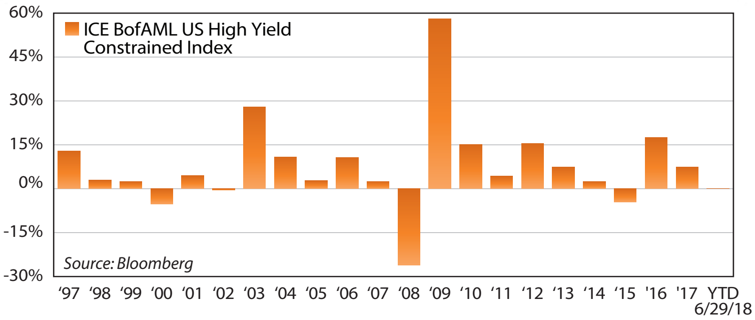
Senior Loan & High Yield Review – 2nd Quarter 2018

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

Macro Overview

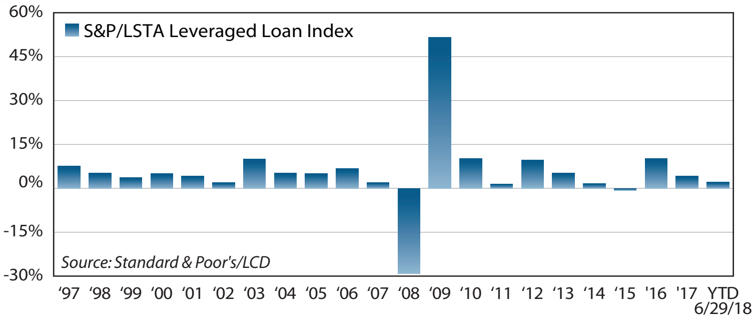
Interest rates remained in an upward trajectory as the 10-year U.S. Treasury bond yield climbed from 2.74% at the end of the first quarter to 2.86% at the end of the second quarter. The yield touched 3.11% in May but retreated shortly thereafter. The interest rate volatility led to further total return declines in rate sensitive fixed income assets, with the Bloomberg Barclays US Aggregate Bond Index, a good proxy for the overall bond market, down 0.16% in the quarter and down 1.62% year-to-date. Investment grade corporate bonds fared even worse, down 0.94% in the quarter and down 3.12% year-to-date. Equity market volatility also increased in the quarter but despite this and the higher interest rates, high-yield bonds and senior loans fared well on a relative basis during the quarter. The high-yield bond index was up 1.00% in the quarter while the senior loan index was up 0.71%. Senior loans are now up 2.17% on the year, better than all other major fixed income markets, while high-yield bonds are up 0.07% (Exhibits 1 and 2).

***Exhibit 1* – U.S. High-Yield Bond Performance: 1997 – June 2018**



Source: Bloomberg

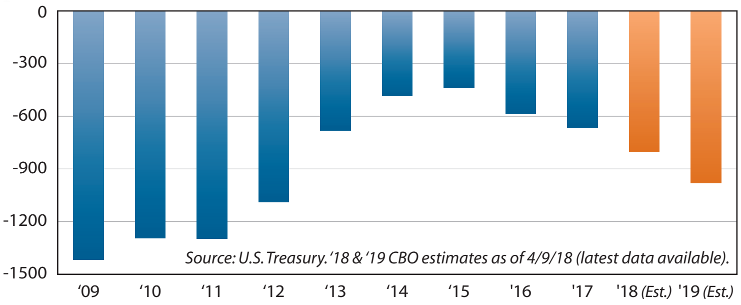
***Exhibit 2* – U.S. Senior Loan Performance: 1997 – June 2018**



