Rates Strategy

Strategically NEUTRAL on govies

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We switch to a strategically NEUTRAL position on USTs (from CONSTRUCTIVE with a negative outlook previously). While current yield levels remain historically appealing, barring a sudden slowdown in economic momentum (which is not our baseline), we believe there is very little room (if any) for yields to decline from current levels. In fact, we see risks skewed more towards higher rates from here, for the following reasons:

1) We expect growth to re-accelerate in 2026, though it will remain moderately below potential.

2) Upside risks to inflation are likely to be priced in, at least during H1 2026.

3) We expect a dovish-leaning Fed to cut rates to slightly below neutral by Q3 2026, with risks of an even quicker adjustment. This represents a more aggressive pace of easing than warranted by our macro-outlook.

4) We anticipate an increase in the political risk premium embedded in USTs.

5) Supply pressures are expected to accelerate in 2026.

The main risk to our strategic NEUTRAL positioning on USTs is a further deterioration in the macroeconomic outlook, with the US economy possibly flirting with recession, a scenario that would justify an accelerated rate-cutting cycle. In such a case, the macro-outlook would become the main driver of government bond performance, leading to a decline in 10Y UST yields well below 4%.

On Bunds, we remain STRATEGICALLY NEUTRAL. With EA growth expected to accelerate in 2026 and Bund supply rising sharply, the medium-term bias for Bund yields remains upward, although strong demand for EA government bonds is likely to partially offset this pressure.

On BTPs, we remain STRATEGICALLY NEUTRAL. The high and positive correlation with Bunds suggests an upward bias for BTP yields in the medium term. That said, we expect solid demand for BTPs (driven by attractive yields and a steeper curve relative to Bunds) and an improvement in the fiscal outlook to offset at least some of the upward pressure.

We switch to a strategically NEUTRAL stance on USTs

After holding a CONSTRUCTIVE strategic stance with a NEGATIVE outlook since July last year, **we switch to a NEUTRAL strategic stance on USTs**. While current yield levels remain historically appealing, barring a sudden slowdown in economic momentum (which is not our baseline), we believe there is very little room (if any) for yields to decline from current levels. In fact, we see risks skewed more towards higher rates from here. Meanwhile, uncertainty remains high, given the unorthodox approach taken by the Trump administration in politics and economics. Against this backdrop, we adopt a more cautious medium-term stance on USTs.

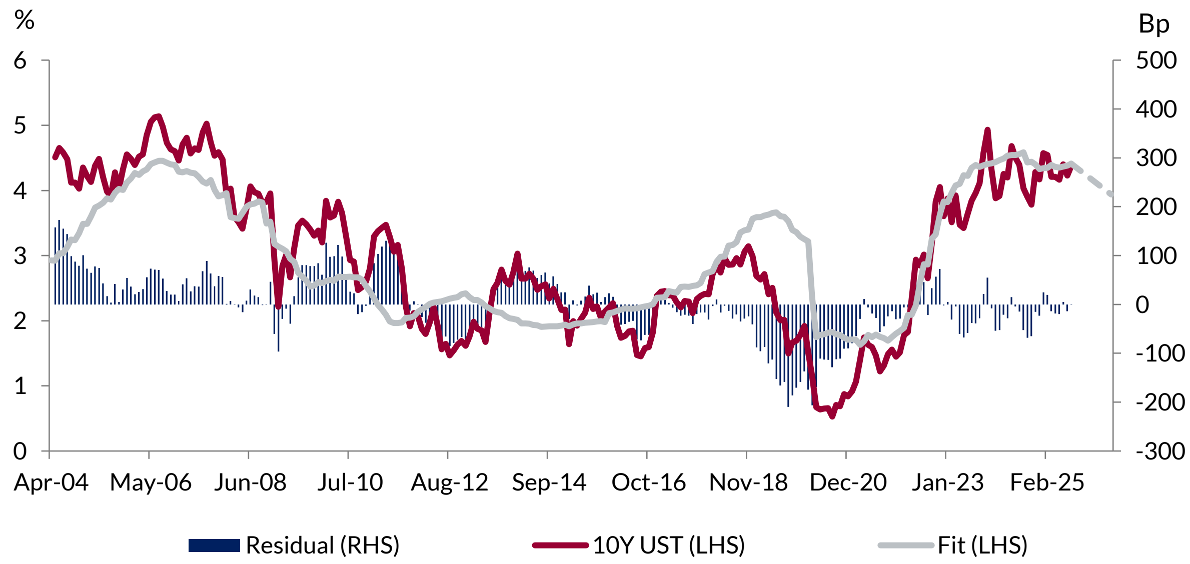
1. Growth expected to re-accelerate in 2026

