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.

FIXED INCOME OUTLOOK

Our expectation going into 2022 is for interest rates to increase. We believe there are three key reasons supporting higher interest rates. First, the Federal Reserve (the "Fed") is now faced with the very difficult task of unwinding extremely accommodative monetary policy in the face of decelerating growth and rising inflation. Quantitative easing is expected to conclude by March, conditions for interest rate lift-off appear to be largely met, and the Fed is considering reducing the size of its balance sheet. The Fed has been a significant buyer of mortgage and Treasury securities and as this stabilizing force recedes, we believe conditions for higher interest rate volatility are ripe. Second, inflationary pressures are not just in the U.S., but are a global challenge. We believe foreign Central Banks will have to react to this high inflationary environment by tapering and eventually ending their own quantitative easing programs and raising interest rates. If they don't react, we expect markets to move global rates higher regardless. As we believe global rates are largely correlated with U.S. rates, we believe that as foreign yields increase, especially German Bunds, we anticipate that to be supportive of higher rates domestically. Already we are seeing German Bunds near their highest levels since 2019. Further supporting our argument for higher rates, we believe real interest rates are simply too low. The 10-year TIPS breakeven, a market estimate of longer-term inflation expectations, is running at approximately 2.59% while the 10-year Treasury yield is at 1.51% (see Chart 1). Empirically, the 10-year U.S. Treasury yield is higher than inflation expectations some 85% of the time. Typically, an investment in Treasury securities should compensate investors for inflation and provide a positive real return. We expect this relationship to normalize as tighter monetary conditions work their way through the markets.

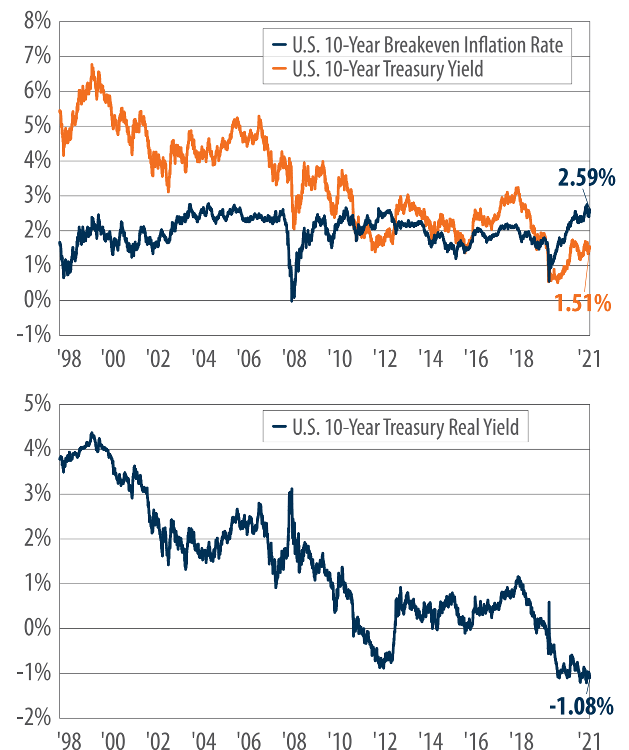
FIXED INCOME MARKET REVIEW

The yield curve flattened over the 4th quarter as the market continued pricing in the more hawkish tone from the Fed amidst spiking inflationary pressures (see Chart 2). The 30-year U.S. Treasury bond yield declined 19 basis points (bps) from 2.09% to 1.90% and the 2-year note increased 44 bps from 0.29% to 0.73%. The difference between the 10-year bond and 2-year note, a common measure of steepness of the yield curve, declined 46 bps, from 1.24% to 0.78%.

The labor markets continue to heal as the unemployment rate declined to 3.9% in December, which is significant because it is now within the Fed's projection for the long run average range. We believe one of the most challenging variables for the Fed will likely be wage inflation, as evidenced by average hourly earnings increasing 0.6% from last month and 4.7% year-over-year.

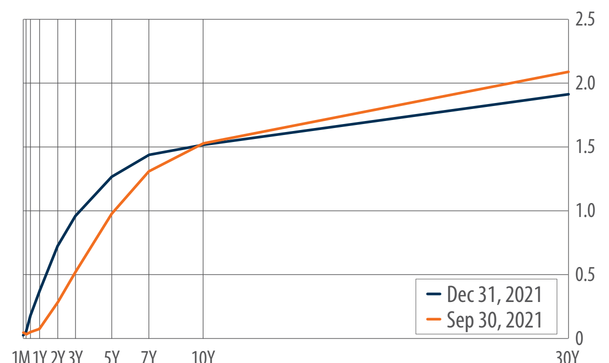
Considering strong economic activity, employment improvements and elevated inflation, the Fed, in November, began reducing the pace of its net asset purchases. By December, they fully abandoned their use of the term "transitory" in relation to inflation pressures and accelerated the taper with the goal of completely ending mortgage and Treasury purchases by March of 2022. They maintained the target range for the federal funds rate at 0 – 0.25%, but they are now anticipating three 25 bps hikes each in 2022 and 2023, which would result in the target rate reaching 1.625%. In September, the Fed expected only 1 hike in 2022 and for 2023 to end at 1.0%, which is a significant hawkish shift in only 3 months. At the December meeting, the Fed discussed the possibility that balance sheet normalization would likely begin closer to policy rate liftoff than the previous normalization cycle and could occur at a faster rate given a stronger economic outlook, higher inflation, and a larger balance sheet.

