First Trust
Portfolios Canada®

Senior Loan & High Yield Review
First Quarter 2018

William Housey, CFA
Senior Vice President,
Senior Portfolio Manager

Market Review

Macro Overview

As we entered 2018, we believed that inflation expectations were too low given the relative health of the U.S. economy and the tightening labor market. This proved to be accurate as inflation data, specifically wage data, began to show modest signs of improvement in the first quarter. This wage improvement was the primary catalyst for one of the largest upward moves in interest rates since the Taper Tantrum, in May 2013. Interest rates, as measured by the 10-year U.S. Treasury, increased 33 basis points (bps) in the quarter to 2.74% from 2.41% and were up 70 bps from the September low of 2.04%. Notably, the yield touched 2.95% during the quarter but later declined. The bonds most susceptible to changes in interest rates moved lower as rates climbed. These include investment grade corporate bonds, which were down 2.20% over the quarter, and a broader measure of the overall bond market, the Bloomberg Barclays U.S. Aggregate Index which was down 1.46%. Despite equity market volatility and higher interest rates, high-yield bonds and senior loans fared well on a relative basis. High-yield bonds were down 0.92% while senior loans were up 1.45%.

After a decade of interest rate reductions and quantitative easing (QE), the U.S. Federal Reserve Bank (the Fed) has begun tightening monetary policy. The Fed is not only increasing short term interest rates, but it is the first major central bank to embark on a balance sheet reduction program following nine years of QE. Concurrent with the Fed slowing bond purchases, the U.S. deficit is growing (Exhibit 1). This will require additional U.S. Treasury issuance. We believe that the combination of reduced Fed bond purchases and increased U.S. Treasury supply will result in a return of normalized interest rate volatility from artificially low levels (Exhibit 2). In addition, we believe that we are likely to see further tapering

Exhibit 1 **– U.S. Annual Budget and Forecast ($BN)**

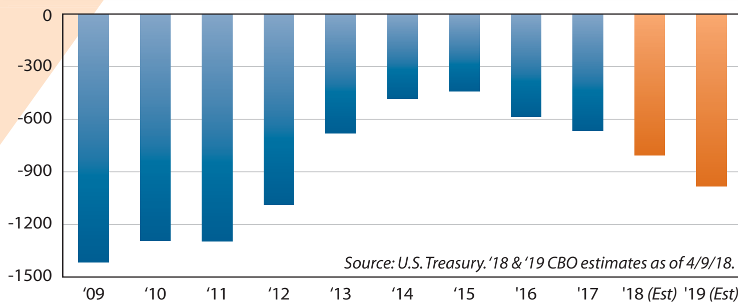
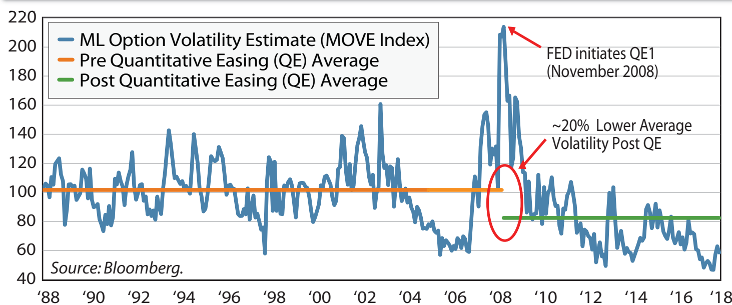
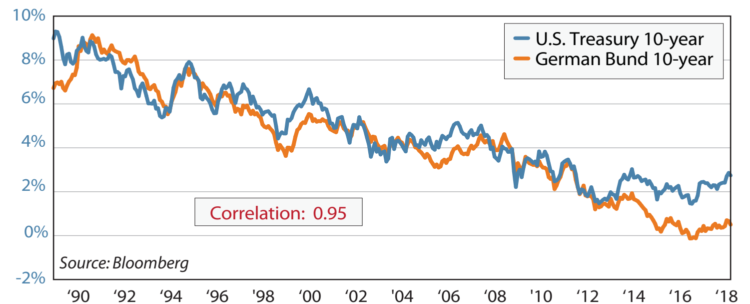


Exhibit 2 **– Merrill Lynch Option Volatility Estimate (MOVE Index)**
December 1988 - March 2018



of the QE program underway via the European Central Bank (ECB), perhaps bringing the program to an end in 2018. We believe that when the ECB does end its QE program, it will lead to higher rates in Europe. We also believe the resulting interest rate increase would likely carry through to the U.S. given the high correlation between foreign yields and U.S. Treasury yields (Exhibit 3). In summary, we believe that a shift to a less accommodating stance by central banks will not only increase interest rate volatility, but will also push interest rates higher.