We expect growth to re-accelerate in 2026 towards potential, supported by expansionary fiscal policy, easier monetary policy, and strong consumer balance sheets, especially among high earners. That said, we do not expect the economy to overheat; rather, we expect growth to remain moderately below potential, even with a dovish-leaning Fed.

While overheating of the economy is not our baseline scenario, a re-acceleration of growth towards potential will be enough in our view to prevent a sustained rally of USTs below current levels. Our fair value model shows that even assuming core PCE converges to 2% and the Fed cuts the federal funds rate to 3%, 4% remains a strong support level for yields in the medium term. And this is assuming that political risk does not increase (see paragraph 4).

Figure 1

Re-accelerating growth will likely prevent 10Y UST yields from falling below 4%



Source: Bloomberg, Haver Analytics, ANIMA Research

2. Inflation will converge to target, but risks will continue to be priced

Our baseline is that US inflation will converge to target by Q3 next year. That said, we expect markets to remain on their toes regarding inflation risk in the medium-term, especially in H1, for the following reasons:

A) We expect real disposable income and consumer demand to re-accelerate in 2026, supported, among other factors, by moderate fiscal easing.

B) We expect a dovish-leaning Fed, operating in a context of already loose financing conditions.

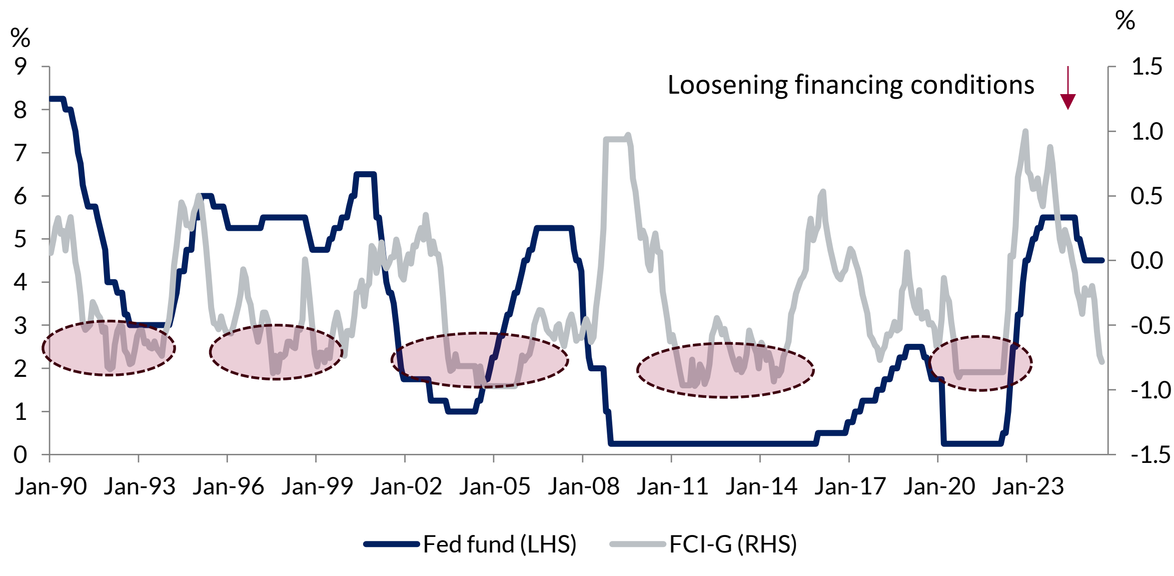
3. We expect the Fed to cut rates to neutral by the end of Q3 2026

Our baseline scenario is that the Fed will deliver two rate cuts in October and December and three additional rate cuts in 2026 and take the Fed fund rate to 2.75-3.00% by September 2026, slightly below neutral. Risks are for an even quicker pace of adjustment.

