



Steep curves and fiscal crossroads

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Key takeaways

- Yield curves remain steep across major markets, driven by fiscal pressures and structural shifts despite policy easing.
- Elevated deficits and rising issuance are shaping long-end yields globally, reinforcing the “higher for longer” narrative.
- In Europe, spreads reflect national fundamentals, while UK gilts and JGBs face unique structural and policy challenges.
- Debates over monetary independence add policy risks in the US while higher yields in Japan can pose demand risks for other markets.

US Treasuries: Restart of the steep curves era

The US Treasury market in 2025 has been characterized by steepening of the **yield curve** – a dynamic that appears likely to endure into 2026 and beyond. Several structural and cyclical forces are converging to reinforce this regime, with important implications for investors’ positioning and risk management.

The post-pandemic era has witnessed a fundamental shift in the **composition of Treasury demand**. A greater share of issuance is now absorbed by more price-sensitive investors as official institutions in other countries and US banks have been reducing their relative holdings over the past few years. While 2025 has seen some stabilization in these holdings, as a share of the overall Treasuries market, the ongoing transition has contributed to a sustained elevation in term premiums, particularly at the long end of the curve.

The Fed’s end of quantitative tightening on December 1, 2025 is relevant but, looking ahead, the underlying forces supporting the yield curve at higher levels are unlikely to dissipate. We see the long end of the yield curve as not being driven primarily by the policy rate easing that is expected in 2026. Instead, persistent fiscal deficits, continued murmurs around the future independence of US monetary policy, and the potential for increased coupon issuance (i.e. of bonds with a maturity of one year or more, rather than T-bills which carry no coupon) in the run-up to fiscal year 2027 all point to renewed upward pressure on term premiums. So far, despite a meaningful decline in policy rates since the rate cycle’s peak, 30-year yields have declined only modestly, underscoring the stickiness of long-end rates and the market’s recognition of persistent supply and fiscal risks.

Fiscal policy remains a central driver. Despite the inflow of tariff revenues, deficits are projected to remain elevated: the 2026 federal deficit is expected to widen to 6.6% of GDP from the already-high 6.4% expected for 2025. The US Treasury’s issuance strategy, favouring T-bills (i.e. short-term debt obligations) while leaving coupon issuance unchanged over the coming quarters, is also likely to run into its limits. This was hinted at in the November refunding statement: “Treasury has begun to preliminarily consider future increases to nominal coupon and Floating Rate Notes (FRN) auction size”. The latest iteration of the Optimal Debt Issuance model of the Treasury Borrowing Advisory Committee also pointed out that the reduction in expected costs due to the move towards higher T-Bill issuance has come at the cost of increased volatility. As a result, it is quite plausible that coupon issuance may increase in the run-up to fiscal year 2027.



On the cyclical front, the US labour market is losing steam only gradually, and our forecast is for any economic weakness during the course of 2026 to be behind us by the end of the year. So our forecast is for the **Fed funds rate** to fall to 3.25% before the FOMC goes on hold. On this basis, we have end-2026 forecasts of 3.50% and 4.15% for 2Y and 10Y US Treasuries respectively.

But it is important to be aware of the **risks** to these forecasts. A Fed policy error – such as easing more aggressively than warranted by fundamentals – could put additional downward pressure on the front end. Such an outcome cannot be discounted, given that the Fed has been characteristically on the dovish side since the Volcker era. In this context, a particularly salient risk for the curve would be “twist steepening” where short-term yields compress further while long-end rates remain elevated or even rise. This could reflect persistent inflation expectations, fiscal concerns, or supply pressures at the long end.

Another important risk factor is the potential impact of **rising Japanese yields** on global fixed income markets and thus US Treasuries. An increase in Japanese yields could, in theory, prompt Japanese investors to reduce their holdings of US Treasuries. Since Japanese investors are, in aggregate, the largest foreign holder of US Treasuries (with around USD 1.9trillion, of which USD 1.06trillion are in long term maturities) this could have an impact on the US Treasuries market generally. However, so far, the data provides scant evidence for any decline in Japanese investor appetite with their holdings in long-term maturities rising in 8 out of the first 9 months of 2026.

