Fixed Income Outlook Q3 2026

FOR PROFESSIONAL INVESTORS

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By BNP Paribas Asset Management

Sovereign bonds : Watching the new Fed Chair

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United States

The second quarter was an eventful period for bond markets, with several key factors driving prices. These included the Middle East conflict; strengthening US payrolls data and decline in the unemployment rate, (3) ongoing passthrough of tariffs and the energy supply shock into CPI, and Kevin Warsh's first policy meeting as new Federal Reserve Chair.

Iran war and Middle East risk

In February, the US and Israel broke off talks with Iran and launched attacks on Iran. Since then, the war has evolved from an acute geopolitical and energy shock into something more complicated – following a fragile peace, hostilities once again have geared back up. The conflict initially produced a classic stagflationary impulse: a severe disruption to Gulf energy exports; a sharp upward repricing of oil and gasoline; and a deterioration in global risk sentiment. The key macroeconomic issue was whether the shock would prove temporary, allowing central banks to look through a one-off increase in headline inflation, or whether the closure and militariation of the Strait of Hormuz would create a persistent energy supply shock.

US labour market

The softer June data, which saw significant downward revisions, highlighted the significant sampling errors and revisions in non-farm payroll prints, and the need to look at a broad selection of labour market indicators. On the pessimistic side, quit rates are relatively low, while the length of unemployment spells has increased, and surveys suggest those looking for work are finding it harder to find positions. Recent graduates in particular are facing difficulty securing their first position.

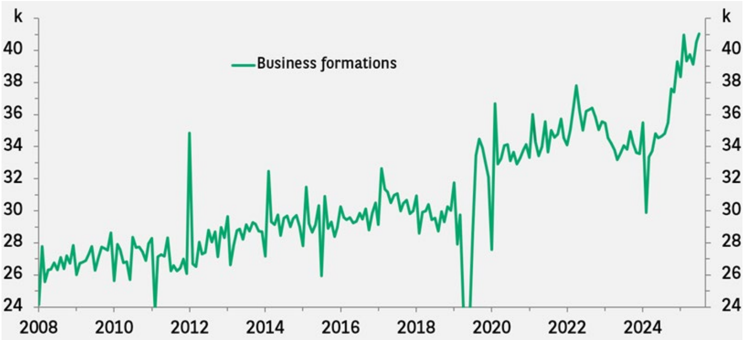
The National Federation of Independent Business (NFIB) Small Business Survey of Hiring Intentions also looks relatively soft. On the positive side, the ISM Business Employment Survey has recovered since the outbreak of the Iran War, initial unemployment claims remain muted, and JOLTS job openings have picked up.

For now, the economy remains in a low hire/low fire mode where turnover is low and job holders are relatively secure but job seekers face challenges. Nevertheless, the current labour market picture, by our assessment, remains one where job creation is likely to remain slightly above the pace required to match labour supply.

Looking ahead, our view is that the US economy should benefit from the One Big Beautiful Bill Act's fiscal stimulus, the artificial intelligence-capital expenditure boom, and improved business sentiment as tariffs are behind us – all of which is leading to relatively firm demand for workers, despite the roll-out of AI technologies.

Indeed, Census Bureau data shows new company formations has risen markedly in the last few months, suggesting the Bureau of Labor Statistics (BLS) birth-death model used to adjust non-farm payrolls might be underestimating business formation, which has likely been facilitated by AI.

Figure 1: Business formations have jumped sharply over the last year



Data as at 30 June 2026. Sources: Census, Bureau, BNP Paribas Asset Management

Over the next few months we anticipate a gentle further decline in the unemployment rate (towards 4%) that should eventually put upward pressure on wages. Of course, higher energy prices remain a risk to the consumer, but with the US being a net energy exporter the overall growth impact should be muted.

The larger downside risk, in our view, would be a pull-back in corporate enthusiasm for AI-related capex investments and a slide in AI-related equities, prompting a rise in household precautionary savings that would undermine consumption.

US CPI and inflation indicators

The inflation story in the second quarter has been dominated by the distinction between headline energy effects and underlying core pressure. Recent months have also revealed a widening wedge between core CPI and core PCE measures, driven by differences in methodology and component weights.

Prior to the Iran war, the inflation picture was, in our view, broadly constructive. Looking at the key components, shelter services continued to soften, non-shelter services prices were broadly consistent with the Fed's inflation target amid wage growth that had cooled to around 3.5% year on year. But core goods prices were lifted by the passthrough of 2025's tariffs. The anticipation was that base effects would permit headline and core inflation to return towards target in the second half of 2026.

The outbreak of hostilities with Iran layered another supply shock onto already-elevated core and headline inflation. Complicating the picture is the fact that PCE inflation looks less benign than CPI, with core PCE moving meaningfully above core CPI due to compositional and methodological differences.

CPI has a larger weight to (soft) shelter prices, whereas PCE has been kept elevated by AI-related price pressure in computer software and accessories, a category with a much larger weight in PCE than CPI. This created a widening CPI-PCE wedge.

Inflation therefore remains ambiguous rather than decisively benign, despite the recently better-than-expected June data. On one side, shelter trends, wages and core goods suggest the underlying trend is cooling once energy and measurement distortions are stripped out. On the other, headline inflation remains elevated, PCE remains sticky, services inflation is not fully resolved, and renewed energy escalation could still contaminate expectations.

This ambiguity matters because Fed Chair Warsh appears more open than his predecessor Jerome Powell to alternative inflation measures such as trimmed-mean or median inflation, raising the possibility that the Fed's operational definition of "underlying" inflation could change over time.

US monetary policy and Kevin Warsh's first press conference

Warsh's first Federal Open Market Committee press conference marked a clear regime shift. June's meeting saw the Fed funds rate held at 3.50%-3.75% but the communications package was hawkish and structurally important.

The FOMC policy statement was much shorter, the Powell-era easing bias and forward guidance were removed, and the Summary of Economic Projections showed that half of participating policymakers saw at least one hike in 2026. Warsh did not submit his own dot to the Fed's closely-watched dot plot, which itself became a signal of his discomfort with the dot plot and traditional Fed guidance.

