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Capital Markets Outlook

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:

- Our main themes from January’s edition of *Capital Markets Outlook* are worth repeating.
- Subprime lending woes aren’t yet over.
- The Fed now has room to lower interest rates if necessary to help ward off recession.

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			•				
CASH					•		
CURRENCY							
Dollar/yen							Favor yen
Dollar/euro							Favor euro
Dollar/pound							Favor pound

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Investment themes from Putnam's market strategists

Our main themes from January's issue are worth repeating.

In the last edition of *Capital Markets Outlook*, we made three key points: that the favorable conditions that propelled stock markets in 2006 still prevailed and were likely to produce further gains; that markets were nevertheless vulnerable to sudden corrections and rising volatility; and that the influence of private capital on securities markets was rapidly growing along with its magnitude. As it turned out, events in the first quarter vividly illustrated each of these points.

First, markets posted respectable returns for the period, particularly outside the United States. The forces fueling the rally of the past four years remained in place: steady and broad-based worldwide economic growth; bountiful corporate profits; ample liquidity; low interest rates; and an accelerating wave of buybacks and buyouts that is shrinking the available supply of publicly traded stocks.

But events during the quarter also demonstrated the sensitivity of today's markets to adverse developments. The sharp dip of late February, and the heightened volatility since then, testifies to investors' current skittishness. Troubles in the subprime mortgage markets have captured most of the headlines, but bobbles in the yen carry trade and in emerging markets have also occurred.

Meanwhile, private equity has played a stabilizing role in the still-unfolding subprime saga. Once the weaker subprime lenders started to falter, private investors quickly swooped in opportunistically to capture value — bolstering certain lenders (and, by extension, the broader markets) with fresh capital. This is only one of many cases in which private capital has provided stability and support to public securities markets.

These three ideas are worth reviewing as we begin the second quarter. As we advised three months ago, even bullish investors need to manage risks, first and foremost through diversification, but also by shifting capital to securities with larger market capitalizations and greater liquidity.

Subprime lending woes aren't yet over.

Investors seemed to overcome their anxiety over subprime lending in March, when capital infusions suggested a floor to the weakness of several key companies in this industry. We caution, however, that some concern continues to be warranted.

The oft-repeated cycle of lax lending practices in good times leading to defaults and losses when conditions sour is once again playing out. In the last years of the housing boom, a rising share of mortgage loans were made on loose terms, with little or no documentation, little or no money down, and/or with low “teaser” interest rates for first-time buyers. Such practices became pervasive. According to a study by Credit Suisse, nearly half of *all* U.S. mortgages originated in 2006 to finance a home purchase — not just those made to subprime borrowers — were loans with little or no credit documentation, so-called “no-doc” or “low-doc” loans.

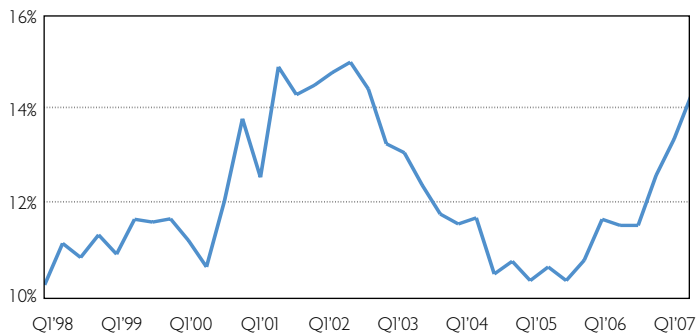
The companies originating subprime loans usually packaged them into pools and sold them to other investors, typically with recourse to the originator in the first year. In some cases, loans were made that were unlikely to be repaid from borrowers' cash flow, but yet were paid — for a while — thanks to ever-rising house prices that allowed buyers to raise cash by selling or refinancing. But now that prices have leveled off and in some areas declined, the day of reckoning has arrived.

Some observers have too readily dismissed the potential impact of subprime woes on overall credit markets and housing prices. Yet we expect further fallout for financial markets, and perhaps for the broader economy.

To date more than 40 mortgage originators have failed. Holders of defaulted loans created by these companies will have no recourse to the original lender, and are likely to suffer a nearly total loss of value. The impact of those losses will reverberate up the chain of securities structured as pools of mortgages, such as mortgage-backed securities and collateralized debt obligations. That is because these securities are internally segmented by level of risk. Deterioration in the highest-risk segments (where subprime loans are concentrated) may thus trigger downgrades of entire securities by the credit-rating agencies. This may in turn lead to forced liquidations, greater market volatility, and a broad upward re-pricing of credit risk.

