

Growth Above Expectations, But Risks Ahead

Since our last Outlook the economic dataflow has surprised on the upside. Consequently, we have upgraded our 2026 growth forecast to 1.5%. However, the external environment has deteriorated recently. Renewed tensions in the Gulf have pushed energy prices back up, forcing a material increase to our 2027 inflation forecast. We expect the BoE to hike rates soon, with two 25bp increases across Q4 and Q1. These factors will weigh on the nascent recovery in early 2027, slowing growth and triggering a slight uptick in unemployment. Growth should recover in H2 next year as energy prices fall back. Risks remain tilted to the downside due to geopolitical tensions. Against this backdrop the upcoming Budget is likely to take a cautious approach.

GDP forecasts revised up, though near-term headwinds loom

Following solid growth in H1, the feared pullback in Q3 has not materialised and, if anything, it looks like growth picked up a bit. As such, our previous projection for 2026 GDP growth (0.9%) now looks too low and we have revised it up to 1.5%. Growth has been driven by public spending, business investment and services exports - the latter two potentially benefiting from increased global investment in tech and AI. Consumer spending growth has been more moderate and reliant on a fall in the savings rate amid weak household income growth. The economy is now set to face some headwinds, including higher energy prices and tighter monetary policy, while fiscal policy remains constrained. As such we expect more subdued growth over the next few quarters, before activity picks back up in mid-2027 as energy prices fall back, with full year GDP growth of 1.3% next year (vs 1.1% previously).

Energy prices pushing up inflation

The inflation picture has changed materially on foot of significantly higher global energy prices. Headline inflation is likely to increase further in the coming months, with a peak in Q1 next year when the Ofgem energy price cap will likely reset sharply higher. Price pressures should begin to abate gradually from Q2 on. We have raised our 2027 headline CPI forecast to 3.5% (2.5% previously). The latest labour market data shows some early signs of improvement. Unemployment has edged down, though volatility in the ONS data means uncertainty remains. While the recovery may stall through Winter, with a slight tick up in the jobless rate, it should resume again in the Spring. We expect unemployment to average 5.1% in 2027 (versus 5.3% previously).

BoE set to hike, Chancellor Healey's first Budget to be challenging

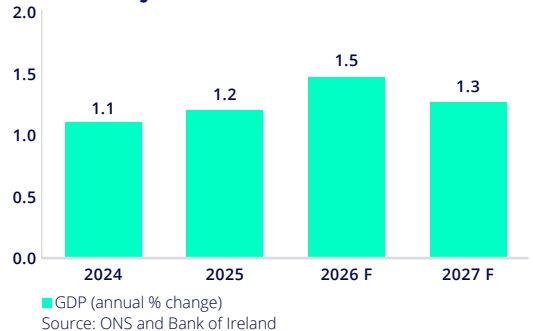
Over recent months the BoE has resisted hiking despite above-target inflation. However, recent developments mean that the MPC's patience is now likely at an end and rate hikes are imminent. That said, we expect only two 25bp increases, in Q4 and Q1, bringing Bank Rate to 4.25%, as monetary policy is already in restrictive territory, underlying inflation is still relatively contained, and the recent tightening of financial conditions will do some of the MPC's work for them. The upcoming Budget looks increasingly challenging despite solid growth in the year so far. Rising Gilt yields and departmental spending pressures have eroded the Chancellor's room for manoeuvre. Consequently, fiscal policy can't provide a material countercyclical boost, though targeted increases to capital taxes may fund expanded departmental spending envelopes and some modest cost-of-living supports.

Middle East conflict remains key risk

The conflict in the Middle East has deteriorated of late and remains the main risk to the world economy. A prolonged or intensified conflict could push energy prices and inflation higher, dampening world growth. Fiscal vulnerabilities are another risk factor, brought into sharper focus by the recent global rise in government bond yields. Policy changes in the upcoming Budget therefore need to be carefully calibrated and communicated. Additional external risks include the potential for a correction in tech/AI stocks, where valuations are stretched, and further erratic US trade or foreign policies. Conversely, there are some upside risks - tensions in the Gulf could ease while AI adoption has the potential to boost growth.

