Senior Loan & High Yield Review – 3rd Quarter 2017

William Housey, CFA • *Senior Vice President, Senior Portfolio Manager*

Macro Overview

Despite numerous geopolitical headlines in the quarter, most notably U.S. tension with North Korea, equities posted a strong third quarter, with the S&P 500 Index up 4.48%. This brought the year-to-date return to a robust 14.24%. Interest rates, as measured by the 10-yr Treasury bond declined for much of the quarter, falling from 2.30% to as low as 2.04% by early September. However, as the quarter progressed, rates bounced to finish the quarter slightly higher than where they began the quarter, closing out at 2.33%. Overall, positive equity market returns supported by relatively benign volatility and optimism surrounding the release of the GOP tax plan combined with higher crude oil prices provided a firm backdrop for credit markets, in our view. Senior loans were up 1.04% in the quarter while high-yield bonds were up 2.04% (Exhibits 1 and 2).

Exhibit 1 **– U.S. High-Yield Bond Performance: 1997 – 3Q 2017**

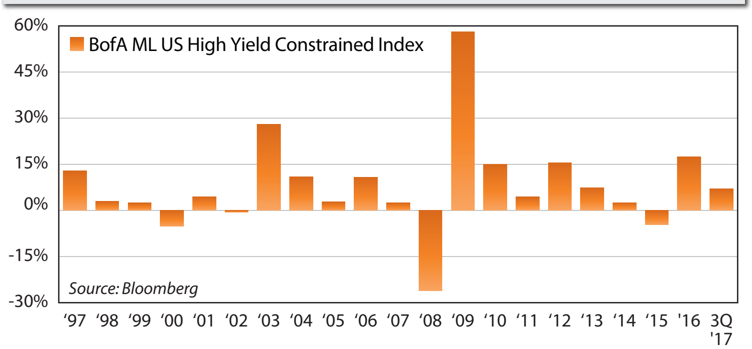
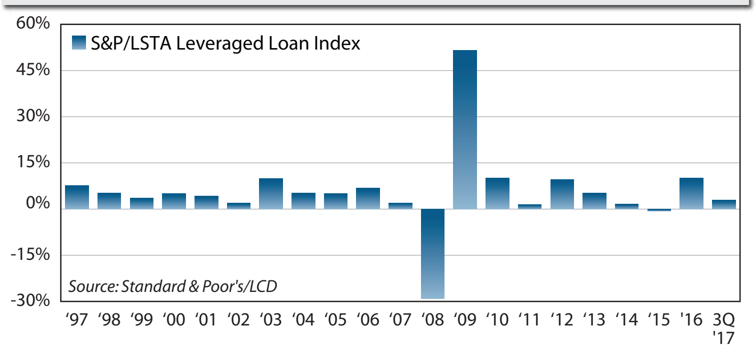
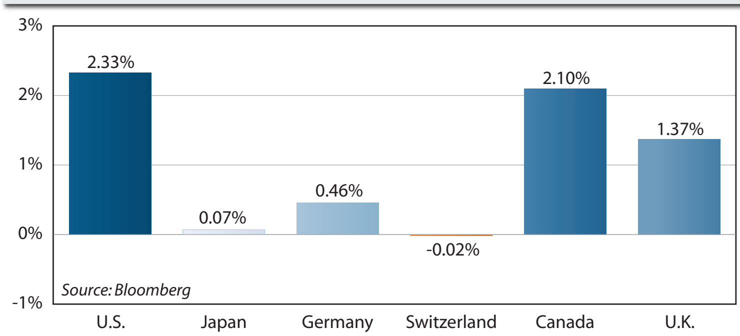


