
Q2 2026 Outlook

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

Yogi Berra

INTRODUCTION

In this Q2 outlook piece, we will update our views on what we identified at the start of this year as the six most important themes for global financial markets this year. First and foremost, geopolitical risk is the single biggest driver for global markets now. In the IMF's latest Global Economic Outlook published in April, it warned that "The global outlook has abruptly darkened following the outbreak of war in the Middle East." The agency came up with three scenarios. Its baseline scenario assumes a relatively short conflict and only moderate gains in energy prices this year. Under this scenario, the IMF sees global growth of 3.1% this year vs. 3.3% seen in January.

We continue to believe that despite the initial hiccups in this most recent two-week ceasefire agreement, the US and Iran will eventually cease hostilities altogether in Q2. This would mean the IMF's baseline scenario would largely hold, with little lasting damage to the global economy. What should then emerge from the fog of war are a set of long-standing drivers that we believe are largely bullish for equities, bearish for the dollar, and feeds into curve steepening.

In the weeks ahead, we will be looking for opportunities to recommit to our current macro calls. For global investors, our FX views suggest that local currency returns from investing in Europe, Japan, and Emerging Markets will outperform those in the US, just as they did in 2025.

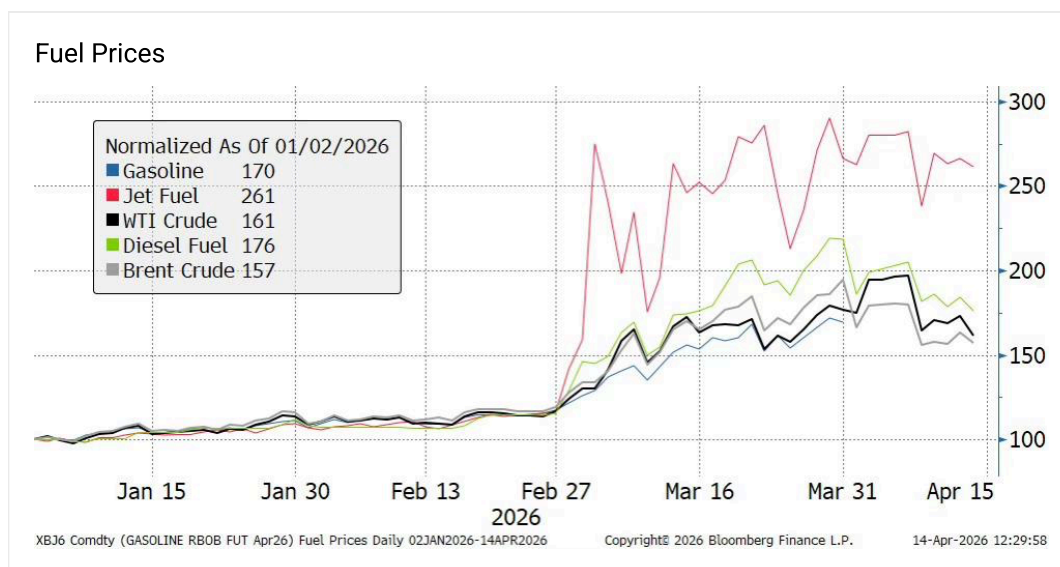
1. Geopolitical Tensions

We knew that geopolitical risks would be a big driver this year. However, increased US hegemony in the Western Hemisphere (the so-called "Donroe Doctrine") after its January intervention in Venezuela has become a mere footnote after the February US-Israeli attack on Iran, which has become the defining political and economic event of 2026.

With Pakistan acting as a mediator, the US and Iran announced a two-week ceasefire on April 7, just hours away from the deadline set by the US. It is a fragile peace, however, as Israel continues to attack targets in Lebanon. Iran claimed this violated the terms of the ceasefire and so it has kept the Strait of Hormuz closed. Despite the tensions, the US and Iran began peace talks in Islamabad but after a 21-hour marathon session, the talks ended with no deal. Iran left the door open for further talks while President Trump announced a blockade of the Strait of Hormuz. However, reports emerged that the two sides are still trying to set up a second round of talks in Islamabad.

