Yield Curve Steepening in the Near Term, Risk of Higher Term Premium Further Out

Bill Campbell, Portfolio Manager, Global Sovereign Debt | October 2025

The U.S. Treasury yield curve can steepen due to interest rates falling more at the front end than the back end (bull steepening) or due to rates on longer-dated Treasury securities rising more than rates on shorter-term Treasuries (bear steepening). In the present cycle, DoubleLine foresees the yield curve steepening in both bull and bear modes. In this cycle and beyond, the investment team will remain vigilant for upward fiscal, monetary and political pressures that risk escalating the term premium embedded in Treasury rates. For reasons which I'll outline below, political gridlock in Washington, D.C., including the Oct. 1 shutdown of nonessential government operations, does not alter this outlook.

At the outset of past rate-cutting regimes at the Federal Reserve, the yield curve typically steepened as front-end rates moved lower in sympathy with the falling level of the federal funds rate while yields on longer-dated Treasuries fell less or moved higher in the expectation of higher growth and inflation in the future. The yield curve historically steepens in line with Fed cutting cycles. *(Figure 1)*

Target Federal Funds Rate vs. 2-to-30-Year Treasury Yield Spread (Inverted)

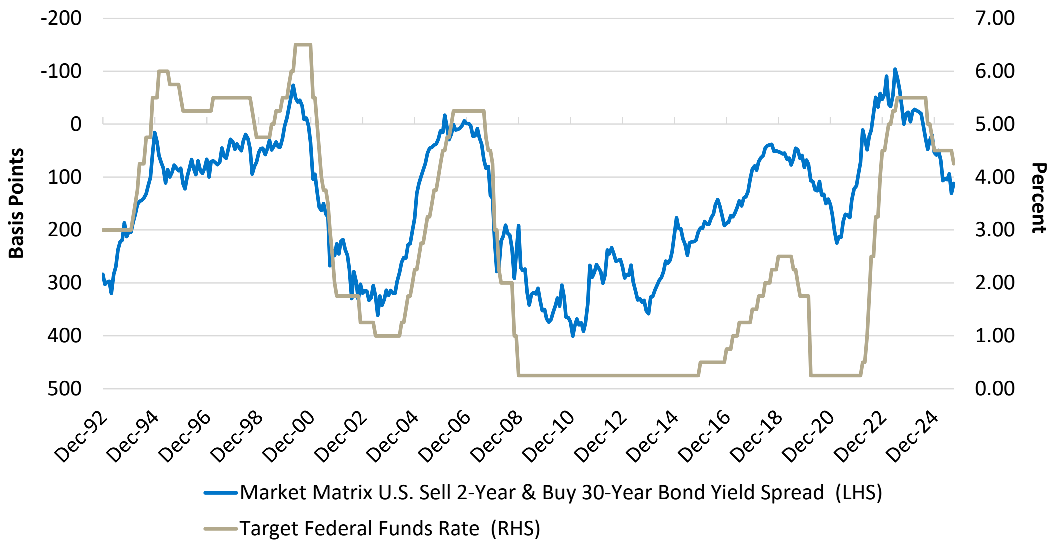

Figure 1
Source: DoubleLine, Bloomberg, as of October 2, 2025

In its last three meetings of 2024, the Federal Open Market Committee (FOMC), the central bank's policy-setting body, lowered the federal funds rate (upper bound) by 100 basis points to 4.50% before leaving the rate unchanged into September of this year. On Sept. 17, the FOMC cut the rate to 4.25%, and markets have priced in two more quarter-point cuts at its Oct. 29 and Dec. 10 meetings with further easing in 2026. The investment team at DoubleLine thinks this policy trajectory will support further steepening of the yield curve in the near term in the form of bull steepening.

In addition, structural pressures on yields of longer-dated Treasuries will likely keep the longer end of the curve elevated or move it higher. Term premium is defined as the extra return investors demand for holding longer-term bonds compared to holding shorter-term bonds. Over the course of the past several years, term premium has built up for several reasons. First, inflation uncertainties have increased; second, fiscal uncertainties have grown; third, questions about the future course of monetary policy have multiplied. Finally, the central bank's pursuit of balance-sheet reduction, aka quantitative tightening (QT), has acted to push yields higher further out the curve.

