Monthly Fixed Income Monitor

Economics and Strategy

NATIONAL BANK OF CANADA CAPITAL MARKETS

July / August 2026

Forecast Summary

By Taylor Schleich, Ethan Currie & Warren Lovely

- Despite the recent escalation in Middle East tensions, oil prices have retreated materially since the spring. Expectations for the Fed's policy rate have not, however. Indeed, moderating near-term inflation risks have been overshadowed by an overhaul at the central bank, with June's rate decision offering the first real glimpse of the Fed under Kevin Warsh's leadership. Policymakers may have again held rates steady, but beyond the headline decision, little about the meeting felt familiar.
- Between Warsh's disproportionate focus on inflation (relative to labour markets) and a dot plot that indicated a greater willingness to raise rates, front end Treasuries endured one of the sharpest Fed Day sell-offs in recent memory. But while markets are now bracing for (modest) tightening, we aren't fully convinced. For one, the FOMC has overestimated the actual year-end policy rate in recent years. Moreover, inflation risks have moderated, with market-based measures of inflation expectations signalling that the worst is behind us and price stability is in sight. Though employment has firmed up from last year's soft patch, there's little to suggest the job market is contributing to above target inflation and Fed officials continue to view risks as skewed to the downside.
- Ultimately, we see the Fed remaining on hold through the end of the year, before eventually returning to easing later in 2027. Suffice it to say, we're constructive on the front end of the Treasury curve. We're less so when it comes to the longer end. We see 30-year yields holding above 5% for the foreseeable future with scope for the curve to steepen further.
- After stumbling out the gate in the first half of the year, Canada's data disappointments may have reached their limit. Growth in the second quarter looks to be on an improved footing, pushing back against the 'technical recession' narrative that took hold after a slight contraction in Q1. Labour markets appear to have firmed up too after a dreadful start to the year. That's not to say that the Canadian economy is out of the woods, however. There is still material economic slack present and ample geopolitical risk weighing on the outlook, including intermittent flare-ups in the Middle East and USMCA negotiations/uncertainty.
- Despite inflation breaching the upper bound of the Bank of Canada's 1-3% control band in May, the recent drop in oil prices is set to provide material relief going forward. With measures of core inflation showing little signs of energy prices broadening, the Bank of Canada will feel more comfortable holding policy steady—though they will still flag the risk of both hikes and cuts going forward.
- One can envision scenarios in which the BoC hikes or cuts, but we think holding rates steady is the best way to balance the risks and confront the 'dilemma' policymakers current face. We see the Bank remaining in a holding pattern for the balance of the year and into early 2027. But as growth steadily picks up and slack is absorbed, we continue to expect a return to neutral by mid-2027. Together with our U.S. forecast, it implies Canada-U.S. rate differentials have reached their limit and short-end Canadian rates are set to underperform going forward. Out the curve, Canadas will remain better supported while U.S. yields may test new highs.

United States						
Quarter	Target	3M	2Y	5Y	10Y	30Y
9-Jul-26	**3.75**	**3.71**	**4.19**	**4.31**	**4.58**	**5.09**
Q3:2026	3.75	3.75	4.20	4.30	4.60	5.15
Q4:2026	3.75	3.70	4.05	4.25	4.65	5.20
Q1:2027	3.75	3.65	4.00	4.15	4.65	5.30
Q2:2027	3.75	3.60	3.95	4.05	4.60	5.20
Q3:2027	3.50	3.50	3.80	3.95	4.50	5.15
Q4:2027	3.25	3.30	3.65	3.85	4.45	5.10
Q1:2028	3.25	3.20	3.60	3.80	4.40	5.05
Q2:2028	3.25	3.20	3.55	3.75	4.40	5.05

Canada						
Quarter	Target	3M	2Y	5Y	10Y	30Y
9-Jul-26	**2.25**	**2.26**	**2.83**	**3.16**	**3.56**	**3.95**
Q3:2026	2.25	2.30	2.80	3.20	3.60	4.00
Q4:2026	2.25	2.40	2.75	3.20	3.60	4.05
Q1:2027	2.50	2.70	2.75	3.20	3.55	4.05
Q2:2027	2.75	2.80	2.80	3.15	3.50	3.95
Q3:2027	2.75	2.80	2.85	3.10	3.45	3.90
Q4:2027	2.75	2.80	2.90	3.10	3.45	3.90
Q1:2028	2.75	2.80	2.95	3.10	3.45	3.90
Q2:2028	2.75	2.80	2.95	3.10	3.45	3.90

