First Trust

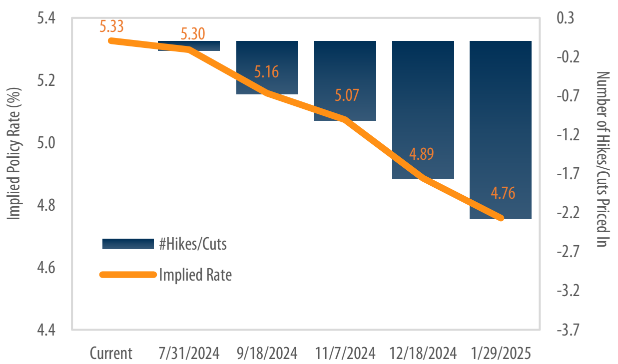
Housey's Income Insights

3rd Quarter 2024

William Housey, CFA

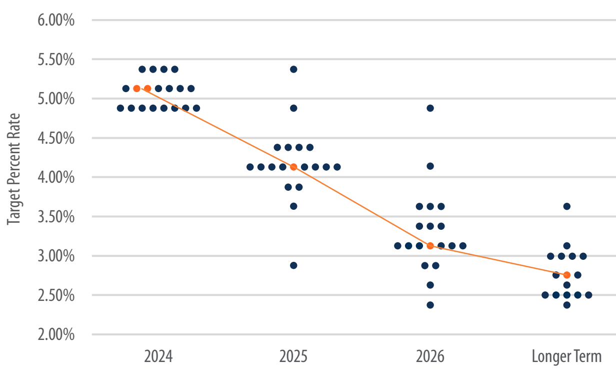
Managing Director of Fixed-Income, Senior Portfolio Manager

Chart 1: Implied Federal Funds Rate & Number of Hikes/Cuts



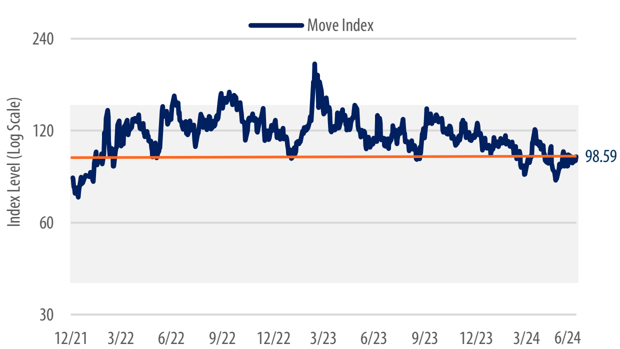
Source: Bloomberg, as of 6/28/2024. The assumed rate movement for one rate hike or cut is equivalent to +/- 0.25%. There is no assurance forecasts will be achieved.

Chart 2: Fed Dot Plot



Source: Bloomberg. Data as of 6/30/2024. Orange dots are the FOMC Dots Median.

Chart 3: Move Index



Source: Bloomberg. Data from 12/31/2021 to 6/28/2024. **Past performance is no guarantee of future results.** The ICE BofA MOVE Index is shown above. The area shaded in gray represents 2 standard deviations above and below the mean of the MOVE Index from 12/31/2021 to 6/28/2024.

While much ink has been spilled over reckless federal spending, ballooning deficits, and exploding U.S. Treasury issuance, it is important to note that these considerations have already been priced into the bond market. In 1982, the pasta sauce Prego introduced the slogan "it's in there." Television commercial after commercial reminded consumers that the necessary ingredients to make a great sauce were already "in there." Similarly, when we assess all the known ingredients in the bond market today, including the impact of agreed upon government deficits and spending, we'd say, "it's in there." Interest rates have not decoupled from underlying data, whether it be inflation, employment, or economic growth, and recent U.S. Treasury auctions have been orderly. That is not to say that additional deficit spending, spending at current levels into perpetuity, or future changes in policy would not negatively affect the bond market. However, it is to say that we believe the current run rate for Treasury issuance is priced into the market.

