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Unpacking interest rate uncertainty in 2025

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Abstract

Amid heightened Canada–US trade tensions in 2025, financial markets showed signs that investors faced greater difficulty anticipating near-term Bank of Canada interest rate decisions. This uncertainty could have stemmed from two sources: uncertainty about the economic outlook or uncertainty about how the Bank of Canada would respond to that outlook. In assessing these sources, changes in the 2-year Government of Canada bond yield around the Bank of Canada's decisions remained in line with historical norms, suggesting that investors broadly understood the Bank of Canada's monetary policy response by the time decisions were announced. At the same time, the 2-year yield remained highly sensitive to incoming inflation and labour market data, indicating that these data releases continued to resolve uncertainty about the outlook. Taken together, the evidence suggests that the heightened uncertainty around Bank of Canada's interest rate decisions in 2025 was more consistent with an uncertain economic outlook than with an uncertain monetary policy response.

Topics: Monetary policy; Monetary policy framework and transmission; Financial markets and funds management - Market functioning; Econometric, statistical and computational methods

JEL codes: E52, E58, E44, C58, D53

Introduction

Government of Canada (GoC) bond yields reflect investors' expectations about the future path of the Bank of Canada's (BoC) policy interest rate and the uncertainty surrounding it. Because the policy interest rate depends on the economic outlook, GoC yields adjust to news about the economy's performance, such as labour or inflation data releases. These adjustments matter for the economy because they transmit to firm and household borrowing costs that matter for investment and consumption decisions.

For this mechanism to work, investors must be able to both assess how the economic outlook could evolve and how the BoC could adjust its policy interest rate in response. When uncertainty about either of these elements rises, investors may demand a higher premium for holding GoC bonds to compensate for greater risk around the path of interest rates. This premium becomes embedded in GoC yields and passes through to higher borrowing costs for households and firms, complicating their consumption and investment decisions.

One such period featuring greater uncertainty was from late 2024 to end of 2025, when the US administration intermittently threatened to impose tariffs on Canadian goods and eventually did so at historic scale (Yale Budget Lab, 2026). Uncertainty about the scale and scope of tariffs clouded the economic outlook. Tariffs also placed opposing pressures on inflation by weakening aggregate demand while raising firms' costs of production (Macklem, 2025), possibly making the BoC's monetary policy response harder to anticipate.

During this period, very near-term interest rates tended to move more than in the past ahead of each BoC interest rate decision. This pattern suggests that investors had more difficulty judging the likely outcome of the BoC decision, which is a sign of greater uncertainty the BoC's monetary policy response. That uncertainty can stem from two sources: increased uncertainty about the economic outlook, or increased uncertainty about how the BoC would adjust its policy rate to economic developments. To assess these possibilities, we compare two metrics from financial markets with their historical norms:

1. Intraday GoC yield reactions following BoC interest rate decisions, which help gauge the extent of new information investors receive about how the BoC will set interest rates going forward.
2. The sensitivity of intraday GoC yields to inflation and labour data releases, which provides insight into the extent to which economic data helps resolve uncertainty about the economic outlook.

In 2025, reactions of the 2-year GoC yield to the BoC's interest rate announcements were broadly within historical norms, suggesting that the decisions themselves were generally well anticipated despite the elevated uncertainty seen beforehand. At the same time, the sensitivity of the 2-year GoC yield to inflation and labour data releases remained near the highs seen over 2022-2024. This high sensitivity indicates that incoming data releases continue to play an important role in helping to resolve elevated uncertainty about the economic outlook. Taken together, these results suggest that investors' difficulty in judging the outcome of each BoC decision was more consistent with uncertainty about the economic outlook than about the BoC's monetary policy response.

Signs of uncertainty in Bank of Canada policy rate expectations over 2025

The BoC typically adjusts its policy interest rate in increments of 25 basis points (e.g., 25, 50, 75, etc.). Ahead of each interest rate decision, investors form expectations about whether the BoC will leave the policy interest rate unchanged or change it by 25, 50, or more basis points.

