Investment Clock – Economic Update

Issue #35, December 2025

Multi asset views

Royal London Asset Management manages £181 billion in life insurance, pensions and third party funds*.

We have six Global Multi Asset Portfolios (GMAPs) across the risk return spectrum with a full tactical asset allocation overlay.

*As at 30 June 2025

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US: There are likely to still be some tariff effects to come. Fiscal policy should be supportive, and I am expecting further rate cuts from the Fed, but inflation risks are a constraint.

China: The domestically driven part of the economy continues to provide cause for concern. Without more policy support, doubts are likely to linger around the outlook.

Euro area: Inflation dynamics may support perhaps one more rate cut from the ECB, but there are risks to the outlook on both sides. The consumer and fiscal policy look likely to support the economy in 2026.

UK: Sentiment around the UK economy has felt overly gloomy of late. Inflation remains elevated, but it should fall significantly in 2026, bringing more rate cuts too.

Japan: I continue to pencil in further gradual rate hikes. The additional fiscal stimulus package is likely to provide some growth support.

Please visit investmentclock for our blog and information about our multi asset range.

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Not expecting a banner year

Activity growth has been more resilient than I anticipated. Still, I am not expecting the global economy to have recorded especially strong GDP growth in 2025 or to do so in 2026. US tariff impacts are still winding their way through the US and global economy. As labour markets have cooled or pay growth slowed, support for consumer spending has also faded in some economies. Fiscal and/or monetary policy is set to be more supportive in a number of economies though. My central case is relatively benign, but there remain plenty of sources of risk.

Summary

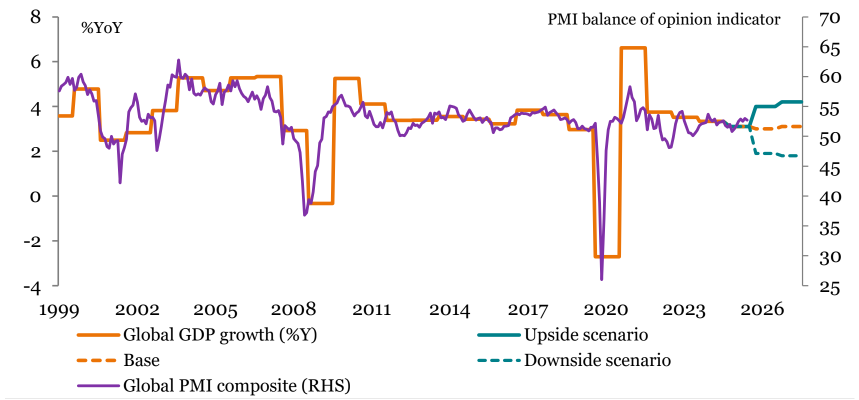
An alright year: Monetary and fiscal policy look set to provide some support in 2026 (to differing degrees in different economies). The forecasts effectively assume that not all of the tariff impact is behind us, but the US Supreme Court ruling might offer some relief (partly depending on the President's response). Consumer fundamentals generally look somewhat less supportive as labour markets and/or pay growth have cooled a bit, but lower inflation should help and there is still potential for European consumers to save less.

Plenty of uncertainty and two-way risk: My central case is relatively benign but there remain plenty of risks, from US policy to geopolitics to AI and markets themselves. The US tariff backdrop may yet provide another bout of growth restraining uncertainty. The impact of existing tariffs might include a late smattering of inflationary pressure post-Christmas as more companies work through low-cost inventories. The mid-terms are likely to steal a lot of attention in the US too, as will the replacement of Jerome Powell as Federal Reserve Chair. On the downside, the US and UK are seeing subdued hiring trends and unemployment rates look at risk of deterioration against that backdrop. Meanwhile, the euro area 2026 growth story looks a bit too centred on German fiscal policy for comfort.

Central banks likely to cut further: In my central case, US and UK policy interest rates are cut a bit further. For the US, there are plausible alternative paths where the next move is a hike and where there are more rate cuts than my central case. Euro area rates are already around the medium-term neutral rate, but inflation dynamics might justify a bit more policy accommodation. In the central case, the Bank of Japan (BoJ) continue with (very) gradual hikes and the Bank of England (BoE) with gradual cuts as inflation reassures.

The **multi-asset team** are moderately overweight equities at the broad asset class level with technical support strong for risk assets. Positioning in equities is overweight US, Japan and the UK. US equities are still supported by a positive relative earnings trends, justifying a short-term overweight position, especially versus Europe. Elsewhere the team remain underweight the US dollar, which continues to be expensive on long-term measures despite having weakened a lot in 2025. For more, see the team's 'ClockWise' blog at www.rlam.com.

Chart 1: Global growth central case: so far, so OK



Source: IMF, S&P Global (past data); RLAM (forecasts). PMI data is to November 2025

Economic forecast summary

December 2025 base case

Region	2024			2025e			2026e			2027e			2028e			2029e			2030e		
	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4
US	2.8	2.7	4.50	1.8 *1.2*	3.1 *3.5*	3.75 *4.00*	1.9 *1.4*	2.7 *2.8*	3.50 *3.75*	2.0 *2.1*	2.4 *2.3*	3.25 *3.50*	1.7 *1.7*	2.4 *2.1*	3.50 *3.50*	2.0 *2.0*	2.5 *2.3*	3.50 *3.50*	2.0 *2.0*	2.5 *2.3*	3.50 *3.50*
China	5.0	–	–	5.0 *4.7*	– *–*	– *–*	4.6 *4.7*	– *–*	– *–*	4.3 *4.6*	– *–*	– *–*	4.2 *4.3*	– *–*	– *–*	4.0 *4.0*	– *–*	– *–*	3.9 *3.9*	– *–*	– *–*
UK	1.1	2.5	4.75	1.3 *1.1*	3.4 *3.2*	3.75 *3.75*	0.9 *0.9*	2.3 *2.4*	3.25 *3.00*	1.3 *1.2*	2.1 *2.1*	3.00 *3.00*	1.3 *1.3*	2.2 *2.3*	3.25 *3.25*	1.5 *1.4*	2.3 *2.3*	3.25 *3.25*	1.5 *1.4*	2.2 *2.2*	3.50 *3.50*
Euro area	0.8	2.2	3.00	1.4 *1.1*	2.1 *1.9*	2.00 *1.75*	1.3 *1.1*	1.9 *1.9*	2.00 *1.75*	1.4 *1.4*	1.9 *1.9*	2.00 *2.00*	1.2 *1.2*	2.1 *2.0*	2.00 *2.00*	1.1 *1.1*	2.0 *2.1*	2.25 *2.25*	1.1 *1.1*	2.2 *2.2*	2.25 *2.25*
Japan	−0.2	2.9	0.25	1.4 *0.7*	2.5 *2.5*	0.75 *0.75*	0.9 *0.7*	1.7 *2.0*	1.25 *1.00*	1.1 *0.8*	2.0 *1.9*	1.50 *1.25*	0.7 *0.7*	1.9 *1.8*	1.50 *1.50*	0.6 *0.6*	1.9 *1.8*	1.50 *1.50*	0.5 *0.5*	2.0 *1.9*	1.50 *1.50*
Global	3.1	–	–	3.1 *2.8*	– *–*	– *–*	3.0 *2.8*	– *–*	– *–*	3.1 *3.1*			3.0 *3.0*			3.0 *3.0*			2.8 *2.8*		

Source: LSEG Datastream, national statistics offices, Bloomberg Finance L.P. for past actual data. All forecasts (e) are RLAM. Current data and forecasts are in black. Forecasts from the July 2025 forecast update are in grey and italics. 2024 figures are past actuals. Note: US policy rate is the upper end of the Fed Funds target range. Euro area policy rate is the deposit rate.

Key economic policy forecasts

- My central case forecasts assume that the US cuts a bit further as job growth remains slow and the Fed grow less worried about inflation risks. Given the amount of uncertainty around the US outlook, these forecasts have significant two-way risk. Euro area rates are already around my estimate of the medium-term neutral. With inflation dynamics appearing soft, I see a reasonable probability of a cut to 1.75% in 2026 but no longer have that as my central case terminal rate. I expect the Bank of England to cut rates next year to a terminal rate slightly below neutral as inflation fears ease but with the balance of risks skewed towards fewer cuts. I am expecting very slow rate hikes to continue in Japan.
- Sharper than expected downturns and more unemployment would see deeper rate cuts than in the base case (as central banks try to rapidly get rates below neutral). Higher than expected inflation (particularly core, services inflation and, relatedly, pay growth), could mean rate cuts pause for a prolonged period and potentially rise slightly if central bankers start to worry that policy isn't restrictive enough (more likely if activity growth is holding up well at the same time). Both scenarios are still plausible in the US given the extent of policy change, but elsewhere too.
- Fiscal policy looks set to become more supportive in the euro area with more defence and infrastructure spending likely to boost growth at a euro area level (even if the spending is relatively Germany-centred). In the US, fiscal policy looks set to be growth supportive in 2026 as some of the tax provisions of the OBBBA fiscal bill bolster disposable income a bit. Fiscal policy is set to drag somewhat on UK growth.

Global economic scenarios (Chart 1)

Upside scenario (20% probability): Growth picks up sharply, but without generating much inflation

- Levels of policy uncertainty fall significantly. European consumers dissave as confidence grows in the outlook and real pay growth remains positive. Consumer spending is much stronger than expected. China's policy efforts see GDP growth stabilise rather than drifting lower over the next few years. US GDP growth surprises on the upside, helped by sustained robust capex (supported by tax measures, AI and deregulation).
- Headline inflation stays relatively close to target as higher productivity growth contains overall labour cost growth. Higher labour market participation and immigration also helps in some cases. In the US, the impact of deportations and changed immigration policy on population growth is less than feared, while AI adoption restrains labour demand so that the labour market doesn't tighten much overall.
- Central banks prove less willing to cut rates but aren't inclined to hike rates either given contained inflation pressures. Policy rates remain closer to pre-financial crisis norms than pre-pandemic norms. Fiscal policy is more supportive than in the central case.

