F.L.PUTNAM
INVESTMENT MANAGEMENT COMPANY

MARCH 31, 2021

QUARTERLY REVIEW

MACROECONOMIC OUTLOOK

The first quarter of 2021 was an eventful one from a macroeconomic perspective. A new President took office, and the election of two democratic senators from Georgia unified Democratic control of congress and transformed the American political landscape. The new administration wasted no time in pushing through a $1.9 trillion fiscal stimulus deal and setting the stage for additional spending to support economic recovery from the pandemic. Monetary stimulus also remained at full throttle with the Federal Reserve (the "Fed") guiding market participants to expect continued near-zero interest rates for years as they await full employment and concrete evidence of inflation consistently exceeding their 2% target. With the economy already gaining momentum as the vaccination rollout gathers steam, the outlook for inflation has become a significant concern for market participants.

It is important to place current inflation concerns within some historical context. Figure 1 below shows the US Consumer Price Index (CPI) over the past 50 years. There has been an obvious downward trend in inflation over this time period as highlighted by the dark blue dotted line. The economy has changed significantly since the elevated inflation rates of the 1970s and 1980s – it has become more service oriented and less industrial as technology has made services more efficient and productive. Technological innovation has had two important impacts on inflation: it has reduced the economy's overall sensitivity to commodity prices, and it has gradually increased the productivity of the workforce. These are powerful long-term trends that have persisted throughout the pandemic and may have been bolstered by the remote work environment.

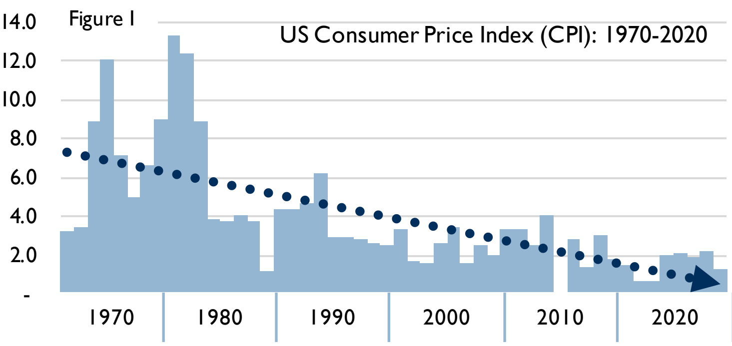
Fiscal and monetary stimulus have resulted in a remarkable rebound in interest rates and inflation expectations over the past year. That being said, inflation expectations remain at levels that are not unusual in recent decades, as measured by the difference between 10-year treasury rates and 10-year inflation-protected treasury rates (this 10 Year TIPS breakeven represents a measure of implied inflation expectations). While the scale of fiscal and monetary stimulus certainly increases inflation risk, there remains a high level of uncertainty as to how much stimulus is too much. While we have already taken action to address inflation risk within portfolios, this is an area that we will continue to focus on as we consider longer-term implications of current events.

With regard to current events, developments this quarter increased confidence in our outlook as increased monetary and fiscal stimulus coincided with successful acceleration of the vaccine rollout. We still expect robust economic growth in the US in the next 6 to 12 months, with unemployment continuing to decline steadily as the economy reopens. Indeed, it now appears that the second half of the year may represent an economic boom of a scale unseen in this country in decades. The result in financial markets is elevated valuations across almost all US assets, which now represent a formidable challenge for investors who must balance rapid economic recovery with downside risks given heightened expectations.

Unfortunately, the economic acceleration that seems to be gaining traction in the US is not a global phenomenon. For example, Europe continues to struggle to provide the fiscal stimulus and vaccination programs that the US has engineered over the past quarter. Valuations remain appealing overseas, but a synchronized economic recovery seems increasingly unlikely. While we still believe that international markets will perform well over time, the shorter-term economic outlook has dimmed as lockdowns persist in many parts of the world. From US investors' perspective, the rise of the dollar as interest rates and economic expectations rise could exacerbate shorter-term impediments for international equity markets while creating increasingly attractive longer-term investment opportunities.

We remain optimistic that we have made appropriate adjustments both within and across equity and fixed income portfolios, and there is ample information on these areas in the pages that follow. The inflation outlook represents a unifying economic trend across these markets and remains a focal point in our investment conversations. At this point, we believe it is prudent to take some action given rising inflation risk, but it is premature to assume that runaway inflation is imminent while inflation expectations remain consistent with recent history. It remains possible that inflation may only show up in unexpected places like asset prices rather than the CPI. ■

Figure 1



Source: 2021 Bloomberg Finance L.P.

