Rates Strategy

Dismissing downside risks to UST yields

AUTHOR

Chiara Cremonesi
Senior Rates Strategist
chiara.cremonesi@animasgr.it

We keep our strategically NEUTRAL stance UNDER REVIEW with a negative outlook.

In the last few weeks, downside risks to UST yields have emerged, in particular from:

1) *a more favourable-than-expected funding mix in 2026;*
2) *the purchases of MBS by Fannie Mae and Freddie Mac mandated by the US administration;*
3) *the US attack on Venezuela.*

While these factors might mitigate upward pressure on the term premium, we believe that none of these risks constitutes a game changer or a major driver of USTs in 2026.

In fact, we continue to think that that UST performance in 2026 will be driven by macro fundamentals and the fiscal outlook, as well as political risk premium. All these factors point to higher UST yields in the medium term.

For several reasons:

1) *We now expect annual growth rate of 2.7% in 2026 (vs 2.0% previously), with growth remaining above potential throughout 2026. Against this backdrop, the risks of overheating have risen.*
2) *The risk of a higher-than-forecasted fiscal deficit is increasing, as Trump seeks to address the affordability crisis in the US and counter his loss of popularity from multiple angles.*
3) *We expect the political risk premium to remain high or even increase further. The unprecedented launch of a criminal investigation into Fed Chair Powell by the Department of Justice confirms that unorthodox moves by the Trump administration are likely to continue in 2026.*

Downside risks to UST yields have emerged, but they are not a game changer

1) A more favorable-than-expected funding mix

Following the announcement at the December meeting that, within the framework of reserve management, the Fed will front-load purchases of T-bills in the coming months to offset the expected large increases in non-reserve liabilities in April (due to the seasonality of tax payments) and owing to the expected growth in stablecoins, **we expect the US funding mix this year to rely more heavily on T-bills compared with the past two years.**
Barring upward revisions to the deficit (which, however, are becoming more likely by the day), the heavier reliance on T-bills will translate into a sizeable decline in medium- to long-term bond issuance compared with 2025.

Figure 1 shows that we estimate net-net supply of medium- to long-term bonds (after the Fed's purchases or redemptions) could decline from USD 1.7tn in 2025 to USD 1.3tn in 2026, assuming that:

1) The Fed absorbs around EUR 400bn in T-bills in 2026 via its reserve- management operations.
2) The Treasury aims to keep net T-bills supply (post Fed purchases) roughly unchanged compared to 2025.

This means that even in the event of an increase in deficit due to:

a) the suspension of tariffs under IEEPA by the Supreme Court,
b) an increase in defense spending, or
c) additional fiscal support for middle- and low-income households,

the US Treasury would still have significant room to increase funding via medium- to long-term bonds before bringing issuance back to 2025 levels.

Figure 1

UST funding mix: 2026 vs 2025

USD bn		2025	2026	Change
Deficit	**Tot. Deficit**	2,0	2,1	0,2
Financing (Net)	**M-L**	1,6	1,3	-0,3
	Bills	0,4	0,8	0,4
Fed	**M-L**	-0,1	0,0	0,1
	Bills	0,0	0,4	0,4
Net-net supply	**Net-Net M-L**	1,7	1,3	-0,4
	Net-Net bills	0,4	0,4	0,0

Source: SIFMA, Bloomberg, ANIMA Research

While this factor could alleviate upward pressures on the term premium, we believe it is not a game changer, for the following reasons:

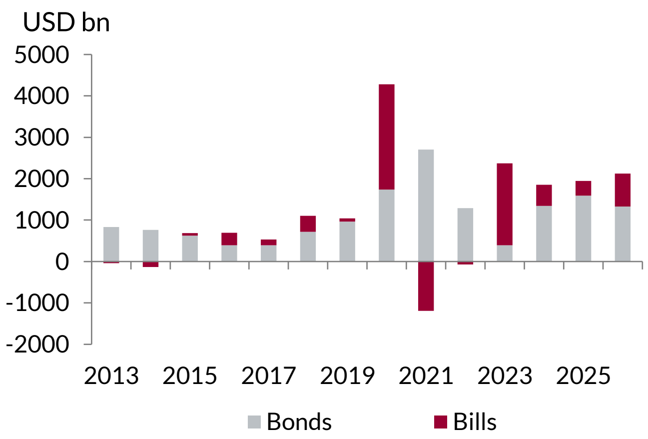
1) Markets had already priced in the end of QT in 2026, which in 2025 added a moderate USD 115bn in M/L term bond supply to the regular net supply.

