

Global Bond Fund

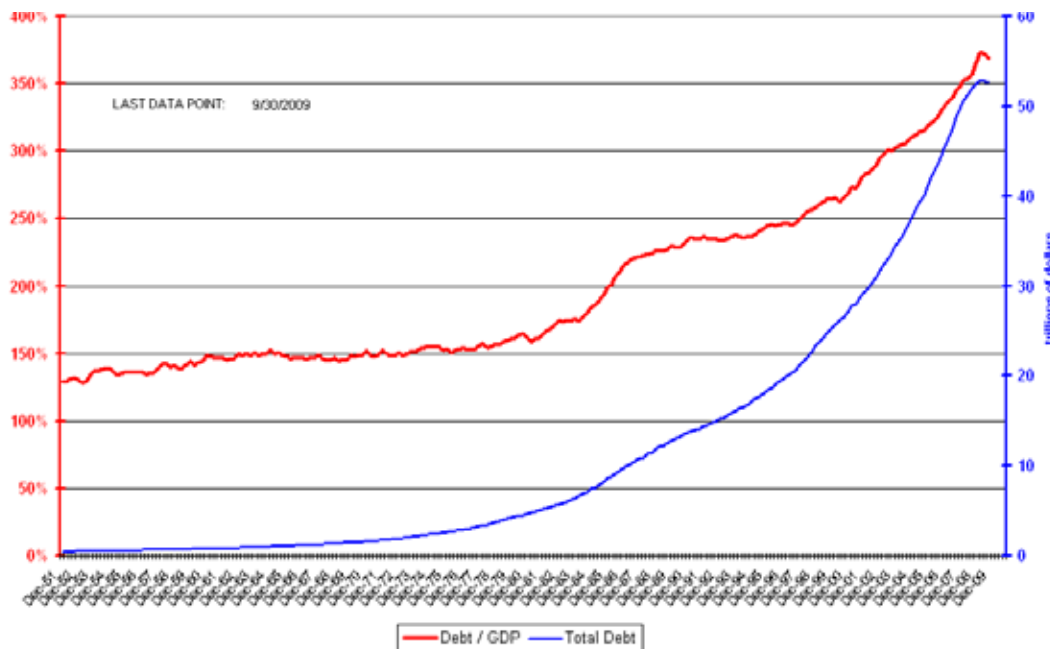
Expanding Bond Boundaries

PORTFOLIO PERSPECTIVES | DECEMBER 2009

The Economy

The primary cause of the U.S. recession was an unprecedented borrowing binge — especially by consumers and financial institutions. Those sectors are now suffering through a deleveraging process — still in its initial stage — that is manifesting itself in higher unemployment and lower economic growth. Charts 2, 3 and 4 show the rapid rise in debt over the past decade (both as a percent of gross domestic product — red line; and on an absolute dollar basis — blue line). The charts also show the beginning of the deleveraging in the consumer (personal) and financial sectors in recent quarters. The deleveraging is more obvious on a dollar basis than on a debt-to-gross domestic product basis because GDP (the denominator) has fallen for three quarters in a row on a year-over-year basis.

Chart 2. Total Debt — Total U.S. Credit Market Debt, Not Seasonally Adjusted – Consumer, Business, Government as a percent of GDP, and in total nominal dollars (trillions)

