

## Rates Strategy

# Stiff steepening

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*Curve steepening across DMs has been one of the most popular trades this year.*

*Our analysis shows that 1) monetary policy easing and 2) increasing free-float were the most powerful drivers behind the move. Institutional changes (e.g. the Dutch pension reform) and changes in the investor base post-Covid also contributed via lower demand for the long end.*

*As our macro baseline anticipates a continuation of these forces, we expect government bond curves to continue steepening in 2026.*

*That said, we expect a less aggressive steepening than in 2025, as we expect debt management agencies in developed countries to adapt to lower demand for government bonds at the long and extra-long maturities and reduce the average maturity of bond issuance.*

*We expect the steepening in 2026 to be concentrated mostly on the 2/10Y bucket of the curves, rather than at the extra-long end of the curve. Based on the level of the 2/10Y spreads across developed countries, 10/30Y spreads are already too steep. Moreover, except for the US, all the other countries have lengthened the average maturity of their debts in recent years, creating extra room for flexibility in reducing the average maturity of issuance going forward, a factor that will ease pressure at the extra-long end of the curve.*

*Risks are to the upside. As the outlook is particularly fluid in the US amid risks that the administration may deliver electoral fiscal easing, the Supreme Court may rule against IEEPA tariffs, and the Fed's credibility remains under severe market scrutiny, there is a risk that the steepening next year could be as aggressive as that which unfolded in 2025. Given the systemic importance of the US market, in any of those risk scenarios, we would expect the EA and the UK markets and, to a lesser extent, the Japanese market, to follow through.*

## Curve steepening in 2025: The triggers

Curve steepening across DMs has been one of the most popular trades this year. Investors have identified fiscal easing as the main trigger for this trend. We only partially agree with this interpretation.

Figure 1 shows the contributions of:

- 1) monetary policy rates,
- 2) rate volatility,
- 3) inflation risk premium,
- 4) free float of government debt,

to the movement in the 2/10Y spreads since the start of 2025<sup>1</sup>.

Results show that the steepening of the curves was overall a consequence of (in order of importance):

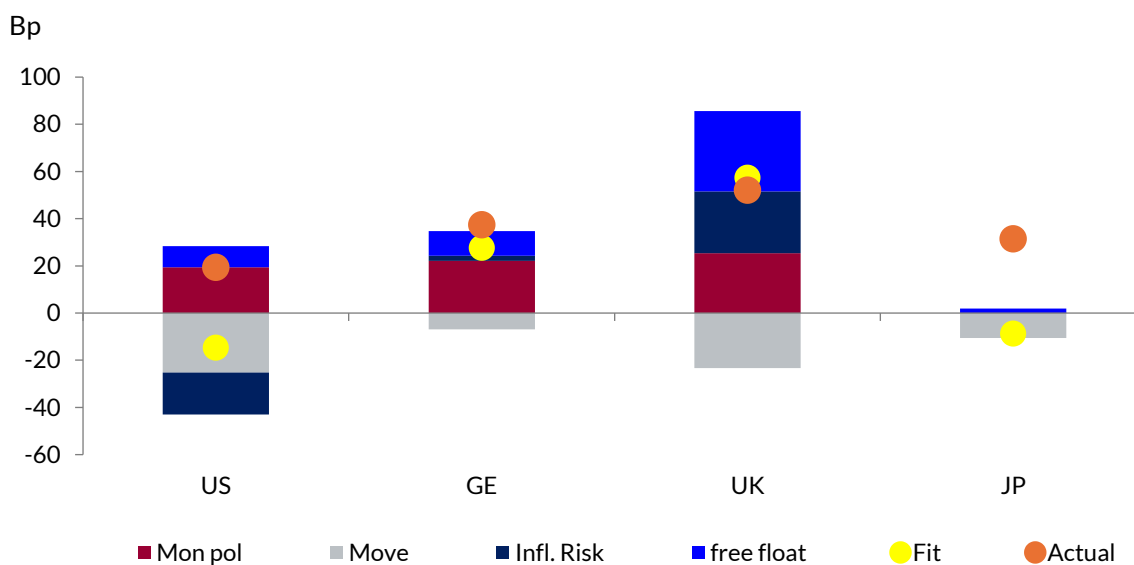
- 1) monetary policy changes (rates cuts),
- 2) an increase in the free-float of government bonds.

