Market review

Investment grade corporates outperformed all other fixed asset classes for the second quarter, as support from an increasingly dovish US Federal Reserve 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 European Central Bank. The Fed’s recent meeting marked a major shift in its interest rate projections or “dots,” as market participants had expected. But with odds of a rate cut in July at 100% and three rate cuts fully priced in for 2019, the market seems priced close to perfection and the risk for the Fed to disappoint is also rising. With trade tensions beginning to impact macroeconomic data, sentiment, and corporate earnings, we’re not surprised that 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.

Spread levels on the Bloomberg Barclays US Corporate Investment Grade Index tightened by 4 basis points over the quarter, and the index produced a total return of 4.48%, outperforming duration-matched Treasurys by 104 basis points. With the quarter’s strong Treasury rally (the 10-year Treasury yield was down 40 basis points), 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 during the quarter. (A basis point equals one hundredth of a percentage point.)

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).

Within the Fund

For the second quarter of 2019, Delaware Extended Duration Bond Fund Institutional Class shares underperformed the Fund’s benchmark, the Bloomberg Barclays Long US Corporate Index.

Contributors to performance:

- Technology – Security selection benefited Fund performance, driven by an underweight to some of the sector’s higher-quality issuers that lagged amid the positive risk backdrop. New-issue participation also benefited performance as anticipation of merger-and-acquisition-related issuance from International Business Machines (IBM) pressured secondary bonds in the benchmark index ahead of the deal, which ultimately priced with a fair amount of concession and performed well amid strong demand.

- Capital goods – Similarly, within the diversified manufacturing subsector, the Fund benefited from positive security selection via an underweight to higher-quality issuers and a lack of exposure to 3M Co., which significantly cut its 2019 profitability outlook. An overweight to United Technologies Corp. also contributed to performance after the company announced the acquisition of Raytheon and committed to achieving “A” ratings, beating market expectations for BBB ratings post-spin-offs and driving spreads tighter.

- Insurance – An underweight to the health insurance subsector benefited the Fund’s performance for the quarter as the industry remained under pressure from Medicare-for-all proposals by some Democratic presidential candidates. Additionally, the Fund’s life insurer names that are exposed to equity markets via their variable annuity liabilities performed well.

Detractors from performance:

- Banking – Security selection detracted from relative performance, driven by exposure to out-of-benchmark shorter-dated maturities that underperformed amid the strong long-end Treasury rally during the quarter.

- Utilities – An overweight allocation detracted from performance as the sector lagged the overall benchmark given the higher-quality nature of the sector.

- Cash and Treasurys – Any exposure to cash or cash surrogates was a drag on performance during the quarter’s strong total return environment.
Outlook

We believe fundamentals remain supportive of valuations, including stable leverage and interest coverage trends, though slowing earnings growth bears monitoring. Supply-demand technicals have improved due to supply running below last year’s pace (as expected) and a rebound in foreign demand. Although technicals remain strong, we are closely monitoring supply and flows, which have the potential to turn quickly. Valuations have compressed dramatically in 2019, moving inside historical averages. However, we believe opportunities still exist, and we favor BBB-rated corporate debt over A-rated and BB-rated corporate debt. BBB-rated securities have been mispriced, in our opinion, due to overblown fears of downgrades and the size of the market. Conversely, we believe higher-rated debt may not be the “up in quality” trade that many investors think it is, as A-rated issuers have more dry powder and rating room to remain investment grade — a volatile combination, in our view. Other risks and catalysts that we are focused on include:

- Growing trade disputes – These could adversely impact not only corporate profitability but also investor confidence and ultimately global growth.
- US Treasury curve inversion – This 3-month T-bill / 10-year Treasury relationship is typically a precursor to a recession, but we believe the relationship would need to go deeper and persist longer than current levels to signal an eventual downturn.
- Technicals – Changes in demand driven by monetary or regulatory policy can turn quickly against markets.
- Idiosyncratic risks – Tighter valuations mean a higher cost of being wrong and require greater emphasis on proper credit selection, in our view.
- Management behavior – Many issuers have the ability to deleverage, but do they have the willingness? We believe avoiding those issuers that do not may prove beneficial in the months ahead.
- Geopolitical risks – The risk of a conflict between the United States and Iran has risen amid increasingly provocative actions on both sides.
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 2.125 3/31/2024 3.50%; Anheuser-busch Companies LLC 4.900 2/1/2046 2.21%; Halfmoon Parent Inc. 4.900 12/15/2048 1.40%; Jpmorgan Chase & CO. 3.702 5/20/2030 1.32%; Brooklyn Union Gas Co. 4.273 3/15/2049 1.32%; Wal mart Industries Inc. 9.000 10/1/2044 1.31%; Verizon Communications Inc. 4.500 8/10/2033 1.28%; Home Depot Inc. 4.500 12/6/2048 1.28%; Fedex Corp. 4.050 2/15/2048 1.27%; Northrop Grumman Corp. 4.030 10/15/2047 1.12%. 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.

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