Rates Strategy

UST: No reason to abandon strategic neutrality

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We remain strategically NEUTRAL on USTs.

While the absolute level of yields remains attractive and macro fundamentals suggest that yields could be lower than current levels, we still prefer to maintain a cautious stance.

First, real yields have recently become more sensitive to uncertainty, especially surrounding monetary policy, the fiscal outlook and exogenous price shocks. Given that at least some of these uncertainties will likely remain in play in the coming months, while economic growth will remain resilient, we do not find sufficient reasons for a sizeable rally in 10Y USTs from current levels in the coming months.

Second, with geopolitical, monetary policy and fiscal risks showing no signs of abating, the risks of a higher term premium remain, especially if the Fed's rhetoric becomes less hawkish. The fiscal outlook in particular will need to be monitored, as it is the only topic on which Democrats and Republicans could find a compromise, leading to a further rise in the deficit. While we think the actual likelihood of a much higher deficit is low, markets may price in the risk.

Third, uncertainty about the Fed's reaction function will not be resolved easily and will contribute to greater volatility in the UST market.

Last but not least, our measure of political risk premium has already declined over the last three months, making a further decline unlikely even if a Democrat-controlled Congress acts as a mitigator against Trump's policies.

A more pronounced slow-down in economic growth than expected would lead us to switch to a POSITIVE strategic positioning, while a deficit-to-GDP ratio rising towards and above 7% would lead us to adopt a strategic SHORT position.

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Completed: 19 November 2026

Sticking to a strategic NEUTRAL positioning

We stick to our strategic NEUTRAL positioning on USTs, as we believe that the potential for a further rally of USTs is limited.

In principle, **our fair value model for nominal yields indicates that 10Y USTs should trade around 4.40-4.50%** (**Figure 1**). However, we believe this should be viewed as a floor, rather than a central estimate, if our macro baseline materialises. This is for the following reasons:

1) Real yields have become more sensitive to uncertainty

We forecast GDP growth of 2.2% in 2027, slightly above potential, but consistent with an economy that is not overheating. With disinflation accelerating over the course of 2027, our fair value model for nominal yields indicates that 10Y USTs could decline to 4.40-4.50% (**Figure 1**). However, we believe this should be interpreted as a hard floor, even if our macro baseline materialises, for the following reasons:

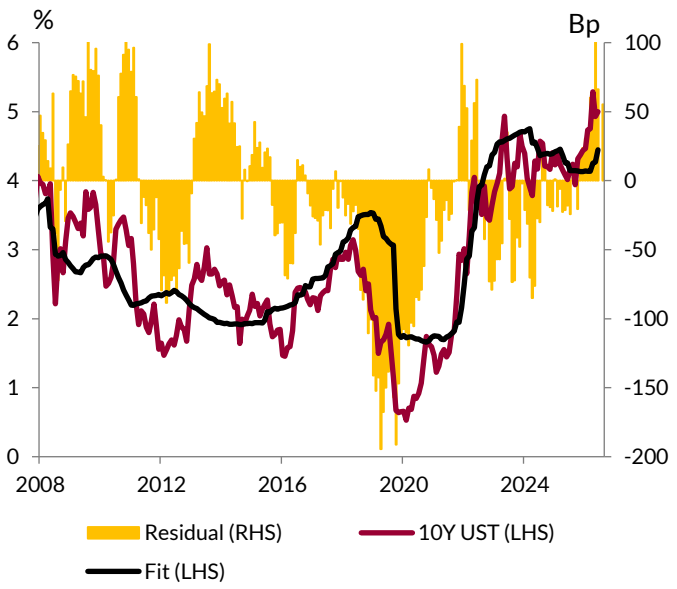
a. 10Y breakeven rates are already trading at around 2.20/2.25%, implying much lower PCE inflation, lower energy prices and lower inflation expectations than those prevailing now (**Figure 2**). In other words, at current levels breakeven rates are already pricing in most of the convergence we expect next year.

b. Meanwhile, real yields remain cheap according to our fair value model (**Figure 3**). That said, as has been evident over the last couple of years, real yields no longer purely reflect the macroeconomic and monetary policy baseline, but have also become more sensitive to uncertainty, especially surrounding monetary policy, the fiscal outlook and exogenous price shocks (**Figure 4**).

