Market review

US Treasury yields fell during the second quarter of 2019, with 2-year notes declining 50 basis points, 10-year yields decreasing 40 basis points, and 30-year yields down 28 basis points. (A basis point is one hundredth of a percentage point.) As expected, the Federal Open Market Committee (FOMC) held the federal funds rate in a range of 2.25% to 2.50%, but the tone from the US Federal Reserve has shifted to one that is more dovish. The FOMC continued to reduce the Fed’s balance sheet for maturing Treasurys and in May lowered the amount to $15 billion a month from $30 billion, as expected. The Fed still plans to end the runoff at the end of September and will begin reinvesting mortgage-backed security (MBS) prepayments in Treasurys starting in October.

Inflation moved lower and remained below the Fed’s 2% target. The short part of the Treasury curve outperformed the intermediate and long parts of the curve as the market moved to price in rate cuts. Inflation expectations, as measured by 10-year Treasury inflation-protected securities (TIPS) break-even rates, fell 4 basis points as oil prices declined 3%. In June, break-even rates fell to their lowest levels since 2016.

Japan’s economy continued to lose momentum in the second quarter due to the slowdown in global growth, particularly in China. Exports and factory output continued to decline as exports hit the lowest levels in two years. The Bank of Japan anticipates a pickup in the economy in the second half of 2019 but noted that it is ready to act, should further easing be needed.

The European Central Bank (ECB) moved to a more dovish stance in the second quarter. The ECB left rates unchanged, as expected, but softened its forward guidance, saying it would not raise rates before the first half of 2020. ECB President Mario Draghi said that the risks to the economic outlook remain tilted to the downside and rate cuts and more quantitative easing (QE) are part of its arsenal. Euro-zone inflation moved lower and remained below target at 1.2% year over year. The Bank of Canada, Reserve Bank of Australia, and Reserve Bank of New Zealand have all tilted to the dovish side, joining the Fed and ECB as growth and inflation remain low.

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). Spreads have been volatile, ending the quarter slightly tighter amid the seesaw effects of rising trade tensions and corresponding dovish reactions from both the Fed and ECB. With trade tensions beginning to impact macroeconomic data, sentiment, and corporate earnings, we’re not surprised investors were focused on the G20 summit between US President Trump and Chinese President Xi Jinping. Although Trump and Xi have agreed to halt further tariffs and restart trade negotiations, a finalized deal is far from complete, and we expect uncertainty and volatility to continue to persist until and unless a deal is reached.

Investment grade supply for the quarter was below expectations at $287 billion, according to Bank of America, and roughly 22% behind last year’s pace despite several expected merger and acquisition deals from IBM and Bristol-Myers Squibb, as rising volatility kept some issuers on the sidelines. Issuance was also highlighted by Saudi Aramco’s highly anticipated $12 billion inaugural US dollar deal. Although the deal garnered more than $100 billion in orders, the issue underperformed in the days after the issuance as initial pricing was too tight relative to sovereign levels and the quality of the order book came into question. New-issue concessions have also begun to rise amid increased volatility after a period of flat-to-negative concessions earlier in the year. Demand remained robust with more than $26 billion of fund inflows into investment grade during the quarter, driving totals to $45.1 billion year to date (source: Lipper).

US high yield bonds, as measured by the ICE BofAML US Cash Pay High Yield Index, returned +2.57% for the second quarter of 2019, while European and global high yield bonds returned +2.33% and +2.75%, respectively, as measured by the ICE BofAML Euro High Yield Index and ICE BofAML US Dollar Global High Yield Index. Higher quality outperformed for the quarter, with BB-rated bonds returning +3.15%, followed by B-rated bonds (+2.42%) and CCC-rated bonds (+0.64%). Year-to-date new issuance totaled $141 billion, up 17% from a year earlier. Refinancing and general corporate purposes (GCP) represented 81% of issuance, while 18% was slated for leveraged buyout (LBO) and merger and acquisition activity. The expected US high yield default rate for 2019 is 2%. (Sources: Bloomberg and J.P. Morgan.)
Emerging markets debt posted strong returns in the second quarter. Sovereign debt, represented by the J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified, returned 4.08%, while the J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad Diversified, the benchmark for corporate debt, was up 3.50%. However, just as in the first quarter, the strong returns in emerging markets debt were generated largely on the back of external factors, most importantly the continuing plunge in US Treasury yields and the expectations of monetary easing by the Fed and ECB. On a spread basis, the J.P. Morgan EMBI Global Diversified finished the quarter just 5 basis points tighter, at 346 basis points. Similarly, the spread on the J.P. Morgan CEMBI Broad Diversified narrowed just 3 basis points during the quarter, to 333 basis points. In this environment, it is not surprising to us that the investment grade component (more sensitive to movements in the underlying US Treasury yields) of both indices outperformed the high yield component.

