

Market Review

In the 1994 film *The Shawshank Redemption*, Andy Dufresne, a quiet and intelligent banker, is wrongly convicted for the murder of his wife and is sentenced to life in prison. After the initial shock and despair of his new reality, Andy develops a plan of escape. Dufresne's plan is to use a small rock hammer to chip away at and eventually, over many years, tunnel completely out of his prison cell. Each night Andy would dig and each day he would spread a pocketful of his cell block wall in the prison yard through a hole in his pants pocket so as to avoid detection. Importantly, Dufresne maintained a reticent and humble demeanor, earning him the trust of the Warden and the prison guards who allowed him, against prison rules, to keep a poster of Rita Hayworth hanging over the growing hole in his cell. Dufresne kept a low profile and quietly executed his plan, never losing hope. He did not allow the bleakness of his unfortunate circumstances or the discouragement of the other inmates to distract him from his plan. Eventually, Dufresne was able to successfully escape from Shawshank Prison and flee to Mexico to happily live out the rest of his life.

Much like Andy Dufresne, the U.S. economy experienced a massive and unexpected shock in the global financial crisis of 2008 and this led the financial media and the political class to despair that capitalism was dead and only the government could save the economy. However, despite the endless negative droning on from the pundits, the steadfastness and ingenuity of the American people has quietly and methodically driven the economy to recover and continue to expand. Just as the Warden, prison guards, and the other inmates were naïve to Dufresne's clever plan to escape Shawshank, the popular media and political pundits are equally naïve to the health and strength of the U.S. economy, and their handwringing narrative simply does not fit the reality of what is transpiring on the ground.

Macro-Economic Overview

Case in point, the U.S. economy is on increasingly solid ground in our opinion, with unemployment claims near the 2000 decade lows, increasing CPI, and expanding Real GDP. Economic policy under the Trump administration which could include lowering individual and corporate income tax rates, increasing infrastructure spending, reducing the regulatory burden on businesses, and repatriation of cash held overseas by multinational corporations, should only help to accelerate the U.S. growth rate. In addition, we believe that the potential exists for global growth to surprise to the upside. Consider the fact that Europe's economy and inflation outlook have stabilized. In the second half of 2016, consumer and business sentiment improved, Eurozone CPI began to increase and unemployment continued to improve. While these improvements do not appear to have translated to GDP growth yet, we believe they are important leading indicators for future growth (*Exhibit 1 & 2*).

Exhibit 1 – U.S. High-Yield Bond Performance: 1997 – 2016

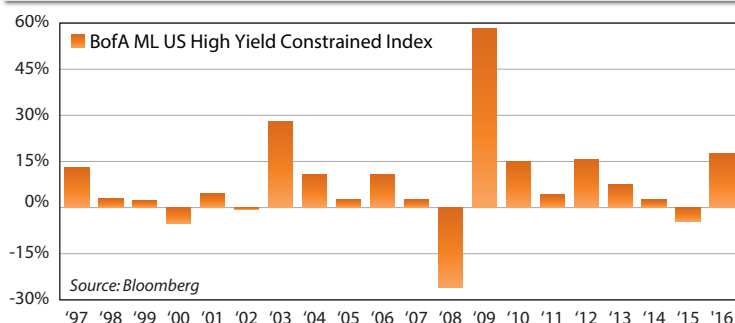
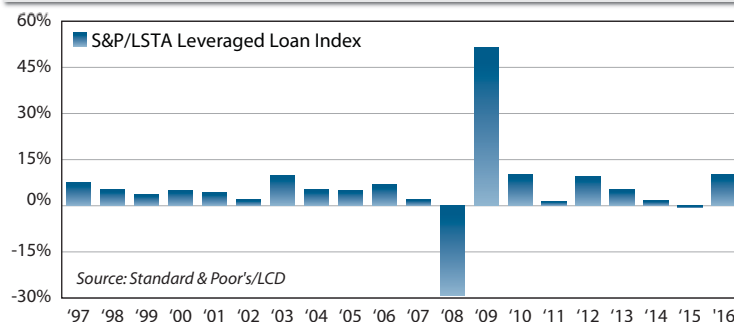
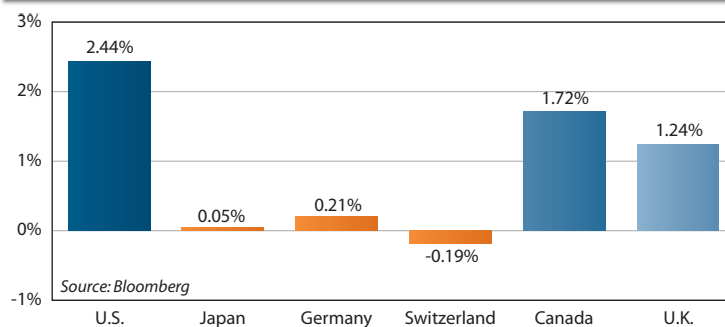


