Q1 2021 | Putnam Municipal Bond Funds Q&A

Municipals outperform, but inflation risk stalls rally

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Municipal bonds outperform the broader taxable market for the quarter.

Stabilizing credit fundamentals and favorable technicals helped counter inflation fears spurred by a faster-than-expected U.S. economic recovery.

We believe the lower tiers of the investment-grade universe and parts of the high-yield market offer attractive income and return opportunities.

How did municipal bonds perform during the first quarter of 2021?

The municipal bond market posted slightly negative performance for the quarter, with mixed month-to-month results. The quarter started off on positive footing, supported by favorable supply/demand technicals and an improving economic outlook. Investors were also in an upbeat mood due to the Biden administration's plans to boost the Covid-19 vaccine rollout and to pass another stimulus package to spur economic growth.

After advancing in January, municipals reversed course in February, along with other interest rate-sensitive, fixed-income securities. The reversal was due to investor worries that additional stimulus measures would accelerate the economic recovery and lead to rising inflation. This resulted in higher bond yields further out on the yield curve while short-term interest rates remained near zero, anchored by the Federal Reserve's monetary policy. The yield on the 10-year U.S. Treasury note rose from 0.93% on December 31, 2020, to a high of 1.74% on March 19, 2021 — a level not seen since January 2020 — and closed the quarter at 1.73%. The sharpness of the rise in bond yields in such a relatively short period of time unsettled the financial markets. Underscoring inflation fears, oil prices spiked to their highest in more than a year on March 15, 2021. The recovery in oil prices was due in large part to production cuts by oil-producing nations to draw down excess fuel inventories and to rising U.S. fuel demand.

Municipals regained their footing in March, with President Biden's signing of the $1.9 trillion American Rescue Plan. This Covid-19-relief bill included another round of stimulus checks and $350 billion in aid to local and state governments. Later in the month, with inflation concerns still on the minds of investors, the Fed downplayed the possibility that it would reduce its support for the economy any time soon. Fed officials also revised their economic outlook for stronger growth for 2021 and affirmed that they still expected to keep interest rates near zero until 2023.

For the three months ended March 31, 2021, the Bloomberg Barclays Municipal Bond Index returned –0.35%, outperforming the broader U.S. fixed-income markets. The Bloomberg Barclays U.S. Aggregate Bond Index and the ICE BofA U.S. 3-Month Treasury Bill Index returned –3.37% and 0.33%, respectively, for the quarter. Revenue bonds outperformed general obligation bonds [GOs]. Within revenue-based bonds, the top-performing sectors for the quarter were hospitals, transportation, and leased-back bonds, while electric and water/sewer were the biggest underperformers. On the credit spectrum, higher-yielding, lower-rated municipal bonds outpaced higher-rated municipal bonds for the quarter.

What contributed to the improving municipal fundamentals and favorable technicals?

Credit fundamentals continue to stabilize, in our view. We've seen an uptick in state and local tax revenue from second-quarter 2020 crisis levels, although states with income taxes have navigated the pandemic better than states that rely more on sales taxes. States with popular leisure destinations, like Nevada and Florida, have felt the economic pain more acutely as mobility restrictions were implemented. Despite pandemic-related challenges, defaults remain low and within long-term ranges. In 2020, the default rate represented less than 0.25% of the overall municipal bond market, with defaults within the investment-grade-rated universe a rare occurrence.

With the outlook and confidence generally improving, technicals are favorable as well. Tax-exempt supply was relatively steady on a year-over-year basis and was met by very strong demand. Fund flows, a measure of investor demand for mutual funds totaled $31 billion for the quarter. The Biden administration's proposed infrastructure plan, which includes increased taxes for corporations, could generate additional interest in tax-free municipal bonds. As such, we believe the technical backdrop is favorable for the asset class and should continue to be a tailwind for the balance of 2021.

How were the funds positioned in this environment?

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. With regard to credit quality, we believe the lower tiers of the investment-grade universe [BBB-rated securities] and some parts of the high-yield market offer attractive income and return opportunities. Duration positioning, a measure of the funds' interest-rate sensitivity, was generally neutral relative to the level of their Lipper peer groups at quarter-end. For our longer-term state and national municipal bond funds, yield-curve positioning was defined by an overweight in bonds with maturities of 10 to 20 years relative to their respective Lipper peer groups at quarter-end. As part of this strategy, the funds generally held an underweight exposure to long maturity holdings compared with the Lipper peer groups.

The funds also 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 profile continues to stabilize and that its 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 PR 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 outlook for the coming months?

Municipal bonds have withstood a lot of market volatility since March 11, 2020, when the World Health Organization announced the coronavirus outbreak had reached the level of a pandemic. Just over a year later, we believe we are coming out on the other side of this health crisis, with the aid of multiple relief packages and medical advancements. The recent cash infusions provided by the American Rescue Plan will help state and local governments enter their 2022 budget sessions with enough cash on hand to help absorb the economic stress of the pandemic, in our view.

In addition, we believe that with the easing of mobility restrictions and the American Rescue Plan, U.S. economic growth will be strong in 2021. At the same time, the Fed remains committed to its twin goals of maximum unemployment and 2% sustained inflation. With these and other factors at play, we believe the greatest opportunities reside in the lower parts of the investment-grade universe as well as the high-yield sectors at this point in the economic recovery.

We'll continue to adjust the portfolio to reflect the team's best ideas to secure income as well as total return prospects in this evolving interest-rate environment.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 3/31/21

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	0.02%	–0.35%
1 year	7.50	5.51
3 years	5.03	4.91
5 years	3.80	3.49
10 years	4.88	4.54
Life of fund	6.29	—

Total expense ratio: 0.58%

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 3/31/21

Class Y shares Inception 1/2/08	**Net asset value**	**Bloomberg Barclays Municipal Bond Index**
Last quarter	1.45%	–0.35%
1 year	12.71	5.51
3 years	5.82	4.91
5 years	4.81	3.49
10 years	6.36	4.54
Life of fund	5.82	6.29

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 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.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed here are those of the portfolio managers as of March 31, 2021, 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; 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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