The Yield Curve
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Is quantitative easing destabilizing the markets?

HIGHLIGHTS

- The last few weeks have been marked by high market volatility and a rebound in bond yields.
- The increase in Japanese yields is limited for the time being. If this trend gains traction, however, it could have major consequences for Japan's public finances and financial institutions.
- Unlike the situation in Japan, the recent yield increase in North America cannot be explained by an increase in inflation expectations—higher real yields fuelled this increase.
- The worst problem for the Federal Reserve (Fed) in the short term is this: if QE3 resulted in an abnormally weak risk premium, any sign of a QE3 slowdown could have the opposite effect, possibly dragging down investor confidence and lead to a significant tightening of financial conditions.
- Volatility is likely to remain high as long as the Fed is not ready to be more explicit about its intentions.
- Stephen Poloz takes the helm as the new governor of the Bank of Canada (BoC) on June 3. It would be very surprising if he were to go against the BoC's current consensus. We should not expect any major shake-ups in the statements to be released by the monetary authorities in the next few months.

CONTENTS

Editorial 1
Monetary Policy
Federal Reserve 3
Bank of Canada 4
Overseas central bank 5
Bond market
United States 6
Canada 7
Tables 8-9

Editorial

A few interesting trends have emerged in recent weeks. Most risk assets continued to do well, with one exception: commodities. The least risky government bond rates were up significantly, as the 10-year U.S. yield shot up from below 1.65% in early May to about 2.15%. Lastly, the markets experienced several highly volatile episodes. Except for the positive U.S. job data, which pushed up rates by about 10 basis points, major financial market moves seem to have been caused by shifts in investor sentiment vis-à-vis the actions taken by the Bank of Japan (BoJ) and the Federal Reserve (Fed).

THE BoJ FINDS ITSELF IN A DIFFICULT POSITION

When he was named to lead the BoJ, the new governor Haruhiko Kuroda clearly stated his determination to defeat deflation and wrestle inflation back to its 2% target. To achieve this objective, the BoJ decided to double its monetary bases by the end of 2014 by buying up massive amounts of government bonds. The initial market response was very positive: the stock markets and bonds in Japan both surged. However, Japan's financial markets have been punctuated by high volatility in the past few weeks, and the 10-year rate reached a peak not seen in more than a year.

That bond yields jumped after the BoJ announced its intention to buy up massive amounts of government bonds may seem incomprehensible. What is important to retain is that bond yields can be divided into two parts: the real rate of return and inflation expectations. By announcing extraordinary measures to combat deflation, the BoJ succeeded in boosting inflation expectations closer to the 2.0% target (graph 1 on page 2). Unless investors can be convinced—or forced—to accept real rates that fall as much as inflation expectations rise, an increase in nominal interest rates is inevitable.

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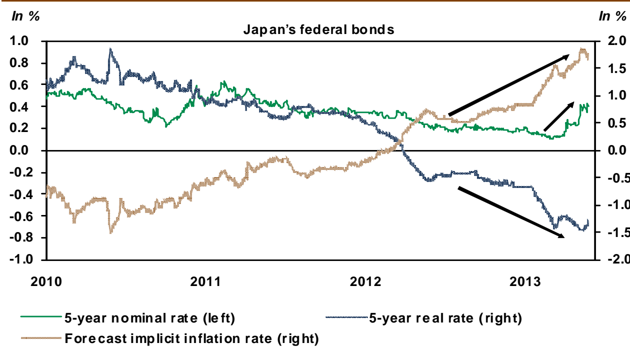
Graph 1 – Japan's inflation expectations on an upward tangent in recent quarters



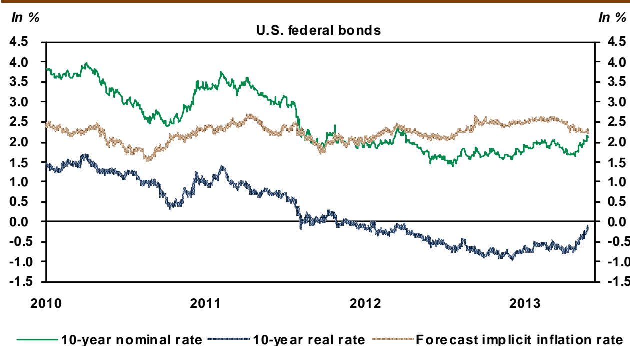
Sources: Bloomberg and Desjardins, Economic Studies

The increase in yields is limited for the time being. If this trend gains traction, however, it could have major consequences for Japan's public finances and especially for financial institutions. The BoJ's own estimates show that a 1% increase in Japan's interest rates would wipe out 20% of the Tier 1 capital held by regional banks—with major banks losing 10%. The reality is that several sectors of Japan's economy have come to depend on extremely low interest rates.