There will also be changes to the **Federal Reserve’s leadership** in 2026, going beyond the replacement of Fed Chairman Jerome Powell. The usual annual rotation will bring Cleveland, Dallas, Philadelphia, and Minneapolis Fed presidents into voting roles, all of whom have recently been on the hawkish side. Additionally, the Supreme Court is expected to rule on whether President Trump is allowed to replace Fed governor Lisa Cook or not. Therefore, there is less predictability to the tilt of next year’s FOMC and its possible future decision-making path.

Not all of these risks point to rising yields. Policymakers also have various tools to help them keep a **lid on yields**, if they are willing to use them. The supplementary leverage ratio (SLR) enhancement was approved by the banking regulators with the aim of allowing banks to hold more Treasuries on their balance sheets (and was used in

the COVID pandemics). Although the possible future use of this has been long priced by the markets, other possible strategies to boost demand for US Treasuries could include the so called “Pennsylvania Plan”, a term coined by our colleagues at Deutsche Bank FX Research. This approach might include measures such as tax advantages for long duration Treasuries and requiring retirement plans to have higher allocations for Treasuries purchases. In an extreme scenario, one element of the Japanese toolkit comes to mind, namely Yield Curve Control (targeting longer-term interest rates through bond purchases/sales). Even if you do not think such extreme measures will be implemented, 2026 is unlikely to be a year where you can blithely ignore risks.

Bunds: elevated yet secure

The outlook for the German government bond market over the coming year will likely be shaped by monetary policy stability, fiscal slippage, and **persistent structural demand** for Bunds. With the ECB expected to remain on hold, with no further rate cuts anticipated, market attention will shift toward the evolution of the yield curve and Germany’s fiscal trajectory. Our current forecasts suggest a 10-year Bund yield of around 2.7% in twelve months’ time, while the 2-year yield should remain anchored around 2%. This suggests that current steepness in the curve will be maintained throughout the year.

Several factors will support this steepness. The **ECB** decision to keep policy rates unchanged removes any prospect of renewed downward pressure on the front end of the curve, with it likely to keep short-dated yields stable. Meanwhile, the long end remains sensitive to global and domestic supply dynamics. Germany’s **fiscal balance** is expected to move from -2.5% of GDP in 2025 to -3.6% in 2026, driven by higher spending commitments. This fiscal slippage will translate into increased Bund issuance, particularly at longer maturities, adding upward pressure on term premia. To illustrate the scale of this issue, the recently-approved German budget envisages EUR180bn in new borrowing for 2026 – more than three times the c. EUR50bn in 2024. Despite this increase in borrowing, disorderly repricing is unlikely: Germany’s debt metrics remain strong by international standards, and Bunds continue to hold their position as the euro area’s benchmark safe asset.



Demand for Bunds remains resilient, supported by investors seeking AAA-rated collateral and institutions with regulatory or risk-management requirements to hold them. German Bunds account for nearly 20% of the AAA-rated universe and represent the most liquid market in this space, making them highly sought after when global risks are elevated. Since the German fiscal boost first announced in March 2025, foreign demand has remained strong, with data showing that 61% of year-to-date net supply has been absorbed by euro area investors outside Germany. Japanese investors have also maintained steady buying interest, apart from a brief pause in April. Foreign investors, especially banks, play a critical role in absorbing supply, particularly as ECB reinvestment of maturing bonds fades. This persistent demand from multiple investors acts as a cap on Bund yields, preventing sharp sell-offs even as issuance rises. Nevertheless, yields are unlikely to revisit the lows of the previous decade: the new equilibrium will be characterized by higher but stable yields and a steeper curve.

Additional **technical and regulatory factors** will further shape the outlook. The transition of major Dutch pension funds to defined contribution systems at the start of 2026 – an adjustment involving around EUR600bn in assets—will have significant implications for European fixed income markets. Ultra-long maturities, such as 30-year Bunds, are expected to face the most pressure, reinforcing the steepness of the yield curve and amplifying duration risk at the long end. Such developments remind us that while the Bund market remains anchored by strong fundamentals and structural demand, the coming year will still be marked by elevated issuance, evolving investor dynamics, and a persistent bias toward steeper curves.

Other European markets: strength beyond the core

The outlook for European government bonds in 2026 will increasingly be defined by national differentiation, as the previous convergence in euro area sovereign spreads gives way to a more nuanced environment. Investors are now compelled to focus on the specific fiscal, political, and macroeconomic realities of each issuer, with France, Italy, and Spain offering sharply contrasting profiles. With the ECB expected to maintain a 2% deposit rate, the interplay of national fiscal discipline, political risk, and structural growth prospects will be decisive in shaping the risk and return characteristics of these individual markets.

