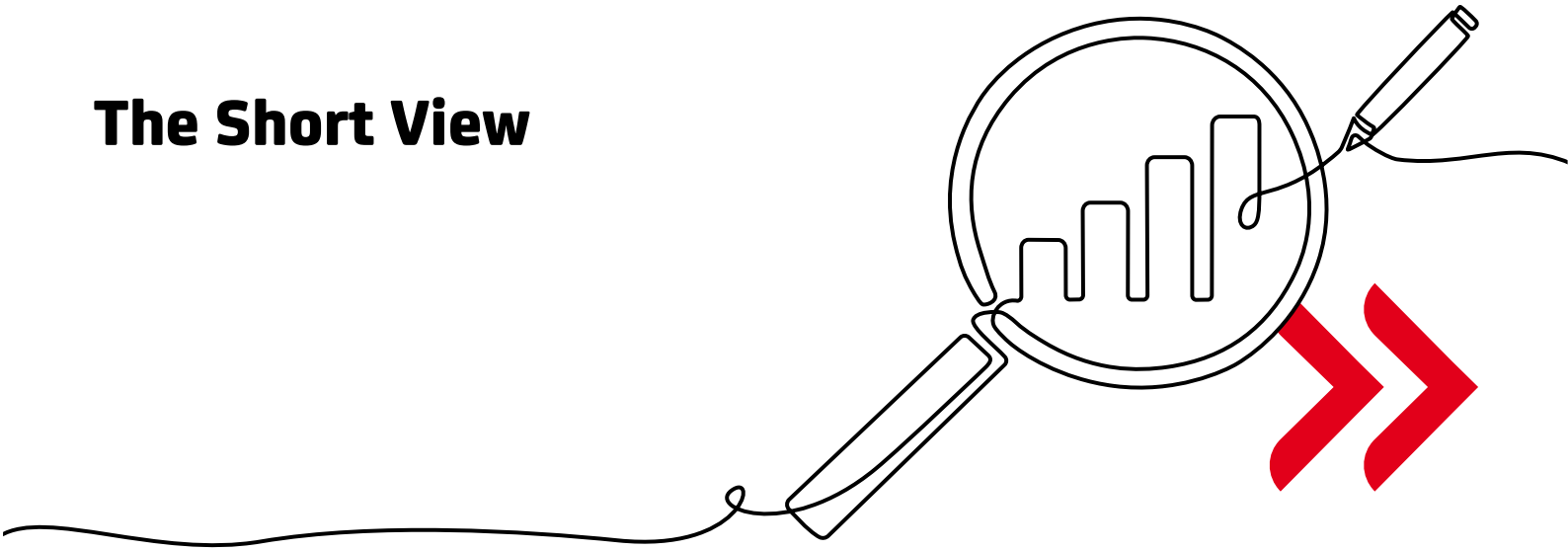
The Investment Institute
by UniCredit

The Short View



The Short View offers insights on key macro and market stories and is designed to promote discussion and debate.

Why bond yields may stay close to current levels

20 October 2026

UST and Bund yields have moderated from recent peaks. We discuss why this is unlikely to be the start of a trend and why we see yields remaining higher than in recent years. Higher yields and too bold expectations of further tightening by the Fed and ECB make the asset class increasingly attractive for medium-term investors.

1. Current Treasury yields offer attractive carry and some protection against further Fed tightening, with the main upside risk being a higher term premium related to fiscal risk. The balance of risks suggests that any sustained UST rally should come from weaker growth or equity market weakness rather than from lower inflation.
2. Higher UST yields have made carry more attractive. Investors with a medium-term investment horizon face an asymmetric distribution of returns, with positive outcomes outweighing negative ones. The picture is less compelling for investors with a shorter investment horizon, for whom carry plays a smaller role. For these investors, a cautious stance on duration remains advisable given the still-elevated rate volatility.
3. Bund yields have risen alongside global rates in 2026. Weaker growth and renewed safe-haven demand amid widening credit spreads suggest limited scope for a sustained rise in yields. Conversely, a decline back towards 3% would likely require a meaningful moderation in ECB rate expectations, accompanied by a similar repricing of the Fed outlook.

