

Q2 | 2009

Capital Markets Outlook



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The opening “General themes” section of the Capital Markets Outlook reflects the thinking of Putnam’s senior market strategists, supported by the firm’s staff of economists and research analysts. The subsequent asset-class commentary distills the views of investment professionals in those specific areas.

General themes

- We recommend a gradual increase in risk profile.
- Emerging markets, particularly China, are showing leadership.
- Cash has been king, but is vulnerable to mounting risks of inflation.

PUTNAM’S OUTLOOK

Asset class	Underweight	Modest underweight	Slight underweight	Neutral	Slight overweight	Modest overweight	Overweight
EQUITY			•				
U.S. large cap			•				
U.S. small cap				•			
U.S. value				•			
U.S. growth				•			
Europe		•					
Japan				•			
Emerging markets					•		
FIXED INCOME						•	
U.S. government		•					
U.S. investment-grade corporates					•		
U.S. mortgage backed						•	
U.S. floating-rate bank loans					•		
U.S. high yield				•			
Non-U.S. developed country			•				
Emerging markets					•		
COMMODITIES			•				
CASH		•					
CURRENCY							
Dollar/yen							<i>Favor yen</i>
Dollar/euro							<i>Favor euro</i>
Dollar/pound							<i>Favor pound</i>

Investment themes from Putnam's market strategists

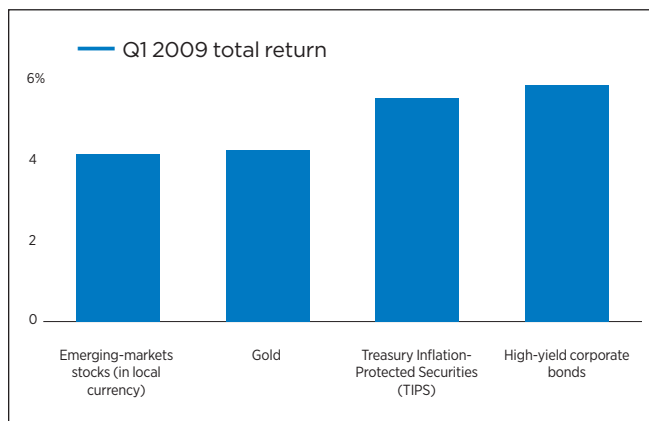
We recommend a gradual increase in risk profile.

For the past two years, our investment strategy has emphasized capital preservation. This objective was wise, though difficult to achieve, as the dual forces of a financial crisis and a global economic crisis have brought substantial harm to the value of nearly every kind of asset. However, for two reasons it appears to be time to change strategy: New profit opportunities have recently emerged, and the safety of cash, a vital component of a capital preservation strategy, now appears likely to be compromised by inflation.

Stock market performance in the first quarter revealed new opportunities: After falling by approximately 25% in the first 10 weeks of 2009, suddenly, with just three weeks left in the quarter, the S&P 500 reversed course. Although it was greeted skeptically by media pundits, to our eyes this rally differed from previous upswings during the bear market in several key respects.

First, government policy became more aggressive and somewhat better directed during the first quarter. The U.S. Federal Reserve (the Fed) signaled its intention to buy Treasury bonds outright, and, in the process, to expand its balance sheet dramatically. The Fed has effectively turned to the printing presses to thwart the fearsome debt deflation gripping the world economy. Also, the Financial Accounting

Figure 1. New profit opportunities emerged in several asset classes during the first quarter of 2009.



Source: Putnam. Emerging-markets stocks are represented by the MSCI Emerging Markets Index, gold by the S&P GSCI Gold Total Return Index, TIPS by the Barclays Capital Global Real U.S. TIPS Index, and high-yield bonds by the JPMorgan Developed High Yield Index.

Standards Board (FASB) offered some helpful relief, at least in the short term, on mark-to-market accounting rules. This change can help ease the pressure of non-performing mortgage-backed securities on bank balance sheets and the capital adequacy of financial institutions. Even the Treasury Department delivered some hopeful news, as the plan to help stabilize the banking system finally materialized. We note that the plan includes some genuinely useful programs, like the expansion of the Term Asset-Backed Securities Loan Facility (TALF) to include consumer and asset-backed loans, and the Public-Private Investment Program, which can help to clear some of the illiquid and distressed assets from bank balance sheets. Measures like these have been announced on a worldwide basis throughout the course of the first quarter. While time will tell whether the execution of these policies lives up to the optimism surrounding their announcements, we believe that these policies address the key problems of the financial system crisis.