RISING MORTGAGE DELINQUENCIES RATTLE EQUITY AND CREDIT MARKETS

Delinquency rate for U.S. subprime residential loans, 1998 through first quarter 2007



Quarterly data. Sources: Mortgage Bankers Association and First American Loan Advisors, via Merrill Lynch.

Because we anticipate further repercussions from subprime weakness, we continue to advise defensive positioning with respect to credit risk, and a careful review of financial-sector holdings for hidden sensitivities to these issues.

Troubles in the subprime market may depress home prices in all tiers of residential real estate, not just those purchased through subprime loans. It is true that these make up only a small share, about 8%, of U.S. residential mortgages. But in freely traded markets, asset prices are set at the margin. The removal of the main fuel for the marginally creditworthy to buy homes could act to unwind the last leg of the past decade's enormous house-price appreciation, particularly at a time when unsold inventories are at elevated levels. Should this occur, consumer confidence and demand could suffer, dampening the overall U.S. economy.

Yet the potential for a sharp dip in house prices is somewhat mitigated by the simple fact that most homeowners are able to postpone or avoid selling if they can't get their target price. And although debt markets are likely to experience further distress and volatility, the widespread adoption by professional investors of risk-management tools such as credit-default insurance, swaps, and derivatives should do much to spread risk and cushion the impact of higher subprime defaults and losses. Lastly, as discussed in the next section, the Federal Reserve Board has some flexibility to help buoy the economy with monetary stimulus if needed.

The Fed now has room to lower interest rates if necessary to help ward off recession.

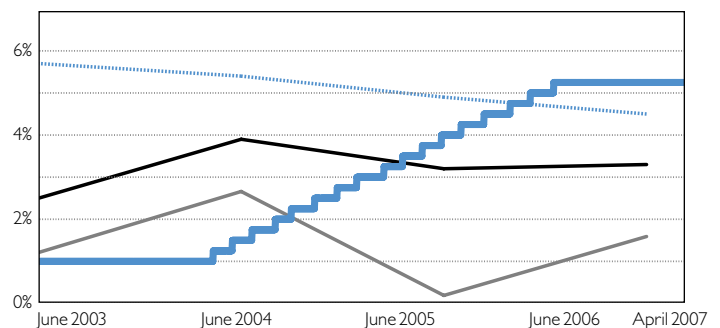
Markets cheered on March 21, when the Fed not only held rates steady but omitted language from its closely watched accompanying statement that in earlier statements had implied a bias toward raising interest rates. Less widely noted was the main reason for that shift: the central bank's concerns about the risk of economic weakening, mainly as a result of softness in housing.

Let us take a moment, however, to recognize what the Fed has achieved in the past three years: It has executed a sizeable and sustained program of interest-rate hikes without derailing the economy. This is no mean feat. Most economic historians believe that Fed monetary tightening did much to deepen the Great Depression of the 1930s and to help trigger the last two severe U.S. recessions, in 1973–75 and 1981–82.

Three years ago, short-term interest rates hovered near zero. Today they are much higher, making it possible for the Fed to stimulate the economy if necessary by lowering rates. At this point we think this is unlikely to happen in the next several months. But if it does, we would advocate an increased exposure to interest-rate-sensitive bonds.

THE ECONOMY REMAINS STEADY AMID FED TIGHTENING

— Fed funds rate
 - - - - - Unemployment
 — Real U.S. GDP
 — Real per-capita disposable income



Sources: Fed funds — Federal Reserve Bank; U.S. gross domestic product (GDP) and disposable income — U.S. Bureau of Economic Analysis; unemployment — U.S. Bureau of Labor Statistics. GDP and disposable income are expressed in constant 2000 dollars.

Asset class views

Equity

U.S. equity U.S. equity markets advanced in March, ultimately recovering from a rocky start to the month. As a result, the first quarter ended with gains across many of the broad market indexes. Yet these overall gains obscured notable volatility in certain sectors. Financial stocks, for example, suffered in March as investors wrestled with the ramifications of rising defaults and drastic reductions in credit availability across the subprime lending business. We expect such volatility to remain an issue in the months ahead, as the subprime story continues to unfold and as first-quarter earnings reports are likely to confirm that profit growth has peaked.

