MONTRÉAL EXCHANGE

Canada Swap Spreads

Futures Flash Series
Article 29 / August 2025

Canadian 5-year swap spreads[1] may have completed their extreme tightening move of nearly 45 basis points, which began just over a year ago. While the geopolitical situation remains unpredictable and the near-term economic outlook uncertain, new opportunities could be emerging for managers looking to add relative value risk.

Typical Drivers of Spread Changes

There are several reasons why swap spreads are dynamic. Typically, spreads will widen due to:

1. Credit Risk concerns or General Risk Aversion: The best example here is (and probably always will be) the extreme widening of swap spreads during the financial crisis when risk aversion was widespread. And, even if you trusted your counterparty, you could not be certain that they were not exposed to other counterparties that could ruin them. Extreme risk aversion and solvency concerns, especially at banks, lead to much wider swap spreads.
2. Reduced Canada bond supply or heightened demand for federal bonds: Although sometimes confused with a general flight to quality, there are many reasons why investor demand for government bonds can increase, including new bank regulations, foreign buying for reserve purposes, or a general shift towards bonds due to high equity valuations (or expectations for falling equities). Both reduced supply and increased demand lead to lower Canada bond yields and wider swap spreads.
3. Hedging demand: Large investors will often hedge in swaps. Although liability-driven investors are typically fixed-rate receivers in the swaps market, adjustments to their hedging programs can widen swap spreads.
4. Regulatory changes: Different regulatory bodies oversee various entities, but changes to regulations can make holding swaps or bonds more or less costly. This is especially true at investment banks, but it can also apply to large pension funds and insurance companies, even if some of these have traditionally absorbed some of these costs themselves, such as capital usage charges.

Spread tightening usually has similar but opposite drivers:

1. Improved market liquidity and risk taking: A shift from government bonds to riskier assets tightens swap spreads.
2. Increased bond issuance: An increase in the government borrowing program raises term rates (increased bond supply) and tightens spreads as bond yields rise relative to swap rates.
3. Liability-driven investing or hedging long-term fixed obligations is often done in the swaps market: Large-scale fixed-rate receiving demand lowers swap rates relative to bond yields, thereby tightening swap spreads.
4. Balance sheet constraints: Spread markets are intermediated by dealers, so spreads may compress if market making becomes easier or less costly in terms of capital charges and hedging. Lower repo costs, as they hedge in bonds or less severe regulatory constraints, may result in tighter swap spreads.

1 We focus here on the 5-year point but many of our observations are also applicable to the 10-year and 30-year points on the swap spread curve.

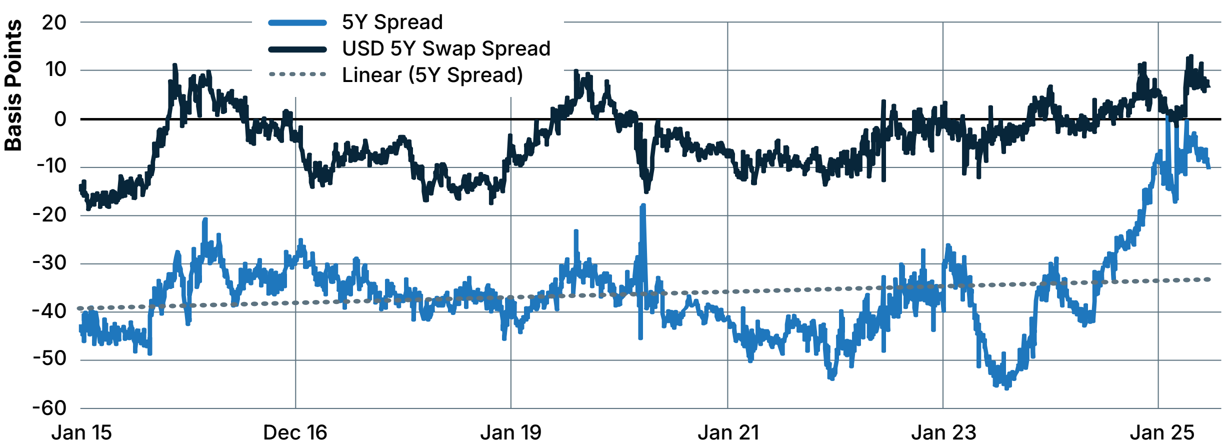
May 2024 to June 2025 – 45 Basis Points Tighter

