William Housey, CFA
Managing Director of Fixed-Income, Senior Portfolio Manager

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.

MARKET OVERVIEW - FIXED INCOME

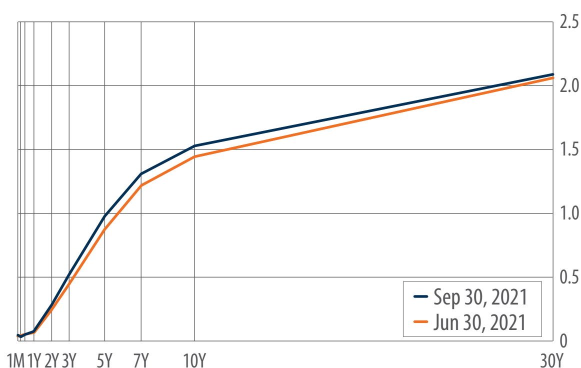
We believe a combination of factors is likely to lead to higher interest rates. Specifically, we expect the labor market to remain robust and we expect inflation to persist above the Fed's 2% target, driven by supply chain disruptions, higher commodity prices, strong wage growth and deficit spending.

Longer term yields were lower for most of the quarter. We believe the lower yields were primarily due to the extraordinary quantity of negative yielding foreign debt which resulted in strong foreign demand for U.S. Treasuries. Moreover, pension funds rebalancing into fixed income securities and state government demand for U.S. Treasuries, given their high cash balances after federal stimulus and tax receipts, also contributed to lower yields. Despite this aggregate technical demand, in the last week of September, the yield on the 10-year jumped 20 basis points ("bps") following the Fed's more hawkish tone about monetary policy, specifically, the likely taper of its Quantitative Easing (QE) program. This resulted in the 2-year U.S. Treasury yield ending the quarter 4 bps higher at 0.29% and the 10-year Treasury yield increased from 1.45% to 1.53% (see Chart 1).

While the Fed maintained the fed funds target and current levels of asset purchases, recent inflation data and progress on employment resulted in an acknowledgment that moderating the pace of asset purchases may be imminent. Additionally, the September "dot plot" highlighted that some Fed participants are pulling forward expectations for liftoff and the pace of rate hikes in 2023. The median Fed projection indicates that the target rate will be 1.0% at the end of 2023, roughly in line with market expectations (see Chart 2) and up from 0.625% in June.

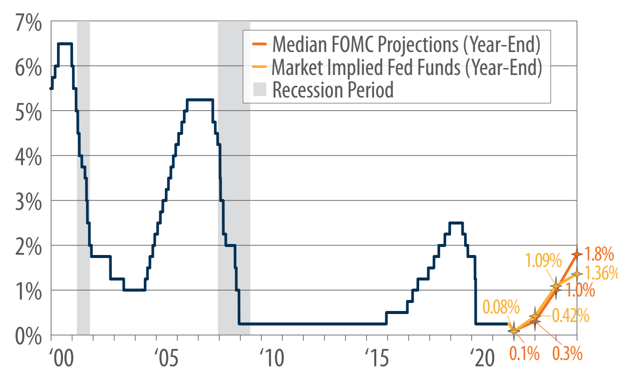
A healthy labor market coupled with strong inflation should continue to support higher interest rates. We expect that the labor markets will continue to improve as extended unemployment benefits were retired in September and job openings remain at historically high levels. The unemployment rate has declined to 4.8% from 5.9% at the end of June. Meanwhile, inflation pressures, driven by supply chain disruptions, higher commodity prices, strong wage growth and deficit spending are likely to persist. The Bloomberg Commodity Index is up over 29% this year while the price of oil ended the quarter over $75.00, more than 50% higher than where it started the year.

CHART 1: U.S. TREASURY YIELD CURVE (%)



Source: FactSet Interest Rate Database

CHART 2: U.S. FEDERAL FUNDS TARGET RATE



Source: FactSet, Bloomberg, FOMC, 9/2000 – 9/2021
Projections from 12/2021 – 12/2024

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

Definition: Duration is a measure of the weighted average life of a bond, which takes into account the maturity of each payment of a bond including coupons and the final maturity payment. The value of longer duration bonds are more sensitive to interest rate changes than shorter duration bonds.

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.

ASSET CLASS VIEWS AND RATIONALE

DURATION POSITIONING

Favor a Shorter Duration Relative to the Broad Fixed Income Market

During the September meeting, the FOMC maintained the target range for the federal funds rate at 0.00 – 0.25% and confirmed they will continue to increase their holding of Treasury securities and agency mortgage-backed securities by at least $80 billion per month and $40 billion per month, respectively. However, given recent inflation prints that have far exceeded the Fed's 2.0% target and continued progress on employment, the Fed also acknowledged that moderating the pace of these asset purchases may soon be warranted. Of the 18 Fed survey participants nine now expect at least one interest rate hike in 2022, up from seven in June and the median expectation is for three hikes in 2023, one more than projected at the last meeting. The Fed decreased its 2021 median growth projection from 7.0% to 5.9%, however, the median GDP growth projection for 2022 was raised from 3.3% to 3.8%. On the inflation front, the Fed again increased its 2021 median PCE projection, now at 4.2%, well in excess of their 2% target, but they stand by expectations for transitory developments to moderate, projecting PCE to fall to 2.2% in 2022 and 2023.

