CIBC ASSET MANAGEMENT

Market Spotlight

Bond markets and the future of the US dollar

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Challenges and opportunities in the US and Canadian bond markets

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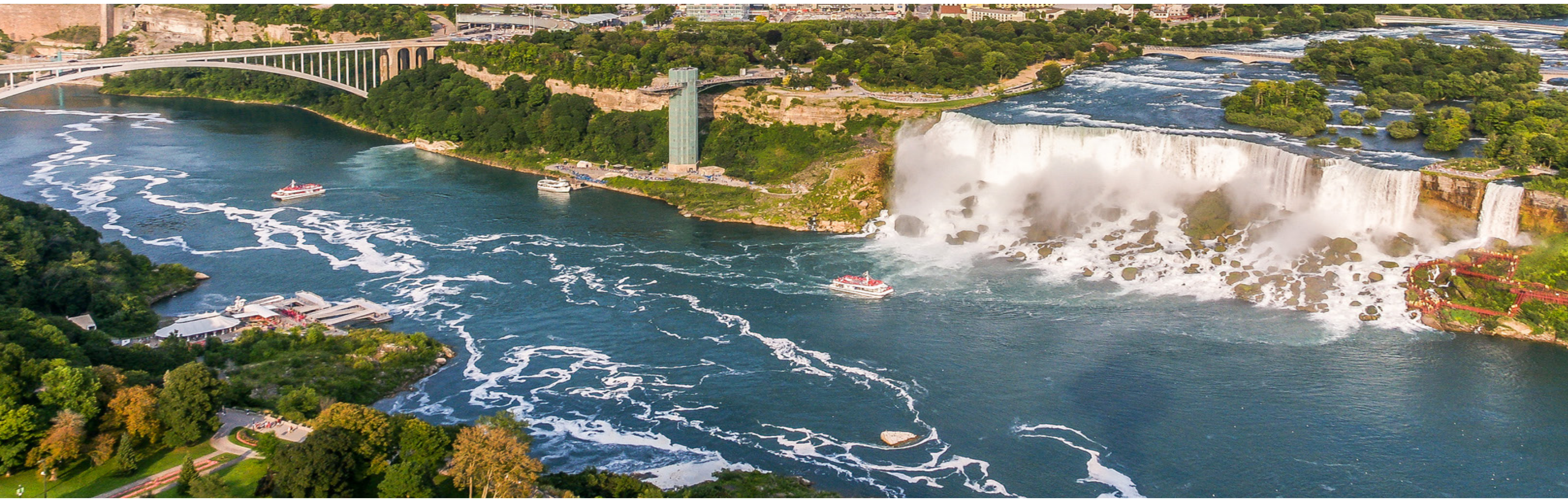

The outlook for the US bond market is clouded by fiscal and monetary policy uncertainties. While Fed Funds Futures are pricing in two rate cuts for the remainder of 2025, signaling expectations of a dovish pivot by the US Federal Reserve (Fed), the timing and magnitude of these cuts remain uncertain. Downward pressure on the short end of the curve reflects concerns about slowing economic growth, rising recession risks, and persistent tariff-related inflation. However, these anticipated rate cuts may not be sufficient to offset structural challenges posed by persistent deficits and rising debt levels.

The US fiscal trajectory is increasingly under scrutiny. Credit rating agencies have already downgraded US debt, and the bond market and US dollar are beginning to reflect these concerns. While a default remains improbable for a country that can print its own currency, the erosion of fiscal credibility could lead to higher borrowing costs, elevated structural inflation, higher neutral policy rates, and increased volatility in both the Treasury market and the US dollar. Against a basket of currencies, the US dollar has declined approximately 10% year-to-date, underscoring the importance of active currency management as part of fixed-income strategies.

Corporate bonds in the US face a mixed outlook. Investment-grade bonds may benefit from a potential Fed pivot, but high-yield bonds could come under pressure as economic growth slows and default risks rise. Investors should focus on quality within the corporate bond space.

What about Canada, eh?

Similarly, Canadian corporate bonds are not immune to global trends, and sectors with high leverage or exposure to interest rate fluctuations may face challenges. High-yield bonds in Canada, in particular, could see widening spreads if economic growth slows further. The Bank of Canada's monetary policy will play a critical role in shaping the bond market outlook. While the central bank has signaled a willingness to adjust rates as needed, its actions will depend on the trajectory of inflation and economic growth. Investors should monitor these developments closely, as they will have significant implications for both government and corporate bonds.

Inflation has moderated significantly from recent elevated levels, however the risk of a resurgence cannot be ruled out, particularly if fiscal policies remain expansionary or tariffs continue to elevate prices. Given these uncertainties, diversification is more important than ever. Non-US bonds, particularly those from countries with strong fiscal positions and dollar-denominated debt, offer an attractive complement to core positions. Additionally, alternatives such as high-quality Collateralized Loan Obligations (CLOs) provide higher yields than other comparably-rated debt and can serve as effective diversifiers in a portfolio by offering lower correlation of returns and minimal interest rate risk.

Self-inflicted wounds weakening the US dollar

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Following an extended period of strength, the US dollar began 2025 significantly overvalued against a range of currencies, including the Canadian dollar. However, it's lost about 10% of its value against a broad basket of currencies since mid-January.

Why has this happened? Investors are pricing a US growth slowdown with sticky inflation and a resilient global economy. Additionally, investors are growing concerned as the market's perception of US fiscal credibility and the quality of its policy making institutions have waned. Indeed, so far this year, the US dollar has not behaved as it typically does in high-stress environments, raising questions about its long-term role as a reliable safe-haven currency.

A continued trend lower

There are a number of reasons why the US dollar may be expected to keep progressing lower in the coming quarters. The US dollar is overvalued across the board and the elevated current account balance deficits make it vulnerable to a less strong appetite for US assets by foreign investors. The liquidity of the US dollar is plentiful and there are grounds to believe the US Federal Reserve (the Fed) will resume policy easing. Policy uncertainty remains high, and investor-unfriendly policy choices will likely counter any relatively resilient cyclical data the US economy generates.

The negative policy headwinds are many, and include: trade tariffs; an apparent greater willingness to threaten asset expropriation and punitive tariffs and taxation of foreign assets as leverage to achieve desired policy outcomes; elevated deficits and ballooning government debt; skepticism about the future independence of the Fed; and, antagonism towards international students, academic institutions and scientific research. Allied to a more restrictive immigration stance, these policies are unfavorable to long-term US GDP growth and are negative for the long-term valuation of the US dollar. Though a likely push to deliver more deregulation represents a partial mitigation of this situation.

While there has yet been no significant change in the broad usage of the US dollar in international financial transactions, the policy headwinds outlined, and less favourable investor views, do appear behind a change in US asset class correlations. If this change persists, it has important hedging implications for Canadian investors exposed to US assets.

Accordingly, these shifting correlations and our expectation that the US dollar will continue to trend lower have led us to increase hedge ratios on the US equity funds we manage and to position the US dollar as a preferred funder in active currency mandates. Looking ahead, FX hedging activity by non-US investors will create a feedback loop that further pressures the dollar. In this context, we expect the Canadian dollar to strengthen over the next year against the US dollar.

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