Inflation risk premium remained very subdued in all areas, therefore its contribution was nil except in the case of UK, while rate volatility declined, partially offsetting the triggers for the steepening.

On top of the triggers indicated by our model, we believe that institutional changes (e.g. the Dutch pension reform) and changes in the investor base post-Covid (increase in foreign investor and domestic non-bank investor participation, as opposed to demand from central banks, Figure 2 to Figure 5) have led to a sizeable decline in demand for long and extra-long maturity paper. Against this backdrop, bond issuance has hardly adjusted yet, creating the case for a relative cheapening of government paper at the long and extra-long maturities.

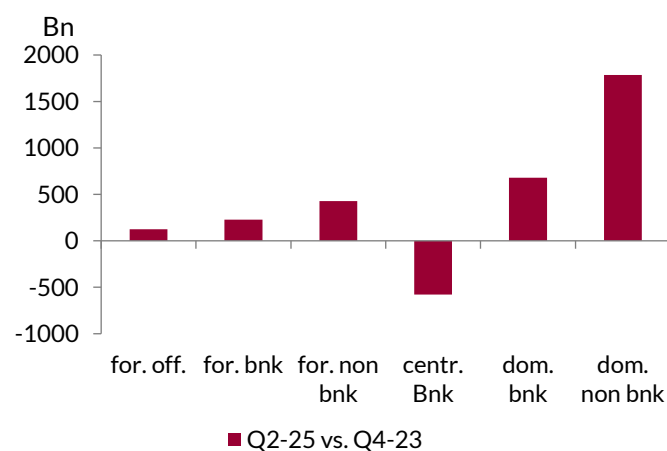
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<sup>1</sup> We ran a regression of 2/10Y spreads in selected countries against: 1) monetary policy rates, 2) rate volatility, 3) inflation risk premium, 4) free float of government debt. The regressions were run on monthly data from January 2004/January 2010 (depending on the availability of data on inflation expectations in the different areas) to the present. The R-squared values for the regressions range from 64% (Japan) to 82% (US).

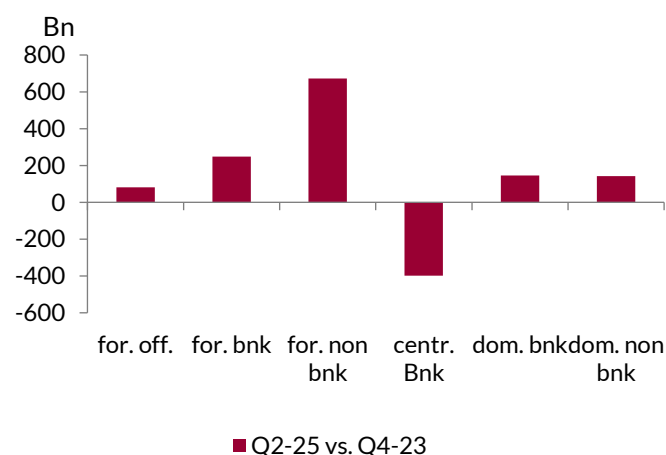
**Figure 1****Contribution to the movement in 2/10Y spreads across selected countries**

The chart shows the contribution to the movement of the 2/10Y spread in 2025 across selected countries from monetary policy rates, the MOVE index, the inflation risk premium and the free-float of government debt. "Fit" represents the change in 2025 in the fit of the regression, while "Actual" represents the change in the 2/10Y spread.