France enters 2026 facing persistent fiscal and political headwinds that are likely to keep its government bond spreads elevated. The 10-year OAT-Bund spread is expected to be still in the 70-80 bps range by end-2026, a level that reflects both the country's structural fiscal challenges and a pronounced political risk premium. The French government's current hopes of bringing the budget deficit down to -5% are likely to remain difficult to achieve: France has lagged its peers in implementing credible deficit-reduction measures, and this has not gone unnoticed by rating agencies, which have responded with negative outlooks. The French political landscape adds another layer of complexity: there is a risk of early elections given the severe divides in both legislative houses, and the approach of the 2027 presidential election is already casting a shadow over market sentiment. While domestic and euro area investors have continued to support OATs, international investors have become more cautious. Given these persistent headwinds, there is little prospect of a sustained narrowing of French spreads in 2026. In fact, any further rating downgrades or political shocks could trigger additional widening, though contagion to other euro area spreads is expected to be limited, as the market increasingly differentiates between sovereigns based on their individual fiscal and political trajectories.

The 2026 outlook for **Italy** is one of relative stability and ongoing convergence with core euro area yields – 10Y BTP yields fell below those on OAT for the first time this year – although the scope for further spread compression is now limited. Italian government bonds are expected to maintain a spread to German Bunds of close to 80bps to end-2026, a level that reflects the significant progress made in fiscal consolidation and political stability. The Meloni government's commitment to bringing the Italian public deficit below -3% of GDP in 2026 is a cornerstone of this stability, and the administration's EU-friendly stance continues to reassure investors. Non-domestic demand for Italian bonds, particularly from outside the euro area, remains robust, driven by attractive carry as well as some flows being diverted away from France in the wake of its ongoing troubles. However, Italy's **debt-to-GDP ratio**, which is projected to remain elevated at around 138%, will act as a limit on further spread tightening. The conclusion of the NextGenerationEU (NGEU) programme in 2026, which has served as a crucial policy backstop, also removes a key layer of support. While the risk-adjusted carry on Italian bonds remains favourable, the spread tightening relative to Bund already reflects current optimism and the market is likely to become more



sensitive to the high debt levels or political noise as the year progresses, especially with the approach of 2027 budget negotiations. The era of rapid convergence has now run its course, and any further tightening will be incremental and hard-won.

Spain, meanwhile, stands out for its continued resilience and outperformance. The 10-year SPGB-Bund spread is expected to remain tight, supported by strong macroeconomic fundamentals, stable credit ratings, and robust investor demand. Spain's GDP growth is projected at 2.1% in 2026, above the euro area average, and with its budget deficit expected to increase only marginally, Spain's A rating with a stable outlook from major credit agencies will further underpin investor confidence. Non-euro area investors have been particularly active in Spanish bonds, absorbing 56% of net supply in 2025, the highest share among the big four euro area issuers. While political fragmentation and reduced take-up of NGEU loans could pose challenges, these are not expected to materially impact spreads in 2026. The risk-adjusted carry on Spanish bonds remains attractive and, in this environment, Spain's relative strength is likely to persist, with spreads remaining anchored near historic lows and the country continuing to benefit from a virtuous cycle of growth, fiscal prudence, and investor demand.

UK Gilts: attractive yields but risks remain

The outlook for UK government bonds (Gilts) in 2026 will be shaped by a mix of monetary policy easing, fiscal pressures, and structural changes in the pension sector. We expect the **Bank of England** to deliver two further rate cuts before the end of 2026, as the central bank responds to a softening labour market and moderating inflation. This should provide some support to gilts, largely at the short end. Our forecast for the 10-year UK Gilt yield at end-2026 is 4.2%.

However, there are significant risks to the upside for gilt yields. The government's high borrowing needs and the large supply of new gilts will need to be absorbed by the market at a time when the Bank of England is continuing quantitative tightening, reducing its own holdings and adding to net supply. A key **structural shift** is also underway: UK defined benefit (DB) pension funds, historically major buyers of gilts, are set to continue declining sharply as a share of GDP over the coming decades. According to the Office for Budget Responsibility (OBR), DB pension assets are expected to fall from nearly 30% of GDP in 2025 to just 11% by 2074, as private sector DB schemes wind down and sell off gilts. While defined contribution (DC) funds will grow, they are unlikely to fully offset this decline in demand for gilts.