Despite these setbacks, we believe an end to the Iran conflict will be seen in Q2. Yes, the two sides remain far apart right now and so we fully expect the two-week ceasefire will have to be extended. However, we believe neither Iran nor the US really wants this conflict to drag on for too long and so we believe a permanent ceasefire will be seen by mid-May. If so, we think the 2-3 months of conflict is a short enough timespan for the global economy to emerge without suffering any long-lasting damage, which would be the IMF's baseline scenario.

China looms in the background but we believe it will help put an end to the conflict in May. Reports emerged that China was instrumental in getting Iran to agree to the two-week ceasefire, and we believe it will continue to play a constructive role in the peace process. Furthermore, we believe that a peace deal in May is made even more likely by the fact that President Trump has rescheduled his planned March summit with China's President Xi to May 14-15. It was postponed by President Trump so that he could focus fully on the ongoing Iran conflict.



2. Tariffs 2.0

The US Supreme Court struck down the bulk of President Trump's tariffs in late February. He has vowed to maintain his tariff regime by other measures and quickly signed an executive order calling for a 10% tariff on all imports. A day later, he said the rate would be increased to 15% but this has not been implemented yet.

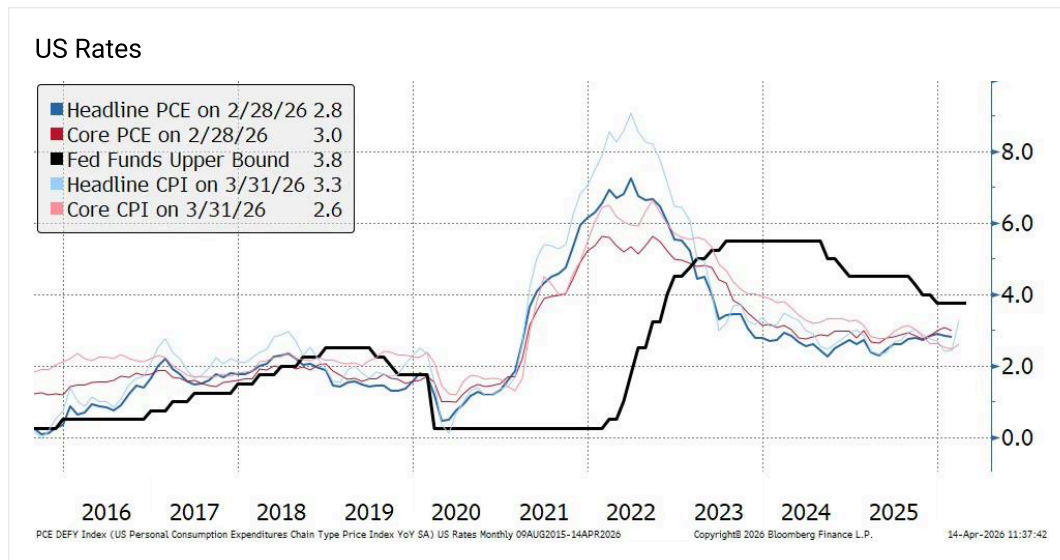
The 10% tariff was done under Section 122 of the Trade Act of 1974, which allows the president to impose temporary tariffs of up to 15% for up to 150 days “in situations of fundamental international payments problems.” This would include “large and serious United States balance of payments deficits” as well as an “imminent and significant depreciation of the dollar.” After 150 days, Congress would have to approve any extensions.

Given that the US is not experiencing a balance of payments crisis nor an imminent and significant depreciation of the dollar, we would expect these Section 122 tariffs to be challenged in court. However, these challenges may be moot as the short 150-day period that these tariffs are in effect will likely prevent any legal challenge from moving through the courts. Treasury Secretary Bessent views these Section 122 tariffs as temporary when said “We’ll see what Congress does, but the 122 is likely a five-month bridge during which studies on Section 232 tariffs and Section 301s are done. So this is more of a bridge than a permanent facility.”

Heightened trade uncertainty is likely to persist. There will surely be legal challenges to the Section 122 tariffs, as well as legal hurdles in the refund process. Until the possible responses are determined and gamed out, the Fed will be even more comfortable with its current wait and see stance.

Longer-term, it seems clear that the SCOTUS ruling will eventually result in a lower average effective tariff for the US and this translates into lower tariff-induced price pressures. Incorporating the Section 122 tariffs, the Yale Budget Lab estimates the current effective tariff rate at 11.0%. This is well below the effective rate of 16% (the highest since 1936) that was in place before the reciprocal tariffs were struck down in February. The Yale Budget Lab also estimates that the effective rate would fall to 8.2% if the Section 122 tariffs were to expire after 150 days.

