Bank of Nassau
SINCE 1982

Q3 2026 Outlook

July 3, 2026

Dr. Win Thin
Chief Economist

"It's tough to make predictions, especially about the future."

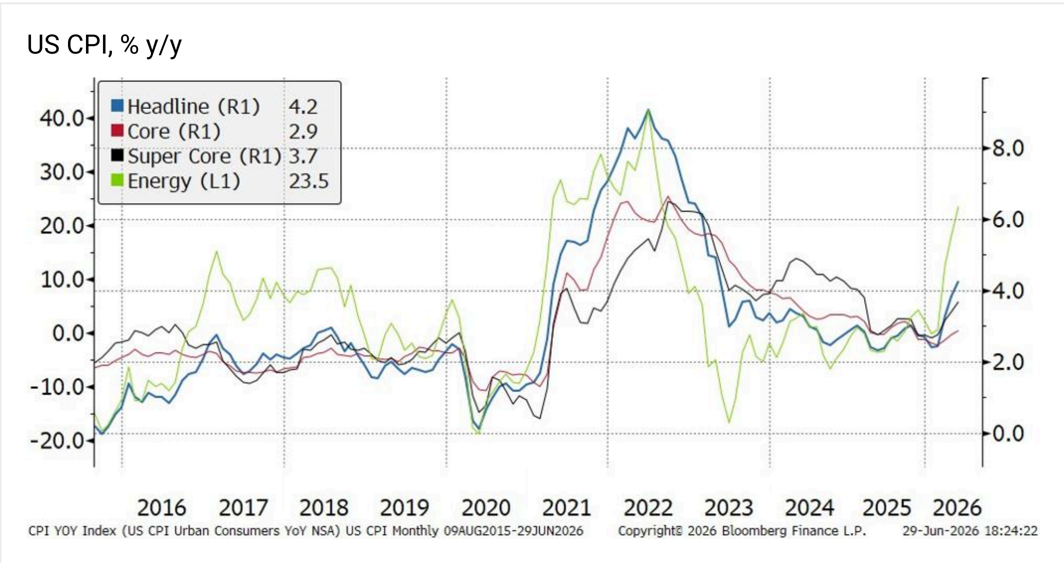
Yogi Berra

We highlighted many risks when we first wrote our outlook for 2026. In our latest quarterly outlook, we discuss the biggest surprises so far this year as we hit the halfway point and identify the potential risks ahead in H2.

The Iran Conflict

Iran conflict is going on far longer than most expected. However, the 60-day extension of the ceasefire has helped push oil prices back down to pre-conflict levels and so the damage to the global economy may be limited. There will of course be ongoing risks of periodic flareups, but markets are clearly pricing in a positive outcome for the peace process that is now taking place. Headline inflation has likely peaked globally and should allow most major central banks to look through the energy price spike. However, policymakers will be on the alert for potential second round effects in the coming months.

Risks: Peace talks between the US and Iran are reportedly progressing but there are already early signs of serious sticking points. With regards to the Strait of Hormuz, the US claims shipping traffic will remain toll-free while Iran claims there will be “service fees.” Oman seemed to back up Iran’s claim after it recently warned European nations of potential fees ahead. With regards to nuclear inspectors, the US and the International Atomic energy Agency maintain that inspections will eventually resume while Iran claims it has made no such commitments. Lastly, the Iran-US ceasefire is predicated on the halt in hostilities between Israel and Hezbollah in Lebanon, which may not hold.



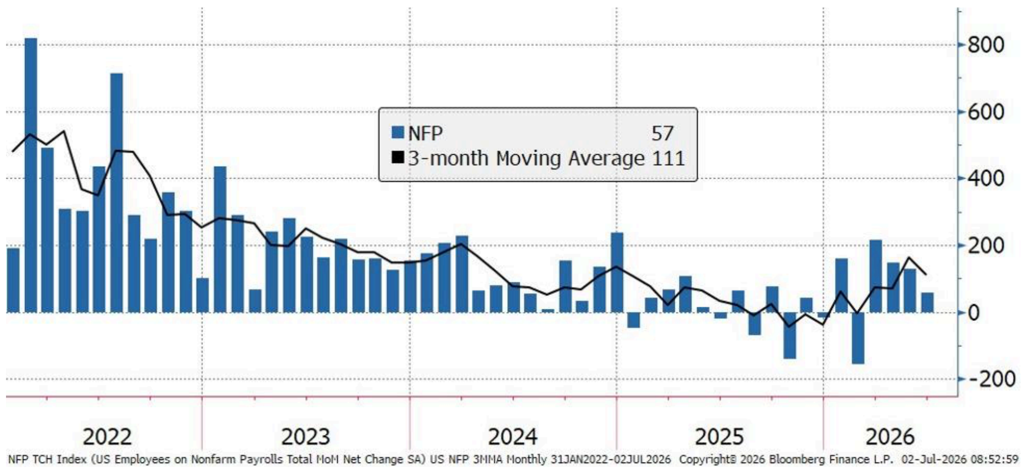
US Exceptionalism

The US economy has been much more resilient than expected. After Q4 GDP growth of 0.5% SAAR, the economy has recovered to grow 2.1% SAAR in Q1. Investment remains strong, due in large part to the Artificial Intelligence (AI) buildout. Fixed asset investment contributed 1.1 ppt to headline growth in Q1, which eclipsed personal consumption's 0.4 ppt contribution. While personal consumption has been softening two straight quarters, recent data suggest it will ultimately be supported by the stabilizing labor market.

