First Trust Portfolios Canada®

Senior Loan & High Yield Review
Fourth Quarter 2017

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Market Review

Macro Overview

U.S. equity markets continued their march higher in the fourth quarter with the S&P 500 Index gaining 6.64%. This brought the 2017 full year return to a robust 21.83%. Interest rates, as measured by the 10-yr U.S. Treasury bond, were basically unchanged in the quarter and over the course of the year, closing out at 2.41% having begun the year at 2.44%. With the introduction of new tax legislation that is expected to boost corporate earnings, a weaker U.S. dollar which tends to benefit multinational companies and relatively low interest rates, markets have experienced very little volatility. Overall, the general tone from equities and low volatility provided a firm tailwind for senior loans and high-yield bonds over the course of the year, with senior loans up 4.11% and high-yield bonds up 7.47% (Exhibits 1 and 2).

Exhibit 1 – U.S. High-Yield Bond Performance: 1997 – 2017

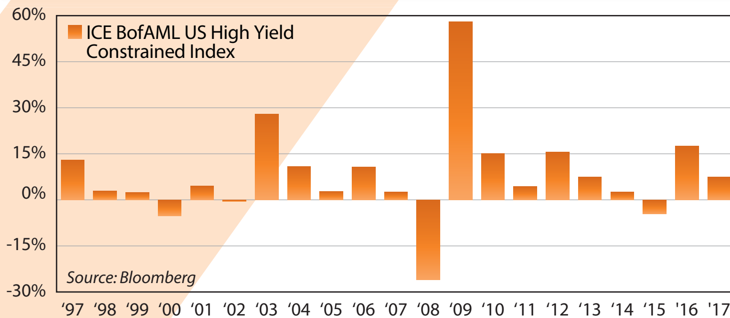
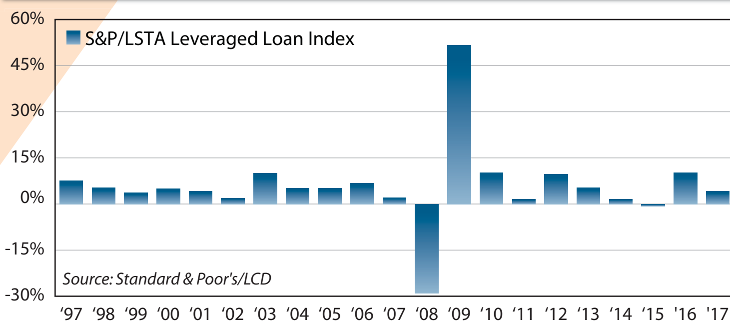
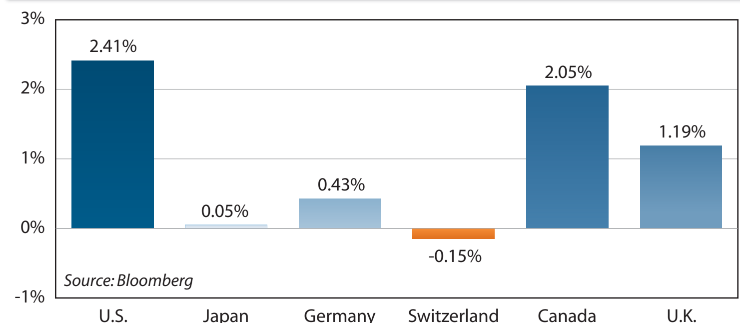


Exhibit 2 – U.S. Senior Loan Performance: 1997 – 2017



As we enter 2018, we continue to be mindful of the fact that the U.S. Federal Reserve ("the Fed") is now embarking on a first-of-its kind balance sheet reduction program. Said differently, after a decade of easing via interest rate reductions and quantitative easing, the Fed is tightening monetary policy. Since 2011, the Fed's balance sheet reinvestment program has resulted in the purchase of over $1.8 trillion back into mortgage bonds, essentially purchasing approximately 20% of all mortgage bonds issued over that time. As stated in our previous quarterly release, we believe that as Fed asset purchases are reduced, interest rate volatility will increase. In addition, we believe that we are likely to see further tapering of the Quantitative Easing (QE) program underway via the European Central Bank (ECB), perhaps even bringing the program to an end in 2018. The strengthening and broadening recovery in the Eurozone area would seem to support such policy action. We believe that when the ECB does end its QE program, such policy action will lead to higher rates in Europe. Importantly, we believe this rate move would likely carry through to the U.S. given the high correlation between foreign yields and U.S. Treasury yields (Exhibit 3: 10-yr yields as of 12/29/2017). Overall, we believe that a shift in behavior to a less accommodating central bank will not only increase interest rate volatility, but will also push interest rates higher.