Exhibit 2 **– U.S. Senior Loan Performance: 1997 – 3Q 2017**



As we enter the fourth quarter, we're especially mindful of the fact that the U.S. Federal Reserve (Fed), with its $4.5 trillion portfolio of government and mortgage debt, is about to embark on a first-of-its-kind balance sheet reduction. The Fed is planning to initially allow $10 billion of debt to mature (without reinvesting the proceeds) each month, eventually growing that number to $50 billion after one year. While the Fed would prefer to execute the balance sheet reduction in a smooth and orderly fashion, we believe that, when taken in isolation, interest rate volatility will likely increase as a result of this move. Consider the fact that since October 2011, when the Fed first decided to reinvest prepayments they received from mortgages on their balance sheet, they have reinvested more than $1.8 trillion back into mortgage bonds. Of the $8.2 trillion of new issuance in the mortgage market over that time, the Fed has purchased more than one fifth. This year alone, the Fed has bought nearly 30% of the new issuance. As the Fed purchases are reduced, we believe volatility should naturally increase. In addition, we believe that we are likely to see tapering of the Quantitative Easing (QE) program underway via the European Central Bank (ECB). ECB President Draghi commented in June that signs are pointing to a strengthening and broadening recovery in the Euro area. While he also suggested that the continued stimulus remains needed, we believe the recognition of the improved trends suggests that the ECB is contemplating how and when to begin pulling back their stimulus. We believe that when the ECB does in fact begin to taper its QE, it will lead to higher rates in Europe and such a move would likely carry through to the U.S. given the high correlation between foreign yields and U.S. Treasury yields (Exhibit 3: 10-yr yields as of 9/30/2017).

Exhibit 3 **–10-Year Government Bond Yields: As of 9/30/17**



We've had a market for some time where the influence of the central banks has created unnatural market conditions. For example, at the time of this writing, Ireland recently sold a €4 billion, 5-year zero coupon bond above par (i.e. a negative yield to investors). In September, Austria issued a 100 year bond at a rate of 2.1%, a rate below that of a 10-yr U.S. Treasury bond. Ironically, Austria hasn't even been a standalone country for 100 years. Even Italy's 10-yr bond has a lower yield than a 10-yr U.S. Treasury bond. This is all incredibly unnatural and, in our minds, certainly suggests that a central bank behavioral shift is anything but priced into the current market. Overall, we believe that a shift in behavior to a less accommodating central bank will not only increase interest rate volatility, but will also push interest rates higher.

High Yield and Senior Loan Market Overview

High-yield bond spreads over U.S. Treasuries tightened modestly in the quarter by 21 basis points (bps) from the end of the second quarter. While spreads are in fact tight to the historic average (the long-term average spread over U.S. Treasuries is T+585, December 1997 – September 2017), we believe there is room for further tightening throughout the cycle given that spreads remain wide of the tight spreads experienced into the top of the last cycle (May 2007 of T+245; Exhibit 4). Moreover, defaults in the commodity sensitive sectors of the high-yield bond market drove the high-yield default rate up to a recent peak at 3.82% in May 2016, but the rate has since fallen to 1.07%. This is well inside the long-term average default rate of 3.26% (March 1999 – September 2017; Exhibit 6). In September, only one company defaulted, making this the third consecutive month with only one or no defaults. This is the lightest stretch of