Overall, lower effective tariffs are good for the economy as households will have more disposable income to spend. The Fed can resume its easing cycle whilst feeling more confident that tariff-related inflation risks have fallen, though this has been complicated by the inflationary impulses coming from the Iran conflict. That said, we continue to believe the Fed will resume easing in H2 and this would be positive for equities and negative for the dollar, two of our long-standing macro investment calls.



3. US Economic Outlook Gets Cloudier

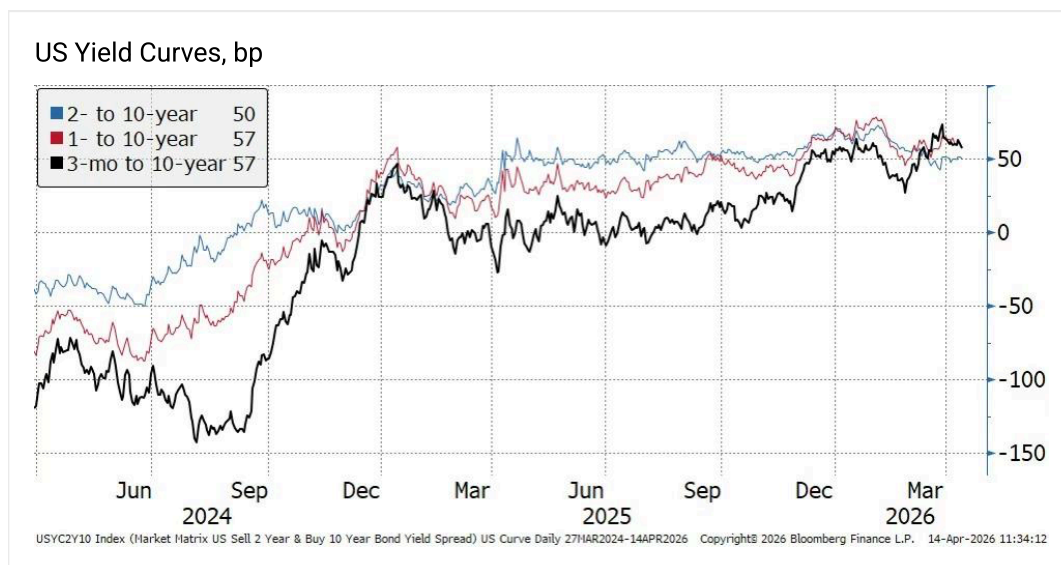
The US economy slowed significantly in Q4. Growth of 0.5% SAAR was the weakest since Q1 2025 but likely due in large part to the government shutdown. However, the rebound in Q1 looks to be fairly unimpressive. Preliminary Q1 GDP data will be reported April 30 and Bloomberg consensus is currently at 2.3% SAAR. Elsewhere, the Atlanta Fed GDPNow model estimates Q1 growth of 1.3% SAAR and the New York Fed's Nowcast model estimates growth of 2.3% SAAR.

Personal consumption remained surprisingly strong throughout last year, despite the tariffs. However, consumption slowed to 1.9% SAAR in Q4, also the slowest since Q1 2025. For Q1, we anticipate a significant consumption slowdown due to further softening of the labor market as well as the squeeze on real incomes due higher inflation. For Q2, that squeeze is likely to continue as energy prices remain elevated.

In March, the Fed revised its 2026 growth forecast up by a tick to 2.4% in 2026 vs. 2.1% in 2025. Compare this to the latest IMF forecast for 2.3% in 2026, down slightly from 2.4% seen in October. Can the US economy hold up in the face of so much uncertainty? Recall that consumption makes up about 70% of the US economy. Compare this to fixed asset investment, which accounts for around 20% of GDP. While strong AI investment can help cushion the blow, it's hard to see how it could totally offset the expected weakness in consumption if jobs are not being created even as household budgets are being squeezed by higher energy prices.

Recession remains a tail risk. Bloomberg consensus sees 30% odds of a recession in 2026, up from 25% seen at the start of this year. While we remain concerned about a slowdown, we think these odds overstate the risk of a deep downturn this year, especially now that an offramp for the Iran conflict seems likely in Q2.