Exhibit 3 –10-Year Government Bond Yields: as of 12/29/17



Despite the potential for interest rates to move higher in 2018, we continue to see the backdrop for corporate credit as relatively solid and providing supportive tailwinds. Specifically, defaults remain low by historical standards given the health of U.S. corporations, and we believe the new GOP tax legislation is a positive for the vast majority of high-yield credit issuers. Most high-yield companies will benefit because of the lower corporate tax rate, which the tax law lowers from 35% to 21%, and the enhanced ability to immediately expense capital expenditures in the year incurred. The offset is that corporations will no longer have the ability to fully deduct the interest expense on their debt against their earnings, however, except for the most indebted issuers, the positives outweigh the negatives and we believe that overall, the tax modifications in aggregate are a net positive for high-yield and senior loan credit. Moreover, if corporations can no longer fully deduct the interest expense on their debt, then at the margin they will have less incentive to borrow which will likely prioritize debt repayment. This could result in less new issuance of debt (lower supply) and therefore the potential for tightening spreads in the market, should demand outstrip supply.

High-Yield and Senior Loan Market Overview

High-yield bond spreads over U.S. Treasuries widened modestly in the quarter by 7 basis points (bps) from the end of the third quarter. While spreads are in fact tight to the historic average (the long-term average spread over U.S. Treasuries is T+582, December 1997 – December 2017), we believe there is room for further tightening throughout the remaining cycle given that spreads remain wide of the tight spreads experienced in the previous cycle (May 2007 of T+245, Exhibit 4). Moreover, the high-yield default rate has fallen from 3.32% a year ago to 1.27%. This is well inside the long-term average default rate of 3.23% (March 1999 – December 2017; Exhibit 6). We believe the low default rate is reflective of the relatively sound financial condition of most companies and the strong backdrop of a healthy macroeconomic environment.

Exhibit 4 – U.S. High-Yield Bond Spread over Treasuries (OAS)*: December 1997 - December 2017

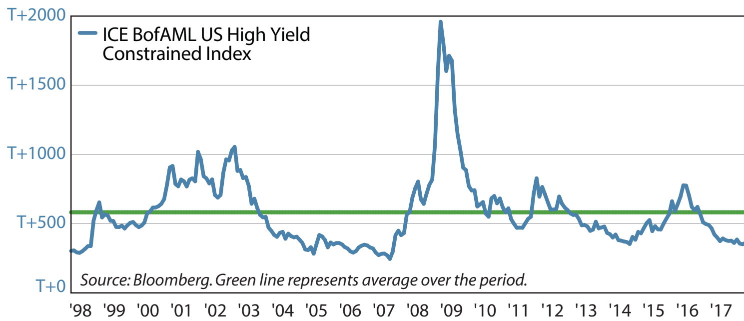
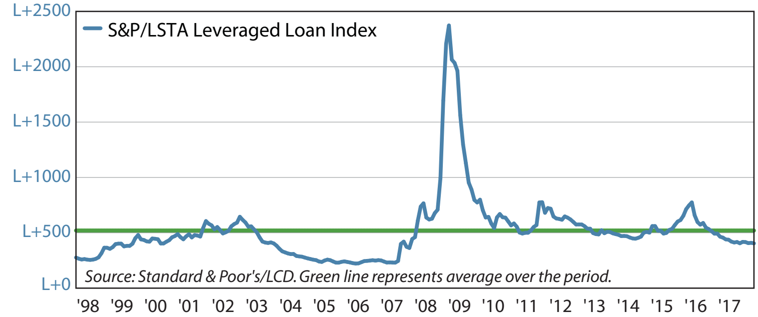


