



Economic Update

Issue #36, April 2026

Multi asset

Royal London Asset Management manages £199 billion in life insurance, pensions and third-party funds*.

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

*As of 31 December 2025

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US: As a net energy exporter, the US will be less impacted by the energy shock than others, but higher oil and gas prices will still bite for consumers. We are now expecting the Fed to keep rates on hold this year.

China: China looks positioned to weather the energy price shock well and moderate expansion in fiscal spending should be mildly supportive for growth this year.

Euro area: Prospects for the Euro area had been relatively good, but events in the Middle East pose a significant challenge to the outlook, given Europe's reliance on energy imports.

UK: With inflation above target, a softening labour market and challenging fiscal backdrop, the jump in energy prices has come at a bad time. We expect inflation to rise in 2026, bringing an "insurance" rate hike.

Japan: With additional fiscal stimulus and now an energy crisis, we continue to pencil in gradual rate hikes.

Please visit www.rlam.com for more of our views and information about our fund ranges.

Energy shock hits outlook

The Iran conflict has injected a substantial amount of uncertainty into the outlook. Crudely, growth will be weaker than previously expected and inflation stronger. But the longer disruption persists, the more significant the impact will be on the global economy. Central banks face trade-offs between managing inflation risks and further damaging the economy. They can look through a short-lived shock but, assuming prices remain well above levels seen at the start of the year, some (very) modest policy tightening seems likely. However, just as the situation in the Middle East is very uncertain, so are the forecasts as a result.

Summary

A mixed backdrop heading into the conflict: In the build-up to the Iran conflict, activity growth appeared to be ticking along at a healthy rate. February PMIs had signalled moderate activity growth, but also relatively weak employment trends. Inflation was running above target in the US, UK and Japan. That is not the best starting point from which to contend with the expected inflationary pressures stemming from elevated energy costs and supply chain disruptions.

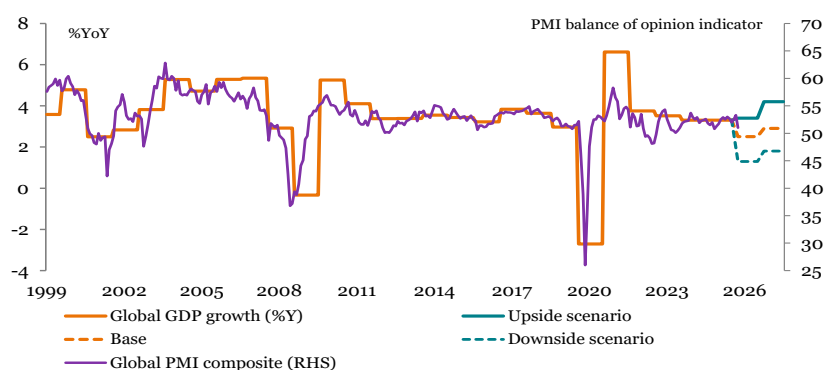
Higher inflation and lower growth: Our central case builds in a gradually declining profile for energy prices from an April peak towards 70-75 US dollars a barrel by year-end that roughly matches the market-implied path in late March. Growth is lower and inflation higher in 2026 than in our previous forecasts. As a net oil exporter, US growth is expected to be less impacted than other economies. As net oil and gas importers, we pencil in bigger impacts on economic growth in the UK and euro area. Inflation looks set to be significantly higher across most major economies.

Central banks pause the cuts: Any central case could easily be knocked off course depending how the crisis evolves and how it feeds into financial conditions, broader prices and inflation expectations. In our central case, we expect the US Federal Reserve (Fed) to keep rates on hold through 2026. In the euro area, we now pencil in two rate hikes but have the European Central Bank (ECB) cutting back to 2% in 2027. We are pencilling in a Bank of England (BoE) "insurance" hike in 2026 but expect to see rate cuts resuming in 2027 on the assumption of weaker outcomes for activity and the labour market.

Recession risk increased but not pencilled into our central case: We do not have recessions pencilled into our central forecast but do assume several economies at least skirt the edges of a technical recession. The outlook for growth and inflation depends largely on the duration of the war and any lasting damage to global supply chains. A prolonged conflict and sustained damage to energy infrastructure, accompanied by broader supply chain disruptions in the Middle East, could see economies pushed into a moderate recession in the second of half of the year.

