How were market conditions in the third quarter?

Persistent volatility challenged bond markets, and most fixed income benchmarks posted negative returns for the three months ended September 30, 2023.

In July, U.S. bond yields rose after the Federal Reserve raised interest rates by 0.25%. The cost of borrowing reached a 22-year high of 5.25%–5.50%. Inflation eased, while the U.S. economy continued to grow. The probability of a near-term recession declined, and risk assets rallied. Investment-grade (IG) and high-yield credit spreads began to tighten. [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.] In August, the yields on U.S. Treasuries soared after Fitch Ratings downgraded the U.S. government’s credit rating.

In September, the Fed held interest rates steady but indicated one more rate hike was possible in the fourth quarter. U.S. inflation remained above the central bank’s target rate of 2% and supported the Fed’s rhetoric to keep rates “higher for longer.” Investors pushed expectations for a U.S. recession to mid–2024.

The yield on the 10-year U.S. Treasury note climbed from 3.84% on June 30 to 4.59% on September 29. Short-term yields rose even more, keeping the yield curve inverted. IG corporate bonds, as measured by the Bloomberg U.S. Corporate Bond Index, returned –3.09% for the quarter. High-yield corporate credit fared better, with the JPMorgan Developed High Yield Index returning 0.71%.
How did the fund perform for the three months ended September 30, 2023?
The fund’s class Y shares returned –2.83%, outperforming the benchmark Bloomberg U.S. Aggregate Bond Index, which returned –3.23%.

Which strategies and holdings had the biggest influence on fund performance relative to the benchmark?
The fund’s duration positioning was the largest contributor to relative performance. U.S. Treasuries sold off significantly, particularly on the long end of the curve. As rates rose, interest-rate volatility increased, which benefited the fund’s term structure positioning. Prepayment risk strategies also contributed to relative returns, driven by exposure to agency interest only (IO) securities. Agency IO securities continued to benefit from low prepayment speeds.

Mortgage credit exposure was a modest contributor to relative returns, led by positioning in residential mortgage-backed securities. The residential mortgage market has benefited from stabilization. Despite higher mortgage rates, supply remains constrained. Corporate credit strategies also were a modest contributor, led by our positioning in collateralized loan obligations (CLOs). Exposure to high-grade CLOs was additive to results, as spreads on CLOs rated AAA and AA tightened over the quarter and underlying loan prices traded higher.

What is the team’s near-term outlook?
We believe headline inflation in the U.S. has likely bottomed as base effects are fading. Sticky inflation has become our base case scenario. In the near term, we expect the U.S. inflation rate will fall to the 3.0%–3.5% range, interest rates will remain elevated, and spreads will be flat to slightly tighter. We believe a U.S. recession is possible in the second half of 2024. That said, central bank action will continue to play an important role. We believe the Fed will have to keep rates higher for longer as tightening continues. If the U.S. avoids a recession in 2024, we believe the Fed may not cut rates at all. As liquidity continues to be withdrawn, financial market risks will increase, in our view.

What are your current views on the sectors in which the fund invests?
U.S. Treasury yields have traded up since the resolution of the U.S. debt ceiling in May. We expect that interest rates will stay higher for longer on the back of increased Treasury supply and hawkish Fed rhetoric.

In corporate credit, healthy market technicals, and supportive macroeconomic data have kept IG credit spread volatility low. This allowed the high-yield market to perform strongly alongside other risk assets. Year to date, corporate fundamentals have shown resilience as second-quarter results surpassed market expectations. Technicals also are improving as inflows increased in recent months. Low new issuance in high yield, combined with a high volume of rising stars [companies that show the potential to improve their credit quality ratings], has created a supportive technical backdrop, in our view. Valuations appear to be attractive. Credit spreads are pricing in a continued increase in defaults along with slower growth. These conditions do not point to a harsh recession, in our view. Year to date, IG spreads have tightened 12 basis points [bps] to 118 bps, leaving little room for error. Risks to our outlook include macro forces of high inflation, central bank tightening, slowing growth, and heightened geopolitical tension.

The commercial real estate sector is facing meaningful headwinds and increased risks, including the effects of a post-pandemic shift in office demand and rising costs of capital. Property values will likely face pressure over the medium term, but prices will vary significantly by geography and property type. However, this scenario is more daunting for the equity investor, in our view. Debt holders only need the borrower to pay off the remaining interest and principal owed, which we believe limits the impact on commercial mortgage-backed securities. We believe much of this risk is already reflected in the market given the significant spread widening in the past 12 months. The most attractive relative value opportunities require detailed loan-level analysis and security selection, in our view.
We believe U.S. homeowner balance sheets are well positioned. Many homeowners are benefiting from locked-in, ultra-low mortgage rates and substantial home price appreciation in recent years. We expect home prices to remain stable for the rest of 2023. However, certain locations that became overheated may be susceptible to retractions, in our view. While sector spreads have tightened compared with 2022, they remain wider compared with 2021. At current levels, we believe attractive risk-adjusted return opportunities can be found across the capital stack.

We maintain a neutral to slightly long position to the mortgage basis overall but remain tactical. [The mortgage basis is the difference between longer-term U.S. Treasury yields and the interest rates on 30-year home mortgages.] The systemic risk posed by regional bank failures in March 2023 appears to be behind us, and market supply should taper down in the near term. However, future bank demand remains uncertain and may hinge upon regulatory changes.

We expect prepayment speeds will be stable going forward. The sector may provide good protection against a recession scenario that negatively impacts home prices or employment. In our view, many prepayment-sensitive assets now offer an attractive risk-adjusted return at current price levels and significant upside potential if rates stabilize and volatility declines.

### Putnam Income Fund (PNCYX)

#### Annualized total return performance as of 9/30/23

<table>
<thead>
<tr>
<th>Period</th>
<th>Class Y shares</th>
<th>Bloomberg U.S. Aggregate Bond Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Last quarter</td>
<td>-2.83%</td>
<td>-3.23%</td>
</tr>
<tr>
<td>1 year</td>
<td>1.23</td>
<td>0.64</td>
</tr>
<tr>
<td>3 years</td>
<td>-5.42</td>
<td>-5.21</td>
</tr>
<tr>
<td>5 years</td>
<td>-0.18</td>
<td>0.10</td>
</tr>
<tr>
<td>10 years</td>
<td>1.34</td>
<td>1.13</td>
</tr>
<tr>
<td>Life of fund</td>
<td>6.90</td>
<td>—</td>
</tr>
</tbody>
</table>

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 Bond 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 September 30, 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.

A world of investing.

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.

Putnam Retail Management