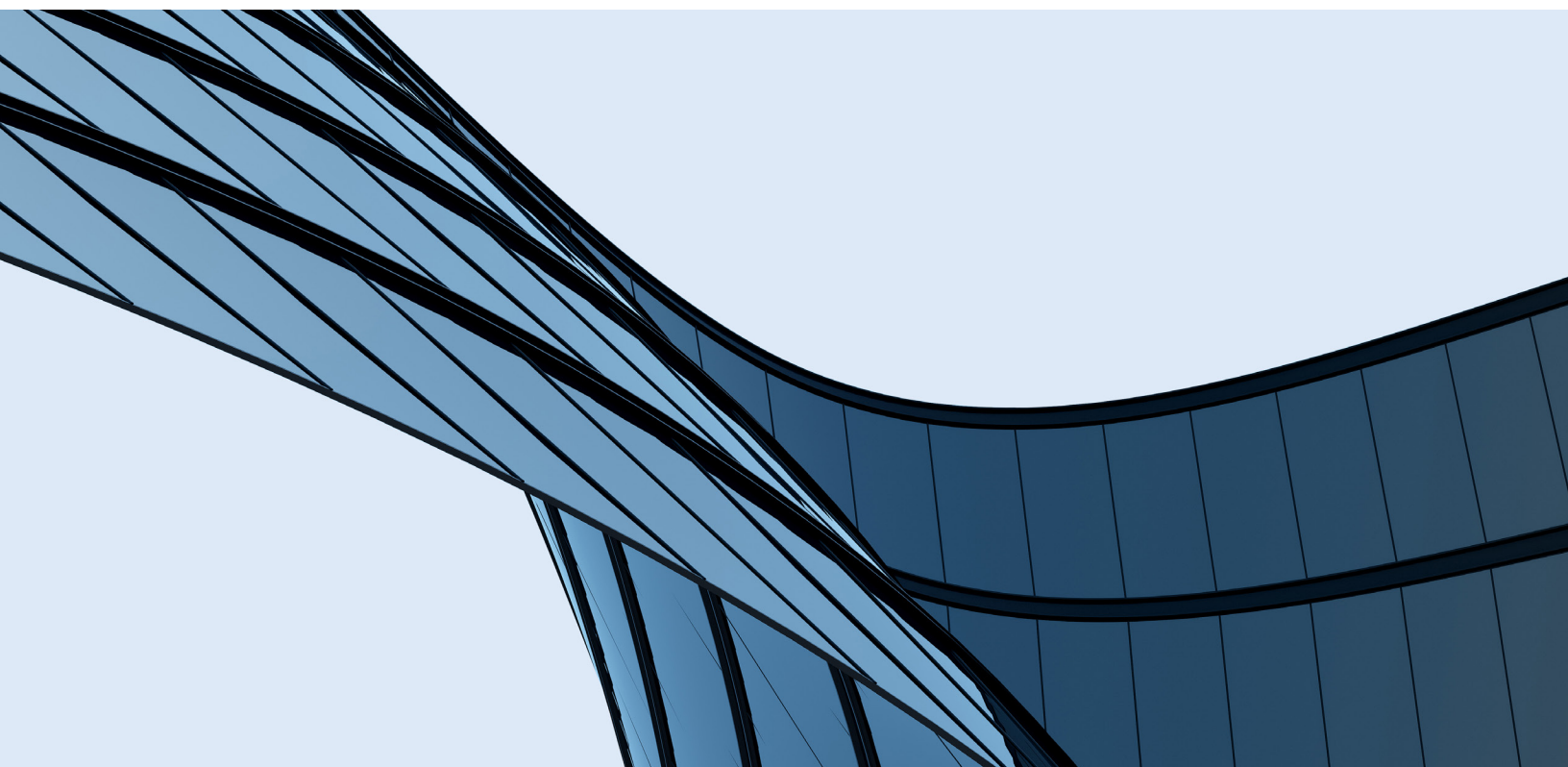


# Bond market commentary: Q3 2025 review and Q4 2025 outlook



## Key takeaways

- Central banks in both the U.S. and Canada resumed rate cuts in Q3 2025, reflecting concerns over labour market weakness and economic slack even as inflation remains above target.
- The U.S. economy remains resilient but is showing signs of labour market softening, while Canada faces a more fragile environment with contracting GDP, rising unemployment, and subdued business investment.
- Yield curves have steepened in both countries, improving opportunities to extend duration, while credit markets remain strong with tight spreads and robust investor demand. These rich valuations carry risks if growth falters or inflation persists.
- Looking ahead, the main risks include loss of central bank credibility, a disorderly rise in long-end yields, or a global growth slowdown, so investors should prioritize high-quality, diversified portfolios and monitor policy developments closely.

The third quarter of 2025 marked a significant inflection point for North American bond markets, as both the Federal Reserve and the Bank of Canada (BoC) resumed their easing cycles following a brief pause.

In September, the Federal Reserve lowered its target range by 25 basis points to 4.00–4.25%, while the Bank of Canada cut its overnight rate to 2.50%. These moves, widely anticipated and largely priced in by markets, reflected growing concerns about labour market softness and economic slack, even as inflation remained above target in both countries.

In the United States, the Federal Reserve's decision was characterized as a "risk management" cut, with Chair Powell emphasizing the rise in downside risks to employment. While core PCE (Personal Consumption Expenditures) inflation remains stubbornly above the 2% target—hovering near 3%—the FOMC's (Federal Open Market Committee) latest projections now point to a moderately stronger easing bias, with the median member expecting two more cuts by year-end, and a further cut in each of 2026 and 2027. However, the committee remains divided, with some members wary of persistent inflation risks, particularly given ongoing tariff pass-through and the resilience of consumer spending, while others are increasingly focused on the risk of a more pronounced labour market downturn. At the time of writing, Fed Fund futures are pricing in a near 100% probability of another rate cut at the October 29th FOMC meeting.