The first message was a renewed emphasis on price stability. Warsh said the Committee would "deliver price stability" and that there was "some work to do" on inflation, but he gave little explicit forward guidance about the near-term rate path. Warsh appears to have consciously rejected the Bernanke-Yellen-Powell communication regime, in which the Fed has used dots, press conferences and speeches to shape market expectations. Under Warsh, the Fed appears more willing to let markets infer the reaction function and price live meetings without explicit reassurance.

This shift has obvious market implications. There is a risk of a move back toward an Alan Greenspan-style Fed: shorter statements, fewer signals and more uncertainty about how the Committee will respond to incoming data. Removal of forward guidance means a higher risk premium should be embedded in the front end. Every meeting is more plausibly live, and unexpected hikes or holds become easier to imagine. This is not simply a hawkish rates story; it is also a volatility and term-premium story.

The second message was institutional reform. Warsh announced five task forces covering communications, the balance sheet, data sources, productivity/jobs, and inflation dynamics/frameworks. The communications task force is the most immediate: it may lead to reduced reliance on the dot plot and fewer attempts to pre-commit to a policy path.

The balance-sheet task force points toward a smaller Fed footprint and potentially a more Treasury-only portfolio, but implementation is likely to be slow and coordinated with the Treasury to avoid market dysfunction. The data task force is potentially far-reaching because Warsh criticised official statistics as lagged, revised and poorly suited to a 2026 economy; he wants more use of real-time and private-sector data.

The inflation framework task force could be the most consequential for the rate path. Warsh has repeatedly argued that the Fed should focus on inflation measures that distinguish structural inflation from one-off “weather” shocks. He has downplayed core PCE and shown interest in trimmed-mean and median measures, which currently look materially lower than core PCE (in large part due to a construction bias).

However, this carries credibility risk: changing the operative inflation benchmark after years of above-target inflation could look like moving the goalposts unless the Fed can show genuine progress across multiple measures.

The near-term policy bias remains “higher for longer,” with hikes possible if evidence of indirect and second-round inflation were to emerge, or if labour market conditions tightened. The BNP Paribas CIB economics team had seen scope for three hikes beginning in December, with risks skewed earlier if data remains strong.

The desk’s view was that evidence of further labour market tightening and higher energy prices feeding through into actual and expected inflation would merit rate hikes, and that Warsh’s hawkish tone at the June meeting merited a pre-emptive repricing of the rate path. Subsequent softer payrolls and CPI inflation in the June data naturally prompted a readjustment.

Third quarter outlook

- The US economy is likely to see output growth of 2.0% to 2.5% in the remainder of 2026. Growth should be supported by a mix of fiscal stimulus and heavy capex investments focused on AI infrastructure and technology deployment. Corporations are generating elevated profit margins and the uncertainty caused by 2025’s tariffs is now over, providing funds for hiring and investment. Higher energy prices remain a risk to households, but so far consumption has been supported by stable employment and wealth effects from rising equity markets.

- We anticipate labour demand to continue to exceed supply by 50,000 to 100,000 per month helping to gradually lower the unemployment rate and eventually provide some upward pressure on wages that could give the Fed reason to worry about non-shelter services inflation.

- A reacceleration of inflation is not an immediate risk, with tariff-related passthrough mostly complete, shelter inflation remaining soft, and wages not yet reflecting any tightening of labour market conditions. Recent stickiness of core PCE reflects in part some measurement issues on components like IT software and accessories. Nevertheless, FOMC members are attentive to the risks of de-anchoring inflation expectations, particularly if renewed Middle East unrest were to push energy prices higher.

- We view financial conditions as slightly stimulative in the context of the AI-capex boom and modest fiscal stimulus. Heavy corporate debt issuance reveals that AI-capex plans are not particularly policy-rate sensitive, and that higher rates would be needed to restrain credit creation. Our view is that the longer-run neutral policy rate may be closer to 3.5% than the FOMC’s 3.0% assessment, and that it could be closer to 4.0% in the near term — suggesting rate hikes would be appropriate.

- Investors are still assessing the new Fed Chair. Warsh has historically leaned hawkish, having opposed taking rates to zero; proposing raising rates in 2010 as the economy was still recovering; he opposed the second and third rounds of quantitative easing, and criticised the magnitude of fiscal packages during the global financial crisis. He has also asserted that a disinflationary AI-productivity boost should permit lower policy rates.

It is our view that economic conditions warrant a rate hike in coming months, with a modest tightening of the labor market, and the Committee's desire to reinforce its inflation credibility being the deciding factors. The assessment is complicated by the lack of clarity over the changes that Warsh will bring. We will be watching his actions, and the broader Committee, very closely in coming months.

Ten-year Treasuries have traded in a 4.35%-to-4.65% range in recent months. Given our outlook for at, or slightly above, trend output growth, a gently firming labour market and upside risks to policy rates, we think this range is likely to hold. Breaching the lower end of the range would require an economic slowdown or evidence of cooling inflation – not our base case. Longer-term yields also face a lift from heavy corporate issuance as so-called hyperscalers come to the capital market to fund their AI infrastructure build-out.

Eurozone

Receding headwinds from geopolitical tension

The Iran conflict has shaken the eurozone's economic outlook, as the surge in energy prices created upside risks to inflation and downside risks to growth. However, the recent decline in energy prices, both in the runup to, and following the signing of the US-Iran Memorandum of Understanding, has brought a welcome reprieve to the economy. However, with renewed military strikes, uncertainty is back on the table.

Recent survey data has pointed to some improvement in private sector activities at the end of the second quarter. There were signs of improved economic sentiment evident in the recent PMI survey and the Economic Sentiment Indicator, while at a country level, both France's INSEE Business Confidence Composite Index and Germany's Ifo Business Climate Index saw improvements in June.

On the consumer side, the eurozone consumer confidence indicator improved in June, although it remains below pre-Iran war levels. Overall, recent data releases are consistent with 0.1% quarter-on-quarter GDP growth in the eurozone during Q2 and point to a gradual recovery in economic momentum as energy prices ease.