Outlook	2025	2026 F	2027 F
GDP Growth	1.2%	1.5%	1.3%
Employment Growth	1.6%	1.0%	0.6%
Unemployment Rate	4.9%	4.9%	5.1%
Inflation Rate	3.4%	3.2%	3.5%

Growth Projections



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Solid growth recently, but challenges ahead



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Set to increase on higher energy prices



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Early signs of recovery, though uncertainty remains



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Difficult Budget ahead for Chancellor Healey



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BoE to hike twice bringing Bank Rate to 4.25%



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Higher mortgage rates set to weigh on activity and prices



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Growth to ease a bit but remain resilient



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Economy

Growth has surprised on the upside

Growth rebound driven by the public sector and business services, but challenges ahead

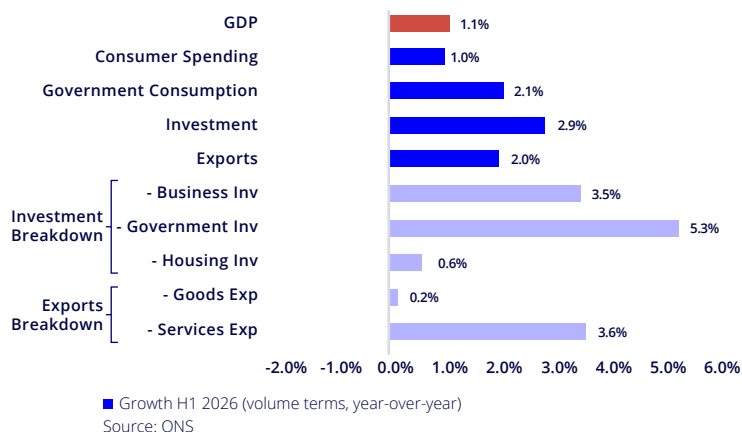
The latest data indicates that the UK economy has performed better than generally expected so far this year, showing significant - and welcome - resilience in the face of geopolitical shocks and elevated global energy prices, along with the residual negative effects of US trade policy changes. After expanding by 0.6% quarter-on-quarter in Q1, GDP growth came in at 0.5% in Q2, and high frequency indicators suggest growth of 0.6%-0.7% in Q3 (barring a surprise in the September data). An analysis of the national accounts for the first half of the year highlights the key drivers of the expansion - government spending (both current and capital) has remained robust, business investment (particularly ICT capex) has been quite strong and services exports have continued to expand at a healthy pace (potentially benefiting from AI related spending on professional services and ICT).

There are a few caveats though. The construction and industrial sectors have continued to struggle. In addition, household disposable income growth has slowed (making the lack of a consumer 'feel good' factor less surprising) leaving consumption growth - which has been moderate - reliant on a fall in the savings rate. Notwithstanding these points, the better than expected overall performance has seen market expectations for UK growth in 2026 revised up towards 1.3%-1.4% from under 1% not long ago, and it is likely the Bank of England and OBR will follow suit when they release new forecasts in the near future.

However, the external environment has deteriorated again and the outlook for the next few quarters now looks more challenging. The situation in the Middle East, which looked to have improved following the US-Iran Memorandum of Understanding signed in June, has deteriorated again of late, and this has pushed the price of oil back above \$100 a barrel. Furthermore, the price of wholesale gas on European markets, including the UK, has also risen quite sharply of late. These developments are going to put upward pressure on inflation over the coming months. While the Bank of England has kept the policy rate on hold this year so far, we now feel this renewed rise in inflationary pressures is going to prompt an imminent increase in Bank Rate (we expect two 25bp hikes in Q4 and Q1).

In addition, the upcoming Budget, the first to be delivered since Andy Burnham took over as PM and John Healey as Chancellor, is going to be more challenging than was hoped a few months ago amidst a rise in borrowing costs. As such, consumers and businesses are soon likely to face higher prices and costs along with tighter monetary policy, weighing on consumption and investment, while fiscal policy is unable to offer material countercyclical support. These factors will all weigh on demand in H1 2027 in particular. It remains to be seen if growth in high productivity tech/AI oriented sectors can provide a significant offset in the near term, as they appear to have in 2026 to date, though it is certainly possible.