Source: Bloomberg, ANIMA Research

**Figure 2****Change in public debt holdings: US**

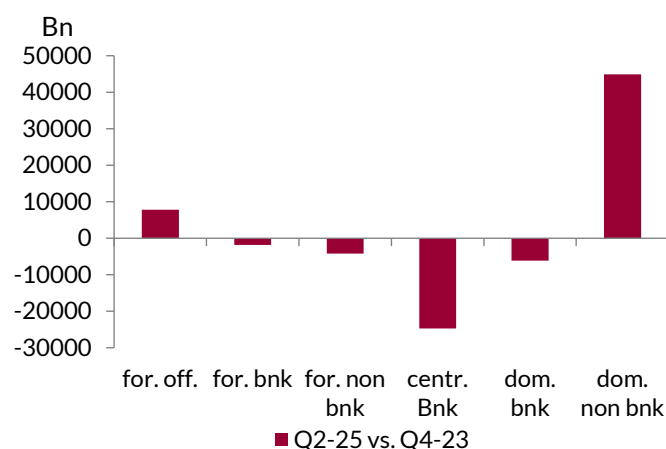
Source: IMF, ANIMA Research

**Figure 3****Change in public debt holdings: EA**

Source: IMF, ANIMA Research

Figure 4

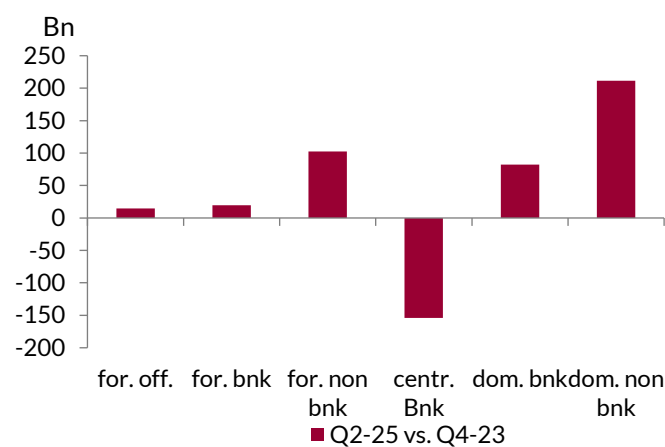
## Change in public debt holdings: Japan



Source: IMF, ANIMA Research

Figure 5

## Change in public debt holdings: UK



Source: IMF, ANIMA Research

## We expect curves to continue steepening in 2026

**We expect government bond curves to continue steepening in 2026**, for the following reasons:

- 1) **Monetary policy is likely to remain in easing mode overall.** We expect the Fed, the BoE and the ECB to maintain an easing stance, albeit with varying intensities and risks. The BoJ will probably remain in tightening mode but will move rates up very gradually and slowly (markets are pricing in two additional rate hikes by the end of 2026).
- 2) **The free float of government bonds will continue to rise and the investors' base will continue to shift towards price-sensitive investors.** We estimate that the ECB will reduce its government bond holdings by EUR 400bn in 2026, the BoJ by JPY 25-30tn, the BoE by GBP 70bn, while the Fed will marginally increase its holdings of government securities. In all countries, especially in the US, we expect an increase in marketable debt outstanding. The combination of these two factors points to a further increase in the free float of government bonds in developed markets and a further increase in the portion of debt held by price-sensitive investors.
- 3) **Inflation risk premiums are already very low.** We do not expect a sharp increase in inflation risk premiums next year, but at the same time we do not see any room for further downside.
- 4) **Rate volatility remains low given the context.** While subdued but stable global growth and a constructive environment for risky assets suggest contained volatility in markets, there is a risk that volatility may increase, given macroeconomic and political uncertainties.

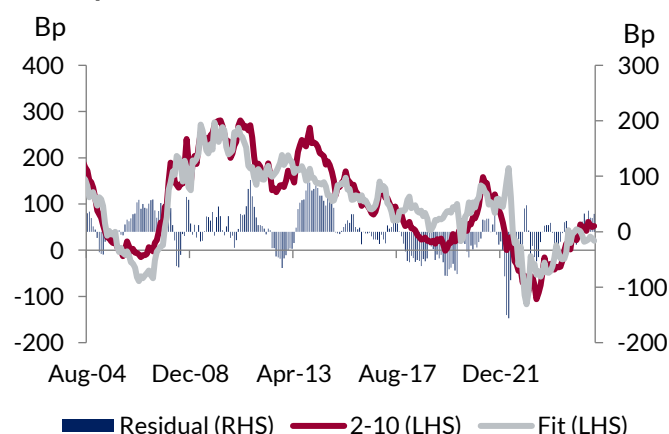
**That said, we expect a less aggressive steepening than in 2025**, for two main reasons:

- 1) Figure 6 to 9 show that, according to our fair value models, in Germany, the US and Japan the 2/10Y spreads are already trading steeper than fundamentals suggest. The UK is the only area where the 2/10Y spread is close to fair value.
- 2) We expect debt management agencies in developed countries to adapt to lower demand for government bonds at the long and extra-long maturities and reduce the average maturity of bond issuance.

