From the Desk of the **Fixed Income Team**

Macro and Fixed Income Update

2025 JAN

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Building Resilient Portfolios with Bonds: Income, Stability & Growth

The market has adjusted expectations for U.S. Federal Reserve ("the Fed") rate cuts lower, now pricing just two rate cuts in 2025 and a terminal rate of just below 4%. Since September 2024, terminal rate projections have risen by approximately 100 basis points ("bps"), indicating that interest rates may remain elevated for longer. As a result, current yield levels provide an attractive return opportunity.

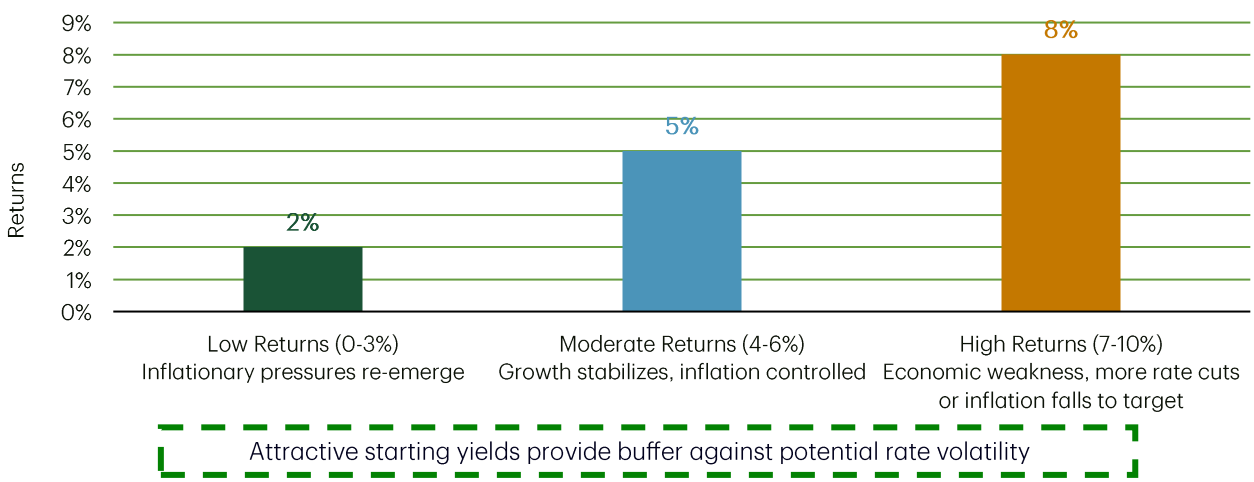
Bonds remain appealing for income generation. For example, short-term Canadian Investment grade ("IG") corporate bonds, which are generating an approximate yield of 3.7%, offer a steady income stream for investment portfolios.

Amid market uncertainties, fixed income continues to provide a hedge against downside growth risks. Investors who are overweight assets including equities, can benefit from an increased allocation to fixed income, as it provides diversification and reduces overall exposure to market risk.

Sustained Attractive Return Opportunities in Investment Grade Bonds

Over the past year, the bond market has delivered attractive returns, driven by higher all-in-yields and rate cuts. Looking ahead, we expect mid-single digit returns driven primarily by attractive income levels. As shown in **Chart 1**, we outline three scenarios mapping bond returns for a five-year Investment Grade (IG) corporate bond. Under the "moderate returns" scenario, we estimate returns of 4% to 6%, achievable through income alone, assuming inflation remains under control.