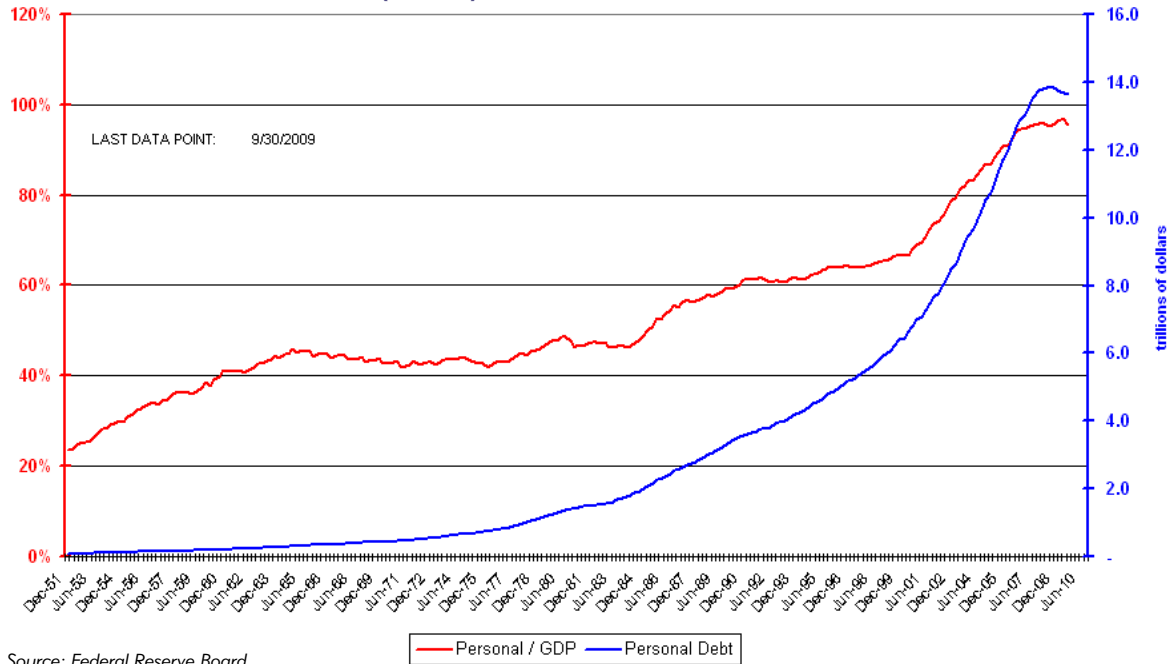


Source: Federal Reserve Board

Past performance is no guarantee of future results.

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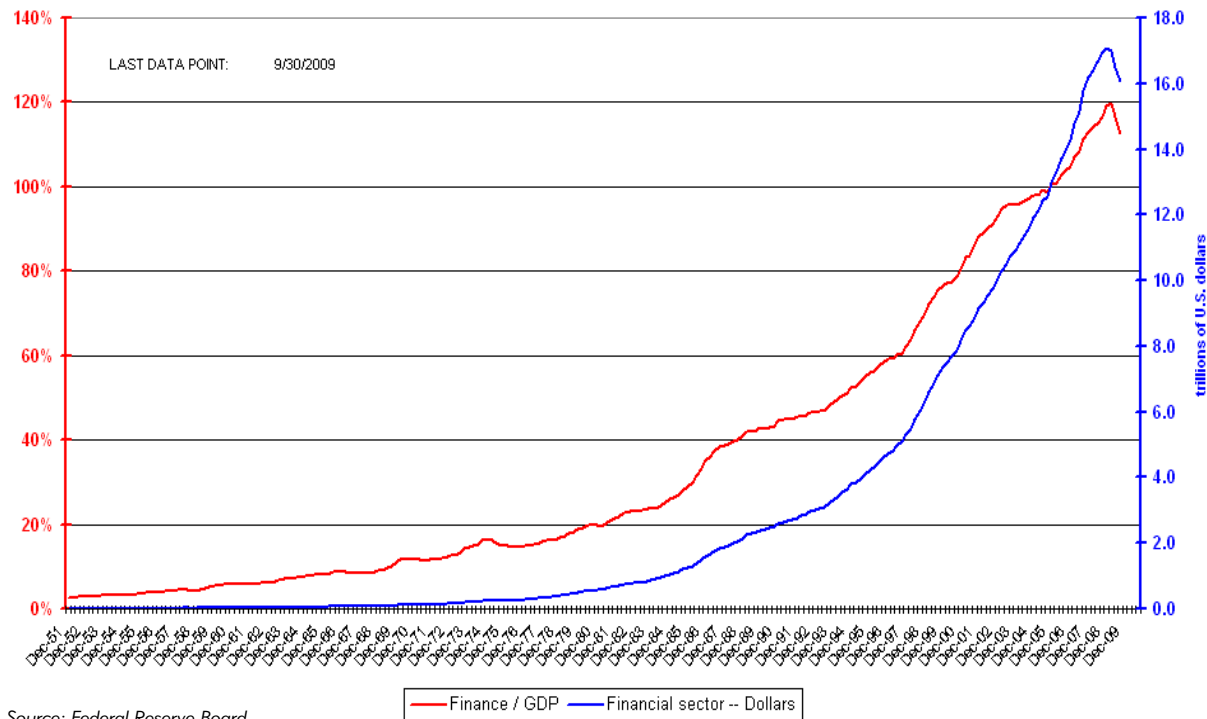
Chart 3. Personal Debt (Not Seasonally Adjusted, including Mortgage Debt) as a % of GDP, and in total nominal dollars (trillions)



