Monthly Fixed Income Monitor

Economics and Strategy

NATIONAL BANK OF CANADA
CAPITAL MARKETS

December 2025 – January 2026

Forecast Summary

By Taylor Schleich, Ethan Currie & Warren Lovely

- It's a 50-50 North American rate outlook. No, that's not us having little conviction in our forecasts. That's a reference to the likely changes in policy rates at the Federal Reserve and Bank of Canada in 2026. For nearly the past decade the two central banks have moved directionally together but that's due to change next year. While we see the Fed keeping its easing cycle going early in 2026, the Bank of Canada will remain on hold before starting to *increase* its policy rate in the fall.
- At the Federal Reserve, policymakers continue to contend with pressures on both sides of their dual mandate. On one side, we're tying a bow on the fifth straight year of inflation running above target. Tariffs, strong economic growth and expansionary fiscal policy all continue to pose upside risks. However, this seems to be less of a concern to a (small) majority of FOMC participants. Instead, it's downside risks to the labour market that's really in the driver's seat right now. In coming months, we may see the sluggish pace of hiring continue. That will keep an already-anxious committee on edge and may lead to 50 basis points of easing in the first half of the year. However, we expect further softness to be short-lived. Fiscal policy will support growth next year and lead to a firming in job market conditions. Even for the most dovish FOMC participants, it will be difficult to justify easing in the second half of the year.
- After easing in late October, Bank of Canada Governor Macklem declared the policy rate was at "about the right level" to keep inflation contained and support the economy through its structural adjustment. At the time, many doubted the sustainability of the BoC's move to sidelines. However, data then started to improve materially, making it clear that the Bank's patient stance would be reaffirmed in December and that the easing cycle was likely over. No data release punctuated that better than the November *LFS*. In contrast to an expected hiring pullback, an impressive pace of job growth continued which helped push the jobless rate down to a 16-month low.
- In the blink of an eye, investor attitudes about the health of the Canadian economy shifted. The modest easing bias that had persisted even after the BoC went on hold, quickly turned into a tightening bias. However, in the Bank's final decision of the year, they did not validate growing expectations for hikes. Instead, Governor Macklem pointed to weak domestic demand in Q3, subdued economy-wide hiring plans and judged that, even after recent data, their outlook hasn't changed much. It's not hard to see why the Bank didn't throw in the towel on its earlier, more bearish economic assessment. Some hard data has looked great, but other data, including soft data, still signal there are problems ahead. To us, the BoC is right in taking time to have more confidence in the direction of the economy. And while we are somewhat skeptical at how strong the rebound in some data has been (i.e., hiring), we agree that the worst is behind the Canadian economy. Our macro outlook is consistent with rate hikes beginning in the fall, a quarter earlier than we'd previously envisioned.

United States						
Quarter	Target	3M	2Y	5Y	10Y	30Y
12-Dec-25	**3.75**	**3.54**	**3.53**	**3.74**	**4.19**	**4.86**
Q1:2026	3.50	3.45	3.50	3.65	4.10	4.75
Q2:2026	3.25	3.30	3.45	3.60	4.15	4.75
Q3:2026	3.25	3.30	3.40	3.65	4.20	4.80
Q4:2026	3.25	3.35	3.50	3.70	4.30	4.90
Q1:2027	3.25	3.40	3.50	3.70	4.35	4.95
Q2:2027	3.25	3.40	3.55	3.75	4.30	4.90
Q3:2027	3.25	3.40	3.60	3.75	4.30	4.85
Q4:2027	3.25	3.35	3.55	3.75	4.25	4.80