Non-U.S. equity Although the Japanese market has lagged in recent weeks, stocks across the rest of the Pacific Rim and Europe have been performing quite well. We anticipate that Japanese shares will recover from their weakness in March; the country's economic recovery seems on track, and the Bank of Japan is unlikely to raise interest rates too aggressively. Global economic momentum has become increasingly independent of the pace of U.S. growth, which contributes to our ongoing bullishness with regard to non-U.S. markets. We also continue to favor developed over emerging markets because of the likelihood of heightened volatility in the months ahead.

Fixed income

U.S. fixed income At this writing, markets reflect expectations of a 0.25% cut in the fed funds rate by year-end. We think this is too optimistic. Global economic growth remains strong, providing a buoyantly supportive environment for U.S. economic activity. Meanwhile, inflation has persistently hovered above the Fed's target ceiling. Absent the emergence of a stumbling block to the domestic economy such as a severe housing-related credit crunch, we believe U.S. rates will likely remain level in coming months, and are as likely to end the year above as below today's levels.

Accordingly, we continue to position our portfolios conservatively. To minimize exposure to rising rates, we are keeping duration short; to protect against potential market-adverse events, such as a sudden spike in inflation or greater fallout from subprime lending woes,

we favor Treasuries versus credit sectors. Yield premiums of certain higher-risk market areas such as emerging markets widened modestly in February and early March in reaction to subprime worries, but have since reverted to narrow levels that in our view do not adequately compensate investors for their extra risk. Among sectors, we continue to underweight pass-through mortgage-backed securities (MBS) and corporate issues, and overweight short-maturity, high-quality structured credit securities such as commercial MBS.

Non-U.S. fixed income Amid a generally robust global economic climate, monetary policy outside the United States seems set to continue tightening. Most notably, the economies of Continental Europe and Japan are accelerating, so their central banks are likely to keep raising rates. Thus we remain underweight in duration and credit risk in our international and global portfolios as well as in U.S. portfolios. We continue to be cautious on emerging markets; they have rebounded from earlier weakness and in our view are once again fully priced.

Currency

With the resurgence of the global "carry trade," in which investors borrow money in countries with low interest rates and invest it in countries offering higher yields, our models are now positive on the Australian dollar and negative on the Japanese yen and the U.S. dollar. We favor the Australian dollar based on strong local and global growth, rising interest-rate momentum, and lower worldwide risk aversion. Conversely, we are bearish on the yen due to Japan's low interest rates, relatively weak economic growth, and net capital outflows, and on the U.S. dollar because of shrinking U.S. interest-rate premiums versus other major nations and a lagging equity market. We are moderately overweight the euro given the eurozone's relatively attractive economic growth and interest rates.

MARKET TRENDS

Index name (returns in US\$)	12 months ended	
	Q107	3/31/07
EQUITIES		
Dow Jones Industrial Average	-0.3%	13.7%
S&P 500 Index	0.6	11.8
Nasdaq Composite Index	0.3	3.5
Russell 2000 Index	2.0	5.9
MSCI World Index	2.5	15.4
MSCI EAFE Index	4.1	20.2
MSCI Europe Index	3.9	25.4
Tokyo Topix Index	3.5	0.0
FIXED INCOME		
Lehman Aggregate Bond Index	1.5%	6.6%
Lehman 10-Year U.S. Treasury Bellwether	1.5	5.8
Lehman Global Aggregate Index Ex-U.S. (unhedged)	1.2	9.1
JPMorgan Global High Yield Index	3.0	11.7
JPMorgan Emerging Markets Global Diversified Index	2.4	10.6

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

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 the U.S. industry, and historically has moved in tandem with other major market indexes such as the S&P 500.

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 **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 **Russell 2000 Growth Index** is composed of those Russell 2000 securities with a greater-than-average growth orientation.

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 **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) Emerging Markets Free Index** is an unmanaged index of securities from emerging markets available to non-domestic investors.

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

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

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

The **Lehman 10-year U.S Treasury Bellwether Index** is an unmanaged index of U.S. Treasury bonds with 10 years maturity.

The **Lehman Global Aggregate Index Ex-U.S. (unhedged)** is an unmanaged index used as a broad measure of the international-grade bond index, excluding U.S. securities.

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 U.S. dollar-denominated Brady bonds, eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

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