For the first time since the spring of 2012, the yield on the Canadian benchmark 10-year bond is around the same level as the U.S. 10-year yield. This is not very surprising, however, in the context of optimism currently prevailing in financial markets. Indeed, in the past two years, the spread has tended to close in phases of optimism and expand during periods of pessimism, as U.S. Treasuries benefit more from the safe haven effect.

Observing the highest levels of the spread, we find that they took place during phases of acute crisis. For instance, in August 2011, it was uncertainty over raising the debt ceiling in the United States. During the summer of 2012, the spread peaked in a context of high financial stress in Europe, as Italian and Spanish bond yields reached unsustainable levels. Since the European Central Bank has put in place a credible crisis management mechanism last fall, the yield gap has tended to shrink, consistent with a decrease in risk aversion. At the turn of the year, the partial resolution of the fiscal cliff has added additional downward pressure on the spread. Recently, the dovish tone of the Bank of Canada, and more importantly a generally optimistic mood on markets have reduced the rate differential to zero.

The spread could struggle to fall into negative territory however, as the recent wave of optimism seems overdone. On one hand, the experience of the last three years evidences frequent cases of market exuberance over the economic outlook early in the year, followed by cooling expectations by spring. This could occur earlier this year, as the economic data that will be released in February will contain the first indications of the impact of austerity measures that became effective in the United States at the turn of the year. On the other hand, after the Republicans folded on tax increases and the debt ceiling, they might be more intransigent on the issue of automatic spending cuts costs due to come into effect in March. These uncertainties are likely to cause a slight outperformance of U.S. bonds in February.

Implications: The experience of recent years and future challenges suggest caution against the recent burst of optimism. In this context we expect U.S. bonds to outperform their Canadian counterparts, resulting in a re-widening of the 10-year spread.

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