First Trust

FIXED INCOME NEWSLETTER 3Q 2022

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William has 25 years of investment experience and has extensive experience in the portfolio management of both leveraged and unleveraged credit products, including senior loans, high-yield bonds, credit derivatives (CDS/LCDS) and work-outs/corporate restructurings. Prior to joining First Trust, William served as Executive Director and Co-Portfolio Manager at Van Kampen Funds, Inc., a wholly-owned subsidiary of Morgan Stanley ("Morgan Stanley/Van Kampen"), where he was a Portfolio Manager of institutional structured products and a Senior Analyst. William previously managed two collateralized loan obligations (CLOs) and an unlevered comingled institutional fund.

FIXED INCOME MARKET REVIEW

In the second quarter, inflation remained stubbornly high with the May (reported in June) Consumer Price Index coming in at +8.6%. Consequently, since March, the Federal Reserve ("Fed") raised the target on its federal funds rate three times from near-zero to 1.5-1.75% as of June 30, 2022, outpacing any tightening cycle dating back to the 1980s. In addition, the Fed hiked the federal funds target rate by 0.75% at the June Federal Open Market Committee Meeting, representing the largest single percentage point increase in the last 28 years. Given high inflation, consumer sentiment hit a 16-month low in June.

The Fed aspires to engineer a so-called "soft-landing," whereby the central bank uses its policy tools to tame inflation without destroying economic growth. However, with a backdrop of slowing growth and inflation that we expect to remain above the Fed's target inflation rate for a prolonged period, we believe the path to such a soft landing is very narrow.

Equities (S&P 500 Index) were down 16.10% in the second quarter and as of the end of June were down 20.47% from the all-time highs on January 3, 2022. Rising U.S. Treasury yields ("rates") were the primary driver of lower prices across the investment grade corporate bond market, while widening credit spreads, in sympathy with the downward pressure in equities, affected both high-yield corporate bonds and senior loans. The 10-Year U.S. Treasury yield touched 3.47% in June, a level not seen since April 2011, and ended the second quarter at 3.01%.

FIXED INCOME OUTLOOK

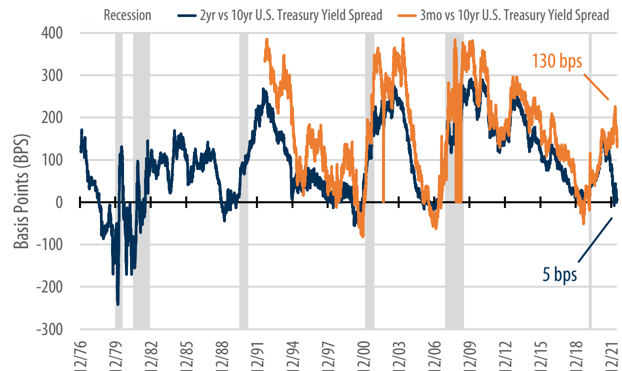
When we entered this year, we believed the Fed's policy shift from unprecedented monetary stimulus to higher rates and eventual balance sheet reduction (Quantitative Tightening) with a backdrop of decelerating economic growth and rising inflation, would be a catalyst for a risk asset correction. Moreover, we expected that central banks around the world would be contending with these same issues, leading to higher global interest rates.

Today, we see two key areas where our view has evolved. First, because of the Fed's latent initial reaction to inflation and ultimately much stronger than anticipated inflation, the Fed has moved aggressively to recalibrate interest rate expectations and to accelerate the pace of rate increases. Second, given how robust the inflation data has become, we do not believe the Fed can pivot to a more accommodative posture until either inflation has been tamed or a recession is near or underway, notwithstanding a major financial market calamity. As such, with the Fed set to raise rates into the whites of the recession's eyes, we expect the likely effect will be a much shorter business cycle. While we do not believe the economy is in a recession yet, we do believe the probability of a recession has increased significantly, especially in 2023.