Source: Federal Reserve Board

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Chart 4. Financial Sector, Not Seasonally Adjusted, as a % of GDP, and in total Nominal dollars (trillions)



Source: Federal Reserve Board

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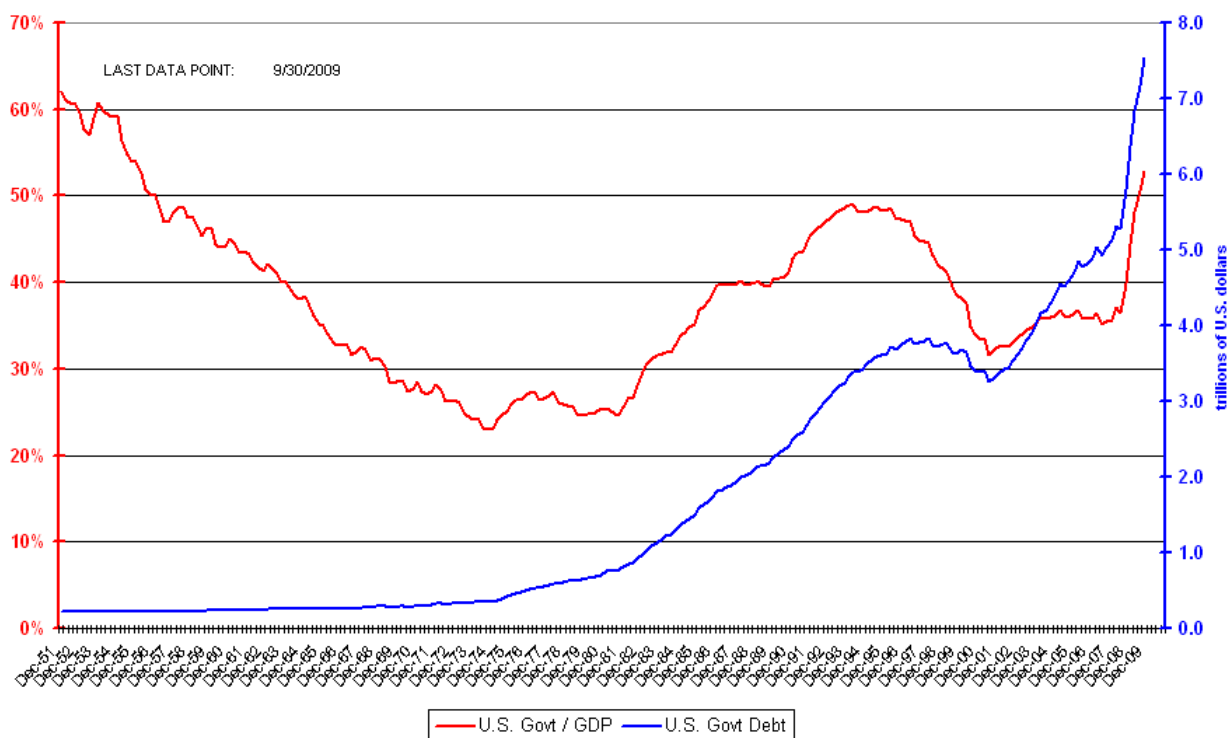
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While the private sector is deleveraging, the public sector is re-leveraging to compensate (Chart 5). This re-leveraging creates very high budget deficits and thus higher debt issuance by the Federal government.¹ Record deficits and borrowings are expected to continue for at least the next few years. The major concern for investors, therefore, is how long the rest of the world will tolerate extreme money and fiscal policies in the U.S. before such policies create crises in the dollar and bond markets.

Crises of this nature are not yet a foregone conclusion. However, to avoid panics in the dollar and bond markets, it is imperative that the U.S. government and the Federal Reserve announce credible fiscal and monetary policy plans sometime in the first half of 2010. These "exit strategies" will be multi-year plans to reverse the extremely loose policies that currently exist. The market will not be patient indefinitely. The longer it takes to reveal credible policies, the greater the probability of crises in the dollar and bond markets.

