Q1 2023 | Putnam Income Fund Q&A

Bonds rally for second consecutive quarter

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Positioning in investment-grade corporate credit and collateralized loan obligations augmented returns, while the duration strategy weighed on results.

We believe the Fed is nearing the end of its monetary tightening cycle, but volatility may persist in fixed income markets.

We continue to position the fund at the lower end of the risk spectrum, with lower spread duration across credit sectors.

How were market conditions in the first quarter?

Fixed income markets delivered their second consecutive quarter of positive performance amid considerable market volatility. After a strong start in January, markets reversed course in February. This was due to fears that the Federal Reserve might increase interest rates higher than anticipated following the release of rising inflation data and continued labor market tightness in January.

Volatility rose considerably in March, as markets sold off due to a few high-profile bank failures. Quick actions by global central banks to minimize systemic risk, including shoring up bank deposits, prevented contagion across the global financial system. While the turmoil stirred recession concerns, it also led to changing expectations about the future path of Fed monetary policy. Investors hoped that a continued economic slowdown might give the Fed room to ease monetary policy.

With signs that inflation was moderating but still high, the Fed announced 0.25% interest-rate increases on February 1 and March 2. Yields peaked in early March ahead of Fed Chair Jerome Powell's testimony before Congress about the central bank's plans for future rate hikes but ended the quarter lower than they were at the start of the year.

Credit spreads widened during the quarter. [Credit spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity U.S. Treasuries. Bond prices rise as yield spreads tighten and decline as spreads widen.] The Bloomberg U.S. Corporate Index returned 3.50%, while the JPMorgan Developed High Yield Index returned 3.83%.

Not FDIC insured | May lose value | No bank guarantee

How did the fund perform for the three months ended March 31, 2023?

The fund's class Y shares returned 1.84%, underperforming the benchmark Bloomberg U.S. Aggregate Bond Index, which returned 2.96%.

Which strategies and holdings had the biggest influence on fund performance relative to the benchmark?

The fund's duration positioning was the largest driver of underperformance, thanks to positioning in January. Treasury rates rallied significantly across most of the yield curve in January, with the yield of the 10-year note ending the month 37 basis points lower than where it started the month. As rates rallied, interest-rate volatility also fell, weighing on our term structure positioning. Interest-rate volatility picked up later in the period, partially offsetting underperformance in January.

Prepayment risk strategies also weighed on relative returns. The fund maintained a long mortgage basis position. Mortgage basis is a strategy that seeks to exploit the yield differential between current-coupon, 30-year agency-pass-throughs and 30-year U.S. Treasuries. This positioning hampered returns as the mortgage basis experienced significant volatility amid the fallout from Silicon Valley Bank and Signature Bank and the expectation that the FDIC would liquidate the portfolios.

Mortgage credit strategies weighed modestly on relative returns. Exposure to mezzanine commercial mortgage-backed security cash bonds detracted from returns, as poor technicals and negative headlines surrounding office properties weighed on returns. However, positioning in non-agency residential mortgage-backed securities [RMBS], particularly exposure to credit risk transfer securities, partially offset underperformance.

Within corporate credit strategies, positioning in investment-grade corporate credit and exposure to collateralized loan obligations [CLOs] augmented relative returns. The portfolio is positioned with a shorter spread duration relative to the benchmark, which was beneficial amid investment-grade corporate credit spread volatility. Stabilizing risk markets and demand for high-grade, floating-rate assets in January and February pushed CLO spreads tighter, benefiting our AAA and AA holdings.

What is the team's near-term outlook?

We believe the central bank is nearing the end of its monetary tightening cycle but will move cautiously. However, volatility may persist in fixed income markets, in our view, as high interest rates will weigh on corporate balance sheets while financial markets digest the probability of a recession. With this as the case, we continue to position the fund at the lower end of the risk spectrum, with lower spread duration across credit sectors.

What are your current views on the sectors in which the fund invests?

We have a cautious outlook on U.S. corporate credit and expect volatility to remain elevated. Macro forces of bank-related volatility, high inflation, central bank tightening, slowing growth, and geopolitical impacts on energy remain considerable headwinds for both fundamentals and market technicals. However, in our view, we are likely nearing a point where the interest-rate hiking cycle will start to wind down, especially given the recent bank turmoil.

