**Index Insights** | Fixed Income

# After the great de-coupling - a Canadian credit index allowing independent hedging

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# Executive Summary

- The correlation of Canadian government bond yields, policy rates and credit spreads with the US continues to fall, reflecting lower Canadian inflation and debt issuance.
- The case for hedging Canadian credit and interest rate risk independently has increased accordingly.
- To enable independent hedging and trading of Canadian credit spreads, with no counter-party risk, FTSE Russell has designed the FTSE Canada Bank Credit Spread Index Series.
- …which also maps credit spreads to underlying Canadian government bonds and futures contracts on the Montreal exchange.
- The ability to blend, or isolate, credit and rate risk are key features of the FTSE Russell Canadian Bank Credit index, which gives a wide range of use cases for hedging and trading.
- Such use cases are not available in CDS contracts since they are pure credit risk instruments, and also carry bilateral counter-party risk, as OTC derivatives.

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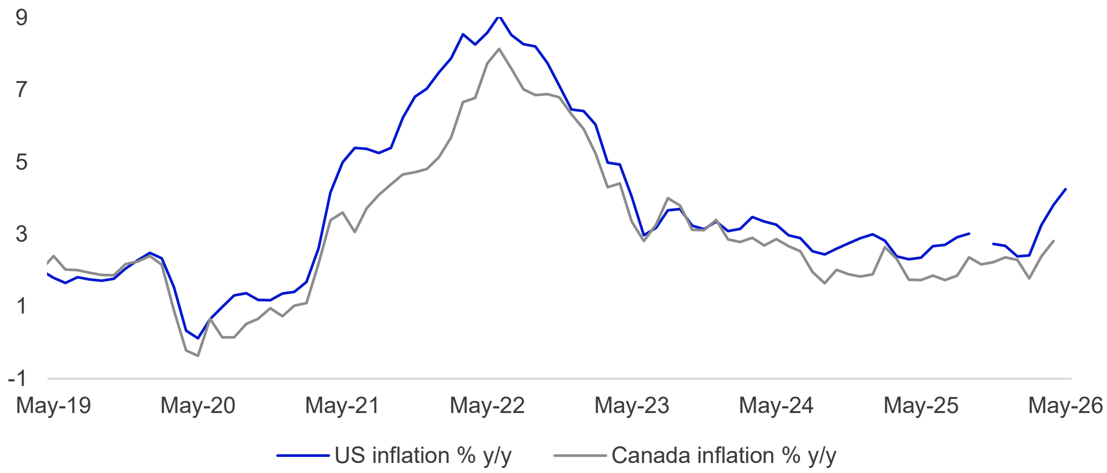
# Introduction

Canadian interest rates and bond yields have diverged sharply from the US in this rate cycle. Several factors have driven this divergence – lower Canadian inflation than US, weaker growth, the Bank of Canada's (BoC) monetary policy adjustments in advance of the US Fed, and less Canadian debt issuance, thanks to a less stimulative fiscal stance. Chart 1 shows consistently lower Canadian inflation relative to the US in the post-Covid cycle.