Chart 5. U.S. Federal Government Public Debt, Not Seasonally Adjusted as a % of GDP, and in total nominal dollars (trillions)



Source: Federal Reserve Board

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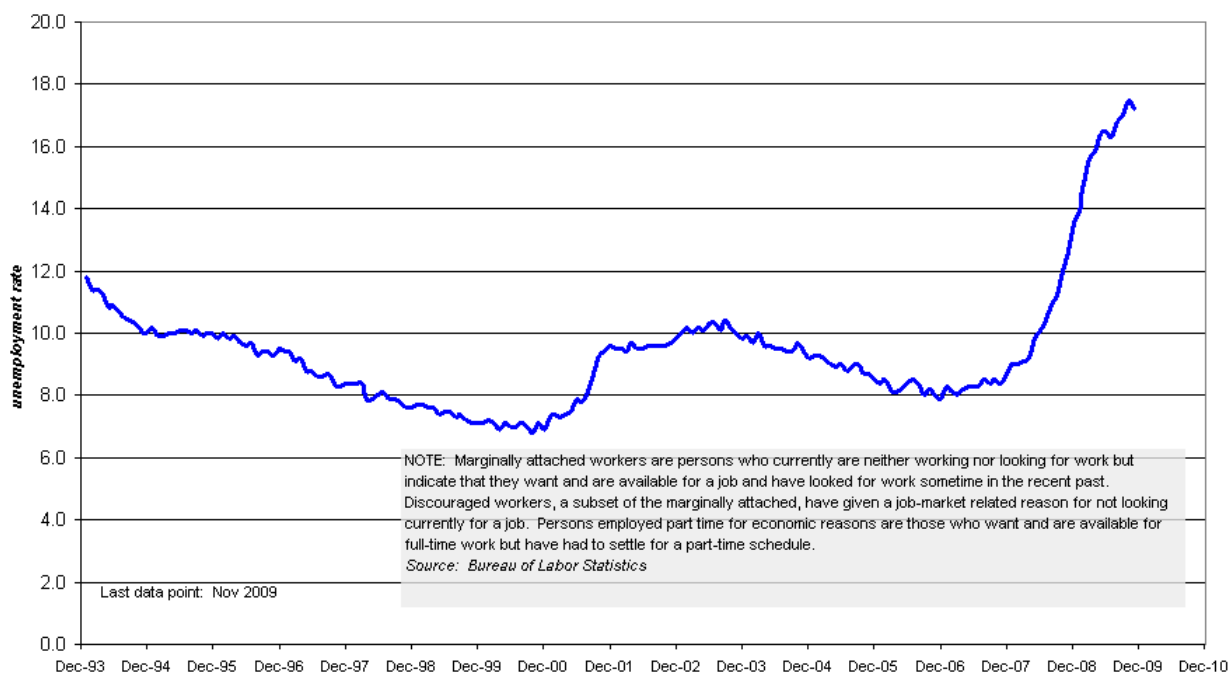
¹ Note that this Federal Government debt figure does not include obligations owed to the Social Security System or other Government entities. If you add those borrowings, total Federal government debt would be over 80% of GDP. However, Chart 5 is adequate to demonstrate the rapid increase in the Federal debt level because nearly all of the increase in the past year has been in the public domain — the surpluses of Social Security and Medical funds are disappearing and will no longer be a major source of funds for the Federal government.

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The consumer should continue to be hit hard — unemployment, underemployment, declining income and wealth and reduced access to credit. In terms of the impact on wealth, think of the impact to consumer assets from the stock market declines of 2000-2002 and 2008, coupled with the even more important 25 percent to 30 percent drop in the value of their homes. Companies are shedding jobs, and many of these jobs are unlikely to return even after the economy moves into a true recovery pattern. It is illustrative to note that because of the tremendous job losses since 2008, the total level of employment today is no higher than it was 10 years ago.

Nearly 25 million Americans today are unemployed or underemployed. Chart 6 shows a measure of unemployment known as U-6. The Bureau of Labor Statistics puts out several unemployment measures. The headline unemployment number that everyone sees is known as U-3. U-6 is a more all-encompassing measure.