Exhibit 2 – U.S. Senior Loan Performance: 1997 – 2016



We believe that the bottom is in for U.S. interest rates and on the back of a potential increase in U.S. and global growth rates, we expect to see even higher interest rates in 2017. Interest rates have already experienced an enormous move from the post Brexit lows (from 1.36% on 7/8/2016 to a peak of 2.60% on 12/15/2016 for the 10-year U.S. Treasury Bond) and we may see some consolidation before moving higher, yet we believe there are a number of potential interest rate catalysts on the horizon. First, we believe the market is not fully pricing in the potential for re-inflation in the U.S. and we've already seen some early indicators here. Specifically, wage growth has begun to increase and while commodity prices have remained relatively benign up to this point, they have stabilized and improved. Second, if the Eurozone is indeed stabilizing, we may see a continuation of tapering the Quantitative Easing program that Draghi announced in December 2016. Note: We believe this would lead to higher rates in Europe (See *Exhibit 3* showing 10-yr yields as of 12/30/16) and would most likely carry through to the U.S. given the high correlation between German Bunds and U.S. Treasury yields. Finally, we've begun to hear some discussion from the U.S. Federal Reserve concerning the size of their balance sheet and how to address it. A decision to begin slowing the reinvestment on the Fed balance sheet, taken in isolation, could send interest rates higher, notwithstanding the potential for a more hawkish stance on rates should inflation begin to increase later in the year.

Exhibit 3 – 10-Year Government Bond Yields: 12/30/16

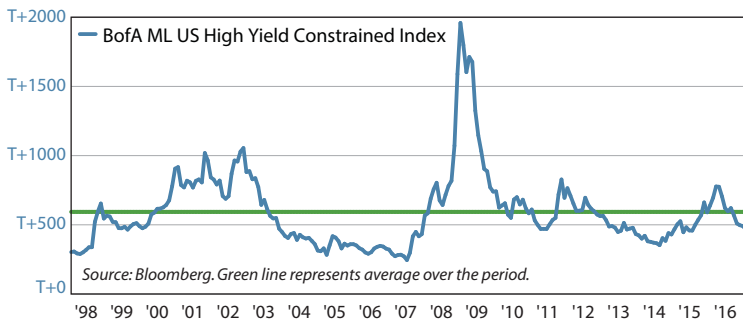


The dollar has strengthened (up 4.4%) since the U.S. elections. This development can have a meaningful impact on the earnings of U.S. multinational companies (a stronger dollar will weaken earnings), as well as, commodities (hard commodities weaken on a stronger dollar). In essence, a stronger dollar can prove deflationary. However, a stronger dollar is not necessarily negative if corporate earnings growth is keeping pace. Nevertheless, we believe that if the dollar continues to strengthen, we may see greater volatility in risk markets. Ultimately, we're going to want to keep a very close eye on the U.S. dollar this year (*Exhibit 4*).

Exhibit 4 – U.S. Dollar Index (DXY) 12/31/13 – 12/30/16

High-Yield and Senior Loan Market Overview

While high-yield bond spreads over U.S. Treasuries are tight to historical norms at T+422 basis points (bps) (the long-term average spread over U.S. Treasuries is T+593, December 1997 - December 2016), spreads remain wide of the tight spreads of T+245 in May 2007, and as such, we continue to find value in certain parts of the market and see room for further tightening (*Exhibit 5*).