We believe that interest rates will continue to increase on the intermediate part of the curve and expect the yield curve to flatten in the near term with eventual curve inversion (see Chart 1). The Fed fund futures market is now pricing in expectations for ~seven rate hikes for the remainder of this year (see Chart 2). This has made shorter duration assets more attractive, in our view, as the intermediate part of the yield curve is more exposed to the risk that rates reprice higher (see Chart 3). We believe that our expectation for elevated inflation supports higher interest rates, creating the potential for asymmetrically negative risks in long duration fixed income assets.

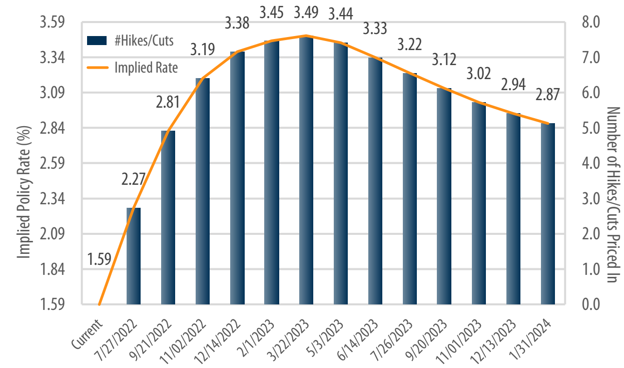
As we progress through this economic cycle, we believe it's important to remember the timeless and sage advice, "Don't Fight the Fed." Inflation is running significantly higher than the Fed's target rate, and to fight inflation the Fed has limited tools at their disposal other than the blunt instruments of persistently increasing interest rates and balance sheet reduction to weaken overall demand. As such, we expect a challenging environment for long duration assets will persist. In our view, during this volatile macroeconomic environment, credit selection and yield curve positioning will be paramount in driving attractive risk-adjusted returns in the bond market.

CHART 1: 2 YEAR VS 10 YEAR U.S. TREASURY YIELD SPREAD & 3 MONTH VS 10 YEAR U.S. TREASURY YIELD SPREAD



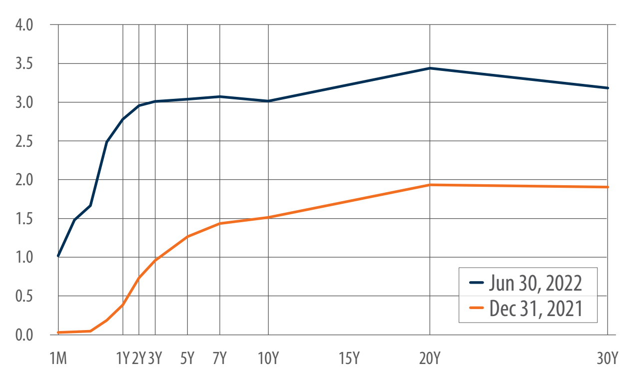
Source: Bloomberg, as of 6/30/2022

CHART 2: IMPLIED FEDERAL FUNDS RATE & NUMBER OF HIKES/CUTS



Source: Bloomberg, as of 6/30/2022

CHART 3: U.S. TREASURY YIELD CURVE



Source: Bloomberg

There can be no assurance that any of the trends and projections cited herein will continue or come to fruition.

SECTOR POSITIONING

Ultra-Short Maturity

We expect short term interest rates to rise, reflecting the rapid acceleration of the Fed's tightening cycle. We anticipate that ultra-short duration securities will produce higher income as rates increase while exhibiting lower volatility than other fixed income sectors.

Mortgage-Backed Securities

Despite significant duration extension in mortgage-backed securities (MBS), we believe agency MBS have limited credit risk, lower volatility, and a lower correlation to corporate credit. We are seeing some initial signs of an affordability driven housing slowdown; however, inventories remain low, and we do not anticipate an immediate severe correction. Mortgage spreads may widen as interest rates increase and quantitative tightening continues. As such, we favor defensive MBS structures.

Treasury Inflation Protected Securities (TIPS)

While we believe inflation will remain persistently higher than long term Fed objectives, we expect the acceleration in hawkish U.S. monetary policy and the Fed's commitment to slow inflation to ultimately pressure TIPS break-even rates that remain at elevated levels.

