# Fund rises as benchmark retreats amid sticky inflation


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***The fund's class Y shares delivered positive returns in the quarter even as headwinds developed for fixed income markets.***

***Optimism for interest-rate cuts gradually waned as economic data showed continuing strength.***

***We continue to pursue mortgage and credit strategies, alert to the risks of tight valuations and challenges in commercial real estate.***



## How were market conditions during the first quarter?

The U.S. economy continued to grow at a strong pace with a resilient job market and stable consumer spending. Gross domestic product (GDP) increased by 3.4% in the fourth quarter of 2023, exceeding market expectations. The gain came primarily from increased consumer spending (both goods and services) and exports. Data released in the first quarter of 2024 saw non-farm payrolls growing by a monthly average of 265,000, higher than the 2023 monthly average of 251,000. The unemployment rate ticked up to 3.9% at the end of February, and year-over-year (Y/Y) average hourly earnings remained around 4.3%. Although there was a dip in January due to severe weather, consumer spending increased over the period in both nominal and real terms. Consumer sentiment trended higher, reaching its highest level since summer 2021. Increases in headline and core Consumer Price Index (CPI) data moderated with the Y/Y change in headline CPI down to 3.2% while core CPI reached 3.8%. A drop of only 0.1% from its December reading signaled that inflation remains sticky.

On the policy front, the U.S. Federal Reserve kept its guidance for three rate cuts in 2024, unchanged from the December 2023 projection. However, there was a level of disparity in committee members' projections toward the future path: Nine participants projected just two or fewer cuts throughout this year versus 10 who foresee three or more cuts will be required. It would take just one Fed member to reduce their expectation for the median number of cuts to fall. Additionally, in the Summary of Economic Projections, the median number of 2025 cuts was reduced by one when compared with the Fed's December 2023 projections, further demonstrating the path of the federal funds rate has become more uncertain. Fed comments combined with strong data pushed market participants to pare back their expectation of 2024 rate cuts from six to three. With that, the yield on the 10-year Treasury ended the period 32 basis points (bps) higher at 4.20%.

Amid this backdrop, risk assets performed well, with the S&P 500 Index rising more than 10% in the first quarter of 2024. Meanwhile, the Bloomberg U.S. Aggregate Bond Index produced a negative total return of –0.78%, while excess returns were +0.23% as spreads moved tighter. Global fixed income also produced negative total returns, with the Bloomberg Global Aggregate Bond Index ending the month down –2.07%, while excess returns were 0.37%.

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

Mortgage credit exposure was the largest contributor to relative returns. CMBS led the way in terms of contribution to relative returns. The improved liquidity seen in recent weeks and months continued as demand remained strong and supply was well absorbed despite changes to expectations for the timing and number of rate cuts. RMBS benefited from the broader market rally, and the general tone across residential credit was strong with good demand across the capital stack.

Prepayment risk strategies broadly performed well. Seasoned agency IO and IIO bonds continued to carry well, and spreads tightened modestly during the quarter as expectations that rates would be "higher-for-longer" increased.

Last, corporate credit strategies were a tailwind to relative returns. Positioning in investment-grade (IG) corporate credit was the primary driver. IG corporate spreads, represented by the Bloomberg U.S. Corporate Index, ended the period 9 bps tighter at 90 bps.

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

Healthy market technicals, a persistent bid from insurance and pension funds, and supportive macroeconomic data have kept IG spread volatility low. While markets have recently repriced the timing and magnitude of 2024 rate cuts, expectations for a Fed pivot in 2024 are pervasive, and valuations are trending at their year-to-date tights. While dovish central bank commentary has reduced the probability of a near-term recession, challenges in commercial real estate and regional banks remain. Additionally, lower-end consumer stress has increased with the depletion of pandemic-era savings and cuts to government stimulus programs. With that backdrop, we continue to seek out and find pockets of idiosyncratic opportunity but remain cautious on overall valuations. Fundamentals have been resilient, with fourth-quarter results largely better than feared. Gross and net leverage were largely unchanged, but Y/Y earnings were lower and interest-coverage metrics deteriorated modestly.