In that regard, the labor market outlook has improved. After 122k jobs monthly jobs were created on average in 2024, the average fell to 10k in 2025. After a weak start to 2026, monthly job creation has averaged 97k so far this year while the unemployment rate has fallen to 4.2% in June, the lowest since June 2025.

Risks: Q2 data suggest the economy is losing some momentum. As of this writing, the two main Fed Nowcast models paint a mixed picture for Q2. The Atlanta Fed's GDPNow model estimates Q2 growth at 1.2% SAAR while the New York Fed's Nowcast model estimates Q2 growth at 2.7% SAAR. Bloomberg consensus currently stands at 2.5% SAAR. Furthermore, NFP growth peaked in March at 214k and has dropped three straight months through June (179k, 129k, and 57k). The unemployment rate fell to 4.2% in June only because the labor force contracted -720k while -507k jobs were lost. Of note, the labor force has contracted 5 of the past 7 months and jobs have fallen 5 of the past 6 months in the household survey. These trends do not suggest a particularly healthy labor market.

US NFP, 000s

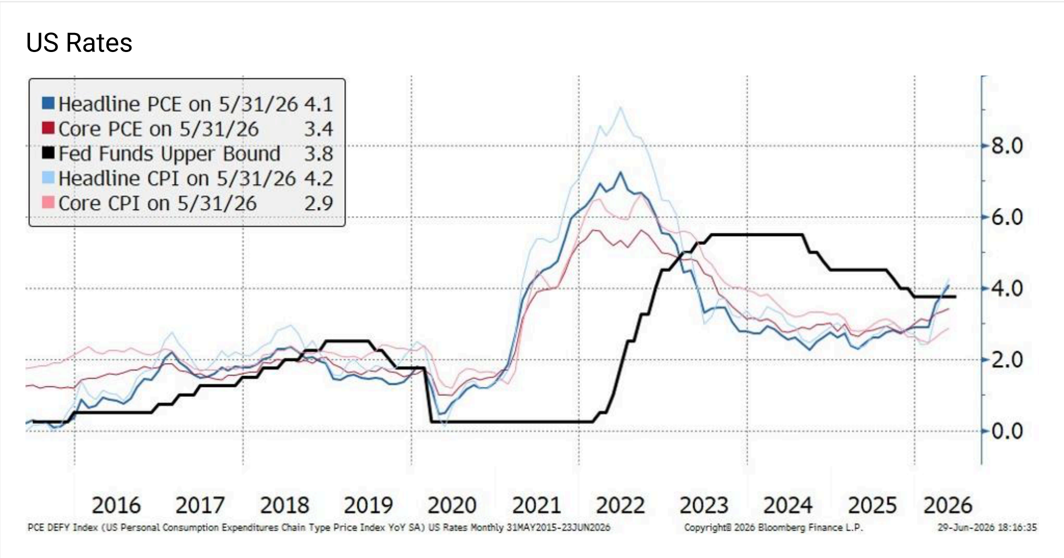


The Hawkish Fed

Contrary to our expectations at the beginning of this year for Fed rate cuts, it has become clear that the Fed will not be easing in 2026. Inflation remains much too high while the resilient US economy suggests no need for additional stimulus right now. Chair Warsh delivered a very hawkish message at his first FOMC meeting in June even as the Dot Plot showed that half of the Fed leadership are open to rate hikes this year.

The market is pricing in a 25 bp hike by December. With energy prices cooling, we do not think the Fed will hike but with inflation still high, neither will it cut. As we noted earlier, headline inflation has likely peaked but core inflation may not cool as quickly and so will require vigilance on the part of the Fed.

Risks: The apparent loss of momentum in the economy in Q2 suggests that there may be growing tensions between the Fed's dual mandate of full employment and price stability. For the last several months, the improving labor market suggested that the Fed could concentrate more on its price stability mandate. If the labor market weakness continues, then the Fed will be caught in policy dilemma as inflation remains too elevated to cut rates.



