RBC Global Asset Management

Global fixed income markets

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Investors are increasingly concerned about the sustainability of government finances and, coincident with the U.S. losing its final AAA credit rating in mid-May, are demanding higher yields in exchange for lending to governments for long periods. The rise in bond yields since the beginning of April reflects a cloudy macroeconomic outlook with growth that is slower but not recessionary, inflation that is lower but not low enough, and central banks that are unlikely to respond with meaningful interest-rate cuts if politicians lean into running still-large fiscal deficits. While acknowledging these concerns, we believe they are behind the rise of bond yields to currently attractive levels.

Investors are already asking for more compensation to lend over long periods to global governments. Term premiums are at decade highs and yield curves are steep, offering investors incentives to lend for longer periods. What is more, the poor fiscal position of developed-market governments is not an overnight development for bond markets. The level of concern has only rarely been seen since the acute European government-debt crisis of the early 2010s. In many ways, investors are living with the scar tissue of the crisis of confidence endured by the UK gilt market during Liz Truss's brief premiership in 2022. France's borrowing costs also soared during a bitter electoral fight in 2023. In the U.S., the uncertainty is not election-related but instead speaks to the lack of serious efforts to tackle the budget deficit amid an already high debt load. Since the middle of 2023, it has been clear that the U.S. would run a budget deficit of 6%-7% of GDP for the foreseeable future. Historically, government-bond investors have taken large increases in bond issuance in stride because they've coincided with recessions. During recessions central banks are quick to cut overnight interest rates, leading investors to purchase bonds just as governments start to spend and support the economy. In turn, yields fall even as more debt is issued. But with deficits so large even during non-recessionary times, the assumption that demand for bonds can be sustained during deep deficits is more suspect.

To be sure, U.S. bond yields are not particularly high compared to history. However, debt and deficit levels are much higher, and this makes a huge difference. Without spending cuts, the current debt-to-GDP ratio would rise over the longer term from an already high level. Based on the Congressional Budget Office's projections and interest rates, the U.S. government could end up spending nearly 40% of its annual budget just to service debt by late in the next decade – up from just under 10% now.

The lacklustre performance of bonds during risk-off episodes has called into question their effectiveness as a hedge for risky assets. From the mid-1980s to the COVID pandemic, bond prices and riskier assets typically moved in opposite directions, particularly during times when risky assets did very poorly. Since the pandemic, however, bonds have often lost value at the same time as equities. This shift appears to be related to higher inflation, leading us to be somewhat more sympathetic to the view that bonds serve as poor hedges for risky assets in periods of high inflation. If inflation remains firmly above 2%-3%, bonds might struggle to return to their negative correlation to stocks. That's why achieving the U.S. Federal Reserve's (Fed) 2% target is so important.

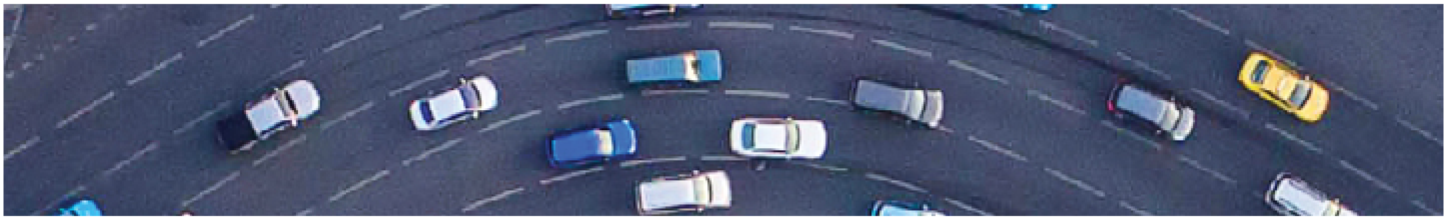
Another issue for bond investors is that a series of trade wars launched by the Trump administration is leading to questions about foreign demand for Treasuries. Part and parcel of the U.S.'s trade deficit is that foreign countries have invested huge sums in U.S. government debt. The U.S.'s net international investment position (NIIP), which takes a country's assets abroad and subtracts the value of its liabilities due to foreigners, is deeply negative. Part of this deficit reflects how attractive the U.S. is as an investment destination. But it also suggests the U.S. is vulnerable to a shift in capital flows, as the country is reliant on foreign financing to fund the trade deficit. Investors fear that countries could respond to the threat of tariffs and broken trading relationships by selling their holdings of Treasuries or by simply choosing not to invest further in the U.S.

