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Fixed income markets in flux

The Delaware Investments Fixed Income team anticipated the Federal Reserve's Open Market Committee (FOMC) would embark on a gradual series of interest rate increases, beginning at its mid December meeting. For some time, we have been anticipating only measured and gradual changes to interest rates by the Fed, and the potential for a generally bearish "flattening" of the yield curve in 2016.

As the FOMC's December monetary policy meeting approached, the high yield bond market underwent severe volatility and tightening. The notes below are a compilation of our outlook on the future direction of monetary policy and the fixed income markets in general, and also includes a discussion of conditions in the high yield bond market.

Highlights of our general outlook

- Monetary policy will be aimed at reducing underemployment and preventing deflationary pressures. Consequently we expect monetary policy to remain accommodative relative to past tightening cycles.
- Commodity prices should continue to feel pressure from a strong U.S. dollar and declining growth in China.
- We expect high yield default rates to rise modestly as a result of stress in the energy and commodity sectors. For the balance of the market, we expect default rates to remain well below average.

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On gradual normalization of U.S. monetary policy

Paul Matlack,
senior portfolio manager,
Oct 28, 2015

The Fed has been anxious to begin "normalizing" its extraordinarily accommodative monetary policy, which would mean slowly unwinding (or selling back into the market) roughly $4 trillion in holdings of Treasurys and mortgages as well as lifting the federal funds rate, which was effectively bottomed.

We believe normalizing is unlikely to entail a significant boost to the fed funds rate over time. More than likely, it'll be a gradual and incremental series of small increases that may play out over several years. While the Fed's balance sheet is likely to remain static for now, Fed officials will likely begin the process of normalizing the fed funds rate when they are satisfied that markets are showing the right combination of (1) economic growth and stronger labor markets in the United States, and (2) a measure of economic stability around the world.

Read more from "Bond market playbook: Diversification, risk control, and patience"

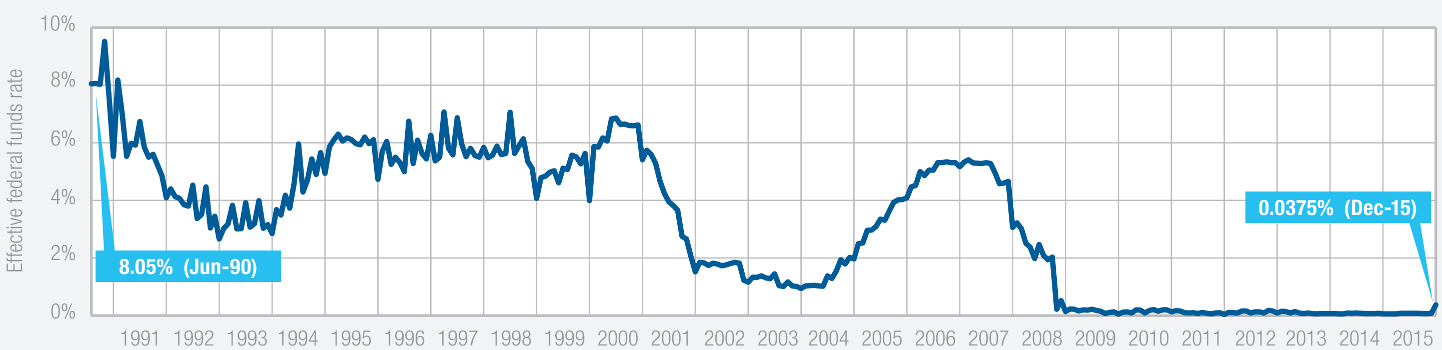
We are not overly concerned about an imminent or significant increase in interest rates. But we are concerned about this scenario: A decline in capital appreciation potential going forward could mean that returns across fixed income sectors could consist largely of income, and opportunities for capital appreciation (as well as capital preservation) will require tactical dexterity. With such considerations in mind, we currently favor diversified, higher-quality portfolios that possess:

- a tilt toward intermediate duration
- a concentration in domestic fixed income sectors
- a bias toward higher-quality credit, mortgage-backed securities, and Treasurys.