Exhibit 3 **– 10-year U.S. Treasury vs. 10-year German Bund:**
January 1989 – March 2018

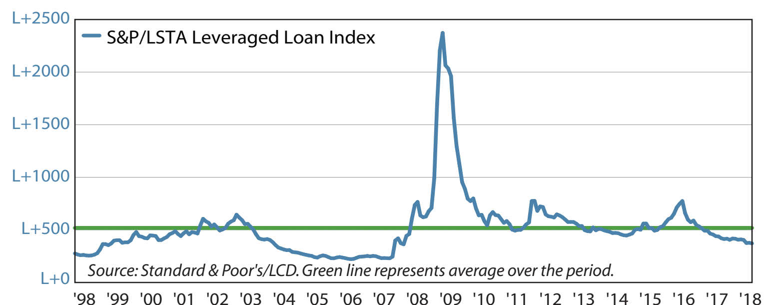


Notwithstanding the potential for interest rates to move higher in 2018, which would negatively impact valuations in traditional rate-sensitive fixed income markets, we continue to see the current environment for senior loan and high-yield credit markets as relatively solid and providing a supportive tailwind. Specifically, defaults remain low by historical standards given the health of U.S. corporations and we see two potential earnings catalysts. First, the weaker U.S. dollar (relative to other developed market currencies) provides an earnings tailwind for multinational companies. Second, we believe the new GOP tax legislation is a positive for the vast majority of high-yield bond and senior loan companies.

Senior Loan and High-Yield Market Overview

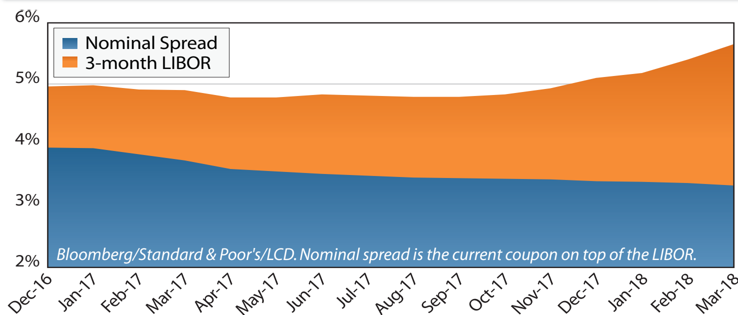
Senior loan spreads over 3-month LIBOR[1] declined 33 bps during the quarter to L+372 bps. This is now in-line with the pre-credit crisis average spread of L+372 (December 1997 – June 2007) but is inside the long-term average spread of

Exhibit 4 **– U.S. Senior Loan Spread over LIBOR[2]:**
December 1997 - March 2018



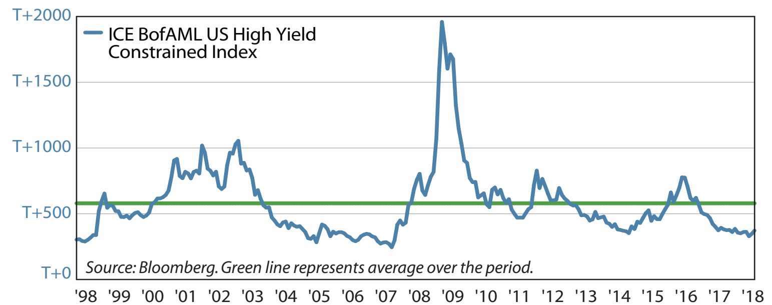
L+519 (December 1997 – March 2018; Exhibit 4). Given that floating rate senior loans are typically priced off of LIBOR, loans benefitted as LIBOR increased from 1.69% to 2.31% over the first quarter. Interestingly, the 10-year U.S. Treasury was around the 2.31% level as recently as the fourth quarter of 2017. Moreover, we believe that with the potential for additional interest rate hikes on the horizon, LIBOR should continue to migrate higher throughout 2018, and we further believe that we've finally reached the inflection point where spread declines on senior loans should be offset by LIBOR increases. As a result, we expect that senior loan investors will begin to see the benefit from rising interest rates (Exhibit 5). Importantly, the last twelve months (LTM) default rate for senior loans remains low, at 2.42% 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 3.01% (March 1999 – March 2018; Exhibit 6).

***Exhibit 5* – Loan Coupons Began to Rise in Late 2017: December 2016 - March 2018**



During the first quarter, high-yield bond spreads over U.S. Treasuries widened by 9 bps, finishing the quarter at T+372. Importantly, high-yield bond spreads tend to tighten over time when interest rates are increasing. Spreads are 21 bps tighter when compared to the same quarter a year ago. While spreads are in fact tight to the historic average (the long-term average spread over U.S. Treasuries is T+580, December 1997 – March 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 cycle (May 2007 of T+245, Exhibit 7). The high-yield default rate increased modestly in the quarter to 2.21% from 1.27% at year-end. This default rate remains well inside the long-term average default rate of 3.21% (March 1999–March 2018; Exhibit 6). 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 7* – U.S. High-Yield Bond Spread over Treasuries (OAS)*: December 1997 - March 2018**