Term Premium vs. U.S. 2-to-30-Year Yield Curve

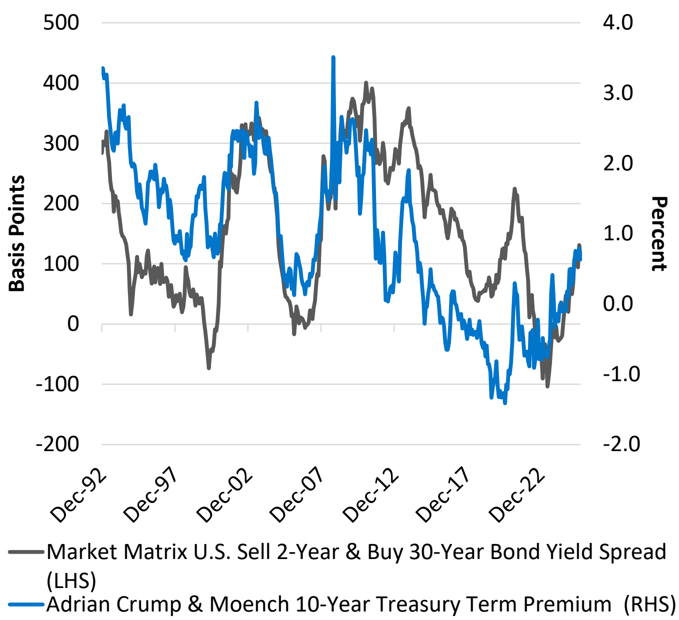

Figure 2
Source: DoubleLine, Bloomberg, as of October 2, 2025

One of the more important factors driving term premium changes over time is investors' inflation expectations. For years, the Fed maintained a credible inflation-fighting posture, broadly containing inflation expectations. During the COVID-19 crisis, a large influx of fiscal stimulus into the economy changed inflation dynamics, resulting in a sharp spike in inflation rates from 2021 into 2022. Elevated inflation rates remain with us, as year-over-year price gauges remain above the Fed's 2% target ceiling. Persistent above-target inflation amid wide budget deficits, positive growth and material change in trade and tariff policy demand elevated term premium.

Fiscal policy, for decades largely ignored by the Treasury market, has emerged as a key driver of term premium for a couple of reasons. Loose fiscal policy can lead to higher prices over time, increasing inflation uncertainty and the risk premium, the premium demanded by investors to assume credit, aka default, risk. In addition, loose fiscal policy expands Treasury supply, which all else equal puts upward pressure on interest rates if demand for holding Treasuries doesn't increase by the same amount. Well aware of this risk, the Treasury Department announced in its last quarterly refunding announcement an intention to keep issuance of long-term bonds steady and instead rely on increased issuance of Treasury bills to fund the additional fiscal spending that the government is incurring.[1] Today, The U.S. budget deficit totals more than 6% of gross domestic product (GDP), the biggest deficit the federal government has run outside recession or war.

Another risk (treated in a recent DoubleLine paper) is that a self-reinforcing cycle of higher interest rates and wider budget deficits will continue to push both in negative directions.[2] We calculated the average coupon payment for Treasury debt coming due in the next year at just below 3%. If Treasury borrowing rates do not ease by the time this debt matures, interest expense for the U.S. will rise commensurately, all else being equal. Of Treasury securities across term spectrum, T-bills, of course, are the most highly correlated to the federal funds rate. This helps explain, in addition to positive economic stimulus of lower rates, the Trump administration's increased pressure on the Fed to lower official short-term rates.

Global Term Premia

Fiscal risks are not confined to the United States, as imbalances are worsening across developed markets.[3] France, Europe's second-largest economy, is struggling with a budget deficit that is over 5% of GDP and a debt-to-GDP ratio above 114%. François Bayrou was appointed prime minister on Dec. 13, 2024, after the previous government failed to reach agreement on a budget. The very same budget impasse toppled Bayrou's government after the prime minister lost a vote of confidence in Parliament on Sept. 8. We are watching closely to see if Bayrou's successor in the Hôtel Matignon, Sébastien Lecornu, will be able to pass a budget in the coming weeks amid increasing public protests, union work stoppages and pushback from opposition parties.