Higher UST yields: a real-rates story

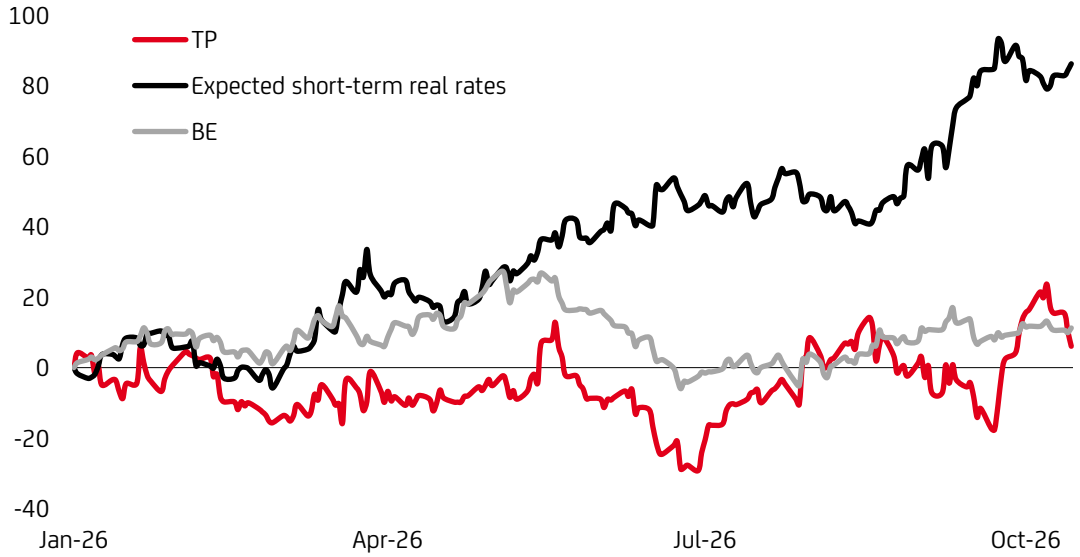
This year has been anything but uneventful for government bond investors. After a positive start, the outbreak of the conflict with Iran put the asset class under pressure. US Treasury yields have risen by around 100bp YTD, reaching levels not seen for decades. As a result, UST returns have turned negative, although the losses have been far less severe than in 2022 thanks to higher starting yields.

What has driven this rise in yields? In Chart 1, we divide the increase in the 10Y Treasury yield into three components: breakeven inflation, expected real short-term rates and the term premium. Breakeven inflation is derived directly from US inflation-linked bonds (TIPS), while expected real short-term rates and the term premium are estimated using the Adrian-Crump-Moench (ACM) model.

Most of the increase in UST yields can be attributed to higher real rates, while inflation expectations and the term premium have remained broadly unchanged.

CHART 1: HIGHER UST YIELDS MAINLY REFLECT HIGHER REAL RATES

10Y BREAKEVEN INFLATION, TERM PREMIUM, REAL YIELDS (CHANGE SINCE JAN 2026, BP)



Source: Bloomberg, The Investment Institute by UniCredit
Note: short term expected rates and the term premium are calculated based on the ACM model.

Are higher real yields justified?

Higher real rates are consistent with the resilience of the US economy, supported by AI-related investment and spending by higher-income households. Higher real rates also align with recent comments by Fed Chair Kevin Warsh, who described AI as a significant benefit to the US economy, with the potential to boost productivity over time. In addition, higher real rates reflect growing borrowing needs from hyperscalers and expectations that investment spending in the AI space will remain strong for years to come.

The evolution of real rates will be crucial for Treasury markets in the quarters ahead. The key question is whether economic growth will ultimately validate current expectations (see Coffee Break - Views from Bangkok for more details on the topic of AI). We believe higher real rates are likely to persist, supported by AI-related investment and productivity growth, at least in the near term. Consequently, while USTs may currently appear somewhat oversold, the scope for a substantial rally remains limited. Investors should get used to yields remaining above the levels typical of the past twenty years.

Inflation expectations remain anchored

Meanwhile, 10Y breakeven inflation has been volatile but broadly trendless despite higher energy prices. This reflects the fact that the US is a net energy exporter and that core inflation, while high in absolute terms, has remained relatively stable this year. The dynamics of US breakeven inflation also highlight the Fed's credibility and investors' confidence in its commitment to price stability. As such, inflation expectations are likely to remain broadly neutral for Treasury yields. At around 2.35%, the 10Y breakeven rate is only modestly above the Fed's inflation target. Since the start of 2022, it has traded between roughly 2.05% and 3.00%. Based solely on recent history, risks to breakeven inflation remain skewed modestly to the upside.