CHART 1: 10-YEAR U.S. TREASURY REAL YIELD



Source: Bloomberg, 8/3/1998 - 12/31/2021

CHART 2: U.S. TREASURY YIELD CURVE



Source: FactSet Interest Rate Database

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

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.

FIXED INCOME OVERVIEW

We enter 2022 with a U.S. economy that is expected to grow above long-term trends, albeit at a slower pace than the growth posted in 2021, and an inflation rate that is running hotter than at any time in the last 39 years. The Fed has begun tightening monetary policy by beginning to taper its quantitative easing program and is expected to end the program entirely by the end of March. Once completed, we believe the Fed will also begin to increase short-term interest rates in the new year. Despite the indication of tighter financial conditions to come, the Fed posture towards monetary policy remains accommodative, and in this environment, with rich valuations across much of the fixed income landscape and robust credit fundamentals, our recommendation is to maintain a shorter duration relative to benchmarks and seek areas of the market that can offer durability, such as floating rate instruments, as rates increase.

SECTOR POSITIONING

Ultra-Short Maturity

As interest rates increase, we believe ultra-short securities will prove defensive in that they are likely to exhibit lower volatility relative to 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 overall risk given their lower correlation to corporate credit. We believe generic and index-based MBS are most at risk as the Fed slows and eventually terminates its 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.

Treasury Inflation Protected Securities (TIPS)

Inflation is high and although we believe inflation pressure will persist, we also believe it will moderate from current levels as we work through the next year. We believe real rates are too low and at current breakevens, TIPS could face pressure if real rates move higher.

U.S. Treasury Securities

The Fed has abandoned its characterization of inflation as 'transitory' and has increased the pace of tapering while now anticipating three 25 bps rate hikes in 2022. In this environment, we believe Treasury valuations appear rich, particularly in the long end of the yield curve, which we believe have been supported by technical factors. We believe the risks are to the downside.

High-Yield Bonds

We believe high-yield bonds have benefited from strong underlying fundamentals and low default rates. Valuations have cheapened into recent interest rate and overall market volatility and yields appear more attractive than they did over the summer. While we anticipate high-yield bonds will outperform senior loans over the course of the year, we believe periods of rate-induced market volatility are likely to lead to attractive entry points. Economic growth is expected to support credit fundamentals and we believe the relatively short duration of high-yield bonds is desirable in a rising-rate environment, relative to traditional fixed income.

Senior Loans

Inflows into senior loan funds have reached 12 consecutive months, this after over 24 consecutive months of outflows. We believe corporate fundamentals within the senior loan market remain robust as evidenced by the low default rate within the market. Bank loan spreads over LIBOR have been relatively stable despite interest rate volatility. Should interest rates move higher, as we expect them to, we believe the senior loan asset class will continue to benefit as investors seek areas of the market insulated from interest rate risk.

Investment Grade Corporate Bonds

We believe corporate credit fundamentals remain a strong point for the investment grade corporate market. Valuations have cheapened recently in the wake of interest rate volatility but remain tight on a historical basis. We believe rising rates are the primary risk to the broad investment grade corporate bond universe. Within the investment grade market, we prefer exposure to short duration securities.

Preferred Securities

Yields appear attractive relative to other fixed income asset types. We believe issuer credit fundamentals remain strong going into 2022 as both U.S. and European banks have reported strong year-to-date results while other major sectors including insurance and REITs have showed stable fundamentals. We believe fund inflows provide a strong demand technical backdrop and the limited net new supply outlook for 2022 continues to look supportive. Institutional preferreds appear to have better valuations at this time than the retail preferred market and we believe they may be less exposed to interest rate volatility given generally lower durations.

Emerging Market Bonds

Emerging Markets faced headwinds from a hawkish surprise to the Fed's dot plot, which led to a strengthening of the U.S. dollar and broader de-risking in China. While the strength of the U.S. dollar has pressured Emerging Market debt returns, over the coming months, we expect clarity on U.S. monetary policy to lead to an improved outlook for Emerging Market debt. Emerging Market valuations appear attractive relative to history.

Municipal Fixed Income

We believe credit fundamentals are improving for most municipal bond sectors given healthy GDP growth, lower unemployment, significantly improved revenues, and hundreds of billions of dollars available through the Cares Act, $1.9 trillion ARPA and passage of the $550 billion infrastructure bill. Yields and spreads are low and tight by historical standards. We believe high yield and short duration municipals are preferable to other segments and see more risk in the 25+ year portion of the municipal bond yield curve.