Long-end yields on France's sovereign debt remain under upward pressure due to this combination of fiscal imbalance and political paralysis.

In the U.K., increased concern around what measures will be politically palatable in the government's Autumn Budget announcement is putting pressure on the long end of the gilt curve. The U.K. is running a budget deficit around 4% of GDP with a sovereign debt-to-GDP ratio of 95%. Finally, in Japan, the long-governing Liberal Democratic Party is holding an Oct. 5 election to choose its next president, who will take over after former Prime Minister Ishiba Shigeru faced declining popularity due to anemic growth, high inflation and a badly constrained budget. These issues combined with a deficit of about 6% of GDP and a debt ratio about 250% of GDP are causing long-end Japanese government bond yields to rise. It is clear global investors are becoming more attuned to fiscal sustainability in and outside the U.S.

President Donald Trump's highly public campaign to push the Fed to lower interest rates is likely to have an impact on increasing term premium, resulting in higher interest rates at the long end of the curve. If market participants perceive the Fed as focusing more on the economy and interest cost and less on keeping inflation under control, inflation expectations will likely rise, raising term premium. So far, Fed Chair Jerome H. Powell has maintained the agency's inflation-fighting credibility, reflected in the steady long-term inflation expectations in markets. I like to use the five-year tenor, five-year-forward zero-coupon inflation swap rate as a reference. *(Figure 3)* If this rate were to meaningfully rise, that would indicate reduced market confidence in the Fed's ability to contain inflation, necessitating a higher term premium.

U.S. Dollar Inflation Swap Forward 5 Year, 5-Year

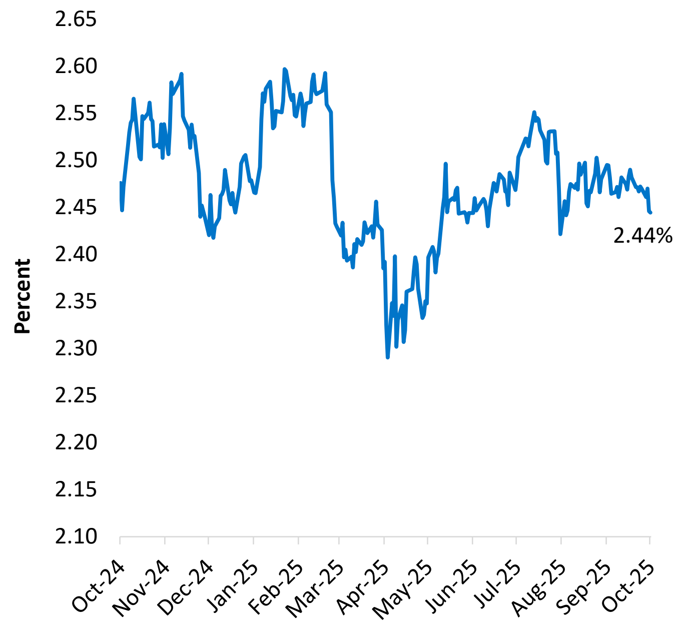

Figure 3
Source: DoubleLine, Bloomberg, as of October 2, 2025

At DoubleLine, we believe the yield curve likely will steepen in the coming quarters. Political gridlock in Washington, resulting in the Oct. 1 shutdown of nonessential government operations, does not change our outlook for the steepener. The Fed is likely to cut on Oct. 29, given the central bank's reception of growing risks around the labor market, adhering to the risk-management framework articulated by Chair Powell in his Sept. 17 news conference. The shutdown will raise additional uncertainties and scrutiny of U.S. data, the fiscal deficit and outlook for U.S. policy, all of which will are likely to keep term premium elevated for the foreseeable future.

