Market review

In early 2019, the US Federal Reserve seemed to take a deep breath while repeating to itself the word “patience.” During the second quarter of 2019, however, the Fed seemed to show signs of “blinking,” setting up a shift from patience to action. Comments from the Federal Open Market Committee (FOMC) after its June meeting centered on a stronger case for risk management (an “insurance” cut in the federal funds rate) due to various global trade and geopolitical uncertainties. The Fed said it will closely monitor the scenario where these uncertainties weigh on economic growth, as it considers its next steps. Importantly, the Fed removed any reference to “transitory” below-target inflation data, as it noted that a “more prolonged period” will be needed before returning to targeted inflation levels. The Fed’s economic growth concerns seem to be correct, in our view, given that the Citigroup® Economic Surprise Index (US) is approaching multiyear lows. Ten-year Treasury notes appear to share this economic growth concern, because the year-to-date drop in yield from 2.7% to 2.0% was driven almost entirely by a drop in the real yield.

Of course, the Fed is not alone in its concern about economic growth. Global central banks have generally taken a more dovish track in recent months. At the May 2019 Macquarie Fixed Income Forum, we conceded that risk markets were once again embracing this return to more central bank support, but we also raised a concern about the ongoing dependency and complacency behind the “buy the dip” mentality. With brief exceptions in 2017 and 2018, global economic growth has not been stronger because of massive central bank accommodation. Even while asset prices rose, longstanding secular headwinds constrained gross domestic product (GDP) growth. Given that significant fiscal policy support is unlikely to occur in the near term, a return to slow global growth seems like a best possible outcome, in our view. (And while the likelihood of a recession in the near future may not be high, we believe the situation must be seriously monitored.)

US economic indicators were weaker during the second quarter of 2019. The Citigroup Economic Surprise Index (US) moved lower and ended the quarter negative. In the first quarter of 2019, US gross domestic product (GDP) growth expanded at a 3.1% annualized pace, compared with 2.2% for the fourth quarter of 2018. Monthly nonfarm payroll growth, which has averaged about 200,000 since 2011, stood at 171,000 in the second quarter as trend employment growth has slowed. Core personal consumption expenditures (Core PCE) – the Fed’s preferred inflation gauge – fell to 1.6% year over year, and the Core US Consumer Price Index (Core CPI) also fell, to 2.0% during the second quarter. Inflation remained below the Fed’s 2% target, and inflation expectations as measured by Treasury inflation-protected securities (TIPS) break-even rates moved to the lowest levels since 2016. (Sources: US Bureau of Economic Analysis and US Bureau of Labor Statistics.)

The Institute for Supply Management’s total Manufacturing and Non-Manufacturing New Orders Index declined during the quarter but continued to indicate expansion. Sentiment indicators were mixed. Small business owners appear to feel more confident about the economy, as the National Federation of Independent Business (NFIB) Small Business Optimism Index rebounded after declining from the highs over the past two quarters. Consumer confidence declined to January levels. The regional Fed surveys are generally at their lowest levels since 2017, but all remain in expansionary territory. The market is pricing in a 0.25-percentage-point rate cut by the FOMC in July 2019.

The Bloomberg Barclays US Aggregate Index recorded a positive return for the second quarter, as did most broad market fixed income indices. The strongest returns came from investment grade sectors, with BBB-rated corporates outperforming US Treasurys by 1.28 percentage points.

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Within the Fund

For the second quarter of 2019, Delaware Limited-Term Diversified Income Fund Institutional Class shares underperformed the Fund’s benchmark, the Bloomberg Barclays 1-3 Year US Government/Credit Index.

Positive security selection within investment grade corporate bonds contributed to the Fund’s performance. An overweight to BBB-rated securities benefited performance as risk assets were strong during the quarter.

Out-of-benchmark holdings in high yield, bank loans, and emerging markets contributed to Fund performance for the quarter, offset to some extent by CDX (credit default swap) hedges in place to help protect these allocations.

Within residential mortgage-backed securities (RMBS), exposure to interest-only (IO) securities generated negative returns as interest rates declined during the quarter. Lastly, as interest rates moved lower, holdings of short floating-rate asset-backed securities (ABS) detracted from performance.

Outlook

Historically, a renewal of global central banks’ dovish policies has tended to lead to a wave of liquidity and a continued bounce in asset prices. However, we identify four offsetting factors that could limit the impact of this wave of liquidity in today’s environment. First, consider the potential inability to weaken the US dollar as many central banks join the race to the bottom in rates. By definition, continued US dollar strength dilutes the size of global central bank liquidity in US dollar terms. Second, the recent surge in negative-rate securities (now more than $13 trillion) has the potential to slow money velocity and will likely encourage saving over spending. Third, any compromise reached on the US debt limit would likely trigger financial tightening as the US Treasury takes steps to increase its cash deposits. Finally, after years of leveraging their balance sheets through issuance in the bond market, corporations could reach the decision to begin deleveraging if an economic slowdown were to put pressure on earnings. All in all, we believe a balanced approach to market opportunities may be more prudent than simply taking on more risk based on global central banks’ renewed dovish policies.
Carefully consider the Fund’s investment objectives, risk factors, charges, and expenses before investing. This and other information can be found in the Fund’s prospectus and its summary prospectus, which may be obtained by visiting delawarefunds.com/literature or calling 800 523-1918. Investors should read the prospectus and the summary prospectus carefully before investing.