Furthermore, if recession risks do materially rise, then we would expect the Fed to ease policy more aggressively. That's because when all is said and done, we continue to believe that the Fed will put more emphasis on meeting its full employment mandate than its price stability mandate. That is behind our call for at least 50 bp of total Fed easing in 2026, which is more than the market pricing for 40% odds of one 25 bp cut as well as the Fed's median Dot Plot for only one 25 bp cut. With the long end of the curve likely to underperform due to heightened inflation, fiscal uncertainty, and Fed independence concerns, the US curve is likely to resume steepening.



4. Attacks on Fed Independence Continue

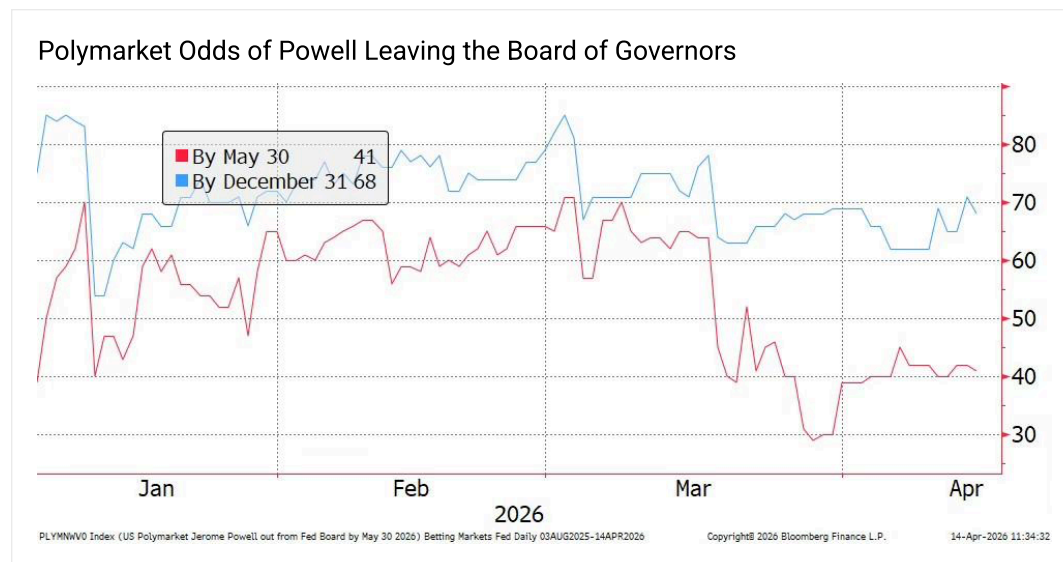
Federal Judge Boasberg upheld his decision last month to toss out the subpoenas that were served to Fed Chair Powell regarding the renovation of the Fed's headquarters. He stressed that "The Government's fundamental problem is that it has presented no evidence whatsoever of fraud." A spokesperson for US Attorney Pirro said "We will absolutely appeal the judiciary's interference with our access to the grand jury." Any appeal would first be considered by the DC Circuit Court of Appeals.

Will Pirro really want to risk drawing this out further? Kevin Warsh is scheduled to become Fed Chair in mid-May. We say "scheduled" because as the ongoing attacks on Fed independence have continued, key Republican Senator Tillis has vowed to block all Fed nominees until the probes have been resolved.

Reports emerged that Warsh's confirmation hearing before the Senate Banking Committee has been scheduled for April 21. We do not think the White House would proceed without having Tillis' support locked up, so we can only surmise that Tillis has received some assurances that the Fed investigation will be quietly dropped. Given the ongoing uncertainty and risks, however, it's possible that Warsh won't be confirmed by the time Powell's term as Chair ends May 15. What would this mean?

Chair Powell said during his post-decision press conference in March that if this were to happen, he would stay on as Chair pro tem (pro tempore, or Latin "for the time being") until Warsh was confirmed. While unusual, this has happened before on several occasions. The most recent was in 1996, when Chair Alan Greenspan served as pro tempore Chair from March 3 to June 20 while awaiting Senate confirmation for a new term.

