RBC Global Asset Management

Global fixed income markets

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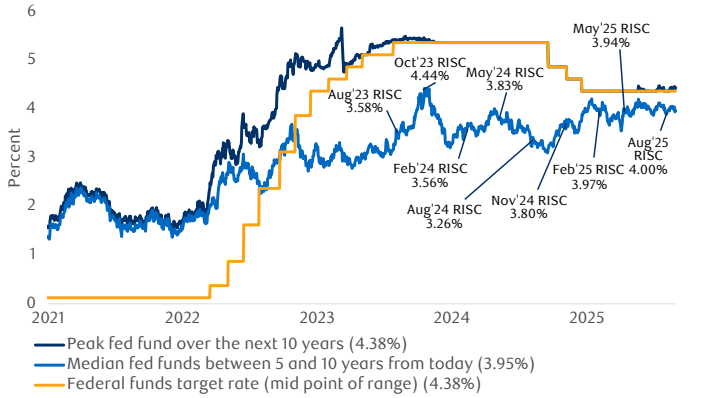
U.S. Treasury yields have stabilized in the 4%-5% range this year, up significantly from 1% in 2022 at the tail end of the bond bull market. While yields are attractive based on projections for moderate inflation and average economic growth, deteriorating sovereign finances and rising interest costs are calling into question their long-celebrated role in capital preservation during times of economic stress. In our view, much of this pessimism is already reflected in today's higher yields and steep yield curves, and we believe that Treasuries currently offer investors a fair income stream. Treasuries continue to be the true risk-free assets given their role as near money in the banking system, and their hedging properties are likely to re-emerge if and when extreme financial conditions return.

That said, we acknowledge that the U.S. is grappling with unprecedented fiscal challenges. According to the government's own forecasts, the federal debt as a percentage of GDP this year will exceed the record 126% recorded in 2020 at the height of the pandemic, and the percentage is expected to rise again in 2026. Additionally, annual interest costs as a percentage of GDP, already at post-World War II highs, are expected to climb to 4% over the next decade from the current 3%.

The substantial rise in bond yields over the past three years, particularly for maturities exceeding 10 years, underscores how investors are pricing in risks associated with elevated debt levels. In a sign of the increased perceived risks of holding long-term bonds, the extra yield required by investors to hold 30-year Treasuries versus 10-year maturities has risen from 15 basis point to 70 basis points over the past year. Against this backdrop, our job is to assess whether investors are receiving adequate compensation for the risks they run in holding Treasuries.

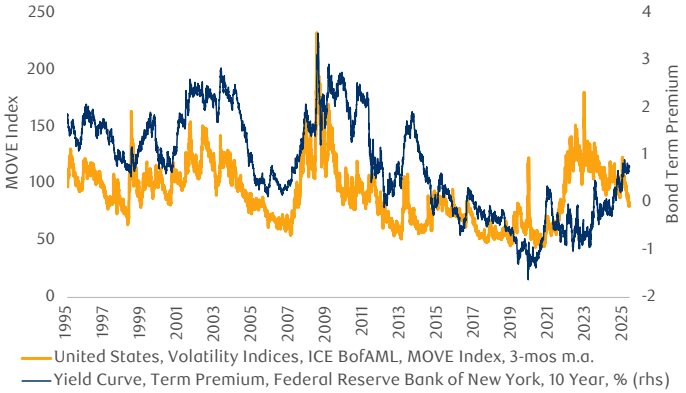
Investors appear to be comfortable with stable long-term yields between 4% and 5% based on inflation expectations and strong economic growth. Inflation expectations have remained in the 2%-3% range since 2022, while inflation excluding food and energy has moved toward those levels. Meanwhile, economic growth continues to positively surprise many forecasters, bolstered by fiscal stimulus, strong financial markets and a weaker U.S. dollar. In fact, investors' expectations have decisively broken from the low-inflation, low-growth mindset. The new framework indicates relatively fast economic growth of 1.5% to 2.5%, coupled with inflation exceeding 2%. Within this framework, bond yields in the 4% to 5% range allow fixed-income investors to compound long-term capital at a rate commensurate with nominal economic growth. Expectations of faster growth and above-2% inflation are also illustrated by the stability of long-term policy-rate expectations, which have hovered near the 4% level over the past two years (Exhibit 1).