Exhibit 5 – U.S. Senior Loan Spread over LIBOR[2]: December 1997 - December 2017



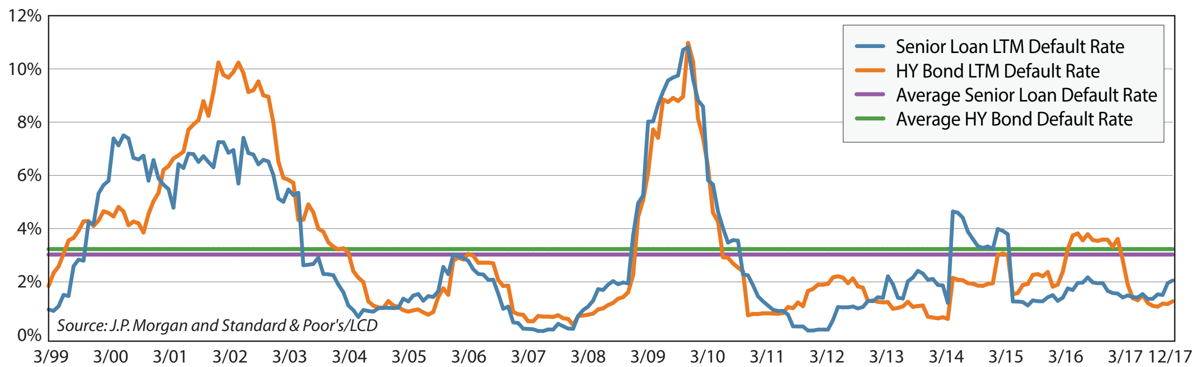
Senior loan spreads over 3-month LIBOR[1] declined 11 bps during the quarter to L+405 bps. This compares favorably to the pre-credit crisis average spread of L+372 (December 1997 – June 2007) but is inside the long-term average spread of L+521 (December 1997 – December 2017; Exhibit 5). While gross new issue volume in the loan market set a new record in 2017 at $974 billion, surpassing 2013's previous record-high $670 billion, over 73% of the volume was either a repricing (coupon reduction) or refinancing. 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 the spread declines on senior loans should be offset by the LIBOR increases. Said differently, we believe that as LIBOR increases, investors may begin to see some benefit from the rising interest rate. Importantly, the default rate for senior loans remains low, at 2.05% 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 3.03% (March 1999 – December 2017; Exhibit 6).

Conclusion

A shift in central bank behavior to a less accommodating stance may not only increase interest rate volatility, it may also push interest rates directionally higher, and such a move would be expected to 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 while corporations gain a tailwind from tax reform and that we are in a healthy part of the economic cycle to own high-yield bonds and senior loans. 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 should continue to perform well given their mid-cycle valuations and declining 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 - December 2017



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	Q4 2017	Q4 2016	12 Mo Ended 12/29/17	12 Mo Ended 12/30/16	Q4 2017 By Rating BB	B	CCC
Senior Loans	1.10%	2.26%	4.11%	10.16%	1.09%	1.09%	2.85%
High-Yield Bonds	0.42%	1.88%	7.47%	17.49%	0.36%	0.86%	1.72%
Investment Grade Corporate Bonds	1.12%	-2.88%	6.47%	5.96%			
Preferred Securities	0.43%	-3.81%	10.58%	2.32%			
U.S. 10-Year Treasury	-0.29%	-6.81%	2.06%	-0.16%			
Emerging Market Bonds	0.50%	-4.50%	9.27%	9.12%			
Municipal Bonds	0.75%	-3.62%	5.45%	0.25%			
S&P 500	6.64%	3.82%	21.83%	11.96%			
Default Rate[3] (Trailing Twelve Months)	Q4 2017	Q4 2016					
Senior Loans (LLI)	2.05%	1.58%					
Long-Term Average *- Since March 1999*	3.03%	3.11%					
High-Yield Bonds	1.27%	3.32%					
Long-Term Average *- Since March 1999*	3.23%	3.32%					
Technicals	Q4 2017	Q4 2016					
Average Senior Loan Price (LLI)	$98.05	$98.08					
Long-Term Average Senior Loan Price *- Since Dec 1997*	$93.99	$93.77					
Senior Loan Spread Over LIBOR[2]	L+405	L+465					
Long-Term Average Senior Loan Spread[2] *- Since Dec 1997*	L+521	L+526					
Average High-Yield Bond Price (HUC0)	$100.59	$99.59					
Long-Term Average High-Yield Bond Price *- Since Dec 1997*	$94.32	$93.96					
High-Yield Bond Spread (OAS)*	T+363	T+422					
Long-Term Avg. High-Yield Bond Spread (OAS)* *- Since Dec 1997*	T+582	T+593					
YTW for High-Yield Bonds (HUC0)	5.84%	6.17%					
YTM for High-Yield Bonds (HUC0)	6.20%	6.48%					
U.S. 3 Month LIBOR[1]	1.69	1.00					
U.S. 10-Year Treasury Yield	2.41%	2.44%					
Flows & Issuance (billions)	Q4 2017	Q4 2016	FYE 12/29/17	FYE 12/30/16			
Retail Senior Loan Fund Flows	-$3.9	$10.5	$13.5	$9.2			
Institutional (CLO) Senior Loan Flows	$34.6	$57.8	$117.1	$73.3			
Retail High-Yield Bond Flows	-$9.5	-$2.0	-$20.3	$9.6			
Senior Loan Gross New Issue	$241.1	$194.1	$973.6	$485.4			
High-Yield Bond Gross New Issue	$72.5	$51.9	$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. 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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(01/2018)

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