2) Even though declining, net supply of M/L bonds remains historically high: since 2021, the average yearly net-net supply has been around USD 1.5tn, and we expect it to be in the USD 1.3tn area this year, with risks skewed to the upside (Figure 2 and 3).

3) In terms of 10Y equivalents, the Fed's ownership of marketable US debt will remain essentially unchanged in 2026 versus 2025, indicating that the Fed's purchases are neutral from a duration perspective (Figure 4).

Figure 2

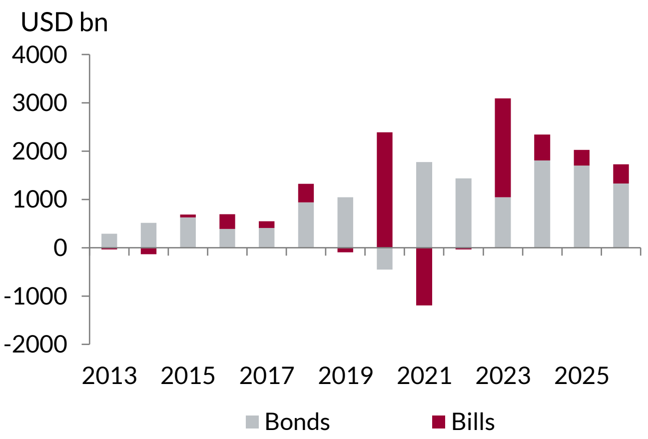
Yearly net supply: M-L bond and bills



Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 3

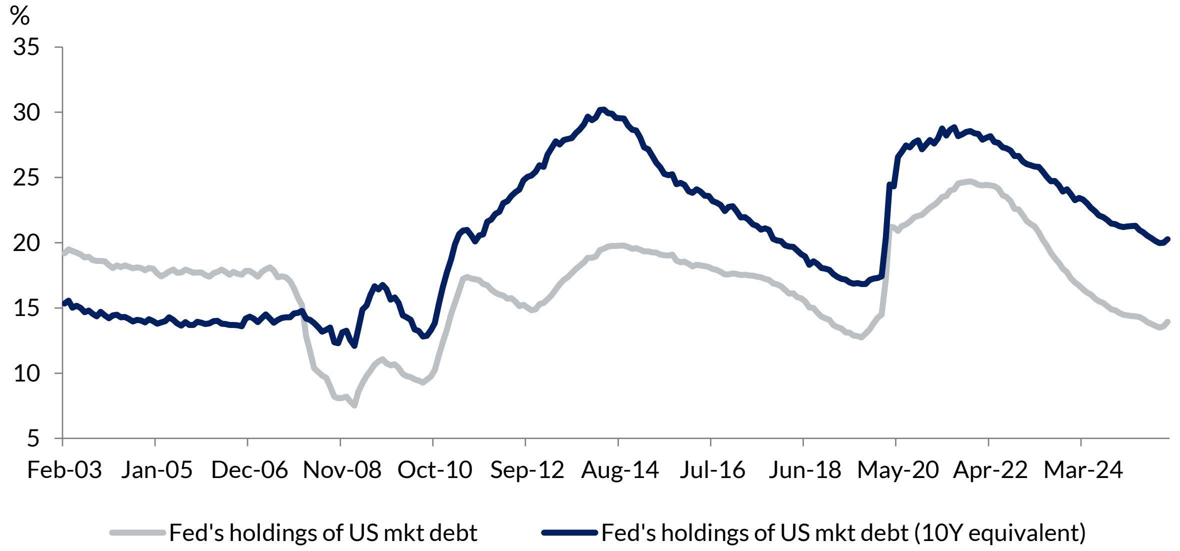
Yearly net-net supply



Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 4

Fed's purchases will not impact duration in the UST market



Source: Bloomberg, ANIMA Research

2) We do not expect demand for USTs to create a "scarcity" effect

In the first three quarters of 2025, demand for USTs has held up relatively well, excluding the episode of market tensions around Liberation Day. That said, Figure 5 shows that most private investors, with the exception of retail investors and non-residents, have absorbed less UST issuance compared with 2024. Moreover, Figure 5 shows a declining trend in UST purchases by mutual funds and pension funds since 2023.