Easing inflation but pipeline pressures remain

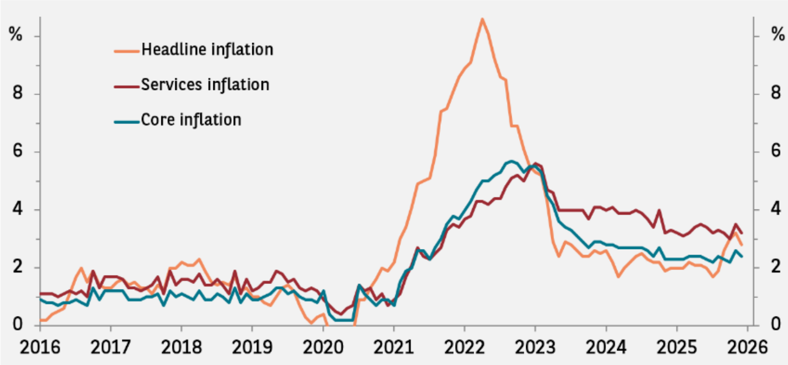
Recent declines in headline inflation are largely due to the moderation in energy inflation, while softer services inflation contributed to a weaker core print. It's also notable that food prices fell slightly, while core goods inflation remained steady.

Inflation rate changes for natural gas and electricity prices were mixed in June, and there were also differences in these components across countries, reflecting variations in fiscal support measures and their respective timeline for implementation and phasing out. In terms of the Middle East conflict's impact on food inflation, it is unlikely to be visible at this stage, as the pass-through of higher fertiliser prices to agriculture products operate with a significant time lag.

Other indicators, such as Purchasing Managers' Indices and the European Commission's Selling Price Expectations indicators, pointed to a tentative easing in input costs and a softening in pricing dynamics across sectors.

That said, these indicators remain well above both their historical averages and pre-war levels, indicating the cost-push pressures stemming from four consecutive months of elevated energy prices are likely to continue generating indirect effects outside the energy sector in the near term.

Figure 2: Lower energy prices reducing eurozone HICP headline inflation



Data as at 30 June 2026. Sources: Eurostat, BNP Paribas Asset Management

The European Central Bank's measured response

Since the European Central Bank's June meeting, the decline in energy prices has reduced the pressure for a more aggressive policy response. This is consistent with the messages from the recent central banking annual forum in Sintra where ECB President Christine Lagarde acknowledged that upside risks to inflation and downside risks to growth are now "more broadly balanced".

Some ECB officials noted the fall in energy prices had reduced the urgency to act, and a wait-and-see approach at the July meeting would likely be appropriate. Some Governing Council members even expressed openness to leaving rates on hold from here.

Still, most policymakers continued to point to some further tightening ahead given higher inflation in the pipeline, suggesting the ECB is likely to remain focused on ensuring that higher energy costs do not spread to the wider economy through indirect and second-round effects, as the risks of inflation persistence have not fully dissipated. Overall, the recent inflation developments and ECB communications are supportive to the case of a "measured" response.

Outlook

Over the past quarter, energy prices defied worst-case warnings from industry experts, and their normalisation in June in the run-up to Iran and the US signing the Memorandum of Understanding happened quicker than expected. The combination of demand destruction, significant inventory drawdowns, import adjustments in China, increases in US energy exports, and faster substitution and adaptation by consumers and businesses meant that the supply crunch was not as bad as feared.

US President Donald Trump has also been balancing his threats with signals of diplomatic off-ramps since the outbreak of the conflict at the end of the February, which has perhaps limited the panic in the energy markets.

In the eurozone, the evidence available so far points to positive (albeit tepid) growth for the second quarter, while first quarter growth was resilient, even with a full month of conflict already reflected in the data. Beyond the Iran war, we expect growth to be driven primarily by domestic demand, supported in part by Germany's fiscal stimulus, which should become more visible in GDP data later this year and next.

By contrast, we do not yet see a clear contribution from AI-related investment in the data. We view technology adoption in Europe as a gradual process, with diffusion across sectors likely to take time. Over the medium term, this should still support productivity growth, although the effect is likely to be modest.

Inflation has so far proved less persistent than feared in March and April. First, energy prices have fallen sharply in recent weeks following the reopening of the Strait of Hormuz. Second, the indirect effects of the energy shock on the broader inflation basket have been more muted than expected, as illustrated by the fall in airfares in May and June and the decline in food prices in the second quarter. Over the next few quarters, we see no material second-round effects, which should keep core inflation contained.

Despite the benign growth and inflation developments, the backdrop remains uneasy for policymakers, with energy price gyrations and continued disruptions threatening upward price pressures in the pipeline. As such, the ECB is unlikely to lower its guard, and we expect the ECB to stick to its "data dependent" and "meeting-by-meeting" approach.

Recent ECB communications suggest two-sided risks to the policy rate path in the coming months. This means upcoming ECB decisions will be highly dependent on Middle East developments and energy markets. Similarly, we expect sovereign bond yields and breakeven inflation rates to remain tightly linked to the same factors as the energy supply shock remains the key driver for near-term inflation outlook.

At the time of writing, the US and Iran are locked in a cycle of tit-for-tat strikes, as the US pushes to normalise commercial shipping through the Strait of Hormuz while Iran resists ceding control. For now, skirmishes in the Middle East are likely to continue as both sides look to strengthen their negotiating position, but we take the view that the appetite to return to more serious military actions remains low, considering the depletion in munitions and interceptors, and the political pressure to keep fuel prices contained ahead of the US mid-term elections.

We are nonetheless also cognisant that the energy market is more vulnerable to escalations at the Strait today than three months ago, as aggressive draws from governments' strategic reserves and commercial energy stockpiles to stabilise prices during previous shutdowns have left little margin to absorb new supply shocks.

Regarding government bonds, we prefer Italy to France. We anticipate fiscal issues in France to come into focus in the coming months, as the negotiations of the 2027 state budget start in the fall. Political risk will also become increasingly important for markets as the election approaches. The return of Marine Le Pen to the race for the French Presidency may draw more attention to the *Rassemblement National*'s expansionary spending platform and heighten concerns about France's debt sustainability.

Recent polling showed the party remains the dominant force in the first round of elections with 36% of support, while none of Le Pen's opponents would have more than 19%. In the run-off, which sees the top two candidates from the first round face off, pollsters point to a narrower win against Former Prime Minister Edouard Philippe.