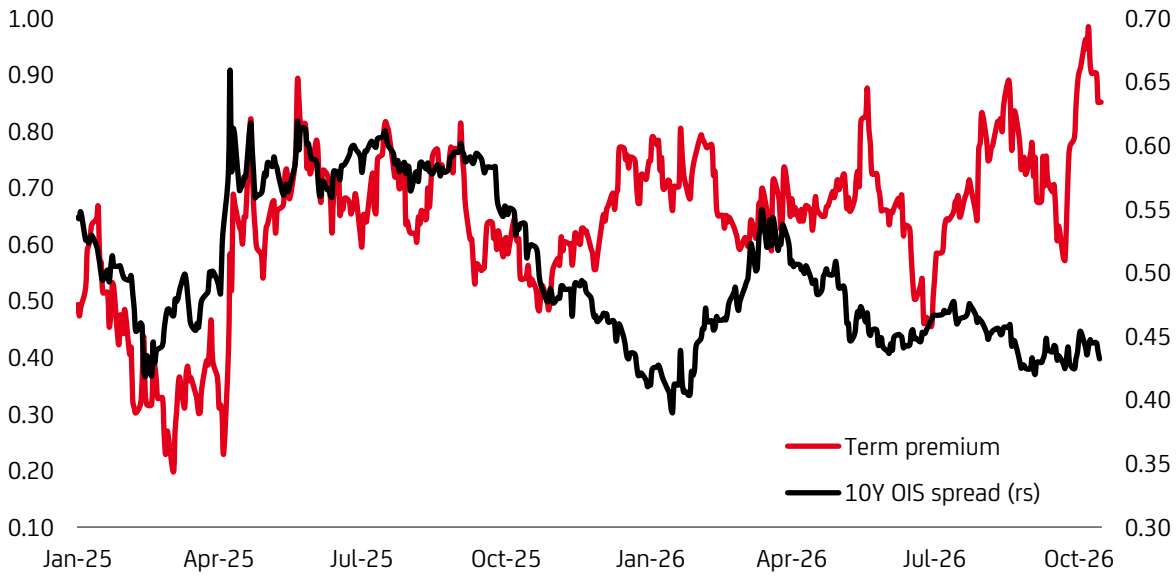
US fiscal concerns are not a driver now but remain a key risk

The ACM term premium has remained broadly stable and currently stands near 80bp. While close to the average observed in 2026, it remains well below the levels prevailing before the global financial crisis, when it averaged around 145bp between 1995 and 2007. The lack of any sustained upward trend in the term premium is somewhat surprising given elevated uncertainty surrounding both monetary policy and geopolitics. It also contrasts with a backdrop of persistent fiscal deficits and a more price-sensitive investor base. In our view, the risk of a higher term premium remains the clearest source of upside pressure on Treasury yields.

Debt supply does not appear to be a significant driver of yields at present. This is evident from the 10Y UST-OIS spread, which has remained broadly stable at around 40/45bp since late August and is still close to the lower end of its range over the past two years. A repricing of the term premium remains a key risk for Treasury investors.

CHART 2: FISCAL RISK NOT A DRIVER OF UST YIELDS (YET)