Exhibit 4 – U.S. High-Yield Bond Spread (OAS)*:
December 1997 - September 2017

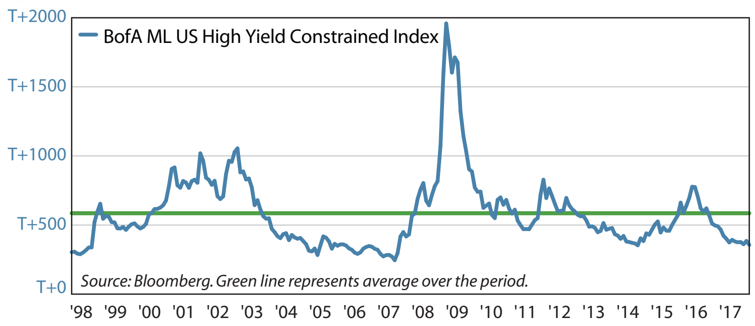
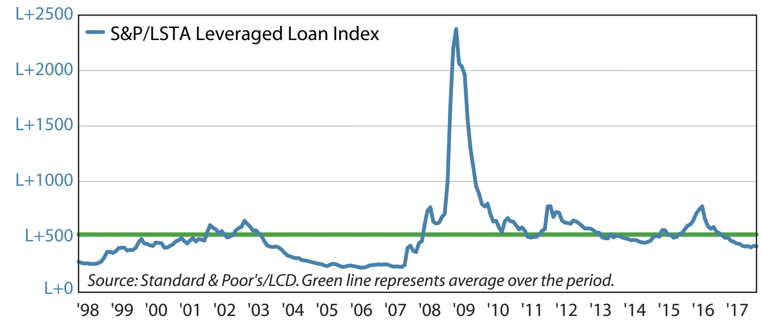


Exhibit 5 – U.S. Senior Loan Spread over LIBOR[2]:
December 1997 - September 2017



default activity since May 2011 (JP Morgan). We believe the low default rate is reflective of the relatively sound financial condition of most companies and the strong backdrop of a healthy macroeconomic environment.

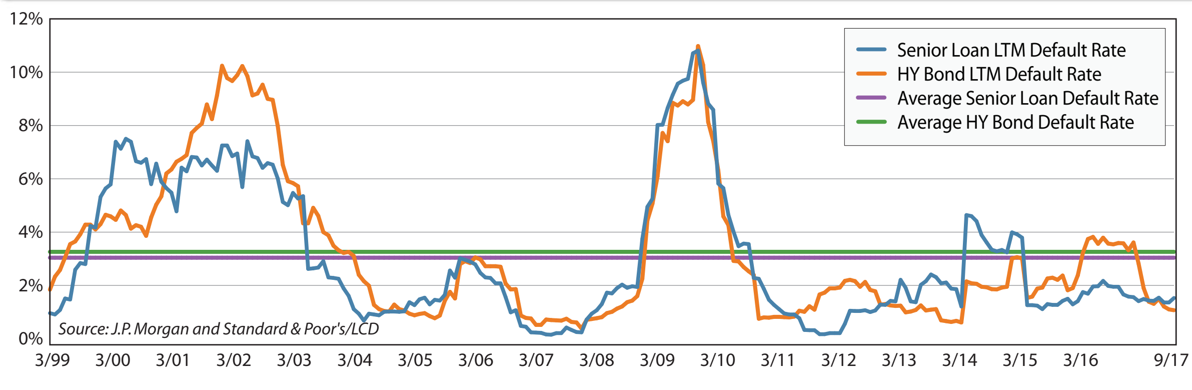
Senior loan spreads over 3-month LIBOR[1] declined 1 bp during the quarter to L+416 bps. This compares favorably to the pre-credit crisis average spread of L+372 (December 1997 – June 2007) but is inside the long-term average spread of L+522 (December 1997 – September 2017; Exhibit 5). While new issue volume in the loan market appears robust at $732.3bn year-to-date, which compares to the previous annual high of $670bn in 2013, 73% of the volume was either a repricing (coupon reduction) or refinancing. The refinancing rate has continued to weigh on the yield to investors given that the LIBOR increases that have come from the Fed rate hikes haven't been enough to offset the spread decline from the refinancings. We believe that with the potential for additional interest rate hikes on the horizon, LIBOR should continue to migrate higher during the rest of 2017 and into 2018. Importantly, the default rate for senior loans remains low, at 1.53% and we believe it is likely to remain low given the overall health of the U.S. economy. This is below the long-term average default rate of 3.04% (March 1999 – September 2017; Exhibit 6).