Second, we are increasingly intrigued by the profit potential of companies surviving the downturn across a variety of industries. Whether through bankruptcies, mergers, or simply the fading potency of struggling competitors, market power is accruing to the survivors. Examples can be seen in the financials sector and in the mergers occurring in the technology and health-care sectors, as well as in the failures of retail and media companies. Surviving firms will be positioned to prosper when conditions stabilize.

Finally, we note that the most recent stock market rally differs from past bear market rallies in some key technical respects. This rally was preceded by clear indications of investor revulsion, as selling pressure left fewer stocks trading above their 200-day moving-average prices than has been the case in several decades. Such wholesale liquidations characterize market low points. Moreover, the breadth and force of the market recovery in March have more in common with major cyclical lows than with so-called "dead-cat bounces."

So there is reason, we think, to begin to strategize about making profits as the second quarter begins. We recognize that formidable challenges remain for the world economy, and we expect market volatility to remain high. Nevertheless, we encourage a careful increase in risk profiles.

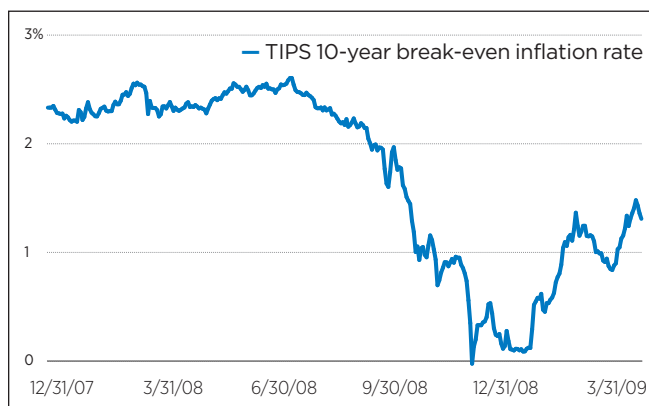
Emerging markets, particularly China, are showing leadership.

The recession has affected nearly all of the world's economies, but it originated in developed markets, where it was driven by excess debt and the collapse of financial institutions. Emerging markets have been less exposed to these aspects of the crisis and, as a result, equities and bonds in emerging markets have offered surprisingly defensive characteristics even during the worst weeks of the first quarter.

An example of this is China. The Chinese economy may be the first to emerge from the slowdown, as an increasing number of economic statistics point to stabilization. For example, purchasing managers' surveys for February showed improvement in business conditions for the third consecutive month. Critics may question the veracity and durability of these economic data, but the performance of the Chinese stock market is unambiguous: The Shenzhen 300 Index has risen by 37.8%. Latin American economies are also showing resilience, with Brazil the strongest of the group. Brazil continues to run a trade surplus, and its leading indicator, as tracked by the OECD, remains the highest among the major emerging economies. Like China, Brazil can boast a strong stock market as well, with the Bovespa Stock Index gaining 10.2% during the first quarter of 2009.

In total, for the quarter, emerging-market equities have smartly outperformed stocks in both the United States and developed international markets. This trend also argues for strength in sectors that respond to growth in these markets, notably energy, natural resources, and materials. We regard these areas as profit opportunities worthy of an increased allocation.

Figure 2. Inflation expectations rose significantly in the first quarter.



Source: Putnam. The TIPS 10-year break-even inflation rate shows the inflation rate at which the yield of TIPS would match the yield of Treasuries of the same maturity, and is a measure of future inflation expectations.

Cash has been king, but is vulnerable to mounting risks of inflation.

Policymakers clearly became more serious about fighting the debt deflation crisis during the first quarter, and the playbook seems quite clear now: Create inflation. Although deflationary forces are likely to maintain the upper hand for the next several months, policy aggressiveness will likely increase until we see inflation. Investors should understand that the consequences of these efforts cannot be quickly reversed. The more serious the problems become for the U.S. economy, including the burdens of state and local budgets and the auto industry, the greater the drain on federal finances. Over time, the sheer size of policy response may cast doubt on the value of the dollar as a store of value. A currency losing value represents inflation in its purest form.

We think that an increase in the overall inflation rate will help those struggling to service current debts. However, if the inflation rate grows too quickly, the purchasing power of cash will erode. Currently, by some estimates, investors hold \$12 trillion in cash equivalents.