While yields remain frustratingly low overall, we believe reaching for yield now (which would mean creeping out further on the risk-reward spectrum) poses unnecessary risk exposure for investors who look to their bond allocations for relative stability. In addition to resisting the urge to take on unwarranted risk for the sake of extra yield, we believe successful bond investors should employ patience. A patient approach provides the opportunity for investors to see how Fed policy and the global economic picture will sort themselves out.

Federal funds rate: Lower for longer

June 1990 through November 2015, monthly observations



Data: U.S. Federal Reserve

All charts shown are for illustrative purposes only.

On “bear flatteners,” and a glance back to 2004-2006

Greg Gizzi,
senior portfolio manager,
municipals,
Nov 16, 2015

Once the Fed does begin to “normalize” rates, we expect the trajectory to be gradual and the interest rate curve to flatten. We anticipate a so-called “bear flattener,” a move in which rates in the shorter end of the curve go up by a greater degree than they do in the longer end. This flattening of the curve happens to be the consensus view among analysts.

In a bear flattening environment, the long end of the curve outperforms (rises less than) the shorter end, and having an income cushion to offset the negative price action becomes paramount to maximizing your return potential.

Bear flattening was precisely the action that rates markets experienced during the 2004–2006 rate hike period. It’s this period that many strategists point to as the best approximation of what the next rate-hike period might look like. From June 2004 to July 2006, the fed funds rate rose 425 basis points, from 1.00% to 5.25%.

Yield curve action, as measured by the difference between the 30-year yield and the 2-year yield, flattened substantially for both municipal bonds and Treasurys: The Treasury yield curve began the period at a difference of 262 basis points and ended the period at 6 basis points, while the municipal yield curve began the period at a difference of 292 basis points and ended the period at 92 points. Isolating municipals, the 2-year segment of the curve rose by 164 basis points in the period and the 30-year segment actually fell by 36 basis points. This means that bonds on the longer end of the municipal curve significantly outperformed the shorter end of the curve.

Additionally, credit spreads at the time tightened (or decreased) anywhere from 7 basis points to 29 basis points, depending on which part of the curve is examined. In general, 1-year to 19-year maturities performed the strongest (credit spreads tightened the most), with 20-year maturities and beyond tightening the least. This meant that bonds that traded with a spread off of the AAA scale (lower-investment-grade and below-investment-grade bonds) outperformed their higher-quality peers, as spreads tightened through the cycle. In the current cycle, we generally expect that credit spreads should behave in a way that they don’t necessarily tighten, but certainly don’t widen out significantly either — as long as the economy continues to grow at the moderate pace it has exhibited over the past year or so.

Read more from “Municipal bonds and rising interest rates: A historical perspective”

On the current credit cycle

Michael Wildstein, senior portfolio manager, Nov 18, 2015

We view the U.S. market as firmly in the expansion phase of the credit cycle, although it appears to be approaching the latter stages. That being said, leading indicators are not signaling an imminent end to the current cycle, and we believe there are still a few years left before we encounter the downturn phase. Notable data points include the following:

- Leverage readings are on the high side, which is common in the latter stages of credit cycles, although above-average equity valuation multiples provide some offset.
- Lending conditions remain relatively open, a key condition for continued expansion.
- While defaults for high yield issues have risen as a result of commodity weakness, defaults still remain below historical averages. We expect default rates to increase during the next 12 months but remain in line (or below) long-term averages.
- Refinancing has shrunk as a percentage of use of proceeds compared to pre-crisis years, although the mix is still favorable (lower leveraged-buyout activity).
- Balance sheets are in much better shape as management teams have taken full advantage of the low rate environment.

