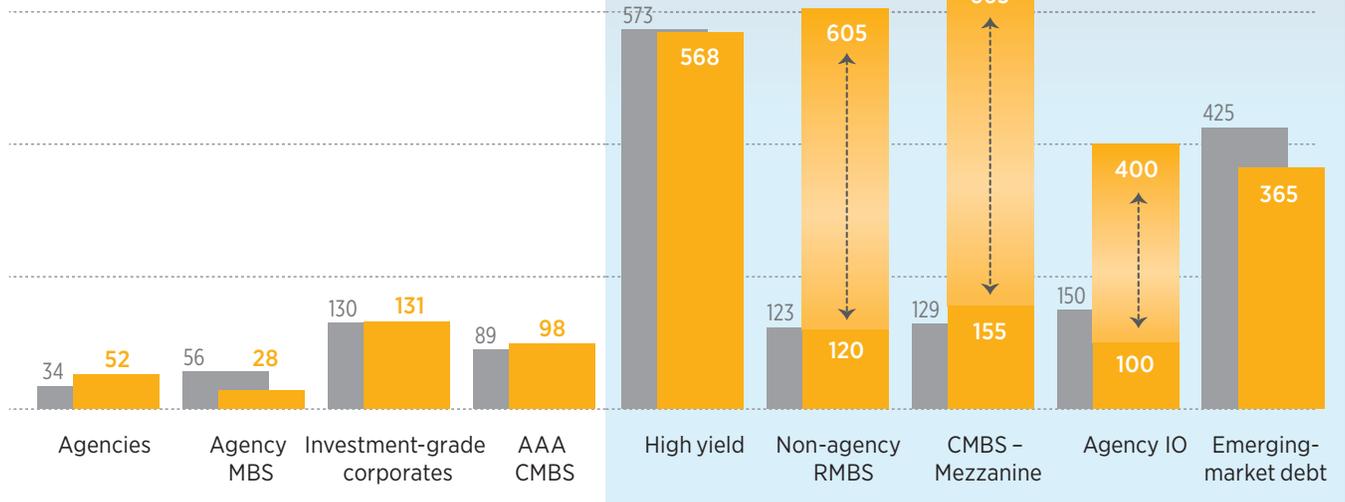
The clearest and most immediate impact of oil price changes is on inflation and inflation expectations. Even though the Fed looks through headline inflation, it, along with many other central banks, must be feeling some discomfort. Lower oil prices stimulate consumption in the United States and other energy importers, but they also bring the risk of outright deflation at the headline level. As we have already mentioned, key oil producers, from Venezuela to Russia, are feeling the acute stress. In the short term, markets will register no small amount of pain from oil priced below \$50 per barrel — as they would from oil at below \$80. In the longer term, the pain may be dwarfed by economic benefits of revitalized consumption: the “tax cut” of lower oil prices that the market is trying to hold on to. But the short-term pain may give the Fed an additional cause for caution.

Economic weakness overseas

As we have stated, economic weakness in Europe and Japan poses important questions for the Fed to consider as it signals rate-hike intentions to the market. Questions abound regarding the likely efficacy of European QE, while the integrity of the eurozone itself is once again in doubt and EU structures of support for peripheral Europe may soon be put to the test. Of course, the story for Europe is not uniformly bad. Lower energy prices will likely help Europe, as will QE. And critically, a weaker euro will boost Europe’s international competitiveness. Optimistically, though, we think it warranted to expect at best a mild improvement in Europe in 2015.

Figure 4. Current spreads relative to historical norms

- Average excess yield over Treasuries (OAS, 1/1/98-12/31/07)
- Current excess yield over Treasuries (OAS as of 12/31/14)