10Y TERM PREMIUM AND 10Y UST-OIS SPREAD

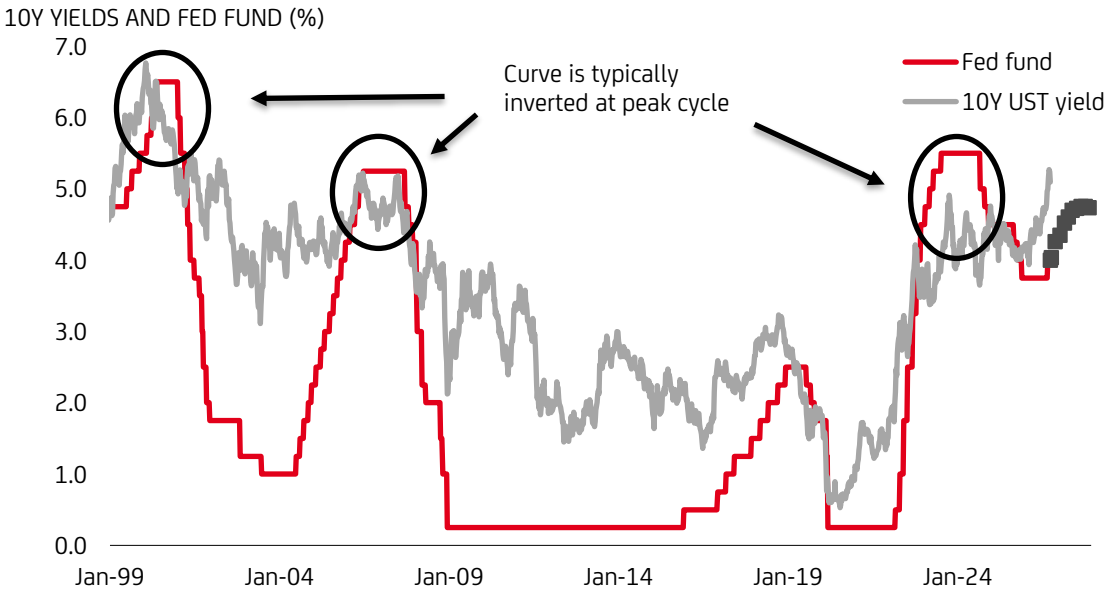


Source: LSEG, The Investment Institute by UniCredit

USTs: higher yields improve attractiveness, the investment horizon is key

In recent weeks, markets have priced the peak fed funds rate at between 4.75% and 5.00%. This is more than we expect from the fed. Moreover, 10Y Treasury yields are now trading above that range. Looking at past tightening cycles, this is unusual: the 10Y Treasury yield has typically traded below the peak fed funds rate (for further details see our Coffee Break – What the shape of the UST curve tells us). Unless markets begin pricing a significantly higher terminal rate, 10Y USTs, currently trading at around 5.20%, already provide a meaningful cushion against further Fed tightening.

CHART 3: UST YIELDS CURRENTLY EXCEED FED PEAK PRICED IN BY FORWARDS

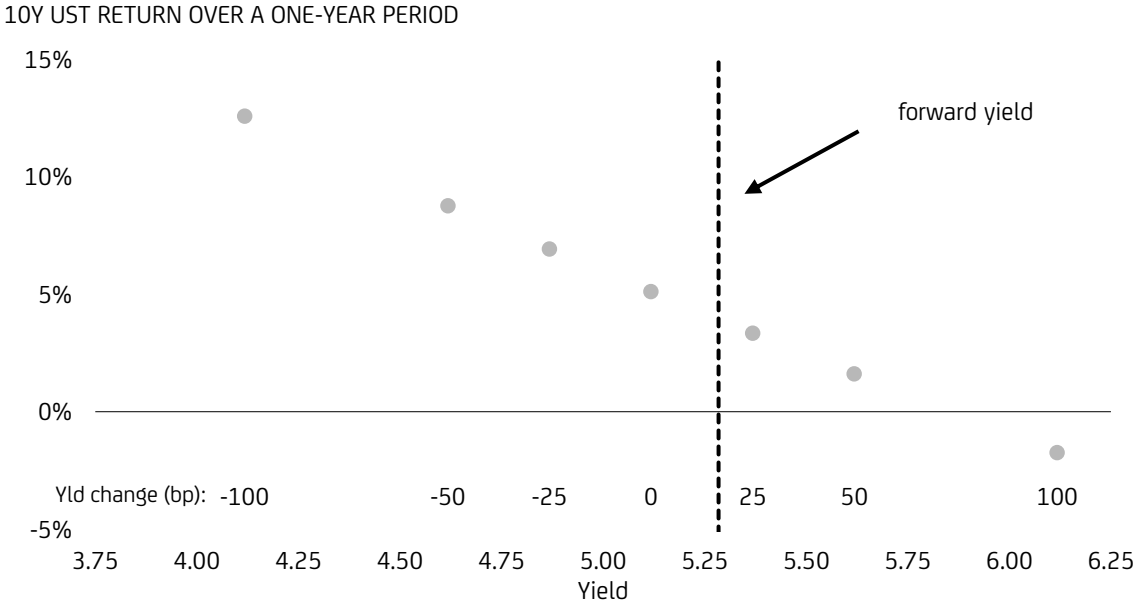


Source: Bloomberg, The Investment Institute by UniCredit

For medium-term investors, current yield levels offer attractive carry and a favourable asymmetry in expected returns. A further 50bp increase in yields, pushing the 10Y Treasury yield to around 5.60%, would still generate a positive one-year total return of roughly 2%. By contrast, a 50bp decline to around 4.60% would deliver a return close to 9%.

The picture is less compelling for investors with a shorter investment horizon, for whom carry plays a smaller role. Given still-elevated rate volatility, maintaining a cautious stance on duration risk remains prudent.

CHART 4: 10Y UST RETURNS UNDER DIFFERENT YIELD SCENARIOS



Source: Bloomberg, The Investment Institute by UniCredit

Bund yields

Bund yields have risen in line with moves observed across most major bond markets. However, unlike UST yields, Bund yields remain well below their historical highs. While 10Y UST yields have reached levels last seen in 2006-07, 10Y Bund yields are still around 3.4%, compared with more than 4.5% in 2007-08.