Base case (60%): Modest growth and somewhat lower interest rates

- Fiscal policy supports activity in some economies, as does monetary policy. Real consumer spending holds up partly as inflation falls, but tepid job growth, demographic/immigration trends act as a constraint. Relatively healthy private sector balance sheets help contain recession risk. Business investment gets some support from interest rate cuts and AI (though it is unclear how much/whether the latter will add to *growth*).
- Domestically driven inflation pressures ease and base effects support lower inflation in some cases. Interest rates are cut a bit further in the US and UK and hiked very gradually in Japan.

Downside scenario (20%): Stronger impacts from tariffs, immigration policy and uncertainty

- Political and policy uncertainty alongside choppy policy decisions weigh heavily on global growth. Tariffs rise again and there is more trade disruption than in the central case. US economic growth is hit more than in the central case by lower immigration and higher tariffs and inflation is bolstered, constraining monetary policy. AI proves more disruptive to labour markets, and faster, than expected.
- Inflation falls more sharply than in the central case a couple of years out.
- This is followed by rate cuts that are deeper than in the central case.

Probabilities are subjective and indicative such that we'd broadly see a 20% chance that the economy performs in line with/better than the upside case and a 20% probability that the economy performs in line with/worse than the downside case.

Global economy: So, where's that slowdown?

I have been in the slowdown camp when it comes to global growth and trying to parse the likely impact of the changed global trade environment, but global growth has proven more resilient than expected. I am not expecting the global economy to have recorded stellar GDP growth in 2025 or to do so in 2026. However, US tariff impacts are taking a while to wind their way through the US and global economy. Redirection of trade from China adds an additional challenge for some. Above-target inflation meanwhile isn't an obvious backdrop for lots of (supportive) rate cuts (though I still think we will see some more in the US and UK) and the outlook for fiscal policy is mixed country-by-country. My central case is relatively benign but there remain plenty of risks, from US policy to geopolitics to AI and markets themselves.

More resilient than expected

Since April and the ensuing shock US tariff announcements during that month, activity growth has picked up (Chart 2). Activity growth looks set to have been stronger than I'd expected in 2025. That has likely been helped by efforts by firms to get ahead of tariff changes by front-loading activity; positive real pay growth over much of the year in a number of major economies; rate cuts and fiscal policy changes in some economies; and spending on AI-related equipment and infrastructure. As of late-2025, the global PMI composite business survey is pointing to moderate positive activity growth. The global PMI however, has also picked up weak employment trends and soft labour markets have become talking points in both the US and UK. That helps explain rate cuts in both economies despite continued above-target inflation.

Summary outlook: Still a bit sluggish

Why not expect stronger growth in 2026? I am expecting moderate, unimpressive GDP growth rates against a still difficult global backdrop, not least from the potential for ongoing US policy uncertainty. Many of the supports outlined above for 2025 seem unlikely to boost growth as much again in 2026. Tariff effects seem likely to stretch into 2026 and it is unclear that AI-related spending will increase as much in 2026 as it did in 2025 for example.

Supports for modest to moderate growth: Support for modest growth is from a number of sources, including:

1) Monetary and fiscal policy have become more supportive in a number of major economies, albeit not uniformly. Fiscal policy should be supportive in the US, Japan and the euro area in 2026. German fiscal loosening should be more of a boost to GDP growth in 2026 than in 2025 given the kind of lags involved in infrastructure and defence spending. Looking at the US too, fiscal policy changes look set to have a more positive effect on GDP growth in 2026.
2) Private sector balance sheets continue to look relatively robust (or at least, not extended enough to make significant recessions feel like a big probability, see Chart 3).
3) Household real pay growth still looks positive in the US and UK (Chart 4); albeit low hiring and the perceived still high level of prices seem likely to weigh on consumer confidence into 2026 in those economies.
4) Businesses globally may perceive the worst of US policy uncertainty as behind us.

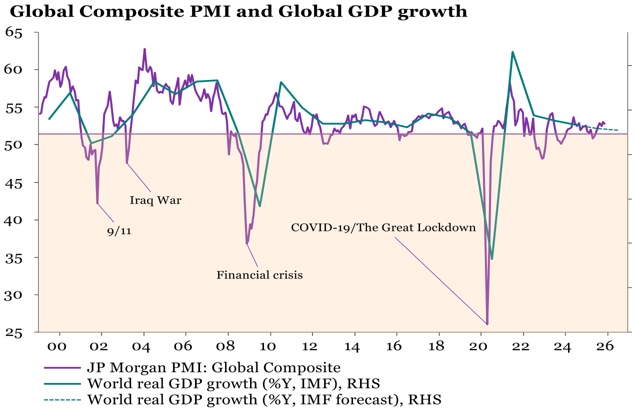
Lower inflation and a few more cuts: I expect inflation to slow in 2026, helped by lower energy inflation (Chart 5), slowing wage growth (in Europe) and assuming that the impact of tariffs will be more disinflationary than inflationary outside the US as we head into 2026. AI should have a downward effect on prices (via and productivity gains) though this seems likely to be more of a medium-to-long term driver than a short-term one. (Past) currency strength may slow inflation in some cases (euro area) and there should be negative base effects in the UK from administered and regulated prices. In the US, the tariff impact has been more spread out than originally expected with some of the upside still to come, but by late 2026 should be pulling down rather than up on annual inflation as the impact rolls out of the year-on-year comparison. Against lower inflation and modest to moderate growth, I am pencilling in further rate cuts from the Fed and BoE.

Where could things go wrong?

As ever, there are plenty of points where this relatively benign central case forecast could go awry. US policy remains difficult to predict, especially with regard to tariffs. Geopolitics remain an underlying concern. I remain worried that fiscal sustainability returns as a market driver and, by extension, a potential cause of tighter financial conditions. I continue to monitor AI as a potentially disruptive force for global economies. Inflation that is more persistent than expected (which I worry about in the US and UK in particular) may act as more of a constraint than expected on central bank action. Equity markets may may be a risk for economies, especially in the US where 'bubble' worries resurfaced in 2025 and where the wealth effects of stock market moves are likely to be higher than in Europe.

Chart 2: Pace of global growth looks healthy

Global Composite PMI and Global GDP growth

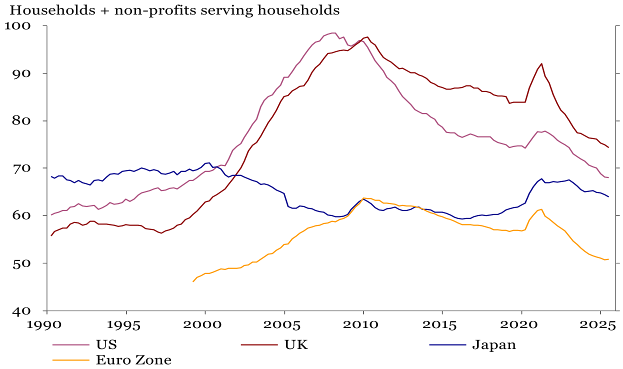


Source: LSEG Datastream; IMF, S&P Global. PMI data is to November 2025. IMF series was updated in October 2025.

Chart 3: Household leverage well below GFC peaks

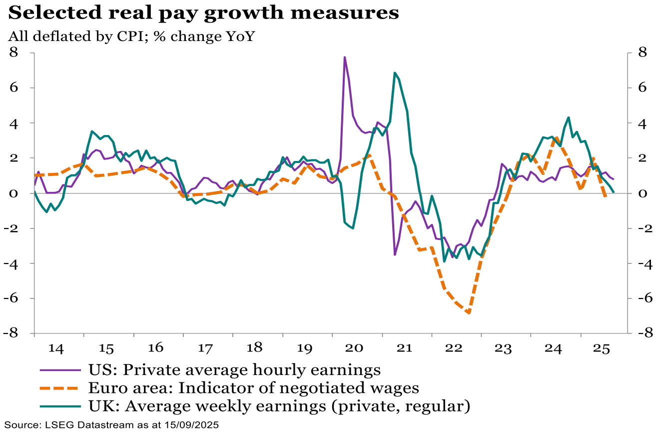
Credit to household sector as % GDP

Households + non-profits serving households



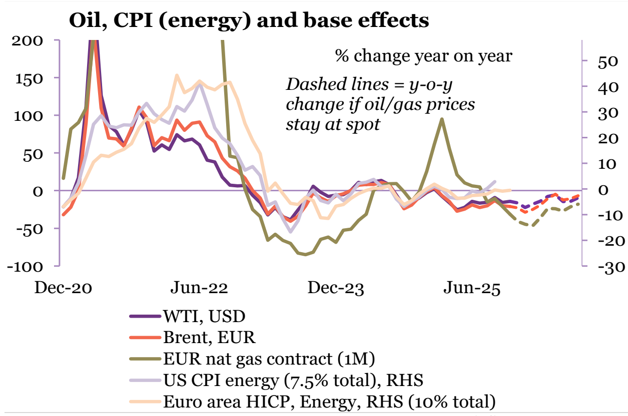
Source: LSEG Datastream, BIS. Data to Q2 2025.

Chart 4: Real pay growth positive in the US and UK (just)



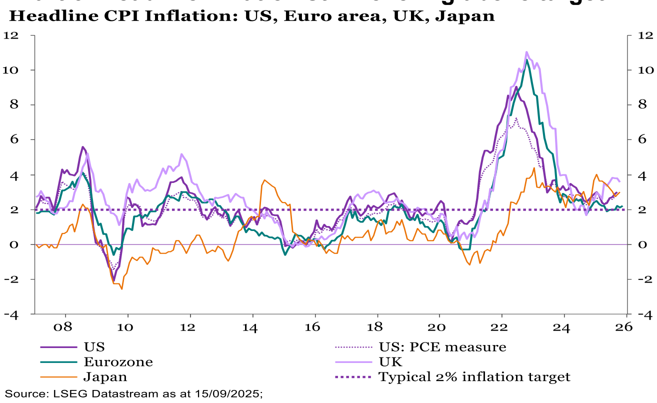
Source: LSEG Datastream, BLS, ONS, ECB, Eurostat. Data is to September 2025 (US, UK); Q3 2025 (Euro area).