Against this backdrop and given that at least some of these uncertainties will remain in play in the coming months (see the following paragraphs), while growth will nevertheless remain resilient, **we do not find sufficient reasons for a sizeable rally in 10Y USTs from current levels in the coming months.**

Figure 1

Based on fundamentals, UST are cheap

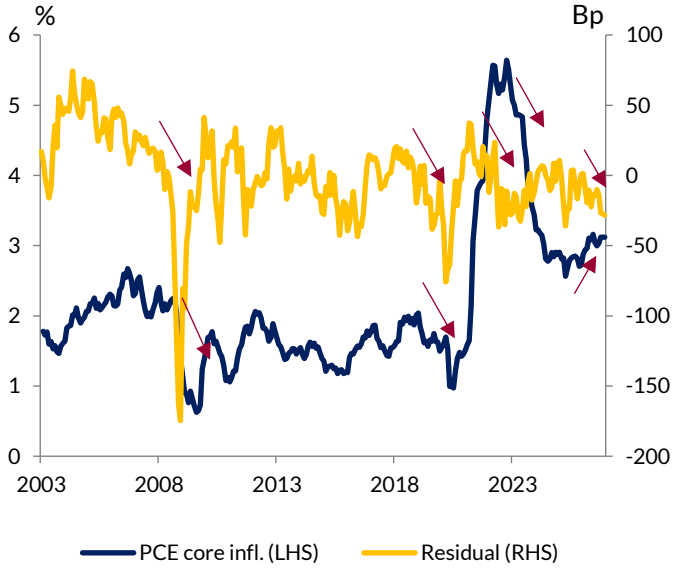


The model regresses 10Y US nominal yields on Fed funds rates, core PCE inflation, potential GDP growth and the amount of USTs held by the Fed, expressed as a share of US federal marketable debt. The model is estimated using monthly data over the period from 2003 to the present.

Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 2

Markets are discounting a sizeable drop in inflation

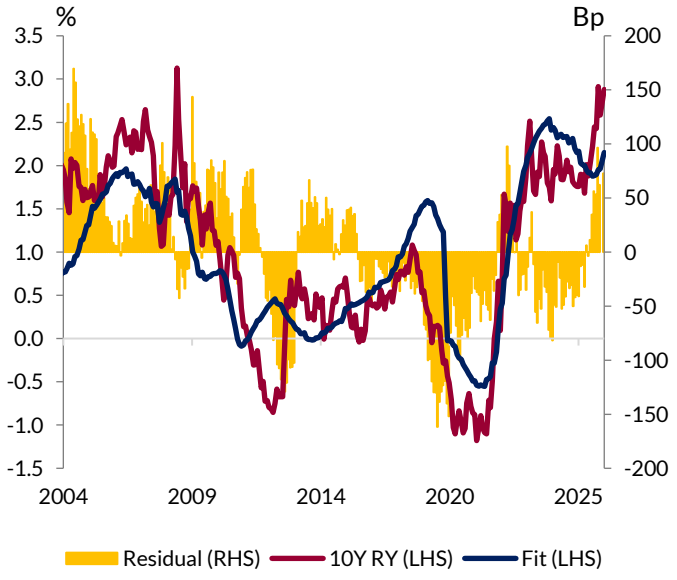


The yellow line is the residual of a model that regresses 10Y US breakeven rates on PCE core inflation, oil prices and consumers' inflation expectations in the next 5-10 year as captured by the U-Mich survey. The model is estimated on monthly data in a sample going from 2003 until present.

Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 3

Based on fundamentals, real yields are too high

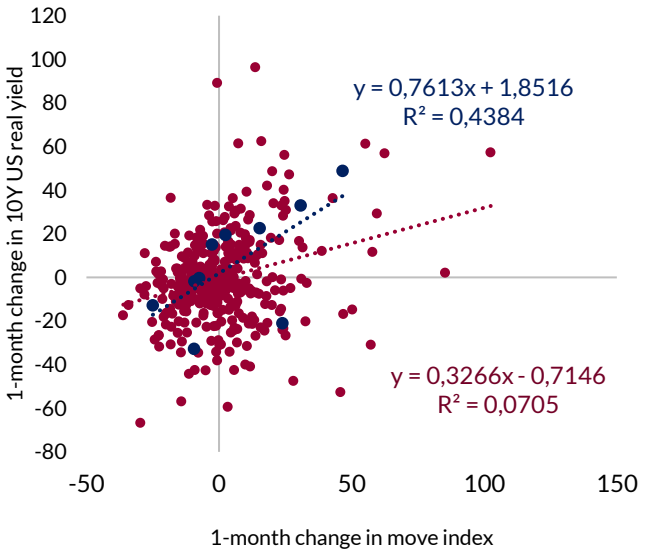


The model regresses 10Y UST real yields on potential growth, the Fed Fund rates and the Fed's holdings of USTs as a percentage of marketable debt. The model is estimated on a sample of quarterly data going from 2003 until present.

Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 4

Real yields have become very sensitive to uncertainty



The red dots denote a sample going from 1997 until end 2025, while the blue dots denote a sample going from January 2026 until present.

Source: Bloomberg, ANIMA Research

2) Term premium still low

In spite of the build-up of fiscal risk, geopolitical fragmentation and monetary policy uncertainty, term premia at the long end of the yield curve are ending 2026 broadly in line with their levels at the start of the year.

One explanation could be that the Fed's credibility in its commitment to fighting inflation has remained intact. Against this backdrop, markets responded to the energy shock by pricing in a much more hawkish monetary policy stance from central banks and significantly higher terminal rates, including over the longer term. This may have prevented an excessive repricing of risks at the long end of the curve.

This is also reflected in the strong performance of the DXY, which was supported by a resilient economy and higher rates driven by increased monetary policy expectations. That said, with monetary policy risks and fiscal risks expected to remain elevated over the next few months, we continue to see upside risks to the term premium.

In particular, we think markets will focus on **fiscal risk and the supply-demand balance**.

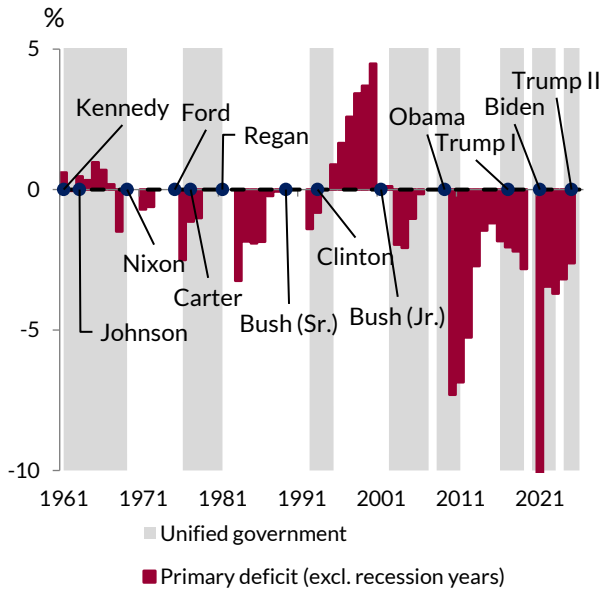
a. **Fiscal risk**

With a Congress entirely controlled by Democrats and a Republican President, we think the only area in which the two parties could find common ground is fiscal policy. This may seem counterintuitive at first: historically, a divided government (where the President and Congress are from different parties) is usually associated with lower or stable primary deficits (**Figure 5**). However, Trump's first term was an exception. The primary deficit not only increased in 2017 and 2018 when Congress was entirely Republican, but continued to rise in 2019 **(Figure 6).** This was partly the result of previous legislation (the continuing revenue effects of the 2017 tax legislation and higher discretionary spending caps agreed in 2018), but was also the result of growth in mandatory spending programmes. Moreover, under a divided Congress, in 2019 Republicans and Democrats agreed on the Bipartisan Budget Act of 2019, which established higher defence spending for Republicans, higher domestic spending, as asked by Democrats, and a debt-ceiling suspension desired by both congressional leadership and the administration. This paved the way for a further increase in the deficit in 2020 and 2021 (to which Covid-related measures to support the economy were added) .