Political uncertainty, with continued rumours of leadership changes, could also push yields higher by increasing risk premia. If inflation proves stickier than expected or global bond markets come under renewed pressure, UK yields could be above our baseline forecast.

Japan: steeper, higher yield curve here to stay

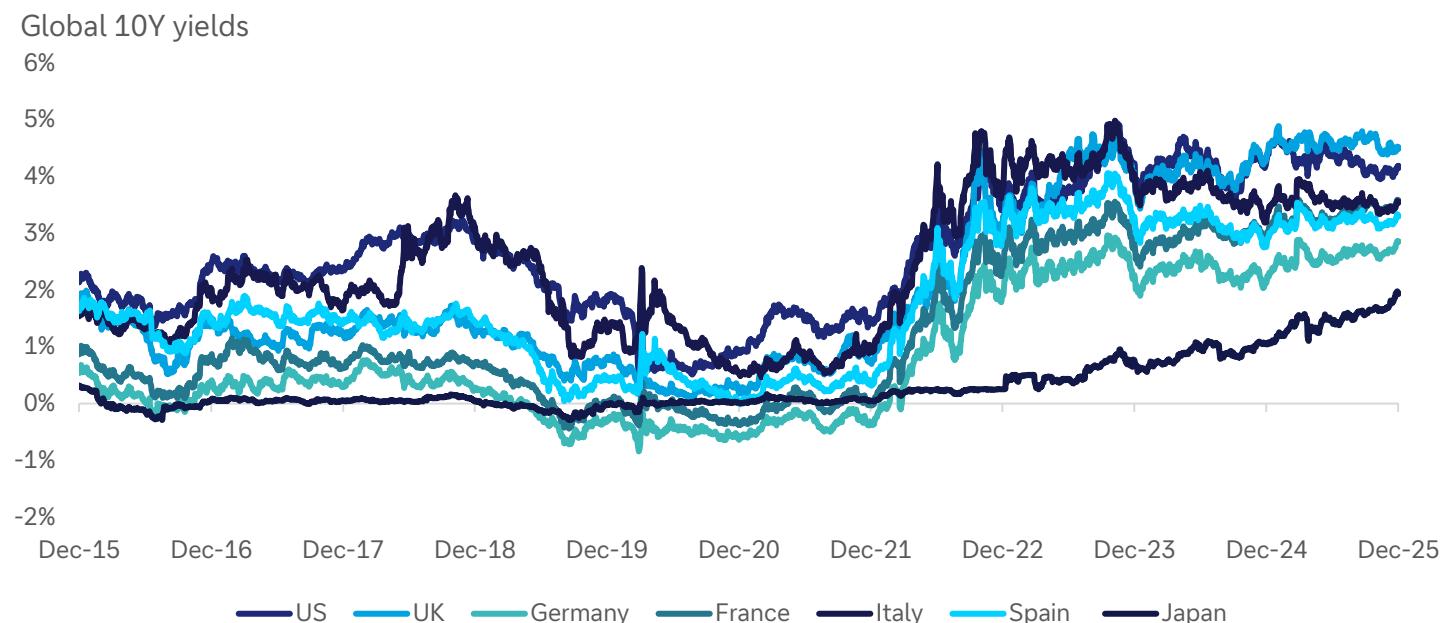
Since 2024, Japan's government bond (**JGB**) market has seen a major shift after decades of near-flat yields under the policy of yield curve control (YCC). Two-year and 10-year JGB yields have now climbed to around 1.05% and 1.92% respectively – their highest levels since 2007 – while the 30-year yield has reached 3.37%, the highest since its introduction in 1999. This broad rise in yields has been accompanied by a sharp steepening of the curve, with the spread between 2-year and 30-year maturities exceeding 230bps – a level unseen for decades. This reflects two key forces: short-end yields rising on the back of the Bank of Japan's first policy normalization in 17 years, and long-end yields driven higher by aggressive fiscal stimulus and mounting government debt.