Lower demand from central banks is also something the bond market is having to contemplate seriously for the first time in a decade. Since 2008, there has been at least one major central bank actively purchasing government bonds. Now though, central banks are keen to shrink their balance sheets, either by actively selling securities or letting bond holdings mature. When either of these things happen, the private market must step in to buy the additional supply. Higher bond yields are the compensation demanded for doing so.

For their part, governments and central banks have been trying to mitigate the impact of this additional supply on a market where demand is not as keen as historically has been the case. Governments have begun to focus on issuing shorter-maturity bonds, which raise the same amount of money but are less risky (since they mature sooner) and thus easier for the market to absorb. Central banks have tweaked their balance-sheet shrinking programs to avoid letting too many longer-maturity bonds end up in the market too quickly.

What central banks have not been able to do - and seem unlikely to do in the near term - is cut interest rates meaningfully, which would likely push bond yields lower. While growth has slowed from the post-pandemic pace, it is not recessionary. In the absence of objectively poor economic growth, policymakers must focus on the inconvenient reality that inflation is still above target, even without the effect of tariffs from the first few months of the year. Although the worst-case scenario of very high sustained tariffs seems unlikely, companies are still very likely to raise prices more than they would have in the absence of such tariffs. Inflation in the U.S. is likely to exceed 3% at some point this year. Absent a sharp downturn in economic growth, it is hard to imagine the Fed cutting interest rates.

Given a cloudy macroeconomic outlook and the backdrop of high supply today and for the foreseeable future, investors are right to demand higher compensation for lending to governments for longer periods. Investors are being paid nearly 1 percentage point more to lend for 10 years than to lend for one year. This extra compensation, the term premium, is the highest it's been since the early 2000s and looks to us to be attractive for long-term investors. Policy rates in most bond markets are above levels that will tend to depress economic activity, and central-bank demand during times of economic downturns means that the term premium should remain attractive.



Direction of rates

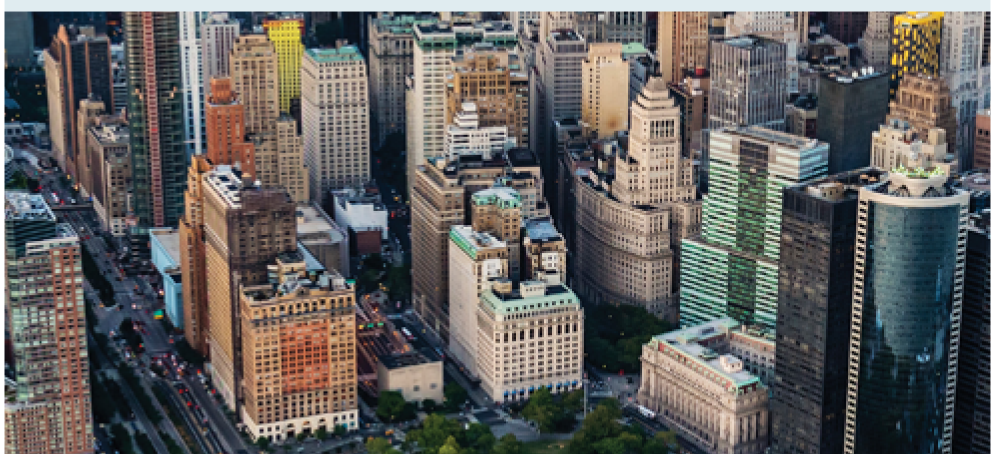
We expect the Fed to deliver three interest rate cuts over the next year, most likely starting in late 2025. In turn, we expect 10-year yields to fall to 4.25%.

United States

With inflation still stubbornly high, the core of the Fed's internal debate now is the outlook for growth. On the one hand, survey data suggests that activity should be slowing markedly as consumer confidence falls and businesses say they are delaying decisions to invest and slashing hiring plans. GDP readings, on the other hand, suggest that economic activity through the first three months of the year was relatively good. Consumer spending too has weathered the uncertainty relatively well. Part of this could simply be that businesses and consumers were front-loading their purchases of goods to lock in lower prices ahead of tariffs. As we mentioned above, fiscal support has also been consistent for the U.S. economy, providing a fillip to growth. For all the fanfare, the Department of Government Efficiency has not made a material dent in total government spending. In fact, the U.S. government's deficit through the first half of the year is worse than at the same point in 2024, and the spending bill making its way through Congress looks likely to worsen the fiscal picture and loosen the purse strings a little bit more.

Strictly speaking, the impact of tariffs on prices should not be persistent. A 25% hike on imported goods should only affect inflation for the next 12 months. With the recent bout of high inflation, however, consumers and businesses are much more likely to extrapolate recent price rises into the future, begetting even more inflation. This is an uncomfortable reality for the Fed and for the bond market.