Beginning from approximately -43 basis points[2] in mid-May 2024, swap spreads in Canada have steadily tightened (moved to higher values or upward in Figure 1) for around a year but topped out at roughly zero, or even slightly above, between March and May 2025. In the chart, swap spreads are expressed as the bond yield less the swap rate. Therefore, the yield of the bond is below the yield of the swap unless the spread is expressed as a positive value. That, of course, means that earlier this year a 5-year swap had a yield lower than that of a 5-year Canada bond, which is an unusual situation for Canada recently.

Figure 1 shows that the surge to higher levels (tighter spreads) over the past 5 years has not been unique to Canada but has also occurred, to a lesser extent, in the American market – although a serious caveat is that U.S. levels have always been significantly tighter (higher on the chart) than Canada's in recent years.

FIGURE 1

5Y Swap Spreads, Constant Maturity



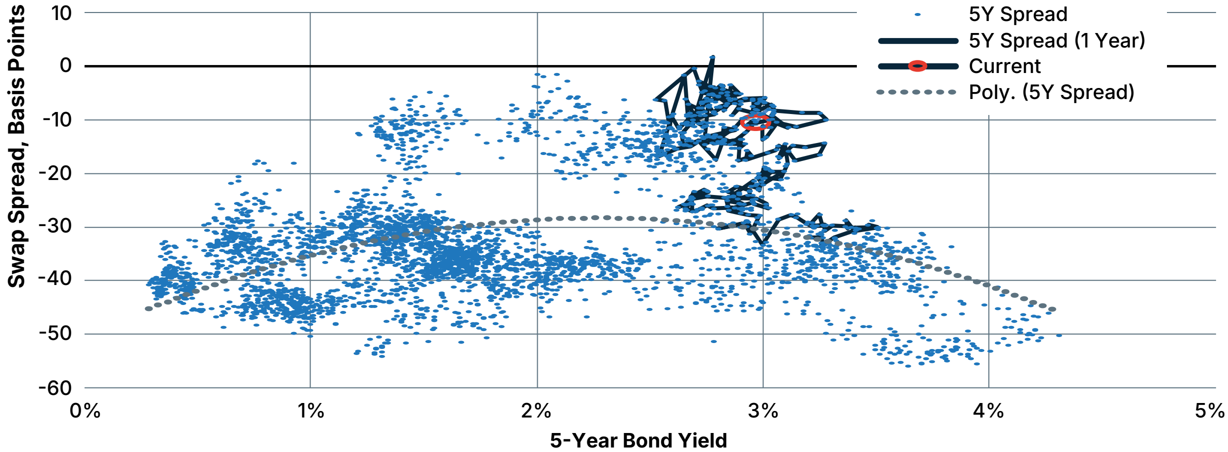
Source: BMO Capital Markets[i] Fixed Income Sapphire database

As discussed above, the level of yields can be an important factor for swap spreads, as well as the overall outlook for the economy, which is embedded in the belly of the yield curve. However, as we observe in Figure 2, the move to tighter swap spreads in the previous year (highlighted in the figure) has moved the spread far from what would be considered normal in a regression of 5y swap spreads versus the 5y yield. They are currently about 20 basis points too high given the 5-year bond yield when using a polynomial fit – not unusual, but certainly far from ordinary.

2 Swap spreads can be expressed either as a number of basis points that the swap rate exceeds the yield on a similar maturity bond (swap yield minus bond yield) or as the opposite (bond yield less swap yield). We use the latter for this paper.