We believe corporate fundamentals have likely peaked for this cycle, as higher rates and slower growth weigh on financial conditions. Market technicals have been improving, although we expect them to remain tethered to investors' risk appetite in the near term. Valuations are somewhat more attractive than they were at the beginning of 2023, but credit spreads are not reflective of potentially recessionary conditions in the future, in our view. Risks to our outlook include further volatility in the banking industry, policy missteps from global central banks, a more severe slowdown or recession, and heightened geopolitical tension.

We believe overall fundamentals for commercial real estate [CRE] will be mixed. Recent turmoil in the regional banking sector and negative headlines surrounding office properties have added to concerns about the CRE market, with borrowers facing the rising cost of capital and a tighter credit channel. But we believe these additional risks combined with a heightened risk of recession are largely priced into the market. As such, current spread levels offer strong opportunities for security selection, in our view.

We expect home prices will decline this year and will be followed by tepid growth in subsequent years due to continued affordability pressures on demand and a gradual increase in supply. Market spreads widened across the capital stack in 2022 amid broader market volatility. Given our macroeconomic and housing outlook, we favor bonds higher in the capital stack with shorter spread duration as well as bonds with seasoned collateral that can withstand home price declines. [The capital stack is the structure of debt and equity, and it defines ownership rights, and their order of priority, to income and profits.] We find value in non-qualified mortgage, reperforming loan, and single-family rental bonds rated AAA and A where spreads are currently very wide in a historical context. We also find value in legacy RMBS and credit risk transfer bonds backed by seasoned collateral.

In our view, many prepayment-sensitive securities offer an attractive risk-adjusted return at current price levels and significant upside potential if prepayment speeds subside further. Given repricing across the market in 2022, our selection efforts span a variety of collateral types. We also are finding value in the mortgage basis strategy. At quarter-end, we were near neutral in our mortgage basis position. We expect opportunities will arise to take a long position, given declining rate volatility, improving technicals, and a receding housing market. These conditions are likely to be tailwinds for the agency mortgage-backed securities sector, in our view.

Putnam Income Fund (PNCYX)

Annualized total return performance as of 3/31/23

	Class Y shares Inception 6/16/94	**Bloomberg U.S. Aggregate Bond Index**
Last quarter	1.84%	2.96%
1 year	–6.69	–4.78
3 years	–2.56	–2.77
5 years	0.60	0.91
10 years	1.55	1.36
Life of fund	7.01	—

Total expense ratio: 0.60%

What you pay: 0.50%

Source: Bloomberg Index Services Limited.

Returns for periods of less than one year are not annualized.

"What you pay" amount reflects Putnam Management's decision to contractually limit expenses through 2/28/24.

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 the historical performance of class A shares (inception 11/1/54), which have not been adjusted for the lower expenses; had they, returns would have been higher. For a portion of the periods, this fund 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 U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed income securities. The Bloomberg U.S. Corporate Investment Grade Index is an unmanaged index of U.S. corporate investment-grade fixed income securities. The JPMorgan Developed High Yield Index is an unmanaged index of high-yield fixed income securities issued in developed countries. You cannot invest directly in an index.

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Diversification does not guarantee a profit or ensure against loss. It is possible to lose money in a diversified portfolio.

For informational purposes only. Not an investment recommendation.

The opinions expressed here are those of the portfolio managers as of March 31, 2023, and are subject to change with market conditions. Market forecasts cannot be guaranteed and are not to be construed as investment advice.

Consider these risks before investing: Funds that invest in government securities are not guaranteed. Mortgage-backed investments, unlike traditional debt investments, are also subject to prepayment risk, which means that they may increase in value less than other bonds when interest rates decline and decline in value more than other bonds when interest rates rise. The fund may have to invest the proceeds from prepaid investments in other investments with less attractive terms and yields.

The fund's investments in mortgage-backed securities and asset-backed securities, and in certain other securities and derivatives, may be or become illiquid. The fund's exposure to mortgage-backed securities may make the fund's net asset value more susceptible to economic, market, political, and other developments affecting the housing or real estate markets and the servicing of mortgage loans secured by real estate properties. The fund currently has significant investment exposure to commercial mortgage-backed securities. 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. Risks associated with derivatives include increased investment exposure (which may be considered leverage) and, in the case of over-the-counter instruments, the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. Unlike bonds, funds that invest in bonds have fees and expenses. The value of investments in the fund's portfolio may fall or fail to rise over 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. 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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Request a prospectus or summary prospectus from your financial representative or by calling 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

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