With higher inflation and okay growth, the Fed will find it difficult to cut its policy rate much before having greater clarity on the trajectory of the economy and tariffs. With the worst case for tariffs being more unlikely now, slower growth is the condition that must be satisfied for the Fed to ease monetary conditions. In the meantime, policymakers are likely to remain on hold and give little indication of the future direction of policy. We expect the Fed to deliver three interest-rate cuts over the next year, most likely starting in late 2025. In turn, we expect 10-year yields to fall to 4.25%.



Our forecast for 10-year German bund yields is 2.50% and 1.75% for the ECB's deposit rate.

Eurozone

The European Central Bank (ECB) lowered interest rates in February, April and June by 25 basis points, bringing the overnight deposit rate to 2.00%. At this point, we see one more cut from policymakers in Europe, as rates should drop to 1.75% in the year ahead. What is more, we think the risk in Europe is that the ECB does less cutting than expected rather than more.

Why do we believe this? While tariffs are likely to drag on eurozone growth, the euro area should benefit from easing already delivered as well as dramatic increases in fiscal spending by Germany, the region's biggest economy, and to a lesser extent, other eurozone countries. We also believe that inflation is likely to pick back up more strongly than anticipated in the single-currency area, leading to the possibility of fewer cuts than anticipated by investors.

Finally, we think the ECB will be less likely to accommodate increased bond issuance by governments. At the margin, this tendency should cause longer-term yields in Europe to rise more than elsewhere. Our forecast for 10-year German bund yields is 2.50% and 1.75% for the ECB's deposit rate.

Our 10-year yield forecast is 1.50%.

Japan

Long-maturity yields on Japanese government bonds (JGB) have surged to the highest levels since the 1990s, when Japan's period of low inflation and interest rates began. However, while Japan leads the G7 nations in wage growth and inflation, these pressures are expected to ease as economic activity slows, and the Bank of Japan (BOJ) has maintained its policy rate at 0.50% since January. A stronger yen and low energy prices are likely to reduce import costs, further dampening inflation pressures. Japan's economy shrank by 0.7% in the first quarter of 2025 from the year-earlier period, marking the first decline in four quarters. This downturn is largely attributable to weak exports and cautious consumer spending, as households contend with rising living costs. Global economic headwinds and trade uncertainties may continue to weigh on Japanese growth in the coming quarters, and the BOJ will likely maintain its accommodative stance for most of the forecast horizon. However, a modest 25-basis-point rate hike to 0.75% may be in the cards as easing of tariff-related noise allows the BOJ to continue raising policy rates to address high inflation.

Meanwhile, the long-maturity JGB market, which has faced significant volatility, is likely to attract renewed demand as yields become increasingly appealing to domestic and foreign investors. In our opinion, Japan's Ministry of Finance may decrease the issuance of long-maturity bonds, or the BOJ could tilt its bond purchases toward long-maturity JGBs such as those maturing more than 30 years from now. Our 10-year yield forecast is 1.50%.

we expect the 10-year government bond yield to reach 3.25%, up slightly from 3.20% at the time of writing.

Canada

The Bank of Canada (BOC) kept its policy rate unchanged at 2.75% in April and again in June after a cumulative 225 basis points of cuts since June 2024. Deliberations by the BOC suggest policymakers are biased towards further easing, but they are wary of the amount of uncertainty surrounding the outlook. Also clouding policy deliberations is the anticipated fiscal support pledged by provinces and, to a largely unknown extent, the federal government. It is widely expected that fiscal stimulus would be forthcoming in the event of prolonged and high tariffs. Most provinces stand ready to top up spending by an additional 0.2% to 0.3% of GDP if tariffs become highly disruptive. The market expects two further cuts from the BOC before the end of the year, which would bring the policy rate to 2.25%. We are in the camp that believes the BOC is likely to be less accommodative with additional fiscal support and expect policy rates to be just 0.25% lower in a year's time at 2.50%. Over the same period, we expect the 10-year government bond yield to reach 3.25%, up slightly from 3.20% at the time of writing.

We forecast the 10-year gilt yield to decline from its current level of 4.65% to 4.25%.