Asset Allocation

Investors continued to drive equity prices higher in the first quarter of 2021, responding to the "reopening" of economies around the world and massive monetary and fiscal stimulus. Well-diversified asset allocations rewarded investors who broadened exposure to companies that are leveraged most to economic expansion. Cyclically exposed companies and small companies produced returns far in excess of large growth companies, which have dominated for years. Bonds, on the other hand, produced losses for the quarter as rising interest rates pushed down bond prices. With yields still very low in absolute terms, there was little income to buffer the negative change in prices as yields rose. Real assets provided stable yields and diversification from bonds.

The S&P 500 Index returned a healthy 6.17% for the three-month period, far exceeding expectations coming into the year. These returns were dwarfed by mid- and small-sized companies, however, which returned 13.47% and 18.23%, respectively. Value-oriented shares also produced outsized gains of 11.29% compared to growth companies that returned only 1.05%. US-based companies also outperformed international firms as developed international markets produced an average of 4.17% and emerging markets produced a return of 2.34%. We still see great value in international equities that are trading at a significant discount to US markets, however. During the quarter, we added exposure to small international companies which offer attractive valuation and diversification potential, given their ties to local economic activity. The allocation to small-cap international stocks also increases diversification while limiting exposure to the large banks and Chinese tech stocks that dominate large-cap international markets.

Fixed income was a challenge during the first quarter. Most fixed income investors suffered losses and those with greater exposure to investment grade credit or duration suffered the most. Here again, diversification supported investors and buffered losses. Short-term treasury protected securities (TIPs) and high-yield bonds produced positive returns while most other asset classes lost money in the quarter. The benchmark Intermediate Government-Credit Index produced a return of -1.86%. Corporate bonds produced losses in the range of -0.56% for short-term bonds to -5.47% for intermediate-term credits. The Intermediate Corporate Bond Index returned -2.19%. Our exposure to preferred securities for yield lost -1.38%. We continue to look for exposure to improve yield levels and provide diversification away from traditional fixed income exposure that is vulnerable to rising interest rates.

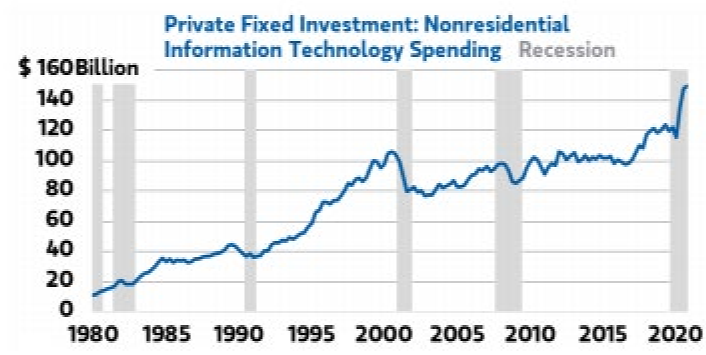
We did benefit from exposure to real estate and real assets, that remained fairly stable for the three-month period and produced returns in the range of 1.64% to 2.00%. Our exposure to gold detracted from returns, declining roughly 10% during the period.

Additional massive fiscal spending and vaccinations allowing economies to reopen should support risk assets in the coming months. While valuation levels remain stretched, economic growth numbers are likely to be at levels we have not seen in a generation. While the ride may get bumpy with possible inflation and uneven growth, we remain constructive on risk assets and look for any weakness to add to equity positions. As for bonds, we remain cautious and continue to seek ways to broaden diversification and improve yield levels. ■

US Equities

During the first quarter, US equity markets were propelled upward by the prospect of a potent economic recovery, accelerating COVID vaccinations, and continuing stimulus. Cyclical stocks, in particular, were driven higher by the idea that better-than-expected economic activity would asymmetrically benefit businesses that had been hard-hit by the pandemic, such as energy and airline companies. The Dow returned 7.7% compared to the Nasdaq up 2.8%, representing the largest divergence since the end of 2018. Similarly, the Russell 1000 Value outperformed its Growth counterpart in the quarter by 11.0%. The large-cap S&P 500 Index increased 6.2% overall, though underlying sector performance was disparate. Financial shares were up 15.4% while health care stocks moved only 2.7%. These returns represented the rotation out of many of the growth areas that were bolstered in 2020 by the coronavirus' shift in consumer patterns, such as those related to "from home" work, leisure, and medical care. In addition to favoring reopening-oriented stocks, year-to-date sector rotation has reflected the impact of higher interest rates. Growth companies' intrinsic worth is weighted towards future earnings and higher rates diminish the present value of those cash flows.