According to a traditional Taylor rule and prevailing financing conditions, our 2026 macro-outlook would be consistent with a Fed fund rate around 50bp higher than our call. Against this backdrop, a dovish-leaning Fed could fuel higher inflation expectations and an increased inflation risk premium, resulting in a steepening of the curve and stable-to-higher long-term yields.

Figure 2

Loose financing conditions not consistent with Fed Fund rate cuts to neutral



Source: Bloomberg, ANIMA Research

4. Political risk premium at the long end of the curve might continue to increase

Figure 3 shows that, according to our fair value model[1] the rise in 10Y term premium (TP) in recent months has been larger than its traditional movers would suggest, leading to a positive model residual for the first time since the end of 2017. We conclude that this was due to political uncertainty stemming from the unorthodox conduct of the Trump administration and believe that the residual of our model could be interpreted as the political risk premium priced into USTs, for the following reasons:

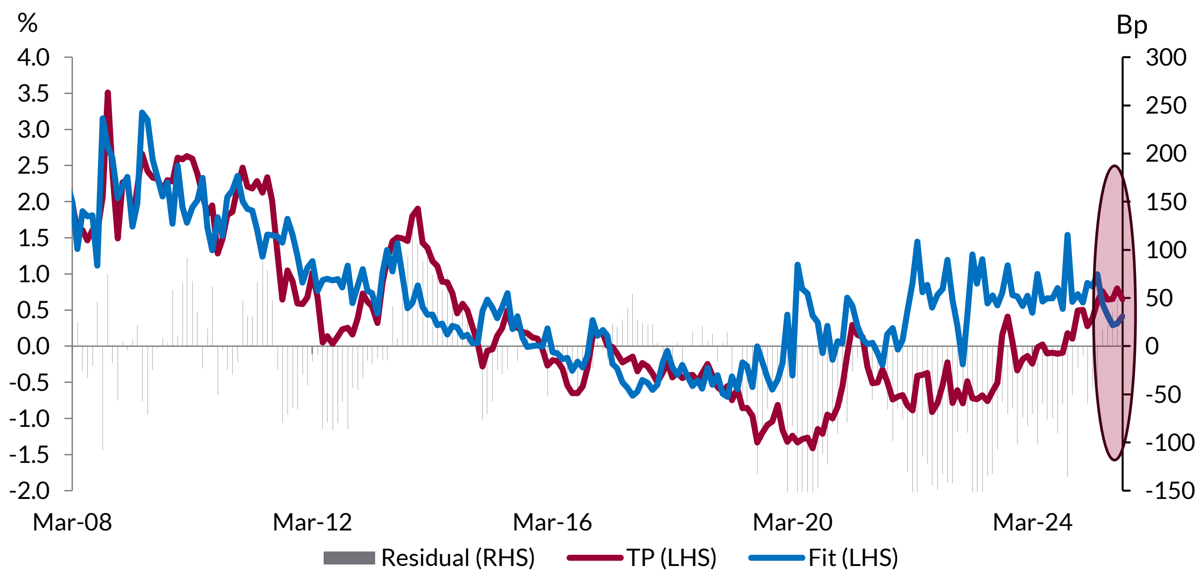
A) From Trump's election until April, the residual of our model was still negative, with the TP rising less than traditional drivers would suggest. The situation reversed starting from April, when the residual of the model turned positive and began to increase. This reflected a wakeup moment, when markets realized that Trump's approach to trade policy and to traditional institutions was not in line with the past.

B) The rise in the residual of our model since April is positively correlated with the increase in US-specific economic policy uncertainty, the widening of US CDS spreads, higher gold prices and the fall in the dollar index (Figures 4 and 5).

C) While fiscal concerns are often cited as a primary reason for a higher term premium in the US (and globally more generally), we think this is only part of the story (and already captured by the free-float variable in our model). The fiscal outlook has been quite problematic for some time and certainly well before the US Congress passed the One Big Beautiful Bill Act (OBBBA). What instead in our view reignited investors' concerns about debt sustainability are the risks connected to Trump's administration, which not only is failing to tackle the issue seriously, but might also lead to a deterioration in foreign investors' confidence.[2]

Figure 3

10Y term premium has risen more than the model predicted since April



Our model regresses the 10Y term premium on the unemployment gap, the inflation risk premium, the volatility in rates markets and the free-float of government bonds. The model is estimated using monthly data from December 1999 to the present.