Against this backdrop, **while the decline in medium- to long-term UST issuance will help the supply/liquidity balance, we do not expect private-sector demand to be strong enough to generate a "scarcity" effect or to trigger a meaningful decline in yields.** For the following reasons:

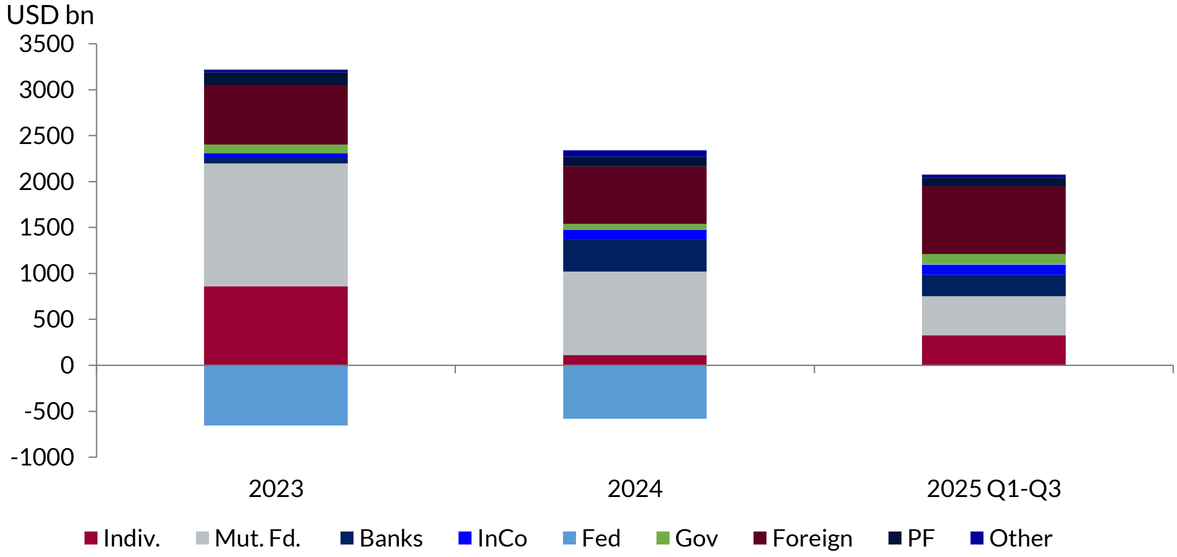
1) Foreign official flows remain overall neutral to negative, and have so far been compensated by strong inflows from foreign private investors. However, higher yields in the EA and Japan (the main buyers of USTs in 2025, together with the UK), combined with elevated hedging costs, point to stable demand at best from foreign private investors in 2026 (Figure 6 and 7).

2) Even after accounting for the Fed's purchase of T-bills, we project unchanged net supply in bills compared with 2025. Meanwhile, short-term yields are substantially lower than in H1 2025, making short-term instruments less attractive for retail investors and money-market funds.

3) Banks could certainly increase their UST holdings (we estimated by at least USD 500bn), but in 2025 their purchases of USTs have been slightly lower compared with 2024. Therefore, unless there is a significant easing of regulation, we do not expect a sharp increase in holdings from this investor category in 2026.