UK

A decade on since the Brexit referendum

The UK's Brexit referendum marked its 10th anniversary on 23 June and while the formal withdrawal only occurred in January 2020, economists are still debating its consequences. Aside from the economic impact, Brexit has been followed by a decade of political instability, resulting in an unprecedented churn of leadership at the top of the government. On 22 June, Prime Minister Keir Starmer announced his resignation, paving the way for the former Greater Manchester Mayor Andy Burnham to take over, who will be the UK's seventh leader in 10 years.

The key issue for the market will be what a Burnham administration means for the UK's fiscal stance. While Burnham pledged he would not take "risks with public finances" and would stick to the current fiscal rules, it remains likely the revamped government will look to increase investment and spending in certain areas to boost growth. Alongside Burnham's pledge to keep the Labour manifesto promise of not raising taxes on working people, the risk is of higher deficits, smaller fiscal headroom, and/or possible tweaks in the fiscal rules in the upcoming Autumn Budget.

Growth and inflation

The UK economy experienced a notable loss of momentum in the second quarter of 2026, with the weakness attributable to the lingering effects of the energy price shock, geopolitical uncertainty stemming from the Iran war, and weaker consumer-related spending.

Figure 3 : UK PMI Indices

Source: S&P Global, Haver Analytics; June 2026

Inflation prints released over the past couple of months suggest that outside of energy, price pressures across much of the rest of the basket, including food and core goods, are comfortably contained, and that the inflation impulse from the Middle East conflict is narrow so far.

Outlook

Prior to the war in Iran, the UK economy was already contending with sluggish growth and above-target inflation. Elevated energy prices have compounded those pressures, and forward-looking survey data looks lacklustre, though the recent progress in US-Iran talks should provide some relief.

For now, however, consumer confidence has weakened and disposable incomes are expected to fall as higher energy costs continue to hit households, restraining consumer spending in the near term. GDP growth is expected to slow in the second and third quarters, reflecting payback from the first quarter strength and a drag from higher energy prices.

Developments in UK inflation has been more benign than expected over the past couple of months but there remain reasons for caution. UK consumers have yet to see the full effect of higher utility bills due to the time lag between wholesale price changes and the regulated utility price cap adjustment, which increased by 13% on 1 July.

The shaky nature of the peace talks between the US and Iran also suggests the decline in energy prices that took place at the end of the second quarter might not be sustained, and it remains to be seen whether indirect and second-round effects of the energy price shock will keep inflation elevated.

In terms of monetary policy, since the outset of the Iran war, the markets have been expecting the Bank of England to hike in response to the energy shock. While the initial response was hawkish, subsequent communications from the BoE revealed a more cautious stance, with a preference to hold policy rate steady as long as second-round effects of the energy price shocks remain muted.

It is also important to remember that relative to the ECB and the Fed, BoE monetary policy was more restrictive at the start of the Middle East conflict, and the market was expecting two rate cuts in 2026. Looking ahead, our expectation is that slack in the labour market and softer demand should limit second-round effects, such that the BoE is unlikely to lift policy rates for the remainder of 2026.

As the UK navigates a leadership transition to its seventh prime minister in 10 years, the market is closely monitoring the shifts in government policies and their implications on growth and fiscal outlook. Burnham offered glimpses of how he might seek to govern as the new leader in recent speeches and media interviews.

At the centre of Burnham's agenda is a radical devolution of power away from Whitehall, aiming to rebalance the UK economy from the bottom up and address extreme regional inequalities. For now, whether devolution will generate economic growth is viewed with cautious optimism, as studies on the economic impact of devolution show mixed results.

Still, we expect the incoming government to seek increases in spending and investment to meet military spending commitments and to address weak economic growth and underfunded public services. To stay within the UK's fiscal rules' constraints, Burnham is looking to private capital via public-private investment funds, or to channel capital through institutions such as the UK's National Wealth Fund which co-invests in infrastructure and clean energy, creating offsetting financial assets that would be treated favourably under the fiscal rules.

There could also be targeted taxation reforms on capital gains and property, which are outside the main manifesto tax commitments, but would bring in additional revenue. For gilt investors, the risk is the incoming government may look to relax the fiscal rules, such as extending the horizon over which they need to be met or tweaking the definition of government debt to create additional fiscal headroom while preserving the appearance of fiscal responsibility. Another risk is the government could simply operate closer to the limit of the fiscal rules, leaving a smaller cushion against future shocks.

Over the past couple of months, the gilt market seemed reassured by Burnham's pledge to maintain fiscal discipline by adhering to Labour's existing fiscal framework. In our view, the risk is that the government seeks to finance investment through greater borrowing, lower fiscal headroom, or technical changes to the fiscal rules.

Even if these measures are formally compliant with the framework, investors may still focus on the underlying increase in gilt issuance and public debt. We expect gilt yields to remain sensitive to future fiscal announcements, particularly the Autumn Budget and any proposed changes to the fiscal framework. Our view is the BoE will likely keep interest rates on hold, while the gilt risk premium will likely rise.

Euro investment grade outlook : Carry and income drive returns

By Victoria Whitehead, Lead Portfolio Manager

- The outlook for the second half of 2026 remains positive, supported by robust corporate fundamentals, a supportive macro backdrop, and favourable technical conditions
- With spreads tight, future performance is expected to be driven primarily by carry and disciplined security selection rather than significant spread tightening
- At present, we prefer European financials, particularly banks, and selected BBB-rated issuers. We also like European industrials benefiting from infrastructure spending and domestic investment

We are positive on euro investment grade credit going into the second half of 2026.

While valuations are increasingly demanding after the strong spread compression observed in the first half of the year, the asset class continues to benefit from a supportive macroeconomic backdrop, solid corporate fundamentals, and favourable technical conditions.

As a result, we expect carry (coupon income minus cost of funding), and credit selection to remain the primary drivers of performance, rather than further significant spread tightening.

Macroeconomic environment

The European economy is expected to continue expanding at a moderate pace, supported by improving domestic demand and fiscal stimulus measures, particularly in Germany.

Inflationary pressures continue to ease, helped by lower energy prices and a more balanced labour market, allowing monetary policy to remain broadly supportive. This backdrop should remain conducive to corporate credit performance.