Chart 5: Energy prices likely to lower inflation a little



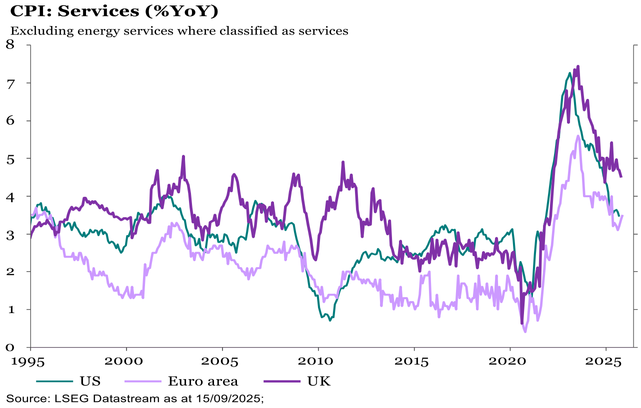
Source: LSEG Datastream, ONS, Eurostat. Actual figures to November 2025 except US CPI which is to September 2025.

Chart 6: Headline inflation still hovering above target



Source: LSEG Datastream, BLS, Eurostat, ONS, Japan Statistics Bureau. Data as at November 2025 (Euro area), September 2025 (US), October 2025 (UK, Japan).

Chart 7: Services inflation still high



Source: LSEG Datastream, ONS, BLS, Eurostat. Data as at November 2025 (Euro area), September 2025 (US), October 2025 (UK).

Inflation outlook: Different economies, different stories

Headline inflation remains above 2% targets in the US, UK and Japan (Chart 6). Services inflation remains elevated (Chart 7). However, my central case (Chart 8) remains for headline inflation slow in 2026.

US: With labour supply restrained by tighter immigration policy, softer labour demand may not generate much disinflationary pressure, and a significant amount of the tariff impact has yet to feed through to prices (see tariffs section). The US is now closing in on five years of above-target inflation and, so far, the US economy in aggregate has held up better than I anticipated. If the economy continues to hold up relatively well, then with core services inflation already seemingly stalling a bit at still relatively high levels and with weaker labour supply trends likely to limit labour market slack, there is a risk that inflation lingers at higher than target levels for longer. Nevertheless, tariffs are expected to boost inflation by less in 2026. Base effects should help US inflation somewhat lower later in the year.

Euro area: In the euro area, headline inflation is only just above target. With indexation regimes with a formal role for inflation developments in wage negotiations covering 18% of employees in the euro area, lower headline inflation in 2025 will itself have a significant role on wage and therefore inflation dynamics in 2026/27. With China likely to export disinflationary pressure to Europe (and elsewhere) as exports reorientate away from the US (Chart 11) and lower energy price inflation, I am expecting headline inflation to slip a bit below the 2% target of the European Central Bank (ECB) in 2026.

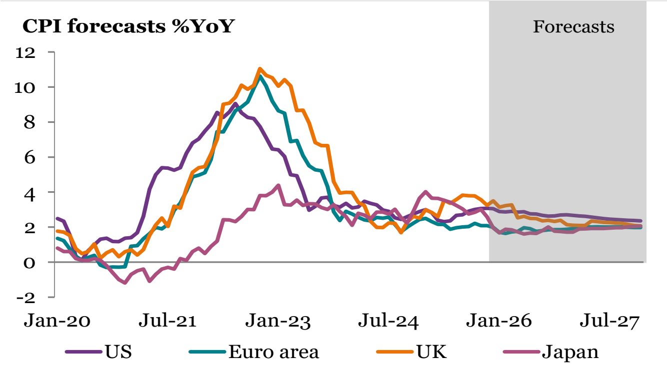
UK: With cooling pay indicators and signs of looser labour markets (Charts 9 and 10), services inflation looks more likely to fall in the UK. Base effects for several administered and regulated prices should also be negative in late 2025 and 2026. Large increases in water bills and duty – especially vehicle excise duty are not set to be repeated, and the April 2025 rise in employer National Insurance Contributions likely added to cost push inflation in 2025.

In the November 2025 Budget, the Office for Budget Responsibility (OBR) assessed that government policy changes would lower inflation 0.4pp in 2026-27. Services inflation merits monitoring though – pay growth, albeit cooling, is still above levels consistent with the inflation target and inflation expectations have risen.

Japan: In Japan, evidence continues to accumulate that inflation is at *sustainably* higher levels than pre-pandemic. Energy subsidies look set to dent inflation a bit in 2026 but the fiscally stimulative stance, e.g. cash handouts could provide some support. Headline inflation looks likely to dip below target in 2026 though, suggesting some risk of an even slower path for rate hikes than in the central case.

Medium-term upside risks to central forecast? Medium-term risks look skewed to the upside, despite AI, on factors such as climate change, as well as tighter immigration policies and ageing populations leading to tighter labour markets. The ECB's Isabel Schnabel echoed some of my medium-term concerns (see below) when she said in early September that: "A more fragmented world with a less elastic global supply, higher fiscal spending and ageing societies is a world with higher inflation…So I think the point where central banks around the world start to hike interest rates again may come earlier than many people currently think."

Chart 8: Central case for inflation

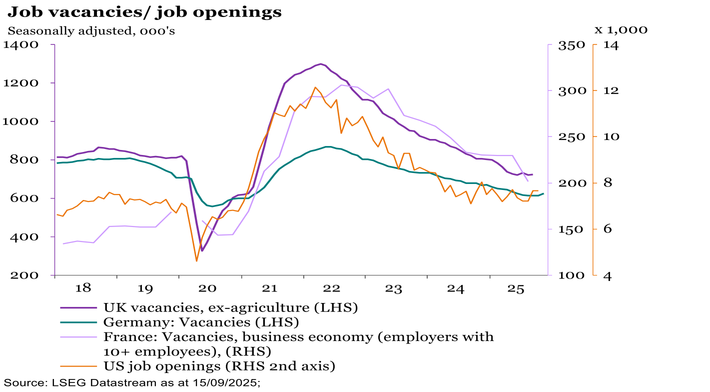


Source: Past data: LSEG Datastream, BLS, Eurostat, ONS, Japan Ministry of Internal Affairs and Communications. Forecasts are RLAM, consistent with forecasts on page 2.

Chart 9: Wage/pay growth has cooled

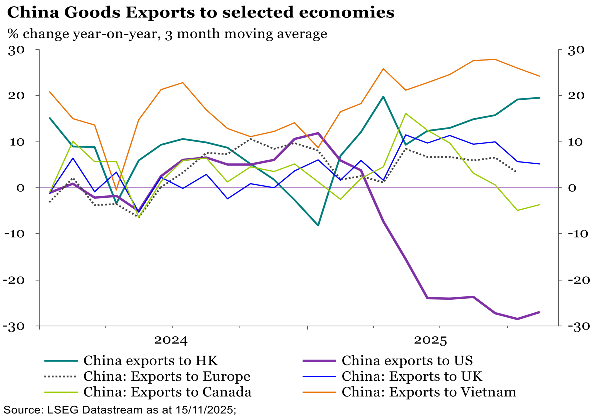
LSEG Datastream, BLS, ECB, ONS. Pay data to September 2025 (US, UK), Q3 2025 (Euro area). *Productivity measures average from 2010: Output per hour (US), Total economy labour productivity (euro area), Output per worker (UK)

Chart 10: Labour market cooled



Source: LSEG Datastream, ONS, Deutsche Bundesbank, Eurostat, BLS. UK data to September 2025, US data to October 2025, France to Q3 2025, Germany to November 2025.

Chart 11: Evidence of China export redirection



Source: LSEG Datastream, China Customs. Data to November 2025 (except for Europe which is to October 2025).

Central bank policy: Risk of fewer cuts (unless independence seriously at risk)

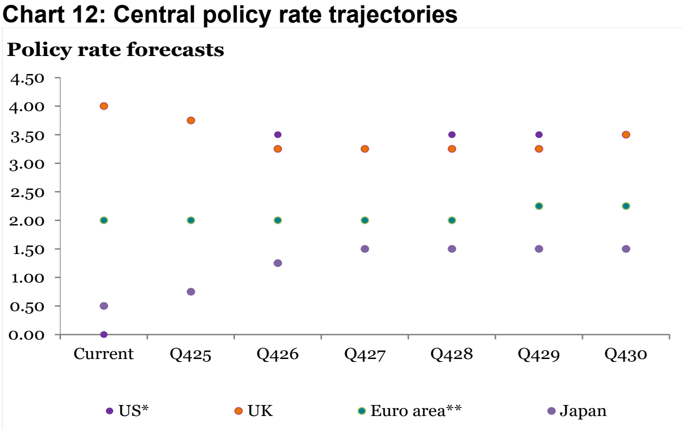
I still expect (further) rate cuts in the US and UK and hikes in Japan (Chart 12). In the case of those cutting rates, I am assuming somewhat weaker domestically driven inflationary pressure develops given softer labour markets (with inflation also helped lower by base effects and energy prices).

However, there are good reasons to think that inflation could surprise on the upside and interest rates cut less than expected, especially in the US. That follows five years of above target inflation, let alone if growth proves more resilient than expected.

In my central case, the Fed cut rates twice more over the forecast horizon reflecting an assumption that tariffs will have ultimately temporarily lifted US inflation around 1pp, and that attempts to trim costs by firms help keep the labour market sluggish. A more substantial downturn would see more rate cuts. In the euro area, facing more benign inflation dynamics, there is a risk of one more ECB rate cut, but I have removed this from my central forecast. I have pencilled in gradual rate hikes from the BoJ again. For the BoE, I am pencilling in cuts to 3.25% in 2026 helped by inflation likely having passed its near-term peak. That would take the UK policy rate below my estimate of a medium-term neutral rate (3.75% medium-term). All central bank trajectories are anchored by my estimates of neutral rates in the medium-term (3.5% in the US, 2.25% in the euro area and 1.75% in Japan).