Drivers of Demand Growth in H1 2026



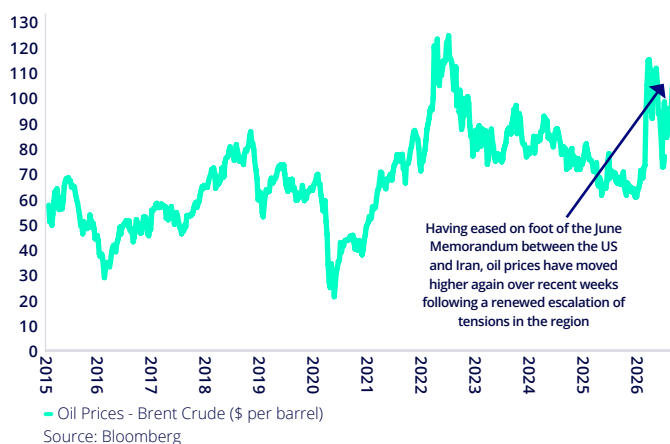
GDP & Inflation Expectations



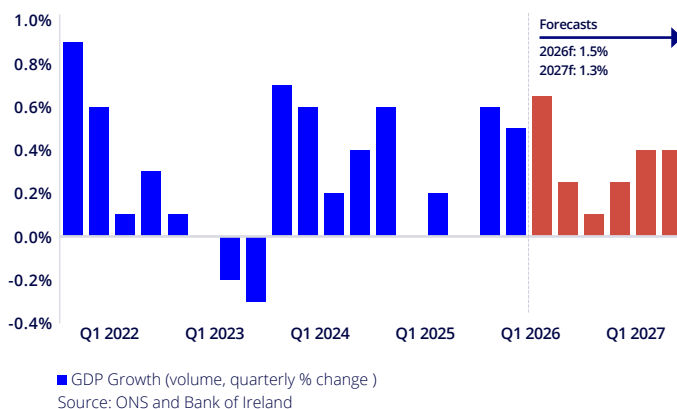
GDP to expand by 1.5% in 2026 and 1.3% 2027

Overall, taking everything into account, we expect the headwinds outlined above to slow quarterly growth from the 0.5%-0.6% rate achieved in Q1-Q3 this year to something more like 0.2%-0.3% in Q4 2026 and something similar in Q1 and Q2 2027. We expect oil prices to follow the futures curve and ease back gradually over the course of next year, with wholesale gas prices set to decline as well. This should see inflationary pressures ebb (albeit with a lag) and the growth drag should begin to fade from mid-year onwards, with quarterly growth picking up towards a trend like 0.4%-0.5%. Ongoing robust global growth, driven in part by the AI boom, should be supportive of a rebound in growth as well. This quarterly profile means that GDP growth should come in at about 1.5% in 2026 before decelerating slightly to 1.3% for 2027. On a Q4/Q4 basis, a measure which is more indicative of the growth impetus within the calendar year, output growth is likely to be register 2.0% this year before easing to 1.3% next year. In terms of the components of demand, we expect consumer spending to be subdued in the near term before recovering in H2 2027. Government current and capital spending growth is likely to remain solid, though perhaps slowing slightly as fiscal constraints bite. Business investment is volatile and quite difficult to forecast, but on balance seems likely to soften in the near term before re-accelerating as firms continue to invest in tech and AI. The outlook for the construction sector remains challenging as financing costs rise and build cost pressures potentially increase. Services export growth should remain quite resilient and will be a key driver of growth (encompassing many high productivity firms in professional services and the ICT sector). It will remain a challenging environment for goods exports (and therefore manufacturing firms) though, due to the ongoing effects of Brexit and intense competition from China.

Oil Prices



BOI Growth Forecasts



Risks remain tilted to the downside

Risks to the UK macro outlook remain to the downside, reflecting a combination of external uncertainties and domestic vulnerabilities. Clearly the most obvious risk remains the conflict in the Middle East. Any significant escalation would likely negatively impact UK growth via a range of channels (energy prices, global demand, consumer and business confidence, monetary policy response). The ongoing Russia-Ukraine war is another geopolitical risk, with particular relevance for European energy markets. The UK fiscal position is a vulnerability - any poorly designed or badly communicated policy changes at the upcoming Budget could interact with the volatile external backdrop to destabilise the Gilt market, with potentially negative implications for financial stability and growth. Additional external risks include the possibility of a correction in equity markets (particularly in relation to tech and AI stocks) and further erratic/damaging US foreign or trade policies. There are obviously some upside risks - the conflict in the Gulf could end quickly, leading oil and gas prices to drop sharply, while AI could boost growth more than expected, both through higher near term demand for business capex and/or tech exports and via higher productivity growth across AI utilising sectors.

Longer term structural challenges remain - an aging population, structurally high energy costs, weak productivity growth (though there have been some more positive signs here of late), an inefficient planning system, insufficient investment and the need to fund higher defence spending amidst a more difficult geopolitical environment.