The broad commercial real estate (CRE) market continues to face meaningful headwinds and increased risks including higher-for-longer interest rates, tighter credit conditions, more conservative cash flow projections, and concerns surrounding the office sector. However, signs of optimism include payoff and refinancing rates that have surprised to the upside and the reduced probability of a widespread regional bank funding crisis. Interest rates will continue to be the predominant factor driving CRE fundamental performance. The office sector remains under the most pressure and faces uncertainty with return-to-office trends and lack of demand for older, outdated properties. Commercial loan modifications and extensions should moderate the pressure of near-term maturities, but delinquencies and liquidations are expected to increase on weaker loans that lack strong sponsorship. There is also potential for more negative headlines from CRE investors, such as banks and insurance companies, as they continue to go through their loss reserves and mark-to-market exercises. Despite potential challenges, we believe that fundamentally strong CRE sectors are likely to receive support from a substantial amount of investor capital sitting on the sideline, which could contain further price declines. We believe some conduit mezzanine tranches offer relative value to corporate credit at current levels given the notable spread widening in 2023. While some parts of the market are now at fair value to slightly rich after the rally at the start of 2024, attractive opportunities for security selection remain available but require rigorous loan-level analysis.

U.S. homeowner balance sheets remain well positioned, supported by locked-in home price appreciation, lower household leverage, strong underwriting standards, and a healthy labor market. A lack of inventory and steady household formation should keep the housing supply and demand mismatch supportive of home prices. Unless inflation cools significantly, wage pressure is likely to increase residential construction costs, resulting in lower new inventory supply. We expect home prices will rise modestly in 2024, but regional variances are likely to persist. Given a positive technical backdrop and our expectations of a soft landing scenario, we anticipate spreads will tighten marginally for the RMBS sector as a whole. At current levels, we favor opportunities near the top of the capital stack, such as recent-issue non-qualified mortgage (non-QM) bonds with higher coupons, where we think spreads are still wide compared with historical levels. In addition, we find value in senior legacy RMBS bonds that have not rallied as significantly as other RMBS markets and stand to benefit from a normalization in long-term rates.

Prepayment speeds remain historically low, and we expect they will remain muted within the range of the 4%–8% constant prepayment rate throughout the year as turnover fluctuates with seasonal housing activity. We remain cognizant of prepayments picking up in higher coupons that display higher negative convexity relative to the overall universe. We do not expect a material increase in involuntary prepayments, as mortgage credit statistics remain robust, borrowers have locked in home price appreciation (HPA), and macroeconomic conditions remain relatively healthy. Money managers have increased their overweight to the Agency MBS sector as peripheral credit spreads have neared their tightest levels in ten years. However, the Fed is no longer purchasing MBS, and bank demand has yet to increase notably. Without a clear source of demand in the near term, we expect persistent interest-rate and swaption volatility could keep MBS basis volatility high. However, demand from U.S. banks and foreign investors could increase in late 2024 as the path of Fed policy becomes clearer, which may offer a tailwind for the sector. We find long-term value in agency mortgages and maintain a neutral position overall, but with a preference for lower- and higher-end coupons.

## Putnam Income Fund (PNCYX)

Annualized total return performance as of 3/31/24

| | **Class Y shares** Inception 6/16/94 | **Bloomberg U.S. Aggregate Bond Index** |
|---|---|---|
| Last quarter | 0.50% | –0.78% |
| 1 year | 3.71 | 1.70 |
| 3 years | –3.16 | –2.46 |
| 5 years | 0.48 | 0.36 |
| 10 years | 1.56 | 1.54 |
| Life of fund | 6.96 | — |

Total expense ratio: 0.63%

What you pay: 0.51%

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 2/28/25.

*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 Global Aggregate Bond Index is an unmanaged index of global investment-grade fixed income securities. The S&P 500® Index is an unmanaged index of common stock performance. The Bloomberg US Corporate Index measures the investment grade, fixed-rate, taxable corporate bond market. You cannot invest directly in an index.



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

Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country’s borders in a specific time period; changes in GDP are an indicator of a nation’s overall economic health.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by consumers for a basket of consumer goods and services, such as transportation, food, and medical care; the CPI is used for identifying periods of inflation or deflation.

For informational purposes only. Not an investment recommendation.

The opinions expressed here are those of the portfolio managers as of March 31, 2024, 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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