Nevertheless, investors should remain attentive to geopolitical developments and potential trade tensions, which could periodically increase market volatility and affect risk sentiment.

Valuations and market outlook

Following a resilient first half of 2026, euro investment grade (IG) spreads remain narrow. While this limits the scope for meaningful spread compression, absolute yields continue to offer attractive income opportunities compared with long-term averages.

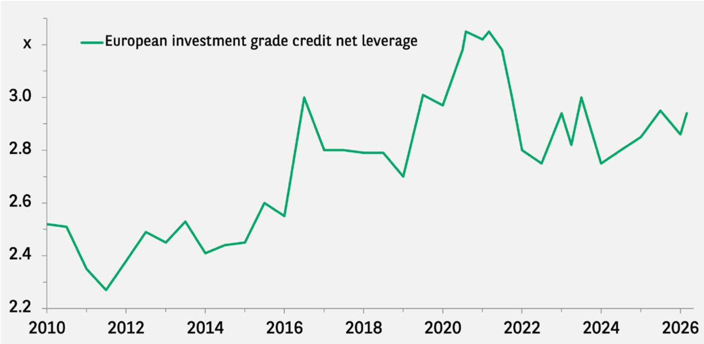
Consequently, returns are likely to be dominated by carry rather than capital appreciation from tighter spreads.

At the same time, elevated issuer and sector dispersion continues to create opportunities for active managers to generate alpha through security selection.

Corporate fundamentals

Euro IG corporate fundamentals remain robust. Leverage levels are generally well contained, liquidity positions are healthy, and free cash flow generation remains supportive across most sectors.

Figure 4: Leverage levels are generally well contained



Data as at 28 February 2026. Sources: J.P. Morgan, BNP Paribas Asset Management

Despite a more challenging economic environment than in recent years, European corporates have demonstrated resilience and continue to maintain strong balance sheets.

European banks remain a key area of strength. Capital ratios are comfortably above regulatory requirements, asset quality metrics remain solid, and earnings continue to benefit from a higher-for-longer interest rate environment.

The potential for increased defence spending in Europe as well as huge investment in artificial intelligence infrastructure bodes well for future profitability of the European industrial and manufacturing sectors. As such we are actively looking to invest in this space using new issuance as an entry point.

Technical factors

Market technicals remain supportive despite elevated issuance volumes. The primary market successfully absorbed record supply during the first half of the year, highlighting the continued demand for high-quality credit and attractive income opportunities.

Supply should moderate during the summer period, further strengthening the technical backdrop.

Any periods of spread widening driven by heavy issuance or temporary volatility are likely to offer attractive entry points for long-term investors.

The technology sector is of particular relevance currently, with a huge amount of new issuance from hyperscalers hitting the market predominantly in US dollar IG public and private credit markets.

The euro IG bond market has been relatively untapped so far by the US tech sector, and we expect a significant increase in issuance in the fourth quarter. Current positioning in technology issuers is fairly light and we are underweight the long end of this sector, which we believe could potentially underperform.

Investment preferences

Given the present environment, we continue to favour European financials, particularly banks and selected subordinated debt. We also like European industrial issuers benefiting from infrastructure spending and domestic investment and BBB-rated credits, where spread compensation remains more attractive than higher-rated segments.

Conversely, we remain more cautious on data-centre real estate investment trusts and selected real estate-related credits as well as private-equity-related issuers. We are also more wary of certain US financial issuers accessing the euro market and highly rated defensive sectors where valuations appear particularly rich. We expect to be opportunistic buyers of US tech issuance.

US agency MBS Outlook : Fundamentals remain robust

By John Carey, Head of Structured Securities

- The mortgage-backed security sector has been resilient, with positive year-to-date total returns
- Agency MBS fundamentals remain strong due to elevated mortgage rates and a lock-in effect that has stabilised prepayment behaviour and limited new supply
- The outlook remains good and we prefer a modest overweight position to MBS, driven by high-quality carry, liquidity, and diversification benefits

Fundamentals

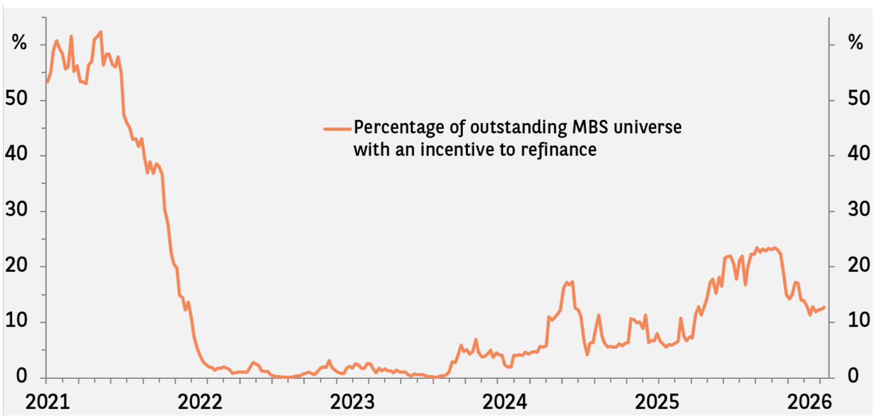
Agency mortgage-backed securities fundamentals remain supported by a combination of elevated mortgage rates, limited refinancing incentives, constrained housing turnover, and low net supply.

Primary mortgage origination rates have remained around the mid-6% area. This rate environment continues to limit refinancing activity and new origination supply, while the broader lock-in effect has kept a large portion of the mortgage universe out of the money.

Prepayment behaviour has therefore remained relatively stable and well behaved. The June prepayment report showed an 11% decrease in 30-year Federal National Mortgage Association aggregate speeds, with elevated mortgage origination rates slowing refinancing activity more than anticipated in higher coupons.

Lower coupons rose only marginally due to seasonal housing turnover, while mortgage origination rates stayed near 6.45% during the month. Only 12% of the mortgage universe has a meaningful incentive to refinance, reinforcing the case for a stable prepayment profile.

Figure 5: Little incentive to refinance mortgages



Data as at 25 June 2026. Sources: Bloomberg, BNP Paribas Asset Management

Demand and supply technicals also remain favourable. The current environment is one with good investor demand from money managers, banks, real estate investment trusts and overseas investors, alongside range-bound mortgage origination rates that are limiting refinancing activity and new origination supply.