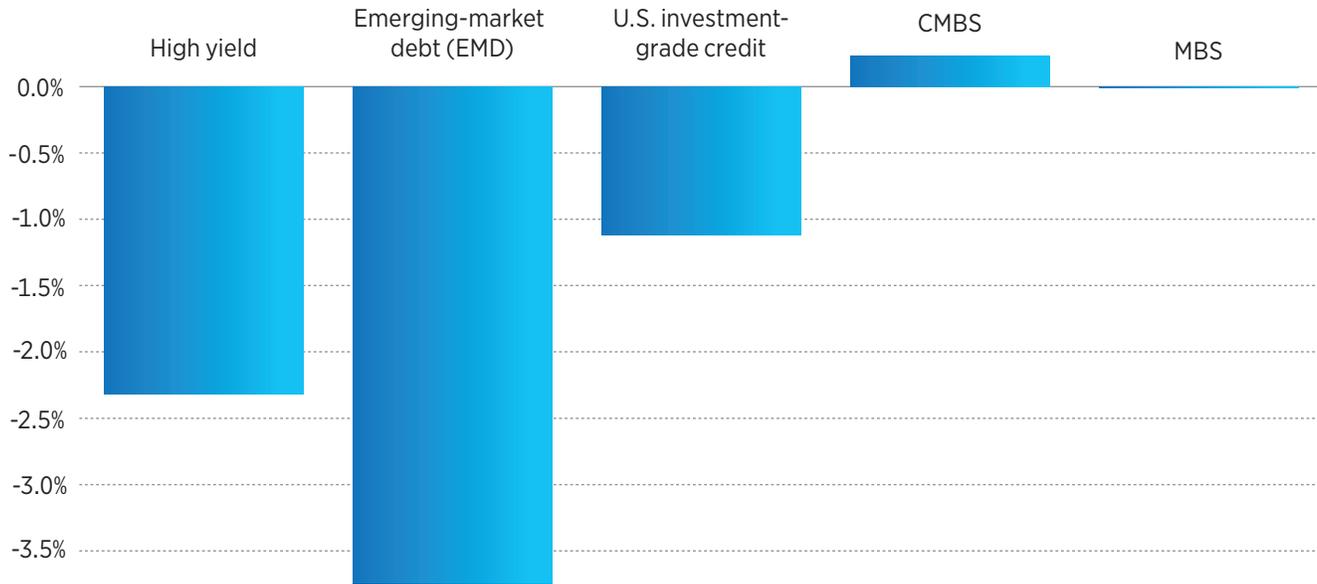


Sources: Barclays, Bloomberg, Putnam, as of 12/31/14.

Data is provided for informational use only. Past performance is no guarantee of future results. All spreads are in basis points and measure option-adjusted yield spread relative to comparable maturity U.S. Treasuries with the exception of non-agency RMBS and mezzanine CMBS, which are loss-adjusted spreads to swaps calculated using Putnam’s projected assumptions on defaults and severities, and agency IO, which is calculated using assumptions derived from Putnam’s proprietary prepayment model. Agencies are represented by the Barclays U.S. Agency Index. Agency MBS are represented by the Barclays U.S. Mortgage Backed Securities Index. Investment-grade corporates are represented by the Barclays U.S. Corporate Index. High yield is represented by the JPMorgan Developed High Yield Index. AAA CMBS is represented by the Aaa portion of Barclays Investment Grade CMBS Index; mezzanine CMBS is represented by the same index using the AA, A and BBB components. Average OAS for Mezzanine CMBS is for the 2000-2007 time period. Emerging-market debt is represented by the Barclays EM Hard Currency Aggregate Index. Non-agency RMBS is estimated using average market level of a sample of below-investment-grade securities backed by various types of non-agency mortgage collateral (excluding prime securities). Mezzanine CMBS is estimated from an average spread among baskets of Putnam-monitored new issue and seasoned mezzanine securities, as well as a synthetic (CMBX) index. Agency IO is estimated from a basket of Putnam-monitored interest-only (IO) and inverse IO securities. Option-adjusted spread (OAS) measures the yield over duration equivalent Treasuries for securities with different embedded options.

Figure 5. Excess returns relative to U.S. Treasuries

Credit underperformed in the fourth quarter on weakness in global growth and the energy sector.



Source: Barclays, as of 12/31/14. Past performance is not indicative of future results.

Concerns over China: Stimulus as usual

Economic data from China have continued to suggest its economy is slowing, and markets have observed regular failures among property development companies. In recent weeks, the authorities announced more monetary easing, but it does not appear to be a particularly powerful tool.