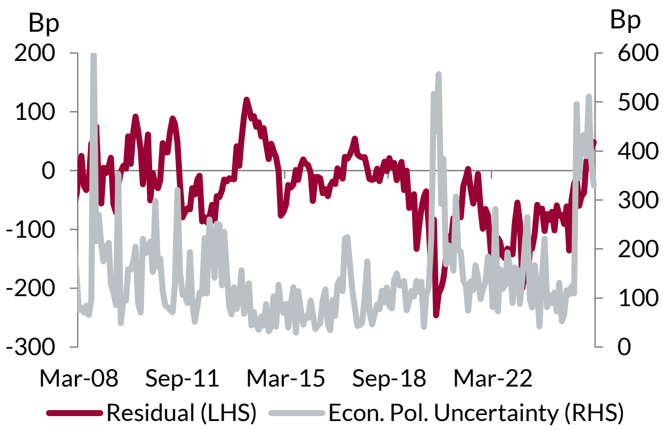
Source: Bloomberg, Haver Analytics, ANIMA Research

[1] Our model 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.

[2] See, for instance: *"Are Bad Governments a Threat to Sovereign Defaults? The Effects of Political Risk on Debt Sustainability"*, Samantha Ajovalasit, Andrea Consiglio, Giovanni Pagliardi, and Stavros A. Zenios. https://www.bruegel.org/sites/default/files/2025-01/WP%2001%202025_0.pdf

Figure 4

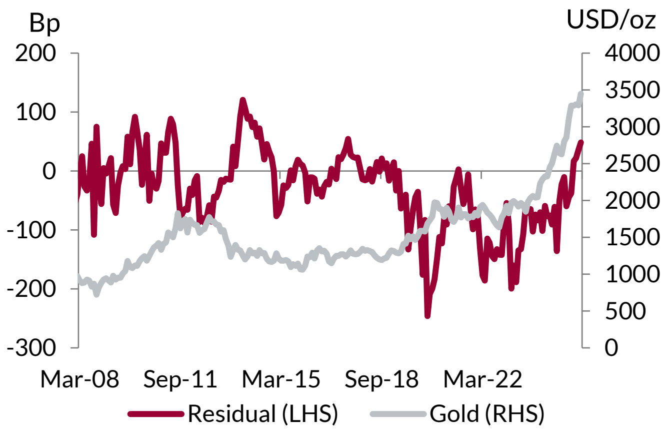
TP model residual and US economic policy uncertainty



Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 5

TP model residual and gold prices

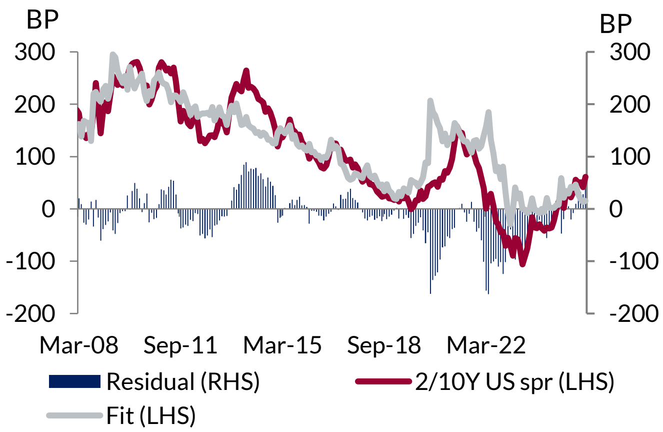


Source: Bloomberg, Haver Analytics, ANIMA Research

We find that the steepening of the UST curve is also connected to the political risk premium. Our models show that both the 2/10Y and the 10/30Y spreads are around 40bp steeper than fundamentals would suggest. In both cases, the divergence from the model fair value began to increase from April (Figures 6 and 7). Moreover, Figure 8 shows that the 2/10Y spread is no longer correlated with the shape of the money market curve, confirming that the recent steepening has been largely driven by the political risk premium rather than traditional factors.

