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EDGE**

What to Expect from Fixed Income when Interest Rates Rise

Fixed income assets, like corporate and government bonds, have historically been an important part of a diversified portfolio as they provide the opportunity for regular income and may reduce risk during periods of elevated volatility – but you may be wondering if that is still the case when inflation and interest rates climb.

This document will help you answer that question by highlighting the relationship between inflation, interest rates and fixed income.

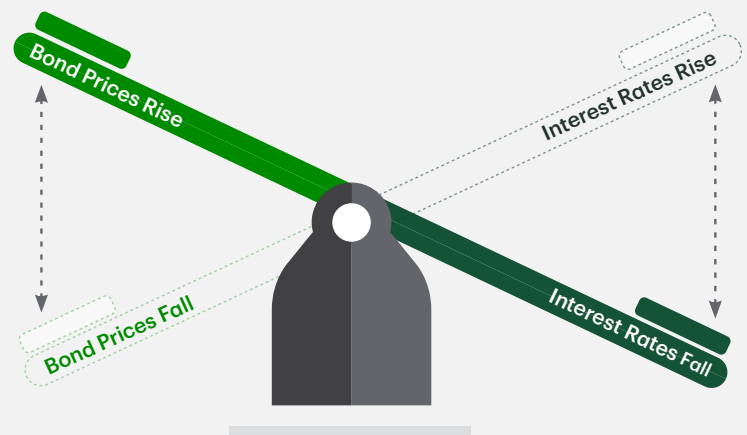
The relationship between inflation and interest rates

- Inflation refers to the ongoing rise in the cost of goods and services in an economy and since 1991, the Bank of Canada has targeted an inflation rate of 2% per year¹. Inflation can occur when companies raise prices due to increases in production costs, such as raw materials and wages. Supply disruptions or a surge in demand can also cause inflation as more buyers compete for fewer goods, forcing consumers to pay more for various products and services.
- When inflation becomes elevated, central banks attempt to discourage spending by increasing interest rates, which aims to cool consumer demand by increasing the cost of borrowing.

How do interest rates impact bond prices?

Bond prices and interest rates move in opposite directions. When interest rates increase, bond prices fall and when interest rates fall, bond prices rise.

Here's what happens...If interest rates go up, new bonds being issued will reflect the higher rates and investors will want to invest in those new bonds which will reduce the demand for bonds with a lower rate. Therefore, the price of a bond will go down to coincide with the lower demand.



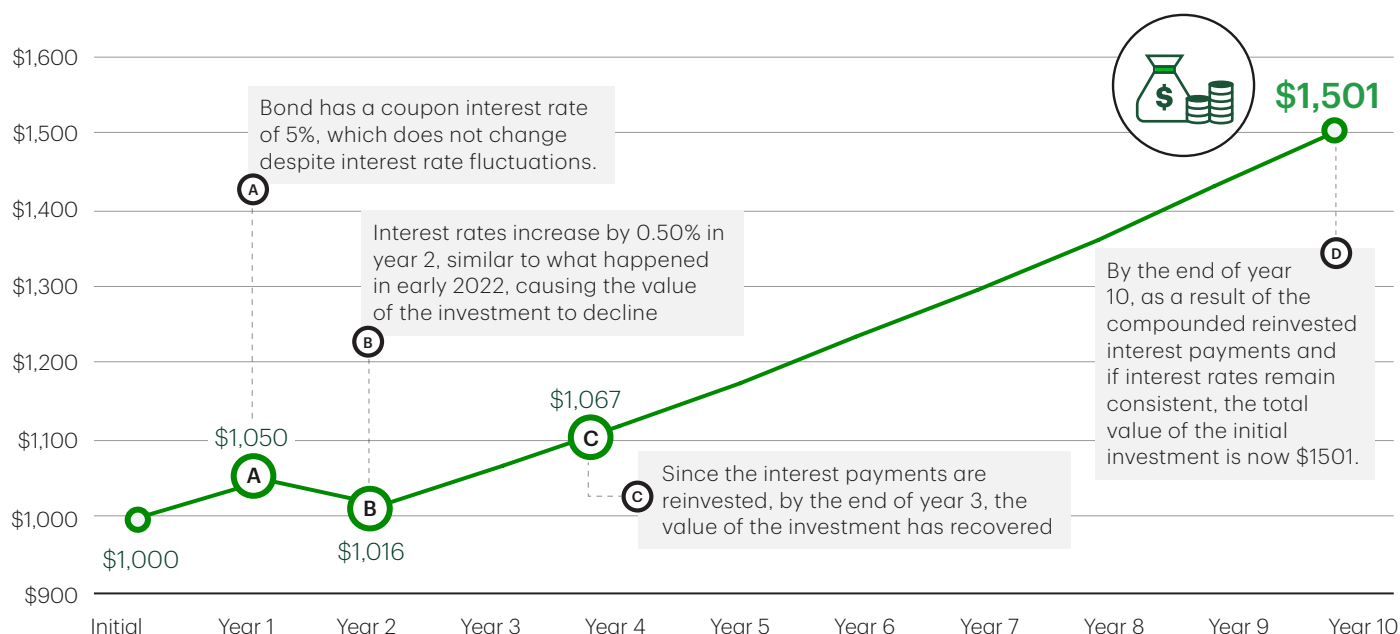
¹Source: Bank of Canada.