The yield curve flattened for most of the 3rd quarter despite persistently high inflation. We believe longer term yields were lower primarily due to the extraordinary quantity of negative yielding foreign debt which resulted in strong foreign demand for U.S. Treasuries. Moreover, pension funds rebalancing into fixed income securities and state government demand for U.S. Treasuries, given their high cash balances after federal stimulus and tax receipts, also contributed to lower yields.

We believe a combination of factors is likely to lead to higher interest rates. Specifically, we expect continued employment gains in the coming months following the expiration of extended employment benefits in September which should support the anticipated imminent tapering of the Fed's QE program. In addition, we expect persistent inflationary pressure driven by continued supply chain disruptions, strong commodity prices, upward wage pressure, and large deficit spending.

Corporate balance sheets are in good shape, bolstered by robust revenue and earnings growth, the consumer is strong and default rates are at cyclical lows. Though valuations across fixed income remain tight, we believe fundamentals will continue to support corporate credit. A trajectory of higher interest rates is expected to benefit investors that are short duration relative to their benchmarks.

SECTOR POSITIONING

Ultra-Short Maturity

As interest rates increase, we believe ultra-short securities will exhibit lower volatility than other fixed income sectors while offering the potential for enhanced income relative to cash. However, yields on these securities have remained near historic lows given the Fed's actions to keep short-term rates near 0%.

Mortgage-Backed Securities

We maintain exposure to agency mortgage-backed securities (MBS) because we believe they have limited credit risk and can reduce risk profiles given lower expected volatility and a lower correlation to corporate credit. Generic agency MBS would be expected to come under pressure when the Fed begins tapering MBS asset purchases. While MBS valuation levels are elevated and duration extension is a concern, we continue to actively manage this risk and have increasingly allocated to sub sectors within MBS that offer income and duration risk management opportunities.

Senior Loans

Investor inflows into senior loan funds have continued for nine months after over two years of outflows. The economic reopening, lower default rates, higher commodities and a strong consumer paired with our expectations of a steepening yield curve should continue to benefit senior loans. While senior loan prices and spreads have continued to tighten, we believe the income characteristics and return potential of senior loans appear favorable to investment grade and high yield bonds.

High Yield Bonds

High yield bonds are expected to benefit from improving fundamentals as the economic reopening is underway. Default rates have fallen to cyclical lows, commodity prices are up, and the consumer is strong. Valuations are very tight, but the income characteristics of high yield bonds appear attractive relative to higher rated credit, especially with respect to short duration high yield. Economic growth is expected to support credit fundamentals and we believe the relatively short duration of the asset class is attractive in a rising rate environment.

Emerging Market Bonds

Yields in emerging market local currency debt are running near historical averages while central bank policy has intensified over the last 3 months. Many central banks are in a hiking cycle which lifts the income characteristics of these bonds. Fundamentals have shown some deterioration; however, we believe global growth and continued vaccine rollouts will support these economies. Emerging market currencies are undervalued relative to history and provide some upside potential; however, they remain subject to U.S. dollar volatility.

Treasury Inflation Protected Securities (TIPS)

TIPS breakeven rates are inverted as the 5 year is higher than the 10 year, reflecting market expectations for inflation to run hotter over the intermediate term. We believe inflation pressures will persist and help to offset the effect of rising interest rates on TIPS. While this would lead TIPS to outperform nominal Treasuries, we believe there are better fixed income opportunities than TIPS.

U.S. Treasury Securities

The Federal Reserve remains committed to keeping the front end of the yield curve anchored, for now, and Treasury yields appear rich. In the third quarter, the curve flattened, however, we believe risks are to the downside with the potential for Fed tapering over the near term and there is risk that the Fed relaxes its transitory inflation view and adjusts monetary policy accordingly.

Investment Grade Corporate Bonds

Credit fundamentals have improved given balance sheet improvement and earnings growth. Demand for credit appears sustainable until sovereign yields improve globally despite historically tight credit spreads and low yields. At current valuations we are less constructive on investment grade corporate bonds given the significant duration extension that has occurred and we believe intermediate term corporates appear especially overvalued and vulnerable to rising rates. We favor short duration investment grade given our expectation for higher interest rates.

Preferred Securities

Credit momentum continues to be positive as U.S. and European banks reported strong first half results and oil prices are providing a tail wind for the energy sector issuers. Fund inflows are providing a robust demand technical and primary market demand is strong because of limited net new supply with redemptions outpacing supply in the $25 par retail market. Income characteristics appear strong relative to other fixed income asset classes but yield to call valuations are near all-time tights.

Municipal Fixed Income

Fundamentals remain strong for most municipal bond sectors given healthy GDP growth, lower unemployment, and hundreds of billions of federal dollars available through government stimulus. In addition, the infrastructure bill pending in Congress, if passed, would be an additional positive for bridges, toll roads, airports and water and sewer systems. Despite strong fundamentals, we continue to believe a cautious approach via active management is warranted given that yields and spreads are low and tight by historical standards and municipal debt could be highly correlated to changes in U.S. Treasuries.