RBC Global Asset Management

Global fixed income markets

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We believe the outlooks for major bond markets have rarely been so different. Investors may be too optimistic about the prospects for the U.S economy and too pessimistic about the outlooks for Canada and Europe. We expect U.S. Treasuries to outperform as the economy is likely to struggle to meet already lofty expectations, regardless of the impact of new policies under the Trump administration.

Bond yields are still near their post-pandemic highs and inflation is much lower. We expect bonds to deliver at least coupon-like returns somewhere in the low-to-mid single digits over the year ahead. Lower inflation is also a boon for those expecting bonds to act as a counterbalance to the risk of an equity sell off as the negative correlation between stock and bond returns has historically asserted itself when inflation is at or below where it is now. All that said, and as we mentioned in the introduction, we expect returns among bond markets to show a greater divergence over the year ahead than has been the case in recent years.

In the U. S., investors are focused on the economy's impressively long run of beating expectations and avoiding a recession, bucking aggressive monetary tightening and a deeply inverted yield curve – a historically reliable indicator that a recession would happen. Investors' outlook is so rosy, in fact, that they do not seem to expect a recession in the U.S. anytime in the next decade. How do we know this? While the fed funds rate is expected to fall by 0.75% more over the next year, investors expect it to begin rising again next year and remain above 3.50% until 2035.

Of course, the election of President Trump and the Republican sweep of Congress has kindled investors' hopes that animal spirits are being amplified in the U.S. economy due to coming deregulation and tax cuts. However, the surveys that investors rely on to measure consumer optimism exhibited the same surge in the aftermath of President Trump's victory in 2016. This surge was undercut by policy uncertainty and tariffs. If anything, policymaking under the second Trump presidency is so far more haphazard and the size of tariffs being contemplated are an order of magnitude larger. We think that investors are likely to be disappointed in their expectations for a coming boom, just as they were during Trump's first term.

More importantly for bond investors, the U.S. economy already reflected high expectations before a Trump victory. Unlike a few years ago, when most investors expected a recession in the U.S., growth expectations are already quite favourable. Thanks to an impressive run of beating expectations that dates back to 2022, the U.S. economy now has a much higher hurdle to clear.

Finally, two of the three pillars of U.S. exceptionalism – the idea that the U.S. economy is structured to grow faster than its peers over time – seem to have come under threat from the new administration. We are talking about immigration and fiscal largesse. Large immigration inflows were a boon to U.S. economic activity as they expanded the labour force. But anecdotal reports from the U.S. suggest that inward immigration flows have slowed to a crawl. Moreover, the unofficial Department of Government Efficiency's actions, as well as actions to stop payments to certain agencies suggest that marginal government spending could be crimped significantly. More importantly, perhaps, there is the risk that a chaotic approach to policymaking undermines business confidence, leading to slower hiring and lower investment. The final pillar of U.S. exceptionalism – the ability of consumers to keep buying in the face of higher borrowing costs – also appears to be fading vis-à-vis U.S. peers. Where other countries should now start to see the benefit of policy easing, the Fed's policy rate sits not far from its peak and most market interest rates are still higher than those on existing borrowings (Exhibit 1).

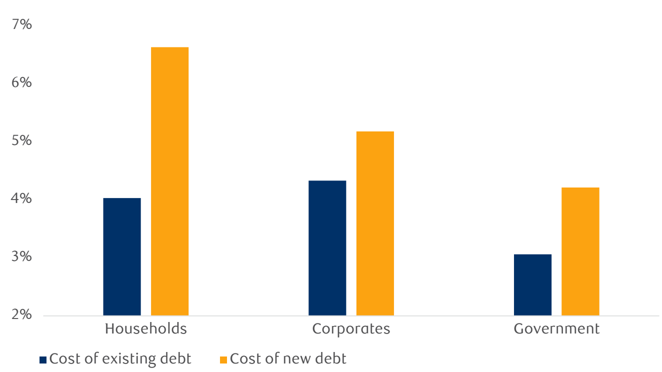
Outside the U.S., investors are quite pessimistic about growth prospects in most regions, especially those which are very exposed to changes and uncertainty in U.S. trade policy: such as Canada and Europe. Even before the threat of tariffs, we believed expectations for Canada and Europe had been beaten down too far. Germany stands out as having particularly dour expectations built in for 2025 (Exhibit 2).