Within the Fund

For the second quarter of 2019, Delaware Diversified Income Fund Institutional Class shares outperformed the Fund’s benchmark, the Bloomberg Barclays US Aggregate Index. The following presents key drivers of performance during the period:

Attribution review

What worked

• investment grade credit overweight
• allocation to bank loans
• emerging markets debt overweight
• agency MBS underweight.

What did not work

• utilities overweight within credit
• underweight to high-quality Asian issuers within emerging markets.

June proved to be a microcosm of the broader themes for 2019. As evidence of a synchronized global slowdown mounted (coupled with trade war fears), investors priced in progressively higher probabilities of monetary policy stimulus and thus lower interest rates and lower risk premia. Central banks seemed to not dare disappoint, with ECB President Draghi’s previewing a restart of asset purchases and the US Fed’s delivering a satisfactory degree of support to concerned investors at its June meeting. In the often-confusing circular logic of bond markets, as recession risk was deemed to escalate, the macroprudential focus of the central bank reaction functions was thought to imply more stimulus, and recession risks were therefore to be pushed forward at the cost of risk asset inflation.

With more than $11 trillion in global debt sporting negative yields, US dollar fixed income, despite historically low interest rates, became increasingly attractive to us. The total return for the quarter was boosted by a 40-basis-point decline in the 10-year Treasury yield and modestly tighter spreads. The Fund’s outperformance was driven principally by sector allocation, specifically the decision to overweight corporate and securitized credit sectors.

Risk assets experienced three distinct regimes during the quarter. A benign environment early on was followed by fears that the mounting evidence of an economic slowdown was not met with enough concern from central bankers. Further exacerbating sentiment, deglobalization took a turn for the worse when President Trump redirected his focus toward Mexico with a threat of additional tariffs. After reaching tight levels year to date in April, credit spreads widened broadly in May as recession risk escalated. The tide turned abruptly on messaging from the ECB and Fed implying that financial conditions had deteriorated sufficiently to mark a decisive shift in monetary policy. Spreads reversed their earlier widening by the end of June.

All sectors with a credit component ultimately posted positive excess returns for the quarter: investment grade corporates (+1.04%), high yield (+0.39%), emerging markets debt (+0.70%), and commercial mortgage-backed securities (CMBS) (+0.31%). Though we cut the Fund’s exposure to the higher-octane sectors early in the quarter, the Fund’s net overweight to nongovernment sectors was the largest contributor to relative returns. Our decision to underweight agency MBS in recognition of rising call risk throughout the year also contributed to performance, as the sector delivered the lowest excess return (-0.39%) across the Fund’s option set.
However, within credit, our decision to overweight more-conservative segments, especially utilities, detracted from relative returns. While the sector posted positive excess returns of 0.46%, it delivered less than half the excess performance of industrials and financials, which benefited from a return in risk appetite.

The Fund’s underweight to investment grade Asian securities within emerging markets also detracted from performance, as the sector benefited from the reach for duration during the quarter.

Lastly, yield curve management was a modest positive as the 2-year to 30-year segment steepened and our strategy of overweighting intermediate maturities relative to short and long segments benefited the Fund’s performance.

Outlook

At the risk of sounding like a broken record, we remain focused on the same issues. Whether we are discussing risks associated with Brexit, the challenges of the German economy, or the loss of economic momentum in China, central banks again are being tested.

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, 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 the issue of trade, we believe investors will lack the degree of conviction that warrants testing the trading levels observed in early 2018.
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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.

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High yielding, non-investment-grade bonds (junk bonds) involve higher risk than investment grade bonds. The Fund may 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.

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