

Q4 2015 » Putnam Perspectives

# Fixed-Income Outlook

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## Key takeaways

- The economic deceleration in emerging markets is unlikely to derail global growth.
- The Fed may begin raising rates sooner than the market currently expects.
- A Fed rate-raising campaign may be muted given U.S.- dollar strength.
- We favor prepayment, credit, and liquidity risks over interest-rate risk.

## Growth concerns temporarily stall Fed action

Recent stock market volatility has been in part a reflection of global uncertainties. Spread widening in credit markets, both investment grade and high yield, reflects at least in part the fallout from lower commodity prices and the rising default risk this entails. These market moves can harm consumer confidence, and they effectively raise the cost of capital to the corporate sector. But while market deterioration is unsettling, we don't believe the recent downturns portend a structural slowdown of growth in the United States.

Weakness outside the United States clearly has given the Fed pause as it considers the lever of a rate-raising campaign. But, as we see it, the Fed's mostly positive view of the economy can be set out as follows:

- U.S. growth is strong enough to allow the labor market to continue to improve.
- Some wage pressures are already being felt in parts of the economy, and they may well broaden.
- Global developments are certainly a headwind for the economy, but the U.S. growth remains domestically oriented.
- It would take a further material deterioration in the global outlook to cause this U.S. outlook to worsen.

## Putnam fixed-income views

	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:**  
**U.S. DOLLAR VERSUS**

