First Trust

Quarterly Market Overview

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We invite you to visit Bob's Market Commentary Blog at www.ftportfolios.com for more insight.

Municipal Bonds Have Delivered Competitive Total Returns Over Time

ICE BofAML Bond Indices: Tax-Free vs. Taxable
(YTD, 1-Year And Average Annualized Total Returns thru 9/30/19)

Index	YTD	1-Year	3-Year	5-Year	10-Year	15-Year	20-Year	25-Year
3-7 Yr. U.S. Municipal	4.42%	6.09%	2.13%	2.23%	2.85%	3.45%	4.11%	4.36%
7-12 Yr. U.S. Municipal	7.13%	9.31%	3.15%	3.73%	4.35%	4.65%	5.28%	5.55%
12-22 Yr. U.S. Municipal	8.27%	10.07%	3.83%	4.44%	5.06%	5.09%	5.82%	6.11%
22+ Yr. U.S. Municipal	9.40%	11.02%	4.07%	5.03%	5.50%	5.33%	6.00%	6.16%
7-10 Yr. U.S. Treasury	9.75%	13.85%	2.36%	3.71%	4.31%	4.78%	5.56%	6.10%
U.S. Corporate	12.94%	12.89%	4.51%	4.65%	5.60%	5.22%	6.02%	6.46%

Source: Bloomberg. Past performance is no guarantee of future results.

Perhaps there is no better time to discuss taxes then while in the midst of a presidential election season. Taxes qualify as a hot-button issue, in our opinion. It was just a little under two years ago that President Donald J. Trump signed off on a major tax reform bill (Tax Cuts and Jobs Act of 2017) that featured a massive reduction in the federal corporate tax rate and the lowering of five of the seven marginal tax rates on individuals. The corporate tax rate was lowered from 35% to 21%. The highest tax bracket for individuals was adjusted down from 39.6% to 37.0%. On the margin, one might think that lower marginal federal tax rates would make municipal bonds a bit less attractive to investors than in previous tax structures, but it does not appear to be the case.

Year-to-date through 8/31/19, retail investors poured a net $63.69 billion into open-end municipal bond mutual funds. Those inflows were a little more than four times the $15.67 billion invested over the same period in 2018, according to the Investment Company Institute (ICI). For comparative purposes, from 2000-2018 (19 years), retail investors funneled a net $189.34 billion into municipal bond funds, or an average of $9.97 billion per year, according to ICI data. Over that period, investors favored national over state municipal bond funds. National municipal bond funds took in a net $221.44 billion, while state funds experienced net outflows totaling $32.10 billion.

Over the past decade, the percentage of municipal bonds managed by professionals has been on the rise, according to *The Wall Street Journal*. Historically, this market was driven more by "mom-and-pop" investors owning individual bonds. Currently, 33% of the $4 trillion municipal bond market is either held by separately managed accounts or mutual funds, according to *The Wall Street Journal*. Money managers hold an advantage over individuals in that they can acquire sought after bonds via bulk purchases and are likely better at accessing risk. The latter has become more of an issue following the recent high-profile losses associated with debt issued by Detroit and Puerto Rico.

As noted above, we are already knee-deep into the 2020 presidential election process. The major headlines are coming from the Democratic candidates out on the stump. Keep in mind, many of the new programs and ideas being pitched, like Medicare for All, come at a price, and the candidates have acknowledged they will be looking for additional tax revenues to pay for them.

Municipal bonds are debt securities issued by states, cities, counties and other governmental entities to finance daily obligations and capital projects, according to Investor.gov. Typically, the interest paid on the debt is exempt from federal income tax, but interest may also be exempt from state and local taxes if the bondholder lives in the state where the bond was issued. The two most common types of municipal bonds are general obligation bonds, which are backed by the taxing authority of the issuer, and revenue bonds, which are backed by revenues from a specific source, such as a toll road. Revenue bonds, in particular, are more cyclical in nature.

The good news is that the historical default rate on municipal bonds is extremely low. From 2009-2018, the average five-year default rate was 0.16%, just above the 0.09% average since 1970, according to data from Moody's Investors Service. For comparative purposes, the average five-year global corporate bond default rate was 6.2% since 2009 and 6.6% since 1970.

Due to a relatively robust U.S. economy, state and local government tax revenues have been encouraging. In Q2'19, combined tax revenues for property, sales and gross receipts, and income taxes increased by 9.0% year-over-year to $398.7 billion, according to the U.S. Census Bureau. Individual income tax collections totaled $121.7 billion in Q2'19.