Spreads and valuation

Agency MBS valuations remain broadly fair relative to other high-quality fixed income sectors, although spreads have tightened from the wider levels observed during the March volatility episode.

Coupon nominal spreads were around +100 at the end of July and attractive versus US Treasuries.

From a relative value perspective, Agency MBS continues to compare favourably with investment grade credit with attractive spreads versus investment grade credit, diversification benefits, and high-quality income without corporate credit risk.

Investor demand is strong, and stable mortgage origination rates and favourable technical factors further support the asset class.

Absolute yield levels also remain a key part of the valuation case. The Bloomberg US MBS Index yield is approximately 5.01%, with current coupon nominal spreads around +100 bps and current coupon option adjusted spread is around +12 bps (data from JPM DataQuery as at 1 July 2026).

The current coupon parity yield is approximately 5.46% (JPM DataQuery, 7 July 2026) and that to-be-announced dollar rolls in production coupons continue to offer attractive carry. These levels suggest that, even if spreads are no longer cheap versus their own recent history, the sector continues to offer meaningful carry and liquidity in a high-quality framework.

Present outlook

The current environment therefore supports a positive bias toward MBS, particularly for institutional investors seeking high-quality carry, liquidity and diversification relative to credit sectors.

At the same time, the valuation argument is more nuanced. Spreads are no longer as wide as they were during the March dislocation and are closer to when they were much narrower, meaning further spread tightening may be more limited. We are therefore neutral on spreads given valuations near the tights.

We currently prefer a modest overweight to Agency MBS, focused on carry, liquidity and relative value versus investment grade credit. We initiated an MBS overweight driven by absolute yield levels and fair spreads, with a preference to increase exposure only on cheaper valuations or further progress in the peace process.

We maintain our overweight recommendation for MBS for carry and diversification benefits, while monitoring Fed policy under Warsh's leadership.

The main risks are a renewed rise in rate volatility, additional curve flattening, tighter spread valuations and uncertainty around Fed policy.

However, with mortgage rates limiting refinancing activity, net supply low, and demand supported by multiple investor bases, the medium-term outlook remains constructive, with carry likely to be the dominant return driver.

European high yield outlook : Market supportive despite geopolitical tensions

By Olivier Monnoyeur, European High Yield Portfolio Manager

- European high yield delivered a solid second quarter amid very strong issuance and robust investor demand, despite geopolitical volatility and energy price fluctuations.
- Credit fundamentals remain supportive, with low default rates, stable balance sheet trends, and a manageable refinancing profile.
- While the third-quarter outlook remains positive due to attractive carry and low default expectations, tight spread levels require a more selective investment approach.

European high yield delivered a solid second quarter despite increased volatility driven by the US-Iran conflict, energy price fluctuations and concerns about global growth.

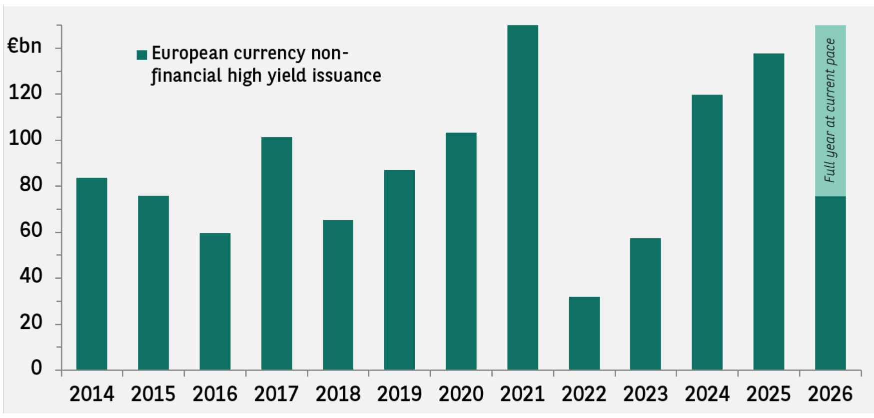
Market performance was supported by strong technical considerations, attractive yield levels and continued investor demand for carry, i.e., income less funding costs.

Spreads compressed by 54 basis points in Q2 to 315bp. Return for the year stands at +1.7%. The market remains bifurcated between performing, high quality names and the rest, which is illustrated in the extremely wide spread of the CCC index at 1260bp versus BB at 211bp according to J.P. Morgan.

Record primary market activity

The second quarter was one of the busiest quarters on record for European HY issuance. Gross issuance reached approximately €49bn according to J.P. Morgan, a new quarterly record, while market access remained strong across sectors and rating categories.

Figure 6: 2026 on track to be a big year for high yield issuance



Data as at 30 June 2026. Sources: J.P. Morgan, BNP Paribas Asset Management.

The issuance mix remained skewed towards higher-quality issuers (58%), although single-B activity increased (36%) compared with Q1 (25%).

Importantly, the market absorbed this large supply without any significant widening in spreads, highlighting the strength of demand.

Investor demand remained exceptionally strong throughout the quarter, supported by attractive all-in yields relative to cash and investment grade alternatives as well as continued demand for income-generating assets.

In addition, there was limited refinancing pressure while spreads remained narrow at close to post-global financial crisis levels, reflecting the scarcity of yield, the dominance of the BB sector and the continued search for carry.

Credit fundamentals remain supportive

The first quarter's earnings season was solid, and expectations were for profit and cash flow to remain robust in Q2.

During Q2, corporate fundamentals continued to prove resilient as default rates remained very low with expectation for a drop to 2.4% by the end of 2026, according to J.P. Morgan.

Most issuers maintained good access to capital markets and refinancing risk remained manageable given limited near-term maturities while balance sheet trends were generally stable across the market.

Outlook: Constructive backdrop, less room for error

We remain constructive on European HY entering Q3, although risk-reward appears less compelling than earlier in the year as spreads remain historically tight.

We think the Middle East conflict will have a measured impact on the growth/inflation mix which we expect to improve in 2027 with 1.3% of growth supported by the German investment plan and a possible recovery in construction activity which has been depressed since 2022.