DOES THE Fed LONG FOR THE DAYS OF THE SUBPRIME BUBBLE?

Unlike the situation in Japan, the recent yield increase in North America cannot be explained by an increase in inflation expectations—higher real yields fuelled this increase (graph 2). In fact, the latest statistics point to steep disinflation in the United States and Canada. The main objective of the Fed's third quantitative easing program (QE3) was not to prevent deflation, but rather to stimulate faster growth in the job market.

Graph 2 – Inflation expectations have declined and real rates have recovered in the United States



Sources: Bloomberg and Desjardins, Economic Studies

William Dudley, the president of the New York Federal Reserve, recently explained how QE3 works: "*Our view is that asset purchases work primarily through the asset side of the balance sheet by transferring duration risk from the private sector to the central bank's balance sheet. This pushes down risk premia, and prompts private sector investors to move into riskier assets.*"

Based on this vision of quantitative policy, stock markets around the world are surging and credit spreads are falling because of the actions taken by the central banks. This approach, however, raises several questions. First, should we always be keen to see the risk premium drop? The last few years have shown that when a financial crisis occurs, there are times when central banks should support certain financial securities. That said, nothing today suggests that the U.S. markets are not functioning smoothly and risk premiums are already very weak. By attempting to push them down further, is the Fed not risking to create another financial crisis with similar causes to the one in 2007–2008?

Another problem with this approach is that it depends largely on investor sentiment, a variable that is very difficult to control, as the Fed does not have a tool to target the risk premium directly. This approach is also very imprecise. Improved investor sentiment can boost a range of risky financial assets around the world, instead of those that have more of a direct influence on job creation in the United States.

The worst problem for the Fed in the short term is this: if QE3 resulted in an abnormally weak risk premium, any sign of a QE3 slowdown could have the opposite effect, possibly dragging down investor confidence and lead to a significant tightening of financial conditions. Investors' aggressive response to recent comments by the Fed's leaders highlights this problem. The numerous criticisms levelled both internally and externally, and the high volatility seen recently on the markets should prompt the monetary authorities to act with great caution as of now. However, volatility is likely to remain high as long as the Fed is not ready to be more explicit about its intentions.

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FEDERAL RESERVE

The Federal Reserve struggles to clearly state its intentions

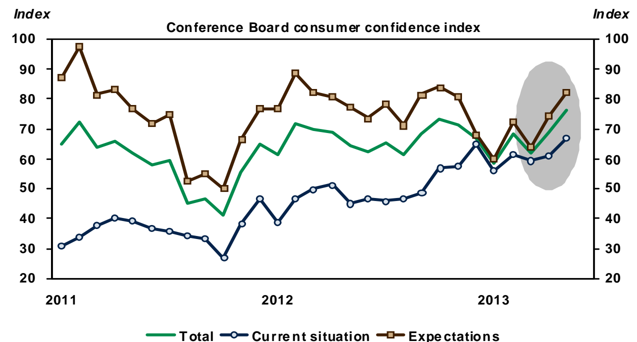
- While the economy continues to grow and financial markets are far from being in a state of crisis, times are relatively tough for leaders of the Federal Reserve (Fed). Investors are still sifting for clues in each comment or speech made by those who set monetary policy, but the message does not always have the intended effect. It is difficult for the Fed to establish a clear line of communication with financial market stakeholders.
- The state of the economy is one of the reasons for the confusion surrounding the monetary policy. The labour situation is a bit better than what the preliminary data for March, published in early April, suggested, but not strong enough to send a clear signal to the Fed that it should cut back on its quantitative policy. In addition, the minutes of the Fed's last meeting stated that corporations continued to be prudent about their investments and hiring. The weak ISM readings for the past two months reflect these concerns (graph 3). On the other hand, consumers are holding up quite well, with confidence gaining ground bit by bit, helped by lower gas prices (graph 4).
- Even if the economy and jobs were to grow at a somewhat faster pace, the Fed would still be facing the dilemma of weakening inflation. The annual change in the total consumer price index is currently at its weakest rate since fall 2010, and the core consumer spending deflator, which excludes food and energy, currently stands at just 1.1%, well below the Fed's 2.0% target. Faster hiring and higher inflation would simplify things for the Fed, by making a clear call to cut back on securities purchases. The reverse could instead prompt the Fed to boost its quantitative measures. The current situation—two indicators charting divergent paths—is simply complicating the task for monetary policy committee members (graph 5).
- It is no surprise then that this situation seeps through the opaque communications released by the Fed's leaders. The minutes of the last meeting stated that one committee member was ready to start cutting back on securities purchases, while another wanted to boost purchases immediately. Others seem to prefer a tapering that would begin at the meeting in June. That said, Ben Bernanke recently expressed reservations about beating a hasty retreat. Faced with such contradictions, our scenario that calls for a gradual reduction of purchases as of this fall is still appropriate.