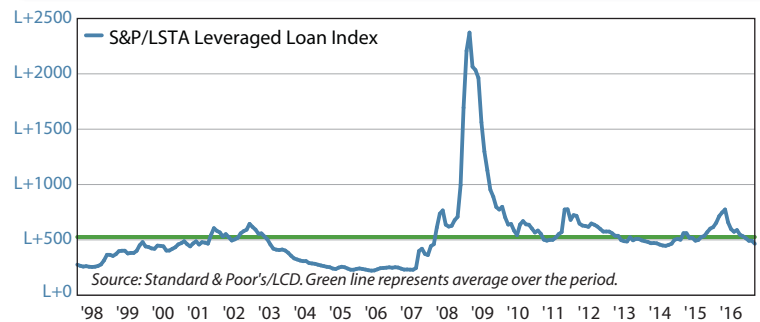
Exhibit 5 – U.S. High-Yield Bond Spread (OAS)*: December 1997 – December 2016

Defaults in the commodity sensitive sectors of the high-yield bond market drove the high-yield default rate up to peak at 3.82% in May 2016, but it has since fallen to 3.32% (0.68% excluding the Energy and Metals/Mining sectors). This is in-line with the 3.32% long-term average default rate of 3.32% (March 1999 – December 2016). We believe the commodity sector has bottomed and we expect the overall default rate to decline as a result.

After several years of senior loan outflows from retail investors, investors have begun to find favor with the senior loan asset class again. According to JP Morgan, the senior loan asset class ended the year with retail inflows totaling +\$6.9 billion. We believe the appeal of senior loans has increased as LIBOR has been increasing and climbed from approximately 61 bps to 100 bps in 2016.¹

Moreover, we believe that with the potential for additional interest rate hikes on the horizon, LIBOR should continue to migrate higher in 2017. The primary challenge in the senior loan market will likely be the pace of refinancing, whereby issuers come to the market to reduce the spread they are paying on their senior loans. This could potentially reduce the yield to investors while we wait for LIBOR to move higher and ultimately push the yield up on the asset class.

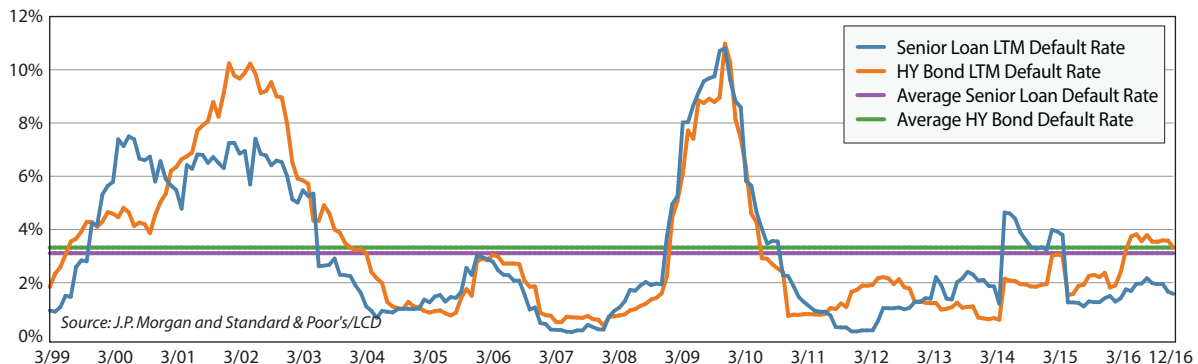
The default rate for senior loans remains low at 1.58% and we believe it is likely to remain low given the overall health of the U.S. economy. This is below the long-term average default rate of 3.11% (March 1999 – December 2016; *Exhibit 6*). Finally, the current spread of L+465 compares favorably to the pre-credit crisis average spread of L+372 (December 1997 – June 2007) and remain relatively in-line with the long-term average spread of L+526 (December 1997 – December 2016; *Exhibit 7*).

Exhibit 7 – U.S. Senior Loan Spread over LIBOR²: December 1997 – December 2016

Conclusion

Just as in the story of *The Shawshank Redemption*, we believe that the U.S. economy has quietly and methodically continued to expand under the radar of market pundits who seem to habitually focus on the negative. Like Dufresne, we remain resolute and optimistic on the current and future state of the economy. We believe the U.S. economy is poised for further expansion and that this bodes well for risk assets. We believe that we are in a good part of the economic cycle to own high-yield bonds and senior loans and that the cycle still has a long runway. Specifically, based on current valuations (average price of \$98.08 and spread of L+465), 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 2017. We also believe that high-yield bonds should continue to perform well given their mid-cycle valuations and anticipated declining default rate.