Figure 5

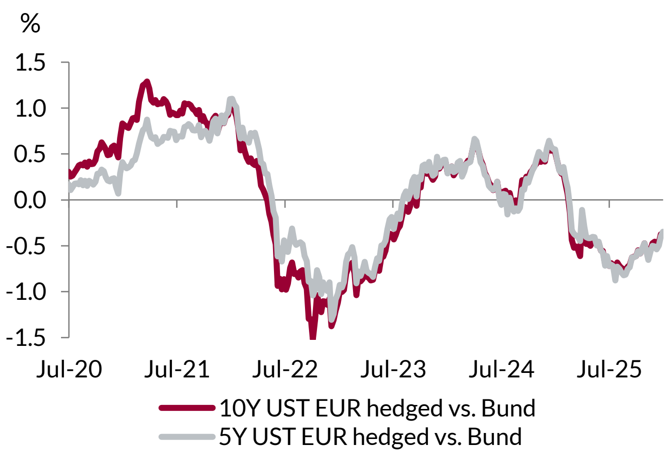
Yearly change in holdings by various categories of investors in USTs



Source: SIFMA, ANIMA Research

Figure 6

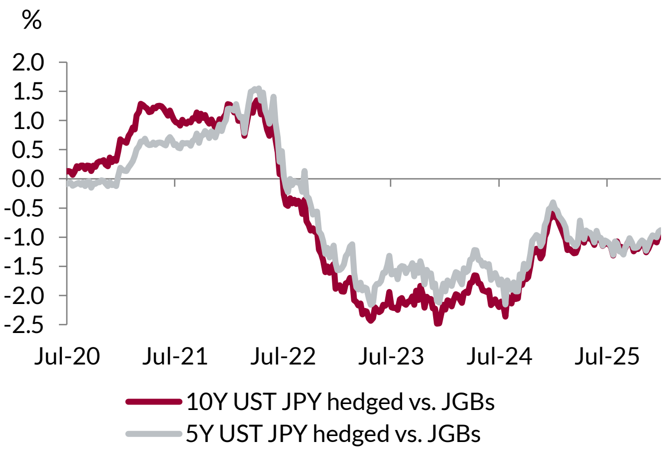
UST EUR hedged vs. Bund



Source: Bloomberg, ANIMA Research

Figure 7

UST JPY hedged vs. JGBs



Source: Bloomberg, ANIMA Research

3) Mandated MBS purchases: no duration impact

Among the various Trump's measures announced in the last few days, there is the mandate to Fannie Mae and Freddie Mac to purchase USD 200bn of MBS. According to the administration, this measure would serve the purpose of lowering mortgage rates as part of efforts to address the housing crisis.

While the announcement led to a compression of MBS spreads, we are skeptical it could spill over to USTs in any meaningful way, for two main reasons:

1) Fannie Mae and Freddie Mac hedge their duration exposure in the swap market, and this effectively neutralises the duration impact of their purchases on the UST market.

2) This measure has already compressed MBS spreads over USTs and pushed mortgage rates towards 6%, which is, at the margin, a positive factor for growth, as it could trigger an increase in housing demand. Any further boost to growth would ultimately be UST-negative.

4) The Venezuela crisis and its impact on oil prices

Following the US attack in Venezuela, one the possible scenarios is that oil supply could further increase in the long-term leading to a further fall in oil prices, especially in a context of already abundant supply of oil and slowing demand.

While this could be the case, we remain cautious that this factor could impact our tactical and strategic positioning for the following reasons:

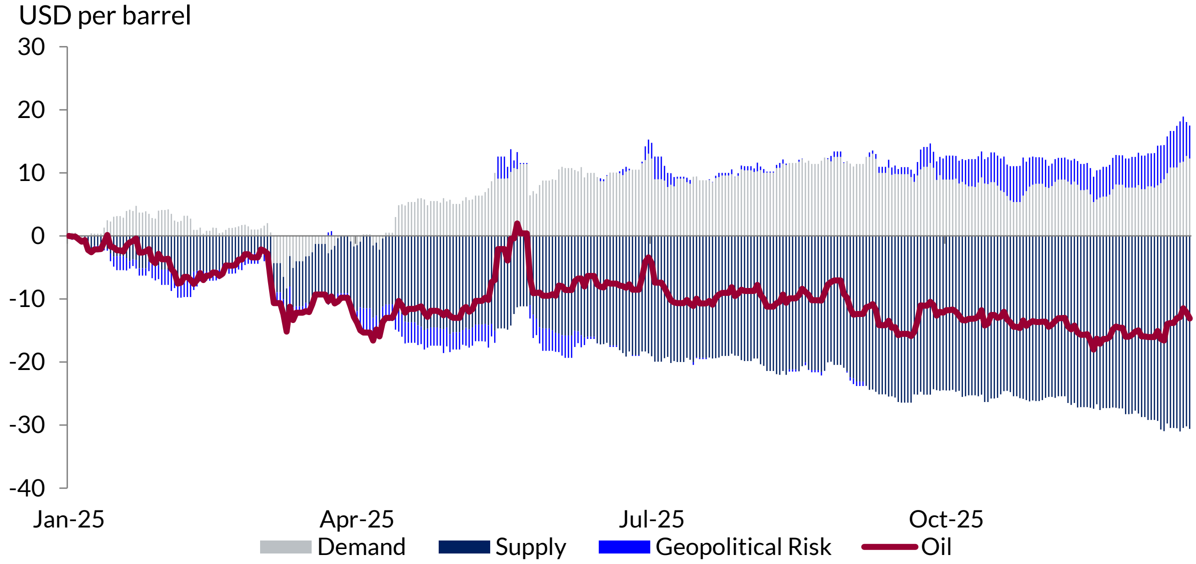
1) It is far from a foregone conclusions that the oil output from Venezuela will increase within a reasonable timeframe. The country's oil infrastructure is severely depleted, and it would take billions in investment to raise production in a meaningful way. Moreover, the necessary conditions for creating a stable business environment - one in which international oil companies are willing to invest - include a peaceful political transition and a change in the ruling class.

2) Figure 8 shows that, while geopolitical risk is increasing, its impact on oil prices remains overall subdued, with oil prices still largely driven by supply-and-demand dynamics. In our view, this reflects the fact that geopolitical instability has not yet affected major oil-producing countries (the supply side) nor created significant downside risks to global growth (the demand side).

3) Looking at the historical relationship between Brent prices and the US 10Y breakeven, we find that a 10% change in oil prices translates into a 4–6bp move in 10Y breakeven rates. This is not a large impact. Moreover, the ultimate effect of changes in oil prices on nominal yields is significantly less clear, as it depends on the monetary-policy stance, the phase of the economic cycle, and whether the shift in oil prices generates second-round effects on inflation.

Figure 8

The impact of geopolitical risk on oil prices remains subdued



Source: Bloomberg, ANIMA Research

We continue to see upward pressure on UST yields

We continue to think that the UST performance in 2026 will be driven by macro fundamentals and the fiscal outlook, as well as the political risk premium. All these factors point to higher UST yields in the medium term. Against this backdrop, **we keep our strategically NEUTRAL stance UNDER REVIEW with a negative outlook.**

1) Upgrading our growth outlook

We have upgraded our growth outlook for this year, as domestic demand ended 2025 on a stronger footing than we had expected. We now expect annual growth of 2.7% in 2026 (vs 2.0% previously), with growth remaining above potential throughout 2026. This, combined with higher productivity, could trigger investors' expectations of a rise in US growth potential - especially considering that annual US growth has remained above potential since 2021.

Our 10Y UST fair-value model shows that, for a 25bp increase in potential growth (real or expected), the equilibrium level of the 10Y UST could rise by around 10bp.
UST yields could rise even further, as investors price in increasing risks of overheating in the economy.

2) Increasing risks of higher deficit

The risk of a higher-than-forecasted fiscal deficit is rising, as Trump seeks to address the affordability crisis in the US and his loss of popularity from multiple angles. The increase in deficit could come from the following sources:

- ✓ The Supreme Court striking down IEEPA tariffs.
- ✓ New measures aimed at supporting middle and low-income families in response to the affordability crisis.
- ✓ An increase in military expenditure: President Trump has stated that defence spending should be raised to USD 1.5tn, up from the current USD 1tn.

