F.L.PUTNAM
INVESTMENT MANAGEMENT COMPANY

September 30, 2020

Quarterly Review

Macroeconomic Outlook

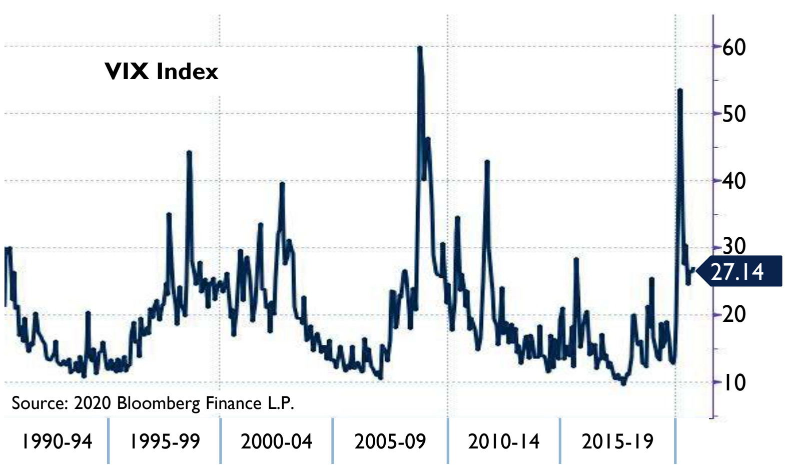
Economic data in the third quarter of 2020 rebounded following the collapse in economic activity in the first half of the year as the pandemic forced many businesses to close. The labor market also rebounded as measures of activity in manufacturing and services industries rose to levels consistent with economic expansion. By the end of the quarter, the unemployment rate had reversed 60% of the jump in the prior quarter as it dropped from 14.7% to 7.9%. Unfortunately, the unemployment rate remains well above the record lows of 3.5% experienced early this year, and the recovery is likely to be slower going forward as some job losses become permanent. In an environment of extreme economic uncertainty, financial markets remained almost exclusively focused on potential recovery from the pandemic during the quarter.

One reason financial markets seemed to take everything in stride and focus on recovery prospects during the quarter was the extraordinary fiscal and monetary stimulus implemented in the spring. The Federal Reserve (Fed), having pinned interest rates at zero and launched a massive asset purchase program, adjusted their inflation target to allow for higher short-term inflation and guided market participants to expect a zero-interest rate policy for at least the next three years. The palliative effects of this policy were obvious during the quarter – treasury yields were incredibly stable, while nearly everything with a materially higher yield appreciated. As the quarter wore on though, the Fed increased its call for politicians to enact additional fiscal stimulus alongside aggressive monetary policy to more effectively limit the economic fallout from the pandemic.

In the bitterly divided political climate of 2020, it is hard to believe that financial markets remained unfazed for so long as the political cycle shifted into high gear. Financially significant new policy proposals and meaningful shifts in polling data didn't seem to have much impact on financial markets, but politics finally seemed to demand markets' attention as negotiations broke down over continued fiscal stimulus. There seems to be a bipartisan consensus that additional stimulus is needed to fuel economic recovery, but significant disagreement remains on the scale and structure of any additional spending package. As we noted last quarter, state and municipal budgets are in particular need of support and avoiding permanent job losses by supporting businesses until they can fully reopen is critical to minimizing the economic impact of the pandemic. There is plenty of blame to go around, but it seems that the impending election is now interfering with effective economic policy. Our goal is always to avoid any political bias or commentary, but as we look forward to the fourth quarter, the election looms large as a potentially significant event for financial markets.

One measure of current expectations for financial market disruption around the election is the CBOE (Chicago Board Options Exchange) Volatility Index, also known as the "VIX." The 30-year chart of the VIX below clearly highlights periods of significant market turbulence including the collapse of Long Term Capital Management (1998), Enron (2002), Lehman Brothers (2008), Greece (2011) and the outbreak of Covid-19 (2020). It also illustrates that volatility levels have not returned to normal even as the stock market reached new highs. While the VIX has been cut in half since its peak earlier this year, it has to be cut in half again from these levels to reach levels consistent with more "normal" stable markets. The election and potential for extreme levels of political and economic uncertainty in the event of a contested election result is the likely cause of this unusual combination. There is also a futures market on the VIX, and futures prices currently reflect an expectation of volatility rising until November, and then gradually declining. Clearly, the market already expects a prolonged level of volatility in financial markets.