Forecasts: The quantitative policy should keep the same pace—US$85B each month—until fall. The monthly purchases should then start to level off and wind up completely in spring 2014. In terms of key rates, we do not anticipate any rate increases before mid-2015.

Graph 3 – ISM indexes are down in the United States

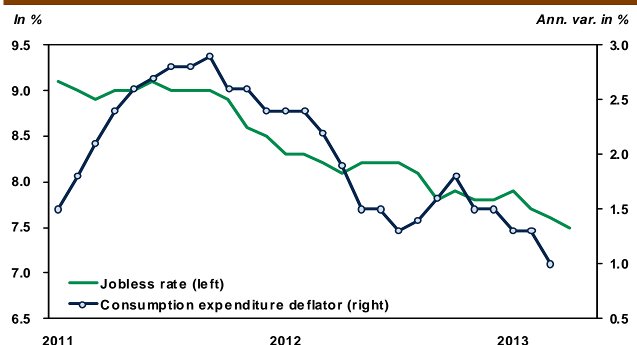
Sources: Institute for Supply Management and Desjardins, Economic Studies

Graph 4 – U.S. consumer confidence is climbing



Sources: Conference Board and Desjardins, Economic Studies

Graph 5 – Jobless rate and inflation are both down in the United States



Sources: Bureau of Labor Statistics, Bureau of Economic Analysis and Desjardins, Economic Studies

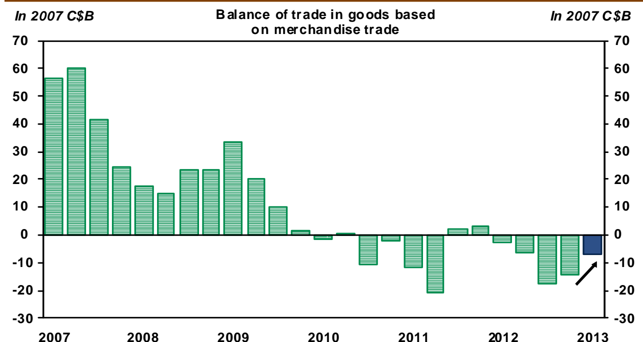
BANK OF CANADA

Stephen Poloz's arrival is unlikely to usher in change

- Stephen Poloz takes the helm as the new governor of the Bank of Canada (BoC) on June 3. Since Mr. Poloz is recognized as a team player, it would be very surprising if he were to go against the BoC's current consensus. We should not expect any major shake-ups in the statements to be released by the monetary authorities in the next few months.
- That said, Canada's economy could deliver a surprise in the first quarter of 2013, posting growth that is much more robust than in previous quarters. The lion's share of this upturn is likely to stem from an increase in exports (graph 6). While this is clearly good news, it in no way guarantees that Canada's economic outlooks will improve to any sustainable degree, with growth expected to be fairly modest in the months ahead.
- On one hand, the global economy is still dealing with many difficulties, particularly the ongoing recession in Europe. In such conditions, the problems with Canada's exports are likely to resurface soon. On the other hand, signs of a slowdown in domestic demand are popping up all over the country—the real estate market is trending downward and budget deficit battles continue to roil.
- Based on our most recent projections, the negative output gap may not fully close until mid-2015; a forecast that is similar to the BoC's (graph 7).
- The annual inflation rate declined from 1.0% in March to only 0.4% in April (graph 8), a level that is below the lower bound of the target range (1%). There is one reassuring factor, however: the risks of another pullback in the inflation rate in the coming months are fairly weak. Not only did gas prices creep up by 2.8% in May, the seasonal effects should increase significantly, which is likely to propel the annual inflation rate back up as of next month. Other than some volatility in the monthly results, Canada is clearly still mired in a weak price growth episode, underpinned in large part by the persistent negative output gap.