**Risks are to the upside and primarily stem from the US.** As the outlook is particularly fluid in the US, amid risks that the administration may deliver electoral fiscal easing, the Supreme Court may rule against IEEPA tariffs, and the Fed's credibility remains under severe market scrutiny, there is a risk that the steepening next year could be as aggressive as that which unfolded in 2025, if not more. Given the systemic importance of the US market, in any of those risk scenarios, we would expect the EA and UK markets and, to a lesser extent, the Japanese market to follow through. Figure 10 shows that the beta of transmission from the 2/10Y UST spread is in the 50-60% range for the Gilt and Bunds curves, and a lower 15% for JGBs.

**Figure 6**

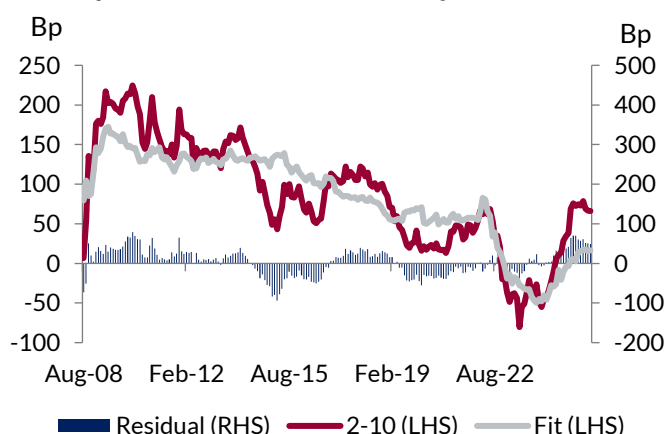
**2/10Y spread: Fit vs. Actual: US**



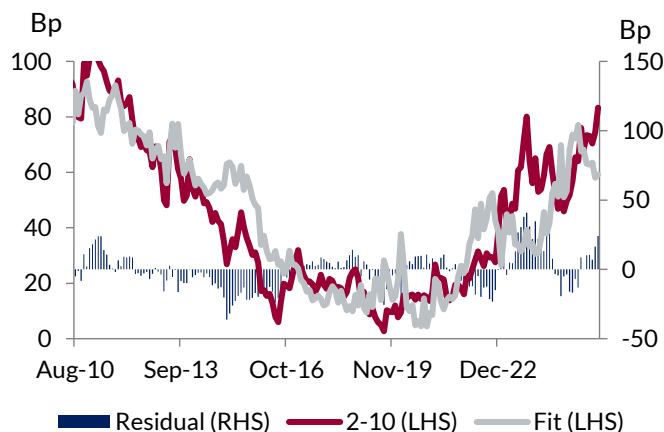
Source: Bloomberg, ANIMA Research

**Figure 7**

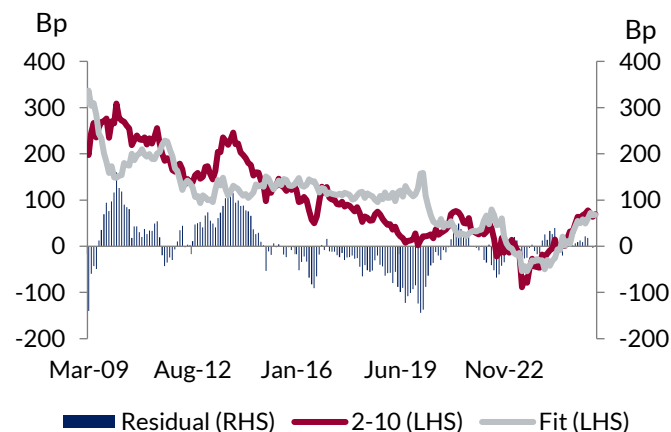
**2/10Y spread: Fit vs. Actual: Germany**