In early January, it became clear that the Chinese government has fallen back on its tried and trusted approach to stimulating growth through public-sector investment. The government approved a 7 trillion RMB (\$1.1 trillion) plan to invest in 300 projects in 2015 and 2016. The plan is apparently heavily front-loaded, and the projects will be financed by the usual mix of local governments, state-owned enterprises, and bank loans.

While this is not a 2008-scale program, it shows that the government has lost patience with its earlier approach of encouraging the economy to rebalance and has — once again — pivoted to pouring capital into projects with an uncertain return and leaving the real handling of the problems until later.

Sector views

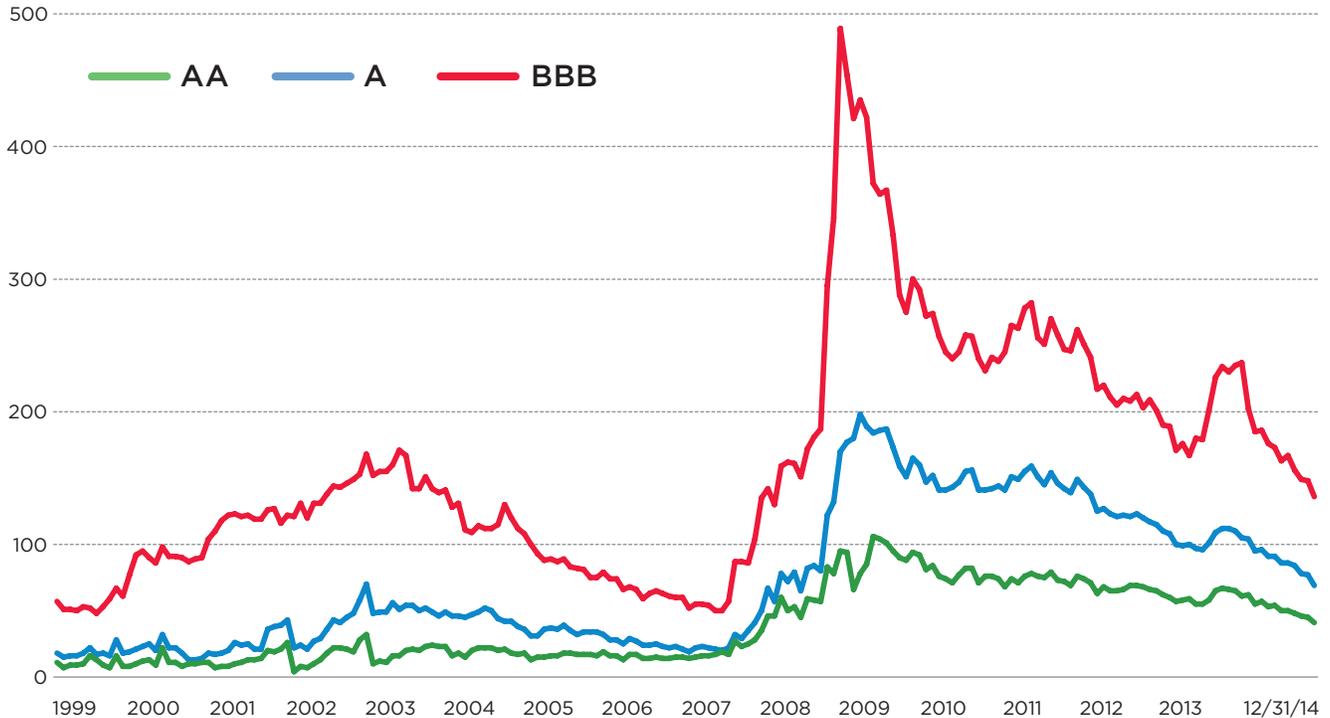
Overall, 2014 was a test for fixed-income investors, as the 10-year Treasury yield fell 86 basis points (from 3.03% to 2.17%) and areas in emerging markets and high-yield corporate credit experienced greater volatility. Despite this risk-averse environment and without the benefit of running higher durations, we found attractive opportunities for investors in a number of areas of the fixed-income markets.

Our outlook ranges from cautiously optimistic to enthusiastic on a number of fronts, particularly in three areas of fixed-income risk: prepayment risk, liquidity risk, and non-energy-related credit. Interest-rate risk, which we believe rounds out the set of four key risks offered by fixed-income investments, continues to present too much risk with insufficient reward potential, even if the Fed’s implementation of a rate-raising agenda takes slightly longer than expected to get underway.