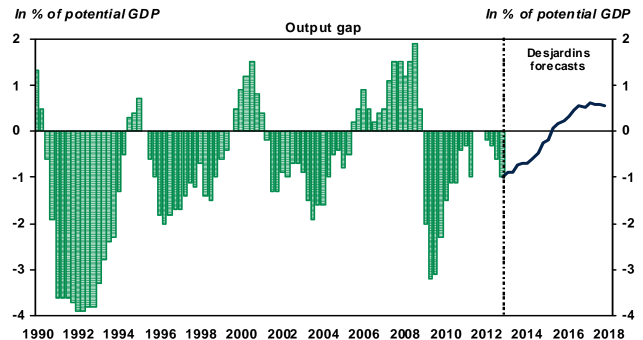
Forecasts: As the monetary authorities keep repeating, the BoC's next move should be to increase the target for the overnight rate to gradually reduce the considerable monetary easing currently in place. The current level of key rates will remain appropriate for several more quarters, however, due to the many difficulties that remain, both internally and externally. Under these circumstances, we still believe that the BoC will wait until fall 2014 before it initiates key rate increases.

Graph 6 – Canada's trade balance improved in Q1 2013



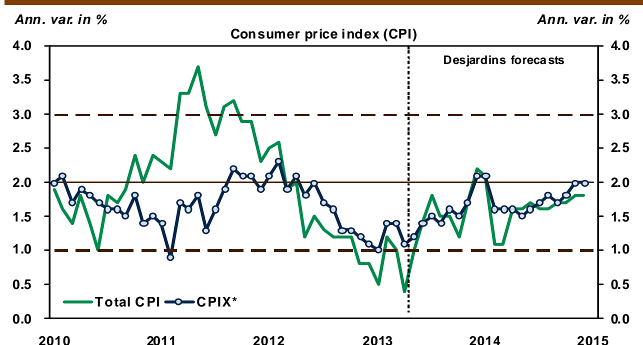
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 7 – No return to full potential is expected before 2015 in Canada



Sources: Bank of Canada, Statistics Canada and Desjardins, Economic Studies

Graph 8 – Inflation in Canada set to remain fairly weak



* Bank of Canada core index.
Sources: Statistics Canada and Desjardins, Economic Studies

OVERSEAS CENTRAL BANK

The European Central Bank took action

EUROPEAN CENTRAL BANK (ECB)

- After a few months of hesitation, the ECB finally announced monetary easing measures at the start of May. While the 25 basis point cut to the ECB's primary key rate had been anticipated amid an ongoing recession and a 1.2% decline in inflation in April, May's meeting held a few surprises. First of all, Euroland's monetary authorities clearly indicated that further key rate cuts were possible and Mario Draghi did not rule out lowering the deposit rate into negative territory. Some ECB leaders don't seem at ease with this last option, however. The ECB also announced that it was extending the extraordinary measures to provide the banking sector with unlimited liquidity. Lastly, the ECB decided to initiate consultations with other European institutions on initiatives to promote a functioning market for asset-backed securities collateralised by loans to non-financial corporations.

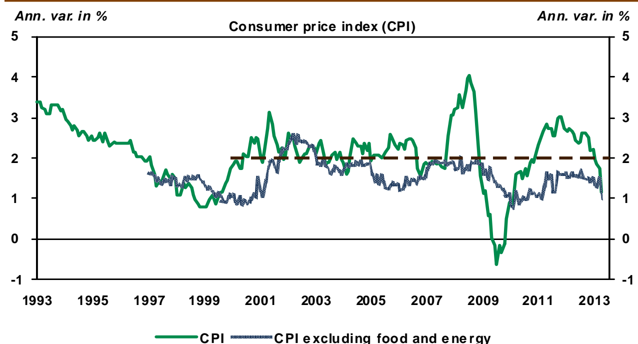
BANK OF ENGLAND (BoE)

- The BoE did not announce any changes at its latest monetary policy meetings. It did announce an improvement to the Funding for Lending program in mid-April, primarily aimed at stimulating business credit. With Britain's economy returning to growth in the first quarter of 2013, the BoE slightly upgraded its forecast for economic growth in its last Inflation Report. All signs point to inflation staying above the 2.0% target for several more quarters. Despite this, three of the nine analysts on the monetary policy committee continue to vote in favour of new financial asset purchases by the BoE. The arrival of Mark Carney in early July could have some influence on the internal discussions and communications released by the BoE.