With respect to new municipal bond offerings, from 2009-2018, issuance ranged from a low of $295.1 billion in 2011 to a high of $451.7 billion in 2016, according to SIFMA.org. The average for the 10-year period was $384.68 billion. Year-to-date through 9/30/19, municipalities have issued debt valued at $276.1 billion. At the current pace, total issuance could end 2019 at approximately $368 billion, so it appears to be business as usual.

We believe the current climate of low interest rates and tempered inflation should be ideal for municipal bonds and the bond market overall. Obviously, the climate could shift if the U.S. were to forge a new trade agreement with China, but that still looks like it is in the offing. A deal with China could inspire investors to assume more risk and shed some of their safe-haven positions, such as government bonds and money market funds. A sell-off of U.S. intermediate Treasuries could potentially push bond yields higher in the near-term. The Treasury yield curve could stand to steepen a bit, in our opinion.

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The U.S. Trade Conflict With China Flipped The Narrative In The Stock Market

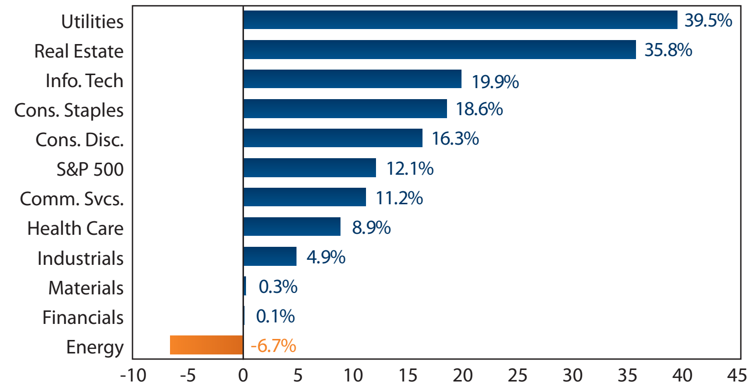
Do you remember back in 2018 when it appeared that the U.S. economy was building momentum off the passage of the Tax Cuts And Jobs Act of 2017? Well, it was. Real U.S. GDP growth rates (annualized) were as follows: 2.8% (Q4'17); 2.9% (Q1'18); 3.2% (Q2'18); and 3.1% (Q3'18), according to data from the Bureau of Economic Analysis. From 12/29/17-9/28/18, the S&P 500 Index posted a total return of 10.56%, according to Bloomberg. All seemed well through the first three quarters of 2018. This is where we introduce trade tariffs into the conversation.

The Trump administration launched its first round of tariffs on imported steel and aluminum on 3/8/18. The trade tariffs were employed as a tactic to garner more leverage over our top trading partners in any future trade negotiations. President Trump promised voters he would secure more favorable trade agreements if elected. One of the reasons given for why President Trump launched the tariffs in March 2018 was because he wanted to do it from a position of strength. He wanted that economic tailwind behind him. While history will likely be the judge of the efficacy of the timing of said tariffs, it would have been interesting to see how much stronger the U.S. economy might have become had he waited at least a few more quarters – allow the tax cuts to work unabated. This is where we recap the disaster that was Q4'18.

After the U.S. successfully negotiated a formal agreement with Canada and Mexico to upgrade the North American Free Trade Agreement on 10/1/18, the attention shifted almost entirely to China. Investors battled two headwinds in Q4'18: President Trump announcing the U.S. was hiking tariffs from 10% to 25% on $200 billion of Chinese imports at year-end and comments from the Federal Reserve that the federal funds rate was a long way from neutral and that more rate hikes were coming. The Fed walked back its comments on additional rate hikes in late December. From 9/28/18-12/31/18, the S&P 500 Index posted a total return of -13.52%, according to Bloomberg. With respect to President Trump's economic tailwind, the data shows it has slowed since Q3'18. The latest quarter available is Q2'19, and real U.S. GDP stood at an annualized growth rate of 2.3%.