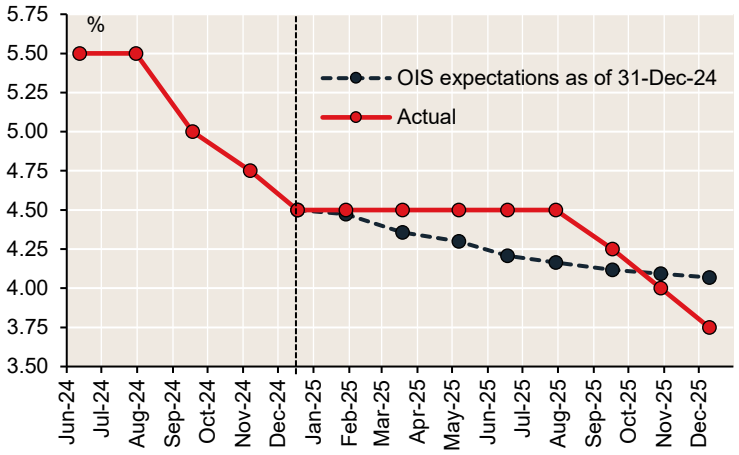
Canada						
Quarter	Target	3M	2Y	5Y	10Y	30Y
12-Dec-25	**2.25**	**2.19**	**2.61**	**3.00**	**3.44**	**3.88**
Q1:2026	2.25	2.20	2.50	2.85	3.40	3.80
Q2:2026	2.25	2.25	2.50	2.80	3.35	3.75
Q3:2026	2.25	2.35	2.65	2.85	3.30	3.75
Q4:2026	2.75	2.60	2.80	2.90	3.35	3.75
Q1:2027	2.75	2.70	2.90	2.95	3.40	3.80
Q2:2027	2.75	2.75	2.90	3.00	3.45	3.85
Q3:2027	2.75	2.75	2.85	3.05	3.45	3.90
Q4:2027	2.75	2.70	2.80	3.05	3.45	3.90

FOMC: Job market remains in the driver's seat

This time last year, the Fed was coming off *back-to-back-to-back* rate cuts but was pressing pause on its easing cycle. With healthy growth expectations owing in part to expected fiscal stimulus, markets saw only modest further easing in 2025. For a time, these expectations were playing out, although not all for the reasons expected. Growth *did* prove solid but there was also an abrupt upheaval of U.S. trade policy that led to worries about inflation and kept the Fed hesitant to cut. In the end, a labour market stumble proved too worrisome to ignore and once again, the year was capped off with three straight cuts.

Fed was more patient than expected yet still cut more

Fed funds upper bound target and OIS expected rate path as of Dec 31, 2024

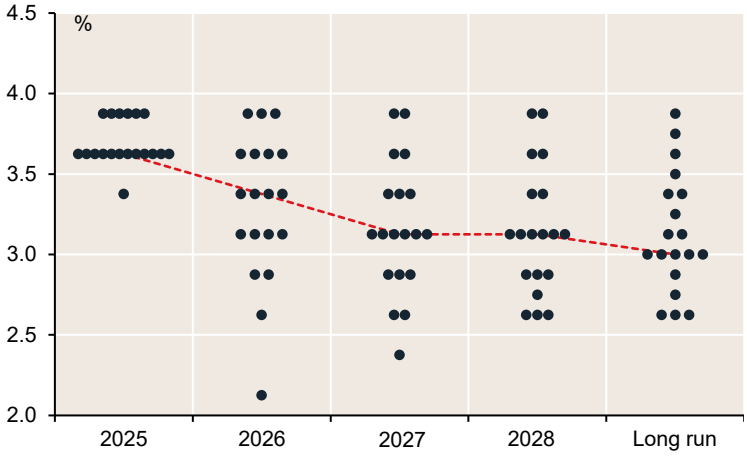


Source: NBC, Bloomberg | Note: OIS rates adjusted to Fed upper bound target

It's easy enough to draw parallels to the end of 2024 but there are also key differences at the Fed this year. Chief among them is the loss of a broad consensus within the committee. Not only are there now more decision day dissents, but perspectives on the rate outlook have also grown more divergent. Consider that in Dec-24, 10 of 19 policymakers agreed that two cuts—the median projection— would be appropriate in 2025. Today's median dot (implying one cut in 2026) is a projection held by just *four* participants. Meanwhile, seven believe rates should be 25-50 bps higher and eight think more material rate relief will be needed.