The views expressed represent the investment team’s assessment of the Fund and market environment as of the date indicated, and should not be considered a recommendation to buy, hold, or sell any security, and should not be relied on as research or investment advice.

As of June 30, 2019, the weightings of the top 10 holdings indicated as a percentage of the Fund’s net assets were: Treasury Note 2.625/21/2019 6.49%; Ccit_17 2.58%; Ameca_19-2 2.20%; FNCL 5 8/19 2.18%; Treasury Note 1.000 8/31/2019 2.07%; Treasury Note 1.625 8/31/2019 2.00%; Ccit_18-a2 1.91%; Ccit_16-a3 1.60%; Georgia-pacific LiC 5.400 11/1/2020 1.30%; Compass Bank 2.875 6/29/2022 1.25%. Holdings are as of the date indicated and subject to change. List may exclude cash and cash equivalents. Please see the Fund’s complete list of holdings on our website for more information.

Investing involves risk, including the possible loss of principal.

Fixed income securities and bond funds can lose value, and investors can lose principal, as interest rates rise. They also may be affected by economic conditions that hinder an issuer’s ability to make interest and principal payments on its debt. The Fund may also be subject to prepayment risk, the risk that the principal of a bond that is held by a portfolio will be prepaid prior to maturity, at the time when interest rates are lower than what the bond was paying. A portfolio may then have to reinvest that money at a lower interest rate. • High yielding, non-investment-grade bonds (junk bonds) involve higher risk than investment grade bonds. • The high yield secondary market is particularly susceptible to liquidity problems when institutional investors, such as mutual funds and certain other financial institutions, temporarily stop buying bonds for regulatory, financial, or other reasons. In addition, a less liquid secondary market makes it more difficult for the Fund to obtain precise valuations of the high yield securities in its portfolio. • If and when the Fund invests in foreign currency contracts or uses other investments to hedge against currency risks, the Fund will be subject to special risks, including counterparty risk. • The Fund may invest in derivatives, which may involve additional expenses and are subject to risk, including the risk that an underlying security or securities index moves in the opposite direction from what the portfolio manager anticipated. A derivatives transaction depends upon the counterparties’ ability to fulfill their contractual obligations. • International investments entail risks not ordinarily associated with US investments including fluctuation in currency values, differences in accounting principles, or economic or political instability in other nations. Investing in emerging markets can be riskier and investing in established foreign markets due to increased volatility and lower trading volume. • Diversification may not protect against market risk.

Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index.

The Bloomberg Barclays 1-3 Year US Government/Credit Index is a market value-weighted index of government fixed-rate debt securities and investment grade US and foreign fixed-rate debt securities with maturities of one to three years. The Bloomberg Barclays US Aggregate Index is a broad composite that tracks the investment grade domestic bond market. The NFIB Small Business Optimism Index is a survey asking small business owners a battery of questions related to their expectations for the future and their plans to hire, build inventory, borrow, and expand. The Citigroup Economic Surprise Index is a 3-month rolling measure of actual economic surprises relative to market expectations. A positive reading means that data have been stronger than expected, while a negative reading means that economic data have been weaker than expected. The Institute for Supply Management (ISM) Manufacturing and Non-Manufacturing New Orders Index monitors new order volume based on the ISM’s surveys of manufacturing and non-manufacturing firms. The Core Personal Consumption Expenditures Price Index (Core PCE) measures the prices paid by consumers for goods and services excluding food and energy prices, because of the volatility caused by movements in food and energy prices, to reveal underlying inflation trends. The Core US Consumer Price Index (Core CPI) is a measure of inflation that is calculated by the US Department of Labor, representing changes in prices of all goods and services, excluding those with high price volatility, such as food and energy, purchased for consumption by urban households.

Institutional Class shares, Class R shares, and Class R6 shares are available only to certain investors. See the prospectus for more information. All third-party marks cited are the property of their respective owners.

The Fund’s investment manager, Delaware Management Company (Manager), may seek investment advice and recommendations from its affiliates: Macquarie Investment Management Europe Limited, Macquarie Investment Management Austria Kapitalanlage AG, and Macquarie Investment Management Global Limited (together, ‘the Affiliated Sub-Advisors’). The Manager may also permit these Affiliated Sub-Advisors to execute Fund security trades on behalf of the Manager and exercise investment discretion for securities in certain markets where DMC believes it will be beneficial to utilize an Affiliated Sub-Advisor’s specialized market knowledge.

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