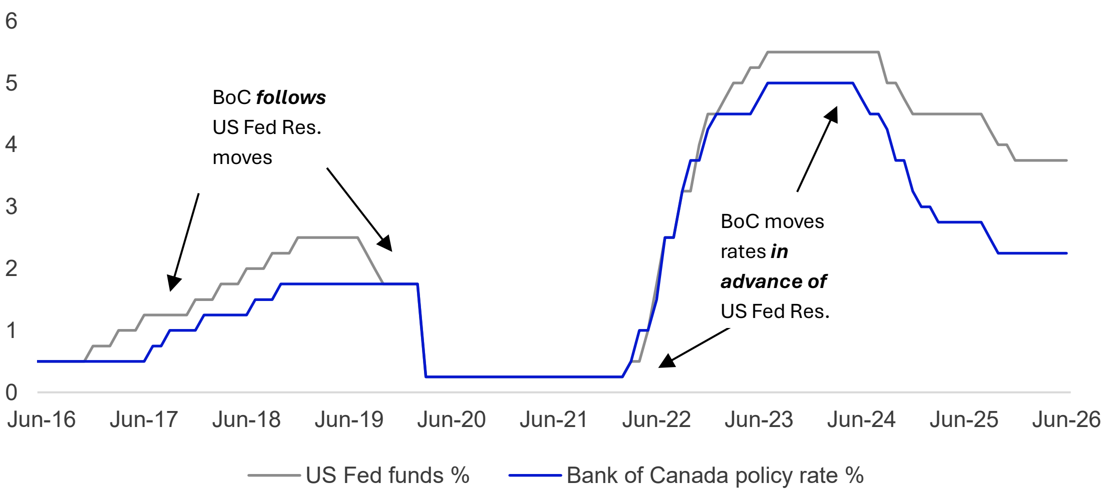
### Chart 1: Canadian and US inflation since 2019




Source: FTSE Russell, data to May 2026.

Chart 2 shows how BoC policy rates increased in advance of the Fed raising rates in 2022, and most significantly, were reduced in advance of the Fed in June 2024. Canadian policy rates now have the widest differential with US Fed funds rates in over 10 yrs.

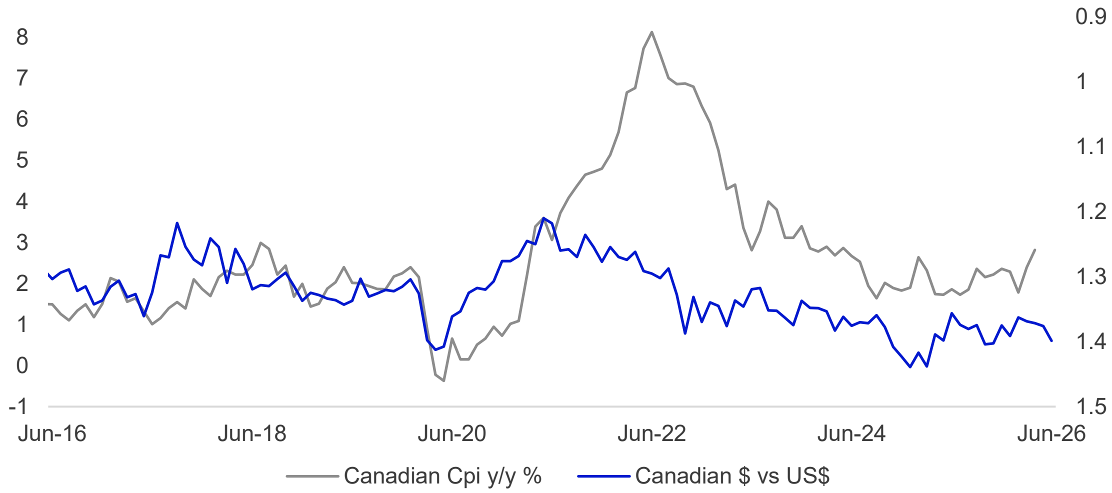
### Chart 2: Canadian and US policy rates since 2019




Source: LSEG FTSE Russell, data to May 31, 2026.

It would be premature to assume this is a definitive regime change in the Canadian monetary policy regime, because the BoC has not changed the 1-3% inflation target, centered on the midpoint of 2% inflation, and can justify recent interest rate adjustments as consistent with that objective. These moves may just reflect the lower inflation performance in Canada. But the BoC has moved in advance of the US Federal Reserve in this interest rate cycle, unlike the pre-Covid cycle, as Chart 2 shows. Although the early easing moves, from June 2024 and well in advance of the Fed, caused some initial weakness in the Canadian dollar, as Chart 3 shows, the currency has recovered since and Canadian inflation remains stable, within the 1-3% target range.