Conclusion

A shift in central bank behavior to a less accommodating stance may not only increase interest rate volatility, it may also push interest rates directionally higher, and such a move would be expected to push long-duration (the most interest rate sensitive) bond prices lower. While this may also result in credit market volatility, we remain confident that the favorable backdrop for the macro economy will persist for the near to intermediate term and that we are in a healthy part of the economic cycle to own high-yield bonds and senior loans. We also believe that the current cycle still has a long runway. Specifically, we believe senior loans, given their senior secured position in the capital structure, floating interest rate, attractive income and low default rate are well positioned as we move through 2017. We also believe that high-yield bonds should continue to perform well given their mid-cycle valuations and declining default rate.

As we evaluate new investment opportunities, decisions will continue to be rooted in our rigorous bottom-up credit analysis and focus on the opportunities that we believe offer the best risk and reward balance.

Exhibit 6 – Senior Loan and High-Yield Bond Historical Default Rates[3]: March 1999 - September 2017



All charts shown herein are for illustrative purposes only and not indicative of any investment. The performance illustrations exclude the effects of taxes and brokerage commissions or other expenses incurred when investing. Past performance is not indicative of future results and there can be no assurance past trends will continue in the future.

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 and the Internal Revenue Code. First Trust has no knowledge of and has not been provided any information regarding any investor. Financial advisors must determine whether particular investments are appropriate for their clients. First Trust believes the financial advisor is a fiduciary, is capable of evaluating investment risks independently and is responsible for exercising independent judgment with respect to its retirement plan clients.

			YTD 2017	YTD 2016	12 Mo Ended 9/30/17	12 Mo Ended 9/30/16	Q3 2017 By Rating		
Index Returns	Q3 2017	Q3 2016					BB	B	CCC
Senior Loans	1.04%	3.08%	2.97%	7.72%	5.30%	5.46%	0.98%	1.03%	1.80%
High-Yield Bonds	2.04%	5.49%	7.04%	15.32%	9.05%	12.82%	2.18%	1.66%	1.45%
Investment Grade Corporate Bonds	1.37%	1.44%	5.30%	9.11%	2.27%	8.50%			
Preferred Securities	1.27%	1.22%	10.11%	6.37%	5.91%	10.05%			
U.S. 10-Year Treasury	0.27%	-0.75%	2.35%	7.13%	-4.61%	5.59%			
Emerging Market Bonds	2.46%	3.53%	8.72%	14.26%	3.85%	15.29%			
Municipal Bonds	1.06%	-0.30%	4.66%	4.01%	0.87%	5.58%			
S&P 500	4.48%	3.85%	14.24%	7.84%	18.61%	15.43%			
Default Rate[3] (Trailing Twelve Months)	9/30/17	9/30/16	FYE 12/31/16	FYE 12/31/15					
Senior Loans (LLI)	1.53%	1.95%	1.58%	1.50%					
Long-Term Average - *Since March 1999*	3.04%	3.13%	3.11%	3.19%					
High-Yield Bonds	1.07%	3.54%	3.32%	1.82%					
Long-Term Average - *Since March 1999*	3.26%	3.32%	3.32%	3.32%					
Technicals	9/30/17	9/30/16	FYE 12/31/16	FYE 12/31/15					
Average Senior Loan Price (LLI)	$97.98	$95.12	$98.08	$91.26					
Long-Term Average Senior Loan Price - *Since Dec 1997*	$93.94	$93.72	$93.77	$93.76					
Senior Loan Spread Over LIBOR[2]	L+416	L+514	L+465	L+714					
Long-Term Average Senior Loan Spread[2] - *Since Dec 1997*	L+522	L+526	L+526	L+523					
Average High-Yield Bond Price (HUC0)	$101.77	$99.24	$99.59	$88.82					
Long-Term Average High-Yield Bond Price - *Since Dec 1997*	$94.24	$93.89	$93.96	$93.90					
High-Yield Bond Spread (OAS)*	T+356	T+497	T+422	T+695					
Long-Term Avg. High-Yield Bond Spread (OAS)* - *Since Dec 1997*	T+585	T+595	T+593	T+594					
YTW for High-Yield Bonds (HUC0)	5.47%	6.25%	6.17%	8.76%					
YTM for High-Yield Bonds (HUC0)	5.99%	6.59%	6.48%	8.90%					
U.S. 3 Month LIBOR[1]	1.33	0.85	1.00	0.61					
U.S. 10-Year Treasury Yield	2.33%	1.59%	2.44%	2.27%					
Flows & Issuance (billions)	Q3 2017	Q3 2016	FYE 12/31/16	FYE 12/31/15	YTD 2017	YTD 2016			
Retail Senior Loan Fund Flows	-$0.3	$2.2	$9.2	-$21.7	$17.3	-$4.2			
Institutional (CLO) Senior Loan Flows	$30.1	$27.1	$73.3	$99.5	$82.5	$54.2			
Retail High-Yield Bond Flows	-$0.6	$6.1	$9.6	-$16.6	-$11.1	$9.6			
Senior Loan Gross New Issue	$155.3	$130.6	$485.4	$325.8	$732.3	$291.7			
High-Yield Bond Gross New Issue	$79.8	$77.7	$286.2	$293.2	$255.6	$233.0			