Exhibit 1: Bond market has been anchoring at 4% long-term policy rates



Note: As of August 1, 2025. Source: Bloomberg, RBC GAM calculations

Exhibit 2: Fair amount of uncertainty pricing are embedded into 4-5% bond yield range



Note: As of August 28, 2025. Source: Federal Reserve Bank of New York, Bloomberg, Bank of America Merrill Lynch, RBC GAM, Macrobond

Part of the reason that Treasury yields have stayed above 4% is that the U.S. government is boosting demand for capital to finance investments in artificial intelligence. This situation is likely to persist as U.S. policies are geared toward greater domestic investment, which will require increased funding.

Real bond yields, which are nominal yields adjusted for inflation, are at levels that suggest decent economic growth will continue. Real yields across developed markets have actually been rising, a sign that economic growth may even shift to a higher plane while inflation remains contained. In this environment, the extra yield that investors demand to compensate for the risk of holding government bonds over longer time periods, known as the term premium, is rising (Exhibit 2). The increase in the term premium marks a clear shift from the mid-2010s, when investors' willingness to sacrifice returns in exchange for capital safety resulted in negative term premiums.

The term premium on the 10-year Treasury bond stands at around 0.80 percentage point, which we believe is fair given that the Fed's significant holdings of U.S. Treasuries—nearly 20% of all outstanding government bonds—will likely limit significant increases in the term premium. To support this assessment, we compare the term premium to the MOVE Index, which measures bond-market volatility based on options prices. Since the MOVE index has returned to its historical average, we suspect the current 4%-5% yield range already reflects a fair amount of uncertainty about the economic outlook.

The shift by investors away from government bonds since 2022 has driven valuations of corporate bonds and derivatives to extreme levels, and some investors have postulated that U.S. government financial woes are making the safest non-government bonds a viable alternative to Treasuries. Our view is that non-government bonds do not currently offer these "safe-haven" characteristics unless U.S. Treasuries cease to be viewed as "risk-free" —an unlikely scenario given their role as the primary collateral and reserve asset for the global financial system. While technical factors such as rising Treasury supply may temporarily support non-government assets, the diminishing compensation relative to traditional government bonds makes the case for sustained outperformance tenuous. Ultimately, an economic downturn may be the catalyst for Treasuries to reassert their dominance as the true risk-free asset.

We acknowledge that the U.S. debt profile bears some resemblance to countries that have experienced debt crises but are confident that the risk of a full-fledged crisis in the U.S. remains remote. Argentina and Sri Lanka exhibited similar fiscal gaps and rising bill issuance leading up to their crises. However, the dollar's status as the global reserve and transactional currency, the nation's ability to attract international capital for innovation, and the U.S. Federal Reserve's (Fed) policy tools provide significant buffers. All these factors are key distinctions.

Maintaining strong economic growth must be an important priority for President Trump and future administrations trying to escape the debt monster. U.S. policies are targeting investments in infrastructure, innovation and productivity to drive sustained growth. The U.S. administration is determined to ensure that the country's economic growth continues to benefit from AI applications and infrastructure investments. In this context, today's Treasury yields offer investors sufficient compensation for the risks of the higher inflation that could ensue, as long as it is moderate.

Even with the U.S. fiscal challenges, Treasuries remain a cornerstone of global financial markets, offering stability, liquidity, and risk-free status. High real yields and steep yield curves provide an attractive entry point for long-term investors, especially as many of the fiscal concerns are already priced in. As valuations for riskier assets reach extremes and economic growth moderates, the relative appeal of government bonds is likely to grow. For investors seeking a balance of income, diversification, and safety, government bonds present a compelling opportunity to lock in favourable yields before market dynamics shift. In an uncertain global environment, U.S. Treasuries stand poised to reassert their role as the foundation of a resilient portfolio.

Direction of rates

We anticipate 10-year Treasury yields to remain elevated and maintain our forecast of 4.25%.

United States

Speaking in Jackson Hole, Wyoming, on August 22, Fed Chair Jerome Powell hinted that the prospect of a weaker job market could prompt the Fed to lower interest rates. His warning is reflected in short-term interest-rate derivatives, which indicate Fed-set rates will fall a full percentage point over the next year from the current setting of 4.33%. We are aligned with market expectations and expect the fed funds rate to decline to 3.38%.