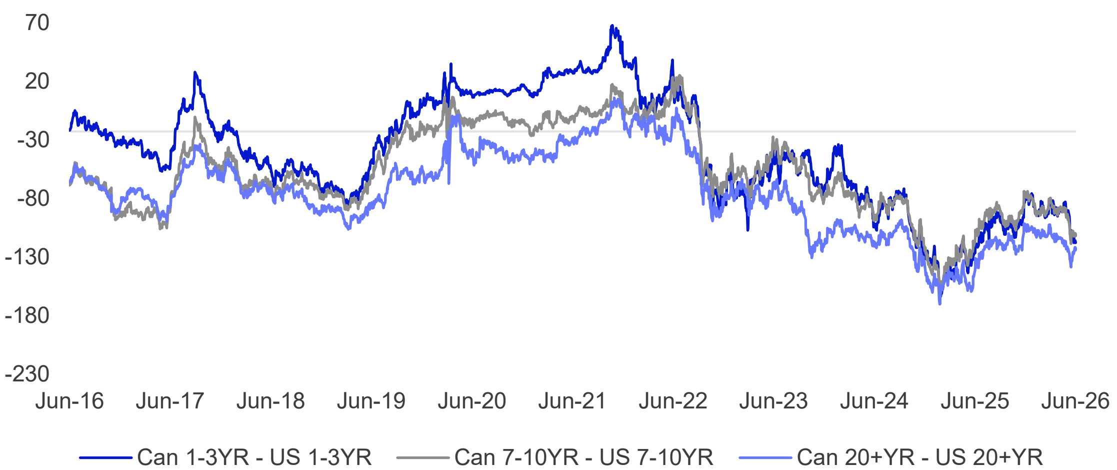
### Chart 3: Canadian dollar versus US dollar, and Canadian inflation




Source: FTSE Russell, data to June 16th, 2026.

Reflecting the widening interest rate differentials between the US and Canada, and lower Canadian inflation, Canadian government bonds have consistently traded through US Treasuries in recent years, in all maturities. This is shown in Chart 4, which also shows that Canadian government bonds traded through Treasuries for some years before Covid.

### Chart 4: Canada versus US government bond yield differentials since 2016




Source: FTSE Russell, data to June 12, 2026.

Inter-connected with the moves in government bond spreads, and the Canadian dollar, there is evidence of de-coupling of Canadian credit spreads from the US, even if spread levels have not de-coupled directionally. This could be expected if the Bank of Canada now has more policy freedom because of lower inflation and has been able to adjust policy in advance of US Federal Reserve rate moves since 2022, without de-stabilizing the Canadian dollar.

### Chart 5: Canadian and US IG credit spreads since 2016


Source: FTSE Russell, data to June 12th, 2026.

## Lower US correlation strengthens case for independent hedging of Canadian credit spreads

Previously, investors in Canadian IG credit often hedged credit risk by using US IG spreads as a proxy, as a means of hedging the global, or systematic, component of spreads. But Canadian and US spread levels show high auto-correlation, or data persistence, not least because they share similar business cycles, and risk premia. As a result, we found correlations in spread levels as high as 0.81 pre-Covid, and 0.77 since Covid as Table 1 shows. However, even for levels, correlations collapsed to -0.18 during Covid, as the two markets responded to different policy responses from the Canadian and US central banks, and the different sector composition of the two credit markets.

But it is the change in credit spreads in the two markets, and the correlation between the changes in spreads that's more important for investors looking to hedge Canadian credit risk exposure. To assess this, first differences can be used, i.e., the change in spreads from one period to the next, and Table 1 also shows that correlation between the two markets drops substantially, even during Covid. Indeed, the overall correlation of 1st differences is very low, and close to zero, which suggests local factors, and sector differences between the 2 markets, may be the key drivers of changes in credit spreads, even if there are common macro factors.