BANK OF JAPAN (BoJ)

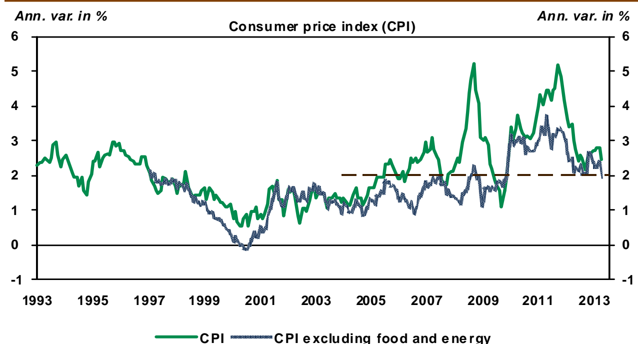
- The honeymoon is already over for the BoJ's new governor, with Japan's surging stock market and bonds giving way to a correction and high volatility (see the editorial). While the BoJ did not announce any new measures at its last meeting, the upgrade to its inflation forecasts shows that the 2% target will be difficult to achieve in 2014. The minutes of its last meeting revealed that certain BoJ leaders were not convinced that the increase in inflation expectations would push inflation higher. Moreover, the leaders seemed to grasp the importance of making sure the BoJ's massive securities purchases do not destabilize the markets.

Graph 9 – Inflation rate in the euro zone



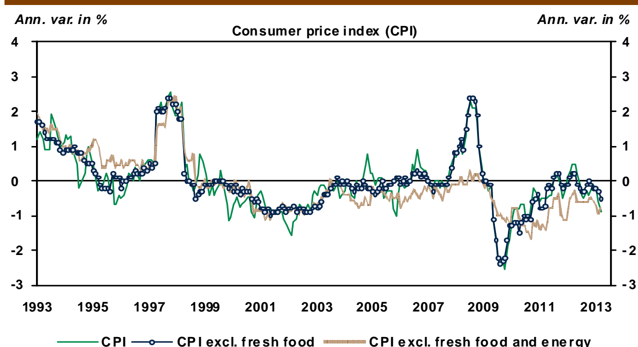
Sources: Datastream and Desjardins, Economic Studies

Graph 10 – Inflation rate in the United Kingdom



Sources: Datastream and Desjardins, Economic Studies

Graph 11 – Inflation rate in Japan



Sources: Datastream and Desjardins, Economic Studies

BOND MARKET

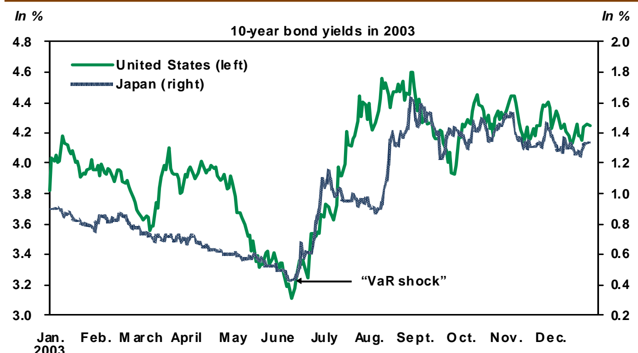
Tensions could remain until the Federal Reserve makes its message clearer

U.S. FEDERAL BONDS

- The U.S. bond market's reversal in May could be qualified of spectacular. After the collapse that saw it plummet to below 1.65% in early May , the 10-year yield recovered by over 50 basis points—the highest monthly increase since December 2010, when the Federal Reserve (Fed) announced a second round of quantitative easing.
- The move was triggered by the job creation figures for April, which beat expectations. Investors then started paying close attention to the influence of Japan's monetary policy. Among other things, fast-rising yields in Japan fuelled fears of a mass bond selloff by Japan's major banks to cut down their exposure.. One such episode occurred in 2003 ("VaR shock"), when Japan's banks also liquidated a large number of U.S. bonds, causing rates to rise in the United States as well (graph 12). The reinforcement of the correlation between U.S. and Japanese bonds (graph 13) fuelled concerns about the possibility of a similar dynamic.
- However, it was the rumours and the public statements associated with the Fed that had the most significant impact on bond yields. Even if we find the overall message conveyed by the Fed's leaders to remain reasonably dovish, investors reacted strongly to the fact that some members of the monetary policy committee have expressed a bias towards reducing purchases as of the meeting of June.
- The magnitude of the markets' response could be partly explained by the fact that most expected purchases to start winding down at a later date, (i.e. end of 2013). The reaction seems somewhat excessive however, especially given the current growth momentum. In that respect, the sharp increase in real yields in May (which for the most part explains the rebound in nominal rates) is inconsistent with economic reality (graph 14). In our opinion, the sharp increase is partly tied to the uncertainty about when monetary stimulus should be withdrawn, something even the Fed seems indecisive about right now. We can nevertheless expect somewhat of a pullback once the U.S. central bank sends a clearer message.