The **multi asset team** has been running reduced levels of risk in light of the Iran crisis and higher levels of volatility seen in financial markets. The team has been overweight commodities and modestly underweight European equities and the US dollar. For more, see the [Our Views](#) section at www.rlam.com.

Chart 1: Global growth central case: building in an energy shock



Source: IMF, S&P Global (past data); RLAM (forecasts). PMI data is to March 2026

Economic forecast summary

April 2026 base case

Region	2024			2025			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	2.1	2.8	3.75	1.9	3.4	3.75	1.9	2.2	3.50	1.8	2.3	3.50	2.0	2.4	3.50	2.1	2.4	3.50
							<i>1.9</i>	<i>2.7</i>	<i>3.50</i>	<i>2.0</i>	<i>2.4</i>	<i>3.25</i>	<i>1.7</i>	<i>2.4</i>	<i>3.50</i>	<i>2.0</i>	<i>2.5</i>	<i>3.50</i>	<i>2.0</i>	<i>2.5</i>	<i>3.50</i>
China	5.1	-	-	5.0	-	-	4.3	-	-	4.1	-	-	4.2	-	-	4.0	-	-	3.9	-	-
							<i>4.6</i>	-	-	<i>4.3</i>	-	-	<i>4.2</i>	-	-	<i>4.0</i>	-	-	<i>3.9</i>	-	-
UK	1.1	2.5	4.75	1.4	3.4	3.75	0.7	3.6	4.00	1.0	2.2	3.25	1.4	1.8	3.25	1.4	2.2	3.50	1.4	2.2	3.75
							<i>0.9</i>	<i>2.3</i>	<i>3.25</i>	<i>1.3</i>	<i>2.1</i>	<i>3.00</i>	<i>1.3</i>	<i>2.2</i>	<i>3.25</i>	<i>1.5</i>	<i>2.3</i>	<i>3.25</i>	<i>1.5</i>	<i>2.2</i>	<i>3.50</i>
Euro area	0.9	2.2	3.00	1.5	2.1	2.00	0.8	3.0	2.50	1.3	1.9	2.00	1.3	1.8	2.00	1.2	1.9	2.25	1.2	2.1	2.50
							<i>1.3</i>	<i>1.9</i>	<i>2.00</i>	<i>1.4</i>	<i>2.0</i>	<i>2.00</i>	<i>1.2</i>	<i>2.1</i>	<i>2.00</i>	<i>1.1</i>	<i>2.0</i>	<i>2.25</i>	<i>1.1</i>	<i>2.2</i>	<i>2.25</i>
Japan	-0.2	2.9	0.25	1.2	2.7	0.75	0.8	1.9	1.25	0.9	1.9	1.50	0.7	1.8	1.50	0.6	1.9	1.75	0.5	1.9	1.75
							<i>0.9</i>	<i>1.7</i>	<i>1.25</i>	<i>1.1</i>	<i>2.0</i>	<i>1.50</i>	<i>0.7</i>	<i>1.9</i>	<i>1.50</i>	<i>0.6</i>	<i>1.9</i>	<i>1.50</i>	<i>0.5</i>	<i>2.0</i>	<i>1.50</i>
Global	3.1	-	-	3.1	-	-	2.5	-	-	2.9	-	-	3.3	-	-	3.0	-	-	2.8	-	-
							<i>3.0</i>	-	-	<i>3.1</i>	-	-	<i>3.0</i>	-	-	<i>3.0</i>	-	-	<i>2.8</i>	-	-

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 December 2025 forecast update are in grey and italics. 2024 and 2025 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

Our central forecast is conditioned on oil prices peaking at above \$100 per barrel in April 2026, before falling and then steadying at around \$75 per barrel by year end and for the remainder of the forecast horizon (Chart 3). The outlook for energy prices remains highly uncertain.