Across these scenarios, we estimate that the additional deficit could range between USD 250bn and USD 500bn, effectively neutralising the decline in medium to long-term UST issuance expected this year.

3) Political risk premium to remain high or even increase

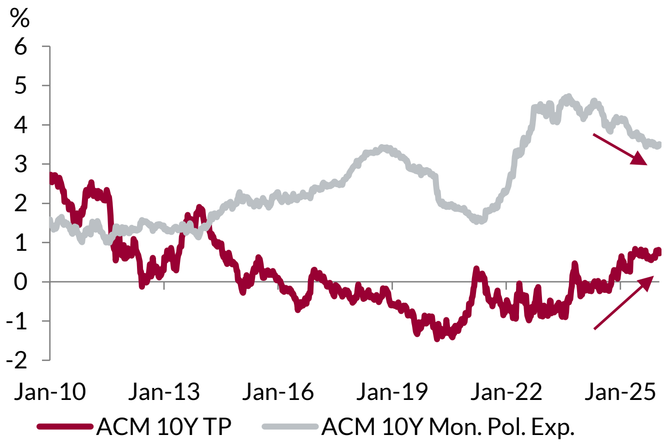
Figure 9 shows that in 2025 monetary-policy expectations (including long-term expectations) declined, while the term premium increased. At the 10Y tenor, the term premium (ACM specification) has returned to levels last seen in 2014.

Figure 10 shows that the increase in the term premium post-Liberation Day is not explained by the traditional drivers of the term premium (unemployment rate, inflation risk premium, rate volatility, or the free float of marketable debt). Instead, based on our earlier analysis, it is more likely attributable to the rise in unorthodox policies under the Trump administration, which we interpret as an increase in the political risk premium. At present, we estimate this premium to be around 100bp.

We expect the political-risk premium to remain high in 2026, or even increase further. The unprecedented launch of a criminal investigation into Fed Chair Powell by the Department of Justice reinforces the view that political interference in monetary affairs will remain elevated, contributing to persistent upward pressure on the term premium.

Figure 9

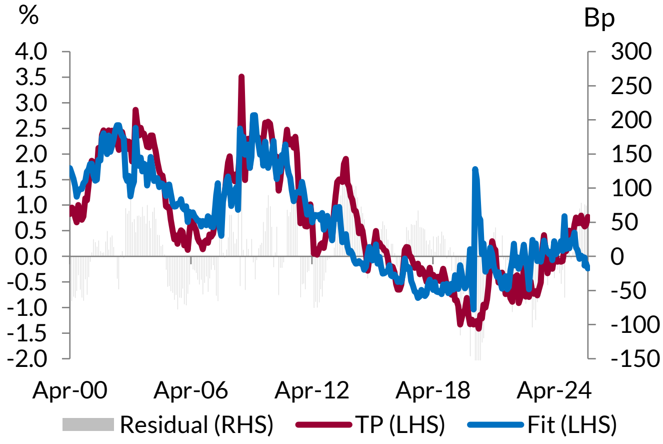
TP rising and monetary policy expectations declining



Source: Bloomberg, ANIMA Research

Figure 10

Political risk premium has risen since Liberation day



Source: Bloomberg, ANIMA Research

Figure 10 shows our model that regresses the 10Y term premium on the unemployment gap, the inflation risk premium, rate-market volatility, and the free float of government bonds. The model is estimated using monthly data from December 1999 to the present. We interpret the residual of this model as the political risk premium.

ANIMA INVESTMENT RESEARCH

FABIO FOIS
Head of Investment Research & Advisory
fabio.fois@animasgr.it

CHIARA CREMONESI
Senior Rates Strategist
chiara.cremonesi@animasgr.it

FRANCESCO PONZANO
Junior Equity Strategist
francesco.ponzano@animasgr.it

MATTEO GALLONE
Junior Macroeconomist
matteo.gallone@animasgr.it

COSIMO RECCHIA
Senior Equity Strategist
cosimo.recchia@animasgr.it