There's a wide range of views on appropriate Fed policy

FOMC dot plot: December 2025



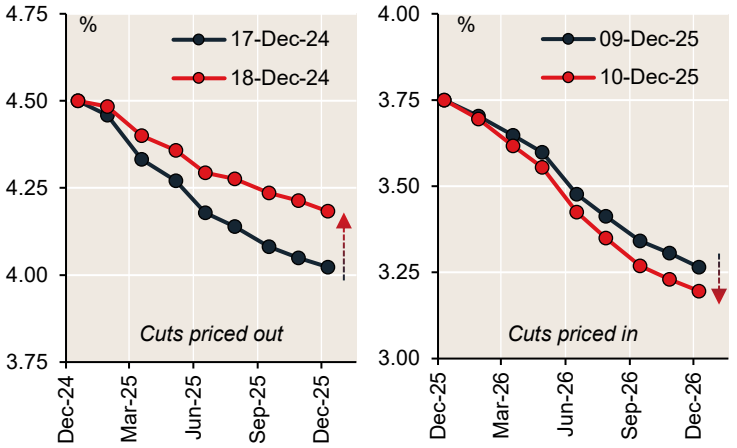
Source: NBC, FRB

For those advocating for further rate relief, the justification is clear. Downside risks to the labour market are outweighing upside risks to inflation. That certainly seems to be the stance of Fed Chair Powell based on his post-decision press conference. He described the labour market as weak multiple times and in multiple ways, theorizing that job growth is actually negative right now. And while he technically acknowledged inflation risks, he didn't sound overly alarmed. Instead, he explained that they see tariff inflation passing relatively quickly and services inflation continuing to moderate.

To be sure, there were *some* hawkish elements to the rate decision. For example, Powell stated the policy rate is in now within a range of neutral estimates. He also assured that they're "well positioned" to deal with tension between their mandate objectives. These comments both suggest the Fed *could* hold in January. Nonetheless, it was a dovish performance on balance. That leaves risks skewed to further near-term easing, a dynamic reflected in Fed pricing post-decision. This was *not* the case a year ago, when the last cut was unambiguously hawkish.

Dec-24 was a hawkish cut, but Dec-25 was not

OIS-implied Fed policy rate before and after Dec-24 and Dec-25 Fed decisions

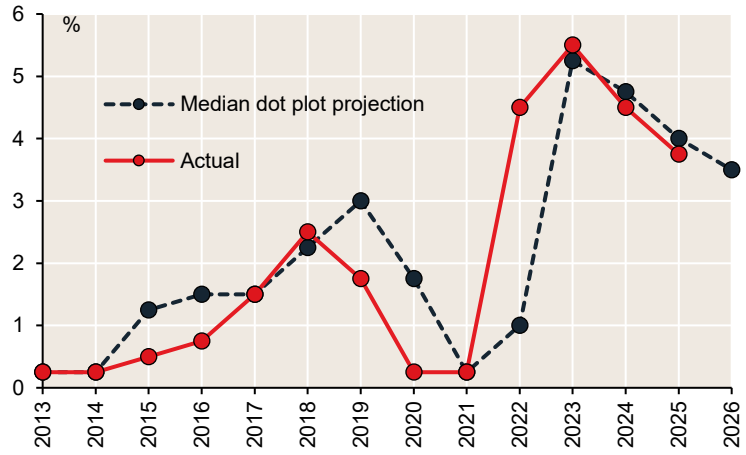


Source: NBC, BBG | Note: OIS rates adjusted to Fed upper bound target

While markets added to easing bets after the latest Fed decision, they still expect only one cut in H1:2026. We feel that near-term easing risks are underpriced and see incoming jobs data keeping the Fed in easing mode. Our call for two H1 cuts conflicts with the latest dot plot but we're not troubled by that. More of the "important" dots (i.e., Fed Governors) seem to be overrepresented in the dovish camp (even though Powell downplayed this divide). Moreover, the dot plot hasn't been an accurate indicator of the *actual* policy path. Consider that just *once* in the last 8 years has December's year-ahead median projection materialized.

