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Managing Director of Fixed-Income, Senior Portfolio Manager

Bill is a Managing Director of Fixed-Income and is also a member of the First Trust Strategic Model Investment Committee and the Fixed-Income Sub-Committee. Bill joined First Trust Advisors L.P. in June 2010 as the Senior Portfolio Manager for the Leveraged Finance Investment Team. Bill has over 26 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.

FIXED INCOME MARKET REVIEW

In the fourth quarter of 2022, inflation eased from the highs seen during the summer, though remained stubbornly elevated with the November (reported in December) Consumer Price Index printing +7.1%. Despite the equivalent of seventeen 25 basis point (bps) interest rate increases in 2022, inflation consistently exceeded the 2% stated target of the Federal Reserve ("Fed") as the labor market remained resilient, leaving the Fed with one likely policy path for the next several months: higher rates for longer. As such, we continue to expect upward momentum across the U.S. Treasury yield curve in the near term.

At the December meeting, the Fed projected a higher-than-expected terminal Federal Funds rate of 5.00%-5.25%; this compares to today's range of 4.25%-4.50%. As the Fed slowed its aggressive pace of rate hikes from 75 bps per meeting to 50 bps in December, the market believed (as evidenced by Fed Fund Futures) the Fed was unlikely to reach its ultimate target (see Chart 1). However, we believe this Fed remains steadfast on raising the terminal Federal Funds rate to levels that are, in their words, "sufficiently restrictive to return inflation to 2%." And, as further stated by the Fed, "it will take substantially more evidence to give comfort that inflation is actually declining." Consequently, while acknowledging that we are much closer to the finish line, we still believe there is upside risk to the Fed's terminal rate target.

FIXED INCOME OUTLOOK

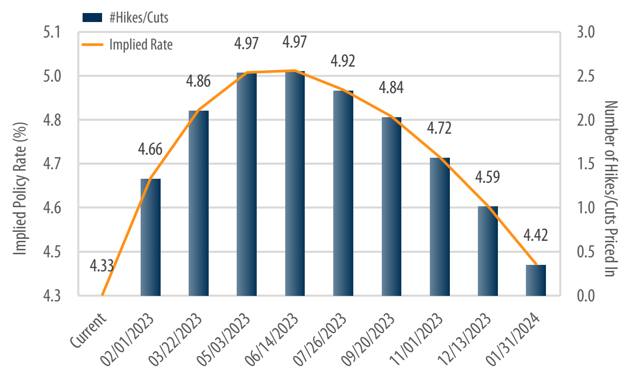
We expect higher rates will eventually result in demand destruction, and lower demand should ultimately result in lower prices. We believe depressed demand will subsequently allow supply chains to rebuild, soften demand for commodities, ease labor pressures, and weaken housing prices (which typically lead rents). Importantly, the Fed's policy tools operate with a lag. Therefore, we believe we have yet to observe the true impact of these recent hikes (or future hikes) on the overall economy. The Fed's dual mandate centers on price stability and employment, both of which are typically lagging indicators of overall economic activity; thus, we believe the risk of a 2023 recession has escalated significantly. While there is much anecdotal evidence to suggest the U.S. economy is slowing, one of the most important indicators is the inversion of the 2-year/10-year U.S. Treasury yield curve; this relationship has a strong track record of inverting prior to recessions. Further, the 3-month/10-year U.S. Treasury yield curve, which typically lags the inversion of the 2-year/10-year U.S. Treasury yield curve, inverted in October, flashing further warning signs for the U.S. economy, in our view (see Chart 2).

As the Fed has increased the Federal Funds rate by 4.25%, and the 10-year U.S. Treasury yield has increased from 1.51% to 3.88%, we are a long way from where we started the year (see Chart 3). Given these drastic moves, negative returns have battered the market in 2022; as such, we find attractive valuations in nearly all segments of the bond market today. We saw the great rate reset of 2022 resurrect the 60/40 portfolio and given our expectation for the U.S. economy in 2023, one could even argue that a 50/50 portfolio may be warranted, de-risking equities in favor of the bond market.

