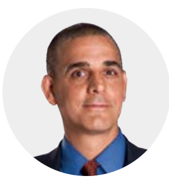
Q1 2018 | Putnam Income Fund Q&A

Fund outperforms in changing market environment



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Increasing risk-aversion created a more challenging market environment in February and March.

Mortgage-credit holdings and favorable interest-rate positioning aided the fund's relative performance.

We continue to have a positive outlook for structured mortgage credit.

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

Following a strong start in January, the majority of risk-driven asset classes declined in February and March, as market volatility and investor risk-aversion returned after being largely absent from the market for the past two years.

At the onset of 2018, stocks and credit-sensitive bonds performed well amid an improving outlook for global economic growth, positive sentiment surrounding U.S. tax reform, and continued strength in corporate earnings. The yield on the benchmark 10-year U.S. Treasury rose by 0.26% in January, ending the month at 2.72%, as optimism about a synchronized global recovery spread.

The environment shifted in late January due to interest-rate jitters, collapsing strategies predicated on market volatility remaining low, and uncertainty about inflation expectations and a corresponding response from the Federal Reserve. Stocks reached correction territory in February, declining by roughly 12% from their January highs, with declines worsening when the Trump administration announced that it would impose tariffs on imports of steel and aluminum, sparking widespread fear of a trade war.

The yield on the 10-year Treasury posted its largest quarterly increase since the end of 2016. Data showed wages and consumer prices rose in January, encouraging more investors to sell government bonds and driving the yield on the 10-year Treasury more than half a percentage point higher in less than two months. But the rise in yields stalled in March. Strong January wage data were revised lower in the following month's labor report. Subsequent weaker-than-forecast inflation data suggested the tax cuts were unlikely to spur growth that matched the move in market expectations. Rising bond yields also attracted buyers. After reaching 2.94% on February 21 — its high for the period — the 10-year yield finished the quarter at 2.74%.

Heightened risk-aversion and rising yields pushed most credit-sensitive and U.S. government fixed-income categories into the red for the quarter. Among the bright spots were foreign developed-market sovereign bonds, which advanced 4.42% in U.S.-dollar terms, and floating-rate bank loans, which gained 1.45%.

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 investments in mezzanine commercial mortgage-backed securities [CMBS]. We held CMBS that were issued between 2011 and 2014, and the yield spreads for these bonds stayed in a fairly tight range versus widening spreads in the broader market. [Bond prices fall as spreads widen.]

An allocation to agency credit-risk transfer securities [CRTs] was modestly additive for the quarter. CRTs benefited from strong overall demand, as investors continued to embrace the sector's relatively high yields backed by robust collateral and rising residential real estate prices. Additionally, credit-rating agencies upgraded various CRT tranches, or sections, recognizing the improved outlook for their underlying collateral.

Our interest-rate positioning provided a further notable boost to relative performance. We continued to de-emphasize interest-rate risk by keeping the fund's duration shorter than that of the benchmark. This strategy positioned the fund to benefit if market interest rates rose, which is exactly what happened during the quarter.

Strategies targeting prepayment risk solidly contributed this period. Our positions in reverse-mortgage interest-only [IO] securities continued to benefit from regulatory changes announced by the Department of Housing and Urban Development [HUD] in August. Investors believe the new regulations will reduce the incentives for owners of reverse mortgages to refinance. The regulations are also expected to bolster the secondary market for these securities.

Lastly, a net short position in high-yield credit also helped, as spreads in this area of the market widened amid increased market volatility.

What about relative detractors?

There were no detractors of consequence this quarter. However, within our prepayment strategies, positions in agency interest-only collateralized mortgage obligations [IO CMOs] contributed only marginally this period, despite a favorable backdrop of rising mortgage rates and a relatively low level of mortgage refinancing.

What is your near-term outlook?

During the past few months, economic data, both in the United States and overseas, have been stronger than most market observers were expecting several months ago, especially given the fact that interest rates have risen. Despite this strength, we think it is unlikely that the global economy will overheat at this stage of the business cycle and spark a sustained rise in inflation. As an example of our view, we believe the U.S. unemployment rate, which has held at 4.1% since October — its lowest level since December 2000 — results partly from demographic and structural factors. Consequently, we don't think the current level of employment will cause the economy to overheat.

During the quarter, we also saw a stabilizing dynamic at work in the markets. With bond yields trending higher, on days when market-moving economic data were released, bond investors would react and the yield curve would adjust, helping to dampen the impact on risk-sensitive assets.

Treasury yields also stabilized, plateauing in March and ending the quarter slightly below where they peaked. We think yields may continue to drift higher over the course of 2018, as rate normalization continues.

Given this outlook, what areas of the market do you find to be most attractive?

Surprisingly, as bond yields rose during the quarter, spreads remained relatively stable. [Spreads are the yield advantage offered by riskier types of bonds over comparable-maturity Treasuries.] Spreads for investment-grade and high-yield corporate credit, as well as mortgage credit, finished the period near their lows for the current market cycle. We think this is justified by the fundamentals underlying these market sectors, namely solid economic growth, rising corporate profits, and a strong housing market. We believe the fundamental backdrop continues to support risk-taking in these sectors, and we think this is particularly true in structured mortgage credit. As a result, we continue to have a positive outlook for securitized mortgage products, such as CMBS, agency IO CMOs, CRTs, and non-agency residential mortgage-backed securities.

Putnam Income Fund (PNCYX)

Annualized total return performance as of 3/31/18

Class Y shares Inception 6/16/94	**Net asset value**	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	0.05%	-1.46%
1 year	4.12	1.20
3 years	1.71	1.20
5 years	2.50	1.82
10 years	5.54	3.63
Life of fund	7.53	—

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 March 31, 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.

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