AI Mania Continues

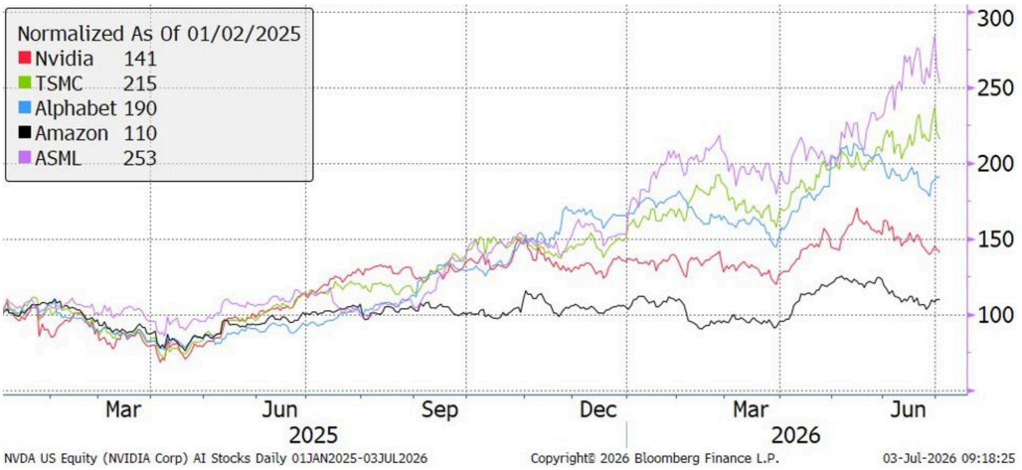
The big AI stocks continue to rise despite ongoing nervousness about a potential bubble. Fueling this rise are strong earnings for AI related companies, which have surprised to the upside this year.

With regards to the Fed task forces, the one on labor productivity is of particular interest. As we wrote here recently, Warsh believes that increased labor productivity from AI is disinflationary. Greenspan was able to convince his Fed colleagues not to hike rates in the 1990s due to higher productivity. Can Warsh do the same?

Meanwhile, we are seeing examples of how the AI buildout is inflationary over the near-term, not disinflationary. Much has been made about higher electricity prices due to the insatiable demand from AI data centers. We are now seeing AI-related inflation creeping into other sectors of the economy. For instance, Apple just announced significant price increases for several of its product lines due to higher chip prices from AI data center demand.

Risks: There are some canaries in the coalmine that bear watching. The KOSPI is nearing a bear market as it's down nearly 19% from the June 19 peak. Once upon a time, EM stocks offered diversification from DM stocks but now the correlations are probably close to 1 as most countries are part of the same global economic cycle now. In addition, Korea and Taiwan in particular have become a huge part of the AI trade as links in the supply chain. Despite being down over 20% from the peak intraday, KOSPI recovered a bit and is now up 92% YTD (81% in USD terms) while TAIEX is up 62% YTD (59% in USD terms). However, if the AI trade crumbles, these two markets are likely to crumble first and will remain the most vulnerable.

AI-Related Stocks



Widespread Central Bank Tightening

2026 was supposed to be the "Year of the Hold." With moderate inflation seen globally as we entered the year, most central banks expected to keep rates steady until 2027. Unfortunately, the spike in energy prices has complicated matters as inflation accelerated and so some central banks have chosen to respond already.

The European Central Bank hiked rates 25 bp in June. Since then, June inflation data came in lower than expected and support the notion that inflation likely peaked in May along with energy prices. The ECB is particularly open to criticism since it hiked right into the Great Financial Crisis and also hiked right into the eurozone crisis a few years later. The good news is that the ECB can limit the damage by not hiking rates further. The market is pricing in another 25 bp hike around the turn of the year but we suspect that will eventually get priced out if the inflation dynamics remain favorable. This certainly validates the wait-and-see stance taken by most other major central banks.

However, the ECB is not the only major central bank to hike this year. The Reserve Bank of Australia had already started a tightening cycle at its February 3 meeting and then followed up with hikes March 17 and May 5. Norges Bank started a tightening cycle at its May 7 meeting and the Reserve Bank of New Zealand may start hiking in July. Only time will tell whether these hikes are warranted but with inflation already peaking, the market may be overestimating the expected tightening ahead. In Emerging Markets, the Philippines, Indonesia, South Africa, and Colombia have hiked rates this year and others may join.

Risks: It's possible that these central banks are overtightening going into a potential global slowdown. While the global economy appears relatively resilient, it nevertheless remains vulnerable.

Other Potential Surprises Ahead

Investors are likely to be buffeted in H2 by even more surprises, both good and bad. Besides the risks we have cited above, the Bank for International Settlements pretty much summed them all up in its recent annual report. Here, the BIS cited a potential AI bubble, high inflation, financial vulnerabilities, and fiscal stresses as growing "pressure points" that pose threats to the global economy.

In particular, we believe that the so-called financial vulnerabilities (what we read as excessive leverage and one-sided positioning) is the one pressure point that can magnify and worsen any negative impulses that emerge. As a result, we counsel investors to be prepared for heightened volatility as some of these potential risks cited are quite likely to emerge. On top of these “known unknowns,” we will also have the so-called “unknown unknowns,” or surprises that were totally unseen.