Chair Powell also revealed during his post-decision press conference that he would remain on the Board of Governors as long as the investigation continues. Powell would not comment on any plans beyond that. His term as Governor ends January 31, 2028, and it is possible that he stays on to complete it. While this would be highly unusual, it has happened before. The last time this happened was back in the 1948, when Marriner Eccles stayed on as a Governor until 1951 in an effort to defend Fed independence at a time of rising tensions over monetary policy with the Treasury Department. If Powell were to step down as Governor, President Trump would get an opportunity to appoint his replacement.



While the Trump administration continues its efforts to pressure Powell, it also has made other efforts to chip away at Fed independence. The Supreme Court has allowed Fed Governor Lisa Cook to remain in her post until her case is decided. The court heard oral arguments in January but a final ruling is not expected until this summer. We are hopeful that the Supreme Court will rule in favor of Cook. If not, the explicit loss of Fed independence would likely lead to massive curve steepening as well as intensified dollar weakness.

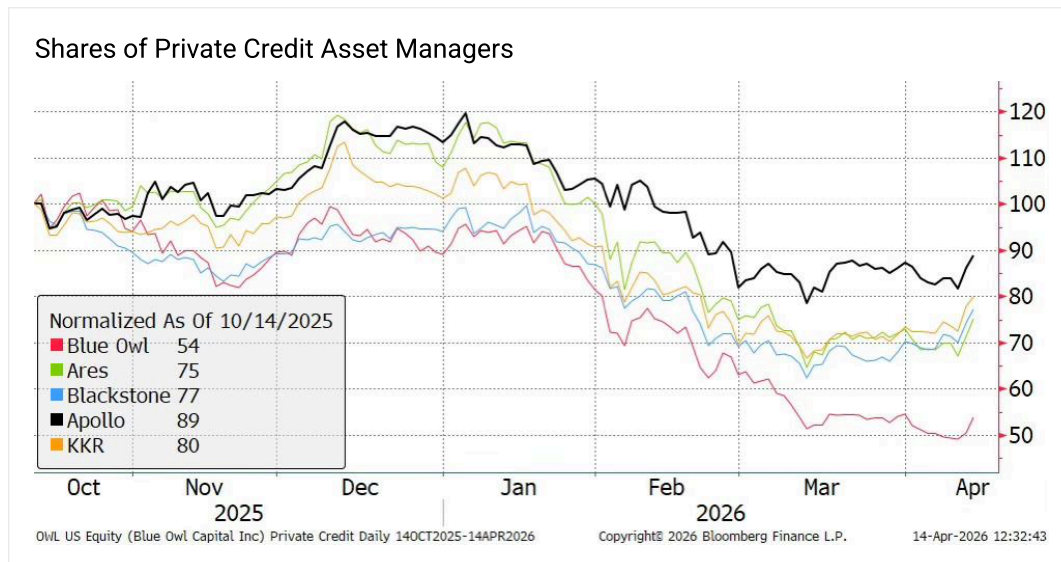
5. More Cockroaches Means More Fear

Last October, JP Morgan Chase CEO Jamie Dimon famously warned about private credit risks when he said “My antenna goes up when things like that happen. And I probably shouldn’t say this, but when you see one cockroach, there are probably more... Everyone should be forewarned on this.” He was of course referring to the two subprime lenders that went bust. In his annual letter to shareholders this April, Dimon warned about private credit once again by noting “Not everyone providing credit is necessarily good at it. There are many players who are late to this game, and it should be expected that some credit providers will do a far worse job than others.”

Since Dimon’s October warning, private credit default rates have continued to rise. Fitch estimated that the trailing 12-month default rate rose 5.8% in January, the highest since inception in August 2024. The historical default rate has been around 2-3% but some industry analysts have warned that the actual rate could move as high as 15% during this credit cycle.

Growing concerns have been manifested in increased withdrawal requests from private credit funds, enough so that many of those funds have imposed withdrawal limits. One can think of this as a bank run in the sense that the private credit funds are invested in long-term, illiquid assets that are difficult to sell when short-term liabilities (withdrawals) rise sharply. The greater the limits that are put on withdrawals, the greater the pressure will build.

Those withdrawal pressures are likely to continue as stresses grow. Analysts calculate that there is a huge \$200 bln maturity wall of high yield debt and leveraged loans in the SaaS (Software as a Service) space coming due between now and 2028. Many of those deals are believed to be currently underwater due to AI disruption. Because private credit is, well, privately held, investors have taken to selling the shares of publicly traded asset managers that are heavily invested in private credit. Since Jamie Dimon’s warning last October 14, the shares of those asset managers have fallen sharply before stabilizing in recent days.



