Economy and markets in review

The third quarter of 2013 was a period filled with important news events. By late August, we were in the midst of the Syrian chemical weapons saga and had already experienced the city of Detroit’s filing for bankruptcy in July. Despite the significance of these events, most market analysts were pointing to September for a series of even more critical, potentially market-moving events. It would have been hard to overstate the significance of the stream of headline-worthy news items that followed. After kicking off the month with a surprisingly weak employment report, the news quickly shifted to Larry Summers’ withdrawing his name from consideration for the Federal Reserve chairmanship.

Of course, things were just warming up. On September 18, the Fed decided not to begin tapering its asset purchase program, and as the month ended the federal government shut down many of its nonessential activities while the powers in Washington seemed to be far apart on any compromise. The Fed’s decision was based on four factors: (1) economic data has not been strong enough to suggest that the recovery is self-reinforcing, (2) inflation remains below the target range, (3) budget battles in Washington create the risk of additional headwinds for the economy, and (4) the bond market’s reaction to the Fed’s May-June tapering guidance had resulted in an unwelcome tightening of financial conditions. All in all, market volatility continues and this is unlikely to change as we approach the debt limit around mid-October.

Speaking of volatility, one thing that most market participants agree on is the concept that “uncertainty helps create volatility.” Focusing on the Fed and its policy actions, uncertainty and a lack of clarity have returned with a vengeance during the third quarter, while credibility took a hit. The range of tapering forecasts now runs from October to “this is a major regime shift and no tapering will take place through at least 2014.” The Fed has made it pretty clear that future tapering decisions will be data-dependent and will not be on a preset course. So, its delay in tapering has placed even more importance on every significant economic report and has subjected the financial markets to more volatile reactions to these reports. Another form of uncertainty revolves around a question that has been around for quite some time: Does quantitative easing (QE) actually help fundamental, economic growth? Given that the Federal Reserve System has generated its share of white papers asking this exact question, the answer is definitely not a simple “of course.”

Previously, some policy makers had spoken about the potential costs of QE in the form of increasing speculation, possible bubbles, and rising financial leverage. Concerns about these costs appear to have moved to the back burner, and this leads the more suspicious market analysts to ask, “What does the Fed know that we don’t know?”

Mixed economic signals

U.S. economic indicators were mixed during the third quarter of 2013, as employment reports showed varied results while jobless claims trended to better levels. Housing statistics showed decent strength, leaving analysts to wonder when higher rates would begin to bite. Manufacturing was generally positive while consumer demand was more challenged.

Overall, the U.S. economy is experiencing moderate momentum as we move into the fourth quarter. Gross domestic product (GDP) growth for the second quarter of 2013 was +2.5%, according to the U.S. Commerce Department. Firming in core prices and headline inflation statistics continued during the third quarter. The Fed continues to refer to

The views expressed represent the manager’s assessment of the market environment as of Sept. 30, 2013, are subject to change, and may not reflect the manager’s current views. Views should not be considered as recommendations to buy, hold, or sell any security, and should not be relied on as research or investment advice. Please see important disclosures and definitions at the end of the document.
an unchanged policy target range of zero to 0.25% (since December 2008) and recently softened the connection between employment and inflation-based economic thresholds and the exact timing of future rate changes. After the most recent Federal Open Market Committee (FOMC) meeting, the Fed’s comments on the economy referenced moderate growth and its GDP projections for 2013, 2014, and 2015 were reduced slightly. (Data: Bloomberg.)

**Fixed income markets: Performance, yields, and rates**

During the third quarter of 2013, yields on 10-year Treasurys rose from 2.49% to 2.61%, and yields on 2-year Treasurys fell from 0.36% to 0.32%. Rates were once again volatile as levels moved with economic and political events. Anticipation of stronger economic statistics and a change in the Fed’s plans for the duration of quantitative easing pushed yields higher during July and August but this trend reversed with the Fed’s change in the timing of tapering.

- The 3-month T-bill / 10-year T-note curve steepened by 14 basis points to 2.60% by the end of the quarter.
- The 1-month London interbank offered rate (Libor) moved just slightly lower, ending the quarter at 0.18%. (Data: Bloomberg.)
- The Barclays U.S. Aggregate Index recorded a solid positive return for the third quarter as mortgage-backed securities (MBS), commercial mortgage-backed securities (CMBS), and corporate bonds led the way.
- Financials, as well as A-rated and BBB-rated corporates, had particularly good results. High yield corporate bonds and non-U.S. bonds (developed and emerging markets) all produced very strong returns.