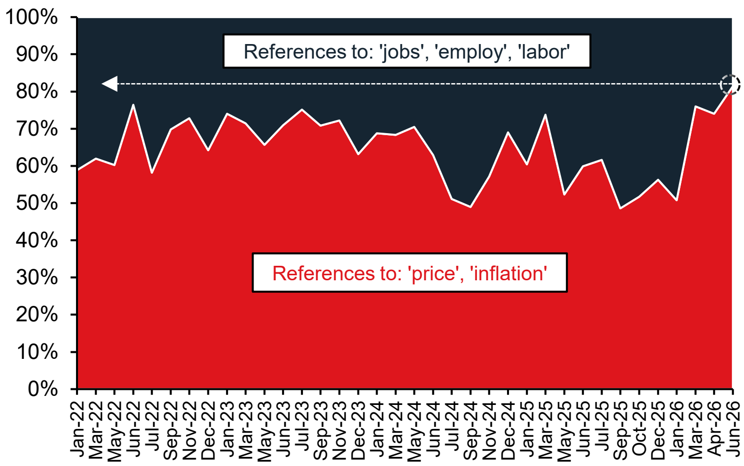
FOMC: Doves in hawks' clothing?

Despite the recent escalation in Middle East tensions, oil prices have retreated materially since the spring. Expectations for the Fed's policy rate have not, however. Indeed, moderating near-term inflation risks have been overshadowed by an overhaul at the central bank, with June's rate decision offering the first real glimpse of the Fed under Kevin Warsh's leadership. Policymakers may have again held rates steady, but beyond the headline decision, little about the meeting felt familiar.

The most immediately apparent change was to the Fed's interest rate statement itself. It was visibly shorter with the word count more than halved. And not only was the Fed's explicit easing bias removed (as was widely expected) but gone was any semblance of forward guidance altogether. This, of course, was deliberate, and should not have surprised anyone familiar with Chair Warsh's long-standing views. He has repeatedly criticized forward guidance and excessive central bank communication as counterproductive to sound policymaking.

Warsh's first presser skewed toward inflation …

References to mandate objectives in Fed press conferences since 2022

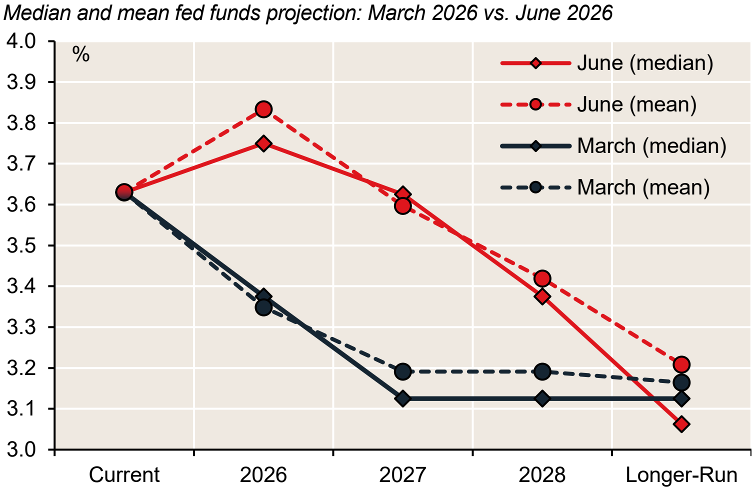


Source: NBC, FRB | Note: Word count includes questions posed to Powell/Warsh

A shift was also evident in the press conference, as Warsh comments disproportionately emphasized price stability, rather than the other side of the mandate, maximum employment. This too aligned with earlier appearances—namely, his Senate confirmation hearing. On the surface, a greater inflation focus implies a greater need for tighter policy especially since job market shakiness drove earlier easing.