It's difficult to make sense of the markets gyrations this year, and perhaps most of all the recent highs in large US equities achieved in early September. In many ways, shifts in monetary and fiscal policy outlook have been critical catalysts this year. Longer term, we expect a traditional business cycle will drive financial markets as the creative destruction wrought by the pandemic pushes businesses to innovate and improve profitability and resiliency. While we expect 2020 to remain an incredible roller coaster ride of emotion, our focus remains squarely on this longer-term investment horizon where opportunities and risks are better defined. ■



US Equities

With a 9% return in the third quarter, the S&P500 came close to producing what investors have seen on an annual average basis over the life of the index. This follows a 20.5% return in the second quarter, which is consistent with the historical statistics we cited in our last newsletter and the playbook from the last recession recovery. At this point, the S&P500 has fully recovered recent losses, and is up over 5% this calendar year even after a recent correction. This performance is remarkable in the face of a pandemic-hobbled economy and a list of short-term risks facing the stock market. As expected, investors continue to question what appears to be a disconnect between the stock market and the economic reality on the ground.

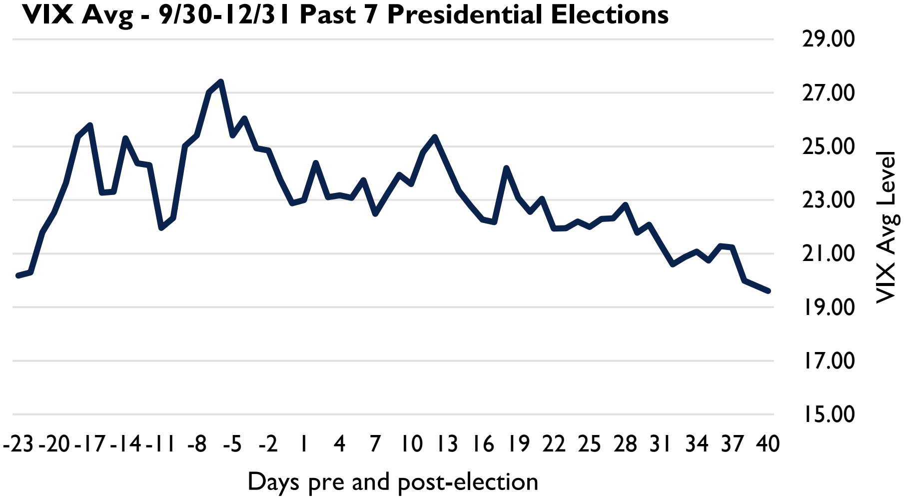
Our equity commentary last quarter covered three key reasons why the stock market often appears disconnected from the economy: a bounce from oversold levels driven by fear, significant fiscal and monetary support, and a forward-looking view. The main point was that the stock market is not the economy, but an index of present values of company cash flows. As disruptions and dislocations emerge, investor time horizons shorten, and values more closely reflect what is happening on the ground. As uncertainty slowly lifts, time horizons lengthen as investors put more weight on future earnings, and all else equal, values tend to rise. For long-term managers like us, bucketing risks and opportunities into short-term and long-term categories can help inform positioning.

Investors are rightly nervous about the short-term risks that flash daily on TV screens tuned to cable news, including a pick-up in Covid-19 infections, an inability to agree on the next round of fiscal stimulus, and a potentially contested presidential election, among others. To be clear, while the US and global economies have bounced from a lock-down low, the gains are not broad-based. Sections of the economy are struggling with dramatically lower demand and high levels of unemployment. A significant pick-up in Covid-19 infections could result in renewed economic weakness. Political deadlock on the next round of fiscal stimulus means many people and companies are now without support, adding additional economic pressure. Perhaps the most talked about risk, uncertainty around the coming US elections, is playing out in front of our eyes with incredible twists and turns.

While the level of uncertainty around the election outcomes is incredibly high and an increase in volatility is likely, we can be reasonably certain about one thing – we will at some point know who our president will be for the next four years (hopefully on Election Day, or shortly thereafter) and have clarity on the makeup of the House and the Senate. As discussed in the macro section of this newsletter, options markets point to high levels of volatility around the elections. This is not without historical precedent as depicted in the chart below. Over the life of the VIX Index, there have been seven presidential elections, and volatility increased by 20% on average over the month heading into the elections and then decreased by 8% over the following two months. The average VIX level over the fourth quarter around each of those election periods shows that whatever the outcome, volatility generally recedes post-election.