As we evaluate new investment opportunities, decisions will continue to be rooted in our rigorous bottom-up credit analysis and focus on the opportunities that we believe offer the best risk and reward balance.

Exhibit 6 – Senior Loan and High-Yield Bond Historical Default Rates³: March 1999 – December 2016

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.

3.

Index Returns	Q4 2016	Q4 2015	YTD 2016	YTD 2015	12 Mo Ended 12/30/16	12 Mo Ended 12/30/15	Q4 2016 By Rating		
							BB	B	CCC
Senior Loans	2.26%	-2.10%	10.16%	-0.69%	10.16%	-0.69%	1.35%	2.18%	8.81%
High-Yield Bonds	1.88%	-2.16%	17.49%	-4.61%	17.49%	-4.61%	0.23%	1.87%	5.36%
Investment Grade Corporate Bonds	-2.88%	-0.56%	5.96%	-0.63%	5.96%	-0.63%			
Preferred Securities	-3.81%	3.46%	2.32%	7.58%	2.32%	7.58%			
U.S. 10-Year Treasury	-6.81%	-1.44%	-0.16%	0.91%	-0.16%	0.91%			
Emerging Market Bonds	-4.48%	0.90%	9.14%	0.71%	9.14%	0.71%			
Municipal Bonds	-3.62%	1.50%	0.25%	3.30%	0.25%	3.30%			
S&P 500	3.82%	7.04%	11.96%	1.38%	11.96%	1.38%			
Default Rate (Trailing Twelve Months)	Q4 2016	Q4 2015							
Senior Loans (LLI)	1.58%	1.50%							
Long-Term Average (Since March 1999)	3.11%	3.19%							
High-Yield Bonds ³	3.32%	1.82%							
Long-Term Average ³ (Since March 1999)	3.32%	3.32%							
Technicals	Q4 2016	Q4 2015							
Average Senior Loan Price (LLI)	\$98.08	\$91.26							
Long-Term Average Senior Loan Price (LLI)	\$93.77	\$93.76							
Loan Spreads ⁴ (Discounted Spread to a 3-Year Life)	L+465	L+714							
Long-Term Average Loan Spread (3-Year Life)	L+526	L+523							
Average High-Yield Bond Price (HUC0)	\$99.59	\$88.82							
Long-Term Average High-Yield Bond Price (HUC0)	\$93.96	\$93.90							
High-Yield Bond Spread (OAS)*	T+422	T+695							
Long-Term Average High-Yield Bond Spread (OAS)*	T+593	T+594							
YTW for High-Yield Bonds (HUC0)	6.17%	8.76%							
YTM for High-Yield Bonds (HUC0)	6.48%	8.90%							
Flows & Issuance	Q4 2016	Q4 2015	FYE 12/31/16	FYE 12/31/15					
Retail Senior Loan Fund Flows	\$10.5 bil	(\$9.6) bil	\$6.9 bil	(\$21.7) bil					
Institutional (CLO) Senior Loan Flows	\$57.8 bil	\$19.8 bil	\$111.8 bil	\$109.6 bil					
Retail High-Yield Bond Flows	(\$2.0) bil	(\$6.7) bil	\$8.2 bil	(\$16.6) bil					
Senior Loan Gross New Issue	\$194.1 bil	\$59.6 bil	\$485.4 bil	\$325.8 bil					
High-Yield Bond Gross New Issue	\$51.9 bil	\$42.3 bil	\$286.2 bil	\$293.2 bil					

¹ The "spread" for a senior loan is typically priced over 3-month London Interbank Offered Rates (herein referred to as LIBOR). Essentially, investors earn a risk-free rate plus a "spread" for the risk of a given company.

² The spread over LIBOR is the discounted spread to three-year life.

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 of flows & issuance: J.P. Morgan High-Yield Market Monitor & Leveraged Loan Market Monitor. Source of senior loan and Collateralized Loan Obligation (CLO) data: S&P/LCD. Source of high-yield bond data: Bloomberg and J.P. Morgan. For illustrative purposes only and not indicative of any investment. Past performance is no guarantee of future results.

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—BofA Merrill Lynch 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—BofA Merrill Lynch 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—BofA Merrill Lynch 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—BofA Merrill Lynch 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—BofA Merrill Lynch 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—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. Indexes are unmanaged and an investor cannot invest directly in an index.

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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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