Source: Bloomberg, ANIMA Research

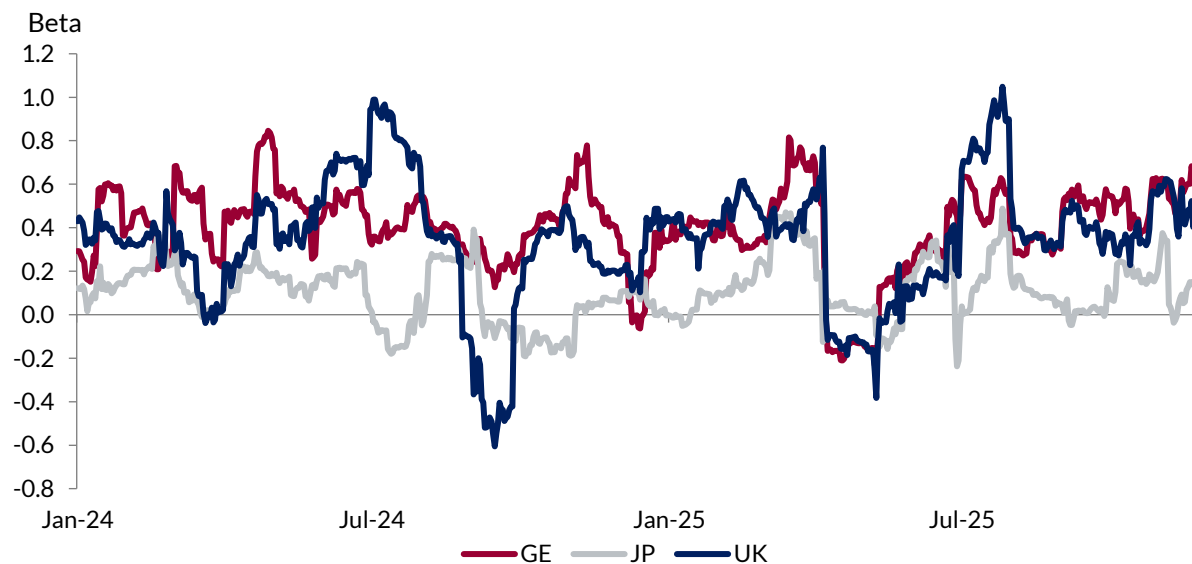
**Figure 8****2/10Y spread: Fit vs. Actual: Japan**

Source: Bloomberg, ANIMA Research

**Figure 9****2/10Y spread: Fit vs. Actual: UK**

Source: Bloomberg, ANIMA Research

Figure 6 to 9 show the result of a model regressing the 2/10Y spread in selected countries against 1) monetary policy rates, 2) rate volatility, 3) inflation risk premium, 4) free-float of government bonds. The model is run on monthly data from January 2004/January 2010 (depending on the availability of data on inflation expectations in the different areas) to the present. The R-squared values for the regressions range from 64% (Japan) to 82% (US).

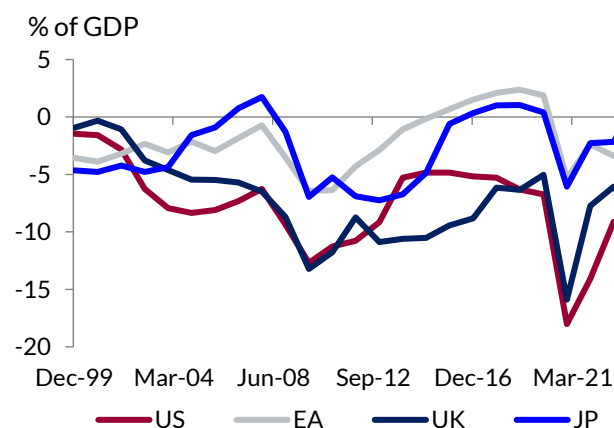
**Figure 10****1-month rolling beta of 2/10Y spread in selected countries vs. 2/10Y UST spread**

Source: Bloomberg, ANIMA Research

## US in the spotlight (again)

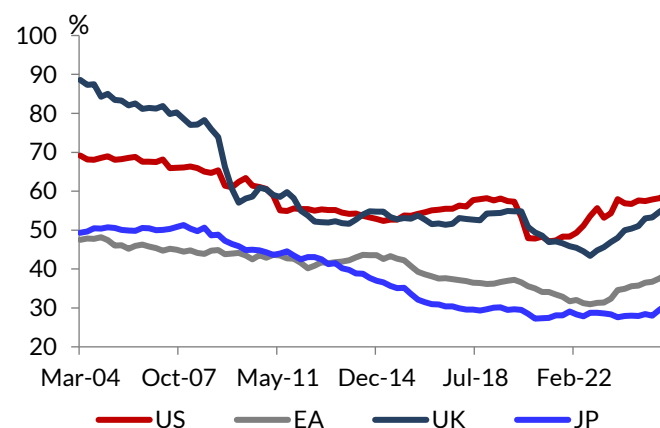
**Within the developed universe, we see the greatest risk of sharp curve steepening in the US,** for the following reasons:

- 1) Figure 11 shows that the **US is in the worse position in terms of the twin deficit** (budget deficit + current account deficit). While the trend in other regions is improving, we expect the twin deficit in the US to deteriorate, as the current account balance is expected to become more negative and there are substantial risks that the budget deficit will worsen significantly in 2026. A higher twin deficit is very often associated with a higher term premium at the long end of the curve.
- 2) Linked to point 1, the **free-float could rise sharply** in the US as a consequence of a significant increase in the deficit. The greater the loss of popularity of Trump's policies, the higher the probability that he will resort to additional easing measures with a sizeable impact on the deficit.
- 3) **The US ranks worst according to our vulnerability index**, which measures the percentage of public debt held by private investors (both foreign and domestic) who are not banks - the most price-sensitive investor categories (Figure 12). While the US remains the world's most important reserve currency and demand for USTs is still solid despite ongoing selling by central banks, UST prices are more vulnerable than those of other countries to supply-demand dynamics. This could contribute to a build-up in the term premium at the long end and a steepening of the curve.
- 4) **An ultra-dovish Fed despite a solid macro environment.** Regardless of who becomes the next Fed Chair, the names selected by the Trump administration all belong to the dovish camp. Solid economic growth, coupled with a tight labour market, could favour the build-up of inflationary pressures from wages. Against this backdrop, a dovish Fed would contribute to an increase in the term premium at the long end of the curve.
- 5) **Limited room to shorten the debt maturity.** While the US Treasury has stated that it will keep medium and long-term bond issuance unchanged for the next several quarters, we believe the US will not be able to rely entirely on T-bills in the event of a sharp increase in bond issuance. Figure 13 shows that the proportion of T-bills in US is the highest among EA, Japan, the UK, and the US.

**Figure 11****US worse positioned in terms of twin deficit...**

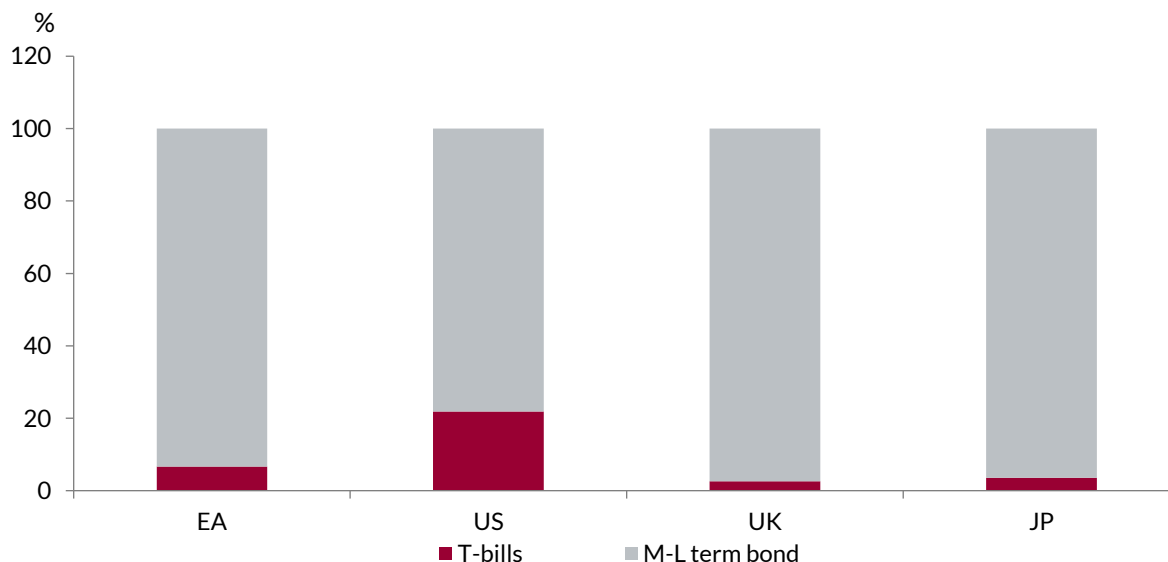
The chart shows the sum of current account balance and the budget balance as % of GDP. A negative number indicates a deficit.

Source: Haver Analytics, ANIMA Research

**Figure 12****...and vulnerability index**

The vulnerability index measures the percentage of public debt held by private investors (both foreign and domestic) who are not banks - the most price-sensitive categories of investors

Source: Haver Analytics, IMF, ANIMA Research

**Figure 13****US shows the highest portion of T-bills on total marketable debt**

Source: Haver Analytics, ANIMA Research



## What about Japan?

Worries about debt sustainability in Japan have resurfaced in the run-up to the approval of the Japanese extra fiscal package by the Takaichi government, leading to a further steepening of the curve.

