THE GLOBE AND MAIL

Why a steepening yield curve suddenly matters to everyday investors

The Bank of Canada paused rate cuts recently, leading to bond yields rising.

KEVIN FOLEY
SPECIAL TO THE GLOBE AND MAIL
DECEMBER 29, 2025

Most investors know that bond yields have risen recently after the Bank of Canada paused rate cuts, leaving only shorter-term yields lower in 2025.

However, fewer understand the quiet force underneath those headlines – the shape of the yield curve – and why it now plays an unusually important role in determining who wins and who loses in the bond market.

The yield curve is simply a chart of interest rates across different maturities, from very short-term Treasury bills to long-dated government bonds.

Normally, shorter-term bonds yield less than longer-term ones, because investors expect to be paid more for locking up money for longer. But the curve changes shape over time, flattening, inverting, or steepening based on market expectations of growth, inflation and central-bank policy.

Right now, the debate is centred on one thing: steepening. And understanding what that means is essential, because not all steepening is created equal.

Two Types of Steepening – and Why the Difference is Critical

There are two distinct ways a yield curve can steepen, and they could not be more different for bondholders.

1. **Bull Steepening** All yields fall, with short-term yields likely falling faster. Bond prices rise across the board. When the move is caused by a rate-cutting cycle, investors in short-term bonds tend to outperform, but everyone wins.
2. **Bear Steepening** Most or all yields rise, but long-term yields rise much more. This is the painful one. Rising yields push bond prices down, and long-duration bonds – the ones most sensitive to rate movements – fall the hardest.

A growing number of market strategists believe we're in a bear-steepening cycle. That doesn't mean a crash – it means longer-dated yields are likely to drift higher relative to the short end, putting pressure on the price of long-term bonds, and likely any bonds other than the shortest ones.

And here's the part most investors don't realize: your outcome depends almost entirely on the duration of the fund you own.

Why Duration is the Silent Driver of Returns

Duration measures how sensitive a bond or bond fund is to changes in interest rates. Higher duration (or "longer" as expressed in years) means higher volatility and bigger price moves – good when yields fall, painful when they rise.

For example:

- The widely held Canadian bond ETF XBB has a duration of roughly 7.3 years and is still up an unexciting but still positive 2.35 per cent year to date.
- While the Government of Canada 2055 long-dated bond price, with a duration near 19 years, is lower by 6.9 per cent over the same period.

Same market. Very different outcomes – entirely because of duration.

In the bear-steepening environment we are in, that distinction becomes even sharper.

How Bond Investors Can Thrive When Rates Climb

If longer-term yields are poised to rise more than short-term yields, investors essentially face two options:

1. Park funds in ultra-short bonds and accept low returns

Yes, this largely avoids the rate risk – but the trade-off is meagre income, likely in the range of 2.25 to 2.75 per cent. For many investors, that's too low to serve as a meaningful part of a portfolio.

2. Stick with traditional bond funds that can't avoid long-duration exposure

This is the trap most investors don't see. Many bond managers are required to stay close to their benchmark – which often necessitates large allocations to long-dated government bonds.

They are playing a relative game: solely trying to beat the benchmark by a small margin, even if the benchmark itself delivers a weak or even negative return.

Neither option feels particularly compelling.

The Third Option: Short-Term, High-Quality Credit

One area of the bond market looks well-positioned for the current environment: short-term, high-quality corporate credit.

Some specialist managers focus on this segment – and importantly, some do so without meaningful exposure to the long end of the curve. They tend not to mimic a benchmark and have the tools and experience to actively manage corporate bonds.

The advantages are straightforward:

1. **Little to no duration risk** Short-term bonds are far less sensitive to movements in long-term yields. If the curve bear steepens, these bonds typically hold their value far better than broad-based or long-duration funds. Notably, some credit managers eliminate most or all of the interest-rate risk.
2. **A "roll-down" tailwind** As a short-term bond naturally moves toward its maturity date, its yield tends to fall, and its price tends to rise toward par – a built-in source of return that doesn't depend on predicting interest rates.
3. **Attractive credit premiums** High-quality corporate issuers currently pay meaningful spreads over government bonds. This provides a stronger yield without requiring investors to take excessive, or possibly even any duration risk.

In plain terms: investors can still earn an effective return in fixed income without accepting the type of interest-rate exposure that would be punished in a bear-steepening scenario.

A More Intentional Bond Allocation

No one can control the shape of the yield curve, and no forecast is perfect. But investors can control how exposed they are to the parts of the curve most vulnerable to rising yields.

For many, that means looking beyond traditional benchmark-hugging bond funds and toward strategies built to prosper in today's environment – funds that stay short, in high-quality corporate credit, and avoid the pitfalls of duration exposure.

As the curve evolves, the most successful bond investors may simply be those who avoid where the damage is likely to occur.

Kevin Foley is managing director, Institutional Accounts, at Canadian asset manager YTM Capital. He was previously a fixed-income executive at a major Canadian bank and serves on several Canadian foundation boards and investment committees. Kevin.Foley@YTMCapital.com