Chart 6. U-6 – Total unemployed, plus all marginally attached workers plus total employed part time for economic reasons,



Source: Bureau of Labor Statistics

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In our opinion, the combined impact of multi-year deleveraging in the private sector, higher unemployment, reduced wealth and lower access to credit will reduce potential economic growth in the United States from 3.5 percent of the prior several years to 2.0 percent or less for the foreseeable future. Economic growth in the United States (and much of the rest of the world) in 2009 has been totally dependent on government and central bank policy initiatives; unfortunately, these initiatives have produced little in the way of private sector traction. Furthermore, as government debt levels pile up, the ability to continue loose fiscal policies is declining. As long as the consumer continues to deleverage and unemployment and underemployment remain high, we see weak U.S. growth prospects for 2010.

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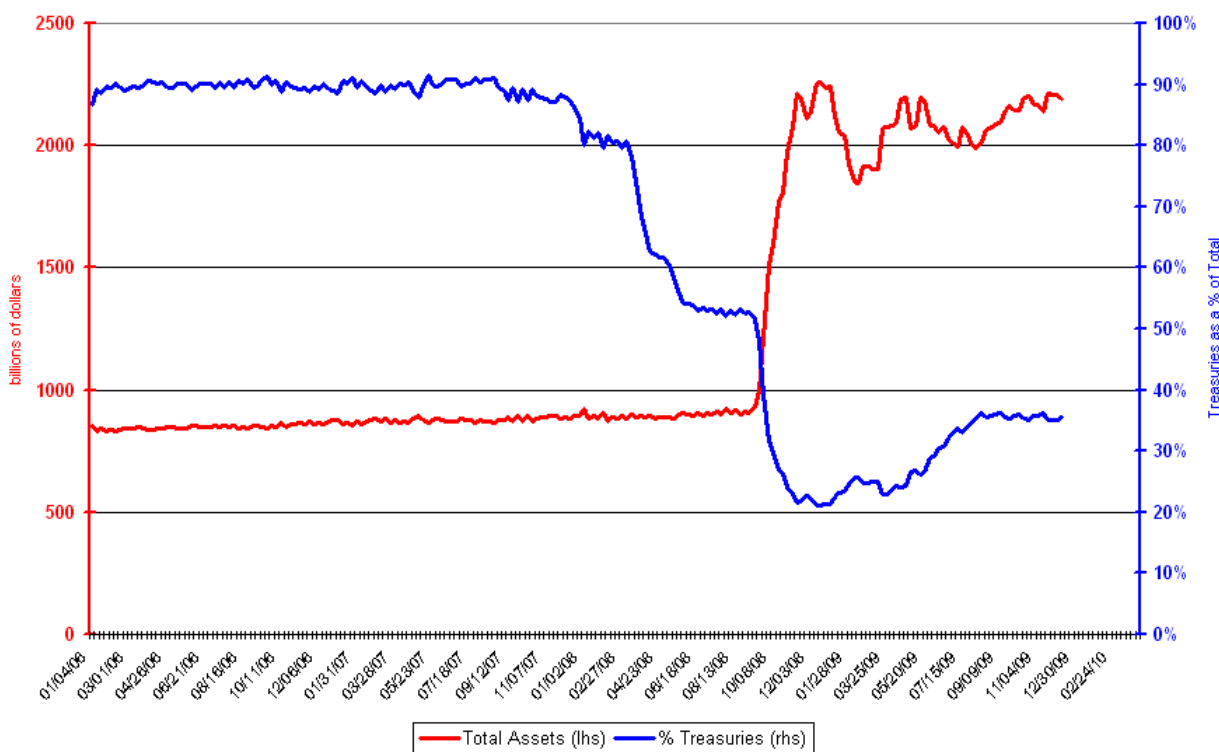
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The Federal Reserve Bank

Given our economic view, our near-term inflation view is benign. Although we believe the Fed will be on hold in 2010, we are increasingly concerned about the Fed's balance sheet, which continues to deteriorate. In terms of size, it has jumped from around \$800 billion to over \$2 trillion over the course of a year (see Chart 7 — red line). This is an unprecedented increase. More concerning has been the deterioration in the quality of the balance sheet. In prior years, U.S. Treasuries represented approximately 85 percent of the Fed's assets. This is important, because the Fed buys and sells Treasuries to implement its monetary policy. Today, the percent of Treasuries on the balance sheet has dropped dramatically from 85 percent to 35 percent (see Chart 7 — blue line). This reflects not only the ongoing \$1.25 trillion mortgage-backed securities purchase program to prop up the housing market, but also the purchases of highly illiquid securitized assets from banks and other financial institutions as part of the Fed's bank bailout efforts during the past year. Generally, the Fed's ability to implement monetary policy is being called into question — both within the Fed and from the outside. The Fed is definitely concerned and is working up ways to deal with this problem.

