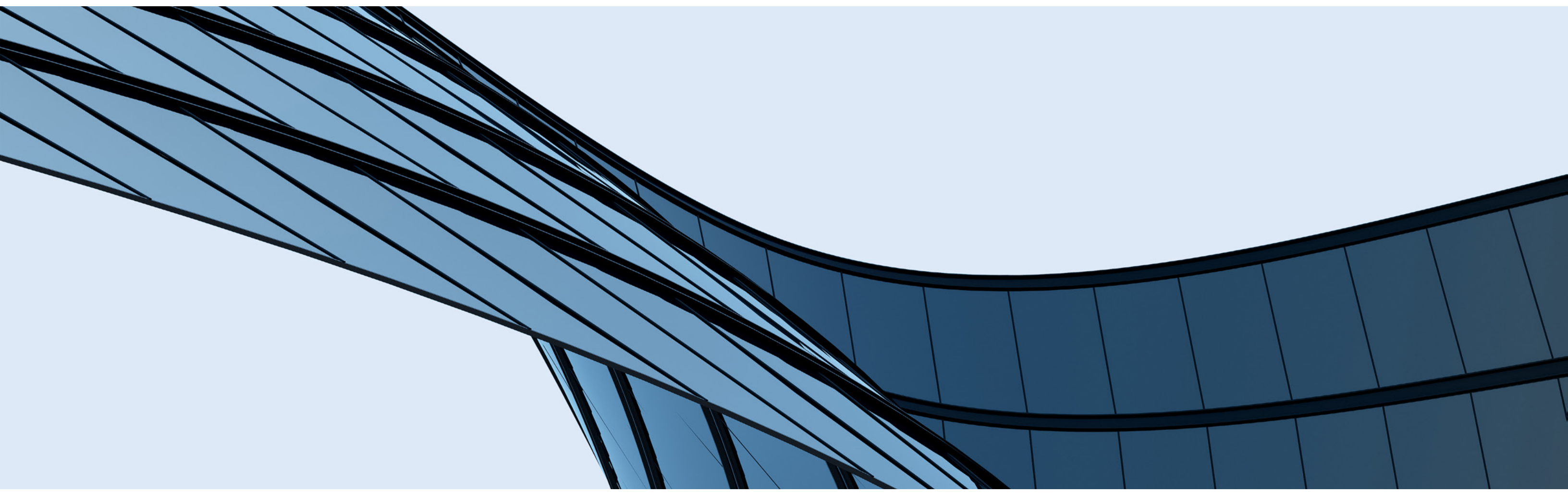
Bond market commentary: Q4 2025 review and Q1 2026 outlook

The fourth quarter of 2025 closed out a year of strength and resilience in the global bond market. Despite a steady stream of negative headlines, ranging from tariffs and trade uncertainty to persistent productivity challenges and political volatility, markets delivered robust returns.

In Canada, core bond benchmarks posted positive results, with the broad bond universe returning 2.64% for the year and corporates (4.48%) outperforming governments (2.05%). US corporate bonds also delivered strong gains over the year of 7.40%, supported by a combination of resilient credit fundamentals and falling yields.



The economic environment over the past year was shaped by apprehension over aggressive US tariffs and their potential inflationary impact. While these tariffs did contribute to cost pressures and business uncertainty, the inflationary effects were less severe than many feared. By year-end, inflation in both the US and Canada settled near 3%, with service disinflation and a cooling in shelter costs offsetting stickier goods inflation. The Canadian bond market benefited from the Bank of Canada's early and deeper rate cuts, which provided a tailwind for domestic fixed income and helped to anchor the short end of the curve.

In the US, the economy demonstrated notable resilience, even as it contended with trade frictions and more restrictive immigration policies. However, the recovery has been uneven, with higher-income households maintaining robust spending and savings while lower-income groups felt the strain of higher prices and a worsening household budget. This "K-shaped" pattern in household finances is likely to persist as we move into 2026.

Central banks on both sides of the border resumed easing cycles in the second half of the year. The US Federal Reserve cut rates three times, bringing its target range to 3.50-3.75%. The Bank of Canada's policy rate reached 2.25% after two cuts in the fall, and markets now anticipate a pause through early 2026. Yield curves steepened across developed markets, reflecting both the anticipation of further cuts and ongoing concerns about inflation and fiscal deficits. In Canada, the 10-year government bond yield ended the year near 3.46%, while US 10-year Treasuries hovered around 4.18%.