In its latest Global Financial Stability Report (GFSR) published in April, the IMF focused on financial stability risks stemming from the Iran conflict. The agency was especially concerned that “Several amplification channels could transmit market stress into broader financial instability.” With regards to private credit, the IMF warned that “signs of more borrower defaults in private credit could cascade into broader concerns about corporate credit, particularly for highly leveraged borrowers subject to the artificial intelligence (AI) disruption.” The agency added that “Although liquidity mismatches in private credit appear limited to semiliquid structures, suggesting contained systemic impact, investors have accelerated the pace of redeeming investments, wary of worsening borrower credit quality.”

In its October 2025 GFSR, the IMF stressed that “Unlike banks, nonbanks, for the most part, operate under lighter prudential regulation. In addition, many provide limited disclosure of their assets, leverage, and liquidity - making vulnerabilities and interconnections harder to detect.” We concur, and would expect the IMF to continue focusing on this asset class in its upcoming GFSRs.

We stress once again that neither we nor the IMF are condemning private credit as an asset class. However, we are urging investor caution as private credit has never been tested by a prolonged downturn in the credit cycle. If the US does experience a slowdown this year, then we would expect further stresses in private credit. If that slowdown is deeper than expected, then we should all be prepared for a stampede of cockroaches.

6. Still Too Much Debt

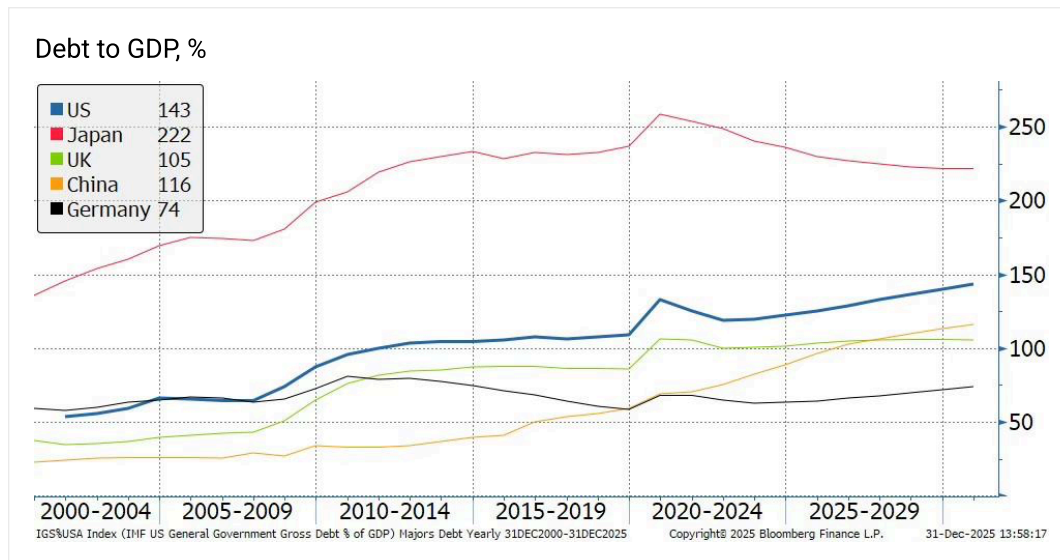
On top of rising inflation risks, we continue to believe that concerns about fiscal policy worldwide are likely to keep global sovereign yields elevated at the long end. This is especially true for the US, as the Supreme Court ruling against the IEEPA tariffs removes a key source of revenue for the federal government.

The Congressional Budget Office (CBO) estimated that the rejection of IEEPA tariffs would result in lost revenues totaling \$2 trln over the next ten years. Recall that the CBO had previously estimated that Trump's IEEPA tariffs would reduce budget deficits by roughly \$3 trln over ten years, which roughly offset the increased deficits resulting from the One Big Beautiful Bill Act of 2024. With the IEEPA tariffs now overturned, that means roughly two thirds of the OBBBA deficits will have to be funded by alternative measures.