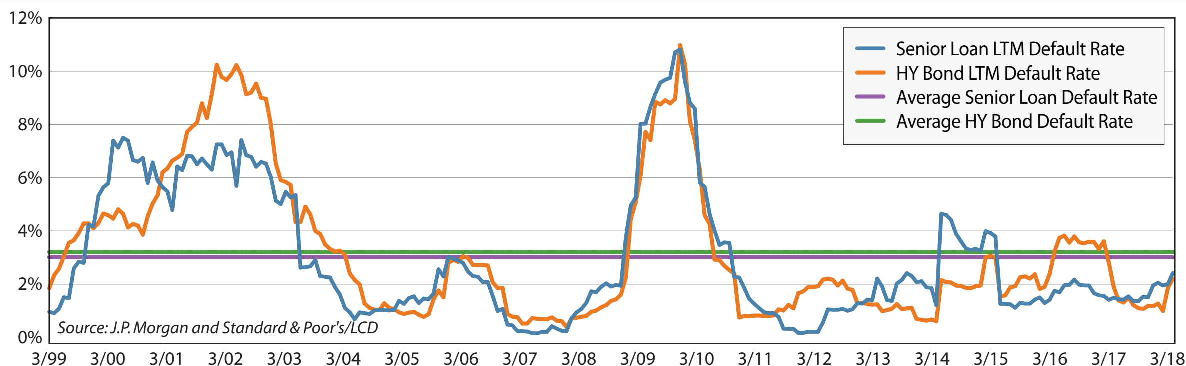


Conclusion

The combination of improved 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 should push interest rates higher. Higher interest rates would 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. 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 6* – Senior Loan and High-Yield Bond Historical Default Rates[3]: March 1999 - March 2018**



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.

Index Returns	Q1 2018	Q1 2017	12 Mo Ended 3/29/18	12 Mo Ended 3/31/17	Q1 2018 By Rating BB	B	CCC
Senior Loans	1.45%	1.16%	4.40%	9.72%	1.17%	1.49%	2.75%
High-Yield Bonds	-0.92%	2.71%	3.68%	16.87%	-1.70%	-0.14%	0.74%
Investment Grade Corporate Bonds	-2.20%	1.42%	2.67%	3.41%			
Preferred Securities	-1.00%	5.21%	4.06%	5.95%			
U.S. Aggregate	-1.46%	0.82%	1.20%	0.44%			
U.S. 10-Year Treasury	-2.39%	0.78%	-1.15%	-3.97%			
Emerging Market Bonds	-1.98%	3.89%	3.10%	7.87%			
Municipal Bonds	-1.11%	1.58%	2.66%	0.15%			
S&P 500	-0.76%	6.07%	13.99%	17.17%			
Default Rate[3] (Trailing Twelve Months)	Q1 2018	Q1 2017	FYE 12/29/17	FYE 12/30/16			
Senior Loans (LLI)	2.42%	1.49%	2.05%	1.58%			
Long-Term Average - *Since March 1999*	3.01%	3.09%	3.03%	3.11%			
High-Yield Bonds	2.21%	1.90%	1.27%	3.32%			
Long-Term Average - *Since March 1999*	3.21%	3.31%	3.23%	3.32%			
Technicals	Q1 2018	Q1 2017	FYE 12/29/17	FYE 12/30/16			
Average Senior Loan Price (LLI)	$98.42	$98.22	$98.05	$98.08			
Long-Term Average Senior Loan Price - *Since Dec 1997*	$94.04	$93.83	$93.99	$93.77			
Senior Loan Spread Over LIBOR[2]	L+372	L+438	L+405	L+465			
Long-Term Average Senior Loan Spread[2] - *Since Dec 1997*	L+519	L+525	L+521	L+526			
Average High-Yield Bond Price (HUC0)	$98.47	$100.80	$100.59	$99.59			
Long-Term Average High-Yield Bond Price - *Since Dec 1997*	$94.39	$94.05	$94.32	$93.96			
High-Yield Bond Spread (OAS)*	T+372	T+393	T+363	T+422			
Long-Term Avg. High-Yield Bond Spread (OAS)* - *Since Dec 1997*	T+580	T+591	T+582	T+593			
YTW for High-Yield Bonds (HUC0)	6.35%	5.88%	5.84%	6.17%			
YTM for High-Yield Bonds (HUC0)	6.56%	6.21%	6.20%	6.48%			
U.S. 3 Month LIBOR[1]	2.31%	1.15%	1.69%	1.00%			
U.S. 10-Year Treasury Yield	2.74%	2.39%	2.41%	2.44%			
Flows & Issuance (billions)	Q1 2018	Q1 2017	FYE 12/29/17	FYE 12/30/16			
Retail Senior Loan Fund Flows	$3.7 *(Est.)*	$13.9	$13.1	$9.2			
Institutional (CLO) Senior Loan Flows	$32.6	$17.3	$117.1	$73.3			
Retail High-Yield Bond Flows	-$19.2 *(Est.)*	-$8.2	-$20.3	$9.6			
Senior Loan Gross New Issue	$242.3	$331.0	$973.9	$485.4			
High-Yield Bond Gross New Issue	$72.7	$97.2	$328.1	$286.2			

[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–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 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.

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.

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For more information, contact

FT Portfolios Canada Co. • 40 King Street West, Suite 5102 • Scotia Plaza Box 312 • Toronto, ON M5H 3Y2 • 1-877-622-5552 • **www.firsttrust.ca**