## Table 1: Correlation of Canadian and US credit spreads

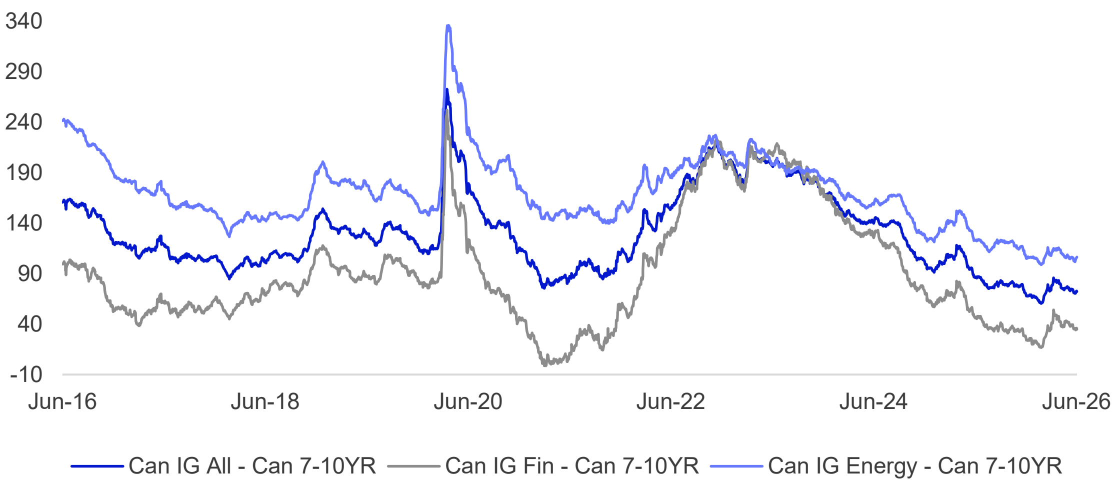
| | Pre-Covid June 2016 – Feb 2020 | Covid crisis March – May 2020 (inclusive) | Post-Covid |
|---|---|---|---|
| Correlation coeff. (spread levels) | 0.81 | -0.18 | 0.77 |
| Correlation of 1st differences (credit spread changes) | 0.044 | -0.12 | -0.07 |

Source: FTSE Russell, data to June 2026.

## Independent hedging requires an index series that maps spreads to government bonds

To enable independent hedging and trading of Canadian credit spreads, with no counter-party risk, FTSE Russell has devised an index series for this purpose[1][2].It also maps spreads to underlying Canadian government bonds and futures contracts on the Montreal exchange, designed to offer clean credit spread signals. Canadian bank bonds comprise a high share of the overall IG credit, approximately 30% and approximately 70% of financials, so have strong correlation to overall credit spreads, are standardized, generally rated A to AA, and highly liquid. With only one sector, the complexities of sector weighting, and sector-specific shocks, like the recent energy shock, are also avoided. Chart 6 shows that Canadian financial spreads also tend to lead broader spread moves, both because of their high weighting in aggregate indices and because of their linkage to financial shocks, and the broader economy.

## Chart 6: Selected Canadian IG credit spreads since 2016




Source: FTSE Russell, data to June 12, 2026.

## Ability to blend, or isolate, credit and rate risk key features of FTSE Bank Credit index…

The other important dimensions that a Canadian bank credit index series and the related futures contracts bring are both the ability to isolate credit from interest rate risk, and the ability to trade, or hedge, yield curve risk. This occurs through various channels. Firstly, the indexes themselves are mapped to bank bonds and futures contracts of different durations, making it possible to hedge, or trade,

[1] See: An innovative approach to benchmarking Canadian credit risk https://www.lseg.com/content/dam/ftse-russell/en_us/documents/research/an-innovative-approach-to-benchmarking-canadian-credit-risk.pdf
[2] Also see: A new tool for managing Canadian bank credit risk https://www.lseg.com/en/insights/ftse-russell/a-new-tool-for-managing-canadian-bank-credit-risk

maturity-specific exposure. So a mid-duration index future can be used to hedge a portfolio of mid-duration bank bonds, etc. or exposure can be taken to bank bonds of that maturity.