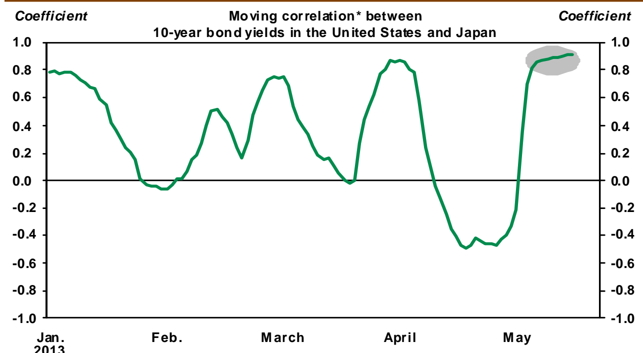
Forecasts: To account for the earlier-than-expected start of the speculation phase surrounding the Fed's monetary policy, we are adjusting our yield target upward for the end of the second quarter. We still expect the 10-year yield to remain below the 2.0% level at the end of June, as the still-fragile economic climate and a clearer message from the Fed should allow bonds to recover a portion of their recent losses.

Graph 12 – In 2003, the sudden rate rebound in Japan following the "VaR shock" had an impact on U.S. rates



Sources: Bloomberg and Desjardins, Economic Studies

Graph 13 – Reinforcing the link between U.S. and Japanese rates created concerns of a repeat of the 2003 episode



* Over four weeks.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 14 – Real rates recovered amid disappointing economic data

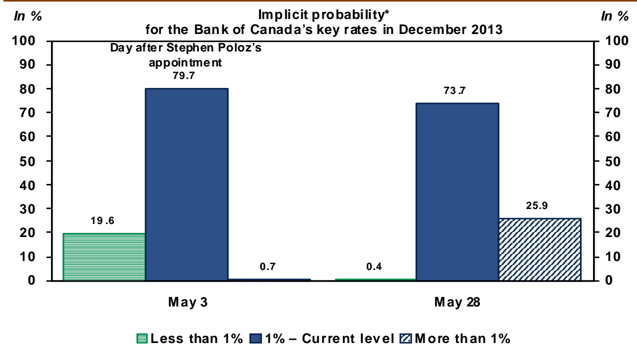
Sources: Bloomberg, Citigroup and Desjardins, Economic Studies

CANADIAN FEDERAL BONDS

- One could not have expected Canadian yields to remain steady in such volatile global bond market environment. In addition to external influences, economic indicators showing that first quarter GDP growth significantly outpaced early expectations paved the way for the increase in Canadian yields.. The light narrowing of the output gap that may result provide counterweight to a pronounced deflationary trend in the last few months, with year-over-year headline CPI slipping to only 0.4% in April, significantly below the lower bound of the operational target range set by the Bank of Canada (BoC).
- Overall, the integration of these factors has resulted in a complete elimination of expectations for rate cuts (graph 15). The appointment of Stephen Poloz as new governor was initially viewed as carrying dovish implications. His expertise in international trade had some investors believing that policy would now be more inclined to counter upward currency movements. In hindsight, investors instead concluded that the arrival of Mr. Poloz would have little influence on the BoC's stance in the near term.
- The end result of the forces at play was a marked steepening of the Canadian curve. The 15 basis points of steepening of the 2/10 curve represents one of the strongest monthly increases of the past three years. That said, the steepening was weak compared to what the United States, Germany and Japan experienced. The curve also remains one of the flattest in the world (graph 16). The slower steepening in Canada also ushered in a narrowing of the spreads between U.S. and Canadian long yields. The 10-year yield spread fell into negative territory while the 30-year rate plummeted by almost 20 points, to -65 basis points (graph 17).
- Compared to our views of last month, we must to acknowledge that the recent moves have been more drastic than expected. However, Canadian bond market outperformance when speculation on the withdrawal of stimulus measures kicks off in the United States is a theme we have maintained since the beginning of the year. Even though we expect long yields to subside somewhat until the end of June, the good performance vis-à-vis the United States may be sustained for a few weeks, especially given that the nervousness surrounding monetary policy in the United States is likely to remain in place until the Fed makes its next decision. The short end of the curve should stay relatively well anchored, especially against weak inflation and the prospect of weaker growth in the second quarter.