One of the key messages in Jackson Hole was that the Fed's policymaking body had erred in 2020 when it adopted an inflation-targeting system based on average inflation. The framework was designed to allow for periods of above-target inflation following periods when inflation undershot the 2% target. The abandonment of this approach implies the Fed is reverting to its traditional goal of simply targeting 2% inflation regardless of where we find ourselves in the inflation cycle. In our view, this policy approach should help limit further increases in term premiums, as bond yields are likely to reflect a more predictable interaction between monetary policy and inflation. This supports our expectation that long-term bond yields will trade within a 4%-5% range.

There is a risk that today's significantly higher term premiums could go even higher as President Trump introduces uncertainty by seeking to influence the Fed's decision-making. If successful, Trump's actions could erode confidence in the Fed's independence and thereby push up long-term bond yields just as the Fed readies to cut short-term rates amid economic weakness, steepening the yield curve.

We expect the Fed to deliver 100 basis points of rate cuts over the next year, likely beginning this month. In an environment of steep yield curves, and questions about fiscal policy and Fed independence, we anticipate that 10-year Treasury yields will remain elevated and maintain our forecast of 4.25%.

Our forecast for the 10-year bund yield is 2.75%, 25 basis points higher than the previous forecast. The ECB's deposit rate should remain at its current level of 2.00%.

Eurozone

In June, the European Central Bank (ECB) reduced its benchmark interest rate by 25 basis points, lowering the overnight deposit rate to 2.00%. We think this reduction was the final rate cut in the current easing cycle, as fiscal stimulus is likely to boost growth and inflation in the eurozone. The ECB's hints that it is done with interest rates for now, coupled with the U.S.-EU trade agreement, underscores the likelihood that monetary easing is coming to an end.

Bund yields are more likely to rise or remain stable than those in other Western countries and regions as fiscal spending begins to filter through the economy. The 10-year bund yield has risen over the past three months, driven by a higher 2-year yield. While we see the potential for 10-year bund yield to surpass 3.25%, there are considerations that could limit any gains over the coming months, including an inevitable re-evaluation of prospects for economic growth.

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We expect the BOJ to raise its policy rate to 0.75% from 0.50% within the next year.

Japan

The Bank of Japan (BOJ) has maintained its policy rate at 0.5% since early 2025, reflecting an exceptionally gradual hiking cycle under Governor Kazuo Ueda. Ueda emphasizes that inflation excluding temporary factors has yet to sustainably reach the BOJ's 2% target. As a result, monetary policy remains accommodative, even with relatively high inflation and weak demand for long-dated bonds.

Japanese economic growth is expected to remain moderate, constrained by inflation and the effect of U.S. tariffs. Temporary factors keeping inflation elevated include a sharp rise in rice prices, while wage growth is broadening beyond large enterprises to small and medium-sized businesses.

Meanwhile, yields on Japanese government bonds (JGBs) are climbing. The yield on the 30-year JGB recently surged past 3.20%, marking the highest levels since the 1990s—a period that ushered in Japan's long era of low inflation and interest rates. The sell-off in long-maturity JGBs preceded similar developments in other major markets, where longer-term rates have also climbed faster than short-term rates. In Japan's case, the yield-curve steepening is exacerbated by reduced demand for longer-maturity bonds, particularly from insurers that have largely stayed on the sidelines.

We expect Japanese policymakers to resume rate hikes in response to persistent inflationary pressures, with the BOJ raising its policy rate to 0.75% from 0.50% within the next year. We expect the BOJ to move slowly on rate hikes as it waits for clearer evidence that rising wages are translating into spending.

As part of its strategy to limit further rises in long-dated bond yields, the BOJ in June announced plans to slow the pace at which it sells bonds to ¥200 billion per quarter from April 2026 to March 2027, from current rate of ¥400 billion (C$3.75 billion) per calendar quarter. The performance of JGBs this year demonstrates limited domestic appetite to absorb the supply when the BOJ is reducing its purchases. We forecast that the 10-year JGB yield will rise to 1.75% sometime within the next 12 months, up from our previous estimate of 1.50%.

We foresee that the yield on the Canadian 10-year government bond will trade at 3.50% over the same period, not far from where it is now.