An apparent hawkish shift at the Fed

Median and mean fed funds projection: March 2026 vs. June 2026

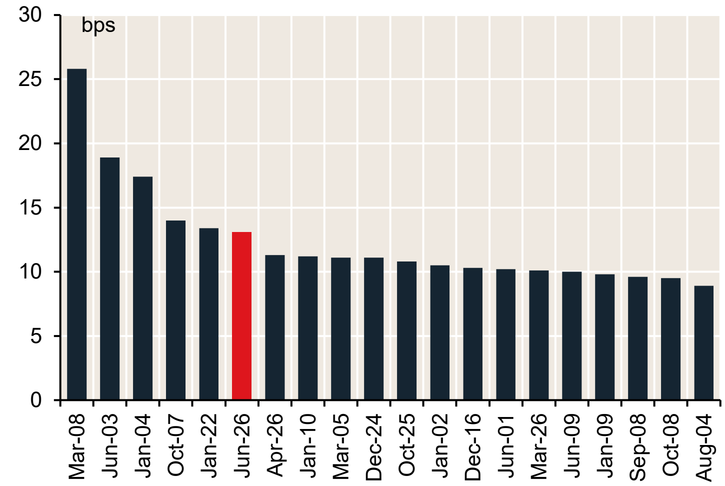


Source: NBC, FRB

An apparent hawkish shift was not confined to the Chair of the FOMC. The rest of the committee also appeared to adopt a more hawkish stance, based on an updated dot plot (which Warsh did not contribute to). Half of the other 18 officials now expect tightening this year, while only three months earlier, a majority expected to be easing monetary policy. Together, the June meeting's developments resulted in one of the largest short-end U.S. Treasury repricings in recent memory. With CPI inflation more than double the Fed's target, the market's conclusion was straightforward: hikes are likely on the way.

Warsh's debut produced a large front-end repricing…

25 largest 2-year yield increases on Fed decision days since 2000

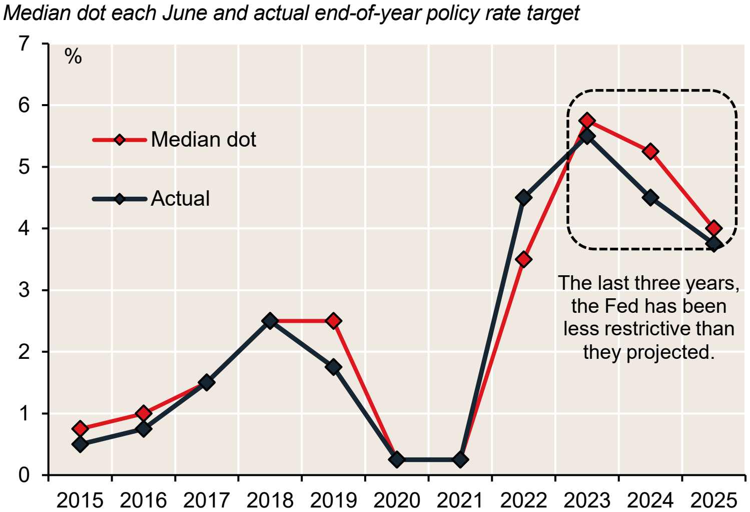


Source: NBC, Bloomberg

We aren't fully convinced. For one, the dot plot should be taken with a grain of salt. In each of the past three years, the Fed's policy rate ended up lower than policymakers had projected in June. Put differently, the Fed, at least under Powell, has tended to signal hawkishness without necessarily following through.

Doubt the dots? Empirically, there's reason to

Median dot each June and actual end-of-year policy rate target

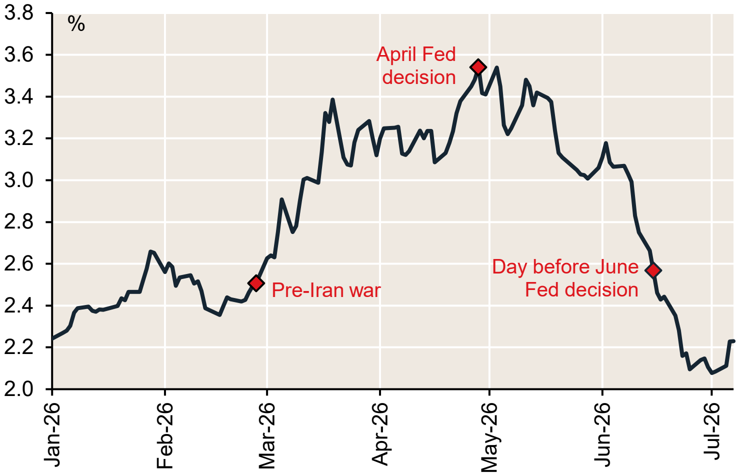


Source: NBC, FRB | Note: Median dot adjusted to upper bound of target range.

