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Bond market commentary: Q3 review and Q4 outlook

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The third quarter was defined by a sharp repricing higher in yields across the curve, led by the US and transmitted through global bond markets, including Canada. The move reflected three overlapping forces: inflation that remained above target, real rates that moved higher as growth held up better than expected, and a supply backdrop that required investors to absorb more government and corporate debt at the same time. That combination pushed bond markets into a higher-for-longer regime and kept volatility elevated through quarter-end.

The back-up in yields accelerated into September as investors confronted a mix of hawkish central bank communication, resilient growth data and renewed energy inflation. In the US, long-term Treasury yields broke well above the psychologically important level of 5%, raising investor concerns over risk assets in general. Despite the pressure, equity prices remained resilient.

Inflation stayed too high for comfort, especially in the US, where policymakers made it clear that price stability had not yet been restored. Energy prices tied to the Middle East conflict kept upward pressure on headline inflation, and central banks could not fully dismiss that risk. But the larger story was that real rates rose because of increased demand for credit.

US growth was resilient, consumer spending held up, business investment stayed strong, and AI-related capital expenditure remained a major source of demand for funds. Hyperscalers and other large issuers came aggressively to market to fund data centers, semiconductors, power infrastructure and related buildout. At the same time, US government funding requirements remained elevated, with large auction sizes raising concerns over structural deficits.

So how much of the quarter's move in yields was supply and demand rather than inflation? In our view, the answer is meaningful. Term premium had to rise to clear a market facing heavier issuance and less support from price-insensitive buyers. Central banks are no longer expanding balance sheets and private investors are asking for more compensation to own duration.

Canada's inflation story was somewhat different. Headline CPI moved back up, but much of that reflected gasoline and energy-related effects. Core inflation in Canada remained more contained, and wage pressures did not show the same degree of acceleration as in the US. That gave the Bank of Canada more room to stay patient. Still, the Canadian bond market, as well as most international markets, could not fully decouple from US yield moves.

In response to persistently elevated inflation, the Federal Reserve delivered a 25 basis point hike in September, moving the policy range to 3.75%-4.00%. By early October, markets were assigning a high probability to another rate increase in December, with some additional tightening still priced beyond that. Chair Warsh and several Fed officials were explicit that inflation had remained too high for too long and that policy was not meaningfully restrictive.

The Bank of Canada held the overnight rate at 2.25% in September, but the tone remained hawkish. Governor Macklem emphasized upside inflation risks, especially those linked to the Middle East and energy markets. The Bank is balancing two opposing forces: trade and tariff uncertainty that could weigh on demand, and higher energy costs that could keep inflation elevated. For now, the Bank appears inclined to wait.

Credit was more resilient than duration. Canadian corporate spreads remained tight by historical standards and stayed in a narrow range for most of the quarter. That reflects still-healthy fundamentals, strong demand for income and limited evidence of broad credit stress. We continue to see value in high-quality credit, but selectivity is critical.

For example, global hyperscaler issuance has been heavy, and that type of supply can push spreads wider even if fundamentals remain solid. We have not seen broad spread breakdown in AI-related debt, but supply itself is a consideration. In a market where spreads are already tight, incremental issuance matters more than it would in a wider-spread environment.

Duration remains a more balanced discussion than it was earlier in the year. We do not think portfolios should be built around trying to time the next central bank move. What matters more is whether investors are being paid appropriately for the duration risk they are taking. At current yield levels, bonds are starting to look like bonds again. Income is meaningful, and investors no longer need falling rates to generate returns. We still prefer a measured approach. Intermediate duration offers a better balance than the far long end, where fiscal concerns, supply pressure and term premium remain live risks.

Looking ahead, the bond market remains caught between a strong nominal growth backdrop and the reality that financial conditions are tighter than they were a year ago. In the US, another Fed hike is likely if inflation stays firm and growth does not slow enough. In Canada, the Bank of Canada has more flexibility, but not enough to ignore energy-driven upside inflation risk. Yield volatility may remain elevated, but higher starting yields have improved the opportunity set.

We favour resilience. In credit, that means staying selective, emphasizing quality and being careful where new issuance is concentrated. In duration, it means using the higher yield environment to add income without overcommitting to the longest maturities. The market has repriced a lot, but inflation, real rates, and supply require ongoing monitoring.

While the scars of the 2022 bond bear market are still fresh, with yields now well above the post-Covid ultra-low levels, duration risk is effectively lower, all else equal. Put simply, when starting yields are higher, a bond's price sensitivity to any given move in rates is less punishing than it was when coupons and yields were near historic lows. That does not eliminate mark-to-market volatility, but it does improve the bond market's downside cushion.

Higher yields also mean investors are being paid more income while they wait. Prices have already adjusted lower as yields moved up, but new purchases now come with materially better carry, and that income helps offset some of the pressure from further rate increases. Just as important, if yields eventually decline, whether because growth slows, labour markets weaken, or inflation falls, bonds offer meaningful upside from price appreciation on top of the higher

running yield. In that sense, the return profile is more balanced than it was just a few years ago. For diversified portfolios, bonds continue to serve an important role both as portfolio ballast and as a source of total return.

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