Q2 2019 | Putnam Income Fund Q&A

Fund outperforms amid shifting rate expectations

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The U.S. Federal Reserve indicated a willingness to reduce interest rates if the outlook for economic growth weakens.

Investments in commercial mortgage-backed securities fueled the fund's relative outperformance. Interest-rate and yield-curve positioning also added value.

We believe the Fed will cut rates at least once this year.

What was the fund's investment environment like during the second quarter of 2019?

Corporate and mortgage credit generally performed well, despite a period of volatility and spread widening in May. During that month, trade negotiations between the United States and China stalled, prompting President Trump to announce that he would dramatically ramp up U.S. tariffs on Chinese imports. [Yield spreads are the yield advantage riskier bonds offer over comparable-maturity U.S. Treasuries. Bond prices rise as spreads tighten and fall as spreads widen.]

In early June, U.S. Federal Reserve Chair Jerome Powell addressed the fears of how the continuing trade dispute might hurt the economy, saying the central bank could respond by cutting interest rates if the economic outlook deteriorated. Investors cheered the news, leading to a rally in stocks and credit-sensitive bonds. Risk assets received a further boost at the end of June, when President Trump and his Chinese counterpart, Xi Jinping, agreed to resume formal trade talks during a meeting at the G-20 summit in Japan.

U.S. government-bond yields fell for a third consecutive quarter, reflecting investor concerns about slowing growth and global trade tensions. The yield on the benchmark 10-year U.S. Treasury note — which falls when bond prices rise — declined by 0.49 percentage point during the quarter, finishing at 2%. The 10-year yield has declined by more than a full percentage point during the past three quarters, its biggest drop over such a period since 2011.

Not FDIC insured | May lose value | No bank guarantee

For the quarter, the fund posted a solidly positive return and outpaced its benchmark. Which holdings and strategies fueled relative performance?

Our allocation to commercial mortgage-backed securities [CMBS] was the main contributor versus the benchmark, led by our exposure to 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. CMBX rallied along with other risk-driven assets in April and June, and actually held up better than corporate credit during the market pullback in May.

Our interest-rate and yield-curve positioning also added value. The fund's duration was slightly longer than that of the benchmark, which aided performance as rates declined. Also, the fund's positioning benefited from a flattening of the yield curve, as yields declined across the curve, while the curve remained inverted [shorter-term yields were higher than intermediate-term yields].

Our corporate credit holdings — both investment-grade and high-yield bonds — modestly contributed, due to favorable sector and security selection. Given the spread widening that occurred in May, spreads in both market segments ended the quarter near where they started. Consequently, spread movements had a roughly neutral impact on our holdings.

What detracted from performance?

There were no relative detractors. All of the fund's holdings and strategies contributed versus the benchmark this quarter.

What is your near-term outlook?

As of quarter-end, we thought market participants, as a whole, were being too aggressive in their forecasts of Fed rate cuts. As a result, we think the market has priced in too many reductions. We believe investors will adjust once they acknowledge that economic growth, both in the United States and overseas, is likely to continue at a measured pace.

In our view, we expect the Fed to trim rates once this year and possibly twice. In light of continued moderate growth, we don't believe the Fed needs to be too aggressive in reducing rates.

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

We continue to have a generally favorable outlook for mortgage credit. We think the underlying fundamentals for commercial real estate appear stable, supported by a growing labor market, interest rates that remain historically low, and a positive U.S. economic backdrop. That said, we think these favorable factors will be partially offset by higher capital costs and low capitalization rates. [Capitalization rate is the rate of return on a commercial investment property based on the income that the property is expected to generate. It is calculated by dividing the property's net operating income by its purchase price.]

In terms of CMBS security selection, we have been focusing on mezzanine tranches rated BBB- that were issued between 2011 and 2014. We also plan to maintain select positions in pre-2008 mezzanine tranches that have less price sensitivity to changes in yield spreads. By way of background, mezzanine CMBS are lower in the capital structure of a deal backed by a pool of commercial mortgage loans. They provide a yield advantage over higher-rated bonds, while having a smaller, yet meaningful, amount of principal protection.

In corporate credit, we think spreads as of June 30 represented fair value, based on generally supportive underlying fundamentals. In an environment where the Fed and other central banks have adopted a more dovish tone, we think spreads could remain steady or tighten slightly in the months ahead.

Elsewhere, within residential mortgage-backed securities [RMBS], we continue to find value among legacy RMBS, where we think a steadily shrinking market and stable investor base provide a supportive supply-and-demand backdrop. A low level of new and existing homes has resulted in lower loan-to-value ratios and declining delinquencies, even though affordability has become more difficult. We favor securities backed by higher-quality collateral as well as bonds from what we consider to be more favorable regions of the country.

In the agency credit risk-transfer [CRT] market, 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.

Putnam Income Fund (PNCYX)

Annualized total return performance as of 6/30/19

Class Y shares Inception 6/16/94	**Net asset value**	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	3.92%	3.08%
1 year	7.59	7.87
3 years	4.93	2.31
5 years	2.99	2.95
10 years	6.49	3.90
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.

For informational purposes only. Not an investment recommendation.

The opinions expressed here are those of the portfolio managers as of June 30, 2019, 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. 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.

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