This backdrop has meant that bond investors in those regions enjoyed relatively strong returns over the past year, but we think this is unlikely to be repeated. In fact, we are generally more positive on the outlook for growth and inflation in Europe and Canada than many investors.

Overall, we think that tariffs are likely to be implemented at much lower levels than Trump has threatened and has briefly imposed. On top of this, we expect there will be significant fiscal support in the event of any prolonged tariffs. Coupled with the arrival of benefits from the substantial monetary policy easing already delivered, we think growth could surprise to the upside, particularly compared with the U.S. In Europe, the prospect of an earlier-than-expected end to Russia's war in Ukraine would likely boost Europe's economic fortunes, regardless of the outcome.

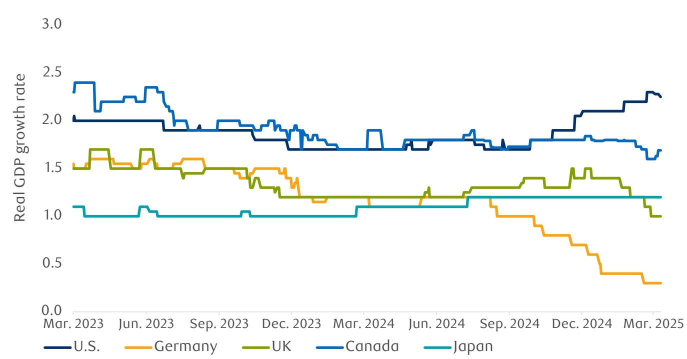
Finally, there is Japan, where policy rates continue to normalize after spending decades at, around and below zero. Inflation and wage growth continue to surprise to the upside in Japan, suggesting that price pressures are domestically generated, rather than a function of currency weakness. What is more, the Japanese economy has withstood over a year of rising bond yields and a couple of hikes by the Bank of Japan (BOJ), suggesting that fears the economy could not handle higher interest rates were overblown. Over the year ahead, we believe the return outlook for Japanese government bonds is poor as policy continues to normalize.

Exhibit 1: U.S. borrowing costs should keep rising



Note: As of March 10, 2025. Source: Bloomberg, Apollo Research, RBC GAM calculations

Exhibit 2: Investors seem much too pessimistic on Germany



Note: As of March 10, 2025. Source: Bloomberg consensus GDP forecasts for 2025

Direction of rates

In the event the Fed stays on hold, we see the U.S. 10-year bond yield at 4.50% in a year's time.

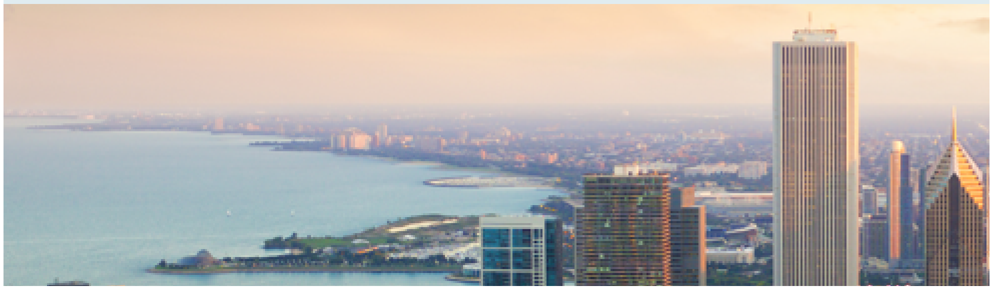
United States

The Fed kept its key policy rate unchanged in January and look likely to remain on hold again on March 19 barring a sharp slowdown in economic activity. The target range for the fed funds rate is now between 4.25% and 4.50%, higher than what the Fed and investors consider neither stimulative nor restrictive for economic growth and prices.

At the same time, the unemployment rate has fallen almost below 4%, and inflation is beginning to pick up. Consumers are increasingly concerned about higher rather than lower inflation. At this rate, the Fed risks undoing much of the good work and credibility it cached by hiking rates aggressively in 2022 and 2023. The task for policymakers is becoming more difficult due to policymaking by the Trump administration, which is focused on slashing immigration and the federal workforce, alongside much higher tariffs for the U.S.'s major trading partners. Investors are becoming increasingly concerned that the policy mix will be bad for growth as well as inflation, and worries are starting to override early optimism that a deregulatory charge from the new administration, as well as nascent animal spirits and generally better sentiment would supercharge already-lofty growth rate in the U.S.

