Q. Reference: CA-NP-076

The response states that "Mr. Coyne does not view the higher government bond yields in the U.S. as a sign that the U.S. market is more risky than Canada." He then goes on to attribute the comparatively lower Canadian bond yields to factors that are contributing to existing weakness in the Canadian economy, which also seem to suggest greater risk for Canada relative to the U.S. Is it Mr. Coyne's contention that bond investors do NOT require higher yields on bonds with higher risk, and in fact they require higher yields on lower risk bonds? Please elaborate.

A. No. Mr. Coyne's contention is not that bond investors do not require higher yields on bonds with higher risk. The primary differentiating factor among risk-free government bond yields across countries with similar country risk, such as Canada and the U.S., is the variability in forecast levels of inflation. The higher interest rates in the U.S. are likely attributable to higher inflation expectations in the wake of continued U.S. economic expansion, particularly as the U.S. takes its first steps toward economic normalization, after the Federal Reserve raised short-term interest rates in December 2015 by 25 basis points, the first such increase in nine years. In Canada, however, the economy spent the first half of 2015 in a technical recession, primarily due to the impact of the severe downturn in oil prices that has had a relatively greater impact on the Canadian economy. Generally, in recession, inflation expectations decrease as spare capacity leads to the lowering of prices and accordingly inflation.

Mr. Coyne believes the government bond yields in the U.S. are higher than those in Canada, not because the U.S. is riskier than Canada, but because inflation expectations have increased in the U.S. as a result of its more robust economic expansion. Canadian inflation expectations have remained low as Canada continues its stimulus measures in attempts to stave off recession.