Sharp Jump in Corporate IT Spending Reflects Strong Digital Demand



Source: FRED, Bureau of Economic Analysis as of Dec. 31, 2020

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US Fixed Income

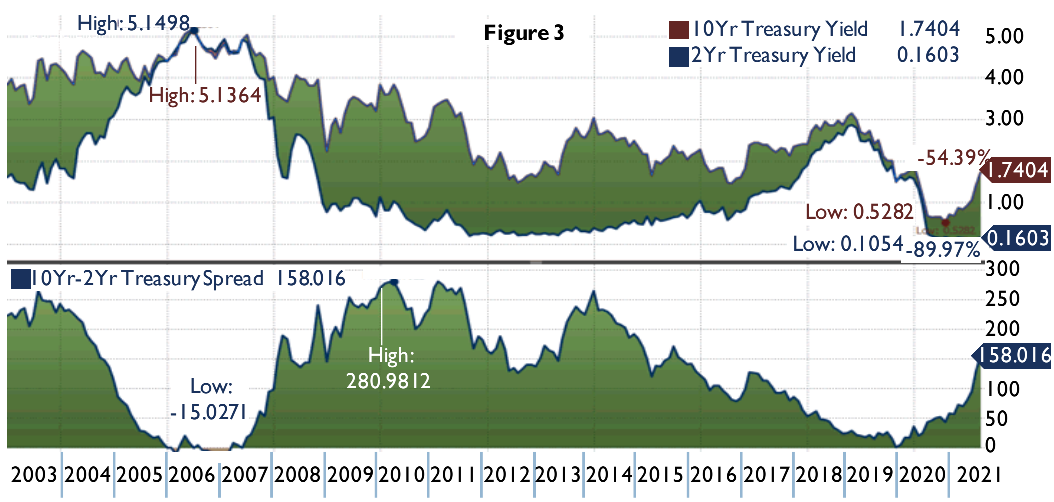
What a quarter it was for the global fixed income markets. The US 10-year government bond yield increased sharply, rising from 0.91% at the beginning of the quarter to 1.74% by the end of March. Because bond prices move inversely to bond yields, US government bonds had a negative return for the quarter: the representative US 10-year government bond declined by nearly 7% over this time period. In addition, because most other fixed income asset classes are keyed off of the US government bond, this meant that most fixed income sub-asset classes also had a negative return for the quarter. This occurred even as most sub-asset classes reflected increased optimism about US economic growth. Let us explain.

We saw optimism about US economic growth manifest in many portions of the fixed income market, including yield curve steepness, credit spreads, and inflation indicators. Looking at yield curve steepness, which is the difference between short-term interest rates (for example, the 2-year government bond) and long-term interest rates (for example, the 10-year government bond), 2021 started off with the 2-10 year spread at 0.79%. During the quarter, it doubled, to 1.58% (See Figure 3). At the same time, inflation expectations also continued to increase, with the 10Y TIPS breakeven increasing from 1.98% to 2.37%. (See Macro Outlook for a discussion of the TIPS breakeven). Both the steepening yield curve and the pickup in inflation expectations reflect investors' belief that US economic growth is set to accelerate.

Credit spreads narrowed, again reflecting investors' underlying assumption that the economy will continue to deliver good news. High-yield spreads, or the amount of extra yield above a Treasury yield that investors require to bear high yield credit risk, continued to decline, from 3.27% to 2.49%, while high-grade credit spreads also tightened, from 2.22% to 2.03%. Credit spreads narrow when investors are more comfortable that companies will be able to meet their ongoing debt obligations.

