Q2 2018 | Putnam Income Fund Q&A

Fund advances as rate environment tightens

Michael V. Salm
Co-Head of Fixed Income
Industry since 1989

Brett S. Kozlowski, CFA
Portfolio Manager
Industry since 1997

Emily E. Shanks
Portfolio Manager
Industry since 1999

Increased global trade and political tensions created a challenging market environment in the second quarter.

Mortgage-credit holdings and strategies targeting mortgage prepayment risk aided the fund's relative performance.

We think U.S. growth may strengthen in the months ahead. Against this backdrop, we continue to have a positive outlook for structured mortgage credit.

What was the fund's investment environment like during the second quarter of 2018?

The period was marked by a continued flattening of the U.S. Treasury yield curve, along with increased global trade tensions.

The yield on the benchmark 10-year Treasury reached a nearly seven-year high of 3.11% on May 17 before mounting concerns about trade issues and slower global growth drove investors to the relative safety of government debt. Longer-dated yields were also held in check by continued strong demand for long-term U.S. bonds from pension funds, insurance companies, and international investors. As a result, the 10-year yield ended the quarter at 2.85%, only modestly higher than where it began the period.

Short-term yields rose more than longer-term yields during the quarter, reflecting market activity related to Federal Reserve policy. The Fed increased its target for short-term rates to 1.75% to 2.00% at its June policy meeting, the second hike this year and the seventh in the past three years. We think the central bank is likely to raise rates twice more in 2018, and possibly once or twice in 2019.

As the year has progressed, the Treasury yield curve has continued to flatten. It is possible that the curve could invert at some point, meaning short-term yields would be higher than longer-term yields. Historically, an inverted yield curve has been an accurate forecaster of recession. This time, however, we think there may be different dynamics at work. The massive amount of longer-term Treasuries that the Fed purchased during the years that it was attempting to stimulate economic growth are still being held on the central bank's balance sheet. This has created a scarcity in the supply of longer-term Treasuries, which is being met by robust demand. As a result, we think demand for long-term debt is having a greater influence on the curve than the pace of Fed rate hikes. We view this as a more benign backdrop that is less indicative of near-term recession.

On the trade front, at the end of May, the Trump administration announced tariffs on steel and aluminum imported from the European Union, Canada, and Mexico. It then applied tariffs to $50 billion in Chinese imports to the United States, a move that was designed to punish China for unfair trade practices. President Trump escalated the trade conflict with China in mid-June, asking his administration to identify a new list of $200 billion in Chinese goods that would be penalized with tariffs. The Chinese government immediately threatened to retaliate with its own equivalent tariffs on U.S. goods. The president has also threatened to impose tariffs on global automobile imports. As of quarter-end, investors remained on edge as to the full scope of President Trump's global trade offensive.

The fund outpaced its benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index, for the quarter. Which holdings and strategies fueled relative performance?

Our mortgage credit holdings were the biggest contributor versus the benchmark, led by commercial mortgage-backed securities [CMBS]. Our long exposure to the BBB-rated tranche within the CMBX — an index that references a basket of CMBS issued in a particular year — benefited from reduced investor concern about the performance of regional shopping malls. Investors now believe mall-related uncertainties are unlikely to materially hamper the CMBS market. An allocation to agency credit-risk transfer securities [CRTs] also added to results for the quarter. CRTs benefited as credit-rating agencies upgraded certain CRT tranches, recognizing the improved outlook for their underlying collateral.

Strategies targeting prepayment risk provided a further boost versus the benchmark. Higher longer-term Treasury yields aided our positions in agency interest-only collateralized mortgage obligations [IO CMOs]. Refinancing activity was subdued due to rising mortgage rates and a continuing trend of fairly restrictive bank underwriting standards. As a result, prepayment speeds on the mortgages underlying our IO CMO positions stayed below market expectations.

Our holdings of reverse-mortgage interest-only securities continued to benefit from regulatory changes announced by the Department of Housing and Urban Development [HUD] in August 2017. The regulations have reduced the incentives for owners of reverse mortgages to refinance, helping to strengthen secondary market demand.

What about relative detractors?

There were no detractors of consequence this quarter. However, positions in investment-grade credit slightly dampened the fund's relative results. Corporate yield spreads widened in May amid heightened market volatility triggered by trade tensions.

What is your near-term outlook?

We think second-quarter U.S. economic growth may be stronger than the 2% annualized rate reported for the first quarter. In May, an inflation measure closely watched by the Fed hit the central bank's target of 2% for the first time in six years, a sign that the economy is on more solid footing after a long run of relatively slow growth. Inflation readings over the past three months suggest the Fed's long battle with weak inflation could finally be drawing to a close. It appears to us that a strong labor market is beginning to push wages up and robust economic growth will increasingly squeeze slack out of the economy.

What areas of the market do you find to be most attractive?

We think the underlying fundamentals for commercial real estate continue to be stable, supported by employment growth, low interest rates, and economic expansion. While we expect some degree of losses related to regional malls, we are encouraged that many malls are attempting to repurpose their space to attract new types of tenants. Ultimately, we believe these issues will lead to losses in only a handful of BBB-rated CMBS tranches.

In terms of CMBS security selection, we plan to continue focusing on BBB-rated mezzanine tranches issued between 2011 and 2014. We also continue to favor CMBX BBB-rated Series 6 and 7 exposure, as spread widening has increased the risk/reward appeal of this part of the market, in our view.

We continue to like agency CRTs on a fundamental basis, but have become more cautious from a valuation perspective. We are focusing on opportunities among securities that have a few years of seasoning rather than newly issued CRTs, as we think this area of the market offers a more favorable risk/reward profile.

Agency IO CMOs also remain attractive to us, along with prepayment risk generally, because we think relatively tight mortgage-lending standards may continue to limit refinancing activity. Interest rates remain low by historical standards, and uncertainty regarding prepayment speeds is not a major concern for us at this time.

Putnam Income Fund (PNCYX)

Annualized total return performance as of 6/30/18

Class Y shares Inception 6/16/94	**Net asset value**	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	0.77%	-0.16%
1 year	2.94	-0.40
3 years	2.25	1.72
5 years	3.17	2.27
10 years	5.66	3.72
Life of fund	7.52	—
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.

The opinions expressed here are those of the portfolio managers as of June 30, 2018, 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 carry the risk that they may increase in value when interest rates decline and decline in value 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 greater for longer-term bonds, and credit risk is 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. Bond prices may fall or fail to rise over time for several reasons, including general financial market conditions, changing market perceptions (including perceptions about the risk of default and expectations about monetary policy or interest rates), changes in government intervention in the financial markets, and factors related to a specific issuer or industry. 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.

This material is for informational and educational purposes only. It is not a recommendation of any specific investment product, strategy, or decision, and is not intended to suggest taking or refraining from any course of action. It is not intended to address the needs, circumstances, and objectives of any specific investor. Putnam, which earns fees when clients select its products and services, is not offering impartial advice in a fiduciary capacity in providing this sales and marketing material. This information is not meant as tax or legal advice. Investors should consult a professional advisor before making investment and financial decisions and for more information on tax rules and other laws, which are complex and subject to change.

A world of investing.®

Putnam INVESTMENTS

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

Putnam Investments | One Post Office Square | Boston, MA 02109 | putnam.com

TL035 311585 7/18