We can see three supportive factors:

- **Attractive carry**: All-in yields remain elevated at 5.74% including CCC (5% excluding CCC) compared with long-term averages and continue to provide a meaningful cushion against moderate spread widening based on J.P. Morgan data. Carry is expected to remain the primary driver of returns in the coming quarter

- **Favourable refinancing profile**: The HY maturity schedule remains relatively benign over the next two years, reducing refinancing concerns and supporting corporate fundamentals

- **Stable default environment**: Default expectations remain low and credit metrics across much of the market remain adequate despite slower economic growth

Key risks to monitor

In our view, the main challenge for the asset class is valuation. Current spread levels leave limited room for disappointment should macroeconomic conditions deteriorate or geopolitical tensions escalate.

And Middle East developments remain the most significant macro risk for credit markets; any further disruptions to energy markets or shipping routes could trigger renewed volatility in risk assets and increase pressure on energy-intensive issuers.

Overall, European growth remains positive but modest. The market is transitioning from a broad beta rally to an environment where issuer and sector selection are likely to play a greater role in performance generation.

Investment implications

Currently, going into Q3, we have a preference for performing single B vs high BB and bonds with higher carry and less focus on capital appreciation.

We are neutral beta with a reduced exposure to hybrid bonds and additional tier one (AT1) bonds which we think are too crowded. We are also cautious on CCC as many have vulnerable fundamentals, with weak cash flow and some difficult 2028 and 2029 maturities to manage

But we do favour defensive sectors with resilient cash flow profiles (telecommunications, healthcare and real estate), companies with clear deleveraging paths and good free cash flow generation and positions offering attractive carry without requiring further spread compression to generate returns, including floating rate notes

However, we remain more cautious on highly leveraged issuers, cyclical credits with limited free cash flow visibility and companies exposed to sustained energy cost inflation.

Since the US and Iran signed the Memorandum of Understanding we have re-focussed our attention to sectors and names that have been negatively impacted by the conflict.

These include rate sensitive sectors like real estate, or anything related to construction, packaging and some consumer companies.

Dispersion was elevated in Q2 and there are quite a few situations whose bonds have lost value on reduced investor confidence and some shorting activity by hedge funds.

There will thus be solid opportunities for recovery for investors with risk appetite willing to express conviction. We have targeted some names that fit these criteria and continue to scout for opportunities.

We think three themes will focus most of our attention and will drive the outperformance potential for the rest of the year:

- **AI winners and losers.** We very early on reduced our exposure to artificial intelligence-threatened software companies. We continue to underweight the sector but there are some nuances between more protected and more exposed business models. We continue to do more work on the topic. Conversely, we continue to gain exposure to the AI theme. We expect to see more issuance and that theme to grow in importance for our market
- **Anything linked to construction:** Investor sentiment to the theme is weak. We think this is an opportunity. While we don't expect a recovery in 2026, expectations are for a modest rebound in 2027. Some names have a more significant exposure to renovation and maintenance than new build. They can afford to wait for the rebound, while their cash flows cover their cost of capital. We as bondholders are being paid to wait in nonconsensual situations
- **Chemicals:** We need to differentiate between the commodity chemicals and the specialty. The specialty usually has a more robust business model, or at least less cyclical. They offer some cyclicality but there are some nuances and some sub sectors that are more stable with robust cash flow profiles. The commodity ones have had a very volatile ride year to date. The Strait of Hormuz closure created massive disruption in the sector, which has supported their margin and market share (to the detriment of Asian and Middle East operators). The market has concluded that its reopening brings them back to where they were before the war. We disagree and are positioned accordingly.

The next stage

European HY delivered another strong quarter powered by exceptional technicals, robust investor demand and record issuance volumes. Looking ahead, the outlook remains constructive, supported by attractive carry, low default expectations and manageable refinancing needs.

However, with spreads at historically tight levels and geopolitical risks elevated, we believe selectivity will become increasingly important in generating excess returns during the second half of 2026.

Emerging market debt outlook : Established resilience

By Alaa Bushehri, Head of Emerging Market Fixed Income

- Emerging markets demonstrated significant resilience during the second quarter of 2026, despite ongoing volatility driven by the Middle East conflict, energy crises, and geopolitical uncertainty
- The geopolitical landscape has created a clear distinction between EM beneficiaries — specifically oil-exporting nations with stronger fiscal revenues — and vulnerable oil-importing economies facing higher inflation and import costs
- As broad market returns tighten, the focus has shifted toward disciplined country selection, prioritising markets with durable fundamentals, credible monetary policies, and attractive real yields to ensure sustainable returns

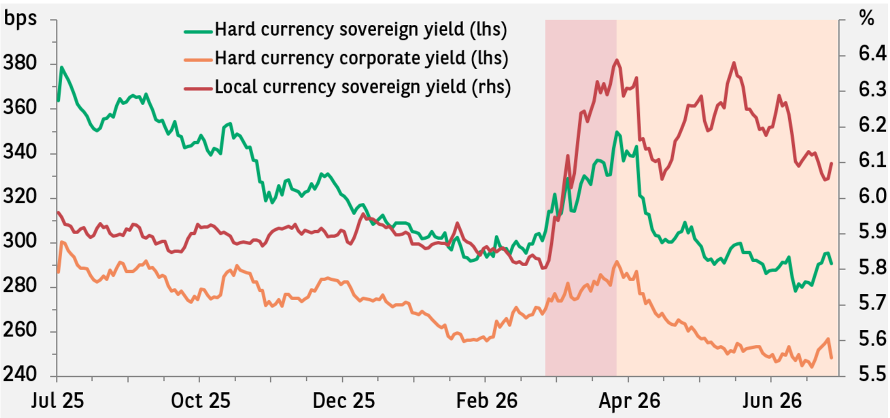
Emerging markets endured continued volatility arising from the Middle East conflict and resultant energy crisis in the second quarter.

But while geopolitical flare-ups remain an ongoing risk, we believe investors can still potentially benefit from resilient fundamentals, compelling yields, and idiosyncratic drivers unique to emerging markets.

Normalisation, or too soon?

The second quarter began against a backdrop of heightened conflict in the Middle East, testing several long-standing vulnerabilities across EM, including regional energy-price sensitivity, supply-chain fragility and renewed geopolitical uncertainty.