More fundamentally, the inflation outlook has shifted meaningfully since the last Fed meeting. Although the peace process hit a snag recently, oil prices are still much closer to pre-war levels than the US$100/bbl mark that was breached in the spring. This will have consequences for June inflation, with material easing from May's peak incoming. Price stability may not be achieved in 2026, but it is expected to arrive within a year. One could argue—and we think a number of officials will—that tightening policy today (or later this year) would amount to fighting yesterday's inflation battle.

Market sees 2% inflation within reach

1-year U.S. inflation swap

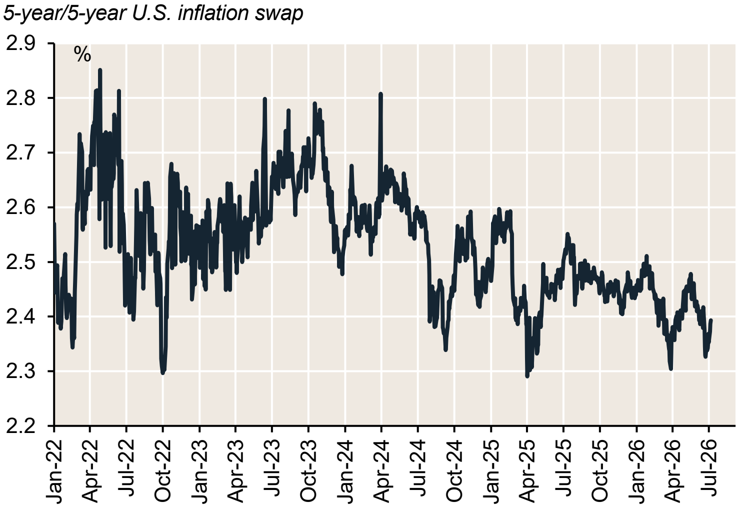


Source: NBC, Bloomberg

Admittedly, there are still some worrying signs when it comes to core inflation. And unlike the headline price gauge, this is expected to take a bit longer to come back target. But this is nothing new and, in the past, officials have looked through those pressures with the support of well-contained longer-run inflation expectations. On that front, there is little cause for concern.

Nothing frightening about longer-run inflation expectations

5-year/5-year U.S. inflation swap

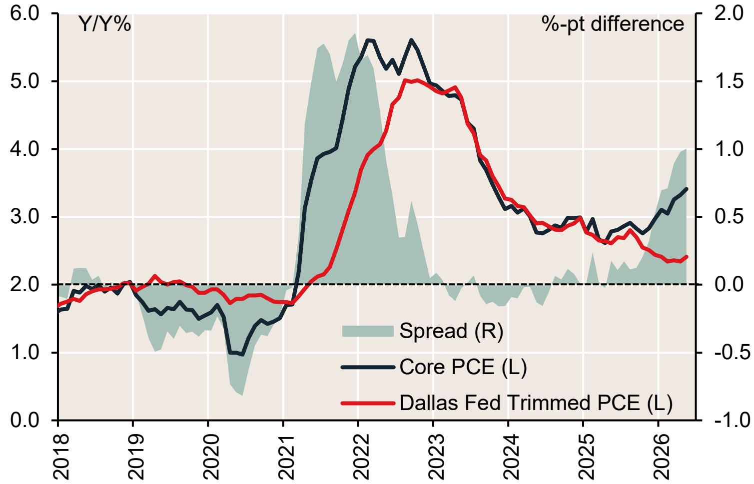


Source: NBC, Bloomberg

There's also the question of whether the traditional inflation measures are what we should be assessing. Recall, Warsh has criticized core PCE, the Fed's preferred core inflation gauge, and has noted he prefers 'trimmed-mean' measures. While these too are running above target, 2.4% (per the Dallas Fed's gauge) is far less concerning than the 3-handle on core PCE. Ultimately, we will need to wait to see what Warsh's inflation task force—one of five—recommends, but it's not difficult to envision a scenario in which a new inflation lens is proposed and adopted. At least as it stands today, this would lean against the rate hikes that investors are braced for.