Once election uncertainty fades, the economic reality on the ground will likely shift focus back to the next stage of fiscal stimulus. Continued fiscal stimulus is necessary to bridge the gap until a Covid-19 vaccine is widely available, likely sometime in the first half of 2021. As long-term investors, we are paying close attention to the short-term risks, though our roadmap for portfolio construction is more focused on longer-term factors. As we look out 6 to 12 months, we believe short-term risks will fade, interest rates will remain at rock-bottom levels and the economy will slowly recover with monetary and most likely fiscal support. This longer-term outlook keeps us positive on the broad stock market, particularly relative to other asset classes. Within this longer-term positive view, we remain cautious shorter term, given elevated expectations embedded in current valuations and still extreme short-term economic and political uncertainty. In addition, we know we will have to navigate a number of longer-term risks such as geopolitical tension with China, supply-chain and wage-induced margin pressure, and possibly higher tax rates. Fortunately, these are risks we can assess across companies and industries as we think about the present value of the businesses in which we invest. This long-term focus on managing risks and seeking opportunity is where we believe we can add value and where we hope clients can try to focus as we work through the remainder of 2020. ■

VIX Avg - 9/30-12/31 Past 7 Presidential Elections

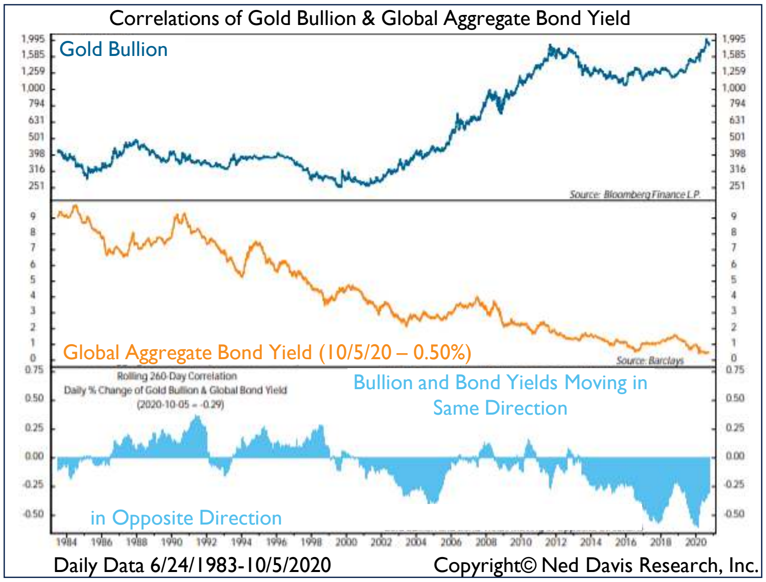


Check out our recent blog on the VIX Index at www.flputnam.com/blog

US Fixed Income

Performance within our fixed income universe was disparate during the third quarter. High yield led, returning over 4%, followed by 2-3% increases in inflation-protected securities and sub-1% gains in investment grade credit. US government bonds anchored the category with returns below 0.5% for the second consecutive quarter. As discussed in the macroeconomic outlook section, the Fed's unprecedented actions and messaging have had significant – and interrelated – impacts across asset classes. The ramifications of central bank policy for fixed income are multifaceted. They include:

- Treasury yields and bond market volatility hitting all-time lows
- Establishment of a reflationary stance driving inflation expectations higher
- Treasury interest rates sinking below the current inflation rate across maturities
- Driving $1.7 trillion in third quarter corporate borrowing based on low interest costs
- Record-setting fund flows into investment grade credit mutual funds, with additions in the April-through-September period exceeding any previous full year amount



Given this backdrop, we have continued to shift our fixed income exposures by adding to sub-asset classes that have historically provided some degree of hedge against both volatile equity markets and rising inflation, such as treasury inflation-protected securities (TIPS) and gold. As shown in the chart above, gold has been tightly tied to bond yields in recent years as monetary policy intervention has driven interest rates.

We also continue to view corporate debt as relatively attractive, as credit spreads remained steady during Q3 and are still above pre-Covid levels (though well below their March spike). Within the investment grade credit arena, a proliferation of BBB-rated bonds has persisted in recent quarters and an estimated $300 billion worth of investment-grade debt is at risk of downgrade into the high yield or "junk" category. Elevated aggregate leverage, slower-than-expected Covid-related business activity (i.e., cash flow) recovery and compressed risk premia will all be factors we monitor as we analyze our positioning within credit on an ongoing basis.