Chart 7. The Fed's Balance Sheet



Source: Federal Reserve Board

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A secondary issue in this regard has to do with the tremendous growth in excess reserves in the banking system. To encourage lending, the Fed has kept interest rates low and also flooded the banks with money. There is much concern over the Fed's ability to withdraw this excess money should the economy begin to grow too fast. Not having enough Treasuries on the balance sheet complicates this problem.

We remain concerned about the financial sector, as there is still no national or international agreement on how it will be structured or regulated.

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The Global Bond Market

Regarding sovereign bonds, it is likely that short-term interest rates will remain low. Central banks will keep policy rates low, as economies remain weak and consumer inflation is not on the horizon. However, easy fiscal and monetary policies will probably put pressure on the longer end of sovereign yield curves. (This is another reason for keeping a short duration in the Global Bond fund.) The risk to this view on the long end of the curve comes from the possibility that the global economy faces a deflationary threat from a prolonged downturn and excess capacity. A Japan-style scenario for the U.S. and possibly a few other developed countries is not outside the realm of possibility. In this scenario, longer-term sovereign bond yields could actually decline further from today's already low levels.

Outside of sovereign bond markets, our economic view leads us to believe that the current "return to risk" rallies — in equities, non-government bonds, and commodities — are overdone. In terms of corporate bonds, the government policies that supported the markets were a good reason for the improvement in spreads from March to June of 2009 (revisit Chart 1). However, we believe that the continued decline in spreads since late July 2009 may be based on unwarranted economic expectations. Therefore, we expect a less favorable environment for risky assets in 2010, and we expect corporate bond spreads to widen from current levels. Therefore, we'll retain a higher cash balance than we would under normal conditions to take advantage of better investing opportunities in the coming months.

There is a way spreads could continue to tighten. Because of the stock market declines of 2000-2002 and 2008, and the housing market decline of 2008-today, individuals have suffered tremendous wealth losses. This has made them much more risk averse. Add to that the fact that baby boomers will begin retiring in larger numbers in the next 10 years. For these reasons, individuals are focusing more on obtaining income and are seeking to reduce the volatility of their investments. The data definitely demonstrate this trend. In the most recently available data from the Investment Company Institute, in 2009 taxable bond mutual funds have net inflows of \$291 billion. In contrast, hybrid funds (funds which are a mix of bonds and stocks) have net inflows of only \$19 billion, and equity mutual funds actually have net outflows of \$11 billion!² This additional money flowing into the bond market has certainly been a factor in the tightening of spreads this year. If individuals' desire for income and greater stability continues, then it is possible that spreads could continue to tighten. In this case, the Global Bond fund will still be in good shape because of our emphasis on corporate bonds (versus other bond funds that tend to have a much greater emphasis on government, agency and mortgage-backed bonds).

This highlights the importance of the Ivy Global Bond Fund's reward-to-risk management philosophy: If spreads widen, the Fund's short duration will mitigate the impact, and if spreads tighten the Fund's corporate investments should benefit.

The Dollar

The dollar's decline since March has been due to a combination of worry over U.S. fiscal and monetary policies and a return of risk appetite. The increased risk appetite has been whetted by the Fed, which has allowed the dollar carry trade³ to explode over the past six months. Our view is that risk appetite will wane over coming months as weak economic fundamentals re-assert themselves in the developed economies of the U.S., UK, Europe, and Japan. Furthermore, central banks around the world will be forced to deal with the deleterious effects of the dollar carry trade, which will reduce the demand for risky assets. Near-term this should relieve some pressure on the dollar.