Markets expect the Bank of Japan to raise rates to 0.75% in December, supported by resilient domestic demand, a weak JPY, inflation which has remained above 2% for 43 months, wage growth, and five quarters of GDP expansion (before a recent dip). Government signals suggest official tolerance for such a hike, and markets have priced in a 90% probability, pushing short-term JGB yields to multi-year highs. We expect a further 25 bps hike by end-2026, taking the policy rate to 1%. Meanwhile, long-end JGB yields have surged on renewed fiscal concerns. Prime Minister Takaichi has announced Japan's largest stimulus since the pandemic – JPY11.7trn (USD 75bn) in new borrowing – which would push the debt-to-GDP ratio, already the world's highest, above 220%.

Higher Japanese yields are reshaping global markets. For decades, the JPY was the preferred funding currency for **carry trades**, but rising JGB yields and BoJ's hawkish stance have increased the risk of unwinds. The possible result was briefly demonstrated in August 2024 when a BoJ pivot and weak US payrolls triggered global volatility: US Treasury yields rose 10bps, Bunds 7bps, the JPY surged and EM currencies tumbled. That said, markets have already priced in an additional rate hike by BoJ in Q3 2026, taking the policy rate to ~1% from 0.5%, so a 2024-style surprise looks unlikely. Both the Japanese government and the BoJ have reiterated their readiness to intervene in FX markets to temper sharp JPY moves, providing a cushion. Against this backdrop, Japan's yields look likely to remain higher for longer: we expect the 2-year JGB yield to reach 1.2% and the 10-year yield to remain near 1.9% by end-2026.

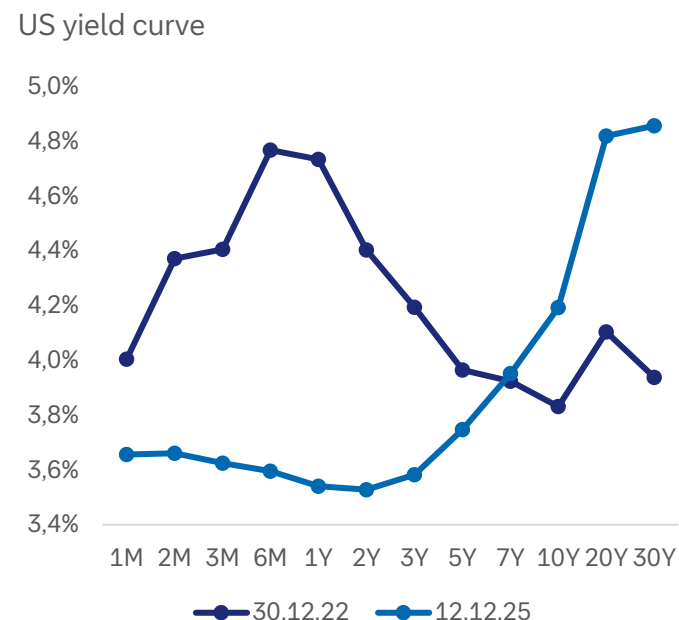


Global yields landscape



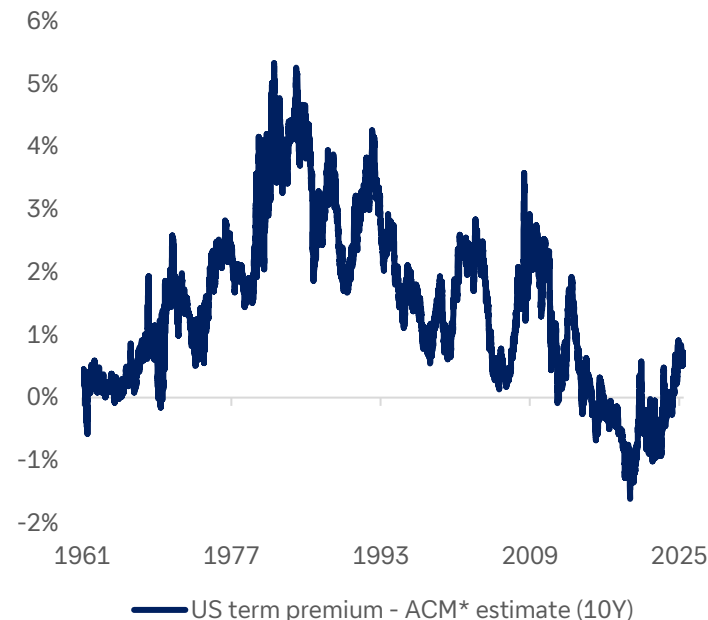
Source: LSEG Datastream, Deutsche Bank AG. Data as of December 15, 2025.