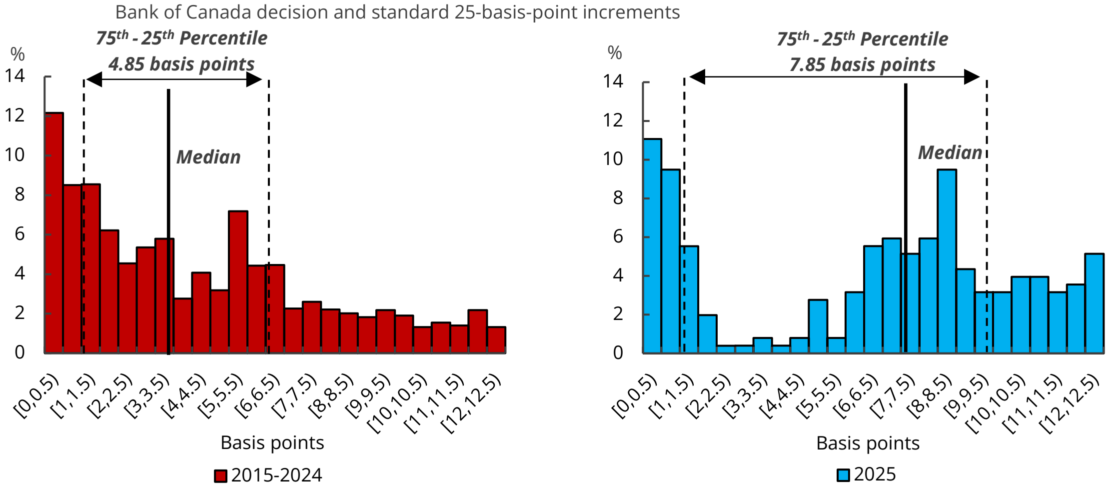
These expectations can be inferred from prices of Overnight Index Swap (OIS) contracts—financial instruments linked to the expected path of the Canadian Overnight Repo Rate Average, an overnight interest rate that closely tracks the BoC's policy interest rate. An OIS contract for the next BoC decision spans the period from the nearest upcoming decision to the following one. Hence, this OIS contract's price is a gauge of the policy interest rate expected to prevail after that next decision. [1]

When this OIS price is very close to the current policy interest rate or to a level that implies a 25-basis-point move, it suggests that investors broadly agree on how the BoC will adjust the policy interest rate at its next decision. However, when the OIS price materially deviates from these standard 25-basis-point increments, it signals that investors face greater uncertainty about the BoC's monetary policy because they have more difficulty judging the outcome of the next BoC decision.

These material deviations were common in the lead-up to the BoC's interest rate decisions in 2025 (**Chart 1**).

Chart 1: Investors found the Bank of Canada's interest rate decisions harder to anticipate in 2025 than in the previous decade

Percentage of trading days grouped by the absolute difference between the Overnight Index Swap price for the next Bank of Canada decision and standard 25-basis-point increments



Sources: Bloomberg, Bank of Canada calculations

Last observation: December 31, 2025

[1] OIS prices also incorporate a risk premium reflecting uncertainty about future interest rates and investors' aversion to such uncertainty. We abstract from risk premiums since we focus on very near-term horizons where this premium is likely small.

Relative to 2015-2024, the distribution of OIS deviations—the absolute difference between the OIS price for the next BoC decision and the nearest 25-basis-point move—shifted higher in 2025. The median OIS deviation close to doubled from about 3.5 basis points to about 7 basis points. The upper end of the distribution also increased, with the top 25% of days above roughly 9 basis points, compared with about 6 basis points over 2015-2024.

The larger OIS deviations in 2025 suggests that investors found the BoC's near-term interest rate decisions harder to predict amid heightened Canada-US trade tensions in 2025. Two explanations can account for the rise:

1. These decisions could be harder to forecast because uncertainty about the scale and scope of tariffs clouded the economic outlook. This source of uncertainty is out of the BoC's control.
2. The BoC's decisions could also be harder to forecast due to the BoC's monetary policy response itself may have been harder to predict. Investors may have been uncertain about how the BoC would manage the opposing effects of tariffs, which could place opposing pressures on inflation by weakening aggregate demand while raising firms' costs of production.

The remainder of this note evaluates evidence regarding which of these factors was the more important driver of the heightened monetary policy uncertainty suggested by the rise in OIS deviations.

Yield reactions to Bank of Canada interest rate decisions were in line with historical norms

Studying the reactions of GoC yields to BoC interest rate decisions provides a starting point to assess whether the BoC contributed to unusually high uncertainty leading up to its interest rate decisions. Large yield reactions following a decision typically reflect investors' updating their views about the path of future interest rates. Such updates can occur when:

- the BoC sets the policy interest rate materially above or below investors' expectations, or
- the BoC's communications alter investors' views about how interest rates will adjust to future economic developments.