**EURO** €

**POUND** £

**YEN** ¥

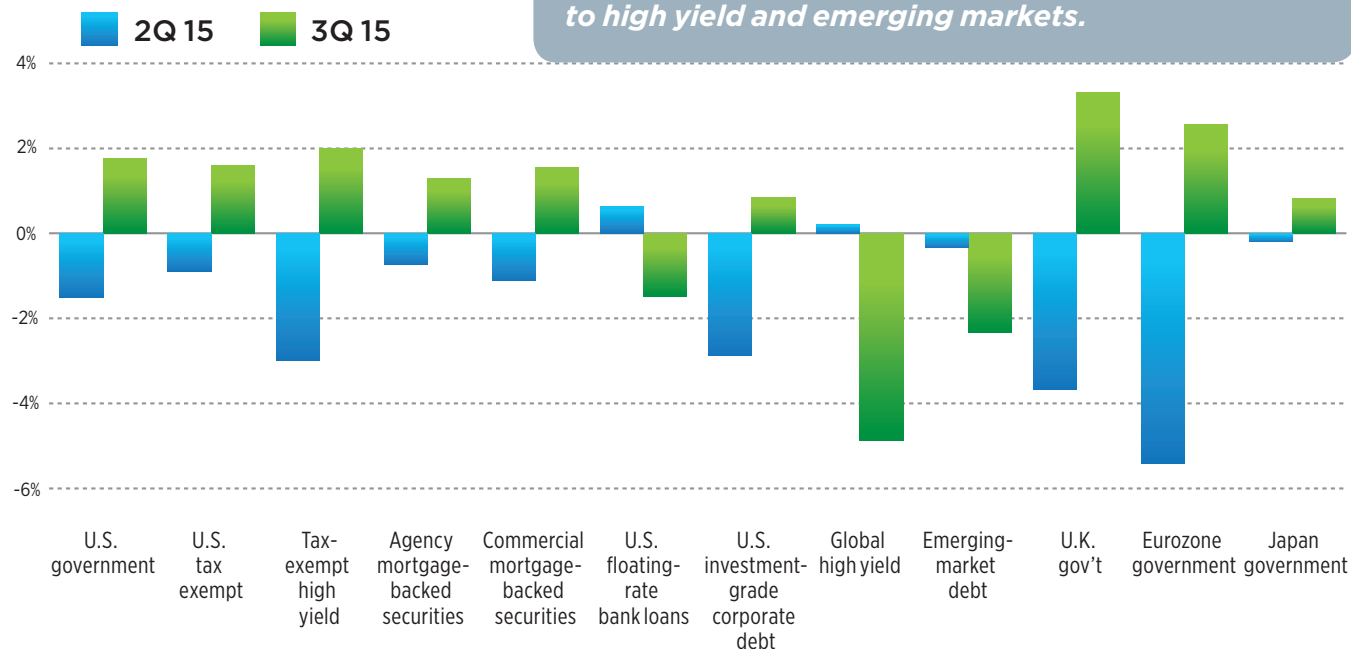
**OUR VIEW:**

**Favor dollar**  
(unchanged from last quarter)

**Favor dollar**  
(unchanged from last quarter)

**Favor dollar**  
(unchanged from last quarter)

**Not FDIC insured | May lose value | No bank guarantee**

**Figure 1. Fixed-income performance**

Sources: Barclays, JPMorgan, Bank of America Merrill Lynch research, as of 9/30/15. Past performance is not indicative of future results.

From this, we conclude that the eventual rate-hiking cycle is likely to be moderate and that policy will remain easy even after a hiking cycle has begun. In the near term, we see the Fed as highly likely to hike, unless risks to the Fed's outlook increase by far more than seems probable.

We continue to think the dollar's strength will effectively tighten financial conditions, which may mean the Fed will wind up being cautious in its rate-raising campaign. This has important implications, since a stronger dollar bears down on the economy rather differently than higher interest rates. In short, a stronger dollar together with a robust labor market would squeeze corporate margins. The economy would then be likely to shift to a path with stronger consumption gains since the dollar will keep inflation and interest rates low, benefiting households.

### Events in China not likely to spell global disaster

Aside from raising questions about global economic strength, events in China also raised the specter of financial contagion. This common concern about the Chinese financial system — which worries about emerging-market (EM) economies more broadly — is not a concern we share. Chinese banks are in disarray, but we believe their linkages to the global financial system are too weak to produce a major shock. We think the same is true for EM more generally. European banks have a decent amount of exposure to the EM world, but in our view it does not constitute a systemic threat. Individual EM economies do look shaky, and there are clear downside risks in Brazil, Indonesia, Malaysia, and South Africa, to name just a few. But it would take a lot to turn this from a headwind for the global economy into a constitutive problem.

The second concern that grows out of China's current problems focuses on the cost of capital in the United States. If the stock market makes another sharply lower move and if corporate spreads continue to widen further, then corporations will be forced to retrench and the labor market will start to weaken. Consumer confidence will fall and as the labor market weakness squeezes incomes, spending will suffer. Again, we do not think that this is a likely scenario.

### High-yield spread widening may have a limit

One development worth noting from the third quarter is the pattern of spread widening in the corporate credit market. Spreads are about 150 basis points (bps) wider since the start of the year, and about 100 bps of this widening took place in September. Until September, the weakness in high yield was overwhelmingly a story of energy and metal & mining. The collapse of commodity prices is clearly threatening the viability of some high-yield companies in the exploration & production industries, though defaults rose across the energy complex. In September, however, the pattern in high yield was rather different. While commodity-related industry spreads continued to widen, there were also idiosyncratic issues associated with the automotives, chemicals, telecommunications, and health care. In fact, according to JPMorgan, eight different sectors declined more than 200 bps during the month.

Among the reasons for the weakness, we believe, were the technical backdrop associated with fund flows and a general risk-off perspective. Investors have been selling high-yield exchange-traded funds, and this has led to the volatility in prices. It is, of course, possible that this will continue, and spreads will get pushed wider. But at some point, we think the valuations associated with high-yield bonds will become attractive to some investors. The current outlook for the economy does not justify the default rates implicit in much wider spreads.