Twist steepening since the end of 2022



Source: LSEG Datastream, Deutsche Bank AG. Data as of December 15, 2025.

Term premium has much room to rise



*Adrian, Crump, and Moench (ACM) model of the New York Fed.

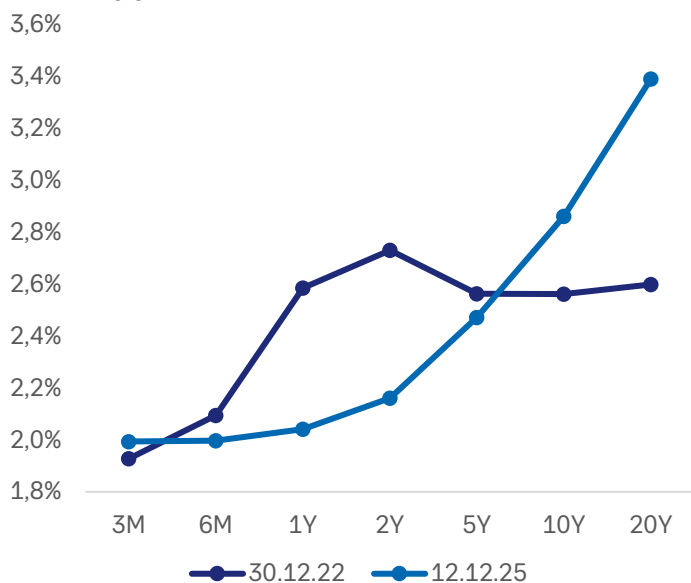
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Steeper curves across the Atlantic as well

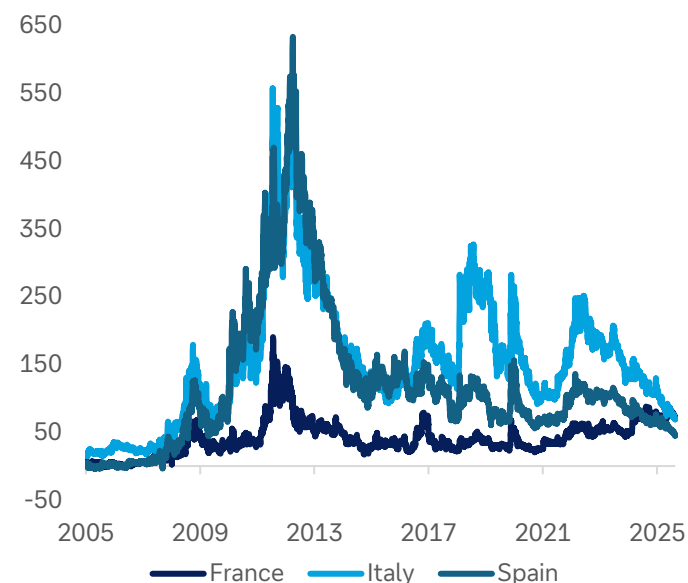
Germany yield curve



Source: LSEG Datastream, Deutsche Bank AG. Data as of December 15, 2025.

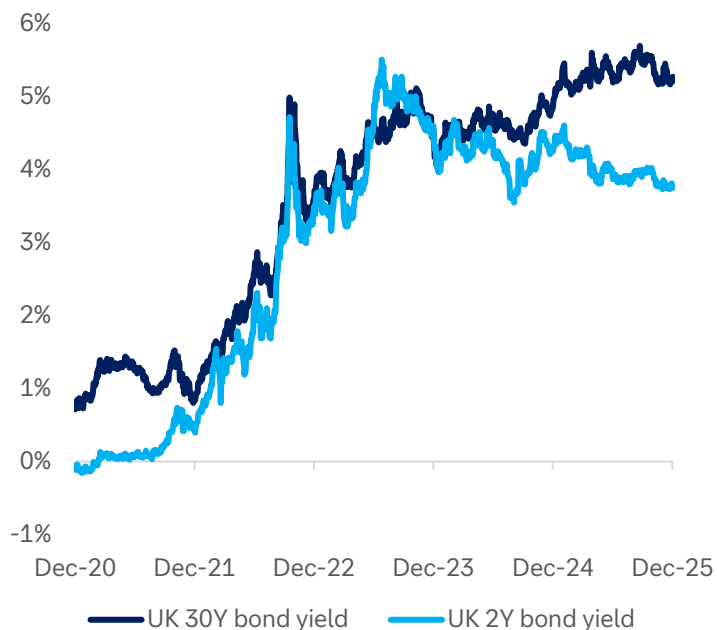
Periphery spreads converging to core

10Y spread to Bund (bps)



Source: LSEG Datastream, Deutsche Bank AG. Data as of December 15, 2025.

