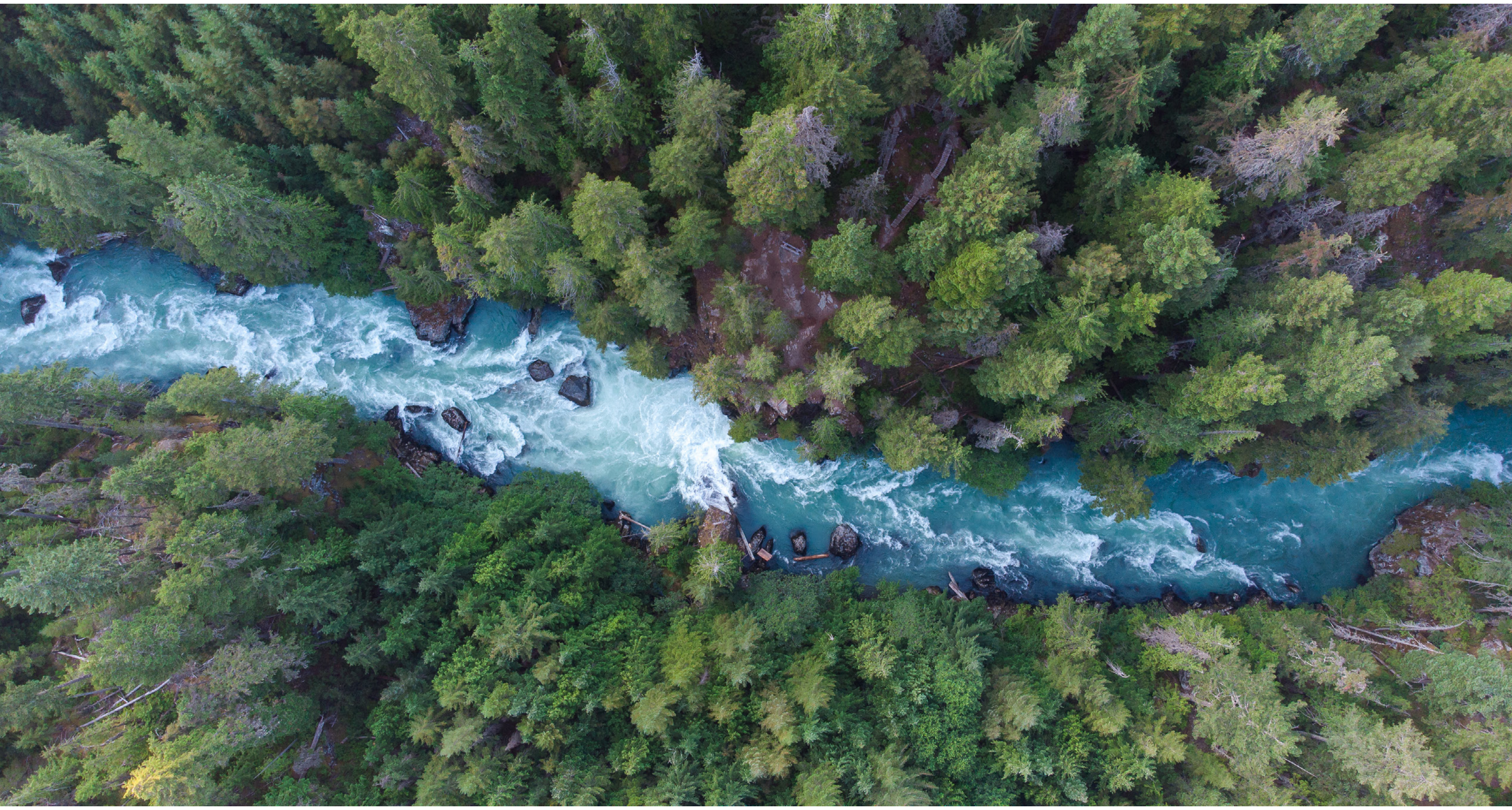
CIBC ASSET MANAGEMENT

Q3 Bond market commentary



Key takeaways

1. **Inflation remains a challenge:** While headline inflation has moderated, core inflation pressures persist, and the final push to target levels remains difficult, particularly with fiscal and tariff-related pressures.
2. **U.S. bond market reflects uncertainty:** The U.S. yield curve remains relatively flat, with the 2s-10s spread at 52 basis points, real yields are elevated, and Fed Funds Futures are pricing in two rate cuts for 2025, though fiscal deficits and debt levels pose structural challenges.
3. **Canadian bond market stability:** Canadian government bond yields have remained relatively stable, supported by fiscal discipline, while corporate bonds face risks in interest rate-sensitive sectors.
4. **Currency and credit risks:** The U.S. dollar has weakened significantly year-to-date, and credit spreads remain historically narrow, emphasizing the need for judicious credit selection and active currency management.
5. **Diversification is key:** Non-U.S. bonds, dollar-denominated debt, and alternatives like CLOs offer opportunities for diversification and higher yields in a volatile bond market environment.