Against this backdrop, from the Democrats' perspective, we could see attempts to pass bills aimed at refinancing programmes (such as SNAP, Medicaid and Medicare), lowering childcare costs and prescription drug costs, and/or, more generally, supporting fiscal policies that benefit lower- and middle-income households. While any bill that is approved by both the House and the Senate could be vetoed by President Trump and overriding the veto is only possible by reapproving the vetoed bill in both chambers with a two-thirds majority, the President may attempt to seek a compromise that would allow for additional spending in support of both Republican and Democratic priorities. Given the size of the US balance sheet and the level of long-term interest rates, we do not expect a significant fiscal expansion to be approved, but what will ultimately matter for markets is the level of risk surrounding the negotiations.

Figure 5

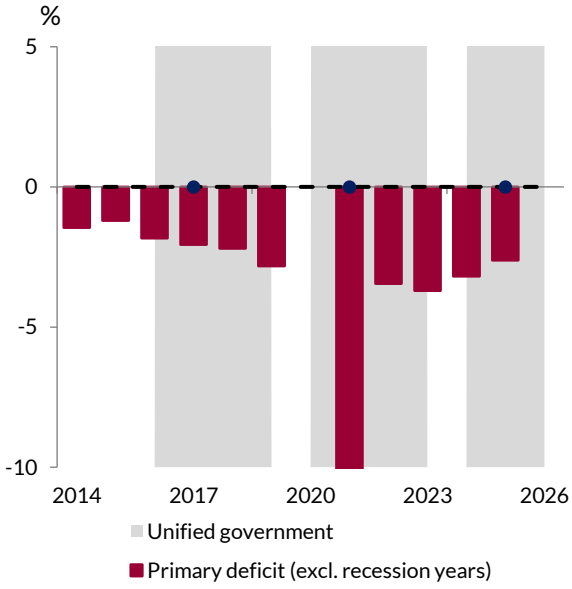
Generally, a divided government is associated with fiscal consolidation…



Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 6

… but not under the Trump presidency



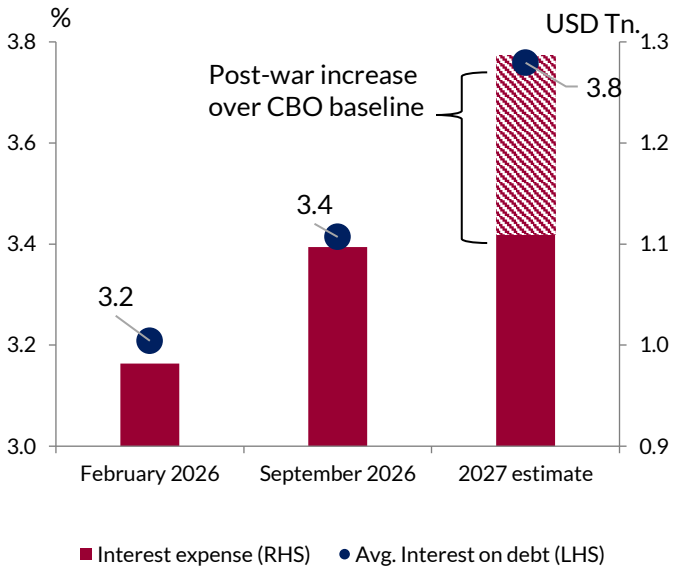
Source: Bloomberg, Haver Analytics, ANIMA Research

b. **Higher interest rates are weighing on the fiscal outlook**

Following the recent increase in interest rates, forecasts for the cost of debt and interest payments have deteriorated significantly. We calculate that, at current funding levels, the average cost of debt at the end of 2027 will rise to 3.8% from the 3.4% forecast by the Congressional Budget Office (CBO), in February this year (or from USD 1.1tn to almost USD 1.3tn), which could add as much as 0.6% to 2027 deficit (**Figure 7**). With little prospect of fiscal consolidation measures being implemented, the rise in interest payments could easily result in a higher deficit (we estimate slightly above 6.5% of GDP) and higher-than-forecasted UST issuance in 2027.