Before these concerns surfaced, investors were expecting strong growth in the US compared to the rest of the world – continuing a theme of the past several years. However, as we highlighted above, we think other regions could start to experience an upswing in fortunes just as the U.S. begins to struggle to meet lofty expectations – a much different environment than surpassing what were very low expectations in prior years with strong growth.

Over the next year, we expect the FOMC to keep rates on hold as the Fed grapples with too-high inflation amid slightly weaker but not recessionary growth. The outlook for the US is highly uncertain and heavily dependent on the policy mix. Compared to the rest of the world, investors are well compensated to own U.S. Treasuries in terms of high real yields, high inflation expectations and high term premium. We like owning U.S. Treasuries even though our forecast calls for no Fed cuts over the next twelve months – if growth majorly disappoints in the U.S., yields could fall more significantly than we expect. In the event the Fed stays on hold, we see the U.S. 10-year bond yield at 4.50% in a year's time.



Our forecast is for the 10-year German bund yield to trade around 2.50%, up from 2.41% at the time of writing.

Eurozone

As we expected, the European Central Bank (ECB) lowered interest rates by 0.25% at each of its December, January and March meetings. The early-March cut marked the 5th consecutive cut and brought the deposit rate to just 2.50%. We see further cuts ahead for policymakers in Europe, as rates should drop to just 2.00% in the year ahead.

However, as much as we think European growth needs additional support from monetary policy, we also think that investors are much too bearish on the outlook for the single-currency area. We think growth is likely to beat expectations in Germany after many years of sluggishness. The resolution of the election uncertainty in Germany should provide a fillip to growth in the form of lower policy uncertainty and perhaps higher fiscal spending. The proposed adjustments to German's fiscal rules would provide a large tailwind to growth for Germany – boosting both military and infrastructure spending.

More uncertain but also a positive for Europe would be a resolution of the Russia-Ukraine conflict. Inflation also is above target in the eurozone, driven by higher energy prices and a weakening euro, and we think this will keep the ECB from cutting policy rates too aggressively.

We do expect the ECB to continue reducing rates in the year ahead. Our forecast is for the 10-year German bund yield to trade around 2.50%, up from 2.41% at the time of writing.

Over the next year we see 10-year bond yields rising to 1.75%, from just 1.37% now.

Japan

After hiking its policy rates twice in 2024, the BOJ remains on hold so far in 2025 despite lofty expectations among investors that they would hike rates. Yields on Japanese government bonds have surged higher even as the BOJ holds off on more aggressive rate hikes. Yields on long-term bonds are, in fact, as high as they were in the mid-1990s, well before Japan's long run-in with persistently low inflation and exceptionally low interest rates. Inflation continues to be strong in Japan. By some measures, Japan is experiencing both the highest wage growth and inflation among the G7 nations – a sentence that would have appeared absurd as recently as a few years ago.

We expect Japanese policymakers to eventually resume hiking interest rates in response to still-strong inflation as well as better-than-expected economic activity. Indeed, the Japanese economy has so far resisted slowing down in the face of higher bond yields, signaling that the BOJ will have the confidence to keep hiking interest rates and normalizing policy. Over the next year, we expect the central bank to hike rates to 0.75%, from 0.50% at the time of writing. Over the same time frame, we see 10-year bond yields rising to 1.75%, from just 1.37% now.

We forecast the 10-year Government of Canada bond at 3.25% over the next year, up from 2.90% at the time of writing.

Canada

The Bank of Canada (BOC) cut the policy rate by 0.25 percentage point in January and again in March, bringing the policy rate to 2.75%. Policymakers cited continued moderation in inflation toward 2%, as well as easing expectations among consumers for future inflation. By some measures, inflation expectations are consistent with the period prior to the pandemic. The labour market and economic activity also remained soft through the final months of 2024 which, alongside cooling inflation, suggests that looser monetary policy is warranted.