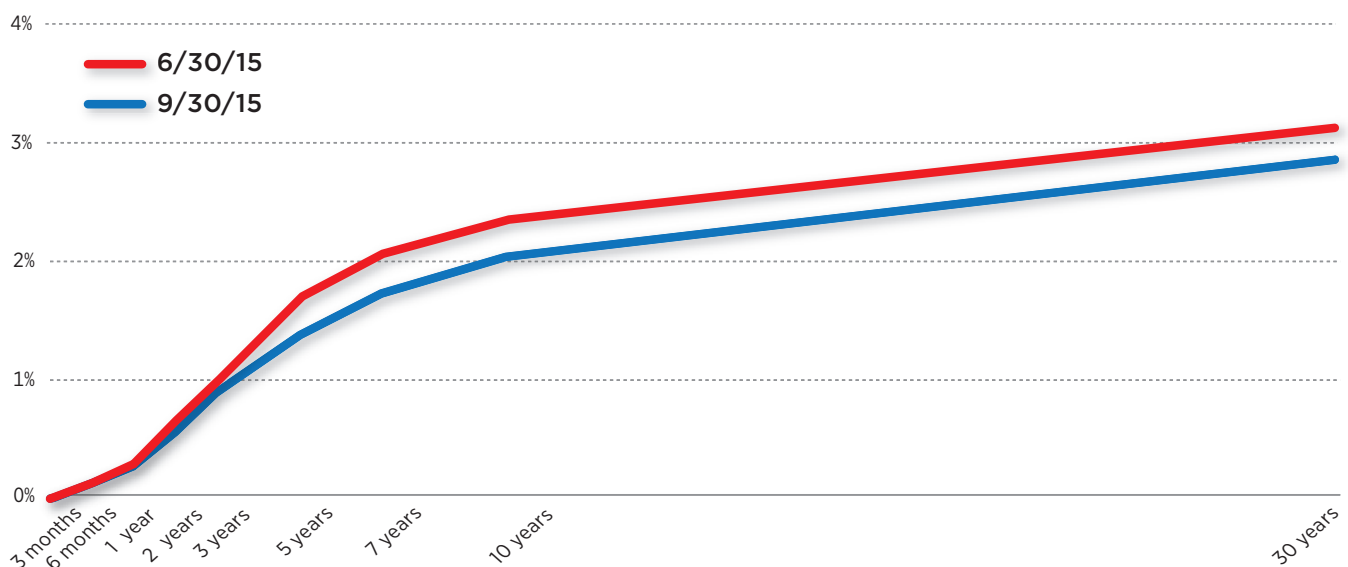
### Fixed-income asset class views

Within the risk-averse environment of the third quarter, investors shifted capital away from riskier market sectors and into U.S. government bonds. For the quarter, the yield on the benchmark 10-year U.S. Treasury declined from a high of 2.45% reached on July 13 to 2.00% on August 24. Developed-market foreign government bonds were also seen as haven assets. For example, the yield on 10-year German bunds went from a high of 0.89% on July 14 to 0.56% on August 21.

Long-term government bonds generated the best returns for the quarter, while emerging-market debt and high-yield bonds fared the worst. Looking at broad market indicators, the Barclays U.S. Aggregate Bond Index returned 1.23% — fueled by its government bond components — and the Barclays Global Aggregate Bond Index rose 0.85% in U.S. dollar terms.

**Figure 2. Rates fell as investors sought safe-haven assets amid global growth concerns**

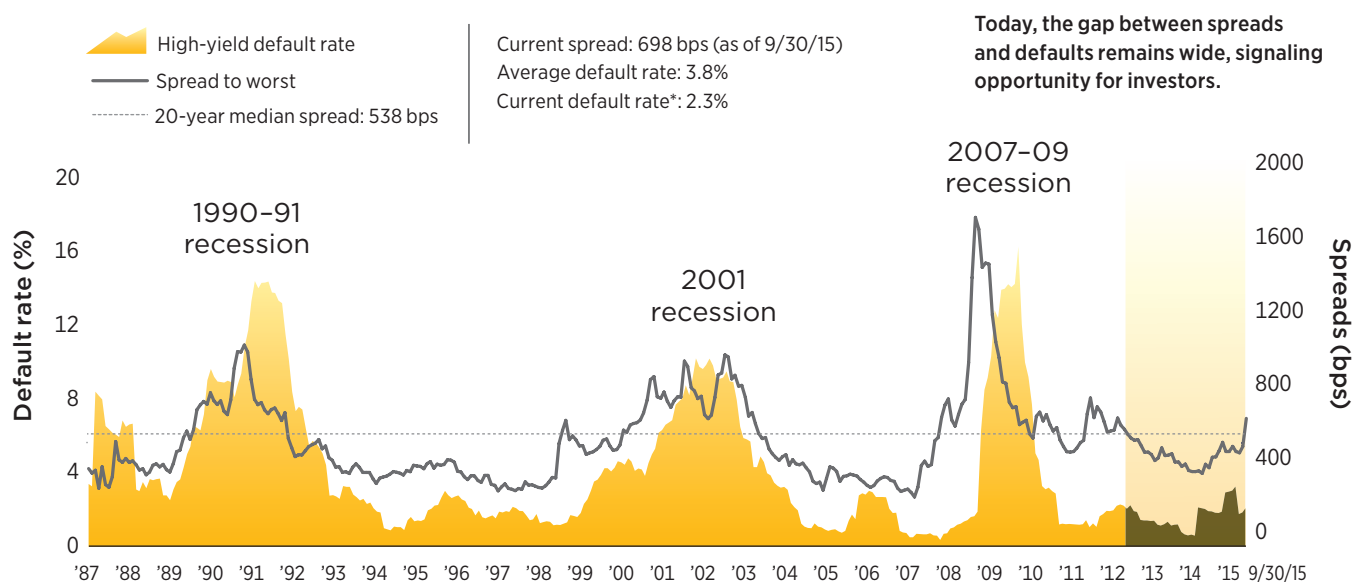
*With few exceptions, rates fell across the yield curve during Q3.*