Figure 7

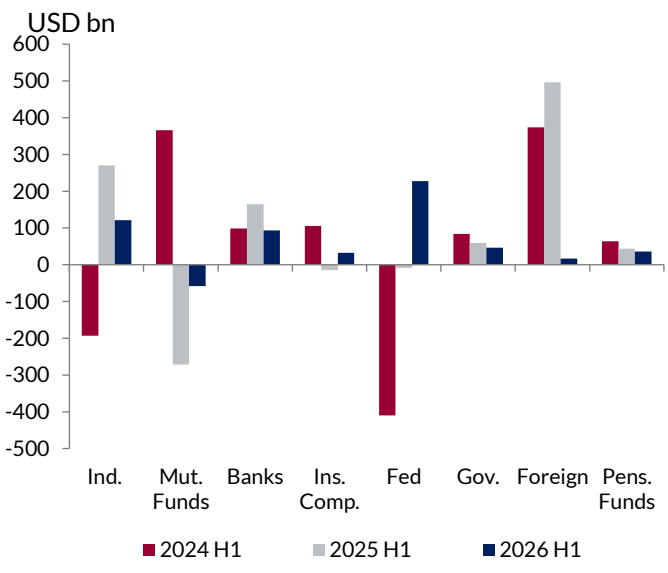
Higher interest rate weighs on fiscal outlook



Source: CBO, Haver Analytics, ANIMA Research

Figure 8

Fed absorbed most of net supply in H1 2026



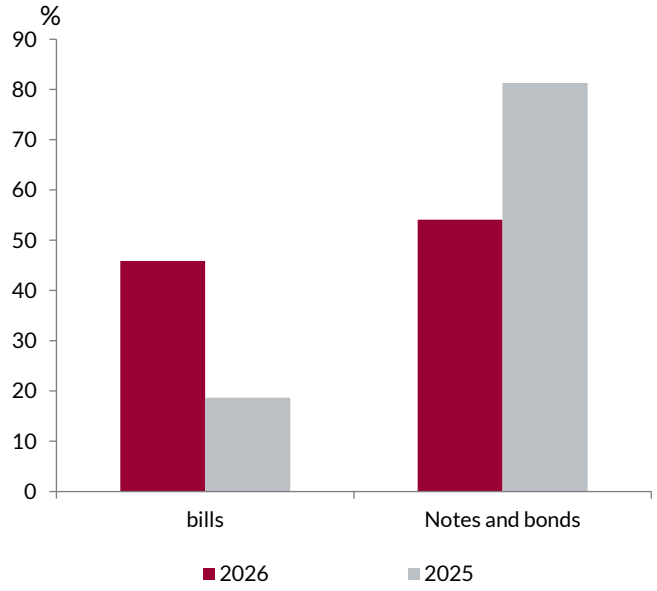
Source: SIFMA, Haver Analytics, ANIMA Research

c. **Demand-supply balance**

In 2026, demand, especially from foreigners, has shown signs of fatigue even in a context of relatively benign supply of duration by the Traeasury. First, in H1 2026 the Fed absorbed most of the net supply as part of its policy of keeping the balance sheet stable (**Figure 8**). The Treasury has adapted to this trend by relying much more heavily on bill issuance (**Figure 9**), significantly raising its refinancing risk. Second, foreigners' inflows (especially from private investors) have been very strong in equities, while inflows into USTs have slowed (**Figure 10**). While in September and October, the 10Y and 30Y auctions registered a record-high demand from foreigners, auctions of lower maturities were even lower than average take-up levels (**Figure 11**).