Credit markets were robust throughout the year, with investment-grade corporate spreads historically tight. Canadian and US corporate bonds both delivered strong returns during 2025. Credit fundamentals remained strong, with low leverage, high interest coverage, and default rates well below long-term averages. High-yield and private credit markets continued to attract capital, with many investors exercising greater selectivity, emphasizing defensive sectors and shorter maturities. Yield carry was a key source of returns, as tight spreads remained stable in the absence of a recession.

In the US, duration performed well over the year as the Federal Reserve shifted its policy stance to easing and 10 year yields declined. Throughout the year, the bond market provided valuable diversification during episodes of equity volatility, reinforcing its role as a stabilizer in multi-asset portfolios.

Q1 2026 outlook: Cautious but constructive

Looking to the first quarter of 2026, the bond market faces a transition period characterized by continued monetary easing, a fading tariff shock, and persistent, but moderate, inflation. The US and Canadian economies are expected to accelerate modestly as tariff and labour impacts are offset by positive fiscal policy. Canadian GDP growth is also expected, however uncertainty remains as domestic demand constrained by a softer labor market and ongoing trade uncertainty as USMCA renegotiations approach mid-year.

Inflation is likely to moderate gradually, with US and Canadian CPI trending toward 2.5% and 1.9% respectively over the next four quarters. The main risks are a resurgence in service inflation and wage pressures in the US, particularly if labor shortages intensify due to restrictive immigration and aging demographics. The risk of a sharper-than-expected slowdown in the US labor market also bears watching, as it could increase recession risk and prompt a more aggressive policy response from central banks.

Fed Fund futures show a mixed outlook for further policy rate cuts in the US during the first quarter. However, history shows these expectations can change quickly, requiring ongoing investor diligence. In Canada, we currently anticipate at least two additional cuts during 2026, but, similarly, this will evolve with the economic environment. The outlook for policy rates is complicated by the prospect of stickier inflation or renewed fiscal concerns that could keep long-term yields elevated. The upcoming appointment of a new Fed Chair in the second quarter is a potential wildcard; a dovish choice could increase the likelihood of further easing, but political interference could undermine central bank credibility, weaken the US dollar, and steepen the yield curve. Recent precious metals performance is partly explained by this risk.

Yield curves are expected to remain steep, with the short end anchored by central bank cuts and the long end supported by fiscal deficits and term premia. The outlook for duration is constructive, especially in the front end, where the bulk of policy easing will be felt. Modestly long duration positions, particularly in US Treasuries and Canadian government bonds, are favoured.

Credit markets should remain well supported by strong fundamentals, but tight spreads and high valuations call for caution. The risk of spread widening is asymmetric—more likely to move wider than tighter from current levels. We remain focused on shorter-dated corporate bonds, hybrids, and high-quality issuers.

In Canada, the emphasis should remain on defensive corporate credit, infrastructure debt, and short-term corporates, given stretched valuations and limited compensation for long-dated or high-yield risk. In the US, investment-grade corporates and high-yield bonds should benefit from policy easing and a resilient macro backdrop, but the market is increasingly reliant on the continued strength of large-cap technology and the AI Capex cycle. Any slowdown in AI-driven investment would have negative consequences for credit markets, particularly for issuers exposed to data center and technology infrastructure.

Key risks for early 2026 include a sharper-than-expected slowdown in the US labor market, stickier service inflation or wage acceleration, political interference in central bank policy, a slowdown in AI-related Capex, and renewed fiscal slippage or debt ceiling concerns. Opportunities remain in active management and sector rotation within credit, private credit and infrastructure debt, duration exposure in the front end of the curve, and currency hedging, as the US dollar is expected to weaken further if the Fed continues to ease and global growth broadens.

We enter 2026 with cautious optimism. Investors are encouraged to maintain diversification across regions, sectors, and asset classes, and to remain vigilant against complacency as the cycle matures. The lesson from 2025 is clear: remain disciplined, diversified, and attentive to the shifting macro landscape. For fixed income, this means focusing on risk-adjusted returns, favoring high-quality, short-duration credit and maintaining flexibility to respond to evolving risks and opportunities.

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