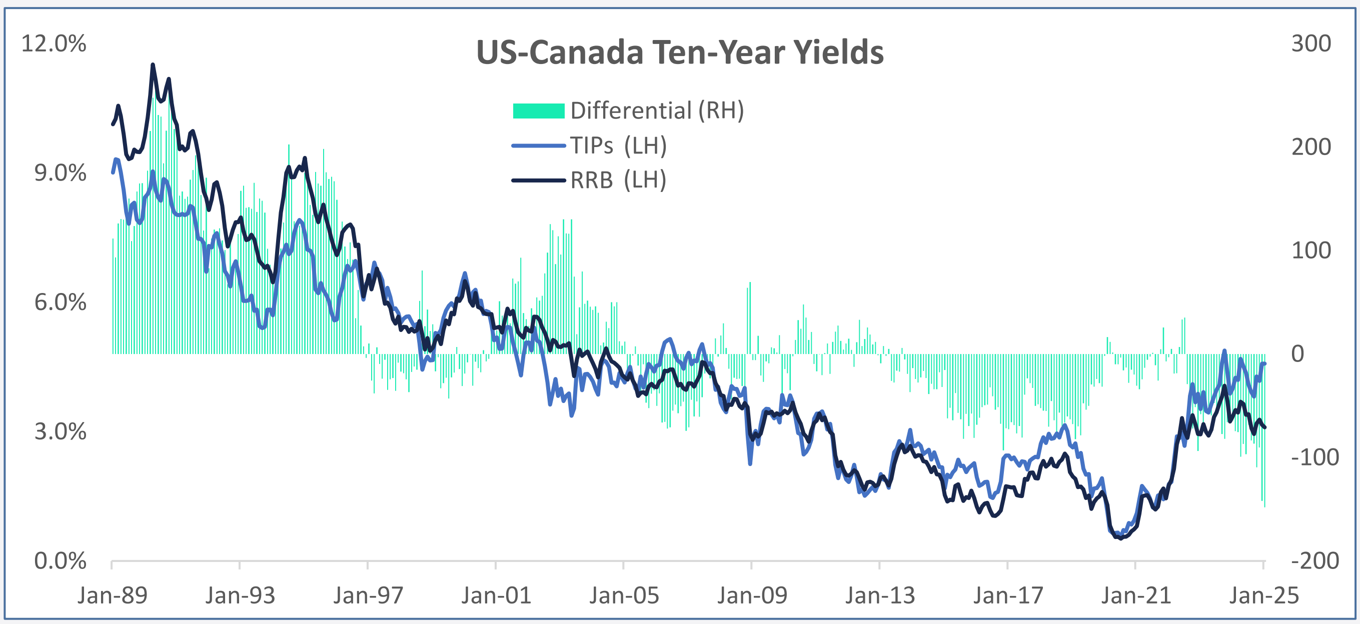
# Do US TIPs Really Hedge Canadian Inflation Risk?

Since May of 2024, a portfolio of US TIPS of same maturity has underperformed the Bloomberg RRB inflation index by 5.1% to mid-January, mostly because of the widening long-term interest differential between the US and Canada.