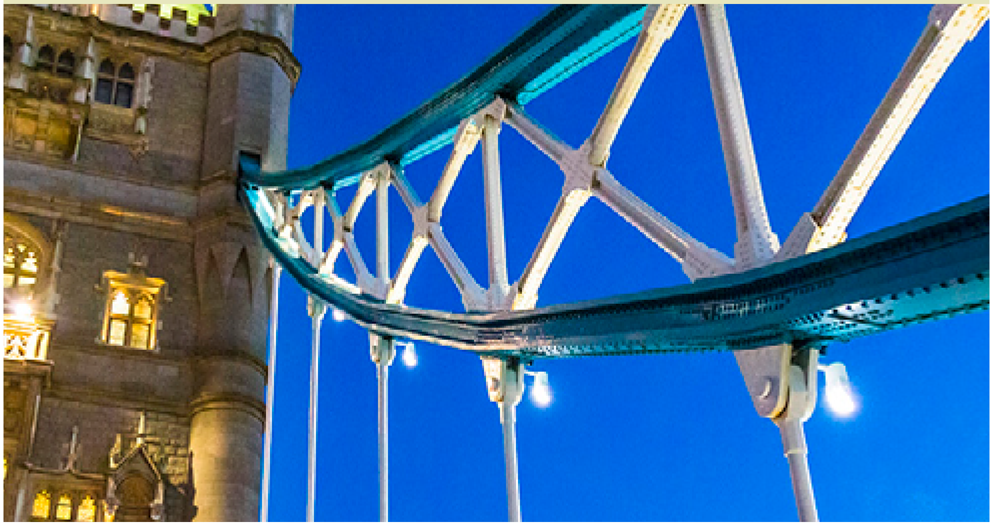
United Kingdom

The Bank of England (BOE) reduced its policy rate on May 8, lowering the bank rate to 4.25% and continuing the gradual series of rate cuts that began in the summer of 2024. However, forecasting the path of monetary policy remains challenging in the current highly uncertain environment. Global economic distortions, such as the U.S. imposing tariffs on its trading partners, have complicated the interpretation of economic data. For example, the UK economy expanded by 0.7% in the first quarter of 2025 from the previous quarter, driven primarily by investment and net exports, while private and public consumption remained weak. We believe this strong performance may overstate the strength of the economy, and we expect growth to decelerate as the impact of U.S. tariffs unfolds.

On the inflation front, wage growth continues to slow, and loosening labour-market conditions are likely to contribute to further moderation in wage pressures. These factors, combined with declining energy prices and the recent appreciation of sterling on a trade-weighted basis, are expected to ease inflationary pressures in the months ahead.

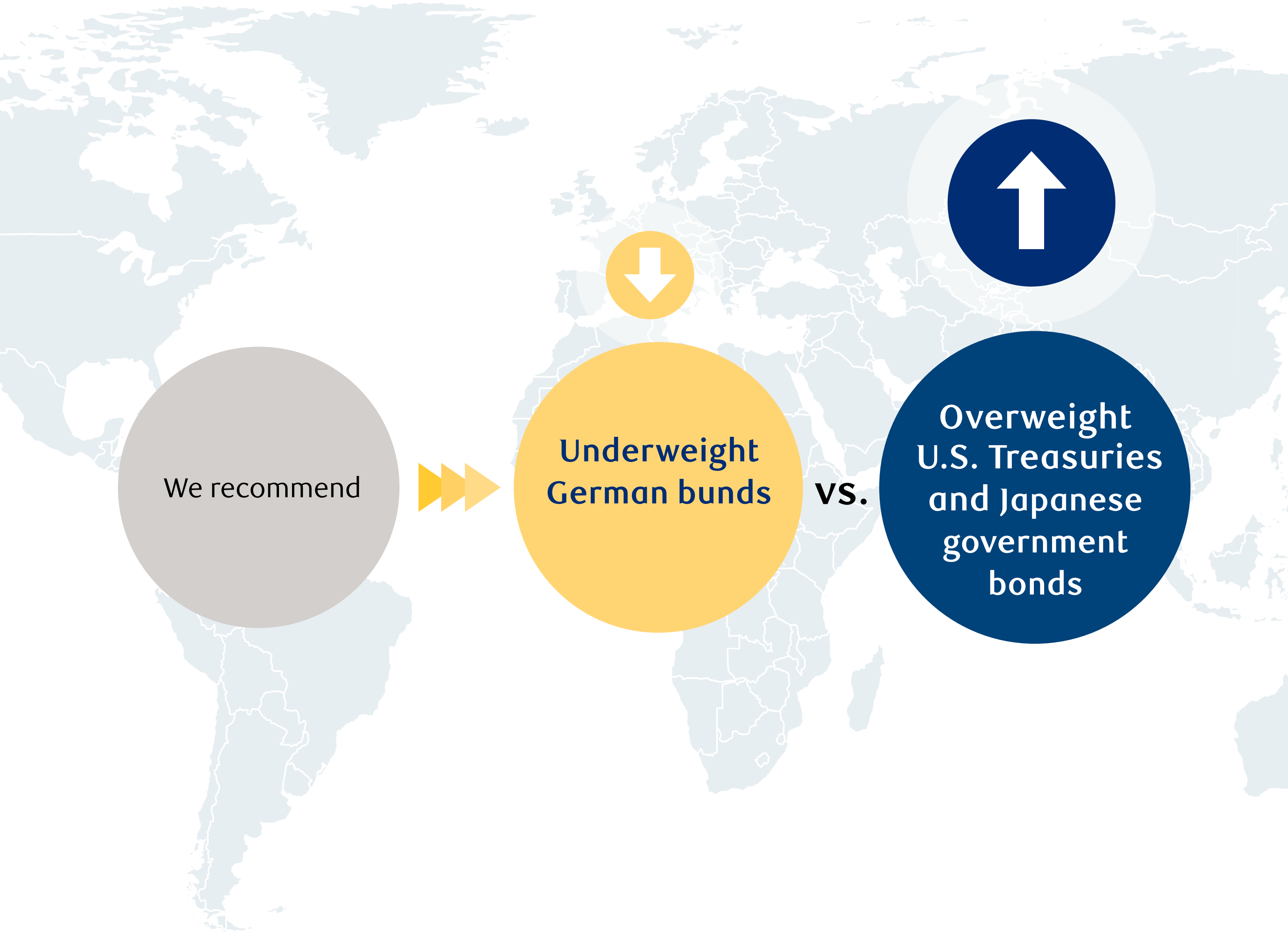
Meanwhile, the bond market has been under pressure, with gilt yields rising as part of a global yield-curve steepening. Investor appetite for long-duration bonds remains weak, reflecting concerns about rising debt levels in nations that are already highly indebted. The lack of demand for long-term bonds may prompt the BOE to review its bond-selling program in upcoming meetings.