Market expectations have evolved significantly over the first half of the year. Coming into 2024, the market was pricing in as many as *seven* 25 basis point rate cuts to the Federal Funds Rate for this calendar year, despite inflation steadily above 3%. Then, a combination of sticky inflation prints, coupled with continued strength in the labor market finally encouraged bond market traders to remove five of those seven rate cuts, sending yields higher (Chart 1). At the June Federal Open Market Committee (FOMC) meeting, the Federal Reserve ("Fed") moved in a similar, more hawkish direction, recalibrating their median estimate for interest rate cuts to only one rate cut in 2024. In observing the Fed's dot plot, the Fed has seemingly coalesced around one to two rate cuts this year. (Chart 2). We continue to view two rate cuts as a base case scenario, reinforced by recently soft inflation data.

In July, one year will have passed since the last interest rate hike by the Fed. While interest rates have indeed remained higher for longer, interest rate volatility has declined (Chart 3). As the Fed signals the end of its tightening regime, thereby implying a high hurdle for further rate hikes, we expect lower interest rate volatility to continue, resulting in calmer conditions for bond investors. We do not expect the 10-Year U.S. Treasury yield to move above 4.70% and should the 10-Year U.S. Treasury yield fall below 4.35%, we would expect the next stop to be 4.00%.

Our message is simple, with two interest rate cuts priced in for this year, the market's interest rate expectations appear reasonable and Treasury yields appear fair. Deficit spending, while reckless by any measure, appears largely priced into the Treasury curve already. Additionally, the Fed has not increased rates for nearly 12 months and is likely to begin reducing rates later this year; consequently, interest rate volatility is decreasing. Further, the yield ("carry") of today's bond market, coupled with the convexity (non-linear relationship between interest rates and bond prices) may offer the potential for both a level of protection and an attractive total return opportunity to investors. In short, bond market investors are getting paid to wait. As such, our duration target remains 105% of the Bloomberg US Aggregate Bond Index's duration for core fixed income.

SECTOR POSITIONING

Ultra-Short Maturity

With yields around 5%, the ultra-short space continues to offer investors a relatively attractive level of absolute and risk-adjusted return. This is particularly notable with the timeframe for monetary policy easing shifting further out this year. Our base-case for the near-term is that fixed-income markets will be characterized by narrow ranges for yields and spreads. In this environment, we believe the allocation to ultra-short assets should remain accretive.

Mortgage-Backed Securities

We expect mortgage-backed securities to provide a ballast relative to broader credit markets during a potential correction in risk assets or a recession. Index agency mortgage-backed securities are concentrated in low coupon securities which results in lower levels of income despite spreads that are wider than historic averages. As volatility remains elevated, we continue to prefer defensive positions and would selectively look to enhance yield in commercial and non-agency sectors.

U.S. Treasury Securities

U.S. Treasuries have repriced to a much more realistic Fed expectation with a more gradual reduction in short term interest rates then was expected late last year. If interest rates were to increase, we would view that as an opportunity to increase duration in U.S. Treasuries and we expect that Treasuries would offset weakness in risk assets if economic risk were to accelerate faster than expected.

High-Yield Bonds

We believe that high-yield bonds offer both a yield advantage as well as attractive discounted prices relative to par, despite tighter than average credit spreads. Under a scenario of continued economic expansion, we expect the potential for an attractive total return from both interest income and price appreciation. Conversely, should defaults accelerate and a recession were to materialize sooner than expected, our analysis suggests that current yields, coupled with falling interest rates, would provide a significant buffer against such spread widening. We continue to maintain exposure to high-yield bonds with a focus on sector diversification and limited cyclical exposure. Further, high-yield bonds offer a structurally senior position in the capital structure relative to other high income producing securities, such as preferred equities, which typically exhibit higher volatility.