The biggest risk to the steepener trade would be a change in the Fed's balance sheet policy. In June 2022, the Fed resumed QT by reducing its holdings of Treasury securities and Agency mortgage-backed securities.[4] In the future, if the Fed were to reenact the policy of quantitative easing, aka purchasing Treasury notes and bonds, we would reevaluate the steepener trade and our ranking of the best sources of return and risk for our portfolios. To date, the Fed has maintained a resolute focus on a careful balancing of inflation and employment mandates. However, given the policy preferences aggressively pursued by the White House, the possibility one day of a politicized Fed bent on yield curve control cannot be dismissed for the future. ■

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Mr. Campbell joined DoubleLine in 2013. He oversees the firm's Global Sovereign Debt team and serves as a Portfolio Manager of the DoubleLine Emerging Markets Local Currency and Global Bond strategies. He is a permanent member of the Fixed Income Asset Allocation Committee. Prior to DoubleLine, Mr. Campbell worked for Peridiem Global Investors as a Global Fixed Income Research Analyst and Portfolio Manager. Prior to that, he was with Nuveen Investment Management Co., first as a Quantitative Analyst in the Risk Management and Portfolio Construction Group then as a Vice President in the Taxable Fixed Income Group. Mr. Campbell also worked at John Hancock Financial as an Investment Analyst. He holds a B.S. in Business Economics and International Business, as well as a B.A. in English, from Pennsylvania State University. Mr. Campbell holds an M.A. in Mathematics, with a focus on Mathematical Finance, from Boston University.

About DoubleLine

DoubleLine Capital LP is an investment adviser registered under the Investment Advisers Act of 1940. DoubleLine's offices can be reached by telephone at (813) 791-7333 or by email at info@doubleline.com. Media can reach DoubleLine by email at media@doubleline.com.

Endnotes

[1] Treasury bills, or T-bills, are sold at discounts in the primary market and carry terms of less than one year. Treasury notes and bonds are issued at par and pay coupons in semiannual payments. Notes are intermediate-term securities with maturities between two and 10 years. Bonds have terms of 20 and 30 years.

[2] Bill Campbell, "Treasury Briefing: Trump, the Fed and Maturity Walls," September 2025, https://doubleline.com/wp-content/uploads/Trump-The-Fed-and-Maturity-Walls_September-2025.pdf

[3] Bill Campbell, "Terrible Trifecta: Paris and Berlin in Crisis as Washington Takes Up Trump 2.0 Agenda," December 2024, https://doubleline.com/wp-content/uploads/Terrible-Trifecta_Paris-Berlin-Washington_12-23-2024.pdf

[4] The Fed implemented an earlier balance sheet reduction in 2017-2019. For further information on the history of quantitative tightening at the central bank, see the Federal Reserve of Bank of St. Louis, "The Mechanics of Fed Balance Sheet Normalization," August 23, 2023. https://www.stlouisfed.org/on-the-economy/2023/aug/the-mechanics-of-fed-balance-sheet-normalization

Agency – Refers to mortgage-backed securities (MBS) whose principal and interest are guaranteed by a U.S. government agency such as Fannie Mae (FNMA) or Freddie Mac (FHLMC).

Basis Points (bps) – Basis points (or basis point (bp)) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument.

Federal Funds Rate – Target interest rate, set by the Federal Reserve at its Federal Open Market Committee (FOMC) meetings, at which commercial banks borrow and lend their excess reserves to each other overnight. The Fed sets a target federal funds rate eight times a year, based on prevailing economic conditions.

Federal Open Market Committee (FOMC) – Branch of the Federal Reserve System that determines the direction of monetary policy specifically by directing open market operations. The FOMC comprises the seven board governors and five (out of 12) Federal Reserve Bank presidents.

Five-Year/Five-Year Forward Inflation Expectation Rate – This rate measures expected inflation (on average) over the five-year period that begins five years from today. The rate is published by the Federal Reserve Bank of St. Louis.

Mortgage-Backed Securities (MBS) – Investment similar to a bond that is made up of a mortgage or bundle of mortgages bought from the banks that issued them. Investors in MBS receive periodic payments similar to bond coupon payments.

Quantitative Easing (QE) – A monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective. A central bank implements quantitative easing by buying specified amounts of financial assets from commercial banks and other private institutions, thus raising the prices of those financial assets and lowering their yield, while simultaneously increasing the monetary base.

Quantitative Tightening (QT) – Reverse of quantitative easing (QE); a central bank that acquired financial assets under QE undertakes steps to reduce its balance sheet.

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