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Rates: Curve pivots and steady spreads

Our three calls for the second half of the year centre on the maintenance of high long-tenor real rates, a curve-steepening tendency on many core curves, and the stability of spreads between the US and the eurozone. And that includes US and eurozone swap spreads

It's a close call whether the Fed will hike rates this year. We think the central bank will hold rates steady for an extended period

Look for elevated real rates, steeper curves and Treasury/Bund/Swap stability

Over the past few weeks, we've been opining on long-dated *real* rates as a factor of significance for bond markets. Primarily, here. There is a link, even if seemingly tenuous, with the ongoing technical and productivity revolution being discounted in the risk asset space. It's not easy to glean this from the ups and downs in bond yields through business cycles, but it's certainly there. They should be higher than normal, and certainly well above the ultra-low real rates seen post the global financial crisis / pandemic periods.

Meanwhile, inflation expectations have dampened dramatically and completely discount a reversal lower in the higher headline prints seen of late. The juxtaposition between the calming of inflation expectations versus the resilience to the rate hike narrative is tough to square, but we think the rate hike discount is mispriced. It is a very close call whether the Fed will hike rates this year, but on balance, we think it will instead choose to look through the near-term energy spike and hold rates steady for an extended period.

We stick to the view that the long end remains heavy (yields holding up), while the front end should richen (yields fall). The richness of the 5yr area of the curve suggests the same (the 5yr rate is below an interpolated line between the 2yr and 10yr rates). This can be seen on the eurozone curve, but it's especially pronounced on the US curve. When the 5yr is rich like this, rate hikes are typically not a dominant force. In fact, cuts are more probable.

Essentially, we have the US yield curve steepening from both ends. Front-end yields should get back below 4%, while the 10yr yield will have a tendency to hug the 4.5% area (and quite potentially test higher). The eurozone curve sees a similar tendency, as the front end calms on reduced rate hike pressure, and the back end holds steady, we think, with the 10yr holding broadly in the 3% area (Germany and Euribor).

Consequently, we don't anticipate much variation in Treasury/Bund spreads. We'd extend that to swap spreads, which appear quite comfortable at around zero for 10yr German Bunds and at or about 40bp for 10yr US Treasuries. There are deficit stories to be told, but they are not proving impactful, and we don't anticipate much change to this in the coming months.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

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