Senior Loans

Senior loans have benefitted from their attractive floating rate income component as Treasury rates have increased in 2024, posing a headwind to fixed rate bond investments. In light of today's elevated rate regime, we believe the yield advantage generated by senior loans relative to other asset classes has remained attractive. Moreover, the floating rate nature of senior loans currently provides the highest historical yield advantage to high-yield bonds, which we believe may support a positive total return profile this year. These attractive yields have led to over $10 bn of inflows year-to-date (as of 5/31/24). Finally, we believe that given the later stages of this economic cycle, both active management and diligent credit selection may offer attractive income enhancement in diversified portfolios.

Emerging Market Bonds

Our outlook is for the U.S. dollar to weaken or stabilize over the intermediate term, creating the potential for a favorable environment to capture the attractive carry opportunities available in Emerging Market fixed income. Emerging Market assets have started to demonstrate resilience and reduced sensitivity to changes in expectations of Fed policy rates, as indicated by Fed Funds Futures. High inflation-adjusted interest rates in Emerging Markets remain supportive of their currencies. While Emerging Market countries have eased monetary policy, several of them, like Mexico, Brazil and Indonesia, have chosen to pause or delay their easing cycles to sustain higher real rates as inflation moderates at a slower pace. Emerging Market local yields over 6.6% appear attractive and their undervalued currencies provide a buffer, in our view.

Investment Grade Corporate Bonds

We believe attractive yields provide adequate cushion should valuations, which appear expensive on a historical basis, cheapen. Investment grade corporate credit fundamentals remain supportive even though we see some weakness from the lower income consumer. Therefore, we believe diligent credit selection is required as we navigate this stage in the economic cycle. We believe there is the potential for positive total returns across investment grade fixed income over the next 12 months given our view that attractive yields and falling interest rates would offset any modest spread widening.

Preferred Securities

The preferred and hybrid securities market has outperformed other fixed income asset classes so far in 2024 driven by a spread recovery after a period of heightened volatility in the banking sector. The preferred and hybrid securities market valuations are largely unchanged over the past 3 months. We believe credit fundamentals across the major sectors in the preferred securities market (large commercial banks, insurance, utilities, energy) reflect macroeconomic resilience, while some pockets of loan deterioration exist across commercial real estate and U.S. consumer finance. Looking forward, we will weigh the potential for additional spread tightening against some of the uncertainty within some of the smaller segments of the market.

Municipal Fixed Income

Given year-to-date municipal securities ("municipals") fund inflows totaling over $11 billion as of 6/12/24, attractive taxable equivalent yields, and our expectations of lower Treasury yields during the second half of 2024, we believe there is potential for positive total returns for both short and longer duration strategies. As we enter the third quarter, we believe the technical backdrop for the municipal market should be favorable. During July to August, municipal new issue supply is expected to be net negative as the expected large new issue supply calendar is more than offset by bond maturities, calls, sinking fund and coupon payments. Muni-Treasury ratios are near fair value relative to their three-year averages. By year-end, we expect longer duration strategies, with some high yield exposure, to have the potential for the highest total returns this year, as credit fundamentals remain stable.

Definitions:

The **Federal Funds Rate** is the interbank overnight lending rate for commercial banks' excess reserves. The **Implied Federal Funds Rate** for the U.S. is the estimated forward rate for the United States and is derived from Federal Funds Futures contracts to determine the probability of the Federal Reserve changing monetary policy at a particular meeting.

The **Bloomberg U.S. Aggregate Bond Index** measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS, ABS and CMBS. The **ICE BofA MOVE Index** is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the CT2, CT5, CT10, and CT30 (weighted average of 1m2y, 1m5y, 1m10y, 1m30y Treasury implied vols with weights 0.2/0.2/0.4/0.2, respectively). Indexes are unmanaged and investors cannot invest directly in an index.

There can be no assurance that any of the trends and projections cited herein will continue or come to fruition. References to specific securities should not be construed as a recommendation to buy or sell and should not be assumed profitable.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.