(Data: Bloomberg, accessed on or about October 2, 2013. Past performance does not guarantee future results.)

**Market comments and outlook**

The Fed chose to delay the start of tapering its current asset purchase program and interest rates fell. This is logical — if a large buyer of government bonds decides to continue buying those bonds, it helps to maintain the supply-demand balance. But there is a problem: since March 2009, every time the Fed has actually initiated or expanded a version of QE that involved “printing money” (so excluding “Operation Twist” and the principal reinvestment actions), interest rates have trended higher, not lower. Significant declines in rates since 2009 have generally occurred in between QE programs or during Operation Twist.

To be clear, there have been times when, in anticipation of upcoming QE actions, government bonds have rallied and rates have fallen, but these trends have consistently reversed once actual asset purchases have begun. The only direct beneficiary during the asset purchase programs (with the related printing of money and creation of excess liquidity) has been risk asset prices. We believe that understanding this information will be important as investors try to manage their risk exposures during the various possible versions of tapering over the months and quarters to come.

The views expressed represent the manager’s assessment of the market environment as of Sept. 30, 2013, are subject to change, and may not reflect the manager’s current views. Views should not be considered as recommendations to buy, hold, or sell any security, and should not be relied on as research or investment advice. Please see important disclosures and definitions at the end of the document.
September 30, 2013 • Third quarter review
Taxable fixed income markets

Important disclosures and definitions

Investing in mutual funds involves risk, including the possible loss of principal. Past performance does not guarantee future results.

Unless otherwise noted, market statistics cited herein are based on data published by sources that include Barclays, Bloomberg, and Dow Jones.

The information is provided with the understanding that Delaware Investments is not engaged in rendering accounting, legal, or other professional services. Seek the services of a competent professional if legal advice or other expert assistance is needed.

Advice (if any) related to federal taxes that is contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code. Individuals should seek advice based on their own particular circumstances from an independent tax advisor.

See Yeng Quek is an officer of Delaware Management Company, a series of Delaware Management Business Trust and a registered investment advisor.

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. Fixed income securities may also be subject to prepayment risk, the risk that the principal of a fixed income security may be prepaid prior to maturity, potentially forcing the mutual fund to reinvest that money at a lower interest rate.

High yielding, noninvestment grade bonds (junk bonds) involve higher risk than investment grade bonds.

Interest payments on inflation-indexed debt securities will vary as the principal and/or interest is adjusted for inflation.

International investments entail risks not ordinarily associated with U.S. 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 increased volatility and lower trading volume.

International fixed income investments are subject to currency risk. Adverse changes in foreign currency exchange rates may reduce or eliminate any gains provided by investments that are denominated in foreign currencies and may increase losses.

If bond ratings are mentioned in this document, such ratings are published by Standard & Poor’s, a nationally recognized statistical rating organization. Bonds rated BBB are believed to be of medium-grade quality and generally riskier than higher-rated bonds over the long term.

The Barclays U.S. Aggregate Index measures the performance of publicly issued investment grade (Baa3/BBB- or better) corporate, U.S. government, mortgage- and asset-backed securities with at least one year to maturity and at least $250 million par amount outstanding.

Indices are unmanaged and one cannot invest directly in an index.

For the national sales desk, please contact 877 693-3546.
Individual investors, please contact 800 523-1918.

All third-party marks cited are the property of their respective owners.

Delaware Investments • 2005 Market Street • Philadelphia, PA 19103-7094

Delaware Investments, a member of Macquarie Group, refers to Delaware Management Holdings, Inc. and its subsidiaries. Macquarie Group refers to Macquarie Group Limited and its subsidiaries and affiliates worldwide.

Delaware Investments is not an authorized deposit-taking institution for the purposes of the Banking Act 1959 (Commonwealth of Australia) and Delaware Investments’ obligations do not represent deposits or other liabilities of Macquarie Bank Limited ABN 46 008 583 542 (MBL). MBL does not guarantee or otherwise provide assurance in respect of the obligations of Delaware Investments.

© 2013 Delaware Management Holdings, Inc.

Not FDIC or NCUSIF insured • No bank guarantee • May lose value