However, the dollar still faces a difficult road ahead. As previously mentioned, investors here and abroad want to see an action plan for the U.S. government to get its deficits under control, and they want the Fed to have a viable exit strategy from its easy monetary policy. If these action plans are not forthcoming in the near future, there could be further downward pressure on the dollar and further upward pressure on medium- to long-term interest rates in the U.S. To its credit, the Fed is mooting ideas in public on its exit strategy.

² Source: Investment Company Institute

³ A carry trade occurs when an investor borrows money in the short-term market to invest in longer-term markets or other risky assets (e.g. equities or emerging markets or high yield bonds). The proposition is that the returns on the riskier investments will more than compensate for the short-term costs of borrowing, and the investor will be able to repay the loan and make a profit. A dollar carry trade simply means that an investor borrows short-term in dollars, and reinvests in risky assets not just denominated in dollars, but in other currencies as well. There are two reasons for this: First, dollar short-term interest rates are very low (both relatively and absolutely), and therefore it is cheap to borrow in dollars. Second, the dollar is seen as a weakening currency, so when the borrower invests in non-dollar risky assets, they get a double bargain — the risky assets return more, and the value of the currency they invest in appreciates versus the dollar. The dollar carry trade is negative for the dollar because it implies the borrowers are selling dollars and buying other currencies. Dollar carry trades exacerbate the weakening of the dollar. Of course, this situation cannot go on forever. If the dollar stops weakening or short-term dollar interest rates start to rise, those investors who borrowed dollars short-term will get caught in a squeeze as their borrowing cost rises and their currency positions in risky assets decline. This causes the dollar to suddenly snap back and begin to appreciate versus other currencies.

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The U.S. Congress and administration are lagging behind in coming up with a credible fiscal policy response.

If we get no concrete evidence of exit strategies over the next several months, will investors abandon the dollar? It could depend upon the state of the global economy. Last year investors actually sought the dollar as a safe haven — abandoning gold and other currencies as the global economy collapsed. This year, however, the U.S. has trillion-dollar-plus deficits for the foreseeable future. Where will investors go?

One asset many investors have focused on is gold. There's simply not enough gold for all the investors who may want to sell out of paper currencies, which could force gold's price even higher. But gold's poor performance in the downturn last year should give investors pause as to whether a continued gold rally is a foregone conclusion.

What about other currencies — the Euro? Asian currencies? The Brazilian real? Many countries are already complaining about how much their currencies have appreciated versus the dollar this year; some have even taken concrete steps to limit their currency's appreciation. Don't expect other countries to graciously accept the burden of a weaker dollar.

Finally, how about the Chinese? We strongly believe the Chinese will be forced to revalue the renminbi — but they are fighting it tooth and nail. Most of their policies are still geared toward pumping up the export sector at the expense of the consumer and domestic-driven growth. This requires them to maintain a weaker, rather than a stronger, currency policy. There is tremendous debate within China today. On one side are exporters and their political friends who favor a weaker currency policy. But the central bank and some other financial agencies fear huge domestic imbalances are building in China — and one way to relieve the pressure is for the renminbi to appreciate. We maintain a long renminbi position in the Fund versus the dollar.

Aside from the Fund's position in the renminbi, we maintain a neutral view near-term on the dollar. The Fund's foreign currency exposure today is less than 10 percent.

In the medium-term, however, we are very concerned about the dollar as the U.S.'s role in the world diminishes on a relative basis. Furthermore, we believe that over the next several years the Chinese will continue to internationalize their currency, and it will become more widely accepted in trade and as a reserve currency, reducing the global need for dollars. The Fund's flexibility with regard to its currency exposure will provide an advantage over the next several quarters.

Conclusion

We believe it will be very difficult in 2010 for the U.S. economy to recover quickly based on the poor health of the consumer and the deleveraging of the economy. This also will be the case in Europe and Japan. China has room to further stimulate its economy, but its growing domestic imbalances may limit its desire to do so. The United States must come up with credible exit strategies from unprecedented easy fiscal and monetary policies. The recent rally in risky asset markets — which we believe has been predicated on a V-shaped global economic recovery — has gone too far and will witness a reversal during 2010. The fate of the dollar is in the hands of the U.S. authorities, but is also dependent on the rate of global economic growth. In this environment, the Global Bond Fund will remain dollar-neutral in the near term, keep a low-duration portfolio and have cash available for better investment opportunities in the next 12 months.



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