Fed rate projections miss more often than not

Actual fed funds target & prior December's median dot plot projection

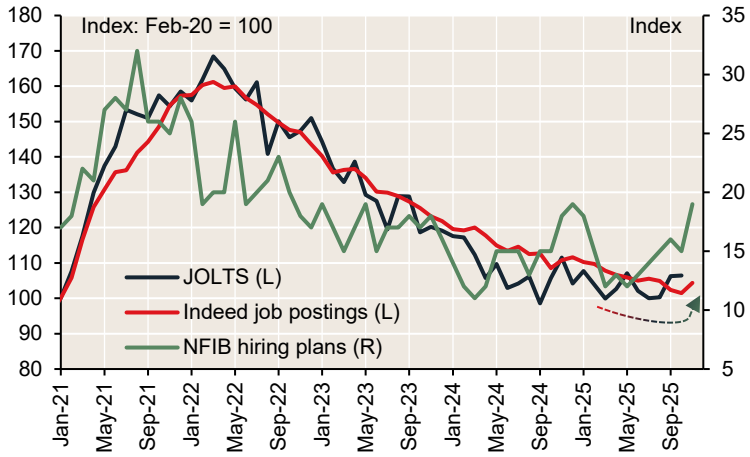


Source: NBC, BBG, FRB | E.g. In Dec-23, the median 2024 dot was 4.75%. The actual fed funds target at the end of 2024 was 4.50

Don't confuse our more aggressive Fed outlook with a downbeat *economic* outlook, however. We see solid growth continuing into 2026 with a big assist from incoming fiscal stimulus. The next few months of jobs data may be soft but hiring should start to firm before too long. In fact, there are already signs of labour demand beginning to recover and by mid-2026, the unemployment rate should be convincingly moving lower. With inflation remaining near 3%, it will become difficult to justify any easing in the second half of the year... even for the doves.

Labour demand is showing early signs of life

Job openings (L), Indeed job postings (L), small business hiring plans (R)



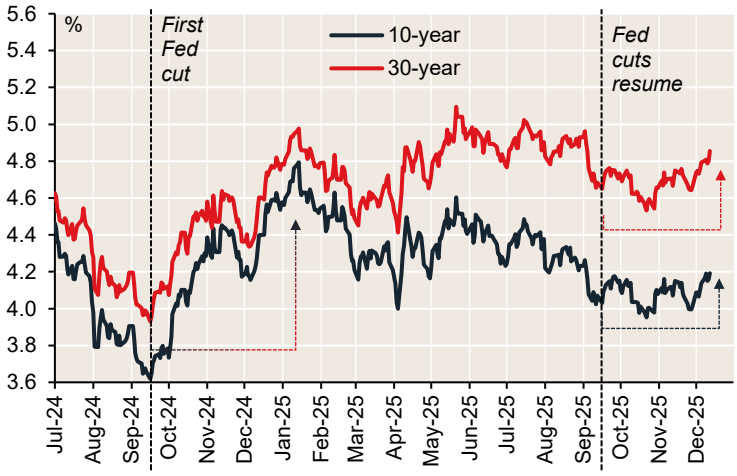
Source: NBC, BBG, BLS, NFIB

We realize that the end of Powell's term will bring in a more White House-friendly Fed Chair, which will create ongoing pressure to ease. But at the end of the day, the Chair represents just one vote. Moreover, Powell is already on the more dovish side of the Committee. Replacing a dove with a dove may not move the needle much.

In "normal" cycles, one would expect Fed easing to lower borrowing costs across the yield curve. But that's not been the experience this cycle. Despite 100 bps of cuts last fall, longer term treasury yields *increased* by ~100 bps. Even after this latest round of easing, yields have crept higher. With sticky inflation, strong GDP growth, loose fiscal policy *and* lower policy rates to characterize the year ahead, we see limited scope for this dynamic to reverse course. Indeed, our baseline scenario involves very little rate cut pass-through out the curve. Moreover, there remains a risk that long-term yields could breach earlier resistance levels if the Fed lets the economy run too hot.