As we proceed into 2023, we anticipate high levels of volatility, as is typical in bear markets, to persist. As the Fed increases interest rates, we continue to favor duration profiles short of the benchmark, while acknowledging that duration extension from ultra-short positioning is warranted as rates have moved significantly higher. We remain cautious around extending duration too significantly in the near term given our expectation of higher rates for longer, placing further upward pressure on the U.S. Treasury yield curve.

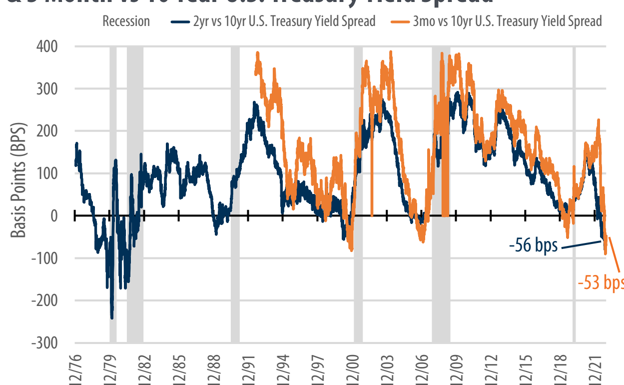
We continue to closely monitor the health of the labor market for further insight into timing our duration extension. Higher rates will eventually slow the economy and likely lead to a recession, which will allow the Fed to begin reducing rates. As the timing of such change remains unclear, we believe patience is required. Given the potential for a shorter business cycle and 2023 recession, we favor higher quality credit in anticipation of wider credit spreads. While not here quite yet, we do believe that the time to move durations back to neutral, and potentially even beyond the benchmark, is nearing.

Chart 1: Implied Federal Funds Rate & Number of Hikes/Cuts



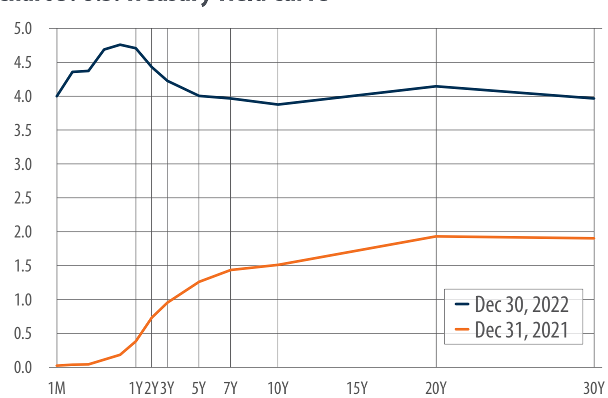
Source: Bloomberg, as of 12/30/2022

Chart 2: 2 Year vs 10 Year U.S. Treasury Yield Spread & 3 Month vs 10 Year U.S. Treasury Yield Spread



Source: Bloomberg, as of 12/30/2022

Chart 3: U.S. Treasury Yield Curve



Source: Bloomberg

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

SECTOR POSITIONING

Ultra-Short Maturity

Short-term interest rates have benefitted from the Fed increasing interest rates aggressively, with the equivalent of seventeen hikes of 25 bps in 2022. We anticipate that short-term interest rates will continue to generate higher levels of income while exhibiting lower volatility than other fixed income sectors.

Mortgage-Backed Securities

Rapid interest rate increases have resulted in significant duration extension within the mortgage-backed securities (MBS) market. The housing market has slowed substantially, primarily as a result of affordability challenges. We believe home prices will decline next year, however, we do not forecast a repeat of the 2008 housing crisis given stringent underwriting standards and the majority of borrowers having locked into historically low mortgage rates and have ample home equity cushion. We believe mortgage-backed security extension risk is lower given how mortgage rates have increased significantly over the last 12 months. Valuations on agency MBS appear to be in line with long-term averages and have shown signs of stabilization as interest rate volatility has declined. We continue to favor active, higher quality MBS strategies that offer a more attractive yield per unit of duration and improved overall risk/reward profile.

Treasury Inflation Protected Securities (TIPS)

We expect inflation to moderate from extraordinarily high levels over the next year given our belief that the Fed's aggressive interest rate policy is likely to induce economic weakness. Historically, the TIPS market has not proven to be an adequate inflation hedge. The sector produced an -11.85% return[1] in 2022, despite inflation having reached a 40 year high. Accordingly, we remain cautious on TIPS until market conditions warrant a more favorable entry point.