Source: U.S. Department of the Treasury, as of 9/30/15.

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

*Among other reasons, spreads gapped wider in Q3 on weakness across the commodities complex.*



\* Current default rate includes distressed exchanges.

Sources: JPMorgan, High Yield Market Monitor, as of 9/30/15; Putnam Investments.

### Securitized debt: Staying the course with prepayment and credit risks

Our prepayment strategies, which we implemented with securities such as agency interest-only collateralized mortgage obligations (IO CMOs), did not perform as well as we hoped during the third quarter. Even though mortgage refinancing activity remained subdued over the past three months, IO CMO yield spreads are sensitive to interest-rate movements, and lower rates across the yield curve caused them to underperform. IO CMOs were also hurt by an overall flight from risk by investors.

On the plus side, various tactical trades that were designed to benefit from the difference between current mortgage rates and Treasury yields were additive and

partially offset the negative impact of our IO CMO holdings. Notwithstanding its disappointing performance in the third quarter, we continue to find prepayment risk attractive given the prospect of higher interest rates, and we expect to continue to seek attractive opportunities in IO CMOs.

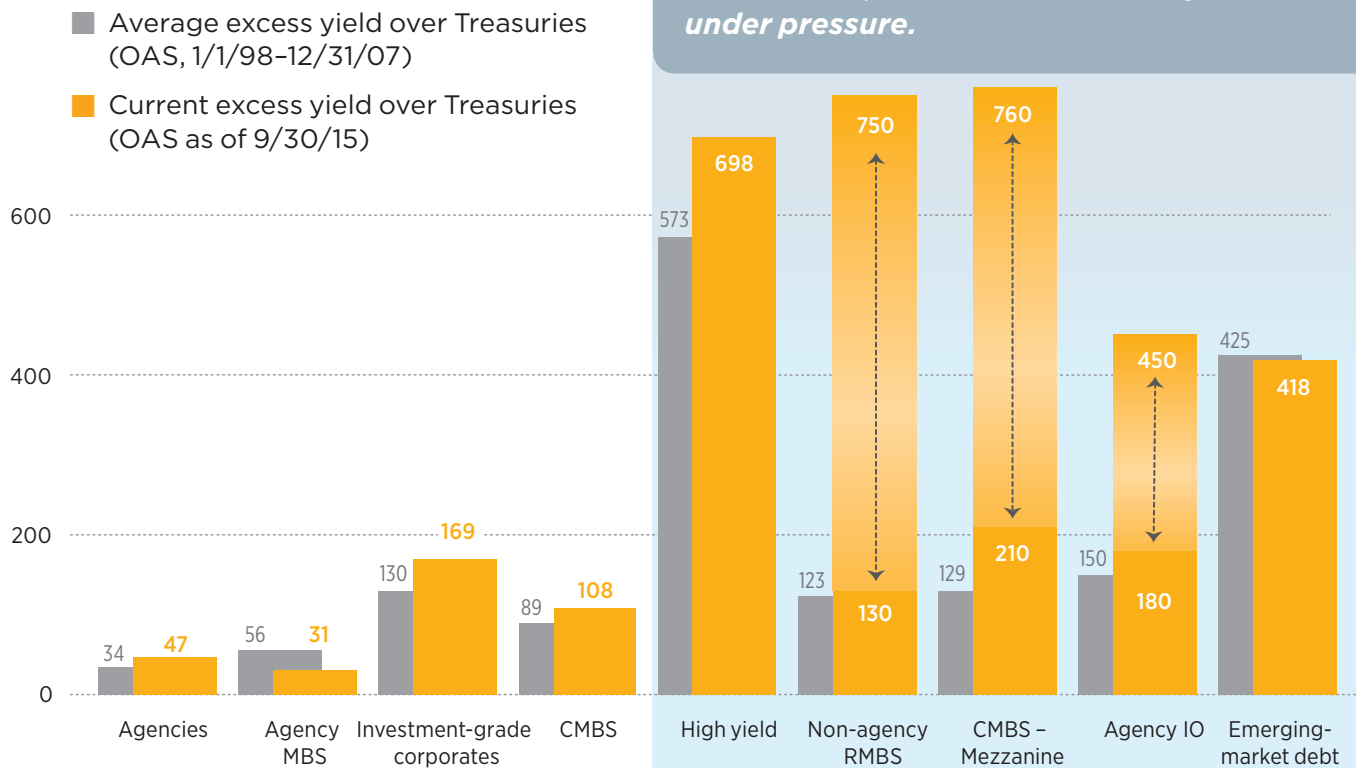
Our exposures to mortgage credit, primarily through mezzanine commercial mortgage-backed securities (CMBS), also detracted from portfolio returns, primarily due to investor risk aversion. In addition, many institutional investors that held high-yield bonds shorted CMBS to hedge their high-yield exposure, further hindering the performance of the sector.