More cuts = higher yields?

10- and 30-year U.S. treasury yields since mid-2024



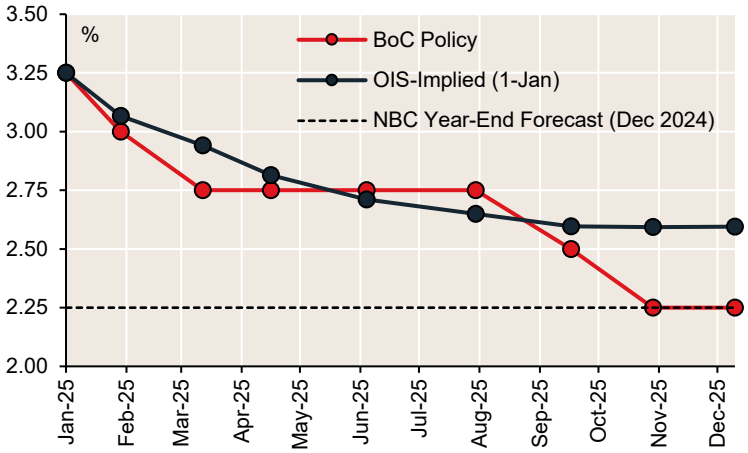
Source: NBC, Bloomberg

BoC: Holding time

At the start of the year, OIS markets speculated the BoC might ease 2 or 3 times in 2025 to address accumulated economic slack, even as data was starting to show signs of recovery. Ultimately, cuts came quickly as tariffs were threatened, and uncertainty weighed. Worries about inflation prompted a four meeting pause but as the trade war fallout became clearer, the BoC finished off the with year another 50 basis points of cuts. Our rate outlook from the beginning of the year thus proved correct, although we'll admit we didn't see it playing out like this.

BoC delivered more rate cuts than (most) anticipated

Bank of Canada policy rate: Actual and OIS-implied at the start of 2025

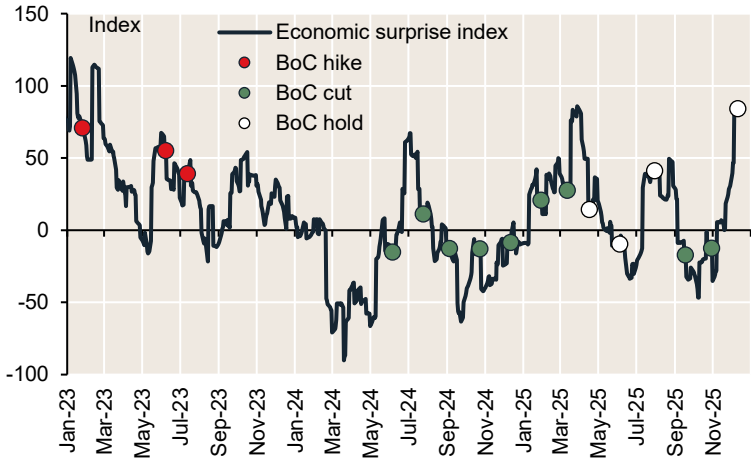


Source: NBC, Bloomberg

After the cut delivered in late October, Macklem declared the policy rate was at "about the right level" to keep inflation contained and support the economy through its structural adjustment. At the time, economic indicators were mixed, and many doubted the sustainability of the BoC's move to sidelines. However, data then started to improve materially, making it clear that the Bank's patient stance would be reaffirmed in December and that the easing cycle was likely over.