We were more optimistic on investment grade valuations at the beginning of the year as spreads had cheapened to what we believed were attractive levels; however, event risk, another year of record supply, and global growth concerns affecting commodity prices have created headwinds and are justifying wider risk premiums. At this point, there are no clear near-term catalysts for further tightening at the index level given Fed uncertainty, fourth-quarter supply expectations (heavy), event risk, weakening earnings growth, and global growth concerns (China). As such, investment grade risk premiums should remain volatile in the near term as pockets of stability will be met with additional supply, placing pressure on secondary levels.

A so-called "bull flattener" pattern in the Treasury yield curve would be an early indicator to us that global growth is deteriorating further.

Read more from "An update on credit market conditions"

On high yield market turmoil

Ted Hart, CFA, fixed income product manager, Dec 14, 2015

The recent move by a prominent high yield mutual fund to bar investor withdrawals while liquidating its portfolio is an unusual one that highlights the volatility that swept through leveraged financial markets in recent days. While such a move is uncommon for a mutual fund, we remind investors that this event affected a fairly atypical high-yield mutual fund, and one that's quite concentrated in lower, off-the-run bonds.

As recently highlighted by market regulators, many measures still indicate a healthy credit market. In higher rated segments of the corporate bond market new bond issuance is at a record level, transaction volumes have continued to grow, and the number of trades is rising. The cost of trading corporate bonds has been decreasing in aggregate.

However, several measures offer evidence of potentially significant changes in how the market is working, including smaller average trade size and a declining proportion of bonds traded in blocks of $5 million or more. Wider than anticipated bid-ask spreads have been observed for companies demonstrating increased idiosyncratic risk. These trends are consistent with a market that has a larger number of issues, more electronic trading and a growing network of counterparties.

Over the last several weeks, we have taken steps to try and reduce the amount of risk in our high yield allocations by reducing exposure to the lowest rated bonds by eliminating and trimming certain higher-risk positions. We have been monitoring the liquidity situation for some time now, and believe we have been in front of the issue by building in additional liquidity into portfolios as appropriate.

Delaware's fixed income portfolio managers embed liquidity considerations throughout their investment management process. We review the overall liquidity of the portfolio's positions as a primary consideration when constructing our portfolios. Based on our experience, key factors include deal size, lead underwriter/syndicate, number and quality of secondary market makers, current concentration/position size, and structure of the security. The liquidity of each security is reviewed as part of the initial evaluation of the security before it is purchased, and on an ongoing basis afterward. The relative liquidity of a security must be consistent with the size of the position taken and the planned exit strategy for that security.

In our investment process, traders are paramount to understanding liquidity. Traders regularly compile and distribute technical market information to team members, in a free flow of information. Our traders are tasked with providing "best execution" during all phases of trading execution, which requires developing strong relationships with sell-side analysts and traders to gain insight into technical market conditions and trends.

In managing asset flows, portfolio managers received fund-related cash flow information on a daily basis. We monitor flows throughout the industry, to better understand our specific liquidity needs. Delaware's portfolio managers adjust cash and liquid asset holdings as necessary to respond to market conditions that may increase redemptions and/or require greater access to liquidity, in order to address increases in risk factors appropriately.

Additionally, we conduct a formal semi-annual review of portfolio liquidity, which consists of security- and portfolio-level liquidity assessments, fund flows analysis, and market stress testing.

The views expressed represent the managers' assessment of the market environment from October 2015 to December 2015 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.

Past performance does not guarantee future results.

Investing involves risk, including the possible loss of principal.

Carefully consider a 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 delawareinvestments.com or calling 800 362-7500. Investors should read the prospectus and the summary prospectus carefully before investing.

Information is as of the date indicated and subject to change.

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.

Bond funds 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.

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.

Investors should not place undue reliance on forward-looking statements as a prediction of actual results. In addition, we disclaim any obligations to update any forward-looking statements to reflect events or circumstances that occur after the date of this document.

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