Canada

The Bank of Canada (BOC) in July left its policy rate unchanged at 2.75% for a third consecutive meeting based on firm inflation and more resilient than expected economy. At the time, the BOC's preferred inflation measures exceeded 3% and were well above the 2% target. However, the bank remains open to future rate cuts if the economy weakens amid the trade war and price pressures are contained. Rising unemployment and household uncertainty mean that consumers are shying away from spending on housing and other major purchases and their actions limit inflation.

As of August, investors expect one further cut from the BOC within the next 12 months, which would bring the policy rate to 2.50%. With inflation and growth continuing to decline, we believe the BOC is likely to cut more sharply by 0.50% to 2.25%. We foresee that the yield on the Canadian 10-year government bond will trade at 3.50% over the same period, not far from where it is now.

We expect the Canadian yield curve will continue to steepen as short-term rates come down on BOC rate cuts and long-term rates stay pretty much where they are given Canada's commitment to meet NATO's defense-spending targets. Prime Minister Mark Carney announced plans to increase defense spending to 2% of GDP this fiscal year, rising to 5% over the next decade. Achieving the 2% defense target will require an additional $9 billion in spending this year alone, compounding an expected budget deficit of $47 billion.



We are keeping our 10-year gilt-yield forecast at 4.25% with the expectation that the yield will decline from its current level of 4.72%.

United Kingdom

A divided Bank of England's (BOE) policy committee cut the benchmark interest rate by 0.25 percentage point to 4.00% in August. The Monetary Policy Committee tied future rate cuts to evidence of lower inflation given significant increases in food and energy prices, and household expectations that inflation will continue to rise.

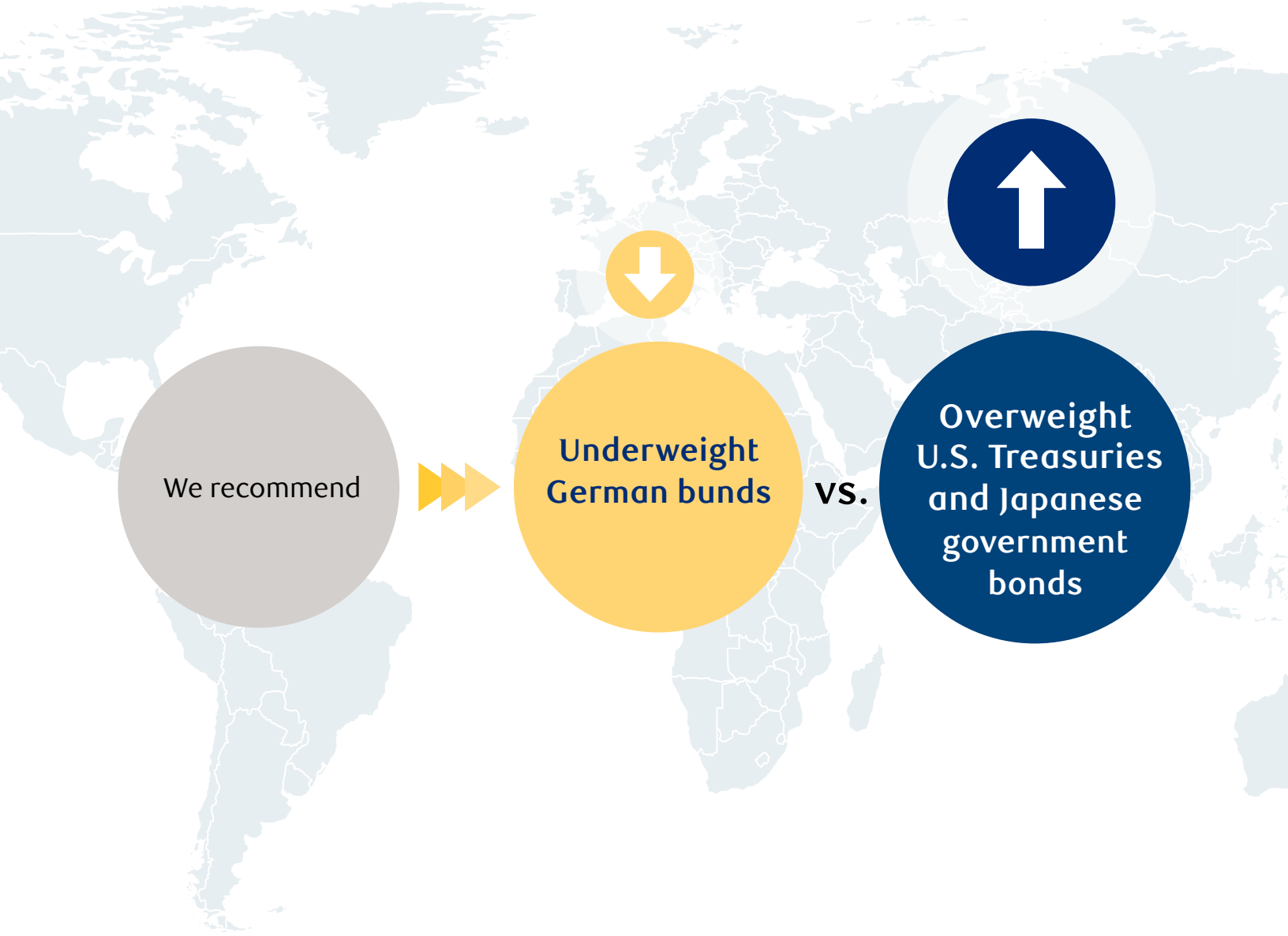
The pace at which the BOE's proceeds on rate cuts will depend on whether inflation comes down enough that the BOE can turn its focus to a weakening labour market. Labour statistics showed that wage growth continues to fall from high levels and employment demand continues to wane. Fiscal policy is a major headache for the Labour Party government, which is likely to raise income taxes in the autumn budget due to strained public finances.

