In a news published in January, we observed that the Canada–U.S. 10-year yield spread tends to narrow in risk-on environment. During these phases, the Canadian dollar generally tends to appreciate. The opposite occurs in risk-off environments. In 2011 and 2012, the correlation between the Canadian dollar and the spread was negative. However, this trend broke in February 2013, as even in a context of risk aversion, Canadian bonds outperformed U.S. Treasuries. The Canadian dollar depreciated during this episode and as a result, the correlation between the 10-year yield spread and the dollar turned positive (graph 1). In light of currently negative speculative positions on the Canadian dollar, some have interpreted this as possibly buttressing continued outperformance of Canadian bonds relative to U.S. bonds.

However, two observations should be made. First, theoretically and empirically, the evolution of the currency follows interest rate differentials and not the opposite. Second, the fact that the correlation has become positive in recent weeks is mainly a result of changes in expectations of monetary policy in Canada. After the efflux of bad data that hit Canada, investors began to pare down their expectations for the amount of Canadian policy tightening that would precede U.S. tightening. This reaction is the common denominator behind the joint decline in spreads and the Canadian dollar. A look at the evolution of the Canada–U.S. differential of priced-in policy rates for a fixed horizon of June 2015, shows a close relationship with the currency (graph 2). A similar observation applies to the 10-year yield spread.

**Implications:** Care should be used in interpreting the evolution of the currency as a precursor signal for spreads. In reality, the two variables are currently governed by the same dynamic, that of monetary policy expectations. In the case of spreads, this element seems to have superseded the effect of risk-on and risk-off patterns that was common over the last two years. In our opinion, and in the light of current macroeconomic trends, this still supports the idea that Canadian bonds could continue to perform well versus U.S. Treasuries over a short-term horizon.

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