Source: Standard & Poor's/LCD

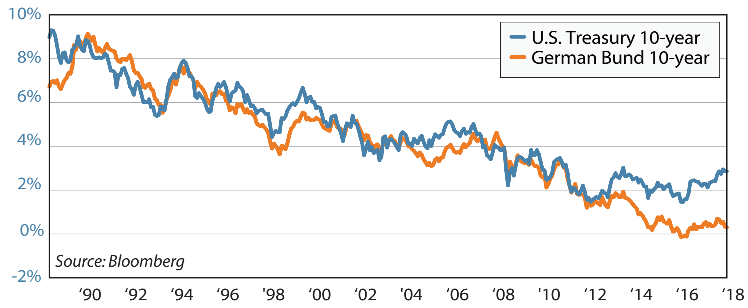
Global trade concerns led to periods of volatility during the quarter. We view the trade issue as more of a dispute than a war and mostly rhetoric at this point. Importantly, the tariffs that have been enacted have been small relative to total imports at only 3.6%. While the trade rhetoric may persist for the next several months, we do not expect tensions to escalate into a major global trade war. As a result, we would expect any negative market reaction driven by additional trade dispute rhetoric to present attractive entry levels for risk assets. While the trade disputes may also result in interest rate volatility with rates temporarily coming down as investors move to the safety of U.S. Treasury bonds, we believe that any move lower in interest rates will likely be temporary. Interest rates should continue to move higher since the U.S. Federal Reserve Bank ("Fed") is tightening monetary policy by increasing the Fed Funds rate and by reducing bond purchases. Moreover, the U.S. deficit is growing (Exhibit 3) which will require additional U.S. Treasury issuance (i.e. more bond supply at a time when the Fed is reducing its holdings). In addition, we expect the Quantitative Easing ("QE") program underway via the European Central Bank ("ECB") to end in the fourth quarter of 2018. We believe that when the ECB does end its QE program, this will lead to higher interest rates in Europe. Given the high correlation between foreign yields and U.S. Treasury yields (Exhibit 4), this interest rate move would likely carry through to the U.S. on the longer dated part of the yield curve.

***Exhibit 3* – U.S. Annual Budget Deficit and Forecast ($BN)**



Source: U.S. Treasury. '18 & '19 CBO estimates as of 4/9/18 (latest data available).

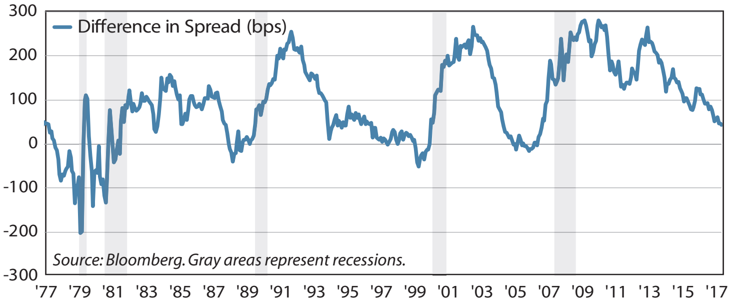
***Exhibit 4* – 10-year U.S. Treasury vs. 10-year German Bund: January 1989 – June 2018**



Source: Bloomberg

The yield curve has continued to flatten. The 2-year/10-year U.S. Treasury bond spread was at a post global financial crisis low of 33 basis points ("bps") at the end of the second quarter 2018 (Exhibit 5). While the current market narrative suggests that the yield curve is close to inversion, which would be viewed as a negative leading indicator for the economy, we believe that the yield curve will not invert in the near term. The combination of improving inflation data, which

***Exhibit 5* – Spread between 2-year and 10-year U.S. Treasuries January 1977 – June 2018**



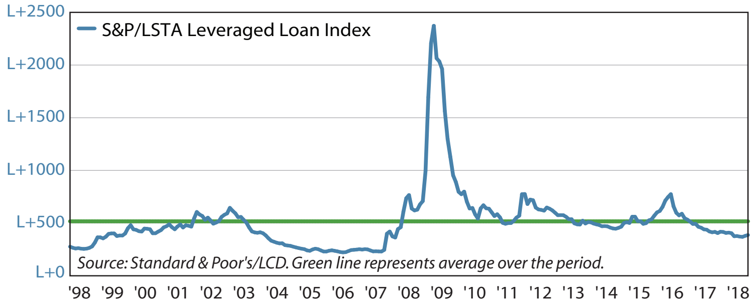
Source: Bloomberg. Gray areas represent recessions.

should continue to be driven by higher commodity prices, increasing transportation costs and a tight labor market, and the end of QE in Europe should be catalysts for a steeper yield curve from present levels.

Senior Loan and High-Yield Market Overview

Senior loan spreads over 3-month LIBOR[1] increased 15 bps during the quarter to L+387 bps as the market worked to digest a healthy pipeline of new issues (Exhibit 6). There has been a significant increase in leveraged buyout ("LBO") activity this year as tax reform clarity emerged and U.S. growth persists which gave private equity firms the confidence to grow their pace of acquisitions. This private equity activity has resulted in $120 billion of loan new issue volume tied to LBO's, the fastest pace in over a decade.