U.S. Treasury Securities

The Fed raised short term interest rates by 75 basis points (bps) in June and federal funds futures are pricing in seven more 25 basis point hikes through the end of this year. We believe, given elevated inflation, that more aggressive action is warranted which is likely to result in additional volatility and pricing pressure in U.S. Treasuries, generally. As the business cycle continues, we anticipate that higher rates across the curve are likely to continue to flatten the yield curve (3Mo/10Yr and 2Yr/10Yr) as the market "prices in" the impact of tighter financial conditions on economic growth and increased recession risk.

High-Yield Bonds

We believe there are attractive valuations within the high-yield bond market, especially in companies we perceive to be acyclical. According to Bloomberg, as of 6/23/22 high-yield bond prices have fallen to approximately 87 cents on the dollar, have an average yield-to-worst of approximately 8.5% and have relatively short maturities given an average maturity of 6 years within the index. We expect default risk to remain low given that corporate balance sheets are coming from a position of strength and debt maturities are minimal in 2022 and 2023. As financial conditions have tightened, credit spreads have widened, and we believe high-yield bond valuations have become attractive relative to senior loans while still providing a relatively short duration profile compared to other fixed income assets.

Senior Loans

Senior loan prices have held up better than many fixed income asset classes as the floating nature of their coupon payments benefit from rising interest rates and the default environment has remained benign. We do not anticipate an immediate uptick in corporate defaults and believe that most senior loan issuers remain on solid fundamental footing. However, given our view that tighter financial conditions are likely to result in significantly greater recession risk, perhaps as early as 2023, we believe that trimming senior loans given their high dollar price relative to most areas of fixed income and up-tiering credit quality given higher yields, especially on the front part of the yield-curve where duration can be kept short, to be prudent at this stage of the business cycle.

Investment Grade Corporate Bonds

We believe corporate balance sheets are in a strong position despite continued supply chain issues, labor, and input cost inflation as well as a strong U.S. dollar. Many issuers have extended their debt maturity profile, reducing rollover and liquidity risk. We are more constructive on the front end of the investment grade credit curve given our expectation that higher interest rates will be required, and yields should out-earn the duration exposure on this part of the curve, assuming spreads improve or remain stable.

Preferred Securities

We believe preferred securities valuations have become more attractive with high yields relative to other fixed income asset classes and prices trading at a healthy discount to par. In addition, U.S. and European banks are well capitalized and coming from a position of strength in the face of economic head-winds, while other major sectors like insurance, utilities, and REITs historically offer lower sensitivity to inflation. We favor actively managing exposure by targeting select variable rate securities trading at a discount to par that we believe have the greatest upside potential. We also see opportunities in securities in the $25 par retail market, where rate volatility and fund flows have created pricing dislocations, while we expect to remain highly selective on longer duration variable rate securities and low coupon fixed rate preferreds.

Emerging Market Bonds

Emerging Market valuations have come under pressure with U.S. dollar strength as the Fed aggressively hikes interest rates ahead of many Developed Market peers while China's zero COVID policies, the Russian invasion of Ukraine, elevated global inflation and tighter financial conditions have increased price uncertainty in Emerging Market risk assets. While we believe valuations appear attractive on a historical basis and higher commodity prices will benefit some Emerging Market economies, the negative headwinds have led to a very challenging return environment for Emerging Market debt.

Municipal Fixed Income

We believe credit fundamentals are stable for most municipal bond sectors given GDP growth, lower unemployment, significantly improved revenues year-over-year and hundreds of billions of federal dollars available through the Cares Act and other government programs while credit rating changes were positive in 2021. As such, defaults remain low. Municipal bond interest rates are sharply higher, especially in the front end of the curve where we believe valuations look much more attractive. Given higher inflation and a more uncertain economic environment, we believe there is more interest rate and curve risk in the 15 year or longer part of the municipal yield curve.