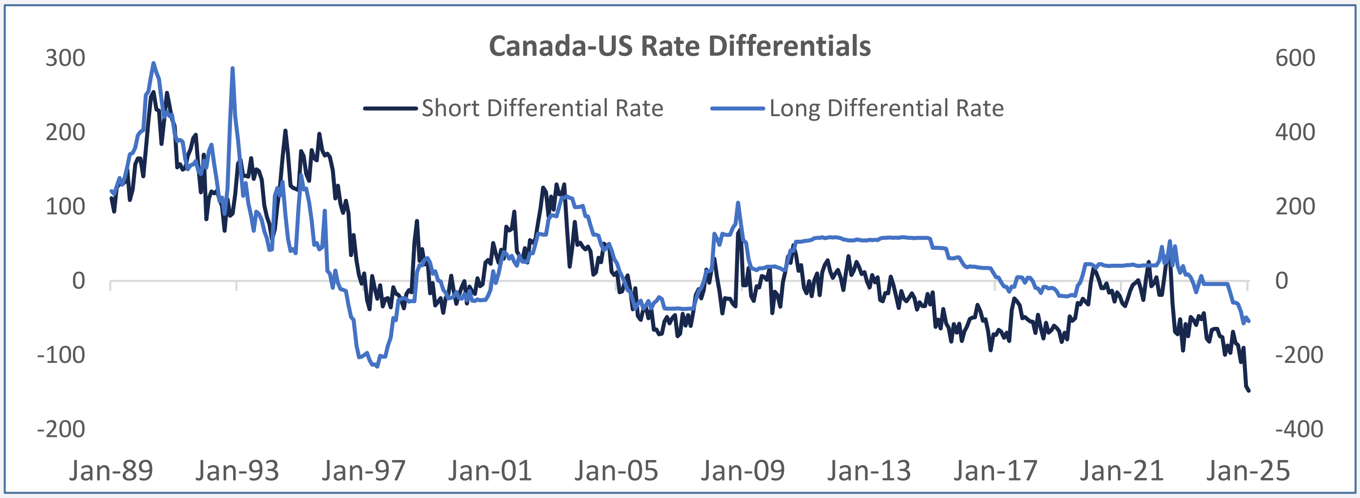
Many Canadian investors who chose US TIPS for inflation protection after RRB's issuance was cancelled in November 2022 did so based on the high correlation of daily returns between US TIPS and the RRB index. But correlation doesn't imply causation, meaning that the forces driving interest rates emerge from the economies of the US and Canada respectively which at times can move apart.




The economies of the US and Canada diverge cyclically *and* structurally given that the underlying structure of the two economies are vastly different, and this can lead to vastly different macro policy settings. Cyclical divergences are usually the product of a swing in commodity prices and are mostly absorbed by the exchange rate constraining interest rate differentials to a +/- 100 basis point range, often for a short period of time. But structural divergences can be prolonged and can lead to significant short and/or long-term interest rate differentials that persist for a significant period.

Canada-US short-rate spreads were +500 bps and ten-year spreads were + 250 bps in the early 1990s as the Bank of Canada held short rates above US rates to bring inflation down to 2.0%. By the second half of the 1990s short-rates and ten-year spreads were about 60bps below the US to offset the fiscal drag on economic growth as deficits swung to surpluses.

Today, Canada is experiencing a cyclical divergence – showing relative growth underperformance and weak income growth compared to the US. Canada is also facing a large structural shock from the potential imposition by the US of 25% tariffs on Canadian exports. Tariffs of this magnitude would increase price pressure for both countries, but they threaten to reignite US inflation as the economy is already in excess demand. In contrast, Canada would experience a large demand shock which means higher prices from retaliatory tariffs would likely soon dissipate. With economic slack likely to rise, the Bank of Canada could ease even more.




Given these pressures, the short-term interest rate differential has opened-up, pulling the Canadian yield curve away from the US. Moreover, real interest rates in the US have been rising rapidly on expectations additional fiscal stimulus lies ahead that will increase excess demand. While this has yet to be priced into US short rates, the long end has moved higher accounting for the bulk of the US TIPS underperformance vs RRBs.

As recent price action demonstrates, the potential difference in Canada-US inflation is not the only source of TIPS underperformance. The widening real yield differential is a powerful driver of underperformance and so is a major, underappreciated, risk.

This year shows that while rare, long rate divergence does occur and has been acute, with the Canada-US long term yield gap widening to all time highs, hitting 140 basis points in January (see chart above).

We presented, in early 2024, our innovative RRBs Dynamic Proxy Strategy, many investors indicated that they used or considered TIPS as a proxy to manage Canadian inflation risk. We highlighted the rate divergence as an important risk which our Canada focus solution avoided.

Since then, this risk which had been absent for many decades materialized with important mark-to-market underperformance for investors and validate the resiliency and relevance of our Canada focused RRB Dynamic Proxy Strategy.

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