Economic data surprising to the upside, supporting pause

Citi Canada Economic Surprise Index with BoC policy decisions denoted

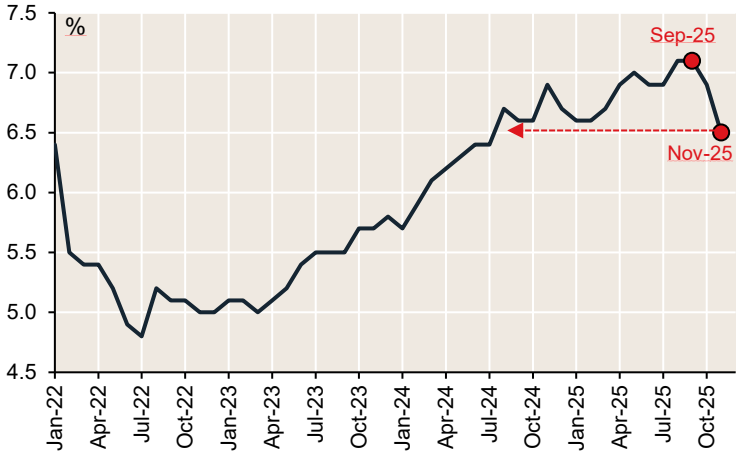


Source: NBC, Bloomberg

Undoubtedly, the most significant surprise this fall came in the form of the November *Labour Force Survey*. After two strong months of job growth in September and October, a pullback was widely expected. Instead, hiring remained strong which helped push the jobless rate down to a 16-month low of 6.5%.

Jobless rate plummets to 16-month low in November…

Canadian unemployment rate

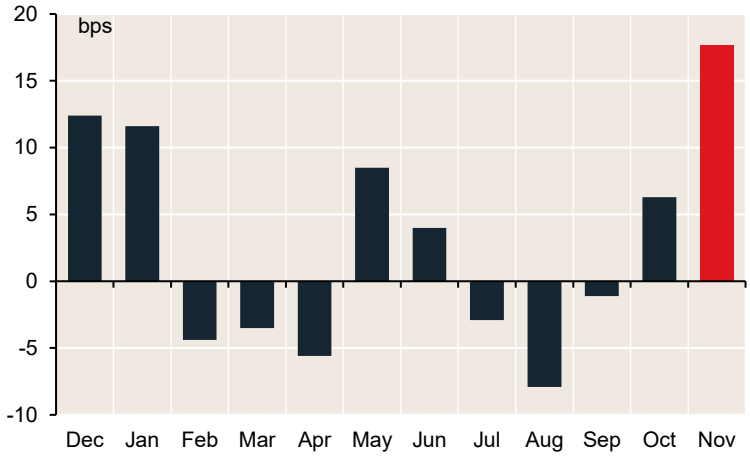


Source: NBC, StatCan

In the blink of an eye, investor attitudes about the health of the Canadian economy shifted. Perhaps the economy's resilience to an unsettled trade environment was stronger than assumed. Indeed, the modest easing bias that had persisted even after the BoC went on hold, quicky turned into a tightening bias. The policy rate-sensitive 2-year yield surged over 17 basis points on the day, representing the largest jobs day rate reaction of the year.

…causing largest selloff in an already LFS-sensitive year

Change in GoC 2Y yield on LFS release dates, last 12 points



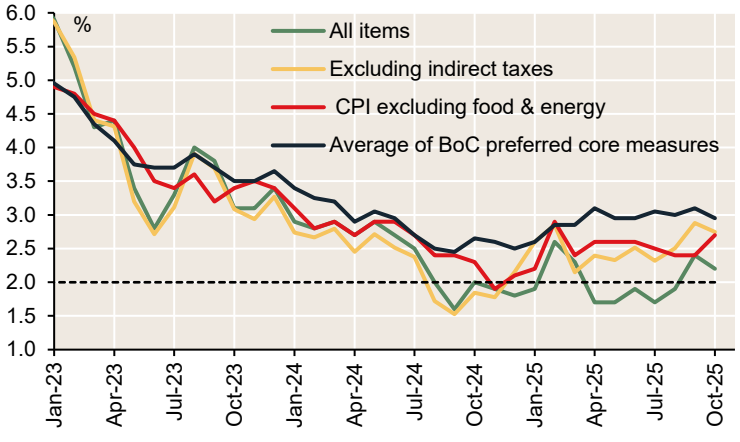
Source: NBC, StatCan, Bloomberg | Note: X-axis denotes data period

Importantly, it wasn't *just* the labour market's health that was reevaluated. Significant revisions to the past three years of GDP data suggested the Canadian economy was in *much* better shape heading into the trade conflict than initially reported. While these upward revisions also have a positive impact on estimates of potential GDP, we still judge that the output gap is smaller than previously assumed.