UK - stickiness of the long end yields



Source: LSEG Datastream, Deutsche Bank AG. Data as of December 15, 2025.

Japan - quite a comeback for yields



Source: LSEG Datastream, Deutsche Bank AG. Data as of December 15, 2025.

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Appendix

Glossary

Benchmark Yield: The interest rate on a standard government bond used as a reference for other debt instruments.

Credit Spread: The difference in yield between a corporate bond and a government bond of similar maturity, reflecting credit risk.

Coupon Rate: The annual interest rate paid by the bond issuer to the bondholder.

Duration: A measure of a bond's sensitivity to interest rate changes, expressed in years.

Forward Rate: The agreed-upon interest rate for a loan or investment that will occur in the future.

Inflation: The rate at which the general level of prices for goods and services rises, eroding purchasing power.

Liquidity: The ease with which an asset can be converted into cash without affecting its price.

Maturity: The date on which a bond's principal amount is repaid to the investor.

Risk Premium: The return in excess of the risk-free rate that investors demand for taking on additional risk.

Real Yield: The yield on an investment adjusted for inflation.

Treasury Yield: The return on U.S. government debt securities, often used as a benchmark for other interest rates.

Term Structure: The relationship between interest rates and different maturities of debt instruments.

Yield Curve: A graph showing the relationship between bond yields and their maturities.

Yield to Maturity (YTM): The total return anticipated on a bond if held until it matures.



Appendix

Historical performance

	16.12.2020 - 16.12.2021	16.12.2021 - 16.12.2022	16.12.2022 - 16.12.2023	16.12.2023 - 16.12.2024	16.12.2024 - 16.12.2025
2Y US government bonds	-0,5%	-5,4%	-1,2%	-0,1%	1,0%
10Y US government bonds	-3,2%	-17,1%	-3,4%	-3,9%	2,1%
30Y US government bonds	-5,1%	-31,7%	-8,2%	-9,6%	-4,1%
2Y German government bonds	-0,8%	-4,0%	-0,1%	-0,3%	-0,6%
10Y German government bonds	-1,6%	-19,7%	1,8%	-1,7%	-4,6%
30Y German government bonds	-3,8%	-42,1%	-5,0%	-8,2%	-18,1%
2Y Japanese government bonds	-0,2%	-0,2%	0,0%	-0,7%	-0,6%
10Y Japanese government bonds	0,1%	-1,3%	-1,1%	-2,2%	-6,7%
30Y Japanese government bonds	-0,4%	-17,8%	-4,4%	-12,2%	-20,0%
2Y UK government bonds	-0,3%	-4,2%	0,7%	1,1%	1,7%
10Y UK government bonds	-3,4%	-19,7%	-1,8%	-5,2%	-0,1%
30Y UK government bonds	-2,8%	-42,3%	-4,3%	-14,2%	-4,6%
2Y French government bonds	-2,7%	-5,4%	1,2%	3,1%	0,6%
10Y French government bonds	-3,4%	-19,4%	2,3%	-3,5%	-3,0%
30Y French government bonds	-7,7%	-41,2%	-4,3%	-9,3%	-14,2%
2Y Italian government bonds	-1,4%	-5,4%	2,1%	1,3%	-0,6%
10Y Italian government bonds	-3,5%	-23,5%	7,2%	3,2%	-0,3%
30Y Italian government bonds	-7,9%	-38,7%	2,3%	4,2%	-5,8%
2Y Spanish government bonds	-0,8%	-7,1%	0,2%	1,2%	-0,5%
10Y Spanish government bonds	-2,1%	-21,3%	3,1%	1,2%	-2,1%
30Y Spanish government bonds	-7,6%	-40,8%	-0,9%	2,8%	-9,3%

Source: LSEG Datastream Deutsche Bank AG. Data as of December 16, 2025.

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