Annual volume growth rates	2024	2025	2026 F	2027 F
Consumer Spending	0.3%	1.0%	1.3%	1.0%
Government Consumption	3.6%	2.3%	1.8%	1.4%
Investment	0.6%	3.4%	2.7%	1.8%
- Business Investment	1.2%	3.9%	3.5%	1.5%
- Government Investment	-0.9%	8.5%	3.0%	4.0%
- Housing Investment	0.2%	-0.9%	0.7%	1.0%
Exports	-0.9%	1.2%	2.5%	1.8%
Imports	1.7%	3.7%	2.5%	1.3%
GDP (annual growth rate)	1.1%	1.2%	1.5%	1.3%
GDP Growth (Q4/Q4)	1.9%	0.8%	2.0%	1.3%

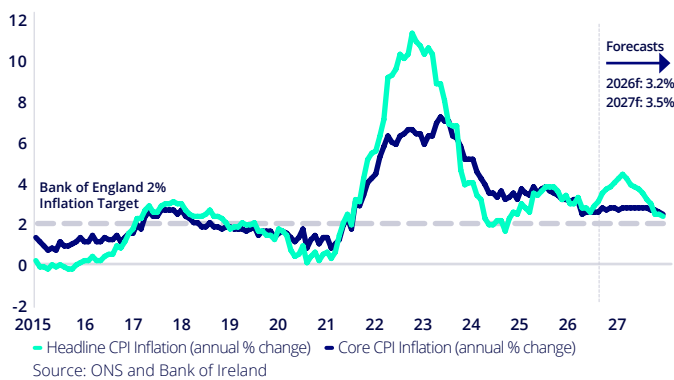
Inflation

Inflation outlook deteriorates

Sharp rise in global energy prices is pushing inflation back up

Price pressures have intensified in recent months, mainly reflecting the impact of higher global energy prices associated with the conflict in the Middle East. Headline CPI inflation rose to 3.5% in September, from 3.1% in August, above consensus expectations on foot of rising fuel prices. Underlying inflationary pressures have also increased a bit, with core inflation rising to 2.8%. Producer price inflation has also picked up materially. Looking ahead, inflation is expected to rise further over coming months as elevated wholesale energy prices continue to feed through to household bills and business costs. The Ofgem energy price cap is likely to reset considerably higher in Q1, and with food prices rising as well, inflation early next year may exceed 4½%. However, softer growth in output, employment and wages in the first half of next year should help contain second round inflationary effects and we expect inflation to ease back from Q2 onwards – measures in the Budget may also help in this regard. Overall, we expect headline inflation to register 3.2% this year (revised up from 3.1%) before rising to 3.5% next year (revised up from 2.5%). Clearly, the main uncertainty remains the path for energy prices – the projections assume oil and gas prices fall back in line with the current forward curves and, should that not happen and prices remain high, or even increase, then there are upside risks to next year's CPI forecast figure.

Headline and Core Inflation



	2024	2025	2026 F	2027 F
Inflation Rate (CPI)	2.5%	3.4%	3.2%	3.5%
Core Inflation Rate (CPI ex-Energy)	3.8%	3.7%	2.8%	2.9%