Figure 9

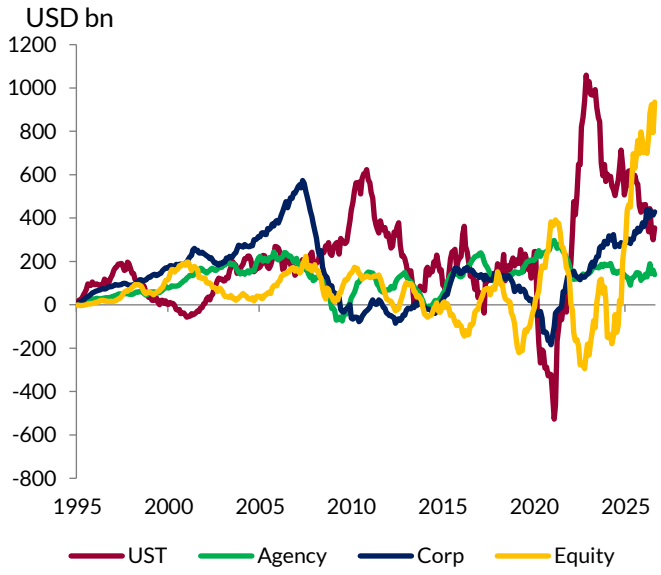
Bills were 50% of the funding in 2026



Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 10

Heavy foreign inflows into US equities and corporates

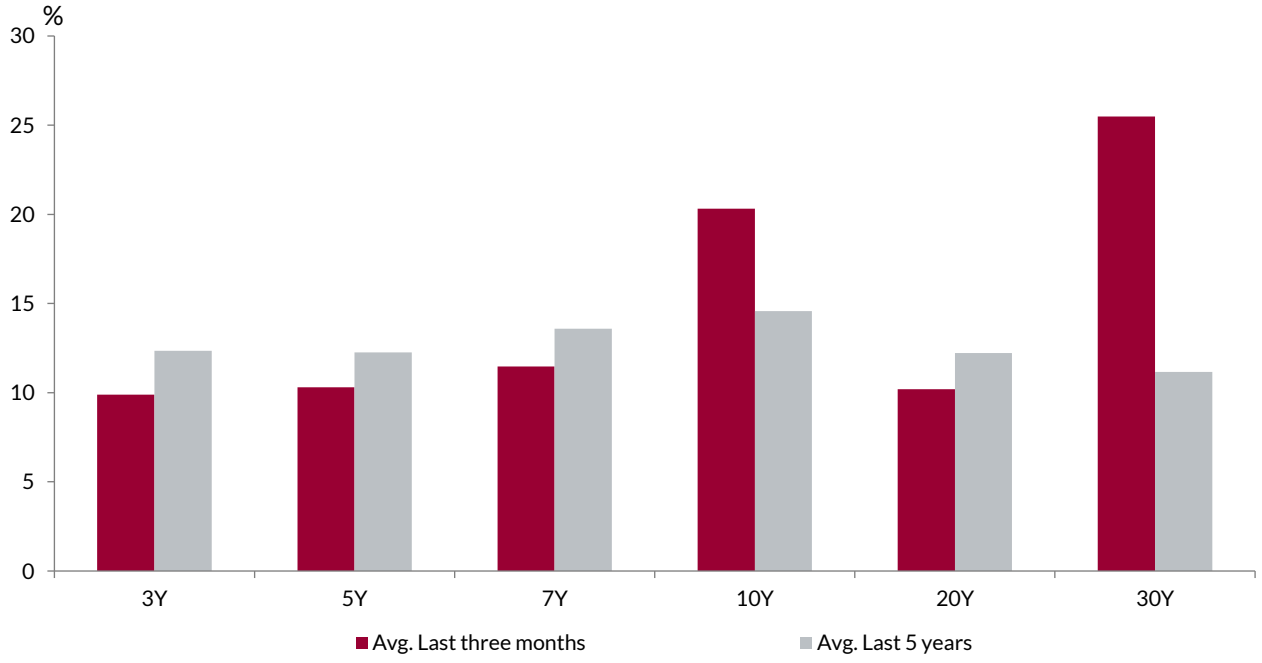


12-months rolling flows from foreigners into USD assets.

Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 11

Higher foreigners' take-up at the 10Y and 30Y auctions in September and October, but lower at other tenors



Source: Bloomberg, Haver Analytics, US Treasury, ANIMA Research

3) The Fed remains a wild card

Monetary policy uncertainty has been rising since the Covid-19 pandemic, but we believe it could increase further under the new Fed Chair, especially if macroeconomic data send mixed messages in the coming months.

Since Chair Warsh took office at the Fed, the following changes have taken place:

1) The Fed's communication has become less detailed. Fed meeting statements are much shorter and have undergone fewer changes compared to the past, while Chair Warsh tends to give terse answers to questions from the press. Moreover, he does not submit his dots and macro projections in the quarterly Summary of Economic Projections exercise.

