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RATES

Rates: Calmer, but dodgy overshoot risks remain

We've managed to get through a week without mapping out new multi-decade highs in various long yields and spreads. That's great, but we'd not get too comfortable. Many of the drivers of prior stresses remain in play. And muddy developments in the Ukraine and Iran wars make for difficult interpretation – enough to keep us all on edge, at least



The mood for US Treasuries has calmed. But don't get too comfortable

Long-end yields have calmed in the past week or so. But pressures remain. The medium-term issuance narrative stemming from fiscal largesse remains. That's the 'bad'. Then there's the 'ugly', in the guise of energy price pressure stemming from the Iran war. That has coincided with higher printed inflation. Arguably, this is the biggest direct impact, as it has prompted central bank rate hikes. And there is the 'good'. Higher real rates have been an important driver, and a part of this likely incorporates AI-driven productivity growth. If that last part was the central driver, we'd have little to worry about. But it's the other, more sinister factors that have predominantly sparked long-end market jitters.

The balance of probabilities suggests there is at least one more leg of long-end weakness still to play out. This could take the US 10-year yield back into the 5.25% to 5.5% range. Other markets would likely move in tandem, mapping out similar, albeit less dramatic, blow-

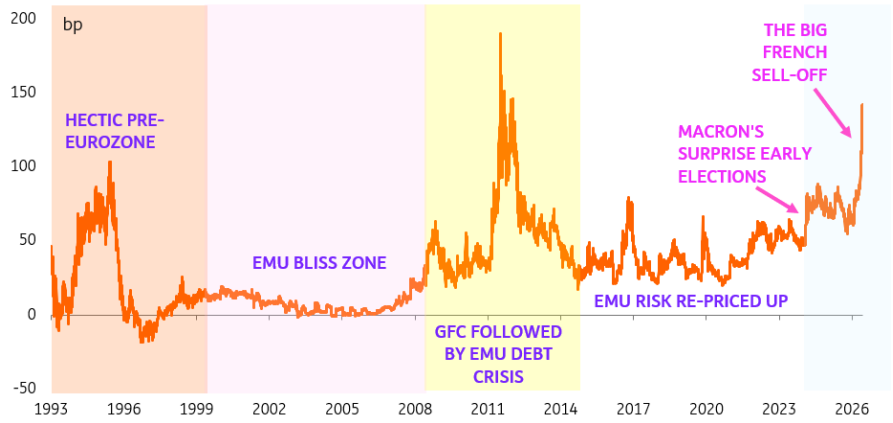
outs. With 5.25% looking like a mean-reversion level, we think the US 10-year yield could overshoot towards 5.5% and remain elevated for a number of months as bond market jitters persist. This could quite easily extend into the first quarter of 2027.

For later in 2027, we think inflation will come down, and long rates should too. On the growth side, we have a 2% real growth forecast tendency for 2027. If we're wrong and we're on the verge of a macro boom (and/or persistently elevated inflation), that's a whole other story, and it would be a route to 5.5-6%. The other way to get there could be the US fiscal story finally unravelling in a bad way, but we aren't quite sure we can call for that yet as a baseline view.

For 2027, we have growth of 2% and inflation of 2% (or slightly above on both counts). That points to 4.75%, representing a mild upside bias relative to the 4.5% level we view as broadly neutral. But first, we need to get through 2026.

The big French widening

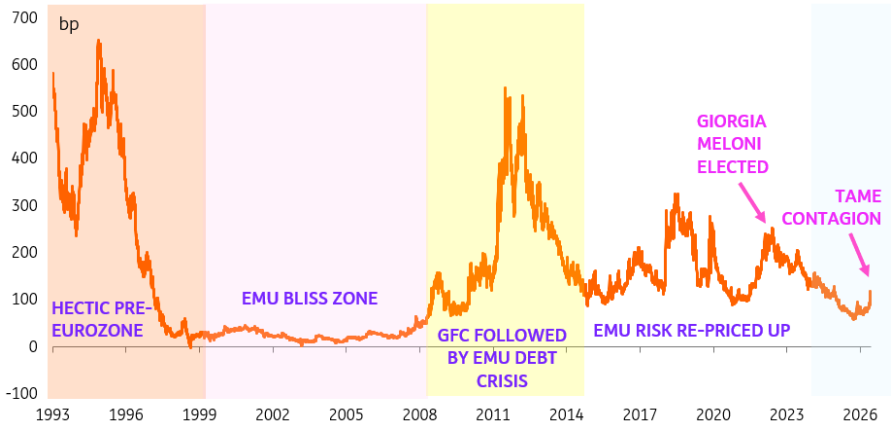
France 10yr yield spread over Germany 10yr yield



Source: Macrobond, ING estimates

Relatively tame Italian contagion

Italy 10yr yield spread over Germany 10yr yield



Source: Macrobond, ING estimates

The eurozone remains in the throes of an uneasy holding pattern at dodgy levels

The focus in the eurozone is increasingly insular, with France front and centre and setting the mood. Here too, there has been some market stability – but at uncomfortable levels. The standout move has been a doubling of the French 10yr swap spread from the 60bp area to the 120bp area. And French spreads to Germany are practically as wide as they've ever been since the dawn of the euro, even versus the immediate pre-EMU years. The safe narrative to reach for is the debt dynamics one, and the lack of ambition to correct it. Made worse, in fact, by the political options being offered for 2028.

This is probably overdone, as a swing to the right (should it occur) could have some tail positives that aren't currently properly discounted. Look at the improvement seen in Italian spreads following the rise of Prime Minister Giorgia Meloni. It's been gradual but persistent, and has not been overly impacted by French concerns. In that sense, the Italian response has been low beta in characterisation, which is good.

In fact, the first real bout of widening in French spreads can be traced back to President Emmanuel Macron's election gamble of mid-2024. Things subsequently calmed, but were not forgotten. The recent spike is an amplification and extension of an underlying tension that has not gone away. So, overdone? Probably, yes. But we also remain in a danger zone for bonds generally. Just like in the US, more overshoots to the upside are entirely foreseeable.

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