All this reflects anticipated growth in the US economy. One way we can examine this is to decompose the increase in the 10Y yield into the portion attributable to higher real yields, and the portion attributable to higher inflation expectations. When both real yields and inflation expectation rise, as they both did this quarter, it reflects expectations of higher economic growth. This is due in part to the recent stimulus plans enacted by the Federal Government, as well as additional proposed plans. In the short-to-intermediate term, these plans will accelerate US GDP growth. In the longer term, we remain concerned about the impact that higher fiscal spending may have on inflation (see Macro Outlook).

For the past year, we have been reorienting client portfolios away from what we viewed as deeply unattractive US government bonds, and into other, more attractive portions of the fixed income markets. This has included Treasury Inflation Protected Securities (TIPS), preferred securities, mortgage-backed securities, corporate bonds, high yield securities, and, more recently, real assets. We will continue to monitor various aspects of the fixed income markets as we seek the most appropriate investment opportunities for our clients. ■



US Equities, *Continued from Page 2*

Outside the US, equities did not fare as well with COVID infection surges in Europe, India, and other regions weighing on sentiment and stocks. Indeed, ongoing lockdowns overseas represent a significant risk for global equity markets going forward. Similarly, the US faces some unique risks because of its successful vaccination program. The combination of low interest rates and stock market euphoria has led to some reckless behavior in US equity markets. The rise and fall of "meme stocks" like GameStop and of highly leveraged private investors like Archegos are notable developments that remind us that quality and valuation still matter even when opportunities for growth abound.

Looking forward, we continue to take a balanced approach within equities by seeking exposure to cyclical investments that stand to gain from the rapid post-COVID rebound in global activity while being cognizant that the explosive rate of economic growth in the second half of 2021 could be relatively short-term. We maintain positions in companies that are well situated to experience long-term, secular growth based on themes such as higher capital spending on technology; increased penetration of automation and Internet-of-things; streamlining and reshoring supply chains; and renewable infrastructure spending. ■

F.L.Putnam is pleased to announce Robertson P. Breed, CFA®, Principal, and Portfolio Manager has once again been named to Barron's annual *Top Advisor* list.

Rob works from our Portland, ME office and has just celebrated 30 years with the firm.

He has been named to the prestigious list four times in recent years.

GLOBAL MARKET RETURNS

		Last 3 Months	Last 12 Months[1]	20-Year Annual Return[2]
US Equities	S&P 500 *(Large US Companies)*	6.17%	56.35%	8.47%
	S&P 400 *(Mid-size US Companies)*	13.47%	83.44%	10.61%
	S&P 600 *(Small US Companies)*	18.23%	95.26%	11.04%
	Russell 3000 *(All US Companies)*	6.34%	62.51%	8.84%
	Dow Jones US Real Estate Index	7.70%	34.90%	9.61%
International Equities	MSCI World Index ex-US *(Developed Markets)*	4.17%	46.51%	6.07%
	MSCI Emerging Markets *(Emerging Markets)*	2.34%	58.92%	10.37%
	MSCI World ex US Small Cap *(Developed Markets Small Companies)*	4.97%	65.75%	9.54%
Fixed Income	Bloomberg Barclays Intermediate US Govt/Credit TR	-1.86%	2.01%	4.03%
	Bloomberg Barclays US Corporate High Yield Total Return	0.85%	23.72%	7.54%
	Bloomberg Barclays Intermediate Corporate Total Return	-2.19%	8.54%	5.03%
	Bloomberg Barclays US Intermediate Treasury TR	-1.76%	-1.27%	3.50%
	Bloomberg Barclays US Treasury Inflation Notes TR	-1.47%	7.54%	5.08%
	Bloomberg Barclays US MBS Index Total Return Value Unhedged	-1.10%	-0.09%	4.24%
	Bloomberg Barclays Global Aggregate ex USD 10% Issuer Capped (Hedged)	-2.14%	1.85%	4.49%
	J.P. Morgan Emerging Bond Market Index Global Core	-5.28%	16.08%	8.24%
	Barclays Capital 5-Year Municipal Bond	-0.31%	5.07%	3.75%
Inflation	US CPI Urban Consumers Less Food and Energy NSA[4]	0.45%	1.28%	1.94%
Treasury Bill	US 3-Month Treasury Bill Index	0.02%	0.11%	1.46%

Source: Bloomberg Capital Markets

[1] Includes dividends for equity indices
[2] Annualized
[3] Inception Date 1/31/2001
[4] CPI data for time period is date ended 2/28/21

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