Considering the softer economic outlook and moderating inflationary pressures, we expect the BOE to continue to gradually lower interest rates, bringing the policy rate down to 3.50% within a year. Additionally, we forecast the 10-year gilt yield to decline from its current level of 4.65% to 4.25%.



Regional recommendation

We recommend overweighting U.S. Treasuries and Japanese government bonds and underweighting German bunds.



Interest-rate forecast: 12-month horizon
Total-return calculation: May 30, 2025 – May 30, 2026

U.S.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	3.75%	3.30%	3.70%	4.25%	4.75%	5.77%
Change to prev. quarter	(0.75%)	(1.10%)	(0.70%)	(0.25%)	0.00%	
High	4.38%	4.50%	4.85%	5.25%	5.65%	0.97%
Low	2.13%	2.30%	3.00%	3.75%	4.35%	8.86%
Expected Total Return US$ hedged: 6.3%						
Germany						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	1.75%	1.60%	2.00%	2.50%	3.00%	2.83%
Change to prev. quarter	(0.25%)	(0.40%)	(0.25%)	0.00%	0.25%	
High	2.75%	2.60%	3.00%	3.25%	3.50%	(2.00%)
Low	1.25%	1.00%	1.50%	2.00%	2.60%	6.38%
Expected Total Return US$ hedged: 5.1%						
Japan						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.75%	1.00%	1.20%	1.50%	3.00%	2.76%
Change to prev. quarter	0.00%	(0.20%)	(0.30%)	(0.25%)	0.40%	
High	1.25%	1.75%	2.00%	2.50%	3.20%	(1.31%)
Low	0.25%	0.50%	0.60%	0.90%	1.90%	16.47%
Expected Total Return US$ hedged: 8.7%						
Canada						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	2.50%	2.60%	2.90%	3.25%	3.60%	2.93%
Change to prev. quarter	(0.25%)	(0.30%)	(0.10%)	0.00%	0.20%	
High	3.25%	3.50%	3.70%	4.00%	4.25%	(0.97%)
Low	**1.75%**	**2.00%**	**2.25%**	**2.75%**	**3.20%**	**5.83%**
Expected Total Return US$ hedged: 5.0%						
U.K.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	3.50%	3.40%	3.60%	4.25%	5.15%	8.01%
Change to prev. quarter	(0.50%)	(0.35%)	(0.40%)	0.00%	0.25%	
High	4.50%	4.50%	4.75%	5.25%	5.60%	2.06%
Low	2.75%	2.60%	2.80%	3.50%	4.70%	13.00%
Expected Total Return US$ hedged: 9.0%						

Source: RBC GAM

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