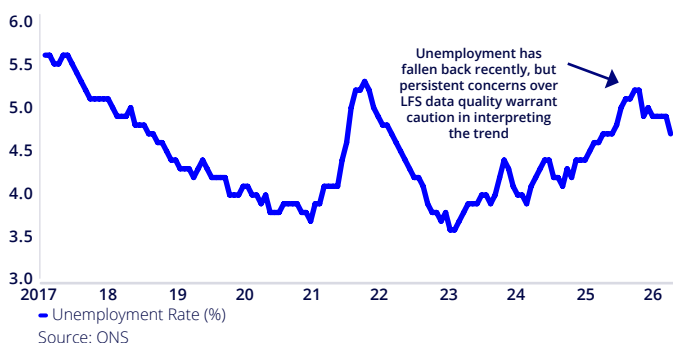
Labour Market

Tentative signs of recovery, but headwinds ahead

Unemployment has fallen recently, but may tick back up a bit

After a protracted period of weakness, the latest labour market data provides some early signs of recovery, though uncertainty regarding the ONS's data makes interpretation of short term changes challenging. The unemployment rate, which touched 5.2% at the end of last year, fell to 4.7% in the three months to August. The LFS survey data suggests solid jobs growth of late, and while the arguably more reliable HMRC payrolls data paints a more subdued picture, it too has improved a bit. Overall, we believe that, taking both series and other information into account, employment growth has probably been flat to very marginally positive in recent months. Wage growth has continued to ease, with whole economy weekly earnings growth down to 3.7% year-on-year for the May-August period. However, clearly, the external environment has deteriorated of late, with increases in energy prices and interest rates. As such we feel this nascent labour market recovery may stall a bit over coming quarters, before resuming in the Spring. We expect the unemployment rate to rise from 4.7%-4.9% now to 5.2% by Q2, averaging 5.1% for 2027 as a whole (revised down from 5.3%). The geopolitical situation remains the main downside risk. The impact of AI is another uncertainty - the evidence to date suggests that AI is beginning to weigh on some entry level white-collar hiring, though evidence of widespread job displacement is limited.

Unemployment



	2024	2025	2026 F	2027 F
Labour Force Growth	1.1%	2.2%	1.1%	0.8%
Employment Growth	0.8%	1.6%	1.0%	0.6%
Unemployment Rate	4.3%	4.9%	4.9%	5.1%
Wage Growth	5.3%	4.8%	3.8%	3.3%

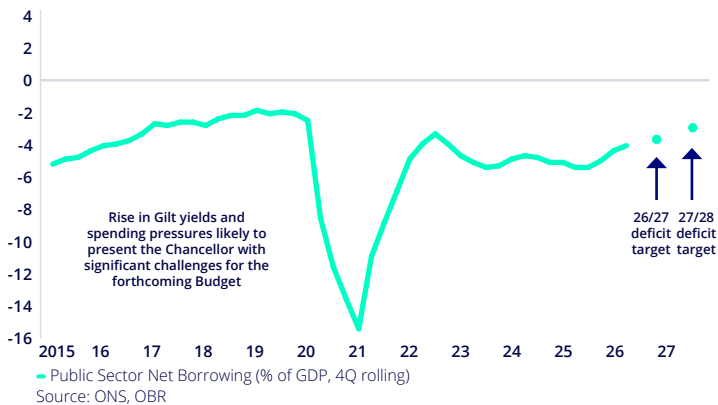
Fiscal Policy

Limited room for manoeuvre in the Budget

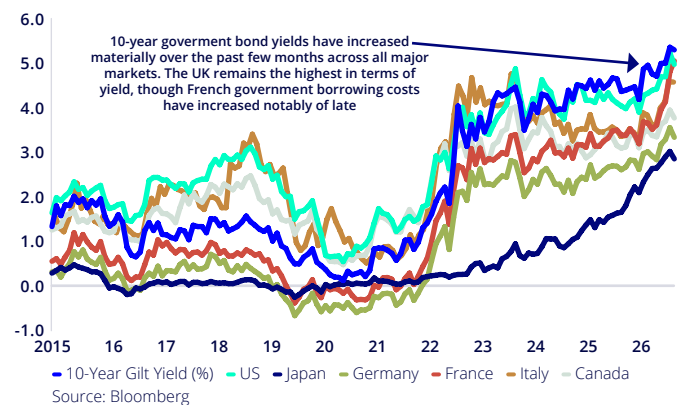
Chancellor to deliver his first Budget on Oct 28th against a difficult external backdrop

The UK's fiscal outlook remains challenging, with limited fiscal space and significant risks around the public finances. As usual, the OBR's fiscal arithmetic will shape options for the forthcoming Budget. The end result of their calculations on fiscal headroom remains uncertain – higher interest rates will reduce headroom, while higher inflation may increase it, with the net effect unclear, though lower headroom looks slightly more likely. Against this backdrop it seems likely the Chancellor will want to achieve a few key objectives, including shielding spending departments from acute cost pressures through increased funding, increases to defence spending, the introduction of some 'cost of living' supports, and increased regional investment. To do this he will need to raise additional revenue – increases to a range of taxes on capital seems probable. Given the volatile external backdrop, and recent increases in Gilt yields, it will be critical to convince the market that the package is realistic and respects the fiscal rules, keeping the deficit on a downward trajectory. Consequently the measures are likely to be fairly cautious and the overall package is unlikely to offer material countercyclical impetus to the economy.