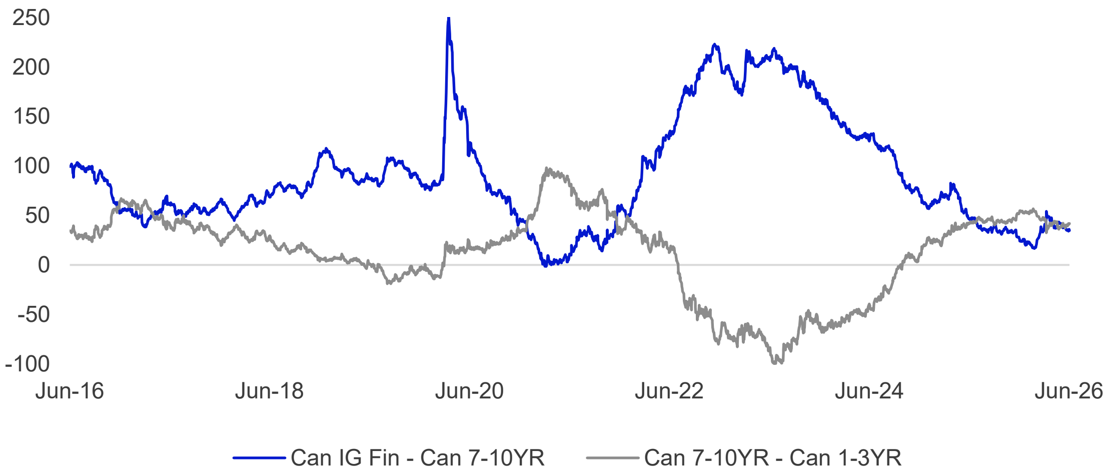
Secondly, it is possible for investors to take credit curve steepening, or flattening, positions. So an investor expecting the curve to steepen could go long short-dated bank credit, but short longer-dated bank credit, using the futures contracts mapped to the underlying credit indexes. Thirdly, because the bank index bond constituents map to underlying government bonds, it is possible to remove duration/interest rate risk, by selling the appropriate duration-matched government bond future, leaving only credit risk. It is true that the duration/rate risk hedging is through the bucketing of bonds and not continuous, but it can be approximated, and we note that most yield curves require some interpolation.

## …. wide range of use cases not available in CDS, which carry bilateral counter-party risk

The ability to remove, or include, interest rate risk is an extra dimension that CDS contracts do not have, since they are pure credit risk instruments, and also carry counter-party risk, as over-the-counter derivatives with a bilateral counter-party. Since there is no embedded interest rate exposure, an investor can only express a credit spread view through a CDS contract.

A related point is that because government yields and credit spreads tend to be negatively correlated, i.e., spreads tighten as government yields rise, and vice versa in risk-off environments as government yields fall, the ability to blend credit and yield curve positions is particularly important. This enhances the appeal of bank credit index futures contracts further. The negative correlation between government yield curve shape and financial credit spreads is shown in Chart 7, and investors can benefit from this by combining credit and yield curve overlay trades.

### Chart 7: Canadian financial spreads and 10s/2s yield curve




Source: FTSE Russell, data to June 12, 2026.

## ABOUT FTSE RUSSELL

FTSE Russell, LSEG's global index leader, provides innovative benchmarking, analytics and data solutions for investors worldwide. FTSE Russell calculates thousands of indexes that measure and benchmark markets and asset classes in more than 70 countries, covering 98% of the investable market globally.

FTSE Russell index expertise and products are used extensively by institutional and retail investors globally. Approximately $20 trillion is benchmarked to FTSE Russell indexes. Leading asset owners, asset managers, ETF providers and investment banks choose FTSE Russell indexes to benchmark their investment performance and create ETFs, structured products and index-based derivatives.

A core set of universal principles guides FTSE Russell index design and management: a transparent rules-based methodology is informed by independent committees of leading market participants. FTSE Russell is focused on applying the highest industry standards in index design and governance and embraces the IOSCO Principles. FTSE Russell is also focused on index innovation and customer partnerships as it seeks to enhance the breadth, depth and reach of its offering.

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