U.S. Treasury Securities

While interest rates have been volatile, the trend higher has been a significant headwind to U.S. Treasury returns. While our near-term expectation is for rates to continue to climb, we see the risk/reward as having improved since the beginning of the year. We believe that over the course of the next year, U.S. Treasuries are likely to provide a solid ballast within a well-diversified portfolio given our expectation for a weaker economic environment.

High-Yield Bonds

High-yield bond interest rates are appealing, but as we enter a recessionary environment and default rates rise significantly, we expect spreads to widen from current levels, at which point we would look for opportunities to increase our allocation at more attractive valuations. Margin contraction, lower revenue and earnings revisions are anticipated as a result of weaker demand, and corporate management's tone is uncertain and cautious. We prefer higher-quality, higher-yielding credits, as well as allocations to sectors that are less susceptible to cyclical economic conditions.

Senior Loans

In recent months, senior loans, given their ultra-short duration and floating rate income, have outperformed many other fixed income asset classes. Default rates are low but are expected to rise in the coming year as margin contraction continues, exacerbated by rising labor and input costs, and earnings and revenue estimates that are expected to be revised lower due to weaker demand. While senior loan prices have declined, the price decline has largely been mitigated by much higher levels of interest income. Moreover, prices have not deteriorated nearly as much as high-yield bonds. Given our expectation for a weaker U.S. economy in the coming year, we believe that leveraged loan prices may depreciate as the economic and default environment deteriorates, providing an opportunity to add to the asset class, potentially in the second half of the year.

Investment Grade Corporate Bonds

Corporate balance sheets are healthy, but earnings are either deteriorating or expected to weaken in consumer-sensitive and cyclical industries. Businesses face margin compression from labor, other inputs, a strong U.S. dollar, and declining consumer and business confidence. Investment grade funds continue to face outflows but are becoming more balanced as investment grade spreads are near longer-term averages and offer more attractive risk/reward. Given elevated inflation and an aggressive Fed, we believe credit spreads will face headwinds. We continue to favor positioning in sectors we believe will provide minimal cyclicality and the front end of the curve, where yield exceeds duration.

Preferred Securities

We believe that the risk/reward balance for interest rate risk has improved, which has created opportunities in the preferred and hybrid securities markets. We believe that discounted securities, such as retail securities with a par value of $25, have the most upside potential when rates stabilize or decline. The biggest risk heading into 2023, in our opinion, is that the Fed tightens too much, resulting in a recession. We prefer to invest in longer-term variable-rate securities that are trading at deep discounts given the potential to pull to par as their first call dates approach. This effect is likely to be driven by variable rate securities with high resets that project much higher coupons after their first call dates. Bank balance sheets and capital ratios remain strong, and higher interest rates typically benefit revenue streams.

Emerging Market Bonds

Momentum has shifted positive for Emerging Market bonds, which performed well following the September and October U.S. Consumer Price Index releases, highlighting the Fed's role as a catalyst for Emerging Market investors. Fundamental conditions in Emerging Markets are negative, with manufacturing Purchasing Managers' Index releases indicating contraction in several countries, with China posing the greatest specific risk. Local yields are attractive, averaging over 6.8% at the end of November, but investor flows remain negative.

Municipal Fixed Income

We expect U.S. Treasury rate volatility, anticipated Fed interest rate hikes and related municipal bond price volatility will continue to affect fund inflows and performance over the coming months. The fundamental credit picture for municipal bonds remains supported by healthy tax receipts, robust balance sheets and hundreds of billions of dollars in federal transfer payments. Given much more attractive taxable equivalent yields than a year ago, we expect a positive shift in fund flows when interest rates stabilize. We anticipate that as the economy deteriorates, defaults will gradually increase but remain at a modest level. We are constructive about the front end of the municipal yield curve because breakeven total returns look much more appealing, in our view, given the noticeably higher short-term municipal rates and the potential income cushion provided if rates rise. In addition, a modest duration extension is justified given inflation appears to have peaked and we are anticipating significantly fewer rate hikes in 2023 as the economy slows.

[1]Return as of 12/30/2022 as measured by the Bloomberg US Treasury Inflation Notes Index.