As of this writing, the CBO has not yet provided updated estimates for tariff revenues under the new Section 122 tariffs. When these estimates are released, we suspect that the updated budget deficit and borrowing forecasts from the CBO will likely be revised significantly higher.

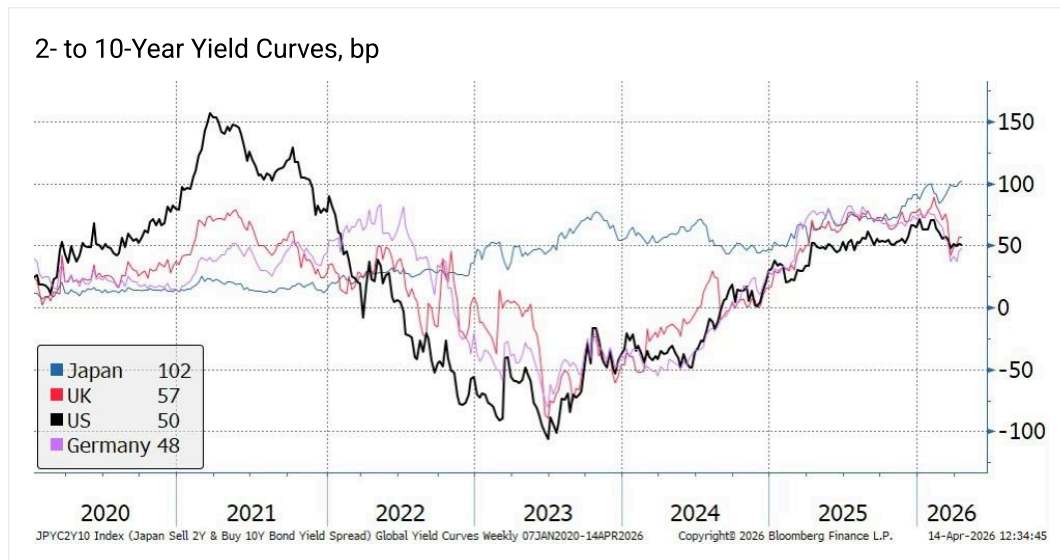
Elsewhere, the Committee for a Responsible Federal Budget (CRFB) released its own set of estimates. First, CRFB found that overturning IEEPA tariffs will result in \$1.7 trln of lost revenue over the next ten years.

Turning to the new Section 122 tariffs, the CRFB noted that these are temporary (150 days) but added that even if they were made permanent by Congress (highly unlikely), the Section 122 tariff revenues would still only generate about \$925 bln over the next ten years at a 10% tariff rate and \$1.3 trln at a 15% tariff rate. Thus, expected revenues from the Section 122 tariffs are estimated to fall short of those from the IEEPA tariffs by \$400-800 bln, depending on the tariff rate. Furthermore, the CRFB estimates that the debt to GDP ratio would be a full five percentage points higher at 125% by 2036.



Another fiscal risk is building from the Iran conflict. This is because many countries are taking many measures to cushion consumers from higher energy prices. These measures included raising fuel subsidies and cutting fuel taxes, both of which can have significant fiscal impacts if energy prices remain elevated for an extended period of time.

With the world awash in debt and upside risks to issuance, it's quite easy to see why the long end of the curves are likely to underperform. Dovish central bank policies should anchor the short end and so curve steepening is likely to continue in 2026. This so-called bull steepening is typically positive for equity markets, especially for banks and other financial institutions. Lower short-term US rates are also likely to boost equities and help offset the likely drag from the softening labor market. Lower rates should also keep downward pressure on the dollar.



FORECAST MATRIX

	Current	End-2026	Change
Equities			
S&P 500	6967	7500	7.6%
NASDAQ	23639	25000	5.8%
DAX	24044	27000	12.3%
Nikkei	57877	62000	7.1%
MSCI EM	1547	1700	9.9%
Fixed Income			
2-Year UST	3.7449	3.25	-0.49
10-Year UST	4.25	4.00	-0.25
2- to 10-year Curve	0.50	0.75	0.25
Currencies			
EUR/USD	1.18	1.23	4.3%
USD/UPY	159	150	-5.6%
EUR/CHF	0.9212	0.9400	2.0%
	0.781009	0.764228	-2.1%
Commodities			
Gold	4838	5000	3.3%
Brent Crude	95	75	-20.9%

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