Independence at risk? Central bank monetary policy independence is a cornerstone of inflation control. Central banks independent of politics lack the need to be 'popular' and are therefore seen as more willing to take tough decisions (i.e. rate hikes) in order to control inflation. Loss of Fed monetary policy independence is on the watchlist but is not yet at least in my central case. US President Trump's attempted firing of Federal Reserve Board member Lisa Cook continues to go through the courts. If Cook departs, that would give Trump-appointees (after Senate approval) a majority on the seven-member Board (excluding Powell). The Board, when adding five voting and rotating regional Reserve Bank presidents, forms the FOMC (who decide US monetary policy). Trump in August, talking about the Board, said that "we'll have a majority very shortly." More recently he said that the next Fed Chair should consult with him on interest rates, but added, "It doesn't mean – I don't think he should do exactly what we say." (Asked where he wants rates next year, he said "1% and maybe lower than that…") So far, the Fed have had good reason to be cutting rates. Much however, will rest on the selection and conduct of Chair Powell's replacement in 2026 and any substantial compromise of Fed monetary policy independence would be a serious concern.

Chart 12: Central policy rate trajectories



Source: National central banks/LSEG Datastream (past actuals). All forecasts (from Q4 2025 onwards) are RLAM estimates.

Fiscal policy: Mixed outlook and threats to fiscal sustainability

In the **US**, fiscal policy looks set to be supportive for growth in the economy in 2026, especially once the effect of tariffs on growth likely peaks. The Trump administration's 'Big Beautiful Bill' largely extended existing tax cuts, but did introduce new tax breaks. It is less clear, however, what the net impact of policy will be on supply and therefore on inflation. Broader policy measures could reduce labour supply (especially reduced immigration); but welfare-related fiscal measures might boost it.

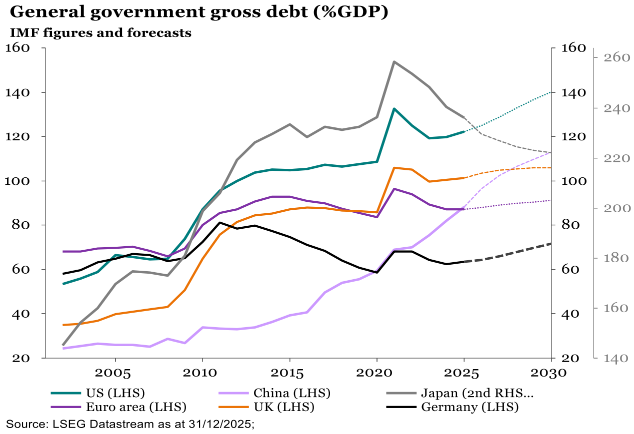
Euro area fiscal policy should move from a drag to a *moderate* support for growth, largely reflecting higher German fiscal spending. The likelihood of other euro area economies contributing substantially is limited by factors including already high deficits, debt and/or fiscal conservatism. Even in Germany, the boost looks set to come from two areas (defence and infrastructure) rather than more broadly without further debt brake reform and may prove vulnerable to shifts in German politics.

UK fiscal policy looks set to drag somewhat on the outlook.

In **China**, fiscal policy is likely to be deployed further. However, much may be in the form of delayed deployments originally expected in 2025.

Fiscal sustainability concerns: I still worry that fiscal sustainability may become a bigger market concern. Chart 13 shows debt to GDP levels for a number of economies. Once you drag these projections out another 20 years and factoring in ageing populations with their higher dependency ratios and pressures for more spending on health and pensions, fiscal trajectories look even less sustainable. It is not clear how much patience investors will have for sizeable government borrowing against this backdrop but it is likely to be limited in economies that can't rely on a steady stream of dependable domestic and or overseas demand for its debt. The UK falls into this category. Economies may duly face fairly tight market-based discipline and more bond market volatility.

Chart 13: Government debt to GDP levels already high



Source: LSEG Datastream, IMF. Data updated in October 2025.

Implications of higher long bond yields likely limited

Long-dated government bond yields have stayed elevated or even risen this year, likely *partly* on concerns about fiscal sustainability and lingering inflation and after a drop in natural buyers in some places. But do elevated (by the standards of recent years) long end yields have economic implications?

The curve (or at least a part of it) is regarded as something of a recession predictor in the US in particular but, more usually, the 10s-2s or 10Y to 3M difference – and when it turns negative – is often cited as a lead recession indicator (though with varying lags and varied success recently).

The causality between bond yields and activity logically is two-way, with economic conditions a driver of bond yields and vice-versa. Different economies will also have different degrees of sensitivity to different bits of the curve depending, for example, on how companies tend to borrow and on the popularity of fixed compared to variable rate mortgages. In the US, mortgage terms are much longer in the UK, for example. Work by the Federal reserve authors suggests, however that the taper tantrum of 2013 when long-term rates spiked 100bps had "no observable negative effect on the overall US economy". Of the main US GDP components, residential investment did fall in the period following the shock in bond yields. However, this shock occurred when interest rates were very low and the authors acknowledge that the impact of a 100bps shock might be more meaningful from a higher starting point.

Where high long bond yields result in debt issuance being skewed towards the shorter end, it does expose governments to more refinancing risk.

Tariffs: Tracking the impact

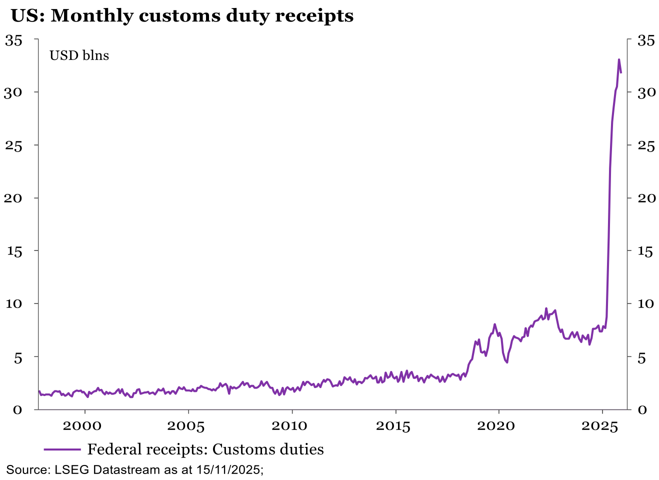
Tariffs are substantial: The US has been running with significantly higher import tariffs since February this year. Government revenue figures shows that substantial tariff revenues are being collected (Chart 14).

Tariffs as a source of uncertainty: The administration's changeable and unpredictable approach to tariff setting has generated economic policy uncertainty that is likely to have dragged on growth. Levels of uncertainty (on news-based measures) have since fallen, although research suggests that the impact may linger for a while on business investment for example.

Tariffs as a tax: Tariffs are a tax on importers. They can improve the fiscal position but weigh on the economy more broadly. Relatively speaking, they favour domestic producers over importers and importing firms facing higher costs will not always be able to switch to domestic producers (who may also use the opportunity to raise their prices).

Economic impact: As higher costs hit, firms can react in a number of ways, largely through 1) negotiating better deals 2) sourcing from elsewhere 3) absorbing in margins/cutting costs, or 4) passing the cost onto consumers. The first may not be possible given relative market power (and will still see someone pay the cost). The second may not be possible or be at higher cost. The third will likely lead to efforts to save costs elsewhere, including less hiring. The fourth will likely mean consumers buy less. Domestic manufacturing can gain as relative competitiveness improves in the domestic market, though the ability to take advantage of this will be limited by any constraints on growth from a labour/skills perspective, a lack of industry ecosystem in some areas and the sheer degree of cost advantage some overseas producers will retain.

Chart 14: Plenty of tariff revenue collected



Source: LSEG Datastream, US Bureau of the Fiscal Service. Data to November 2025.

The overall impact on the economy of tariffs will also depend on how far currency movements offset tariff moves (not helpful so far) and how universal tariffs are. Very different tariff rates mean more scope for US importers to avoid the worst of the tariffs by (where possible) adjusting where goods are imported from. With headline tariff rates on different countries ranging from 10% (UK) to 50% (India), there will be some scope for that.

Estimates of the likely overall impact on GDP vary. The Congressional Budget Office (CBO) September economic revisions blamed a downward forecast revision in GDP growth by 0.5pp (compared to January) to 1.4% year-on-year in Q4 2025 on the impact on output of tariffs (and on the reduction in immigration). The Yale Budget Lab, for example estimate a 0.5pp impact over 2025 and 2026 with the level of GDP 0.4% smaller in the long run. However, they also suggested some positive effects for industry, with industrial output in tariff-sensitive industries they claim up 3.5% year-to-date, returning to early 2024 levels. Economic impacts, though apparent in business surveys and import data in particular, are difficult to isolate and unlikely to be fully apparent for a while. With tariffs having been so changeable and with evidence of firms 'getting ahead' of tariffs to try and avoid paying them at their highest levels (see jumps in US goods imports in January and July), it will take time for the full impact to be felt in prices and consumer spending.

Price impacts patchy: The impact of tariffs on prices has been patchy so far. In June 2025, Yale Budget Lab analysis of data suggested that 61-80% of the new tariffs might be passing through to consumers (see Short-run Effects of 2025 Tariffs So Far, September 2 2025). Looking at the level of core goods prices (goods ex-food and energy) and durable goods prices (which will include for example, autos), there appears to have been a change in trend around the time increases in tariffs were first implemented (Chart 15). However, looking across key tariff-affected categories of goods prices in CPI or PCE data shows very mixed patterns. In the September release of CPI, the furniture and bedding category saw inflation of 3.8% year-on-year, but appliances only 1.3% year-on-year for example. Inflation in 'tools, hardware, outdoor equipment and supplies' is 4.3% year-on-year but -0.1% year-on-year in apparel.