Warsh's preferred inflation gauge isn't all that hot

Core PCE, Dallas Fed Trimmed PCE and resulting spread



Source: NBC, Bloomberg

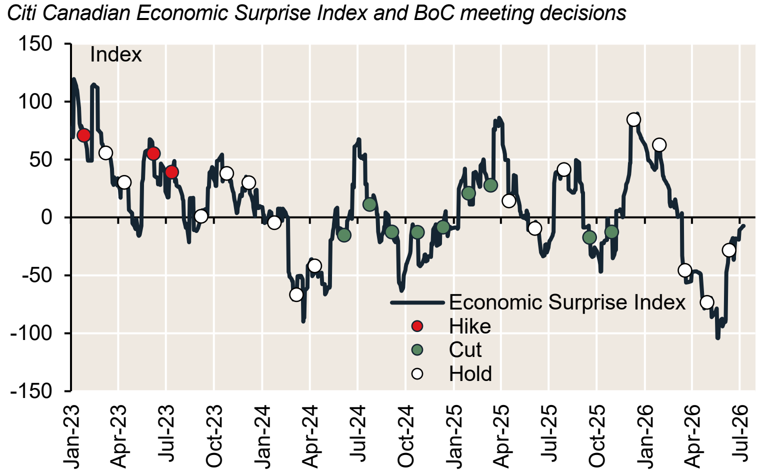
Suffice it to say, we see value in the front-end of the Treasury curve. We don't think the Fed will tighten this year and continue to expect eventual easing before the end of 2027. As for the longer-end, we're less constructive due, in part, to the creation of one of Warsh's *other* task forces. Given the Chair's well-established skepticism toward Fed intervention in Treasury markets, a review of balance sheet policy is unlikely to offer much support to the long end of the curve—even if we are also doubtful the Fed will be able to shrink its holdings meaningfully. We continue to see 30-year Treasury yields holding above 5% for the foreseeable future, bringing more steepness to the curve.

BoC: Sidelined, facing a policy dilemma

After stumbling out the gate in the first half of the year, Canada's data disappointments may have reached their limit. Growth in the second quarter looks to be on an improved footing, pushing back against the 'technical recession' narrative that took hold after a slight contraction in Q1. Labour markets appear to have firmed up too after a dreadful start to the year. That's not to say that the Canadian economy is out of the woods. There is still material economic slack present and ample geopolitical risk weighing on the outlook, including intermittent flare-ups in the Middle East and USMCA negotiations. We therefore expect volatility in economic data to persist.

Data has improved, but that doesn't mean it looks good

Citi Canadian Economic Surprise Index and BoC meeting decisions

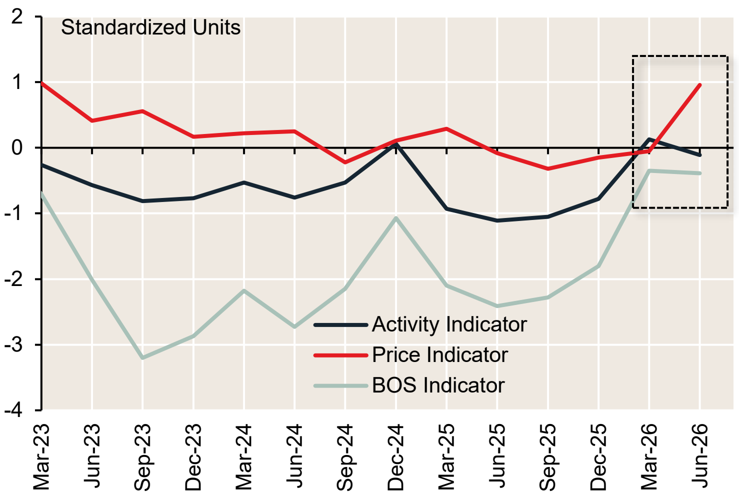


Source: NBC, Bloomberg

Look no further than the recent *Business Outlook Survey* (covered in detail **here**) to confirm that economic conditions are underwhelming. These soft data underscore the policy "dilemma" facing the Bank of Canada: price pressures are mounting even as slack remains evident via excess capacity, subdued hiring intentions, and a muted sales outlook weighed down by a stressed consumer.

