Q1 2023 | Putnam Municipal Bond Funds Q&A

Municipals weather rate volatility amid inflation concerns

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Municipal bonds delivered positive performance despite stubbornly high inflation and Fed interest-rate hikes.

We remain cautious on lower-rated municipal bonds due to our view that the Fed's aggressive tightening cycle could result in slower U.S. economic growth in 2023.

While it appears to us that inflation has peaked in this cycle, we believe U.S. economic data remains relatively strong.

How did municipal bonds perform during the first quarter of 2023?

The municipal bond market started the quarter strong, with the Bloomberg Municipal Bond Index rising 2.87% in January amid signs of cooling inflation. Investors cheered December 2022's Consumer Price Index coming in at 6.5%, down from 7.1% for the preceding month. The asset class reversed course in February, returning –2.26% for the month. Investor sentiment deteriorated due to fears that the Federal Reserve might raise interest rates higher than anticipated following the release of January's hot inflation data and continued labor market tightness. With investors ratcheting up their expectations for interest-rate hikes and for the Fed's terminal interest rate, U.S. Treasuries sold off sharply. Yields on municipal bonds rose and prices fell as the markets priced in more aggressive monetary policy.

Monthly corrections with a negative return of more than 2.00% don't occur often. In fact, from January 1990 through March 2023, there were only 16 months [4% of total] when the benchmark declined more than 2.00%. While the sell-off erased much of January's gain, it presented attractively priced investment opportunities for us to add selectively to our municipal bond portfolios.

The benchmark rose 2.22% in March despite a few high-profile bank failures during the month. This was the benchmark's second-best return for March since its inception and contributed to a first-quarter return of 2.78%. Quick actions by global central banks to minimize systemic risk, including shoring up bank deposits, prevented contagion across the global financial system. With the turmoil in the banking sector stirring recession concerns, the municipal bond market rallied as investors lowered their expectations for future interest-rate hikes from the Fed.

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

Municipal credit fundamentals continue to be stable, in our view. Higher employment and increasing wages have bolstered tax receipts. Home values, a factor in property tax revenues, are facing headwinds in the form of rising mortgage rates. We believe assessed values, another factor in taxes, should continue to reflect growth given the roughly two-year lag between tax assessments and actual property values.

Municipal defaults are running near long-term averages as of March 31, 2023, and they remain a very small percentage of the market. As such, we believe the credit outlook remains favorable, though we continue to actively monitor the market. We expect economic conditions to weaken during 2023, which could impact municipal bond credit quality.

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

The funds held an overweight exposure to lower-investment-grade bonds and the highest-rated portions of the high-yield market. We remain cautious on lower-rated municipal bonds in general, given our view that the Fed's aggressive tightening cycle could result in slower U.S. economic growth in 2023. However, we have found value in some of the upper tiers of the high-yield market. While credit spreads widened over the period, they were not excessively wide versus previous recessionary periods, in our view.

The funds were invested in a wide range of sectors, including land-secured, charter school, retirement community, and higher education bonds, as well as some housing-related credits. Duration positioning, a measure of the funds' interest-rate sensitivity, was slightly long relative to the average level of their Lipper peer groups.

The funds remained underweight in their exposure to Puerto Rico municipal debt relative to their Lipper peer groups. However, we note that the U.S. territory has experienced recent improvement in credit fundamentals since coming out of bankruptcy in March 2022, in our view. We continue to closely monitor Puerto Rico's credit fundamentals and remain vigilant for investment opportunities.

What do you see on the horizon that could influence your management of the funds?

While it appears to us that inflation has peaked in this cycle, we believe U.S. economic data remains relatively strong. Especially noteworthy is the low U.S. unemployment rate and strong consumer spending.

Market expectations for future rate hikes have come down, with the thought that the recent bank turmoil may cause the Fed to pause sooner than previously expected. Our expectation is the Fed will likely hike by 25 basis points one more time in May before pausing given the continued resilience of the U.S. consumer and tight labor market.

Seasonal factors are typically weaker in early spring but turn more favorable in late spring and summer months. Against this backdrop, we believe valuations offer investors attractive tax-free income, as well as the potential for price appreciation once the Fed concludes its monetary tightening cycle.

Putnam Tax Exempt Income Fund (PTEYX)

Annualized total return performance as of 3/31/23

	Class Y shares Inception 1/2/08	Bloomberg Municipal Bond Index
Last quarter	2.84%	2.78%
1 year	–1.39	0.26
3 years	0.46	0.35
5 years	1.79	2.03
10 years	2.30	2.38
Life of fund	5.88	—

Total expense ratio: 0.58%

Source: Bloomberg Index Services Limited.

Putnam Tax-Free High Yield Fund (PTFYX)

Annualized total return performance as of 3/31/23

	Class Y shares Inception 1/2/08	Bloomberg Municipal Bond Index
Last quarter	3.10%	2.78%
1 year	–3.53	0.26
3 years	1.78	0.35
5 years	2.08	2.03
10 years	3.08	2.38
Life of fund	5.32	5.82

Total expense ratio: 0.62%

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 of class A shares for Tax Exempt Income Fund (inception 12/31/76) and class B shares for Tax-Free High Yield Fund (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.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed here are those of the portfolio managers as of March 31, 2023, 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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