Figure 6: Muni credit spreads have narrowed from historical wides, but remain attractive

Municipal bond spreads by quality rating

We continue to find the most attractive relative values in the BBB-rated segment of the muni market.



Source: Putnam, as of 12/31/14. Credit ratings are as determined by Putnam.

Investment-grade: Fundamental corporate health, but short-term U.S. government rates may push higher

Overall, investment-grade corporates appear to us to be in good shape, and they continue to benefit from a backdrop of low rates and comfortably rapid economic growth in the United States. With strong cash-flow generation, high margins, large cash balances, and no signs of dangerously high leverage, investment-grade bond issuers continue to represent an anchor to windward amid broader market volatility. In addition, unlike other areas of the fixed-income markets, such as high-yield and emerging-market debt, investment-grade bonds are not as susceptible to the risks posed by dramatic weakness in oil prices.

At the same time, interest rates were volatile at the start of the fourth quarter of 2014, before settling down and generally declining through year-end. With the Fed ending its bond-buying program in October while other countries appeared poised to ramp up monetary stimulus, it was not surprising to see some degree of rate volatility. Additionally, with U.S. GDP growing at a 5% annual rate in the third quarter of 2014, investors sought to fine-tune their forecasts as to when the Fed is likely to begin raising its target for short-term interest rates. Shorter-term Treasury yields rose during the fourth quarter, partially discounting the central bank's first rate increase.

The Fed purchased roughly half the Treasury bonds that were issued during the most recent round of quantitative easing that began in September 2012. Now that this program has ended, the U.S. government will need to find other balance sheets to hold future Treasury issuance. Domestic private-sector investors tend to be more sensitive to yields versus the Fed or foreign government buyers. As a result, we think Treasury yields may need to go higher to attract sufficient demand from private-sector investors. That said, we think the recent rally in Treasuries was partly driven by domestic investors returning to the market.

High yield: Energy-related defaults may rise, but broader credit fundamentals remain attractive

In our view, domestic corporate fundamentals are generally on track to remain strong in 2015. The obvious exception to that overall corporate strength is the energy sector, which represents approximately 15% of the market and which has seen a precipitous drop in oil prices. Should prices stay at current levels for the bulk of 2015, the energy sector would weigh on the overall high-yield market. Outside the energy sector, the bulk of corporate earnings continue to trend higher and many sectors benefit on the margin from lower energy prices.

Aside from the energy companies confronted by falling commodity prices, high-yield issuers appear to be in reasonably good shape. Corporations continue to take a conservative approach toward managing their assets and liabilities. This can be seen in the fact that most of the new-issue activity in the fourth quarter was to refinance existing debt, which helps issuers lower their overall borrowing costs.

We believe the default rate, which stood at 1.9% at the end of 2014 — well below the long-term average of 3.8% — could remain low. That said, sustained weakness in energy prices would likely elevate defaults among energy-related issuers. All told, excluding the energy sector, we continue to have a reasonably positive outlook for the asset class.

We have been selectively adding Ba-rated holdings to bring high-yield allocations closer to neutral versus common benchmarks. Additionally, to compensate for heightened market unease, we have increased cash allocations and are limiting their interest-rate sensitivity to below-benchmark levels.

Securitized debt markets: Diversified exposure remains a key strategy

Our mortgage credit investments, specifically positions in subordinated mezzanine commercial mortgage-backed securities (CMBS) and non-agency residential mortgage-backed securities (RMBS), aided portfolio performance in the recent quarter. Our CMBS positions were bolstered by supportive commercial real estate fundamentals amid an improving U.S. economy, while both CMBS and RMBS benefited from persistent investor demand for higher-yielding bonds. Non-agency RMBS were also helped by strong supply-and-demand dynamics. The universe of investable securities continued to shrink, but their values were supported by consistent demand from long-term investors.

Our exposures to prepayment risk detracted from relative returns in the closing months of 2014. However, we intend to persist in our efforts to capitalize on anticipated slower prepayment speeds through allocations to agency interest-only collateralized mortgage obligations. We continue to find prepayment risk fundamentally attractive — given the potential for higher interest rates amid a strengthening U.S. economy — and a good source of diversification relative to other more conventional areas of the fixed-income universe.