Asset Allocation

While economic trends in 2020 have defied the norm due to Covid-19, investment trends relating to asset allocation positioning continued to reward risk assets during the third quarter. Despite concerns relating to rising Covid-19 cases, an uneven economic recovery, and election concerns, investors stuck to the investment adage of "Don't fight the Fed" and may have even extended it to "Don't fight the government" to include fiscal spending as well.

During the third quarter, states began the process of restarting their local economies. Employment numbers improved and profit hopes rebounded. Stocks also continued the rally started during the second quarter, logging significant gains during the 3rd quarter. The S&P 500 Index produced a total return of 8.93% for the three months, pushing equities back into positive territory for the year at 5.57%. These above-average returns occurred despite an almost 10% correction from peak in early September.

US growth stocks continued to dominate, returning a whopping 13.2% for the three-month period. While US value stocks gained a respectable 5.59% for the same period, value was dwarfed by growth. Large companies also continued their relative outperformance over mid and small companies, which returned 5.88% and 4.93%, respectively. US large company stocks also continued to outperform developed international equities, as developed international returned 6.36% (MSCI World ex US). Emerging market stocks produced gains of 10.25%, reflecting investors' appetite toward risk assets.

We remain somewhat cautious toward equity markets shorter term. While monetary stimulus favors remaining fully positioned in equities as we currently are, we recognize that equity valuations reflect an economic and corporate profit recovery that leaves little room for disappointment. We have looked to add to more attractively valued securities, such as our small company and international exposure. That being said, we have yet to see the catalyst of accelerating (as opposed to merely rebounding from the shutdowns) global growth to attract investors away from the US growth stocks.

Continued ▸

◂ *Asset Allocation, Continued*

On the fixed income side, interest rates remained stable during the third quarter, and investors sought out yield in corporate bonds. Intermediate term credit and high yield produced returns of 1.3% and 4.05% respectively. As with equities, this reflected investors' increased appetite for risk assets. Within the government sector, TIPS returned over 4% for the quarter as inflation expectations increased with a corresponding drop in real yields (nominal interest rates less expected inflation) below zero percent.

We continued to move client portfolios toward corporate credit and away from treasuries, except for TIPS exposure. We expect interest rates to remain relatively flat and the economy to continue to stabilize, making corporate debt an attractive source of incremental yield. We added to high yield where appropriate for clients and shifted some funds out of fixed income and into gold to hedge against rising inflation. We still value fixed income as a buffer against volatile stock prices but realize that historically low interest rates will lessen this asset class's historic volatility benefit. ■

GLOBAL MARKET RETURNS		Last 3 Months	Last 12 Months[1]	20-Year Annual Return[2]
US Equities	S&P 500 *(Large US Companies)*	8.93%	15.15%	6.42%
	S&P 400 *(Mid-size US Companies)*	4.77%	-2.17%	7.90%
	S&P 600 *(Small US Companies)*	3.17%	-8.32%	8.33%
	Russell 3000 *(All US Companies)*	9.21%	14.99%	6.57%
	Dow Jones US Real Estate Index	2.07%	-11.39%	8.95%
International Equities	MSCI World Index ex-US *(Developed Markets)*	5.01%	0.63%	4.11%
	MSCI Emerging Markets *(Emerging Markets)*	9.70%	10.91%	8.17%
	MSCI World ex US Small Cap *(Developed Markets Small Companies)*	10.22%	7.28%	7.64%
Fixed Income	Bloomberg Barclays Intermediate US Govt/Credit TR	0.62%	6.32%	4.46%
	Bloomberg Barclays US Corporate High Yield Total Return	4.60%	3.25%	7.21%
	Bloomberg Barclays Intermediate Corporate Total Return	1.33%	6.78%	5.42%
	Bloomberg Barclays US Intermediate Treasury TR	0.19%	6.03%	3.95%
	Bloomberg Barclays US Treasury Inflation Notes TR	3.03%	10.08%	5.51%
	Bloomberg Barclays US MBS Index Total Return Value Unhedged	0.11%	4.36%	4.62%[3]
	Bloomberg Barclays Global Aggregate ex USD 10% Issuer Capped (Hedged)	4.48%	6.57%	4.93%
	J.P. Morgan Emerging Bond Market Index Global Core	2.32%	1.76%	8.45%
	Barclays Capital 5-Year Municipal Bond	1.28%	4.56%	4.02%
Inflation	US CPI Urban Consumers Less Food and Energy NSA[4]	1.11%	1.74%	1.98%
Treasury Bill	US 3-Month Treasury Bill Index	0.04%	1.17%	1.62%

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 8/31/2020

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