[1] LIBOR–London Interbank Offered Rates
[2] The spread over LIBOR is the discounted spread to three-year life. The "spread" for a senior loan is typically priced over 3-month LIBOR. Essentially, investors earn a risk-free rate plus a "spread" for the risk of a given company.
[3] High-yield bonds are represented by J.P. Morgan's high-yield bond universe. Senior loans are represented by the S&P/LSTA (Loan Syndications and Trading Association) U.S. Leveraged Loan Index and based on the last twelve months (LTM).
*Option Adjusted Spread (OAS) is the current spread over a treasury security of similar tenor.
Source for all data: Bloomberg, unless otherwise noted.
Source of flows & issuance: J.P. Morgan High-Yield Market Monitor & Leveraged Loan Market Monitor.
Source of high-yield bond data: Bloomberg and J.P. Morgan.

Index Definitions:

Senior Loans–S&P/LSTA Leveraged Loan Index (LLI) is designed to track the current outstanding balance and spread over LIBOR for fully funded term loans.
High-Yield Bonds–BofA Merrill Lynch U.S. High Yield Constrained Index (HUC0) tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market but caps issuer exposure at 2%.
Investment Grade Corporate Bonds–BofA Merrill Lynch U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade (BBB/Baa-rated or better) corporate debt publicly issued in the U.S. domestic market.
Preferred Securities–BofA Merrill Lynch Fixed Rate Preferred Securities Index tracks the performance of fixed rate U.S. dollar denominated preferred securities issued in the U.S. domestic market.
U.S. 10-Year Treasury– BofA Merrill Lynch Current 10-Year U.S. Treasury Index is a one-security index comprised of the most recently issued 10-year U.S. Treasury note.
Emerging Market Bonds–BofA Merrill Lynch U.S. Emerging Markets External Sovereign Index tracks the performance of U.S. dollar emerging markets sovereign debt publicly issued in the U.S. and eurobond markets.
Municipal Bonds–Bloomberg Barclays Municipal Bond Index tracks the performance of the tax-exempt bond market.
S&P 500–S&P 500 Index is a capitalization-weighted index comprised of 500 stocks used to measure large-cap U.S. stock market performance.

Past performance is no guarantee of future results. Historical performance figures for the indices are for illustrative purposes only and not indicative of any actual investment. Indexes are unmanaged and an investor cannot invest directly in an index.

All opinions constitute judgements as of the date of release and are subject to change without notice. There can be no assurance that any forecasts will be achieved. Data is taken from sources we believe to be accurate and reliable but we do not guarantee its accuracy or completeness.

Senior floating rate loans are usually rated below investment grade but may also be unrated. As a result, the risks associated with these loans are similar to the risks of high-yield fixed-income instruments. High-yield securities tend to be less liquid than higher-quality debt and are subject to greater market fluctuations and risk of loss than securities with higher ratings.