S&P 500 Index & Sector Index Returns Since Tariffs Enacted

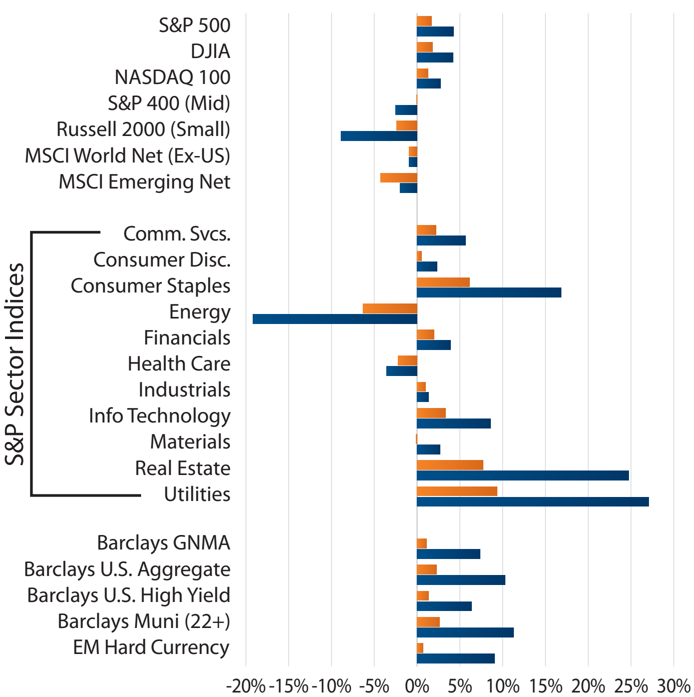
(Cumulative Total Returns from 3/8/18-9/30/19)



Source: Bloomberg. Past performance is no guarantee of future results.

Global economic growth is also slowing. In its latest release, the International Monetary Fund downgraded its 2019 global growth estimate by 0.3 percentage points to 3.0%, the lowest it has been since 2008-2009. Slower growth has altered investor sentiment, in our opinion. Investors have become more risk averse since the trade tariffs were introduced, and investors seem to be opting for high-yielding equities, as evidenced by the returns posted by the utilities and real estate sectors in the table above. For comparative purposes, here is how the S&P 500 Index and the sectors that comprise it were performing (cumulative total returns) during the bull market leading up to the tariffs (3/9/09-3/8/18): 661.0% (Cons. Disc.); 584.6% (Info. Tech); 571.5% (Financials); 494.4% (Industrials); 389.2% (S&P 500); 362.6% (Health Care); 348.4% (Real Estate); 319.3% (Materials); 261.5% (Cons. Staples); 212.7% (Utilities); 182.5% (Comm. Svcs.); and 97.8% (Energy), according to Bloomberg.

Total returns for Q3 and past 12 months (9/30/19)



Sources: Bloomberg and Barclays. Past performance is no guarantee of future results.

A Look Ahead:

A year-over-year earnings comparison in U.S. dollar terms. The S&P 500 Index dollar figures reflect the 11 major sectors on a weighted-adjusted basis.

Index (Weighting In S&P 500)	**Q4'19E**	Q4'18A	**Q1'20E**	Q1'19A	**2019E**	2018A
Communication Svcs. (10.4%)	**2.42**	2.17	**2.30**	2.09	**8.83**	11.78
Consumer Disc. (10.1%)	**10.65**	9.67	**9.87**	9.13	**40.72**	39.84
Consumer Staples (7.6%)	**7.76**	7.13	**7.25**	6.99	**30.17**	29.35
Energy (4.5%)	**6.43**	9.22	**6.48**	3.75	**21.90**	30.61
Financials (12.9%)	**9.18**	4.34	**9.54**	10.97	**39.49**	31.25
Health Care (13.7%)	**16.47**	12.26	**17.76**	14.19	**61.96**	50.04
Industrials (9.3%)	**9.71**	8.98	**9.27**	8.44	**37.09**	37.43
Information Tech. (21.9%)	**19.01**	17.13	**16.70**	14.07	**64.63**	63.70
Materials (2.7%)	**4.69**	4.30	**4.91**	4.05	**18.38**	21.58
Real Estate (3.2%)	**1.39**	1.78	**1.26**	1.43	**6.28**	6.40
Utilities (3.6%)	**3.21**	2.34	**4.19**	4.12	**15.69**	15.41
S&P 500 Index	**42.17**	35.03	**41.42**	37.99	**161.03**	151.60
S&P 400 Index (Mid-Cap)	**28.15**	21.20	**26.74**	24.14	**104.01**	95.98
S&P 600 Index (Small-Cap)	**14.05**	9.77	**12.49**	6.97	**43.25**	39.05

Source: S&P Dow Jones Indices (10/2/19). Sector weightings as of 9/30/19.
There is no guarantee past trends will continue or projections will be realized.

As of 9/28/18, the Global Industry Classification Standard (GICS) was reconstituted and the Telecommunications Services sector was renamed Communication Services. GICS sector information for periods prior to 9/28/18 may not necessarily be comparable to the reconstituted sectors.
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