Figure 7: Emerging market debt saw a strong recovery in spreads in the second quarter



Data as at 30 June 2026. Sources: J. P. Morgan, DataQuery, BNP Paribas Asset Management.

The situation remains fluid, with repeated setbacks in negotiations, attacks on neighbouring infrastructure and disruption risks around key global chokepoints. This environment reinforces several important considerations for both Middle East dynamics and the broader EM outlook:

- As geopolitical shocks increasingly reverberate through energy markets, shipping routes, food systems and broader supply chains, we are likely to see a further acceleration in regionalisation and de-globalisation. Countries may continue to become more inward-looking, rely on a narrower set of strategic partners, and place greater emphasis on economic security, protectionism and supply-chain resilience, particularly in critical areas such as technology and energy.

- The oil price rise has sharpened the distinction between those countries that benefit from it and those that are more vulnerable. Oil-exporting markets, including the Gulf Cooperation Council (GCC), have generally benefited from stronger fiscal revenues, improved terms of trade and more resilient external balances. By contrast, oil-importing economies, such as India and Turkey, have faced higher import bills, renewed pressure on inflation and a greater potential drag on the current account.

- Developing markets are likely to continue demonstrating resilience, even against a backdrop of elevated geopolitical uncertainty and the risk of prolonged conflict. Importantly, this resilience is increasingly underpinned by country-specific fundamentals, with many markets benefiting from improving growth dynamics, credible central bank policy and greater fiscal discipline.

Inflation considerations

We have seen higher energy prices already starting to filter through to consumer prices, and for now at least, inflation remains a concern for central banks globally.

Therefore, we have seen market expectations of Federal Reserve rate cuts shift from two cuts by the end of the year to no cuts or even hikes, which could be enough to inspire some EM central banks to keep rates on hold and shift any planned cuts into 2027.

Moreover, the scope for fiscal policy to cushion external shocks remains constrained, as elevated debt burdens and higher financing costs limit the ability of governments to deploy the broad-based, untargeted support measures seen during the pandemic.

As demonstrated throughout 2025 and the first half of 2026, the US will continue to play a pivotal role in shaping the direction and volatility of EM assets. While markets are still digesting the impact of earlier tariff disruptions and the ongoing Middle East conflict, the upcoming US mid-term elections create scope for further uncertainty.

US President Donald Trump may adopt a more assertive policy stance to influence the electoral narrative, although there is also the possibility that the administration seeks to reassure markets through measures that promote a degree of stabilisation.

Taken together, these dynamics reinforce the need to separate cyclical volatility from the more durable structural improvements now visible across parts of EMs**.**

The importance of selectivity

Emerging markets enter the second half of 2026 from a position of established resilience, yet this resilience has made selectivity increasingly important in the sector.

Stronger growth differentials versus developed markets, improving external balances, and credible monetary policy frameworks continue to support the asset class, offering compelling income and diversification potential.

However, valuations have tightened meaningfully across parts of hard currency credit, leaving less room for broad beta-driven returns.

Going forward, investors should therefore distinguish between markets supported by durable fundamentals, credible reform momentum, and attractive risk premia, and those more vulnerable to policy slippage, fiscal pressure, or external shocks.

In local currency, easing cycles and still-elevated real rates remain supportive. Overall, the opportunity set remains attractive, but disciplined country selection, active management, and robust risk controls will be essential to converting EM resilience into sustainable returns.

Real yields and undervalued currencies

In our view, local currency emerging market debt remains one of the more compelling areas of the asset class, supported by attractive real yields in places, improving inflation dynamics and a more credible policy backdrop across many key markets.

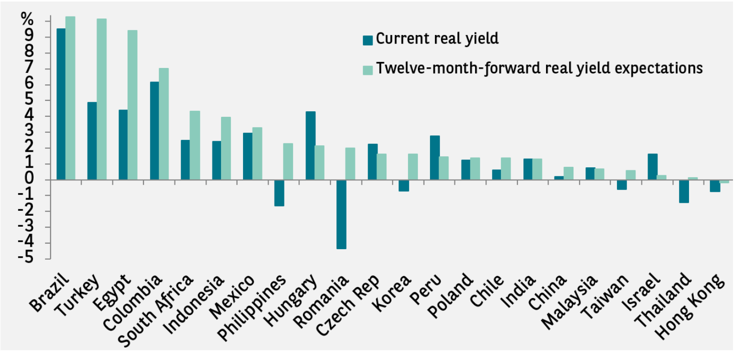
While the global rates environment remains an important source of volatility, several EM central banks retain scope to ease gradually without compromising macro stability, particularly where inflation expectations are anchored and external balances have strengthened.

This creates an attractive carry and duration opportunity, but one that requires careful differentiation across regions and policy regimes.

Developing market currencies also appear selectively attractive after periods of pressure, with valuation support, lighter positioning and improving current account dynamics providing a constructive medium-term foundation.

However, currency performance is likely to remain highly sensitive to the US dollar, commodity prices and geopolitical shocks. As such, investors should prioritise markets where high real yields are reinforced by credible central banks, disciplined policy frameworks and robust risk management.

Figure 8: Look for real yields reinforced by other factors like credible central banks



Data as at 30 June 2026. Sources: Haver, BNP Paribas Asset Management.

Geopolitical fragility – what next for emerging markets?

Geopolitical fragility is likely to remain a defining feature of the EM landscape in the second half of 2026.

For investors, the key question is no longer whether EMs can withstand geopolitical shocks, but which countries are best positioned to absorb them. Energy exposure, external financing needs, food-price sensitivity and policy credibility will all be critical differentiators.

Oil exporters may benefit from improved terms of trade, while import-dependent economies remain more vulnerable to renewed energy price spikes and inflation pass-through.

The upshot

Overall, markets demonstrated commendable resilience over the second quarter despite a highly challenging backdrop. While ongoing geopolitical events suggest that conditions may be becoming more stable and somewhat clearer heading into the second half of 2026.

If a de-escalation occurs, it could help restore investor confidence, support a normalisation in oil prices and encourage a more constructive view on inflation. However, with geopolitics likely to remain a persistent theme, we believe investors should continue to prioritise selectivity and disciplined risk management across EM allocations.