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.

Investment grade corporates outperformed all other fixed asset classes for the second quarter, as support from an increasingly dovish Fed drove a strong Treasury rally that buoyed total returns in the asset class to the strongest first six months of a year since 1995 (source: Bloomberg). With the quarter’s strong Treasury rally, investment grade sectors with longer duration profiles, such as telecommunications, railroads, and universities, outperformed. Conversely, shorter-dated sectors including homebuilders, construction machinery, and senior bank debt lagged.

Within the Fund

For the second quarter of 2019, Delaware Investments Ultrashort Fund Institutional Class shares outperformed the Fund’s benchmark, the ICE BofAML US 6-Month Treasury Bill Index.

- The Fund’s effective duration was 0.64 years versus 0.49 years for its benchmark, while the Fund’s SEC 30-day yield as of June 30, 2019 was 2.38% (Institutional Class shares) versus the benchmark’s yield to worst of 2.06%.
Delaware Investments Ultrashort Fund

• We reduced the Fund’s allocation to short investment grade credit by 3 percentage points during the quarter and reallocated the proceeds to commercial paper. In our view, this allocation is marginally more defensive given the heightened interest rate volatility, while maintaining an attractive yield advantage relative to money market instruments, contributing to the Fund’s total return and excess return profiles.

• The Fund’s allocation to money market instruments slightly detracted from performance as commercial paper provided a lower yield relative to the benchmark.

Outlook

After many developed market central banks returned to a more dovish tilt in the second quarter, their policy responses going forward will be tested for efficacy as global growth feels the weight of an uncertain trade environment. Without US consumers’ resilience, growth would have slowed further as manufacturing continued to cool during the quarter. At this point, we believe we should all be asking how effectively monetary policy responses to slower growth will translate into economic fortitude. Although history is a bit muddled on who first used the phrase “pushing on a string,” it may be an accurate description of the level of usefulness the Fed and other central banks may have to arrest the challenges associated with trade policies weighing on the confidence of investors globally.

With a continuing increase in negative yielding sovereign bonds, coupled with a Fed that appears to be predisposed to cut rates, we believe US dollar assets will likely find additional support from offshore investors. However, we believe that, in many instances, US investors are not being adequately compensated for investments that include those that are significantly down in quality or capital structure. Until we gain a better understanding around trade, we believe investors will lack the degree of conviction that warrants testing the trading levels observed in early 2018.
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 delawarerec.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.

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 fixed income security that is held by the Fund may be prepaid prior to maturity, potentially forcing the Fund to reinvest that money at a lower interest rate. • 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 derivative 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 than investing in established foreign markets due to economic or political instability encountered in those countries, potential exchange control regulations, and less civilized legal systems. Transactions in emerging market securities may involve higher transaction costs and more risk of adverse fluctuations in currency values and interest rates. • 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 Asia (Australia) 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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