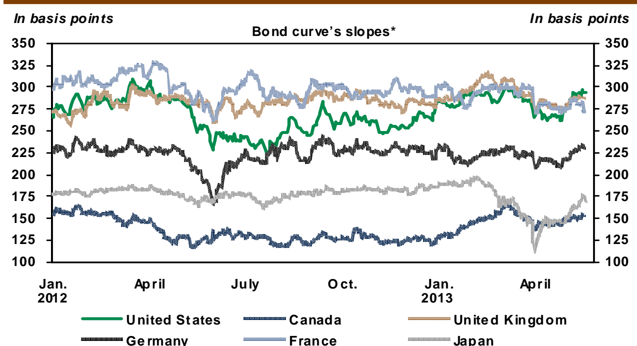
Forecasts: In line with our forecasts for the United States, we are revising our targets for Canadian bond yields upward for the end of the current quarter. Nevertheless, we currently expect yields to increase somewhat less rapidly in the third quarter and our year-end targets remain unchanged.

Graph 15 – The perspective of a more dovish Bank of Canada under Stephen Poloz didn't last long



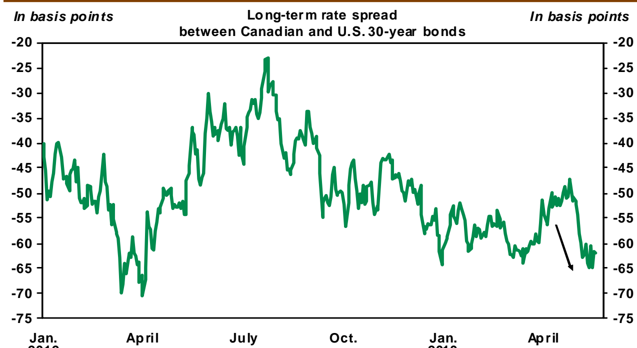
* Based on swap rates indexed to the overnight rate.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 16 – The Canadian curve remains among the world's flattest



* Spread between 30- and 2-year rates.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 17 – The long-term rate spread is back to the trough reached in April 2012



Sources: Datastream and Desjardins, Economic Studies

Table 1
Key interest rates

End of period in %	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2f	2013 Q3f	2013 Q4f	2014 Q1f	2014 Q2f	2014 Q3f	2014 Q4f
United States												
Federal funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Canada												
Overnight funds	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.50
Euro zone												
Refinancing rate	1.00	1.00	0.75	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.50	0.50
United Kingdom												
Base rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Japan												
Overnight funds	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Table 2
Schedule and key rates

Date	Central Bank	Decision	Rate
March 2013			
6	Bank of Japan	s.q.	0.10
7	European Central Bank	s.q.	0.75
7	Bank of England	s.q.	0.50
8	Bank of Mexico	-50 b.p.	4.00
13	Reserve Bank of New Zealand	s.q.	2.50
14	Bank of Norway	s.q.	1.50
14	Swiss National Bank	s.q.	0.00
20	Federal Reserve	s.q.	0.00 / 0.25
April 2013			
1	Reserve Bank of Australia	s.q.	3.00
4	European Central Bank	s.q.	0.75
4	Bank of England	s.q.	0.50
4	Bank of Japan	s.q.	0.10
17	Bank of Sweden	s.q.	1.00
17	Bank of Brazil	+25 b.p.	7.50
17	Bank of Canada	s.q.	1.00
23	Reserve Bank of New Zealand	s.q.	2.50
26	Bank of Japan	s.q.	0.10
26	Bank of Mexico	s.q.	4.00
May 2013			
1	Federal Reserve	s.q.	0.00 / 0.25
2	European Central Bank	-25 b.p.	0.50
7	Reserve Bank of Australia	-25 b.p.	2.75
8	Bank of Norway	s.q.	1.50
9	Bank of England	s.q.	0.50
22	Bank of Japan	s.q.	0.10
29	Bank of Brazil	+50 b.p.	8.00
29	Bank of Canada	s.q.	1.00