What are companies themselves saying? Business surveys mention ongoing concerns around tariffs. According to the September Fed Beige Book, for example, "contacts frequently cited economic uncertainty and tariffs as negative factors" in a section on consumer spending. ISM business surveys include direct comments from survey respondents. In the August 2025 survey, for example, the commentaries in the ISM manufacturing survey mentioned tariffs heavily as important for raising costs, prices and hitting volumes. US earnings reports this year, meanwhile, point to firms taking a variety of approaches with tariffs but some firms in Q3, for example, were warning that more of the cost will need to be passed on.

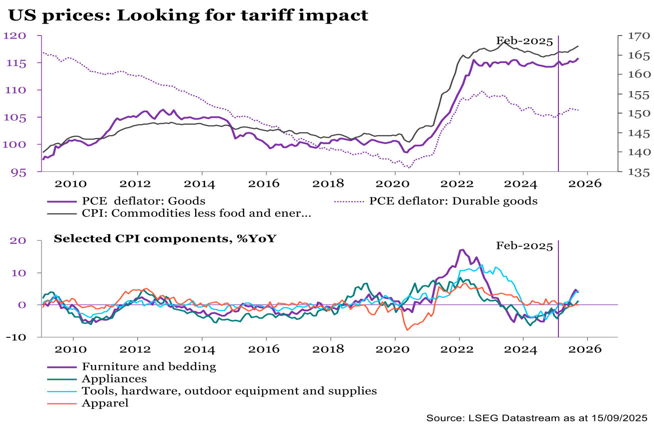
How fiscally important are tariffs? Revenue data suggests that customs duties raised $139bn over May through September, compared to $36bn for the same period a year earlier (Chart 14). That crudely suggests that the US could raise some $250bn a year extra or around 0.8% GDP. That is sizeable against a budget deficit running at around 6% GDP. It could be a conservative estimate given that import data suggests that companies have been front-loading imports ahead of tariff increases. However, tariffs against China have already dropped again and tariff revenue would likely be eroded somewhat over time as trade is then redirected to areas with lower tariffs or to domestic producers. The CBO estimates that the rise in tariffs to 19 August (if they persisted) would decrease deficits by $4.0tn cumulatively for the 2025–2035 period once the indirect impact on interest costs is included (i.e. around $400bn a year or 1.3% GDP, though the estimate did not include any impacts that tariffs have on the size of the economy).

Here to stay? What does it mean if the Supreme Court rules against Trump's tariffs? There is some sense now of tariffs reaching a semi-settled state, but they are still subject to court rulings, we could see more sector-based tariffs and ad hoc additional tariffs remain a threat. The Supreme Court has heard the case for the legality of Trump's tariffs as currently framed with a ruling expected soon. While the economy would likely welcome a tariff reprieve, it wouldn't be welcome news for fiscal sustainability. However, I would also not assume that a court ruling will hold tariffs back for too long. First, tariffs are central to the Trump agenda. Second, the court case revolves around Trump's use of IEEPA (International Emergency Economic Powers Act) as a basis for tariffs rather than the use of tariffs themselves. Other routes (which generally take longer or come with time limits) are available. Third, the tariffs might be able to continue to be applied while the case proceeds further (e.g. sent back to lower courts). Ultimately though I would expect that such a Supreme Court ruling would result in a somewhat lower tariff rate on average.

AI: Already disrupting the labour market?

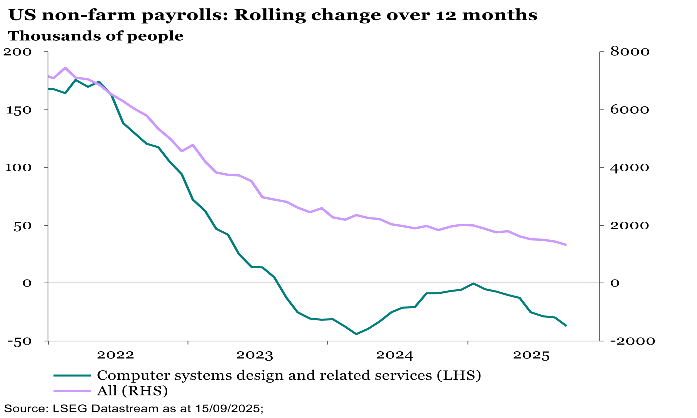
One of the reasons some indicators of US activity seem to have held up well is likely AI-related spending. Estimates of the impact vary and those at the upper end (~1% GDP annualised) are exaggerated by not subtracting imports but the impact is nonetheless likely to have been significant. Meanwhile, there are some signs of potential-AI related labour market disruption already (Chart 16). One of the theoretically most exposed groups to AI in its current guise are new graduates in white-collar roles. AI will be well suited to doing many tasks which in the initial stages of a role often need to be checked by a supervisor anyway. Indeed highlighted research suggesting that internship opportunities fell 11% compared to 2024. The unemployment rate for college graduates aged 20-24 has been rising on average. LinkedIn acknowledged that hiring rates for college graduates are slow but suggest other factors are at play (including previous strong hiring and then lack of job quits). The impact is likely to remain hard to disentangle. According to the November Fed Beige Book, "a few firms noted that artificial intelligence replaced entry-level positions or made existing workers productive enough to curb new hiring". While producing more with fewer people would improve productivity growth, there is some risk here of damage to talent pipelines and therefore future growth. There are clearly scenarios where the technology brings substantial labour market disruption. In such scenarios, there would presumably also be an attendant risk of a substantial public and political backlash against the technology.

Chart 15: Patchy picture on tariff pass-through



Source: LSEG Datastream, BLS, BEA. Data to September 2025.

Chart 16: AI-related job disruption? Exposed sector jobs lost



Source: LSEG Datastream, BLS. Data to September 2025.

United States: Tariff impact ongoing

US growth has been more resilient than I'd have expected, although the US economy is likely to slow in Q4 2025 against the shutdown and tariffs backdrop. However, not all the data is upbeat, and the labour market has softened substantially. Growth is not as solid as it looks in that sense. Fiscal policy should be supportive, and I am expecting further rate cuts from the Fed, but inflation risks will likely act as a constraint. Meanwhile, despite all things AI, US potential growth may be sustaining some damage.

Growth on shaky ground?

Looking across the span of US data, there is a case for suggesting that things are not as strong as the last couple of quarters of GDP growth would have you believe. Should Q3 US GDP growth come anywhere close to the Atlanta Fed nowcast (3.5% quarter-on-quarter annualised) after Q2's 3.8% GDP growth, it looks like the US economy is sailing through the challenges posed by policy uncertainty, tariffs, deportations, let alone the low hiring backdrop. Why the relative resilience? It seems too early for an additional boost to be coming from fiscal policy. The lack of an apparent strong impact from tariffs could be partly explained by companies having got ahead of tariffs early this year by frontloading imports when they were cheaper, delaying pass-through to consumers. It also seems likely that data is being flattered by AI-related spend that isn't showing up in hiring (data centres don't need many people to run them and AI may be used as reason/excuse to cut hiring). For now, real consumer spending seems to be holding up. That can almost single-handedly support the economy but could yet be undermined by higher prices and a weak labour market. To the extent consumer spending is being held up by higher income consumers, there is also vulnerability to any stock market correction. Work by the Boston Fed, for example, confirmed that since 2022 real consumer spending has been 'propelled' by the highest income consumers, supported by lower levels of credit card debt. In sum, US GDP growth may be on somewhat shaky ground. Politics also provides a source of risk with another government shutdown possible when the current deal ends on 30 January 2026 and with the midterms coming in November 2026.

So far, the data suggests the continued existence of a multi speed economy (Chart 17), e.g. with the housing sector still subdued but AI-boosted investment spending strong. Private sector balance sheets, however, don't make the US look obviously recession-vulnerable (Chart 18) and fiscal policy should boost GDP in 2026. The Supreme Court ruling on tariffs might provide some relief but also come with market impacts (see global section).

Rate cuts in the central case, but plenty of two-way risk

Having restarted rate cuts in September, I only have two more Fed rate cuts in my central forecast. Markets are pricing is similar at the time of writing. If the US is heading for a serious downturn, two rate cuts will not be enough, but if the US economy sails along even two cuts may be too many given that the Fed are now heading for their fifth consecutive year of above-target inflation (Chart 6).

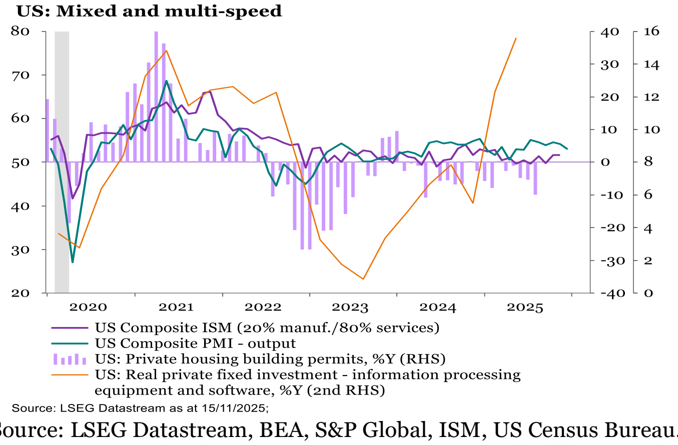
Some FOMC members do not think that policy is very restrictive at all (limiting their appetite for rate cuts). The December dot plots again showed a substantial span of participant views on the outlook with the projections for rates at end 2026 ranging from 2.1-3.9% from a current 3.6% (mid-point of the Fed Funds target range). In my central case, I expect the impact of tariffs to push up prices moderately and temporarily but also to cool activity and jobs growth and for the unemployment rate to rise further. There is a plausible scenario though where inflation stays persistently well above 2%, with lower immigration raising the risk of labour markets staying tight even as hiring slows. Risks around monetary policy independence remain on my radar but aren't a driver of my central case (see More to Worry about than Just Rates, 16 September 2025 and global section). I am not assuming any new strong rate cutting impetus from the Fed once the new Chair comes on board, but acknowledge that this assumption will need monitoring.