Fiscal Deficit



Gilt Yields



Monetary Policy

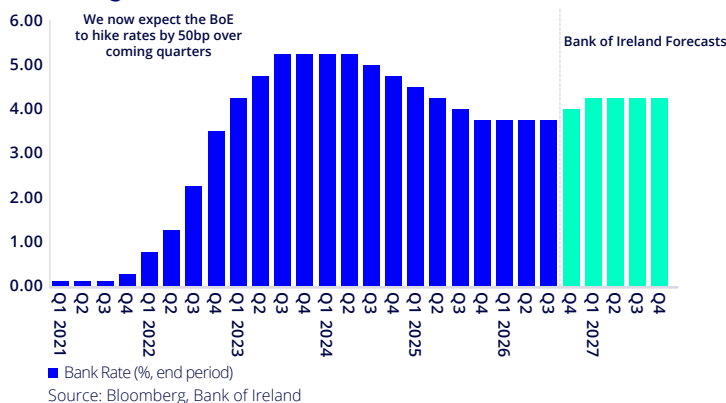
BoE set to hike

Rising inflation to push the MPC to increase Bank Rate by 50bp to 4.25%

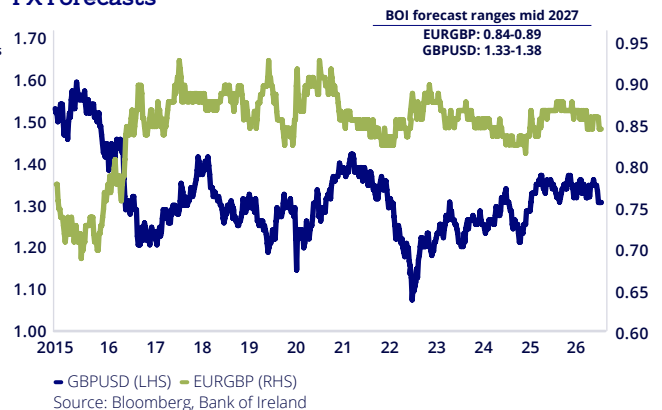
The BoE MPC voted 6-3 to keep rates on hold at its September meeting, with three dissenters preferring to hike. It noted that the "risk of [second round effects] is greater the longer higher energy prices persist". Clearly, the situation in the Gulf has not improved since and energy prices have continued to move higher, while headline CPI inflation ticked up in October. In addition, growth has surprised on the upside and the labour market seems to have improved. Overall, therefore, we believe the remaining members of the MPC are soon going to join their colleagues and vote for some rate hikes. The market is currently pricing in four hikes, taking Bank Rate to 4.75%. We don't expect the BoE to be that aggressive for a number of reasons – policy is already in restrictive territory and the recent tightening of financial conditions (higher Gilt yields for example) will do some of the MPC's work for them. As such we see two 25bp hikes taking Bank Rate to 4.25%, with the Bank then going on hold through end 2027.

UK Gilt yields have risen sharply of late, in tandem with other G7 countries - the Chancellor will clearly need to tread carefully in the Budget with yields at these levels. Sterling has weakened versus the dollar over recent weeks, but has strengthened marginally versus the euro (the single current has been weighed down partly due to concerns regarding France).

BoE Policy Outlook



FX Forecasts



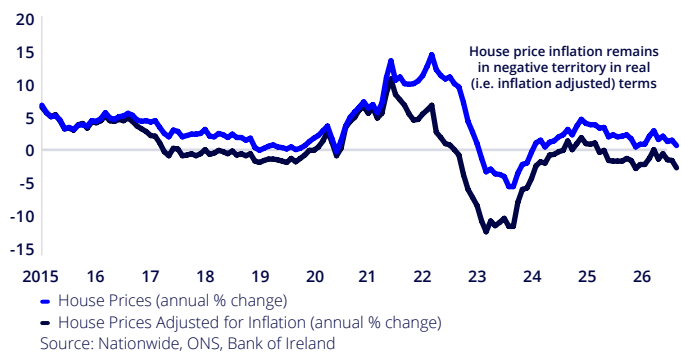
Housing Market

Outlook deteriorates

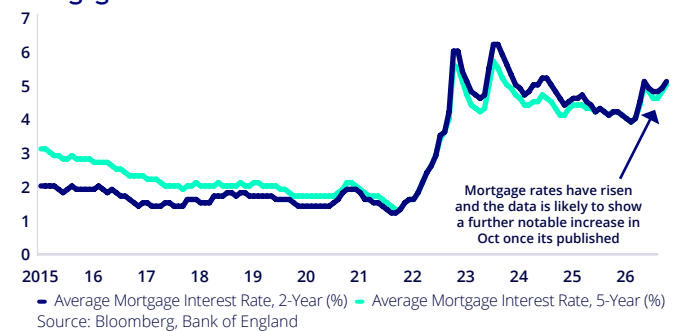
Mortgage rate increases to weigh on sentiment and activity