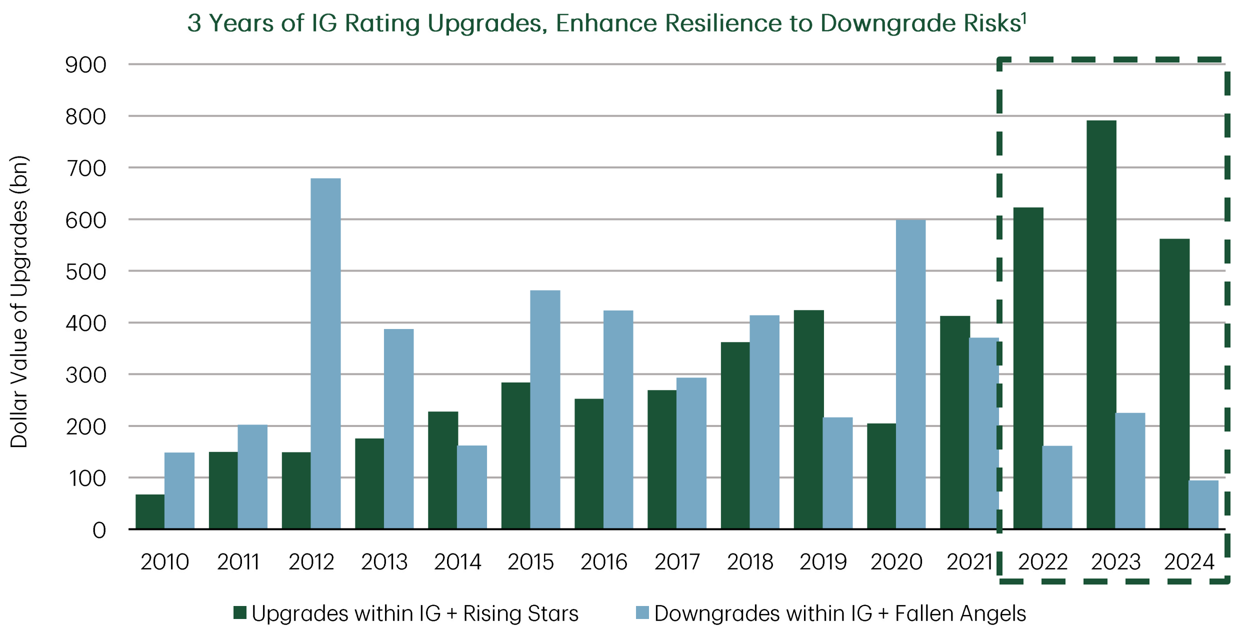
Chart 1: Mapping Potential Bond Returns

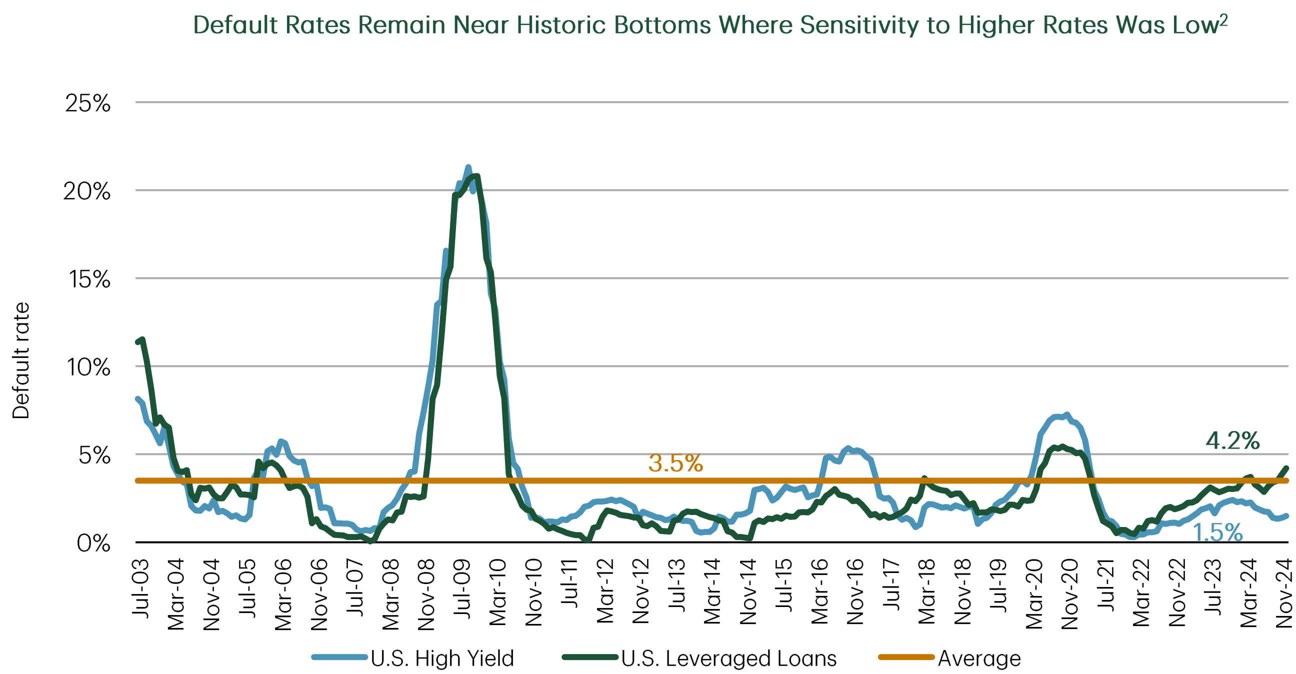


Source: TD Asset Management Inc., Bloomberg Finance L.P. As of Dec 31, 2024

Conversely, we must also consider a potential "low returns" scenario. If inflation accelerates, due to aggressive tariff policies or if the Fed halts policy easing, markets could experience a downturn. In this case, credit spreads may widen as inflationary pressures dampen consumer sentiment. However, even under this scenario, attractive total yield levels should provide return cushions. We anticipate solid credit demand, and total returns are likely to be flat to slightly positive in the 0% to 3% range.

Chart 2: Resilient Credit Fundamentals Support Fixed Income Outlook





[1]Source: Bloomberg Finance L.P. As of Dec 31, 2024.
[2]Source: Bank of America, As of Dec 31, 2024.

As shown in Chart 2 (top), the quality of the Investment Grade index has improved over the past few years, primarily driven by the prudent debt management by companies since the COVID-19 pandemic. Following strong investment grade issuance in 2024, we estimate that coupon income alone could support for over 75% of net-investment grade issuance supply, providing support to investment grade demand in 2025.

Furthermore, default rates remain a critical measure of credit fundamentals. As seen in Chart 2 (bottom), default rates continue to remain at historical lows. The current default rate stands at under 2%, compared to a 20-year average of 3.5%. Additionally, broader credit metrics, including leverage and liquidity, continue to support a healthy credit environment.

Current Positioning and Outlook