Medium-term potential growth: Probably down

There is a good chance that US medium-term potential growth has been damaged. Economic policy uncertainty has been high in 2025 which is likely to have disincentivised investment and the build of capital beyond AI. Meanwhile, a great deal of capital seems to have been absorbed by the AI sector. With the technology moving fast, some of this may be obsolete within a few years (putting aside concerns that the growth-boosting promise of AI will take longer than expected or not fully materialise). Lower immigration looks set to lower working age population growth (hindering the growth rates the US is likely to be capable of sustaining without inflation ramping up). Attacks on universities and foreign student restrictions might limit future US technological and scientific breakthroughs. Worries about US checks and balances as more power is concentrated in the executive may also raise the premium on US debt, making it more expensive for US firms to borrow (against a backdrop of high government borrowing).

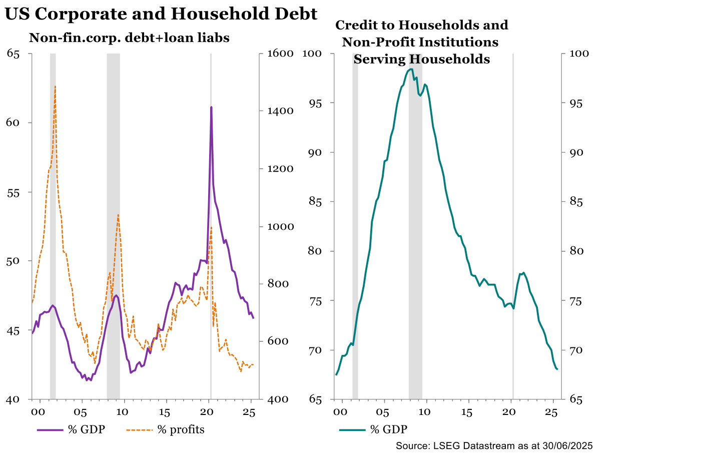
Box: Crypto and stablecoin exposure and linkages: When thinking about the US consumer and wealth effects, the focus tends to be on the housing market and equities. However, digital currencies are now widely enough held (and so volatile) that it is worth considering their potential impact too. 2024 survey data from the Pew Research Centre found that 17% of US adults said they had ever invested in, traded or used a crypto currency, although only 61% of those said they still held any. A 2023 NBER working paper estimated significant spillover effects on the real economy with a household marginal propensity to consume out of crypto that is bigger than that for equities, with the authors finding a link to house prices where households use crypto gains for a number of things, but including housing purchases. One to keep on the radar.

Chart 17: Mixed and multi-speed



Source: LSEG Datastream, BEA, S&P Global, ISM, US Census Bureau. Data to Q2 2025 (IT fixed investment), August 2025 (building permits), November 2025 (ISMs), December 2025 (PMI).

Chart 18: Lowering recession risk: Healthier leverage



Source: LSEG Datastream, BEA, Federal Reserve, BIS. Data to Q2 2025

China: Easing risks, but tough path ahead

The Chinese economy continues to look relatively resilient against the sharp challenge posed by US trade relations. However, the domestically driven part of the economy continues to provide cause for concern. Without more policy support for that part of the economy, doubts are likely to linger around the outlook. Meanwhile, trade relations – including beyond the US – provide a source of risk, as do longstanding issues around demography.

Status update: Still not looking strong

China's activity indicators have been mixed against a backdrop of higher and changeable US tariff rates. Q3 GDP growth was stronger than expected at 1.1% quarter-on-quarter and 4.8% year-on-year. So far, weak exports to the US have mostly been met by stronger exports elsewhere (Chart 11). Still, the PMI business surveys have been pointing to subdued activity growth and domestic demand growth indicators remain soft: consumer confidence remains weak, retail sales growth still looks relatively weak and growth in fixed asset investment moved negative year-to-date at the end of Q3 (Chart 19). CPI inflation has been weak.

Less risk for the near-term, but worried about the medium-to-longer term

Domestic economy falling short: Domestic demand data has underwhelmed in recent months. It is difficult to get a reliable picture on the state of the labour market, but that may be adding to the narrative. Official statistics suggest a relatively stable unemployment rate at not particularly elevated levels. The PMI business surveys, however, look consistent with falling employment (Chart 20). Before the series was discontinued, Chinese data was suggesting a particular problem with youth unemployment.

Policy support: More of a short-term boost to come? Despite weak domestic demand, much of the focus from Chinese policymakers has remained on the supply rather than demand side of the economy and the anti-involution campaign, while trying to curb price wars, may be contributing to the slump in fixed investment. Efforts to help alleviate financial problems in local governments (local government debt swap) and interventions in the property sector more broadly should be helpful medium-term though, and there have been some short-term demand boosting schemes (e.g. the trade-in scheme). More fiscal support is expected to come through in the next calendar year. Although industrial policy is likely to remain a key focus for policymakers, boosting consumption at least appears to be an aim of the next five-year plan as is social security reform. Comprehensive reform of China's social security safety net, should that ever occur, could transform Chinese saving and spending habits. Given experience so far, it seems unlikely that we will get much easing from the People's Bank of China (PBoC), although they retained an easing bias in Q3 ("moderately loose" policy stance).

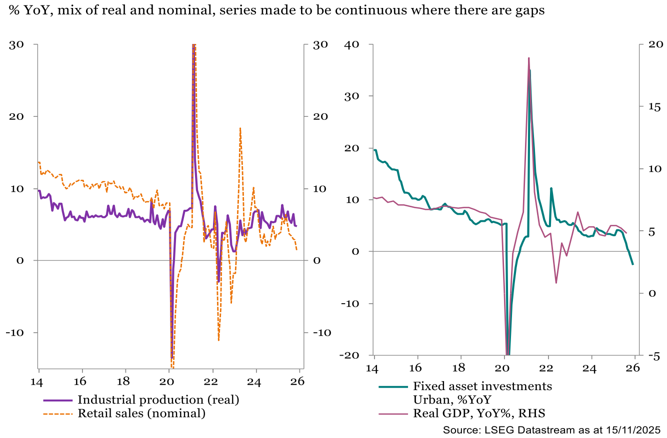
Long-term challenges remain substantial: Medium-to long-term challenges facing China still include population ageing. China's falling working age population is a key reason to expect overall GDP to steadily trend lower in coming years. China's stance toward Taiwan continues remains a concern too, should escalation there lead to a broad deterioration in China's relationships with other trading partners. It also remains a flashpoint for China's relations with the rest of the world, as seen in the deterioration of China-Japan relations in November after Japanese Prime Minister Sanae Takaichi's comments on Taiwan.

Trade vulnerability?

Domestic demand continues to look insufficient to mop up industrial supply, with symptoms including low inflation, youth unemployment problems and a high household savings rate. However, the external environment seems at least temporarily less hostile. The US instigated a further 90-day pause on higher rates of China tariffs in August and after US President Trump and China's President Xi met in late October on the sidelines of the APEC meeting a 'deal' between the two saw a US tariff reduction and saw China pause rare earths export controls. It is not clear, however, how 'still' the trade environment will stand, where the degree of escalation and de-escalation of US-China trade tensions and tariffs has been dizzying. There are plenty of sources of potential tension between the two economies and things could as easily worsen as de-escalate further next year.

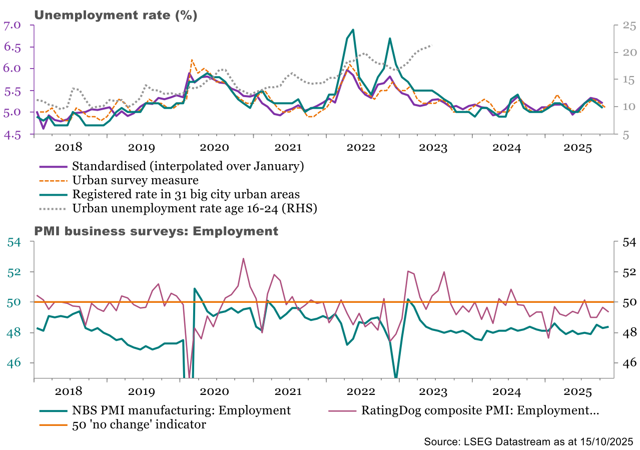
China, so far at least, also appears to have seen a pick-up in exports to non-US destinations to help compensate for a deterioration in exports to the US (Chart 11). This may, however, result in tensions with other economies. The FT, for example, reported that EU imports of China clothing and textiles rose 20% in value and volume in H1 2025 compared to the same time the previous year, with Europe's textile body reporting them as "behaving in a very aggressive way to sell in Europe". Although an aggressive expansion of exports into Europe could be good news for consumers in the form of lower prices, that won't be the case for competing European producers. China risks an increase in broader trade tensions by going down this path.

Chart 19: Data disappointments



Source: LSEG Datastream, NBS. Data is to November 2025 except GDP which is to Q3 2025.

Chart 20: Survey data suggests a weak employment picture



Source: LSEG Datastream, China Ministry of Human Resources and Social Security, NBS, S&P Global. Data to October 2025 except youth unemployment (to June 2023) and PMIs (to November 2025).

Euro area: In the balance

The euro area economy has surprised on the upside a little this year, despite the external challenges thrown at it. Monetary policy easing has likely helped somewhat, alongside hopes of more fiscal support. The consumer and fiscal policy look likely to support the euro area outlook in 2026. Inflation dynamics may support perhaps one more rate cut from the ECB, but there are risks to the outlook on both sides with challenges including trade relations, regional politics, demographics and a still unmet need for further reform in order to make the euro area a more interconnected and dynamic economy.

