

ECONOMIC NEWS

Is the correlation with U.S. interest rates too high?

COMMENTS

The correlation between Canadian and U.S. bond yields is currently very high (graph 1). Canadian rates are therefore tracking their U.S. counterparts very closely. This is not an unusual phenomenon given the close ties between the Canadian and U.S. economies and financial markets. It may still seem odd in the current context, given that the factors that are buoying interest rates in the United States are not all present in Canada.

If rates have gone up in the United States, it is mainly because investors are more optimistic about the economy and inflation, and are anticipating stronger monetary firming. Donald Trump's pledges on tax cuts and infrastructure spending may also be having an upside impact on rates, by intimating faster growth of U.S. debt.

Canada's economy improved recently, but inflationary pressure remains subdued, suggesting that monetary firming will not come for some time. Also, the Bank of Canada continues to point to many downside risks, carrying a lot of uncertainty about future economic growth. The situation in Canada is thus less favourable to a rise by bond yields. The correlation between Canadian and U.S. 2-year yields is especially hard to explain given the expected monetary policy divergence.

In Europe, in contrast, the correlation with U.S. yields has declined, particularly with 2-year yields (graph 2). This is a good reflection of the expected monetary policy divergence and the downside risks that are still hovering over Europe's economy.

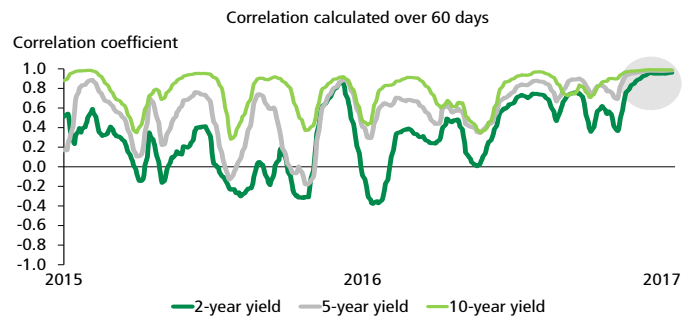
IMPLICATIONS

Failing some upheaval in the U.S. situation, it is hard to believe that Canadian yields will remain this closely correlated with U.S. yields. This seems to be particularly true for shorter-term yields, like the 2-year yield.

A weaker correlation would imply widening rate spreads with the United States, which would take the Canadian dollar down. This

GRAPH 1

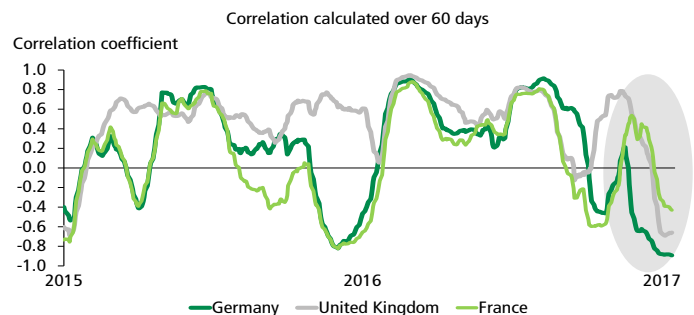
Strong correlation between Canadian and U.S. yields



Source: Desjardins, Economic Studies

GRAPH 2

The correlation with the U.S. 2-year yield is inverted in Europe



Source: Desjardins, Economic Studies

is one of the assumptions included in our forecasts for the loonie. We believe it could go closer to US\$0.70 by the end of the year.

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