

Rates: downside limits for yields, versus bigger room to the upside

The Fed and ECB are expected to cut rates ahead. We'd then usually be bullish on longer-tenor bonds, especially given the tariff uncertainties. However, there isn't huge room for yields to fall. There's more room for yields to rise, with the biggest driver being fiscal deficit pressure. Watch for the passage of US tax cuts as a catalyst...



Major central banks are as uncertain as the rest of the market when it comes to the geopolitical uncertainties that lie ahead

How far can 10yr yields fall based off current thinking on interest rate cuts?

We've moved into calmer waters for market rates. The 10-year Treasury yield has recently tended not to stray too far from 4.5%. In the eurozone, the 10yr Euribor rate has trended around the 2.5% area, and the 10yr Bund yield is broadly flat to this.

If we were to map out a case for these rates to fall, we'd point to the rate-cutting tendency ahead as a key component. Here's how that would go for the eurozone and the US:

- In the eurozone, we anticipate that the European Central Bank will get to 1.75% (now 2.0%). The current 10yr rate is only 75bp above that future low. Perhaps we could squeeze a 25bp move lower. Realistically, the ECB would have to dip to 1.5% to make some room for a structurally lower 10yr rate. That, in fact, is the market discount. If that were to be realised,

we could talk of 10yr rates dipping to the 2-2.25% area.

- In the US, the Federal Reserve is expected to cut to the 3.25-3.5% range (now 4.25-4.5%). That would imply a curve of some 115bp to the current 10yr yield at 4.5%. That appears to present value in the 10yr yield. However, we need to account for the swap spread to 10yr SOFR, which cuts the "true curve" down to roughly 65bp (10yr SOFR now at around 4%). Maybe we could squeeze a 25bp move to the downside. To see a proper manoeuvre to the downside for the 10yr yield, the Fed would need to cut much more than is currently discounted.

The bottom line is that when we look at yields' capacity to fall, we find there are constraints. Yes, there is macro angst to consider, and a rate-cutting backdrop. But we'd need more than is currently discounted to rationalise meaningful falls in longer-tenor yields.

The other extreme - how much room is there for yields to rise?

In contrast, when we consider the potential for yields to rise, things begin to open up. The key ingredient on both sides of the Atlantic is the fiscal balance.

In the US, if the tax-cutting package currently going through Congress ultimately gets passed (and it looks like it will), it will leave the bond market with no plan in place to reduce the fiscal deficit. This piles the issuance pressure on as a theme. In the eurozone, plans for more spending (on defence "plus"; Germany in particular) won't push average fiscal deficits to US-style extremes, but it will add to issuance pressures in a meaningful way, albeit likely more from 2026 onwards.

This has implications for how we see longer tenor market rates evolving through 2025/2026.

- For the US, we see the passage of the tax-cutting bill plus a tariff-induced rise in inflation as themes for the third quarter, manifesting in upward pressure on the 10yr yield. We pitch 4.75% as a target, but would not be surprised to see this extend to 5%. Subsequently, we have a calming process as the Fed cuts, starting in the fourth quarter. And the 10yr yield eventually eases its way back down towards 4.25% (mostly through 2026).
- For the eurozone, the bigger independent upside pressure for the 10yr Bund yield is through 2026 as the ECB finishes with cuts, and the aforementioned fiscal pressure builds. That coaxes the 10yr yield to the 2.75% area (and likely above).

Bigger upside to yields, and issuance pressure is the common denominator

On balance, we're left with a bearish tilt to our forecasts for bond yields. The US front end can certainly be dragged lower should economic data disappoint in the coming few months (and quarters), but this should mostly serve to steepen the curve. The primary driver of longer-term yields comes from longer-term issuance pressure.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user’s investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.