Fund advances as lower inflation helps market rally

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How were market conditions during the fourth quarter?

Mixed economic data and geopolitical concerns added to volatility in fixed income markets during the fourth quarter. In addition, investors closely monitored central bank actions and policymakers' comments for hints of when the Federal Reserve may begin to cut the federal funds rate. Increasing optimism about the central bank's ability to achieve a soft landing for the economy and anticipation of rate cuts in 2024 helped drive a bond market rally in the latter part of the period. For the quarter, most fixed income benchmarks posted positive returns. The Bloomberg US Aggregate Bond Index returned 6.82%.

The Fed left the policy rate unchanged at its November and December meetings. Data showed growth had eased and labor market pressure had moderated, although the unemployment rate remained low at 3.7%. Inflation continued to ease but remained above the central bank's target. In the final weeks of the period, Fed Chair Jerome Powell reiterated that policymakers would continue to be dependent on incoming economic data. At the same time, the Fed's outlook suggested that rate cuts may be considered in 2024. The 10-year U.S. Treasury note yield rose from 4.59% on September 29 to reach new highs briefly during the quarter before declining to 3.88% on December 29.

In October, volatility dominated global markets as geopolitical concerns intensified around the growing conflict in the Middle East. In the United States, markets priced in the Fed's "higher for longer" rate outlook. Treasury yields rose significantly, and the 10-year Treasury yield ended the month at 4.93%. Spreads widened, and returns were negative across fixed income sectors for the month. In November the bond market rallied, and returns were positive. Easing inflation and economic data helped support the rally. Credit spreads tightened. The pause in monetary tightening was a tailwind for risk assets. Emerging markets also saw positive returns as inflation eased.

Global bond markets also rallied as inflation eased, and central banks paused monetary tightening. The Bank of England and the European Central Bank both held rates steady at their December policy meetings. For the quarter, global bonds outperformed the U.S., with the Bloomberg Global Aggregate Bond Index posting a return of 8.10%. In the U.S., within corporate bonds, investment-grade corporate credit posted a positive return of 8.50%. Corporate credit spreads were tighter than recent averages. High-yield corporate credit also recorded a positive quarter. The JPMorgan Developed High Yield Index posted a 6.82% result.

Which strategies and holdings had the biggest influence on fund performance relative to the benchmark?

Mortgage credit exposure was the primary contributor to benchmark-relative returns, driven by exposure to residential mortgage credit, particularly credit risk transfer (CRT) securities, which continued its positive outperformance. Spreads across the entire CRT capital stack tightened, most notably later in the period on the heels of strong demand and a broader risk-on tone in the market.

Corporate credit strategies also benefited the portfolio during the period, driven by exposure to collateralized loan obligations (CLOs) and high-yield corporate credit. CLOs continued to perform well, as underlying loan prices improved during the period. Additionally, a modest out-of-benchmark position in high-yield corporates boosted relative returns, with yield spreads ending the quarter significantly tighter.

Prepayment risk and term structure risk strategies were neither notable contributors nor detractors during the period.

What is the team's near-term outlook?

The expectation that central banks will hike interest rates or hold rates steady for a longer period to bring inflation back to target has faded. In December, many central banks opened the door to rate cuts earlier than expected as the inflation outlook softened. This helped to spur a global bond rally, led by the Fed's communications and the direction of U.S. rates.

In the U.S., softer data releases and the Fed's plans to cut rates have caused the 10-year Treasury yield to rally significantly. The market has priced in a number of rate cuts in 2024, which may begin as early as March, while the Fed has signaled three 25 basis-point rate cuts. It appears that the Fed shifted to an accommodative stance when mortgage and corporate borrowing rates, driven by Treasury rates, surged in October. The Fed is willing to bring the policy rate down to ease pressure.