During the fourth quarter of 2024, our Fixed Income portfolios have moved towards a neutral to slightly underweight duration position. However, we continue to be tactical in our approach as we assess the evolving macroeconomic environment. Currently, we have a preference for shorter duration IG instruments, which help limit duration risk while enhancing income potential.

We maintain a favourable view toward an overweight credit position as credit fundamentals remain solid despite macro uncertainty. Moderate growth is expected to support credit markets, particularly in absence of significant Merger and Acquisition ("M&A") activity that could lead to higher leverage for issuers.

Additionally, we favour a long U.S. dollar position, supported by continued U.S. economic strength. The U.S. dollar has outperformed major currencies, and we anticipate further support from policy proposals related to tariffs, fiscal measures, and deregulation following President Trump's return to White House.

TD Asset Management Inc. (TDAM): Expanded Suite of TD ETFs Offers Greater Flexibility for Investors

At TDAM, our credit research and investment management teams are constantly reviewing and monitoring the economic landscape to find value and seek opportunities to take advantage of opportunities within the market. To reduce potential currency volatility, we are excited to add a recent addition to our U.S. dollar ETF product shelf, TD U.S. Cash Management ETF for investor's cash management needs. In addition to our new U.S. dollar ETF offering, we are excited to offer series extensions to our suite of Target maturity bond ETFs, TD Target 2028 Investment Grade Bond ETF, TD Target 2029 Investment Grade Bond ETF and TD Target 2030 Investment Grade Bond ETF, which provides investors with diversified fixed income exposure, a target maturity date, and an efficient way to replace direct bond exposure.

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