Intuitively, investors may find it harder to anticipate monetary policy if their interest rate forecasts consistently missed, or if the BoC frequently communicated material changes to how it intends to set interest rates.

To isolate the impact of the BoC's decisions on investors' near- and medium-term interest rate expectations, we look at the 2-year GoC yield's change from 10 minutes before to 10 minutes after the interest rate announcement.[2] In 2025, these yield reactions ranged

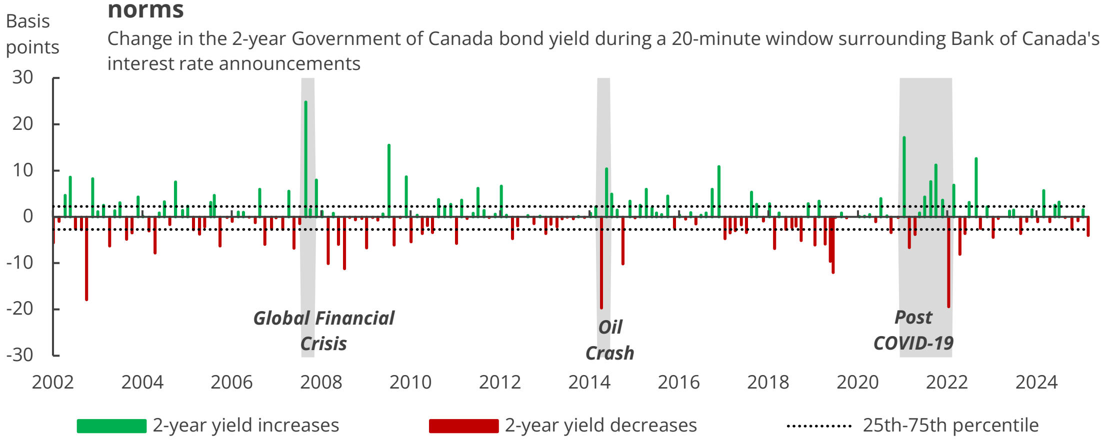
[2] The narrow 20-minute window isolates the BoC's interest rate decision as plausibly the sole driver of the 2-year yield. A larger window risks capturing news that yields would react to that is unrelated to the BoC's decision. A larger window would, however, capture any delayed reaction to the BoC's decision, for instance if it takes time for investors to digest all the information from the decision.

between -3 and 2 basis points (**Chart 2**). These reactions are significantly smaller than those in past major episodes, including:

- the global financial crisis, when the BoC cut interest rates to very low levels over 2008-2009,
- the oil crash in 2015, when the BoC cut interest rates by 25 basis points in its January meeting, and
- the post-COVID-19 era of high inflation, launching an interest rate hiking cycle from 2022 to 2023.

Chart 2: Yield reactions to Bank of Canada interest rate decisions were in line with historical norms

Change in the 2-year Government of Canada bond yield during a 20-minute window surrounding Bank of Canada's interest rate announcements



Sources: CanDeal, Bank of Canada calculations

Last observation: December 10, 2025

The smaller reactions in 2025 suggest that while uncertainty was unusually high leading up to each interest rate decision, the BoC's decisions themselves were not too surprising around the time of the announcement day. This evidence points to uncertainty around the economic outlook as the driver of the rise in OIS deviations, rather than a harder to anticipate BoC monetary policy response.

Yield sensitivity to labour and inflation data were in line with recent history

Reactions of GoC yields to economic data releases help gauge uncertainty about the economic outlook. For instance, investors may be unsure about how quickly tariffs would pass through to inflation. If an inflation data release then leads yields to move sharply, that suggests the release provided important new information about the inflation outlook and helped resolve some of that uncertainty.