### Investment-grade bonds: Fundamentals largely intact

As in the second quarter, U.S. investment-grade spreads widened in the third quarter. In the more recent case, concerns about slowing growth in China potentially affecting the U.S. economy, uncertainty about Fed monetary policy, and the general risk-off sentiment all worked to drive spreads wider.

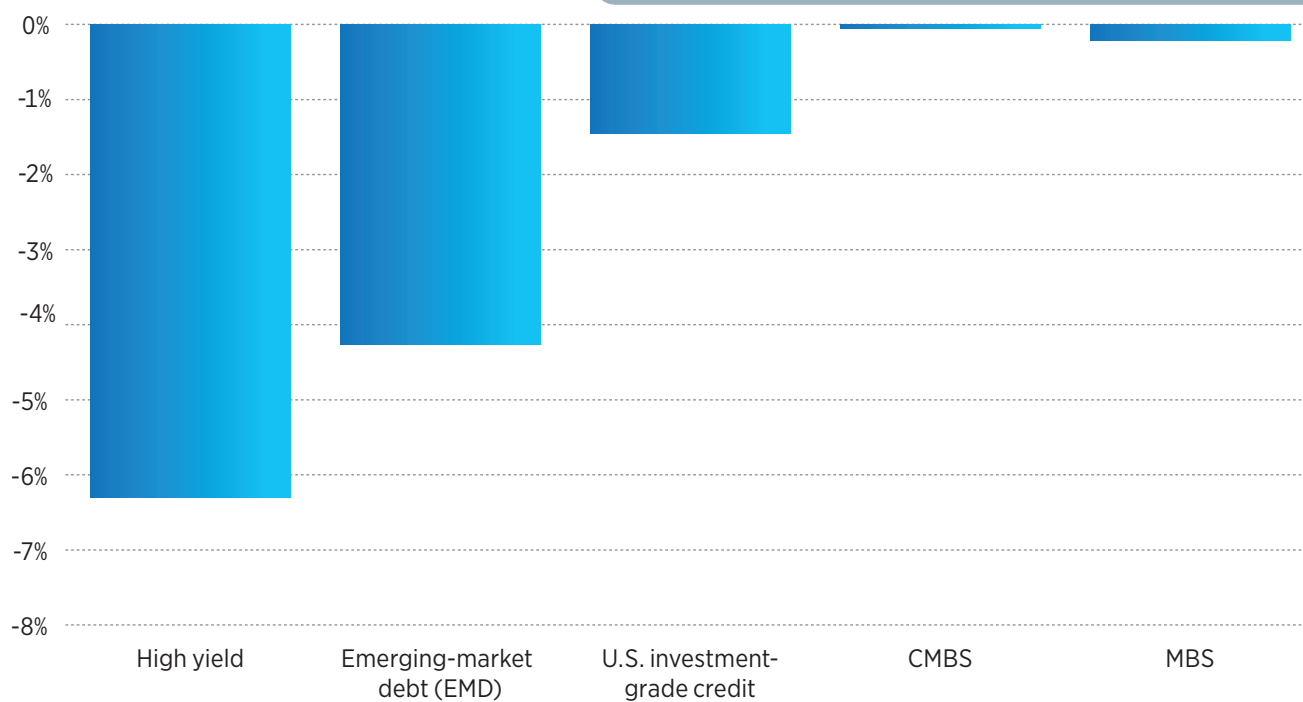
Nevertheless, we think corporate fundamentals remain solid. Investment-grade corporate balance sheets and profit growth may have peaked, but there does not seem to be a major deterioration in credit. Leverage within investment-grade corporates as a whole is rising, but it is mostly increasing at higher-quality companies and in specific sectors. While we think it is possible that spreads can compress during the balance of 2015, global economic concerns, continued pressure on oil and commodity prices, geopolitical headlines, and/or volatile and rising U.S. Treasury rates may drive spreads wider.