Exhibit 6 – **U.S. Senior Loan Spread over LIBOR[1]: December 1997 - June 2018**

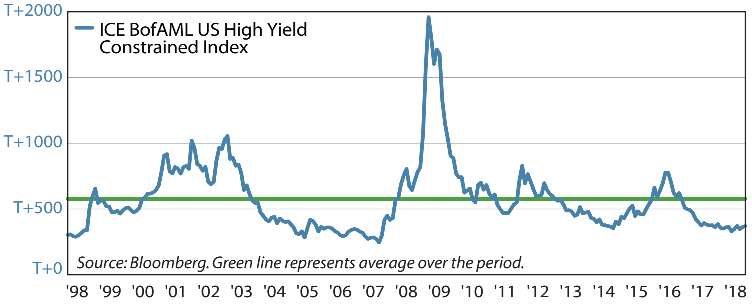


Source: Standard & Poor's/LCD. Green line represents average over the period.

Floating rate senior loans are typically priced off short term interest rates, notably LIBOR[2], and as a result, loan investors have benefitted as LIBOR increased from 1.69% entering 2018 to 2.34% by the end of June. Moreover, we believe that with the potential for additional interest rate hikes on the horizon, LIBOR should continue to grind higher throughout 2018. Importantly, the default rate for senior loans remains low, at 1.95% 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 3.00% (March 1999 – June 2018; Exhibit 7).

High-yield bond spreads over U.S. Treasuries remained essentially unchanged tightening 1 bp from the end of the first quarter to T+371. Spreads proved to be a mitigant to the increasing interest rates in the quarter. While spreads are in fact tight to the historic average (the long-term average spread over U.S. Treasuries is T+577, December 1997 – June 2018), we believe there is room for further tightening throughout the remaining cycle given that spreads remain wide of the lowest spreads experienced in the previous business cycle (May 2007 of T+245, Exhibit 8). The high-yield default rate decreased in the quarter to 1.98% from 2.21% at the end of the first quarter. The default rate remains well inside the long-term average default rate of 3.20% (March 1999 – June 2018; Exhibit 7). We believe the low default rate is reflective of the sound financial condition of most companies and the strong backdrop of a healthy macroeconomic environment.

Exhibit 8 – **U.S. High-Yield Bond Spread over Treasuries (OAS)*: December 1997 - June 2018**



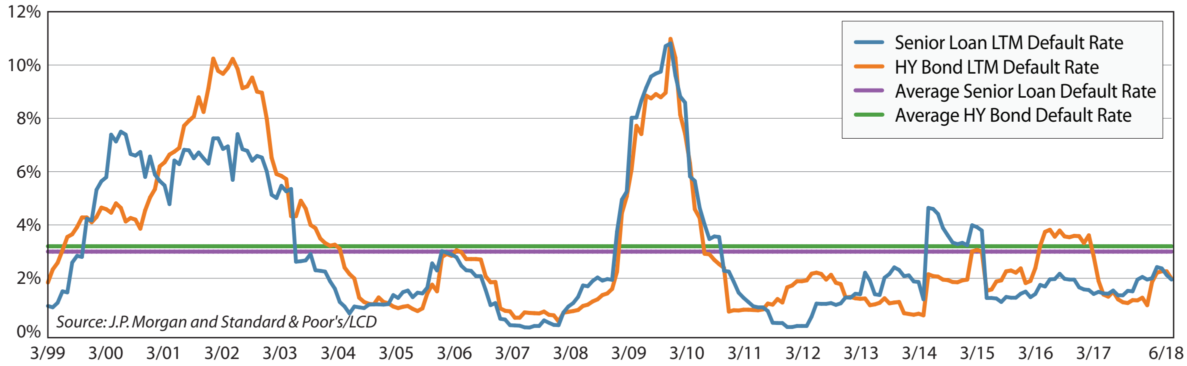
Source: Bloomberg. Green line represents average over the period.

Conclusion

We believe the combination of healthy labor and inflation data in the U.S., less accommodation from global central banks and increased U.S. Treasury issuance to fund greater deficits will likely continue to increase interest rate volatility and drive interest rates higher. We believe the trade dispute is a temporary issue that will be resolved and higher interest rates should continue to pressure long-duration (the most interest rate sensitive) bond returns. 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. 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 2018. We also believe that high-yield bonds, when managed appropriately, can continue to perform well relative to other fixed-rate bonds given their mid-cycle valuations and low default rate.