Status update: Not bad

GDP grew 0.6% quarter-on-quarter in Q1, boosted by net trade, then 0.1% quarter-on-quarter in Q2 and a stronger than expected at 0.3% quarter-on-quarter in Q3. Somewhat stronger growth than seen on average in Q2 and Q3 is expected by forecasters over 2026 bolstered by fiscal policy. The composite PMI business survey indicator remained above the 50 'no growth' level over the whole of 2025. At 51.9 in December 2025, it was pointing to modest rather than strong positive private sector activity growth. But that comes despite continued challenges for the manufacturing sector as exporters contend with higher US tariffs, competition from China and a stronger euro. The unemployment rate remains close to its lows and credit demand has improved in 2025.

Mixed feelings

My central case is for modest positive GDP growth. There remain a number of supportive factors for the euro area growth outlook, but enough challenges to stop me being too optimistic. Two of the most supportive elements of the outlook are the consumer and fiscal policy in my view:

- **Euro area fiscal policy** should move from a drag to a support for growth albeit a moderate one (Chart 21), largely reflecting German fiscal spending following debt brake reform that allowed for more infrastructure and defence spending and with expectations of more defence spending across Europe. However, developments in Germany need watching. That includes signs of political instability and threats to the position of Chancellor Friedrich Merz who led the reform. The German government faces a shortfall to achieve its net borrowing targets. While spending restrictions have effectively been eased for infrastructure and defence spending, other types of spending for now face relatively tight rules. A commission of experts was commissioned to look at broader debt brake reform that met for the first time in September; a cornerstone of German fiscal prudence, it may be difficult to agree further reform. The Germany fiscal restraint theme might be at threat of revival.
- **The consumer** remains potential support for the euro area growth outlook. Real pay growth has been positive for much of the year. Labour force growth has been strong in the post-pandemic period. The household savings rate remains well above pre-pandemic norms. Lower short-term interest rates should be disincentivising saving and encouraging spending. More generally, a less uncertain global backdrop would likely help consumers spend more/save less. The EU-US trade deal might do something to help here, but likely held back by memories of jumps in bills and prices post-pandemic (supporting precautionary savings) let alone war on Europe's Eastern flank. It is encouraging that mortgage lending has picked up alongside household fixed investment Chart 22 though.

Trade certainties and challenges: The EU-US trade deal and 15% import tariff for the EU provides at least some certainty over trade relations (for now). China trade redirection may prompt a wider response from the EU and lead to a ramping up of trade tensions, however. In October, the EU imposed a 50% steel tariff above tighter new quota levels, partly in response to cheap imports from China (but hitting the UK in particular). The industrial sector faces challenges, especially the important German autos sector, exacerbated by the Trump tariffs.

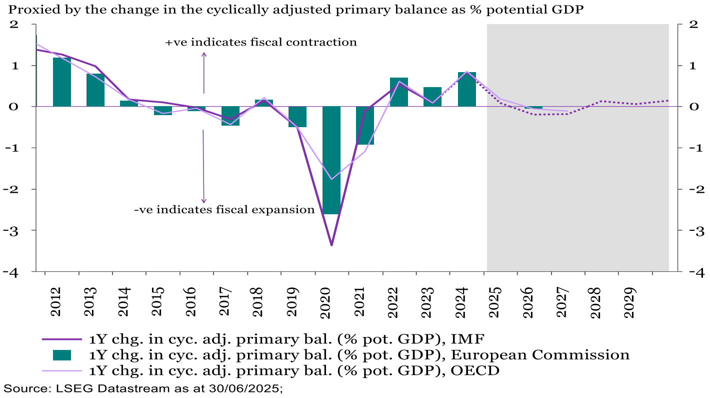
Local politics: French politics remain in focus and are likely to remain a source of uncertainty against the current makeup of parliament and deep policy divisions between parties. The size of the French deficit remains significant and collective political will to seriously address it looks limited.

Longer-term challenges still include adverse demographic trends, incomplete capital markets union and a lack of harmonised regulation in some areas across the region.

ECB: Done?

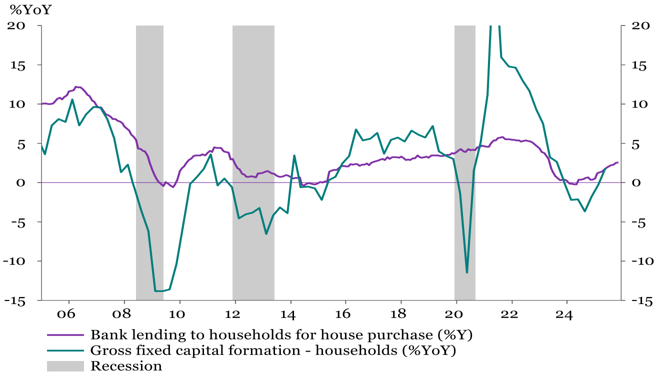
ECB policy rates are now around neutral on both my own and ECB estimates. I continue to think there is a good chance of a further cut from the ECB (even if not central case) with my forecast for inflation set to fall below 2.0% year-on-year early in 2026, with a potential disinflationary impulse from China playing a role. Underlying inflation dynamics look relatively subdued to me – at least compared to the likes of the UK – and the ECB might take a small step into accommodative territory to try and bring their forecast inflation trajectory back on track at some point in 2026. For now, the ECB sounds comfortable with rates as they are and my central case is for rates to stay where they are over the next 12 months.

Chart 21: Euro area: Fiscal drag to fiscal support



Source: LSEG Datastream, IMF (last updated October 2025); EU Commission (November 2025) and OECD (December 2025).

Chart 22: More life in housing?



Source: LSEG Datastream, ECB, Eurostat. Data to October 2025 (lending); Q2 2025 (GFCF)

United Kingdom: Overly pessimistic?

Sentiment around the UK economy has felt overly gloomy of late. The UK continues to face significant challenges, but the data hasn't been awful. The November Budget was not a pro-growth Budget but did backload most of the (widely expected) additional tax hikes. Inflation remains elevated, but there are good reasons to expect it to fall significantly in 2026 (including on some direct government measures announced before and alongside the Budget) and further rate cuts still look plausible to me as inflation worries likely ease.

Status update: Not awful

Much of the UK data could be summed up by 'not great, but not awful either'. UK GDP growth was a stronger than expected 0.7% quarter-on-quarter in Q1, then a stronger than expected 0.3%Q in Q2 but a weaker than expected 0.1%Q in Q3 with monthly figures leaving GDP at risk of falling slightly in Q4. The PMIs have been signalling modest positive private sector activity growth in H2 though. Worries about this year's Budget and the impact of the previous Budget (employer National Insurance tax hikes) may have been dragging on activity and sentiment this year and there were disruptions visible in some of the Q3/Q4 data reflecting shutdowns at JLR (Jaguar Land Rover) on the back of late-August's damaging cyber-attack. Meanwhile, labour market indicators broadly remain soft in the UK and many have been that way since the 2024 Budget.

Overly pessimistic?

The UK economy continues to face a challenging backdrop. Fiscal pressures are significant, resulting in the government announcing further tax increases at the Budget in late November. It has been easy to present a gloomy case for the UK economy given the soft jobs market, headlines around 'fiscal black holes', persistent inflation, and a BoE that, for much of the period since the summer, sounded hesitant to cut rates further. But, including in light of 'not awful' data, it is worth asking if the pessimism is overdone.

On the upside, UK households are saving more out of income than they did pre-pandemic, which could translate into spending power if confidence improves, and rate cuts reduce the incentive to save. The UK-US trade deal looks relatively favourable in hindsight. There has been a push by the government to increase public investment and ease planning constraints which should be at least somewhat beneficial to the economy in the medium-to longer term. There are more noises being made too about a closer trading relationship with the EU. In the longer term, as a services-heavy economy with a strong business services sector, it *might* even be that UK activity growth ends up receiving more of a boost than some from AI. Nearer term, just being past the uncertainty of the Budget might prove a positive.

Constraints: The state of the UK labour market and limited scope for policy support help keep my forecasts for the UK growth outlook contained:

- UK labour market metrics are still soft (Chart 23). Looking across PMI surveys, employment is one of main metrics where the UK really stands out negatively from other major economies. Last year's tax measures, other increases in the cost of hiring, the impact of US tariffs on global activity and the explosion of AI don't form a favourable hiring backdrop. Real pay growth has also slowed.
- The fiscal policy backdrop is tightening gradually in the UK, though additional near-term implications from the November Budget don't look set to be particularly significant with the main tax changes backloaded beyond the next couple of years. The Budget also saw a welcome more than doubling of the headroom the Chancellor has before the main fiscal rule is broken. However, the sensitivity to underlying variables like nominal growth and bond yields is such that it wouldn't be that much of a surprise to see the Chancellor back asking for more in the next couple of years.
- For now, sticky UK services inflation constrains the likelihood of the Bank further supporting UK activity growth via significant rate cuts.

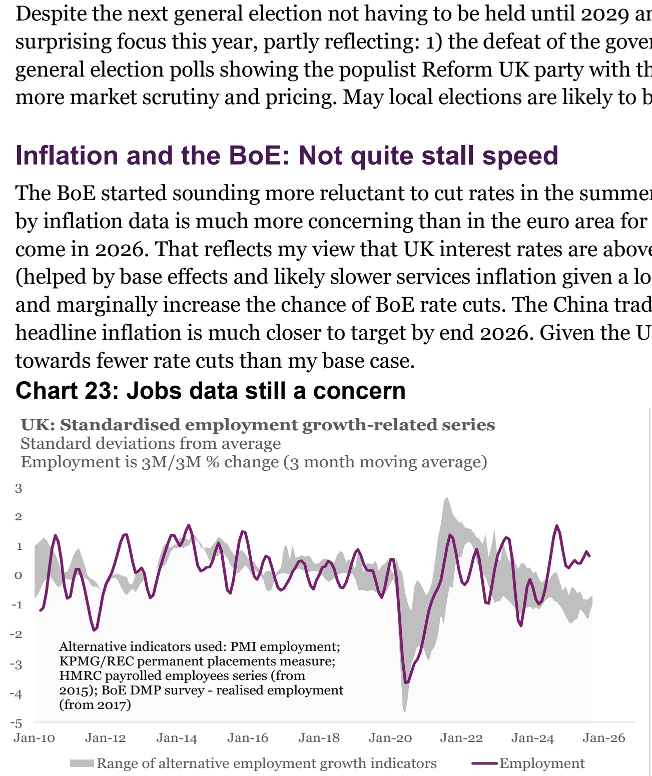
More of a political premium?