While headline inflation has moderated, core inflation metrics suggest that price pressures remain persistent and are not yet at ideal levels. In the U.S., the Federal Reserve's focus on inflation control, particularly in the context of tariffs, has kept monetary policy tight. Fed Chairman Jerome Powell recently highlighted the impact of tariffs on inflation, stating, "In effect, we went on hold when we saw the size of the tariffs, and essentially all inflation forecasts for the United States went up materially as a consequence of the tariffs."

The U.S. 10-year Treasury yield has remained rangebound over the past six months, fluctuating between 4.24% and 4.58%, supported by sticky inflationary pressures and a Federal Reserve committed to cautious monetary policy. In contrast, the 2-year Treasury yield declined by 53 basis points during the same period, reflecting growing concerns about slowing economic growth and potential rate cuts. The U.S. yield curve remains relatively flat, while real yields hover at levels not seen since 2007. Elevated real yields suggest that investors are growing impatient with policy rates and are increasingly cautious about fiscal deficits.

Historically narrow spreads warrant careful credit selection, particularly in sectors sensitive to economic and interest rate changes. In Canada, similar inflationary pressures persist, but fiscal discipline has helped maintain investor confidence. Canadian 10-year government bond yields have remained flat, while 2-year yields have declined. The FTSE Universe Bond Index returned 1.44% year-to-date as of June 30, while the FTSE All Corporate Bond Index delivered a stronger 2.28% return over the same period. However, corporate spreads in Canada reflect a cautious outlook, especially in sectors like real estate and consumer discretionary, which are more sensitive to interest rate changes.

Outlook: Challenges and opportunities

The outlook for the U.S. bond market is clouded by fiscal and monetary policy uncertainties. While Fed Funds Futures are pricing in two rate cuts for the remainder of 2025, signaling expectations of a dovish pivot by the Federal Reserve, the timing and magnitude of these cuts remain uncertain. Downward pressure on the short end of the curve reflects concerns about slowing economic growth, rising recession risks, and moderating tariff-related inflation. However, these anticipated rate cuts may not be sufficient to offset structural challenges posed by persistent deficits and rising debt levels.

The U.S. fiscal trajectory is increasingly under scrutiny. Credit rating agencies have already downgraded U.S. debt, and the bond market and U.S. dollar are beginning to reflect these concerns. While a default remains improbable for a country that can print its own currency, the erosion of fiscal credibility could lead to higher borrowing costs, elevated structural inflation, higher neutral policy rates, and increased volatility in both the Treasury market and the U.S. dollar. Against a basket of currencies, the U.S. dollar has declined approximately 10% year-to-date, underscoring the importance of active currency management as part of fixed-income strategies.

Corporate bonds in the U.S. face a mixed outlook. Investment-grade bonds may benefit from a potential Fed pivot, but high-yield bonds could come under pressure as economic growth slows and default risks rise. Investors should focus on quality within the corporate bond space. Similarly, Canadian corporate bonds are not immune to global trends, and sectors with high leverage or exposure to interest rate fluctuations may face challenges. High-yield bonds in Canada, in particular, could see widening spreads if economic growth slows further.

The Bank of Canada's monetary policy will play a critical role in shaping the bond market outlook. While the central bank has signaled a willingness to adjust rates as needed, its actions will depend on the trajectory of inflation and economic growth. Investors should monitor these developments closely, as they will have significant implications for both government and corporate bonds.

Inflation has moderated significantly from recent elevated levels, but the final leg to reach target levels remains challenging. Moreover, the risk of a resurgence cannot be ruled out, particularly if fiscal policies remain expansionary or tariffs continue to elevate prices. Given these uncertainties, diversification is more important than ever. Non-U.S. bonds, particularly those from countries with strong fiscal positions and dollar-denominated debt, offer an attractive complement to core positions. Additionally, alternatives such as Collateralized Loan Obligations (CLOs) provide higher yields than other highly-rated debt and can serve as effective diversifiers in a portfolio.

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Sources: Federal Reserve Bank of St Louis and FTSE Russell, June 30th 2025.

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