Several investments merit consideration as inflation hedges. We will briefly describe three.

- **Treasury Inflation-Protected Securities (TIPS):** At the end of March, 10-year TIPS were priced to reflect a break-even inflation rate of 1.3%, and would outperform equivalent-maturity Treasury bonds should inflation increase higher than that level.
- **Gold:** Since all major currencies could be affected by inflationary policies, gold makes sense as a store of value that is safe from policy debasing.
- **Common stocks:** Since revenues and profits are measured in nominal dollars, stocks can appreciate in nominal terms even if corporate performance holds steady. We especially advocate companies whose results may even benefit from inflation, like gold mining, resource, and staples companies. With inflation posing a risk to cash, we believe a shift toward slightly more aggressive investment alternatives makes sense as the second quarter begins.

Asset class views

Equity

U.S. equity March's rally corresponds more closely to significant historic turning points for the stock market than to the numerous doomed upticks of the past year. In fact, this rally may end up erasing the year-to-date losses in the broad market averages. That was already nearly the case as April began, if financial stocks were excluded from the calculation. We expect greater strength ahead for financials, with recent policy measures likely to stabilize if not improve the health of key firms in the sector.

Even as market conditions become steadier, however, we do not anticipate that the major indexes will rebound to early 2008 levels any time soon. Economic softness, rising unemployment, and ongoing deleveraging will subdue stocks in the intermediate term. As the recovery continues, we expect leadership to shift to smaller-company stocks.

Non-U.S. equity European equities have been among the world's laggards, and we expect that pattern to persist. Asian markets, however, provided some relative cheer during the first quarter. With early evidence mounting that stimulus is working in China, we expect this market to lead Asia higher. In Europe, we prefer stocks in the United Kingdom over those of the continent.

We have turned more positive on emerging markets and now recommend an overweight exposure to them. Emerging markets' surprising resilience even in the worst weeks of the first quarter could help to identify likely candidates for leadership coming out of the bear market. Generally, we prefer Asian and Latin American equities to those of emerging Europe.

Fixed income

U.S. fixed income Our base case for the U.S. economy is continued recession through the end of the year, but with gradually diminishing severity. However, for non-government-backed securities, both technicals and valuations are now supportive. Treasury and Fed policy initiatives to restart credit markets are starting to bear fruit, as evidenced in slowly receding risk spreads and lessened trading volatility. Enormous sums of capital sit on the sidelines in cash or Treasuries, waiting for the right opportunities.

These conditions lead us to favor securitized credits — notably commercial mortgage-backed securities (CMBS), agency-issued collateralized mortgage obligations (CMOs), and residential MBS — that have senior claims to high-quality cash flows. In contrast, we are underweight corporates vulnerable to economic weakness and Treasuries, which we believe are overpriced.

Non-U.S. fixed income The deepening global recession has hit much of Asia and Europe particularly hard. A steep decline in world trade has battered the economies of export-driven manufacturing nations such as Japan, Taiwan, and South Korea, even as countries with leveraged financials and housing sectors, such as the United Kingdom, Ireland, Spain, and Australia, continue to suffer. However, in our multisector global portfolios we are starting to boost exposure to select emerging markets, such as Mexico and Poland.

Commodities

With the risk of monetary inflation growing, commodities deserve some consideration as an inflation hedge, but there are two important headwinds that will continue to constrain returns from investments in commodities. First, spot prices for most commodities have been extraordinarily volatile, reflecting, in our view, the interaction between wild demand swings and rigid supply conditions. Consequently, we will remain cautious on spot commodity prices until we see a meaningful improvement in the global economy.

Second, commodity investments often depend upon the futures markets for their implementation. The cost of maintaining commodity exposure through the futures market has been increasing, with the result that the total return of the Goldman Sachs Commodity Index was -10.6% in the first quarter despite rising spot prices. The current conditions in the futures market subdue our enthusiasm for commodity investments.

Currency

We have begun to build an overweight to the Australian dollar based on favorable interest rates, attractive valuation, and strong domestic equity performance. The euro is our greatest underweight, partly because we expect further rate cuts by the European Central Bank. The Canadian dollar is another underweight, driven by negative technical signals and concerns that the Royal Bank of Canada will initiate quantitative easing. Waning global risk aversion has made the “haven” currencies — the U.S. dollar, the Swiss franc, the yen — less appealing. The expansion in the supply of U.S. dollars built into the Fed’s new initiative to buy U.S. Treasuries is another reason to modestly underweight this currency. Worldwide policy stimulus, along with extreme overselling, has prompted us to move from a defensive position to mild bullishness in certain emerging-market currencies.