Despite the next general election not having to be held until 2029 and the current government's sizeable parliamentary majority, politics have been a surprising focus this year, partly reflecting: 1) the defeat of the government on their welfare reforms in the summer after an internal rebellion and 2) general election polls showing the populist Reform UK party with the largest share of the vote. Should polls remain as they are, their fiscal policies may see more market scrutiny and pricing. May local elections are likely to be a focal point for UK politics in 2026 given the state of the polls.

Inflation and the BoE: Not quite stall speed

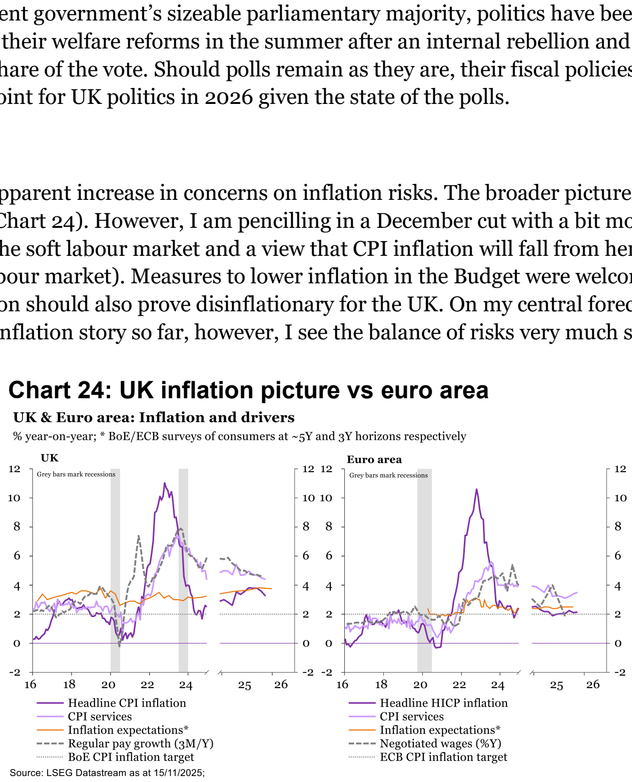
The BoE started sounding more reluctant to cut rates in the summer with an apparent increase in concerns on inflation risks. The broader picture painted by inflation data is much more concerning than in the euro area for example (Chart 24). However, I am pencilling in a December cut with a bit more to come in 2026. That reflects my view that UK interest rates are above neutral, the soft labour market and a view that CPI inflation will fall from here (helped by base effects and likely slower services inflation given a loosening labour market). Measures to lower inflation in the Budget were welcome too and marginally increase the chance of BoE rate cuts. The China trade redirection should also prove disinflationary for the UK. On my central forecast, headline inflation is much closer to target by end 2026. Given the UK's sticky inflation story so far, however, I see the balance of risks very much skewed towards fewer rate cuts than my base case.

Chart 23: Jobs data still a concern



Source: LSEG Datastream; BoE, S&P Global, S&P Global, KPMG/REC, ONS/HMRC. Survey data (grey area) to October 2025. Official employment series to August 2025.

Chart 24: UK inflation picture vs euro area



Source: LSEG Datastream, ONS, BoE, ECB, Eurostat. UK data to November 2025 except inflation expectations (Q3) and pay growth (October 2025). Euro area data to November 2025 except wages (Q3) and inflation expectations (October).

Japan: Still gradual and careful

Political change has brought more uncertainty into the BoJ rate profile. I continue to pencil in further gradual rate hikes largely on evidence that inflation is now on a sustainably higher path than it used to be and in response to BoJ messaging. The additional fiscal stimulus package is also supportive of that view (even if there are measures being taken by the government that will temporarily lower inflation). That said, both global and domestic developments have the potential to knock any central forecast off course.

Status update: Inflation remains above target, but activity data mixed

Measures of inflation remain elevated in Japan by historical standards (Chart 25). As of October, headline CPI and both main 'core' measures of inflation remain well above pre-pandemic norms. Neither services inflation nor pay growth have slipped back to the low levels seen before the pandemic either. Supporting all that, the labour market continues to look relatively tight though the weak yen has likely helped too. The picture from activity data has remained mixed. GDP growth held up well in the first half of the year but contracted in Q3. Indicators from business surveys so far look consistent with modestly positive growth in Q4 2025 (Chart 26).

Above trend, but pockets of concern

Annual GDP growth in 2025 still looks likely to come in significantly higher than in 2024 (-0.2%). 2026 seems likely to hold up reasonably well. The economy is contending with a number of challenges, including the one posed by higher US tariff rates. However, so far, the economy has been relatively resilient, and supportive fiscal measures under new Prime Minister Takaichi should help. Japan's real GDP growth has averaged 1.1% quarter-on-quarter annualised over the last four quarters (even if it did contract in Q3). That is well above my estimate of Japan's trend real GDP growth rate, at only 0.5%. Japan's trend growth though, could be changing. A more flexible-looking labour market (e.g. through corporate reforms and changing attitudes to lifetime employment) arguably should have raised Japan's potential growth rate. Technological change can also ameliorate the impact of a falling population.

Some sectors of the economy still feel a little fragile though and there remain some significant sources of uncertainty:

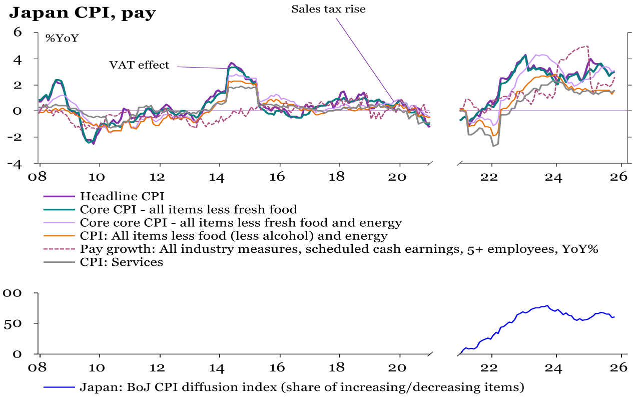
- Although the labour market continues to look relatively tight, *real* pay growth (at least based on headline labour earnings growth measures) is still negative. Consumers are not comfortable with current inflation rates. A survey conducted by the Cabinet Office over August into September 2025 found that 73% of those polled thought that the government should prioritise measures to combat rising prices (66% at the same time last year). Post-election and change in PM, however, consumer confidence has climbed and reached its ten-year average
- Data suggests that parts of Japan's economy have found the changing global trade environment challenging too. Industrial production has struggled to retain momentum this year and export growth has been soft for much of the year. Externally, uncertainty has dropped after the US and Japan agreed a trade deal in July and then after President Trump signed an executive order in September to cut tariffs on Japanese car imports from 27.5% to 15%. That clearly doesn't mean that the tariff environment won't change further but seems to have drawn something of a line under the trade relationship. That is clearly also still a fairly substantial level of tariffs on a key part of Japan's industrial sector
- Domestic politics have been unsettled this year with July's Upper House election resulting in the LDP losing its majority having already lost its majority in the Lower House. The subsequent LDP leadership election was won by Takaichi but not before the collapse of the LDP's 26-year partnership with Komeito and replacement by Ishin leaving the new (untested) coalition two seats short of a majority and potentially vulnerable to internal disagreements. Japan's external relations are also a source of risk, including Japan's relationship with China after the recent deterioration. The weak Yen might also become more of a source of tension with trading partners and competitors.

(Very) gradual rate rises

PM Takaichi is (crudely) considered pro-monetary policy stimulus and has been calling for close coordination of monetary and fiscal policy. That has helped lead to changing expectations on monetary policy, but ultimately hasn't stopped markets pricing rate hikes. At the first face-to-face meeting of Takaichi and BoJ Governor Kazuo Ueda, Takaichi said that, "it is extremely important that appropriate monetary policy management be conducted toward achieving both strong economic growth and stable price increases". Weighing this and the economic backdrop, further gradual rate hikes seem likely, though my forecast only has rates at 1.25% by end-2026.

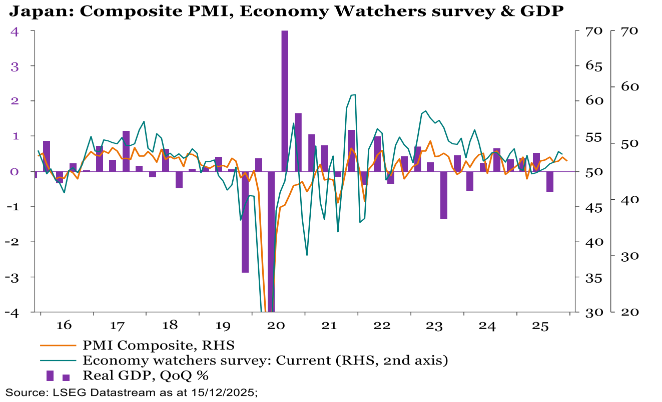
Policy settings remain accommodative. The policy rate still at very low levels and with inflation rates around 3% is keeping real rates negative. My estimate of a nominal neutral policy rate is 1.75-2%. That supports there being some upside risk to my expectations of an only very gradual rate hike path (including my forecast of only 1% by end-2026).

Chart 25: Still strong inflation (by Japan's standards)



Source: LSEG Datastream, Ministry of Internal Affairs & Communication, Ministry of Health, Labour and Welfare, Bank of Japan as of October 2025.

Chart 26: Activity trends somewhat resilient



Source: LSEG Datastream, S&P Global, Cabinet Office. Data to November 2025 (Economy Watchers), December 2025 (PMI); Q3 2025 (GDP).

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