2) Forward guidance has largely been abolished, and the Fed's reaction function has not been clarified yet. What we know so far is that Chair Warsh has adopted a holistic approach to assessing inflation, taking into account both the traditional Powell-era view of core goods and core services inflation as well as wider measures of inflation breadth. The inflation target will probably remain at 2%, with no flexibility and no softening of the target, but the interpretation of Fed's members on the progress to target will likely remain confused in the coming months.

3) The conference of the Fed's Productivity and Jobs task force did not shed any light on how the Fed thinks about Ai in terms of its impact on the economy or monetary policy. Going into 2027, this topic will be particularly relevant given the projected slow-down contribution of AI to economic growth and doubts about whether its impact on the economy will be inflationary or disinflationary.

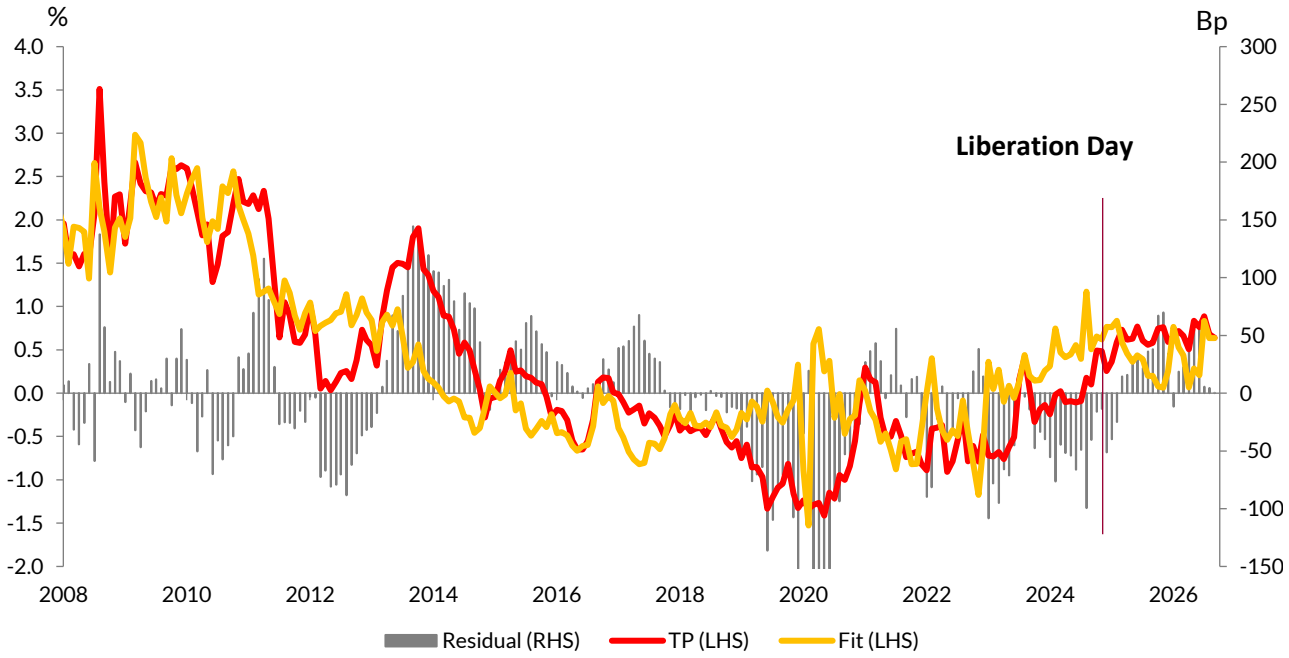
While markets have remained relatively constructive so far about the Fed's credibility and its willingness to bring inflation back to target, we believe the situation could become more complicated in the coming months, as the results of the various task forces become publicly available and are discussed within the FOMC. Potential conflicts between the various factors that drive the Fed's reaction function could also emerge.

4) Political risk premium has evaporated

Since September, we estimate that the political risk premium has declined sharply from around 50bp to around 0bp (**Figure 12**). Even with the Democrats in control of Congress, we believe that the balance of risks is tilted towards an increase in the political risk premium in the coming months.

Figure 12

Political risk premium has evaporated since September



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. We interpret the residual of this model as the political risk premium.

Source: Bloomberg, Haver Analytics, ANIMA Research

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