The U.S. economy remains resilient, with Q2 GDP revised up to 3.8% annualized, supported by strong consumer spending among higher-income households. Yet, labour market data is softening, with job gains slowing to roughly 27,000 per month and recent revisions revealing weaker underlying momentum than previously thought.

In Canada, the economic environment is more fragile. The second quarter saw a contraction of 1.6% in GDP, and job gains have been limited to part-time positions. Business investment remains subdued, and the drag from tariffs and trade uncertainty continues to be felt. The output gap has widened to -1.3%, with the unemployment rate climbing to 7.1%, the highest since 2016 excluding the pandemic period. Wage growth has slipped below inflation, and the drag from tariffs and trade uncertainty continues to weigh on exports and business investment. Although core inflation has moderated, the BoC remains cautious, signaling a data-dependent and gradual approach to further easing. The Bank's communications highlight the removal of retaliatory tariffs and the fading of earlier inflationary pressures as key drivers of its more accommodative stance, but policymakers are careful not to commit to a rapid series of cuts in the face of ongoing economic uncertainty.

The yield curve dynamics in both countries have shifted meaningfully over the past quarter. In the U.S., the curve has steepened after a long period of inversion, as front-end yields have fallen in response to policy easing while the long end remains anchored by persistent fiscal concerns and elevated term premiums. The 10-year U.S. Treasury yield ended the quarter at approximately 4.13%. In Canada, the curve has also normalized, with five- and ten-year government bonds yielding around 2.74% and 3.17%, respectively. This normalization has opened up opportunities for investors to extend duration, as the risk/reward for holding longer-dated paper has improved relative to the environment of 2022–2023.

Credit markets in both countries have been buoyant, with investment-grade and high-yield spreads compressing to multi-year tightness. In the U.S., investment-grade (IG) spreads are now below 75 basis points. This reflects a combination of robust risk appetite, strong technicals (e.g. limited net new issuance) and resilient corporate fundamentals.

For example, on September 24th, Oracle made a significant impact on the U.S. bond market by raising \$18 billion in senior unsecured notes across six tranches, ranging from 5-year to the rarely seen 40-year tenors. This amount exceeded its initial \$15 billion target. It represents the second largest deal in the U.S. bond market this year. For context, the entire Canadian investment grade bond market only reached \$25 billion in August. Demand for Oracle's offering reached \$88 billion, resulting in the deal being four times oversubscribed and highlighting strong investor appetite for investment grade corporate bonds. This issuance follows recent contract announcements with OpenAI and supports Oracle's ongoing capital expenditures.

The successful placement of such a large deal continues to highlight the strong demand for yield among market participants. Our primary focus remains on spread, as we look beyond headline yields to evaluate the relative attractiveness of credit risk premiums, which remain at exceptionally tight levels. These rich valuations are not without risk; if economic growth disappoints or inflation remains sticky, spreads could widen abruptly.

Relative value trading is increasingly important for success in the corporate bond market. Although outright spread levels remain unattractive, active managers can capitalize on dispersion and spread volatility to generate value in credit markets without making significant directional bets on overall risk. As is often the case, the BBB segment of the market continues to present the most compelling relative value opportunities due to its greater diversity of issuers. The notable difference in dispersion between A and BBB securities highlights where active managers can add value. Overweights in BBB securities are not necessarily a sign of a "risk-on" stance, but indicate a focus on relative value opportunities.

Looking ahead, the outlook for both economies is shaped by a complex interplay of growth, inflation, and policy credibility. In the U.S., most forecasts anticipate a slowdown in GDP growth in 2025 and 2026, as the tailwinds from AI-driven investment and robust consumer spending are offset by tighter immigration, higher tariffs, and waning fiscal stimulus. Unemployment is expected to rise modestly, while inflation is projected to remain above target through much of next year before gradually returning to the 2% goal. The risk, however, is that sticky inflation could persist longer, pushing long-end yields higher through a rising term premium. This would be further exacerbated if the Fed's independence is perceived to

be compromised by political pressures. Canada faces a slower recovery, with GDP growth expected to remain below trend and the labour market likely to stay soft. Inflation should remain contained, especially with the removal of retaliatory tariffs and a subdued housing market limiting upside pressures. The BoC is expected to continue easing, but the pace will be dictated by incoming data.

A key theme for the coming quarters will be the evolution of central bank independence and fiscal risks. In the U.S., political pressure on the Fed is mounting as Powell's term nears its end, raising concerns that an unnecessarily dovish central bank could undermine long-term credibility, weaken the dollar, and push long-end yields higher. The combination of large deficits and higher debt service costs is expected to keep the supply of Treasuries elevated, contributing to curve steepening and volatility in the long end.

Credit spreads are likely to remain tight in the near term, supported by strong corporate balance sheets and technicals, as implied by recent issuance.

With curves now upward-sloping and policy rates likely to fall further, adding duration is less risky than in the recent past, offering both income and potential price appreciation if central banks deliver further easing. The trend toward a steeper curve is likely to persist, especially in the U.S., as the front end falls with policy rates and the long end is held up by fiscal and inflation risk premia. Any signs of renewed recession risk or sharp disinflation, however, could temporarily flatten the curve.

The environment supports a preference for high-quality. Investors should be cautious about overextending into long-dated corporates given tight spreads and the potential for volatility.

The principal risks to this outlook include a loss of central bank credibility, a disorderly rise in long-end yields, or a sharp slowdown in global growth. Investors should maintain diversified portfolios with attention to liquidity and quality, and continue to monitor policy developments, particularly around central bank independence and fiscal dynamics.



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