A smaller output gap may also help explain recent inflation trends. Measures of core/underlying inflation have been running above target for most of the year and the earlier moderation in inflation momentum has fizzled out more recently. Indeed, the market's earlier easing bias was *in spite of* inflation, *not* because of it. To be sure, we're not overly concerned about price pressures accelerating. A modest output gap should help keep inflation relatively well contained. Moreover, we see relief in pipeline from the CPI's rent component (which is currently running much hotter than real-time readings of the Canadian rental market). Nonetheless, inflation is above target today which means the BoC's stand-pat stance is now better aligned its mandate variable.

No matter the measure, inflation is running above target

Measures of Canadian inflation (Y/Y% change) since 2023

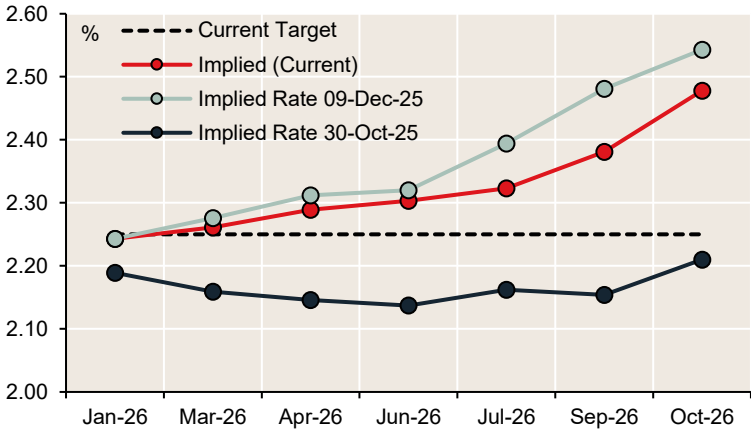


Source: NBC, StatCan, BBG | Note: Preferred core measures = avg. of CPI-Trim, -Median

Despite stronger growth, faster hiring and still-warm inflation, the BoC failed to validate the market's hiking bias. Instead, Governor Macklem pointed to weak domestic demand in Q3, subdued economy-wide hiring plans and judged that, even after recent data, their outlook hasn't changed. That produced a moderation in the expected pace of easing.

There is no longer an easing bias in rates pricing

OIS-implied BoC policy rate: Latest, prior to Dec meeting and after Oct meeting

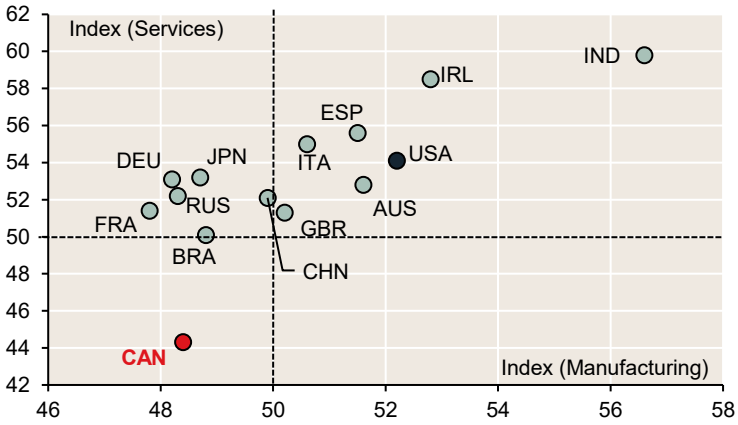


Source: NBC, Bloomberg

It's not hard to see why the Bank didn't throw in the towel on its earlier, more bearish economic assessment. Some hard data have looked great, but other data, including soft data, still signal there are problems.