After the lift-off: Why fixed income remains an important part of a diversified portfolio

While volatility in a rising rate environment can be concerning, it's important that investors **stay invested and stick to their plan.**

Let's take a look at an example of what could happen to a \$1,000 investment in a bond when interest rates rise.

Chart 1: Value of a \$1,000 Investment



For illustrative purposes only. Source: TD Asset Management Inc. Illustrates a \$1000 investment into a bond fund with a coupon rate of 5.00%. As well as duration of 7.32, which is the same as the FTSE Canada Universe Bond Index as at September 30, 2017. Interest is received annually at the end of the year and reinvested at 5.00%. A 0.50% interest rate increase occurs during year 2.

Key takeaways

If the issuer of the bond does not default, **investors will receive their principal back along with interest** regardless if the price of the bond fell along the way as interest rates moved higher.

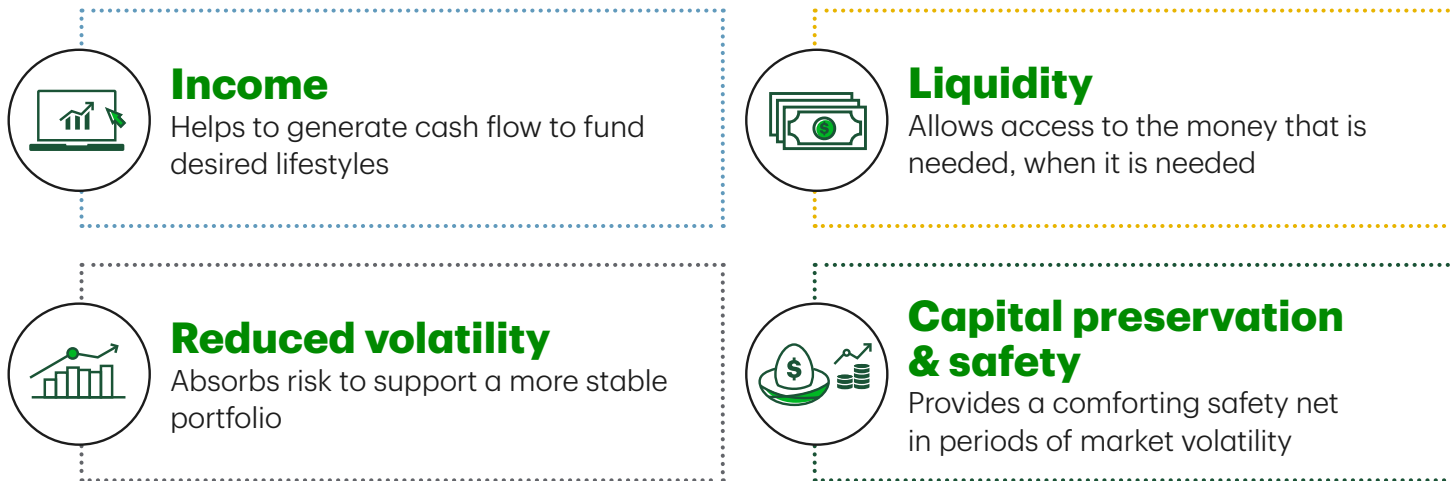
Diversifying fixed income holdings

- Short-term bonds are an important part of fixed income diversification because they are less sensitive to interest rate changes than long-term bonds. A 1- or 2-year bond will be less impacted by a sudden increase in rates than a 7-year bond of the same quality.
- Short-term bonds are helpful for capital preservation, and in a higher-yield environment, they can also help to provide income.
- But long-term bonds are also a powerful tool in a diversified portfolio: if the economy hits a low point and central banks decide to lower rates, longer-term bonds stand to benefit. Although more sensitive to rate changes than short-term bonds, they can benefit from decreasing yields at times when equities could suffer.
- Diversification among short- and long-term bonds can help strengthen a mutual fund holding during times of economic change, such as a high interest rate environment, by capturing opportunities and reducing risk.

The TDAM Fixed Income Team

- At TD Asset Management Inc. (TDAM), our experienced Fixed Income team is comprised of over 80 investment professionals who collaborate closely to manage over **\$161.1 billion²** in assets on behalf of our institutional and retail investors.
- Our portfolio managers are constantly monitoring the bond market to attain the optimal balance between managing risk and seeking out opportunities to generate income - both key factors that may help investors achieve their long-term financial goals.
- Our team of seasoned credit research analysts navigate the changes in the fixed income market to complement our extensive and independent credit research. These capabilities enable our portfolio managers to seek yield opportunities through the construction of diverse portfolios while actively managing allocations across sectors, terms, and credit quality.

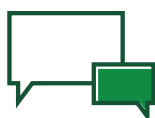
The key characteristics of bonds include:



²Fixed income assets under management (AUM) as at March 31, 2022 for TD Asset Management Inc., and Epoch Investment Partners, Inc. TD Asset Management Inc. operates in Canada and Epoch Investment Partners, Inc. operates in the United States. Both entities are affiliates and are wholly-owned subsidiaries of The Toronto-Dominion Bank.

Making the right choices for your investment objectives and time horizon may help protect you from rising rates and inflation, so over the long-term you can strive to live the life you want, not just the life you can afford.

Invested



Let's talk

For more information about rising rates and inflation, and what they could mean for your investments, please contact your **investment professional**.

Connect with TD Asset Management



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