In the near term, Fed rate-cut expectations may be challenged with stronger data prints, but rates are likely to trend downwards owing to the Fed's rate-cutting intentions. The Fed is also likely to reduce the pace of quantitative tightening (QT). We believe the Fed's intention to cut rates matters more to the outlook for the 10-year Treasury yield than the timing of the first cut. Additionally, we expect the yield curve to steepen as the Fed cuts rates. The 1-year to 10-year portion of the curve may remain inverted, but we expect the 2-year to 10-year is likely to normalize by year-end.

What are your current views on the sectors in which the fund invests?

Healthy market technicals and supportive macroeconomic data have kept investment-grade spread volatility low. Increasingly pervasive expectations for a Fed pivot in 2024 have driven valuations to their year-to-date tights. While dovish central bank commentary has reduced the probability of a near-term recession, challenges in commercial real estate and at the regional banks with high concentrations to these challenges remain. Additionally, stress on consumers with lower incomes has increased with the depletion of pandemic-era savings and the cuts to government stimulus programs. With that backdrop, we continue to seek out and find pockets of idiosyncratic opportunity, but we remain cautious on overall valuations.

Areas of the commercial real estate market continue to face meaningful headwinds and increased risks. However, the U.S. economic outlook improved in recent months as inflation came down notably, and the labor market remained strong. Meanwhile, the increased likelihood of Fed rate cuts in 2024 has driven long-term rates lower, which should benefit commercial borrowers. Nonetheless, commercial property prices are likely to continue to face pressure over the medium term, although this pressure will vary significantly by geography and property type. We believe property types that can adjust rents, such as hotels and apartments, will hold their value better, while property types with longer leases and greater exposure to higher capital costs and/or needs for capital investment will face pressure. In our view, the CMBS market has priced in much of these additional risks, and this adjustment has contributed to significant spread widening over the past two years. This trend has created value relative to corporate credit, in our opinion, along with attractive opportunities for security selection. We expect greater return dispersion across the market in the near term, which increases the importance of rigorous loan-level analysis to uncover relative value.

U.S. homeowner balance sheets remain well positioned, supported by the combination of locked-in ultra-low mortgage rates and the substantial home price appreciation of recent years. These strengths limit the likelihood of a housing and/or economic correction leading to widespread defaults and delinquencies, which means supply is not likely to increase substantially due to distressed home sales. While the supply of new homes has risen, it is still not high enough to create oversupply on a national level. We expect home prices will be flat in 2024, as affordability pressures continue to limit demand, while supply gradually increases. Residential mortgage credit spreads performed well in 2023 but continue to offer attractive value and carry, in our view. At current levels, attractive risk-adjusted return opportunities are available across the capital stack. Using conservative macro and housing assumptions in our modeling, we favor higher-quality bonds with shorter spread durations as well as bonds with seasoned collateral that can withstand home price declines due to significant built-up home equity.

We expect prepayment speeds will be stable for deeply discounted securities that make up the bulk of current outstanding bonds. The sector also offers risk mitigation against a potential recession scenario that would negatively impact home prices and/or unemployment. Volatility in rates can hinder performance, but we anticipate volatility will decline and further support the market. The systemic risk posed by regional bank failures appears to be behind us and market supply of Agency MBS will continue to be subdued, as new production remains low. Demand has been robust in recent months, and the likelihood of Fed rate cuts in 2024 may bring banks back to the market sooner rather than later. We see long-term value in agency mortgages and currently maintain a modest long position overall, but we will remain tactical and actively trade the basis as new information emerges and events occur. Many prepayment-sensitive assets (e.g., agency interest-only securities) now offer an attractive risk-adjusted return at current price levels, in our view, and potential upside if rates stabilize and volatility declines. Certain subsectors offer the potential for additional upside if prepayment speeds can slow further.

Putnam Income Fund (PNCYX)

Annualized total return performance as of 12/31/23

	Class Y shares Inception 6/16/94	Bloomberg U.S. Aggregate Bond Index
Last quarter	6.85%	6.82%
1 year	5.10	5.53
3 years	–4.06	–3.31
5 years	1.11	1.10
10 years	1.83	1.81
Life of fund	6.98	—

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 Global Aggregate Bond Index is an unmanaged index of global 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.

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 December 31, 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.

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.

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