Business sentiment takes a hit as price impacts weigh

Business Outlook Survey Indicator

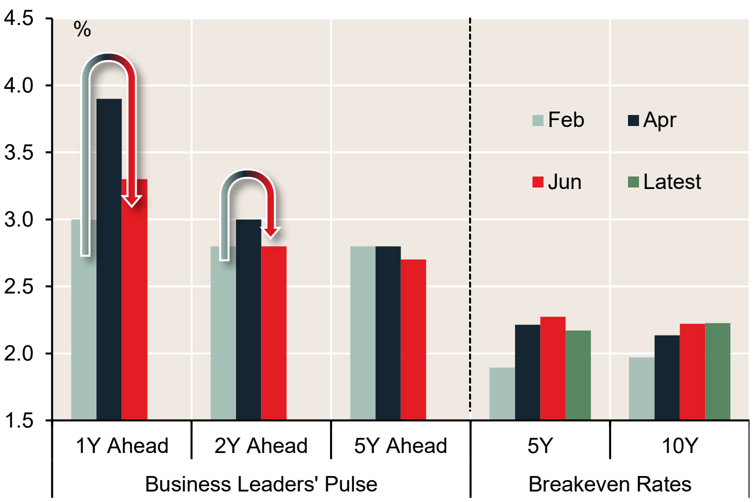


Source: NBC, BoC | Note: BOS Indicator re-estimated every Q, with historical avg set to 0

While business' inflation expectations appear alarming, the latest survey was conducted in the first three weeks of May and failed to capture June's material oil price retreat. Fortunately, the timelier *Business Leaders' Pulse* indicated that these subsequently moderated. Of course, Mideast tensions are on the rise again but as long as energy prices remain well below the spring's high watermark, it's unlikely inflation expectations will reaccelerate meaningfully. Breakeven inflation rates have also retreated from their highs, hovering just above 2% in the long end. The Bank will continue to take comfort knowing that expectations are well contained.

Inflation expectations have already retreated materially

BLP inflation expectations (Q2 BOS) and Canada breakeven rates

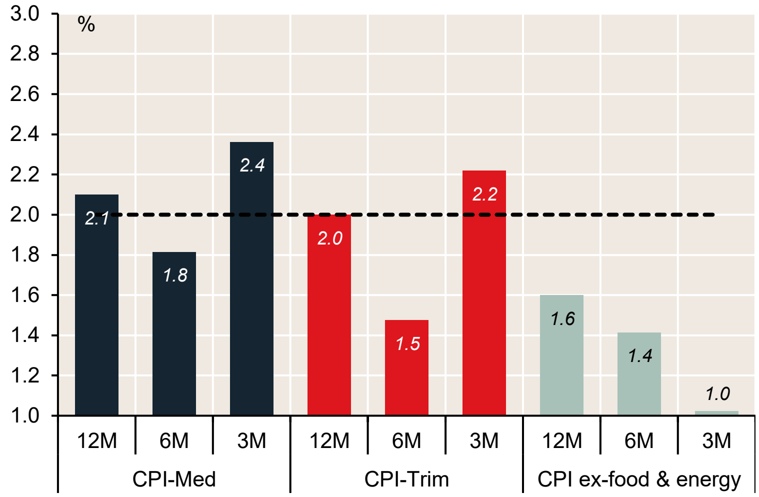


Source: NBC, BoC, Bloomberg | Note: For breakevens, beginning of month value used

Notwithstanding crude prices rising at the time of writing, there's going to be material headline CPI relief in the coming months. That should help contain inflation expectations and limit second-round effects, which the Bank has expressed concern about. With core pressures already well-contained, there is little evidence that inflation pressures are broadening. This has allowed the Bank to remain patient, and we expect that patience to persist. The broader backdrop supports that view as slack remains evident, capacity pressures are low, and labour market conditions are too soft to add meaningfully to inflation.

Little evidence of spillover, with relief in the pipeline still

Canada core inflation measures on a 12-, 6-, and 3-month annualized basis

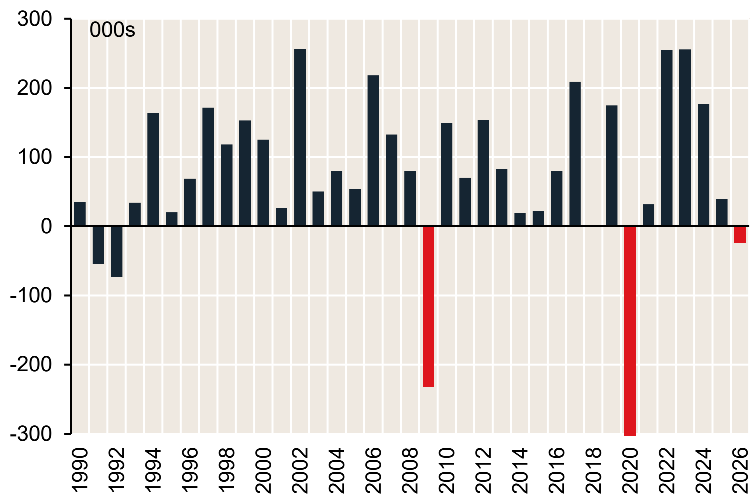


Source: NBC, StatCan, Bloomberg | Note: Dotted line denotes BoC target (2%)