Figure 6

2/10Y spread is ca. 40bp too steep

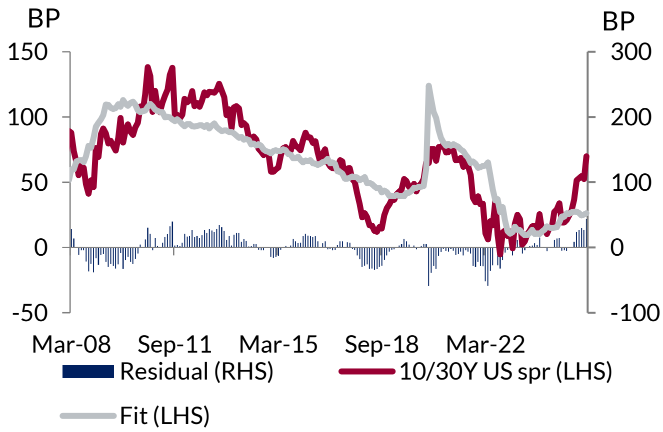


Our model regresses the 2/10Y and the 10/30Y spreads on the unemployment gap, the inflation risk premium, the volatility in rates markets and the free-float of government bonds. The model is estimated using monthly data from December 1999 to the present.

Source: Bloomberg, ANIMA Research

Figure 7

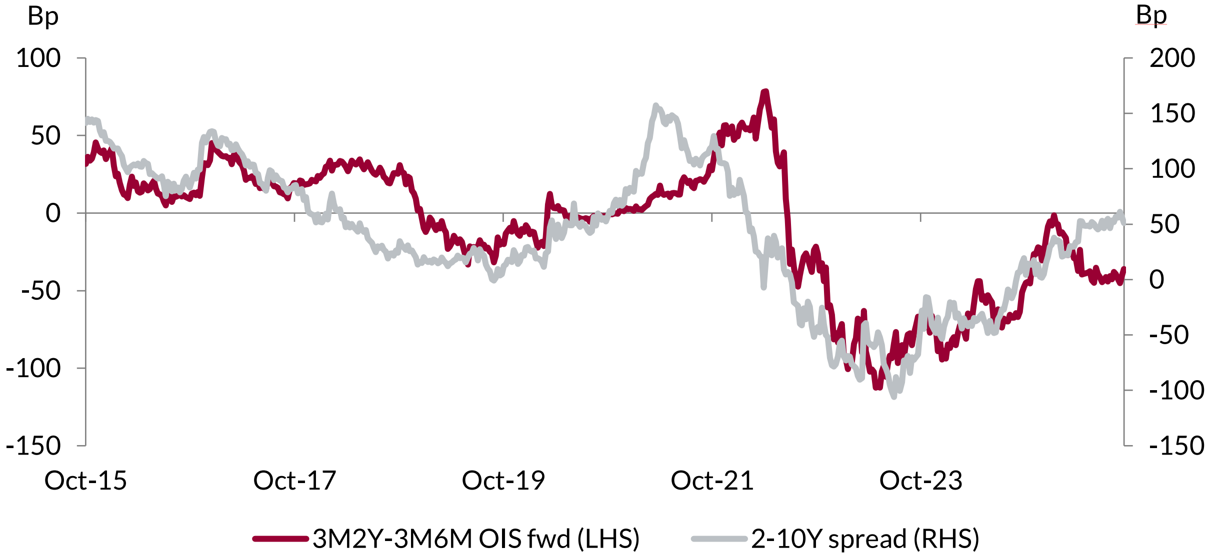
10/30Y spread is ca. 40bp too steep



Source: Bloomberg, ANIMA Research

Figure 8

2/10Y is no longer a function of the shape of the money market curve



Source: Bloomberg, ANIMA Research

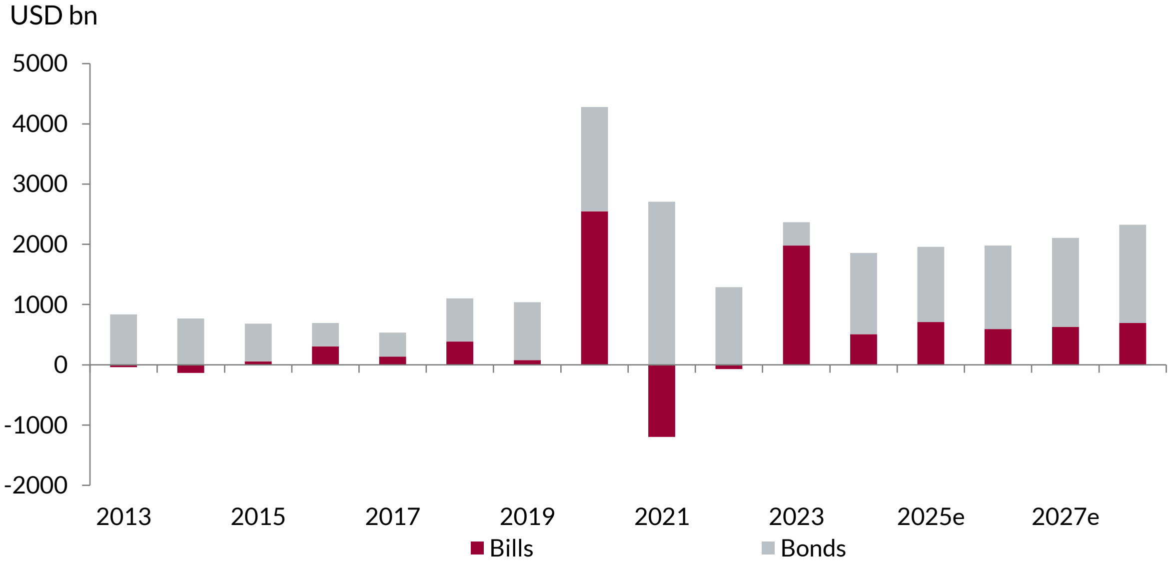
We think that the political risk premium could increase further from current estimated levels, in the medium term, especially if Trump's attitude towards traditional institutions remains confrontational and/or if the various courts involved in judging the administration's actions (e.g., the Supreme Court on the use of IEEPA as a means to impose universal tariffs) rule in favour of the Trump administration without a strong, law-compliant rationale. Against this backdrop, **we expect the trend of UST curve steepening to continue next year.**

5. Supply pressure will accelerate

While we expect 2025 to turn out better than expected in terms of fiscal position, mainly due to higher-than-expected tariff revenues, the fiscal outlook will begin to deteriorate again in 2026. Our projections show that the deficit could rise to above USD 2tn in 2026 (from an estimated USD 1.7tn) and continue increasing to reach USD 2.3tn by 2028 (these figures are already net of tariffs revenues). We expect the Treasury to continue financing at least 30% of net borrowing via bills, but even so, this would still leave USD 1.4–1.6tn to be financed annually via long-term bonds over the next three years - an historically high amount (Figure 9).

Figure 9

Net supply to rise in the next years, even accounting for tariff-related revenues relief



Source: SIFMA, US Treasury, ANIMA Research

6. Carry remains a protective force

While we see very little room for UST yields to decline from current levels in the medium term, we acknowledge that **carry at the long end of the curve remains a strong reason not to go short USTs**. Taking into account current yield levels and assuming an investment horizon of one year, today's levels in 10Y USTs can offset as much as a 45bp increase in yields, while at the 5Y they can offset as much as 70bp increase.

Risks to our NEUTRAL strategic stance

The main risk to our NEUTRAL strategic stance on USTs is a further deterioration in the macroeconomic outlook, with the US economy flirting with recession, **which would justify** an accelerated rate-cutting cycle. In that case, markets would read a dovish-leaning Fed as a positive factor rather than focusing on the long-term adverse consequences of political interference. In this scenario, **the macro outlook would become the main driver of government bond performance, leading to 10Y yields well below 4%.**

We remain strategically NEUTRAL on Bunds

We stick to our NEUTRAL strategic positioning on Bunds. While the current level of Bund yields is in the high end of the last three years' range, we continue to expect Bund yields to increase towards the 3% level in the medium-term, due to:

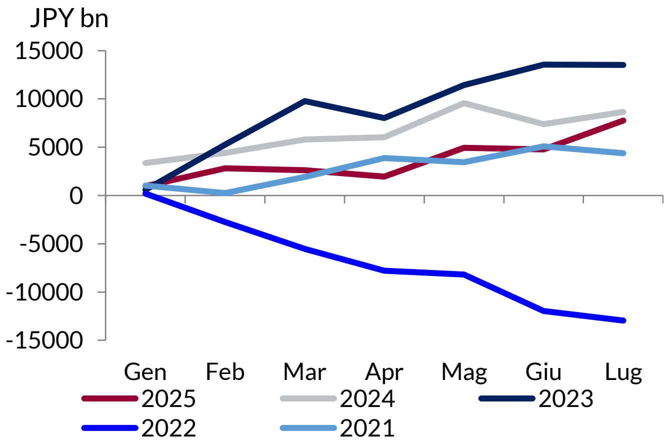
1) A re-acceleration in German and EA growth, mainly driven by the German fiscal package. We expect EA growth to average 0.3% q/q in H1 2026 and 0.4% q/q in H2 2026, up from 0.1% q/q in Q4 2025.

2) A steep increase in Bund issuance. We expect net issuance to increase from EUR 145bn in 2025 to around EUR 175bn in 2026, surpassing 3.8% of GDP. Including QT, net supply in Germany will climb towards EUR 275bn. We expect the free float of Bunds to increase from less than 60% in 2025 to 70% by the end of 2026, and to continue rising in the following years.

The upward pressure on Bunds will be partly mitigated by robust demand, especially from foreign and domestic banks. Figure 10 and 11 show that between January and July 2025, while Japanese investors' flows into USTs were moderately lower than in previous years, flows into EGBs strengthened significantly. Figure 12 also shows that, in addition to foreign investor inflows, EGBs are benefitting from strong demand from EA banks.

Figure 10

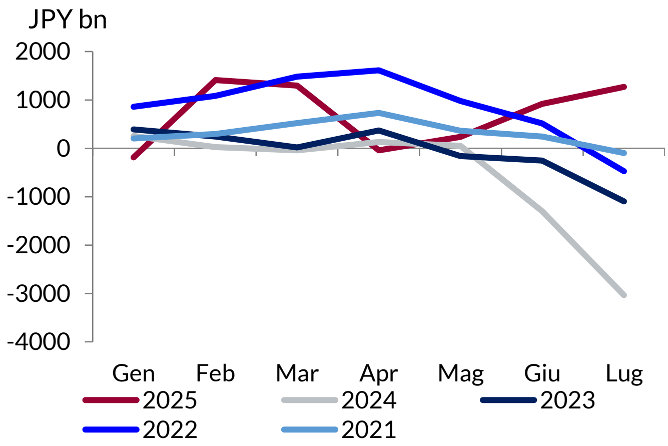
Jan-Jul: cumulative flows into USTs from Japanese investors



Source: Bloomberg, ANIMA Research

Figure 11

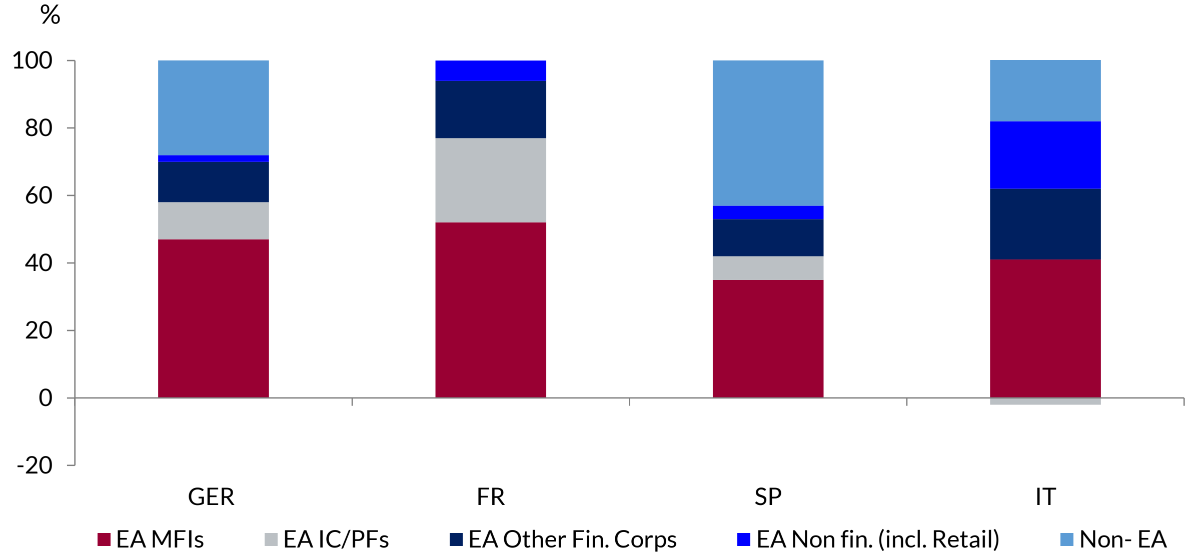
Jan-Jul: cumulative flows into Bund, OAT, BTP & SPGB from Japanese investors