Having shown some tentative signs of improvement a few months, the housing market looks to have weakened of late and the signs for the quarters ahead are not promising. House price inflation, as measured by the Nationwide measure, has slipped to under 1% on a yearly basis (with a 0.2% month-on-month decline in September). Price dynamics are weakest in the south of England, with flats in particular struggling. The latest RICS survey shows ongoing weak buyer demand, with near term price expectations slipping into negative territory. Mortgage interest rates, which have increased over recent months, reflecting the impact of the situation in the Middle East on inflation expectations and money market swap rates, are likely to be a headwind for the market. Reflecting this, mortgage approvals have weakened significantly. Overall, we expect the housing market to remain sluggish, with higher financing costs and the softening economic backdrop (particularly 'cost-of-living' challenges facing households), likely to weigh on demand and activity. Nevertheless, underlying housing shortages (new construction remains structurally too low) and continued nominal income growth should provide some support to valuations, limiting the scope for prolonged weakness – as such we expect the market to pick up in H2 2027 as energy prices and interest rates pull back. There are obvious downside risks should the conflict in the Gulf escalate.

House Prices



Mortgage Rates



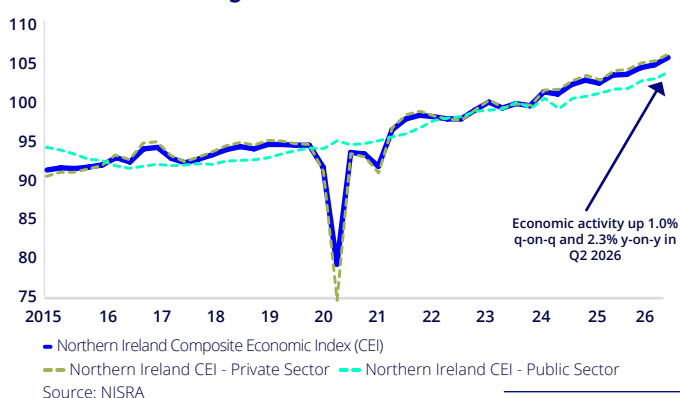
Northern Ireland

Growth continues to surprise, but risks ahead

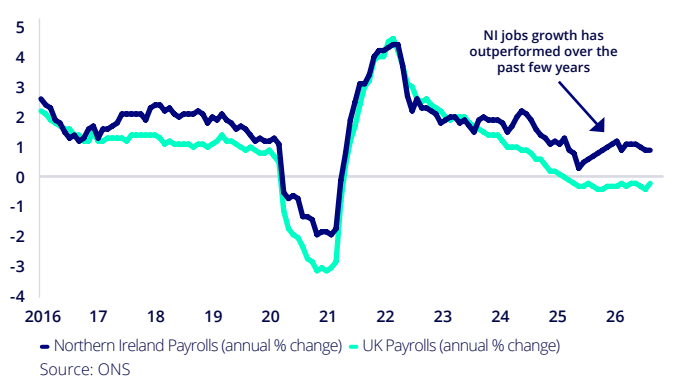
Composite Economic Index up a solid 2.4% in H1 on an annual basis

The performance of the Northern Ireland economy has continued to surprise on the upside of late. The Composite Economic Indicator, a proxy for regional GDP, points to a solid expansion in H1. Growth has been driven by manufacturing (particularly engineering and ICT – possibly AI related) and by business services, with consumer oriented sectors a bit softer. The latest PMI readings, for September, point to sustained increases in output and rising new orders – though cost inflation picked up. Although the latest payrolls data suggests employment growth stalled over the summer, recent survey data is suggestive of renewed job creation. The housing market has continued to outperform in terms of price appreciation. However, clearly the past month or so has seen the headwinds to growth pick up – with energy prices and inflation rising, and mortgage rates increasing. As such, it seems likely that early 2027 will be a bit more challenging and growth may slow somewhat, while labour and housing market conditions may cool. The risks are to the downside should the US-Iran conflict escalate, though the resilience shown to various shocks in the past couple of years is a cause for optimism.

NI Economic Activity



NI Labour Market



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