We'll get another look at the Canadian jobs market when the June LFS is released, but we don't expect this to change the BoC's outlook much. For now, employment is little changed this year (down ~5K per month) and to see labour market slack truly absorbed will require hiring to pick up over a number of months. With USMCA uncertainty continuing to weigh on some sectors, we don't see a broad-based improvement arriving anytime soon. Therefore, expect the Bank to retain its two-sided language in coming meetings, leaving both rate hikes and cuts on the table.

Hiring won't prompt rate hikes any time soon

YTD (through May) net change in Canadian employment per the LFS

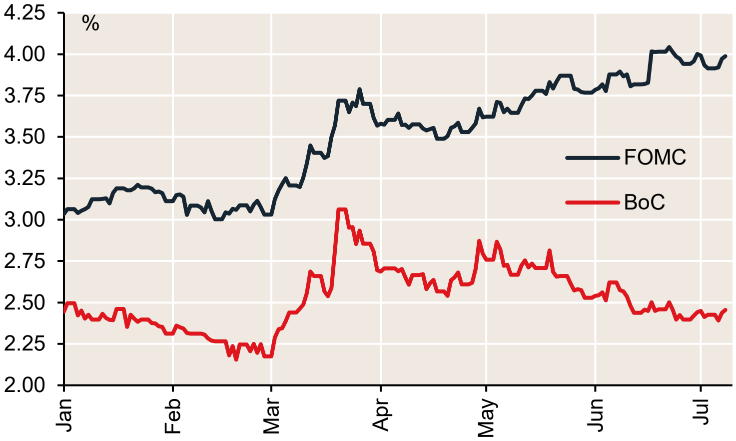


Source: NBC, StatCan, Bloomberg

Given a weak economy and well-contained inflation, OIS markets have appropriately pushed rate hikes out the horizon. Current pricing, discounting ~50 bps of tightening by this time next year, is directionally appropriate and consistent with our call for a return to neutral by mid-2027. Saying that, we'd still fade the market's tightening bias *this year* as we don't see rates arriving until at least early 2027.

Near-term hikes continue to fade in Canada, but not in U.S.

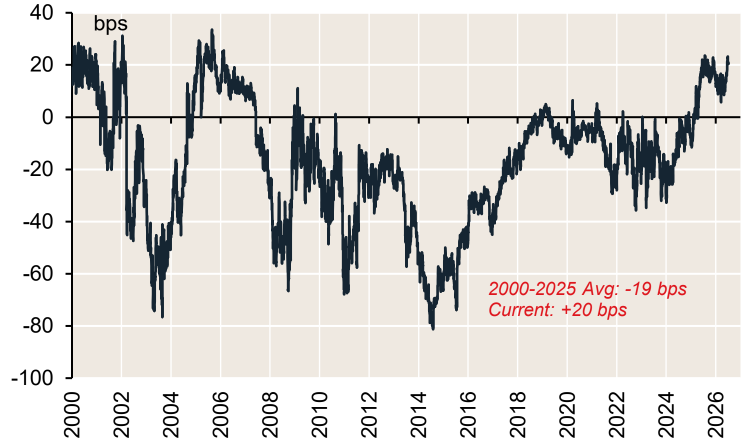
OIS-implied policy rate at the December 2026 meeting, year-to-date



Source: NBC, Bloomberg | Note: Fed aligned to upper-bound rate

Canada front-end steepness is historically elevated

GoC-UST 2s5s yield curve differential (box)



Source: NBC, Bloomberg

Owing to the disjointed near-term policy rate risks on either side of the border, Canadian government yields are left much richer (and yield curves much steeper) relative to USTs. If our policy rate outlook, which sees both central banks unchanged through the remainder of 2026, plays out, GoCs are positioned to underperform over the balance of the year (which should offer support for a battered Canadian dollar). In the immediate term, however, we see relatively rich valuations persisting. Relatedly, Canada's relatively steep yield curve (e.g., the 2s5s curve) should flatten compared to the U.S. Treasury curve.

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