Source: Bloomberg, ANIMA Research

Figure 12

Strong inflows from EA banks into EGBs in H1 2025



The chart shows the % of net supply absorbed by each type of investor in H1 2025

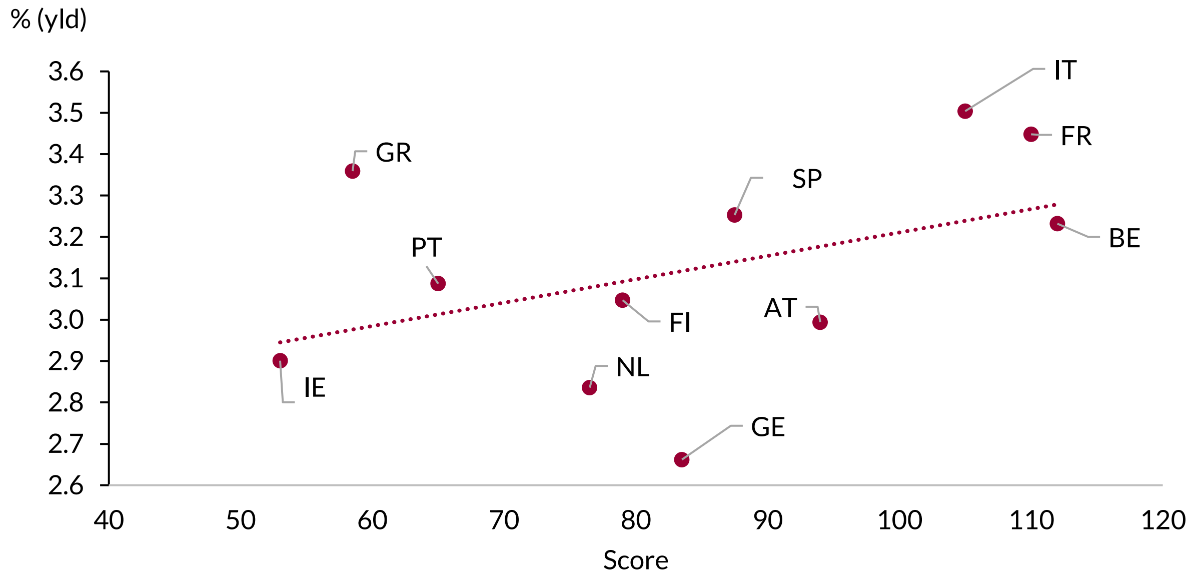
Source: ECB SHS, Deutsche Bank, ANIMA Research

We remain strategically NEUTRAL on BTPs

Strategically, we remain NEUTRAL on BTPs. The high and positive correlation with Bunds suggests that the bias for BTP yields is upwards in the medium term. That said, we expect solid demand for BTPs (driven by attractive yields and a steeper curve relative to Bunds) together with an improvement in the fiscal outlook, to offset at least part of the upward pressure coming from core yields. Figure 13 shows that, according to fundamentals, BTPs still trade cheap within the EGB universe.

Figure 13

BTPs are cheap relative to EGBs, according to fundamentals



Source: Bloomberg, Haver Analytics, IMF, ANIMA Research

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