**Figure 4. Current spreads relative to historical norms**



Sources: Barclays, Bloomberg, Putnam, as of 9/30/15.

Data are 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 Barclays U.S. Agency Index. Agency MBS are represented by Barclays U.S. Mortgage Backed Securities Index. Investment-grade corporates are represented by Barclays U.S. Corporate Index. High yield is represented by JPMorgan Developed High Yield Index. CMBS is represented by both Agency and Non-Agency CMBS that are eligible for inclusion in the Barclays U.S. Aggregate Bond 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**

Source: Barclays, as of 9/30/15. Past performance is not indicative of future results.

### High yield and bank loans: Maintaining a constructive view

High-yield bonds struggled during the quarter amid a broad retreat from risk assets, fueled by concerns about the pace of growth in China and elsewhere around the globe. Uncertainty about the strength of demand from the world's second-largest economy and biggest importer of raw materials deepened a sell-off in commodities. The uncertainty was compounded in September when the Federal Reserve opted not to raise its target for short-term interest rates, citing concerns about the potential impact of international developments on U.S. economic growth.

New issuance of high-yield bonds decelerated considerably during the quarter as heightened market volatility exacerbated what is normally a slow summer season. Issuers that brought bonds to market were forced to make concessions, such as paying a higher coupon, which spurred a repricing of existing bonds in certain sectors, such as chemicals and health care.

Several unexpected developments in the automotive, telecommunications, health-care, and chemicals sectors also gave investors pause. For example, Moody's downgraded the credit rating of bonds issued by wireless communications provider Sprint Nextel, which weighed on performance in the telecom sector.