Yields on long-dated gilts are likely to rise in line with other markets, where subdued investor demand reflects concerns over high debt levels. This could prompt the BOE to reconsider its intention to reduce sales of gilts in the months ahead. Considering the softer economic outlook, higher gilt yields will add to economic woes. We therefore expect the BOE to gradually lower interest rates, bringing the policy rate to 3.25% sometime over the next year. We are keeping our 10-year gilt-yield forecast at 4.25%, with the expectation that the yield will decline from its current level of 4.72%.



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: September 1, 2025 – August 31, 2026

U.S.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	3.50%	3.50%	3.75%	4.25%	4.90%	4.31%
Change to prev. quarter	(0.25%)	0.20%	0.05%	0.00%	0.15%	
High	4.38%	4.60%	4.80%	5.25%	5.75%	(0.21%)
Low	2.13%	2.50%	2.70%	3.50%	4.25%	8.57%
Expected Total Return US$ hedged: 5.3%						
Germany						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	2.00%	2.20%	2.50%	2.75%	3.50%	1.75%
Change to prev. quarter	0.25%	0.60%	0.50%	0.25%	0.50%	
High	2.50%	2.75%	3.00%	3.25%	3.70%	(0.28%)
Low	1.50%	1.50%	1.90%	2.25%	3.00%	6.04%
Expected Total Return US$ hedged: 3.8%						
Japan						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.75%	1.20%	1.50%	1.75%	3.25%	2.25%
Change to prev. quarter	0.00%	0.20%	0.30%	0.25%	0.25%	
High	1.50%	1.90%	2.00%	2.25%	3.75%	(3.29%)
Low	0.50%	0.70%	0.75%	0.90%	2.00%	17.44%
Expected Total Return US$ hedged: 6.8%						
Canada						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	2.25%	2.70%	3.00%	3.50%	4.00%	2.66%
Change to prev. quarter	(0.25%)	0.10%	0.10%	0.25%	0.40%	
High	3.25%	3.50%	3.75%	4.00%	4.25%	0.14%
Low	1.75%	2.00%	2.50%	3.00%	3.40%	5.81%
Expected Total Return US$ hedged: 4.0%						
U.K.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	3.25%	3.10%	3.60%	4.25%	5.50%	7.37%
Change to prev. quarter	(0.25%)	(0.30%)	0.00%	0.00%	0.35%	
High	4.00%	4.50%	4.75%	5.25%	5.80%	2.45%
Low	2.75%	2.60%	3.00%	3.75%	5.00%	11.75%
Expected Total Return US$ hedged: 8.1%						

Source: RBC GAM

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