s.q.: status quo; b.p. : basis points
Source: Desjardins, Economic Studies

Table 3
Coming soon

Date	Central Bank
June 2013	
4	Reserve Bank of Australia
6	European Central Bank
6	Bank of England
7	Bank of Mexico
11	Bank of Japan
12	Reserve Bank of New Zealand
19	Federal Reserve
20	Bank of Norway
20	Swiss National Bank
July 2013	
2	Reserve Bank of Australia
3	Bank of Sweden
4	European Central Bank
4	Bank of England
10	Bank of Brazil
11	Bank of Japan
12	Bank of Mexico
17	Bank of Canada
24	Reserve Bank of New Zealand
31	Federal Reserve
August 2013	
1	European Central Bank
1	Bank of England
6	Reserve Bank of Australia
8	Bank of Japan
28	Bank of Brazil
September 2013	
3	Reserve Bank of Australia
4	Bank of Canada

Source: Desjardins, Economic Studies

Table 4
United States: fixed income market

End of period in %	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2f	2013 Q3f	2013 Q4f	2014 Q1f	2014 Q2f	2014 Q3f	2014 Q4f
Key rate												
Federal funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Treasury bills												
3-month	0.07	0.09	0.10	0.05	0.07	0.05	0.10	0.15	0.15	0.20	0.20	0.25
Federal bonds												
2-year	0.35	0.32	0.24	0.24	0.25	0.25	0.30	0.35	0.40	0.45	0.45	0.50
5-year	1.03	0.72	0.61	0.70	0.74	0.85	0.95	1.20	1.30	1.35	1.40	1.60
10-year	2.22	1.66	1.64	1.75	1.85	1.95	2.05	2.30	2.45	2.50	2.55	2.70
30-year	3.35	2.77	2.83	2.94	3.11	3.10	3.20	3.40	3.50	3.55	3.65	3.80
Yield curve												
5-year - 3-month	0.96	0.63	0.51	0.65	0.67	0.80	0.85	1.05	1.15	1.15	1.20	1.35
10-year - 2-year	1.87	1.34	1.40	1.51	1.60	1.70	1.75	1.95	2.05	2.05	2.10	2.20
30-year - 3-month	3.28	2.68	2.73	2.89	3.04	3.05	3.10	3.25	3.35	3.35	3.45	3.55

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Table 5
Canada: fixed income market

End of period in %	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2f	2013 Q3f	2013 Q4f	2014 Q1f	2014 Q2f	2014 Q3f	2014 Q4f
Key rate												
Overnight funds	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.50
Treasury bills												
3-month	0.92	0.88	0.97	0.92	0.97	0.95	1.00	1.00	1.00	1.00	1.20	1.50
Federal bonds												
2-year	1.20	1.03	1.07	1.14	1.00	1.00	1.05	1.10	1.20	1.40	1.60	1.75
5-year	1.57	1.25	1.27	1.36	1.30	1.35	1.45	1.70	1.85	2.00	2.15	2.30
10-year	2.11	1.74	1.73	1.80	1.76	1.90	1.95	2.20	2.35	2.45	2.55	2.70
30-year	2.66	2.33	2.32	2.37	2.51	2.55	2.70	2.90	3.00	3.10	3.20	3.35
Yield curve												
5-year - 3-month	0.65	0.37	0.30	0.44	0.33	0.40	0.45	0.70	0.85	1.00	0.95	0.80
10-year - 2-year	0.91	0.71	0.66	0.66	0.76	0.90	0.90	1.10	1.15	1.05	0.95	0.95
30-year - 3-month	1.74	1.45	1.35	1.45	1.54	1.60	1.70	1.90	2.00	2.10	2.00	1.85
Spreads (Canada - U.S.)												
3-month	0.85	0.79	0.87	0.87	0.90	0.90	0.90	0.85	0.85	0.80	1.00	1.25
2-year	0.85	0.72	0.83	0.90	0.75	0.75	0.75	0.75	0.80	0.95	1.15	1.25
5-year	0.54	0.53	0.66	0.66	0.56	0.50	0.50	0.50	0.55	0.65	0.75	0.70
10-year	-0.11	0.08	0.09	0.05	-0.09	-0.05	-0.10	-0.10	-0.10	-0.05	0.00	0.00
30-year	-0.69	-0.44	-0.51	-0.57	-0.60	-0.55	-0.50	-0.50	-0.50	-0.45	-0.45	-0.45

f: forecasts
Sources: Datastream and Desjardins, Economic Studies