Major Markets Letter #3
17th December 2025

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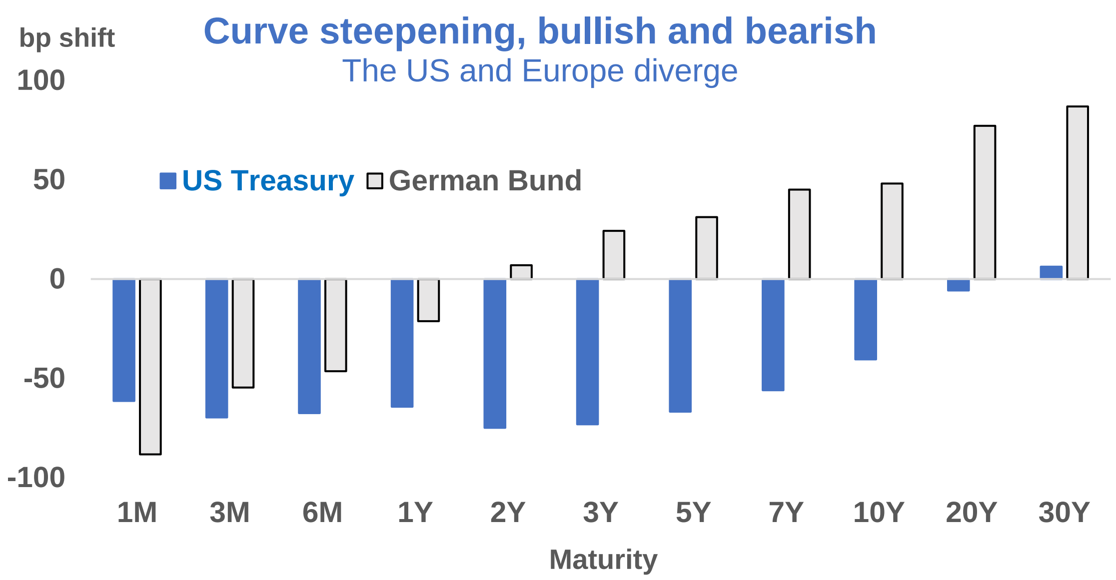
A tale of two curves: The US and Europe diverge

The yield curve has steepened for three consecutive years, and the prevailing narrative says the US curve is on track to make it four. Consensus feels comfortable. Which is usually the moment to ask an uncomfortable question: what could possibly go wrong?

Anyone who trades or invests in bonds knows that talking about “the curve” is meaningless unless you specify which part of it. There is also an important difference between being right in principle and making money in practice. Curve calls live and die by segment, timing, carry, and magnitude.

The chart we show highlights this point clearly by comparing the shifts in the US Treasury and German Bund curves since the start of the year. The Bund curve has steepened decisively across its entire length, from front to back, delivering both bullish and bearish steepening. Yields out to 12 months have fallen, while those from two years onward have risen - and at an accelerating pace. By contrast, the US curve has simply shifted lower almost in parallel below the seven-year point. Apart from in the longer maturities, which rest beyond this midpoint, there has been little meaningful steepening at all, a result that will have frustrated the consensus positioning for a steeper US curve.

Understanding why these two curves have diverged is key to thinking about what might come next.



Source: Bloomberg benchmarks yield shift in 2025.

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At the front end, the story is the same in both markets: policy rates were cut by more than investors expected at the start of the year. What was priced in turned out to be insufficient, so front-end yields adjusted lower. How far that rally can extend further out the curve depends on the proximity of policy rates to their perceived neutral level.

Mention the neutral rate and eyes tend to glaze over, but it remains central to how markets think about the destination for policy. In simple terms, it is the equilibrium rate at which the economy is neither too hot nor too cold, with full employment and inflation at target. It is unobservable, model-driven and deeply uncertain; all good reasons for economists to argue about it endlessly.

Whether we like it or not, neutral rates remain embedded in central bank communication. They allow policymakers to frame policy as restrictive or accommodative and form a key part of forward guidance - the mechanism by which central banks try to shape expectations about where rates are headed next.

Looking toward 2026, it is this destination that matters most for the curve. In the US, the Fed funds rate appears to be heading toward neutral, implying another two or three 25bp cuts if the FOMC's longer-run median dot of 3.0% is a reasonable guide. In the euro area, today's policy rates are already close to the ECB's estimate of neutral, around 2.0%, which naturally limits how much further short-dated Eurozone yields can fall.

Incoming data will ultimately determine where policy rates settle, well that's the view economists and central bankers will offer. The difficulty is that the data picture is far from clear. Some key US releases are still pending, and heightened geopolitical uncertainty only clouds the outlook further. The market reaction to tariff headlines in April 2024 was a reminder of how quickly geopolitics can spill into growth, inflation, energy prices and safe-haven flows; whether into gold, currencies or bonds.

Then there is the influence of future central bank leadership.

In the US, the next Fed Chair will not take office until after Mr Powell's term ends in May 2026. Even so, the views of any leading candidate will be priced into forwards well before then. A more dovish Chair-elect could easily pull expectations for the long-run policy rate closer to 2% rather than the roughly 3% currently implied for the second half of 2026.

In the Eurozone, the ECB President's term runs until 2027, but that has not stopped potential successors from signalling their views. With policy rates already close to neutral, some of that rhetoric points not to further cuts, but to the possibility that the next move could eventually be higher.

It is tempting to point to fiscal deficits and increased bond supply as an automatic recipe for curve steepening. In reality, fiscal developments only matter when they represent a genuine shock relative to expectations. Yields reflect the expected path of policy rates, which already incorporates assumptions about fiscal policy and its impact on growth and inflation. In 2025, the standout fiscal surprise was Germany's shift in defence spending, which emerged in the first quarter and helped drive the pronounced steepening of the Bund curve.

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Those who entered 2025 positioned for a steeper Bund curve were rewarded across almost any segment they chose. In the US, by contrast, what passed for steepening was largely the result of a parallel rally in yields out to seven years rather than a classic curve trade.

So will the curve steepen again? At the start of 2025, the extent of the Bund steepening to come was far from obvious. If the US curve delivers another version of this year's move, it is most likely to be led by the front end rather than the long end selling off aggressively. In that environment, the cleanest trade may not be a curve position at all, but simply holding an outright long in intermediate maturities and letting policy do the work.

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