Fixed Income Outlook Q3 2026

FOR PROFESSIONAL INVESTORS
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By BNP Paribas Asset Management

Sovereign bonds : Watching the new Fed Chair

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.

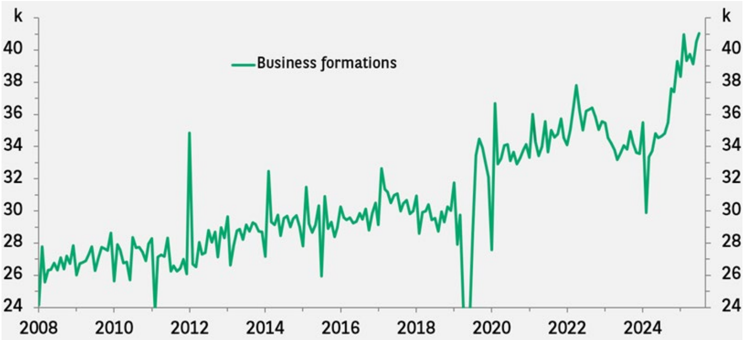
The National Federation of Independent Business (NFIB) Small Business Survey of Hiring Intentions also looks relatively soft. On the positive side, the ISM Business Employment Survey has recovered since the outbreak of the Iran War, initial unemployment claims remain muted, and JOLTS job openings have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

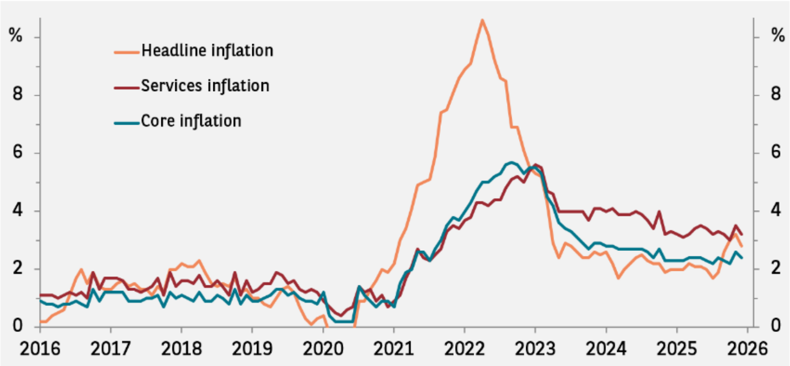
Recent declines in headline inflation are largely due to the moderation in energy inflation, while softer services inflation contributed to a weaker core print. It's also notable that food prices fell slightly, while core goods inflation remained steady.

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

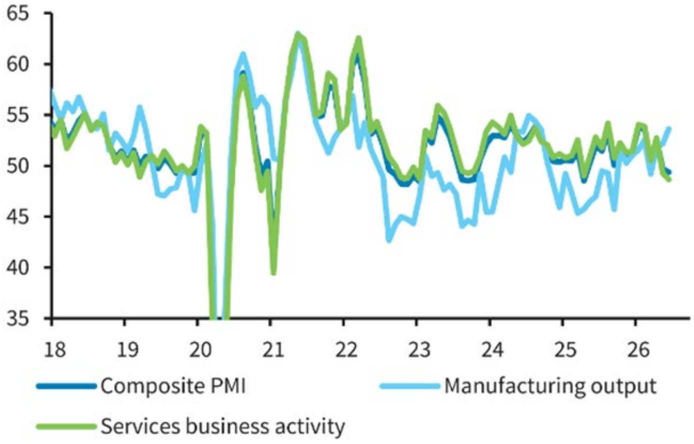
The UK's Brexit referendum marked its 10th anniversary on 23 June and while the formal withdrawal only occurred in January 2020, economists are still debating its consequences. Aside from the economic impact, Brexit has been followed by a decade of political instability, resulting in an unprecedented 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.