FIGURE 2

5Y Swap Spread v. 5Y Bond Yield

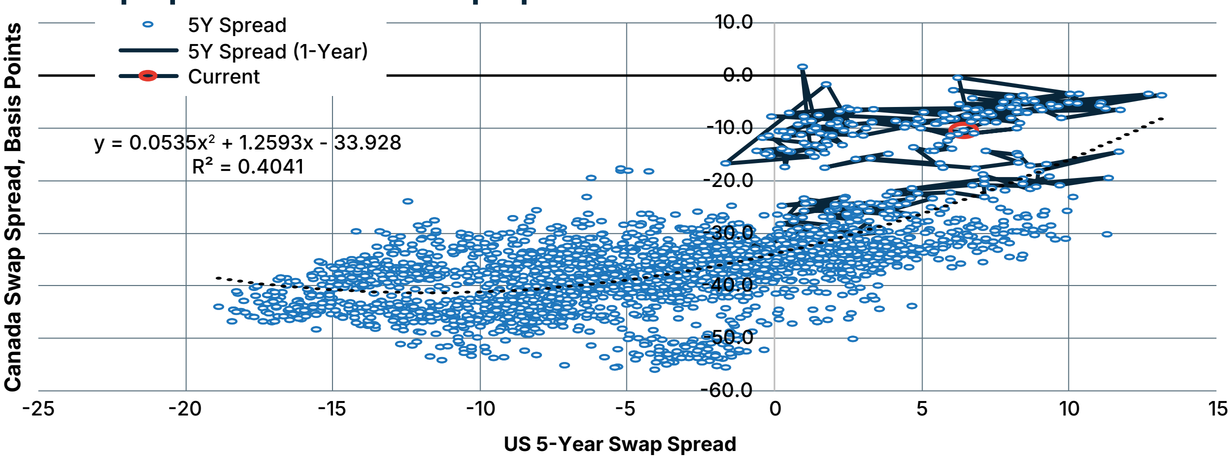


Source: BMO Capital Markets[i] Fixed Income Sapphire database

Additionally, Canadian markets rarely operate independently of international influences, although our correlation with U.S. markets may weaken over time due to the current trade turmoil. Figure 3 shows a regression between the Canadian 5-year swap spread and the endogenous factor of U.S. 5-year swap spreads, showing a modest correlation. The current level is roughly 15 basis points tighter than the 5-year historical lookback used in the chart.

FIGURE 3

5Y Swap Spread v. US 5Y Swap Spread



Source: BMO Capital Markets[i] Fixed Income Sapphire database

Tighter Swap Spreads

Regarding the general explanations for tighter swap spreads listed above, we lean heavily towards the first two items to explain the large recent move. Equity markets are at historical highs and, despite some recent volatility associated with trade uncertainties and a potential recession in Canada (possibly?) risk-taking is in vogue. Additionally, with expectations of higher military spending and lower government revenues in the event of a prolonged economic downturn, bond issuance is expected to increase. Virtually no one anticipates less government borrowing in Canada in the near future. We have no information to corroborate our view, but higher interest rates should attract some interest from pension funds and insurers to hedge their liabilities. Our perspective here is cautious given that a lot of these large players have already mitigated much of their interest rate risk long ago.

A final explanation could be the modest decline in Canadian housing markets in recent years. Traditionally, mortgage lenders estimate how many mortgages they will write each spring and summer when the Canadian housing market is most active and hedge their expected future fixed cash inflows by paying fixed in the swaps market – often at the 5-year mark since many of their mortgages are for 5-year fixed rates.

If banks and other housing lenders over-hedged on optimistic mortgage underwriting projections, they might have been receiving fixed in swaps to unwind excess hedges that did not result in mortgages. As shown in Figure 4, monthly Canadian home sales fell significantly and are below their 10-year moving average. While the sophisticated hedging programs at some of the country's largest lenders likely anticipated this development, excess hedges accumulated in previous years could be a factor. The unwinding of excess mortgage hedges contribute to—though not fully explain—the multi-year tightening of swap spreads.