MARKET TRENDS

Index name (returns in U.S.\$)	Q109	12 months ended 3/31/09
EQUITIES		
Dow Jones Industrial Average	-12.42%	-35.90%
S&P 500 Index	-11.01	-38.09
Nasdaq Composite Index	-3.07	-32.93
Russell 2000 Index	-14.95	-37.50
MSCI World Index	-11.92	-42.58
MSCI EAFE Index	-13.94	-46.51
MSCI Europe Index	-14.56	-49.91
Tokyo TOPIX Index	-16.39	-34.31
FIXED INCOME		
Barclays Capital Aggregate Bond Index	0.12%	3.13%
Barclays Capital 10-Year Treasury Bellwether Index	-2.68	10.49
Barclays Capital Global Aggregate Bond Index ex-U.S. (unhedged)	-5.44	-9.70
JPMorgan Global High Yield Index	6.07	-20.05
JPMorgan Emerging Markets Global Diversified Index	3.84	-9.20

Data are historical. Past performance is not a guarantee of future results. Indexes are unmanaged and are not available for direct investment.

The Barclays Capital 10-year U.S. Treasury Bellwether Index is an unmanaged index of U.S. Treasury bonds with 10 years’ maturity.

The Barclays Capital Aggregate Bond Index is an unmanaged index used as a general measure of U.S. fixed-income securities.

The Barclays Capital Global Aggregate Bond Index ex-U.S. (unhedged) is an unmanaged index used as a broad measure of the investment-grade bond index, excluding U.S. securities.

The Barclays Capital Global Real U.S. TIPS Index is an unmanaged market index made up of U.S. Treasury Inflation-Protected securities.

The Bovespa Stock Index is a total return index weighted by trading volume and comprised of the most liquid stocks traded on the Sao Paulo Stock Exchange.

The Dow Jones Industrial Average Index (DJIA) is an unmanaged index composed of 30 blue-chip stocks whose one binding similarity is their hugeness — each has sales per year that exceed \$7 billion. The DJIA has been price-weighted since its inception on May 26, 1896, reflects large-cap companies representative of U.S. industry, and historically has moved in tandem with other major market indexes such as the S&P 500.

The Goldman Sachs Commodity Index is a composite index of commodity sector returns that represents a broadly diversified, unleveraged, long-only position in commodity futures.

The JPMorgan (formerly Chase) Global High Yield Index is an unmanaged index that is designed to mirror the investable universe of the U.S. dollar global high-yield corporate debt market, including domestic (U.S.) and international (non-U.S.) issues. International issues are composed of both developed and emerging markets.

The JPMorgan Emerging Markets Global Diversified Index is composed of U.S. dollar-denominated Brady bonds, eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

The Morgan Stanley Capital International (MSCI) EAFE Index is an unmanaged list of equity securities from Europe and Australasia, with all values expressed in U.S. dollars.

The Morgan Stanley Capital International (MSCI) Europe Index is an unmanaged list of equity securities originating in any of 15 European countries, with all values expressed in U.S. dollars.

The Morgan Stanley Capital International (MSCI) World Index is an unmanaged list of securities from developed and emerging markets, with all values expressed in U.S. dollars.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The Nasdaq Composite Index is a widely recognized, market-capitalization-weighted index that is designed to represent the performance of NASDAQ securities and includes over 3,000 stocks.

The Russell 2000 Index is an unmanaged list of common stocks that is frequently used as a general performance measure of U.S. stocks of small and/or midsize companies.

The S&P 500 Index is an unmanaged list of common stocks that is frequently used as a general measure of U.S. stock market performance.

The S&P GSCI Gold total Return Index is a total return index comprised of active and liquid gold futures markets and is calculated primarily on a world production weighted basis.

The Shenzhen 300 Index is a cap-weighted index that tracks the daily price performance of the 300 most representative class A share stocks listed on the Shanghai or Shenzhen Stock Exchanges.

The Tokyo Stock Exchange Index (TOPIX) is a market-capitalization-weighted index of over 1,100 stocks traded in the Japanese market.

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