What was the fund’s investment environment like during the third quarter of 2019?

The U.S.–China trade conflict, slowing global growth, and fears of a recession injected volatility and risk aversion into the market for risk assets the past three months. That said, expectations that the Federal Reserve would maintain an accommodative monetary policy helped offset fears about economic growth and skepticism that the U.S.–China trade dispute will be resolved soon. The Fed cut its target for short-term interest rates by a quarter percentage point twice during the period, its first reductions in more than a decade. The rate cuts are part of an effort to keep borrowing cheap, credit widely available, and businesses and consumers confident.

Government bond yields in the United States and Europe fell sharply in August, before rising and then falling again in September. The yield on the benchmark 10-year U.S. Treasury finished the quarter at 1.68%. This was down from 2% at the end of the second quarter and a full percentage below where it stood at the end of 2018.

Against this backdrop, the Bloomberg Barclays U.S. Aggregate Bond Index — a broad gauge of the investment-grade bond market and the fund's benchmark — gained 2.27% for the quarter. Investment-grade corporate bonds outperformed U.S. government and agency debt, mortgage credit, high-yield credit, and emerging-market debt.

Oil prices were volatile, reflecting concern that softening demand and steady production from the U.S. and other suppliers will result in excess supply.
For the quarter, the fund posted a solid positive return and outpaced its benchmark. Which holdings and strategies fueled relative performance?

Our strategies targeting prepayment risk contributed the most versus the benchmark this quarter, led by holdings of reverse-mortgage interest-only [IO] securities. Reverse-mortgage IOs are structured from the income streams of loans used by older homeowners to borrow against the existing equity in their home. Our “mortgage basis” positioning also added value. 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.

Within mortgage credit, exposure to commercial mortgage-backed securities [CMBS] was another leading contributor. The fund’s CMBS exposure was primarily via CMBX, an index that references a basket of CMBS issued in a particular year. Within CMBX, the fund benefited from exposure to the BBB-rated tranche representing 2012 issuance. Our allocation appreciated when CMBX rallied in September.

Our corporate credit holdings — both investment-grade and high-yield bonds — marginally contributed, due to favorable sector and security selection. Yield spreads in both market segments ended the quarter near where they started. Consequently, spreads movements had a neutral impact on our holdings. [Yield spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity Treasuries. Bond prices rise when spreads tighten and fall when spreads widen, all else equal.]

What detracted from performance?

Our interest-rate and yield-curve positioning slightly dampened relative performance. The fund’s duration was longer than that of the benchmark at times. This hurt performance during the first half of September as interest rates rose.

What is your near-term outlook?

The general view across Putnam is that global growth momentum continues to slow, and most major economies have progressed to later stages of the business cycle. We think the U.S. economy, despite some recent signs of weakness, is still in good shape overall. We believe the yield pickup offered by U.S. corporate and mortgage credit relative to lower- and even negative-yielding international alternatives may remain attractive to investors.

Consumer spending has been a major driver of U.S. growth. It expanded at a 4.7% annual rate in the second quarter, the strongest pace since late 2014. The U.S. housing market has also picked up, aided by the substantial decline in the 10-year Treasury yield — a key benchmark for mortgage rates.

We think interest rates may stay within a moderate range over the near term, given the late stage of the economic cycle. For that reason, we expect to keep the fund’s duration close to the benchmark’s duration.

As for the Fed, we believe the most likely scenario is for one more rate cut in 2019 and perhaps another cut during the first half of 2020.

What is your assessment of the various areas of the market in which the fund invests?

We continue to have a favorable outlook for mortgage credit. We think the underlying fundamentals for commercial real estate appear stable. They are supported by a growing labor market, interest rates that remain historically low, and a positive U.S. economic backdrop. We also think the pricing of securities in the sector continues to reflect overly negative sentiment toward retail properties.

Generally speaking, after a strong run during the past 12 months, we think corporate credit is fully valued. As a result, in our security selection process, we are looking to avoid companies with weak balance sheets.

In parts of the market where we target prepayment risk, we don’t think our allocations to agency interest-only collateralized mortgage obligations will benefit from rising interest rates in the near term. As such, we are focusing on security selection in this area of the market.
**Putnam Income Fund (PNCYX)**

Annualized total return performance as of 9/30/19

<table>
<thead>
<tr>
<th>Class Y shares</th>
<th>Net asset value</th>
<th>Bloomberg Barclays U.S. Aggregate Bond Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inception 6/16/94</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Last quarter</td>
<td>2.83%</td>
<td>2.27%</td>
</tr>
<tr>
<td>1 year</td>
<td>11.05</td>
<td>10.30</td>
</tr>
<tr>
<td>3 years</td>
<td>5.19</td>
<td>2.92</td>
</tr>
<tr>
<td>5 years</td>
<td>3.61</td>
<td>3.38</td>
</tr>
<tr>
<td>10 years</td>
<td>5.57</td>
<td>3.75</td>
</tr>
<tr>
<td>Life of fund</td>
<td>7.53</td>
<td>—</td>
</tr>
</tbody>
</table>

Total expense ratio: 0.63%

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

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 Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities. You cannot invest directly in an index.

Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.
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. 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). The fund may have to invest the proceeds from prepaid investments, including mortgage-backed investments, in other investments with less attractive terms and yields. 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 extended periods of 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. You can lose money by investing in the fund.