This reflects Europe's weaker growth backdrop. Euro area GDP is expected to expand at less than half the pace of US GDP this year and next. The eurozone is also lagging the US with respect to the tech sector, so the case for a higher R-star is less compelling. Indeed, compared to the US, the rise in Bund yields has been less driven by real yields, while inflation expectations have played a larger role, rising by around 40bp since the start of the year.

In recent weeks, Bunds have also benefited from renewed pressure on EGB spreads. Selling in OATs and BTPs has generated safe-haven demand for Bunds, which remain the benchmark risk-free asset within the euro area.

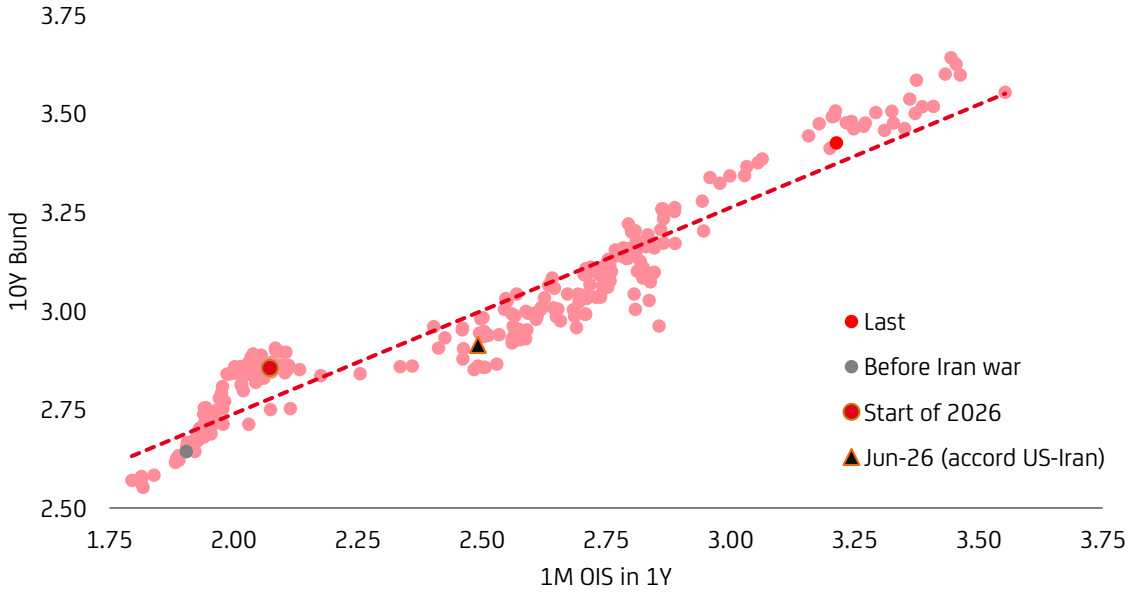
It remains difficult to build a strong bearish case for Bunds. For 10Y Bund yields to move above 4% on a sustained basis, a much stronger growth story would likely be required, which currently appears unlikely. The eurozone's neutral real rate may be around 0.5%, depending on the success of fiscal and infrastructure initiatives and the extent to which AI boosts productivity while demographic trends remain a structural headwind for Europe, limiting the upside potential. In such an environment, any increase in the ECB policy rate above 2.50% is likely to be viewed as temporary and have only a limited impact on long-dated yields, as seen in 2022-23. An ECB policy rate remaining in the 3.0-3.5% range for an extended period (consistent with neutral real rates in the 1-1.5% area) would probably be necessary to push 10Y Bund yields towards 4.0-4.5%.

Conversely, a scenario in which 10Y Bund yields move towards 4% despite ECB rates stabilising around 2.5% would require a structurally much steeper yield curve, likely related to higher risk premiums. This appears unlikely, given that euro area fiscal expansion is still expected to remain relatively limited, even after accounting for Germany's fiscal plans.

What could drive Bund yields lower? Most likely, a significant repricing of ECB expectations, triggered either by weaker growth data or lower energy prices or rising flight to quality if tensions on EGB spreads escalate. As Chart 5 illustrates, 10Y Bund yields were below 3% in late June amid an improving outlook for the Middle East conflict, when markets were pricing ECB rates at around 2.5% one year ahead. However, back then 10Y UST yields were below 4.5%, reflecting more subdued expectations for Fed tightening. Reverting to that situation is less likely now that the Fed has hiked rates. This should also limit the downside potential for Bund yields.

CHART 5: BUND YIELDS AND ECB EXPECTATIONS

EXPECTED ECB RATES ONE YEAR AHEAD AND THE 10Y BUND YIELD



Source: Bloomberg, The Investment Institute by UniCredit

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