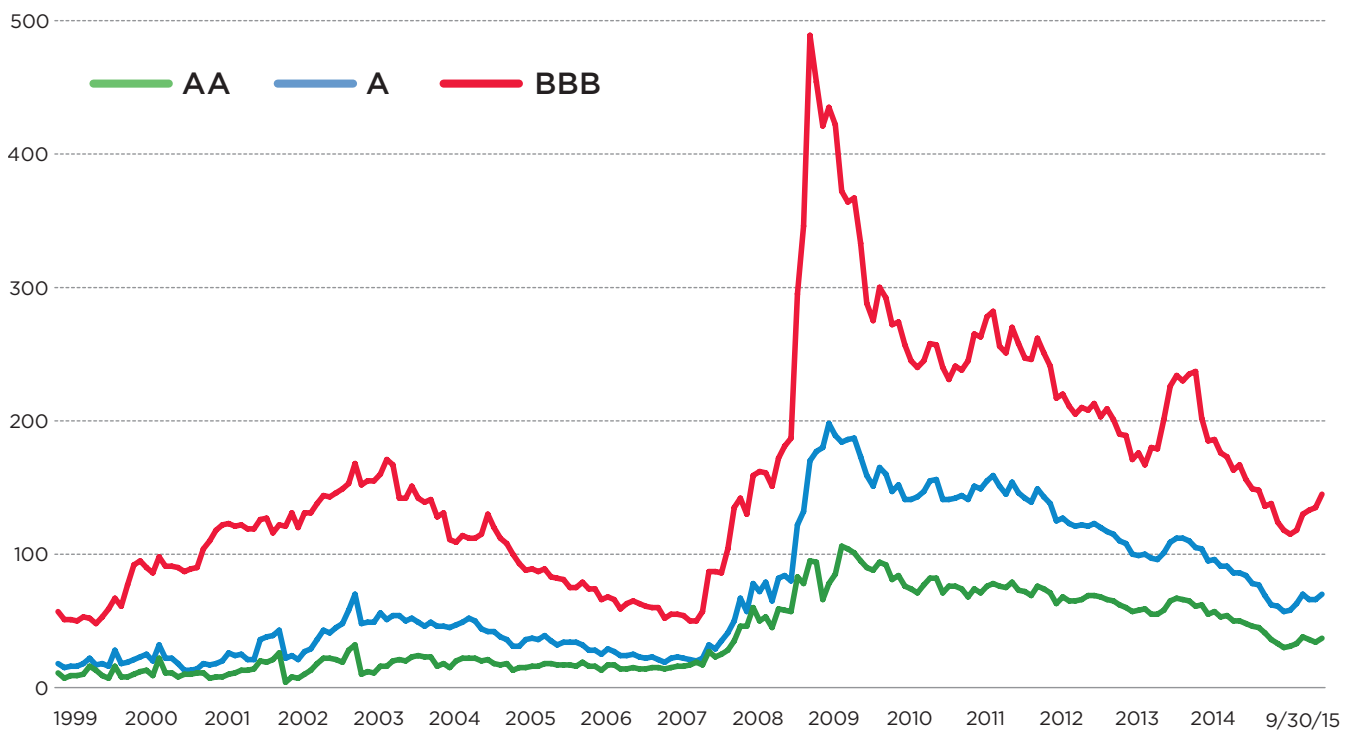
### High-yield defaults still below historical norms

The 12-month high-yield default rate rose modestly in September to 2.3% but is still meaningfully below historical norms. It's important to note that this increase was driven by defaults in commodity-related sectors such as energy and metals/mining, which accounted for roughly 80% of default volume year to date through September 2015. Despite the impact of these sectors, we think the default rate could remain muted. With interest rates at low levels, we believe high-yield issuers should continue to benefit from low debt-servicing costs, which could keep the default rate below the long-term historical average for some time.

In the high-yield market, we believe most issuers — excluding those in more commodity-sensitive industries — are in reasonably good shape from a fundamental credit perspective. Marketplace liquidity has been constrained but not overly so, allowing us to accomplish our trading objectives. With valuations more attractive following recent market turbulence, and an abundance of new high-yield issuance on the horizon, we continue to have a constructive outlook for the asset class overall.

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

*Municipal bond spreads by quality rating*



Source: Putnam, as of 9/30/15. Credit ratings are as determined by Putnam.

*Credit spreads widened in Q3 but remained fairly tight, with lower-quality bonds modestly outperforming higher-quality issues.*



*Bank loans outperform high yield*

Bank loans held up better than high-yield bonds amid the various macro gyrations hampering the markets, and generated significantly stronger relative performance for the quarter. Bank loans' better performance was partly due to the fact that loan indexes had considerably less exposure to energy-related sectors during a period when the price of oil and other commodities declined.

Within the bank-loan index, similar to high-yield bonds, loans in the highest-quality credit tiers posted the best relative returns, while the lowest-quality loans sold off sharply, and more-defensive industry groups were the top relative performers.

**Emerging markets: Pressures continue to mount**

Outside the United States, we think emerging markets are likely to remain under pressure for some time. As the biggest buyer of commodities from many EM countries, China's economic slowdown is having a major impact on many other developing economies, such as Brazil, South Africa, and Malaysia. Capital has been flowing out of EM countries seeking better investment opportunities, primarily in the United States. This capital outflow is forcing some EM nations to devalue their currencies or dip into their foreign-currency reserves to defend their exchange rates.