Emerging-market debt: Outflows and oil pose key risks, but idiosyncratic opportunities remain attractive

A pronounced outflow of investment capital was a major headwind for both emerging-market currencies and emerging-market debt for much of the second half of 2014. In addition, the plummeting price of oil put the debt and equity markets of oil-exporting countries under severe pressure. This development affected riskier asset markets such as Venezuela and Russia, but also more advanced emerging-market economies such as Mexico. That said, emerging-market countries that are energy importers, such as South Africa, Indonesia, and India, appeared poised to benefit from sustained lower oil prices toward the end of 2014.

The risks posed by pronounced outflows and an oil-price collapse have not diminished the diversifying potential of EMD in the context of a broader bond portfolio. By the end of 2014, EMD offered a yield advantage of approximately 3.75% over U.S. Treasuries, which put it roughly in the middle of investment-grade and high-yield bond spreads. This suggests to us that EMD is neither richly nor cheaply valued.

Even though economies outside the United States are growing more slowly than in recent years, the fundamental creditworthiness of many emerging-market countries and corporations appears to be improving. As we have pointed out, some countries that formerly struggled under high oil prices, such as Turkey and India, appear to be benefiting economically from oil's decline. For this and other reasons, we are optimistic about prospects for the asset class in 2015, and seek to employ strategies that can take advantage of the wide variety of opportunities in the EMD space, from external and local government debt to emerging-market corporate bonds.

Municipal bonds: Taking a cue from Treasuries

With the Federal Reserve's benchmark rate anchored near zero percent during the final quarter of 2014, municipal bonds were beneficiaries of heightened demand from investors searching for attractive yield opportunities. Municipal bonds continued to take their cue from Treasuries, which despite some volatility, declined over the quarter. The yield on the benchmark 10-year U.S. Treasury began the period at 2.42%, fell to 2.07% on December 16 — its low for the period — and ended the quarter at 2.17%.

Against this backdrop, municipal bonds, as measured by the Barclays Municipal Bond Index, posted positive results for the fourth quarter — a solid closing to a year that the Fed's accommodative monetary policy and strong investor demand made into one of the best ever for the asset class. As a result, municipal bonds outperformed many fixed-income asset classes, including the broader bond market represented in the Barclays U.S. Aggregate Bond Index.

While investors should stay mindful of the long-term potential for tax reform, we believe the most significant driver of municipal bond returns in 2015 will be the Fed's interest-rate policy and its effect on demand for the asset class. The central bank's decision to begin increasing its benchmark federal funds rate from near zero is expected to depend on the pace of the U.S. recovery, inflation, and further improvement in the labor market. We believe the Fed's actions, along with the direction of longer-term U.S. Treasuries, will highly influence the performance of municipal bonds in 2015.

In this environment, we will continue to manage tax-exempt portfolios with an eye to keeping their interest-rate sensitivity lower than that of their Lipper peers. As part of this strategy, we will continue to overweight bonds rated A and Baa while managing duration with cash and security selection.

After the run-up in prices in 2014, it has become more challenging to find attractively valued municipal bonds. As we head into 2015, our credit research will be key to finding relative value in the municipal bond market.

Currency: Foundations for continued dollar strength

We continue to favor the U.S. dollar. The pillars for U.S. dollar strength are based upon relative growth outperformance and the subsequent implications for attractiveness of U.S. assets and relative monetary policy.

The euro remains unattractive. Growth in the euro-zone remains at virtually zero, and inflation expectations have fallen. The ongoing geopolitical concerns coming from the Russia/Ukraine conflict have stabilized, but the corresponding sanctions have damaged sentiment, likely delayed investment, and exacerbated the growth slowdown.

In the United Kingdom, growth levels remain solid while inflation and inflation expectations have come down considerably. This has seen the market push out the first rate hike until mid-2016, putting pressure on the pound against the U.S. dollar.

We favor the U.S. dollar over the yen. Abenomics remains intact following the government's recent election victory, while the Bank of Japan has demonstrated its resolve to reflate the economy, and remains ready to do even more to meet its goal.

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