A useful proxy to assess this uncertainty is the sensitivity of the 2-year GoC yield to labour and inflation data releases, which directly inform on the economic outlook and as a result inform on monetary policy. The Appendix contains details behind measuring this sensitivity, but broadly it follows two steps:

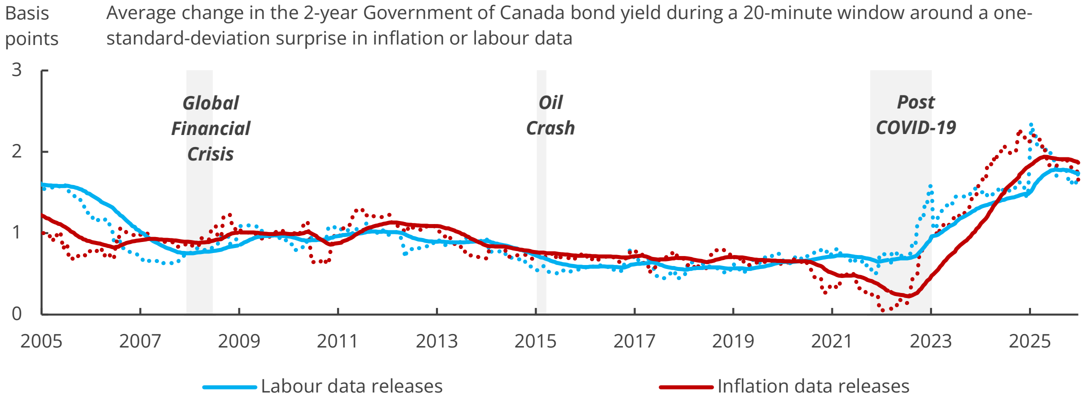
1. Compile changes in the 2-year GoC yield 10 minutes before to 10 minutes after each data release, and

2. Compare these changes to headline CPI inflation and unemployment rate surprises—the actual headline inflation or unemployment rate minus their survey forecasts.[3,4]

Following 15 years of relative stability, this estimated sensitivity doubled from late 2021 to 2024, when inflation reached historic highs (**Chart 3**). The high level of inflation raised uncertainty about its persistence and the economic outlook more broadly (Bank of Canada, 2023). The stronger reactions of the 2-year GoC yield to inflation and labour data release surprises during this period suggest that these releases played a larger role in resolving, at least some, of that uncertainty.[5]

Chart 3: Sensitivity to labour and inflation data surprises are similar to the peak sensitivity seen in 2024

Average change in the 2-year Government of Canada bond yield during a 20-minute window around a one-standard-deviation surprise in inflation or labour data



Note: Dotted lines show the estimated market sensitivity over a rolling two-year period, adjusting for simultaneous United States economic data releases. Solid lines represent the smoothed average of these trends. Labour data surprises are adjusted so that positive values reflect a stronger-than-expected economy, which typically drives bond yields higher.

Sources: CanDeal, Bank of Canada calculations

Last observation: December 23, 2025

In 2025, this estimated sensitivity was close to the elevated levels seen over the prior two years. A closer look at the recent underlying data also reveals no apparent break in the relationship between data surprises and movements in the 2-year GoC yield (**Chart 4**). Yields rose after positive data surprises and fell after negative surprises, by similar magnitudes as over the previous three years.

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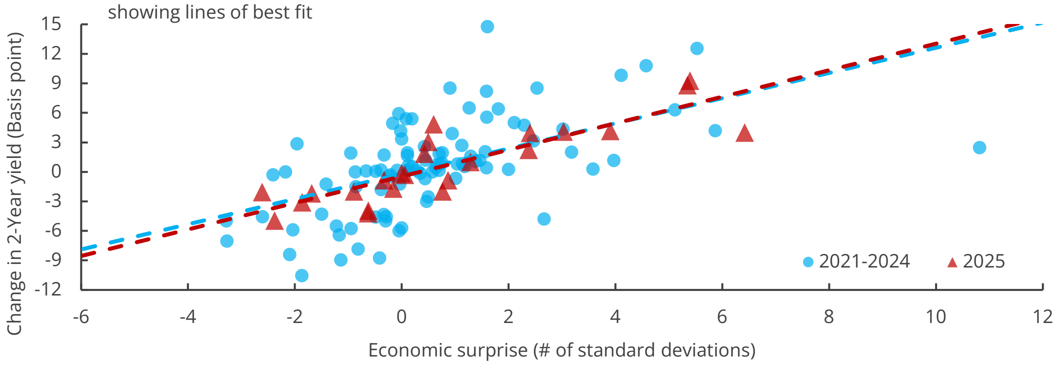
[3] The use of narrow 20-minute windows around the data releases mitigates the influence of other news that also affect the 2-year GoC yield. Survey forecasts are based on Bloomberg's consensus forecast, which compiles forecasts from a range of institutions.