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

Exhibit 7 – **Senior Loan and High-Yield Bond Historical Default Rates[3]: March 1999 - June 2018**



Source: J.P. Morgan and Standard & Poor's/LCD

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.

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			YTD 2018	YTD 2017	12 Mo Ended 6/29/18	12 Mo Ended 6/30/17	Q2 2018 By Rating		
Index Returns	Q2 2018	Q2 2017					BB	B	CCC
Senior Loans	0.71%	0.76%	2.17%	1.93%	4.35%	7.42%	0.46%	0.79%	1.90%
High-Yield Bonds	1.00%	2.14%	0.07%	4.90%	2.52%	12.74%	0.18%	1.40%	2.22%
Investment Grade Corporate Bonds	-0.94%	2.42%	-3.12%	3.88%	-0.71%	2.33%			
Preferred Securities	1.05%	3.35%	0.04%	8.73%	1.75%	5.86%			
U.S. Aggregate	-0.16%	1.45%	-1.62%	2.27%	-0.40%	-0.31%			
U.S. 10-Year Treasury	-0.29%	1.29%	-2.67%	2.08%	-2.70%	-5.58%			
Emerging Market Bonds	-3.42%	2.16%	-5.33%	6.13%	-2.53%	4.94%			
Municipal Bonds	0.87%	1.96%	-0.25%	3.57%	1.56%	-0.49%			
S&P 500	3.43%	3.09%	2.65%	9.34%	14.37%	17.90%			
Default Rate[3] (Trailing Twelve Months)	Q2 2018	Q2 2017	FYE 12/29/17	FYE 12/30/16					
Senior Loans (LLI)	1.95%	1.54%	2.05%	1.58%					
Long-Term Average - *Since March 1999*	3.00%	3.06%	3.03%	3.11%					
High-Yield Bonds	1.98%	1.50%	1.27%	3.32%					
Long-Term Average - *Since March 1999*	3.20%	3.29%	3.23%	3.32%					
Technicals	Q2 2018	Q2 2017	FYE 12/29/17	FYE 12/30/16					
Average Senior Loan Price (LLI)	$98.05	$98.02	$98.05	$98.08					
Long-Term Average Senior Loan Price - *Since Dec 1997*	$94.10	$93.88	$93.99	$93.77					
Senior Loan Spread Over LIBOR[1]	L+387	L+417	L+405	L+465					
Long-Term Average Senior Loan Spread[1] - *Since Dec 1997*	L+517	L+523	L+521	L+526					
Average High-Yield Bond Price (HUC0)	$97.84	$101.31	$100.59	$99.59					
Long-Term Average High-Yield Bond Price - *Since Dec 1997*	$94.43	$94.14	$94.32	$93.96					
High-Yield Bond Spread (OAS)*	T+371	T+377	T+363	T+422					
Long-Term Avg. High-Yield Bond Spread (OAS)* - *Since Dec 1997*	T+577	T+588	T+582	T+593					
YTW for High-Yield Bonds (HUC0)	6.53%	5.69%	5.84%	6.17%					
YTM for High-Yield Bonds (HUC0)	6.68%	6.11%	6.20%	6.48%					
U.S. 3 Month LIBOR[2]	2.34%	1.30%	1.69%	1.00%					
U.S. 10-Year Treasury Yield	2.86%	2.30%	2.41%	2.44%					
Flows & Issuance (billions)	Q2 2018	Q2 2017	FYE 12/29/17	FYE 12/30/16	YTD 2018	YTD 2017			
Retail Senior Loan Fund Flows	$7.0 *(Est.)*	$3.6	$13.1	$9.2	$11.9	$17.5			
Institutional (CLO) Senior Loan Flows	$37.7	$35.1	$117.1	$73.3	$69.8	$52.4			
Retail High-Yield Bond Flows	-$3.8 *(Est.)*	-$2.3	-$20.3	$9.6	-$23.7	-$10.5			
Senior Loan Gross New Issue	$258.8	$246.0	$973.9	$485.4	$501.1	$577.0			
High-Yield Bond Gross New Issue	$53.5	$76.7	$328.1	$286.2	$126.3	$175.3			

[1] 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.

[2] LIBOR–London Interbank Offered Rates

[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–ICE BofAML 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–ICE BofAML 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–ICE BofAML 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. Aggregate-Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS, ABS and CMBS.

U.S. 10-Year Treasury–ICE BofAML 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–ICE BofAML 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.

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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.