FIGURE 4

Canada Monthly Home Sales & 10Y Moving Average

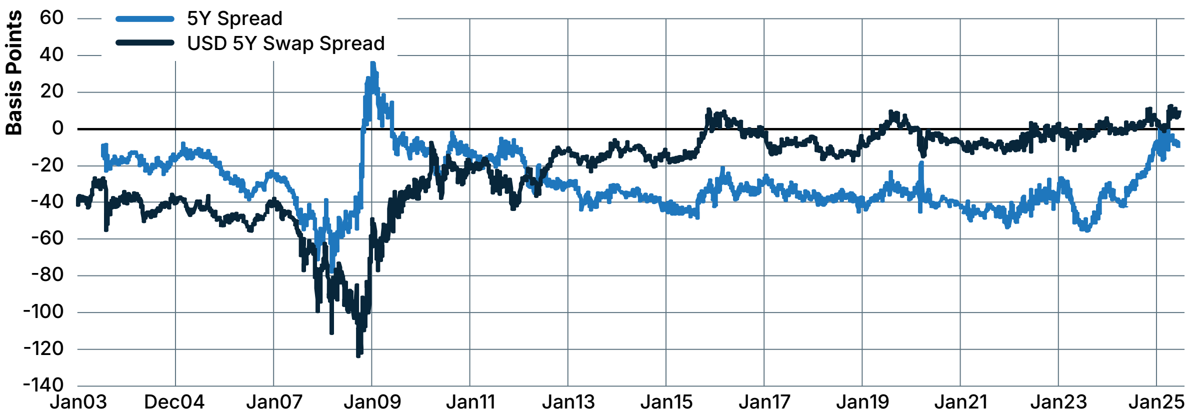
Source: The Canadian Real Estate Association

General Risks – Additional Tightening

The largest risk in taking a position on swap spread widening at this point is illustrated in Figure 5, where U.S. swap spreads have consistently traded at higher levels than Canadian spreads for at least the last 10 years. While good reasons may exist for this long-term differential, it has not always been the case. Figure 5 shows a longer-term chart of 5-year swap spreads for both countries. Prior to the years immediately following the financial crisis, Canadian spreads were tighter than their U.S. counterparts almost all the time.

FIGURE 5

5Y Swap Spreads, Constant Maturity



Source: BMO Capital Markets[i] Fixed Income Sapphire database

Structure in Futures

Many managers, especially those without inherent bond exposure, choose to structure relative value trades in swap spreads using futures instead of bonds since the futures are self-funding – requiring no participation in repo markets to raise cash for bonds and do not require borrowing bonds to sell short.

Figure 6 illustrates a swap spread widening strategy designed to capitalize on the potential reversal of the 12-14 month tightening trend in 5-year swap spreads. The strategy involves buying[3] CGFU25 contracts while paying fixed in the swap market using a term to maturity that matches the cheapest-to-deliver bond for the futures contract. This position profits when bond yields decline relative to swap spreads, resulting in spread widening (shown as downward movement in Figure 5). Based on early July pricing, the trade enters at -5.7 basis points and will profit by $25,000 for every basis point of swap spread widening, while remaining virtually[4] DV01-neutral, eliminating overall interest rate exposure.

3 Note that a manager should have a good understanding of futures contract dynamics, especially the notion of forced early delivery for long positions. More information on [MX Bond Futures manual](#).

4 Futures contracts must be traded in round numbers of contracts and swaps are usually rounded to a single decimal point when the notional is expressed in millions so the structure has a very small amount of interest rate directionality.

FIGURE 6

5Y Swap Spread Widener via CGF Invoice Spread

POSITION	SECURITY	CTD COUPON/ YIELD	MATURITY	DV01/100	TOTAL DV01
508	CGFU25	2.75%	01-Mar-30	4.92	25,018
-58.0	Pay Fixed	3.00%	01-Mar-30	4.32	-25,039
					-20

Source: BMO Capital Markets[i] Fixed Income Sapphire database, Montréal Exchange

Kevin Dribnenki writes about fixed income derivatives and opportunities in Canadian markets. He spent over 10 years managing fixed income relative value portfolios as a Portfolio Manager first at Ontario Teachers' Pension Plan and then BlueCrest Capital Management. During that time he managed domestic cash bond portfolios as well as international leveraged alpha portfolios and has presented at several fixed income and derivatives conferences. He received a BA in Economics from the University of Victoria, an MBA from the Richard Ivey School of Business, and holds the Chartered Financial Analyst designation.

For more information

irderivatives@tmx.com

m-x.ca/futures

i BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking business of Bank of Montreal, BMO Harris Bank N.A. (member FDIC), Bank of Montreal Ireland plc., and Bank of Montreal (China) Co. Ltd and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada and Asia and BMO Capital Markets Limited (authorized and regulated by the Financial Conduct Authority) in Europe and Australia. "BMO Capital Markets" is a trademark of Bank of Montreal, used with permission.