[4] Although these data releases also affect yields over time, our focus on narrow windows around the releases is still meaningful in capturing the immediate headline response investors takeaway from the release. The impact of macroeconomic news on bond yields has been documented at different frequencies and over longer horizons (Feunou et al., 2018). Major US macroeconomic data released at the same time are also controlled for, since these releases have been shown to have a strong influence on Canadian bond yields (DeBruin Martos et al., 2025 ; Feunou et al., 2018).

[5] The alternative possibility is that investors learned that the BoC would be more responsive to inflation and labour market developments, increasing the sensitivity of yields to data surprises.

Chart 4: Sensitivity of the 2-year Government of Canada yield to economic surprises remained unchanged

Change in the 2-year Government of Canada bond yield versus the size of the economic surprise, with dotted lines showing lines of best fit



Note: Labour data changes are adjusted so that positive values represent a stronger-than-expected economy, which generally pushes bond yields higher.

Sources: CanDeal, Bank of Canada calculations

Last observation: December 23, 2025

Conclusion

Since the onset of the Canada-US trade tensions, the OIS price for the next BoC decision deviated from standard 25-basis-point increments by more than in the past. These larger OIS deviations suggest that investors faced greater uncertainty about the economic outlook, or greater uncertainty about how the BoC would adjust its policy rate in response to economic developments.

In assessing these possibilities, reactions of the 2-year GoC yield around the BoC's interest rate decisions in 2025 were well within historical norms, suggesting that investors broadly understood the BoC's monetary policy response by the time of each decision. At the same time, the sensitivity of the 2-year GoC yield to inflation and labour data releases remained elevated at comparable levels to those in the previous two years. This suggests that uncertainty about the economic outlook remained high, as investors continued to use incoming data more than in the past to partly resolve this uncertainty.

Taken together, these results point to uncertainty about the economic outlook—rather than uncertainty about BoC's monetary policy response to economic developments—as a more important driver of the higher-than-normal OIS deviations observed in the lead-up to BoC interest rate decisions.

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Appendix

Rolling regression to estimate sensitivity to inflation and labour news

We evaluate the intraday reaction of bond yields to macro news during the period between 2005 and 2025. This is measured using a regression that relates changes in bond yields to the surprise component of inflation and labour releases on any given day. To maintain a consistent directional interpretation across variables, the labour data surprise are multiplied by -1, such that positive surprise reflects a stronger-than-expected economic outcome, pushing bond yields higher.

- Prior to April 2012, inflation and labour data was released at 7 a.m., therefore we capture the yield reaction by measuring the change from the last quote on the previous day (4 p.m.) to the first available quote on the release day (8 a.m.).

- After April 2012, we measure the yield change as the difference between the quote 10 minutes after the release and the quote 10 minutes before.

We run two distinct OLS regression (with sample based on the method used to measure yield changes) to get the fitted yield changes by regressing yield changes (Δy_t) on the Canadian macro news variables (X_t) and control variables to account for any US macro news on the same day.

$$\Delta y_t = \beta_0 + \beta_1 surprise_{CA,t} + \beta_2 dummy_{US,t} + \beta_3 dummy \cdot surprise_{US,t} + \varepsilon_t$$

Then, we use the fitted yield changes from the equation above as the independent variable in a rolling OLS regression with a 2-year rolling window to estimate the market's sensitivity to inflation and labour news over time (captured by δ_t).

$$\Delta y_t = \gamma_t + \delta_t \widehat{\Delta y}_t + \varepsilon_t$$

Robustness check

To ensure our findings hold using a more rigorous approach as well, we conducted a robustness check by implementing a non-linear regression and minimizing the sum of squared residuals (Swanson and Williams, 2014, Elenev at al., 2024). The model estimates a common year-specific overall sensitivity scalar parameter (β_a) and another sensitivity parameter (γ_n), which is constant over time and it's estimated on the whole sample, specific to each type of news (X_n).

$$\Delta y_{a,t} = \alpha_a + \beta_a \left(\sum_{n=1}^{k} \gamma_n X_{n,t} \right) + \varepsilon_{a,t}$$

The results are consistent with our main findings from the rolling regression and show increased sensitivity to labour and inflation in recent years.