We believe these fears are overstated and think that, among the major developed countries, **Japan is potentially the least exposed to a sharp steepening of the curve going forward**, for the following reasons:

- 1) Judging from past experience, most analysts (including us) expect only a portion of the JPY 21.3tn extra budget to be financed through JGB issuance.
- 2) Japan shows the strongest position in terms of the twin deficit (Figure 11), the vulnerability index (Figure 12) and debt composition (Figure 13).
- 3) Unlike the Fed, the BoE, and the ECB, the BoJ is in (moderate) tightening mode. This should slow- the build-up of the term premium at the long end of the curve.
- 4) The steepening on the Japanese curve has already overshoot our model fair value (Figure 8).

## Steepening challenge: 2/10Y or 10/30Y spread?

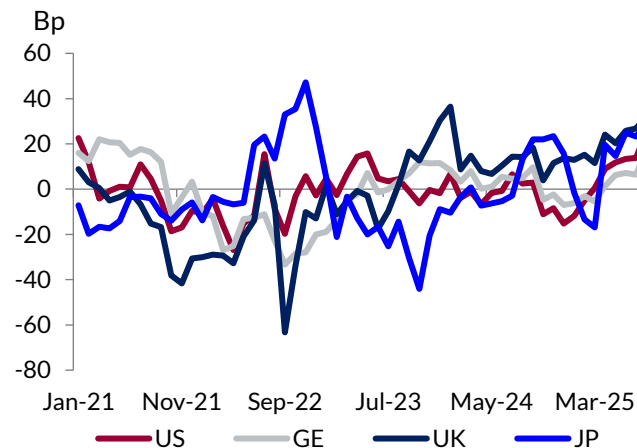
**We expect steepening next year to concentrate on the 2/10Y bucket of the curves**, rather than at the extra-long end of the curve, for the following reasons:

- 1) Based on the level of the 2/10Y spreads across developed countries, 10/30Y spreads are already excessively steep, with the degree of overshooting at the top of the range observed over the last five years (Figure 14). In particular, the overshooting of the 10/30Y spread has been especially pronounced in Bunds, most likely due to the Dutch pension reform, and in Gilts, likely driven by the decline in demand for ultra-long paper from UK pension funds.
- 2) Except for the US, all the other countries have lengthened the average maturity of their debt in recent years. This has created additional flexibility to reduce the average maturity of issuance going forward and adapt to changing investor preferences (Figure 15). For what concerns the US, extra-demand for T-bills coming from the Fed (MBS re-investments and stabilization of reserves) and possibly from the increase in stablecoin volumes, should limit the need to sharply increase supply at the extra-long end of the curve.

**This suggests that, going forward, most of the steepening in the curves should occur within the 10Y maturity bucket rather than in the 10/30Y segment.**

**Figure 14**

**10/30Y spreads steepening have overshoot 2/10Y spreads steepening**

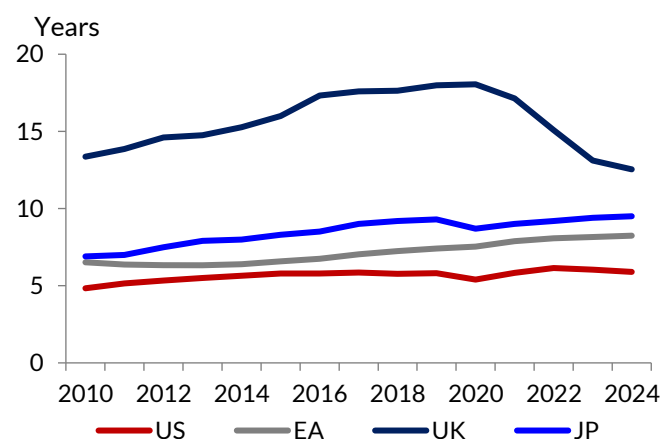


The chart shows the residual from a linear regression of 10/30Y spreads on 2/10Y spreads in selected countries. The regressions were run on monthly data starting in January 2021.

Source: Bloomberg, ANIMA Research

**Figure 15**

**Average maturity of debt creates room to lower maturity of issuance except in US**



Source: Haver Analytics, ANIMA Research

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