Alongside relatively lacklustre domestic activity, the threat of significant tariffs being imposed for a prolonged period by Canada's largest trading partner, the U.S., suggests that policymakers will want to err on the side of easier policy over the next year. According to the BOC's own estimates, the policy rate at 2.75% is not particularly accommodative – it lies at the midpoint of the range of estimates for a neutral interest rate – the rate where policy is neither restricting nor stimulating economic growth.

While tariffs would likely boost inflation, we think the BOC will be more attentive to concerns about growth. Reflecting our view that tariffs are unlikely to be fully implemented for a prolonged period and, if so, at least partially offset by a boost in government spending – we expect no change in the BOC policy rate over the next year. We forecast the 10-year Government of Canada bond at 3.25% over the next year, up from 2.90% at the time of writing.

We see bank rate falling to 4.00% over the next year and gilt yields falling to 4.25%, from 4.48% at the time of writing.

United Kingdom

The Bank of England (BOE) cuts the policy rate at its February 6 meeting, dropping the bank rate to 4.50% and extending the slow, steady pace of rate cuts that began in the summer of 2024. Like the Fed, we think the BOE faces some tough decisions ahead as growth has remained relatively strong and inflation seems to be firming. Indeed, inflation for the year ended in January accelerated to 3%, the fastest pace in 10 months. Underlying measures of inflation also showed signs of firming, casting doubt that prices will ease back towards 2% as quickly as had been expected. Meanwhile, the labour market unexpectedly strengthened early in the year alongside economic growth. We think the BOE now is likely to remain on hold for a time, barring a sharper slump in activity. Eventually, we see policymakers delivering further cuts to support economic activity, with bank rate falling to 4.00% over the next year and gilt yields falling to 4.25%, from 4.48% at the time of writing.

Regional recommendation

We expect returns in Japan to lag those in the U.S. and Europe. High starting yields near 4.50% and the risk of underperforming lofty growth expectations should enable the U.S. bond market to outperform that of Japan, where we expect interest rates to continue rising. We recommend being 5.0% overweight Treasurys and 5.0% underweight Japanese government bonds.

We expect returns in Japan to lag those in the U.S. and Europe.

Underweight Japanese government bonds

vs.

Overweight U.S. Treasuries

Interest-rate forecast: 12-month horizon
Total-return calculation: February 28, 2025 – February 28, 2026

U.S.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.50%	4.40%	4.40%	4.50%	4.75%	2.64%
Change to prev. quarter	0.63%	1.00%	0.80%	0.50%	0.35%	
High	5.25%	5.10%	5.00%	5.00%	5.20%	0.08%
Low	2.80%	3.00%	3.25%	3.75%	4.10%	7.17%
Expected Total Return US$ hedged: 3.8%						

Germany						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	2.00%	2.00%	2.25%	2.50%	2.75%	1.96%
Change to prev. quarter	0.25%	0.40%	0.40%	0.25%	0.15%	
High	3.00%	3.00%	3.10%	3.25%	3.30%	-2.80%
Low	1.50%	1.50%	2.00%	2.25%	2.60%	3.68%
Expected Total Return US$ hedged: 3.6%						

Japan						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.75%	1.20%	1.50%	1.75%	2.60%	-1.01%
Change to prev. quarter	0.00%	0.20%	0.20%	0.25%	-0.20%	
High	1.25%	1.75%	2.00%	2.25%	3.50%	-10.33%
Low	0.33%	0.50%	0.75%	1.00%	2.00%	7.39%
Expected Total Return US$ hedged: 3.1%						

Canada						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	2.75%	2.90%	3.00%	3.25%	3.40%	1.09%
Change to prev. quarter	0.00%	0.10%	0.10%	0.00%	-0.05%	
High	3.50%	3.30%	3.40%	3.50%	3.60%	-0.47%
Low	2.00%	2.00%	2.40%	2.75%	3.00%	4.02%
Expected Total Return US$ hedged: 3.0%						

U.K.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	4.00%	3.75%	4.00%	4.25%	4.90%	6.74%
Change to prev. quarter	0.00%	-0.15%	0.00%	0.00%	0.20%	
High	4.75%	4.90%	5.00%	5.25%	5.25%	1.49%
Low	3.00%	3.00%	3.10%	3.50%	4.10%	14.65%
Expected Total Return US$ hedged: 5.8%						

Source: RBC GAM

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