Soft data still offers some conflicting signals

S&P Global manufacturing & services PMI by country: November 2025



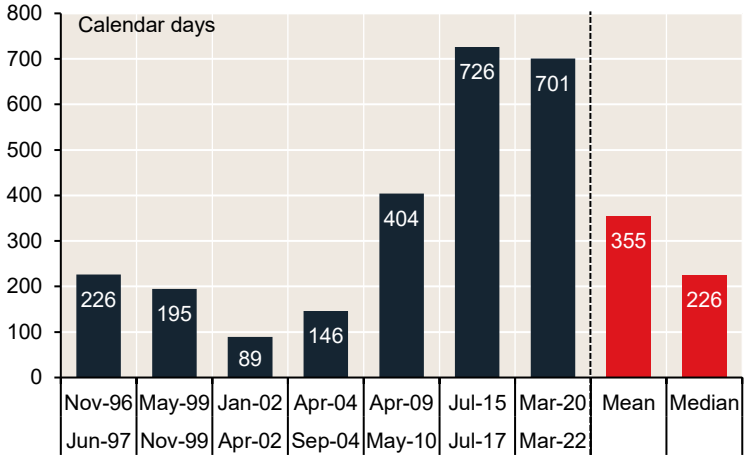
Source: NBC, Bloomberg, S&P Global | Note: >50 indicated 'expansion', <50 'contraction'

Even when it comes to the labour market, some jobs data aren't nearly as strong as suggested by the LFS (i.e., SEPH jobs data). There's also uncertainty to contend with. For now, Canada's relatively favourable tariff treatment through USMCA is a strength (relative to other countries). But that could change in 2026 when the USMCA agreement is up for review. We've already seen what acute uncertainty can do to sentiment and the economy.

All that to say, we think the Bank is right in waiting for greater confirmation of this economic rebound. And while we're skeptical at how strong the rebound in some data has been (i.e., hiring), we agree that the worst is behind the Canadian economy. Assuming we can get through the aforementioned USMCA review relatively unscathed, the path of the economy is pointed up. That should ultimately lead to rate hikes later this year. While that call is driven by our macroeconomic outlook, we'd note that this timing is also consistent with the empirical record. Every BoC cycle is different but, on average, the BoC begins to tighten policy roughly one year following its final rate cut.

How long does the BoC hold after easing cycles?

Duration of hold period after historical Bank of Canada easing cycles

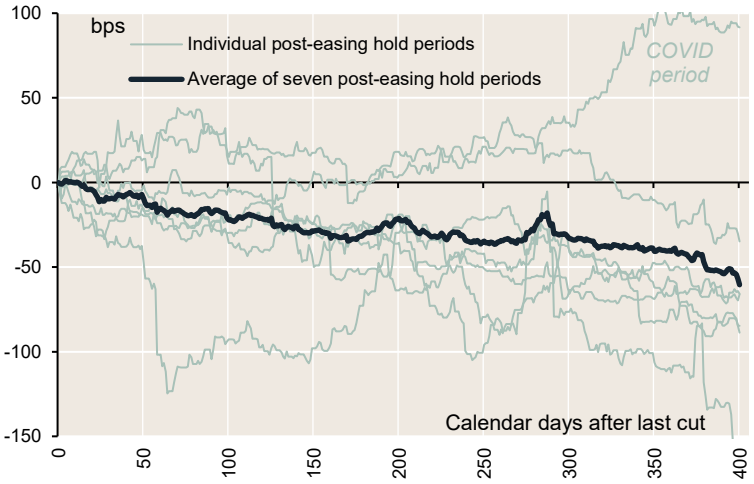


Source: NBC, BBG, BoC | Note: Hold period is defined as the time between final cut of easing cycle and the next hike

History also suggests that the yield curve should flatten in 2026. Since the Bank's final rate cut in October, the curve has done the opposite. However, as we move into 2026 and hikes come closer into focus, we expect the flattener to take hold.

How does the yield curve behave post-cuts?

Change in 2s-10s curve after final cut of historical BoC easing cycles



Source: NBC, BBG | Note: In some cycles, the BoC began hiking before 400 days (x-axis length). These are still included in the sample average.

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