Although capital outflows have moderated somewhat more recently, the authorities across EM are struggling with weak commodity prices, stressed financial asset markets, falling exchange rates, and weakening economies. In some, this unhappy economic configuration is interacting with difficult political circumstances. In our view, some countries are much better placed than others: Poland, for example, looks steady, and Mexico appears to us to be well positioned. But Brazil, Indonesia, and South Africa have to contend with far more difficult conditions. We believe that the selling off of EM assets is not normally enough to change market sentiment; what is needed is economic reform that gives investors a plausible belief in a better tomorrow.

**Municipal bonds: Mixed technicals and positive returns**

While equity markets experienced considerable volatility, posting negative returns for the third quarter, the municipal bond asset class saw positive gains. Tax-free bonds, as measured by the Barclays Municipal Bond Index, led taxable fixed-income markets, outperforming the Barclays U.S. Aggregate Bond Index and the BofA Merrill Lynch 3-Month Treasury Bill Index for the quarter.

Technicals — or the market's supply and demand dynamics — were fairly well balanced. The supply of municipal bond issuance has been relatively heavy, almost 34% higher in the first nine months of 2015 than for the same period in 2014. The bulk of new issuance has been earmarked for refinancing activity as municipal issuers took advantage of the low-interest-rate environment to replace their older, higher-coupon bonds with lower-cost debt. So the supply side is still healthy but was met with decent demand.

Municipal bond flows were modestly negative in the third quarter. However, we believe this development was more a result of broader market factors than fundamentals within the municipal bond market. Credit spreads (the difference in yield between higher- and lower-quality municipal bonds) remained tight during the period, contributing to slightly better returns for lower-quality investments than for higher-quality investments for the quarter.

With the 2016 campaign season in full swing and the presidential candidates better defining their policy agendas, we are hearing chatter about individual and corporate tax reform and the elimination of some loopholes and tax deductions. We would caution municipal bond investors from overreacting to discussions about changes to the tax code until after the 2016 election, when we will know better if reform becomes a bona fide priority. As we have seen in previous instances, headlines about isolated municipal credits can lead to investor overreaction and temporary price dislocation. Such price action often results in investment opportunities for Putnam's Tax Exempt team.



### **Currency: Though less ascendant, the dollar still holds advantages**

Within active currency strategies, our U.S. dollar position is a more modest overweight. 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 U.S. growth story has stabilized at more moderate levels, but on a relative basis it is not the standout leader as other major economies have seen improvement as well. The United States is regaining equity market leadership, and it remains an attractive destination for fixed-income capital with the Bank of Japan (BoJ) and the European Central Bank (ECB) actively purchasing local government debt.

While maintaining this long-term view on the dollar, we note that the euro has some short-term advantages. Growth in the eurozone has stabilized at modest levels. The ECB policy remains easy. The current situation in Greece remains fluid and provides a great deal of volatility for the single currency. A more benign outcome (which is our base case) in which Greece agrees to additional austerity measures and receives a new financial assistance program from creditors, should see the single currency move higher in the short run. A Greek exit would likely cause quite a bit of financial market volatility and would require the ECB to ensure the monetary policy transmission channel remains functional through even more extensive purchases of sovereign debt (on top of its current QE program). This would likely cause the single currency to drop sharply.

While still at a disadvantage versus the dollar, the British pound sterling benefits in the near term from U.K. growth levels remaining solid. Although inflation levels and expectations have come down considerably, they appear to have reached a trough. Additionally, the labor market data is showing signs of wage pressure, and the hawks on the Bank of England Monetary Policy Committee could start to voice the need for rate hikes in coming meetings.

Regarding the Japanese yen, we still favor a modest short. BoJ Governor Kuroda continues to highlight that the BoJ does not have any intention to ease the policy near term given the current economic and price conditions, explaining that the decline in core CPI inflation is temporary and could be reversed in line with oil price developments. Most importantly, Kuroda stresses that the BoJ will not hesitate to adjust the policy if fundamental price trends change and if the early achievement of the inflation target is found to be difficult. This very easy policy (and expectations that more will be needed) coupled with the Fed possibly lifting rates sooner than the market expects should continue to keep pressure on the yen.

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