- Our central case forecasts anticipate a jump in 2026 inflation across all major economies, reflecting the steep increase in energy prices since the start of the Middle East conflict. The BoE and ECB are expected to increase rates slightly in 2026 to help contain potential second-round effects and the Bank of Japan (BoJ) to adhere to a policy tightening path. Beyond 2026, we would expect the ECB and BoE to cut rates as inflation subsides and growth softens. We assume the Fed keeps rates on hold throughout 2026, with a cut in 2027 as inflation risks fade. Our estimate of medium-term neutral rates helps anchor the rate forecast in the medium-term (3.50% for the Fed, 3.75% for the BoE and 2.50% for the ECB).
- Sharper than expected downturns and more unemployment would see deeper rate cuts than in the base case. Higher than expected inflation and second-round effects (particularly core, services inflation and, relatedly, pay growth), would likely mean sharper rate rises.
- Fiscal policy was already set to be supportive in 2026 in the US, euro area and Japan. Fiscal policy in response to elevated energy prices could also support growth and partly shield households. In the euro area, defence and infrastructure spending is likely to boost growth. In the US, fiscal policy looks set to be growth supportive in 2026 as disposable income is bolstered by the OBBBA and businesses potentially benefit from tariff refunds.

Global economic scenarios (Chart 1)

Upside scenario (20% probability): Energy prices fall back quickly

- Energy prices fall back more quickly than assumed in the base case and without sustained and significant disruption to supply chains. Higher inflation in the near-term shows fewer signs of leading to second round effects than in the base case. Central banks look through the supply shock and the Federal Reserve and BoE resume rate cuts after a pause.
- US GDP growth surprises on the upside, helped by robust capex (supported by tax measures, AI and deregulation). AI adoption steps up and productivity rises beyond just the US, but the technology does not lead to significant net job losses over the forecast horizon. China's policy efforts see GDP growth stabilise rather than drifting lower over the next few years.
- Headline inflation runs somewhat below the central case over much of the forecast, reflecting higher productivity growth.

Base case (60%): Growth slows; "insurance" rate hikes as energy prices remain elevated

- Elevated oil and gas prices lead to higher inflation and lower growth in 2026, and somewhat tighter monetary policy than previously expected.
- Fiscal policy supports activity in some economies, as does past monetary policy easing. Real consumer spending gets some support from government cost-of-living measures. Uncertainty and higher energy prices weigh on business investment, but tech-related investment remains a support in the central case.
- Domestically driven inflation pressures ease and base effects weigh on inflation in some cases, but that is more than offset in the current year by the impact of higher energy prices. Interest rates are raised slightly in the euro area, UK and Japan despite risks to economic growth.

Downside scenario (20%): Energy shock bigger and more persistent; recessions

- Energy prices rise higher for longer than in the base case with widespread disruption to supply chains. Shortages result in output disruptions. Higher inflation shows more signs of leading to second round effects than in the base case. Central banks hike rates more than in the base case and recessions follow.
- Uncertainty alongside higher prices, tighter policy settings and market downturns weigh heavily on hiring and real global growth, although healthy balance sheets temper the risks of more substantial recessions.
- Inflation falls more sharply than in the central case beyond 2026 on weaker labour markets and sees substantial rate cuts.

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: Recession risks rise again

Having proven more resilient than expected in 2025, global growth is likely to slow significantly in 2026 on higher energy prices, supply chain disruption and central banks keeping policies tighter than they would have done. However, any central forecast – including this one – needs to at least pencil in a path for energy prices and that remains highly uncertain. The global economy looks set to at least briefly skirt recessionary levels. Fiscal policy and AI-related investments can provide some offset, but uncertainty around the global outlook is itself likely to weigh on activity. For now, the forecast assumes that second-round price effects are relatively contained and that central banks raise rates once or twice (insurance hikes) where they raise rates at all. There are clearly strong upside and downside risks to the central case depending how the conflict evolves.

Solid start to the year... in the process of deteriorating

In the build-up to the Iran conflict, activity growth appeared to be ticking along at a healthy rate and had seen some recent improvement judging by the PMIs (Chart 2). Looking at the March global PMI, the composite index fell to an 11-month low. The global PMI however, had also picked up relatively weak employment trends and soft labour markets had become talking points in both the US and UK. The impact on inflation has been immediate through petrol and diesel prices at the pump, though temporary subsidies will help contain the near-term jump in some economies (e.g. in Italy and Japan).

Summary outlook: Overcast

Rising energy prices look set to weigh significantly on global activity in 2026. At the time of writing, oil and gas prices are some 50% above levels seen in mid-February (Chart 3). Extrapolating [IMF analysis](#) shows that the rough scale of increase could hit global GDP by around 0.5%-1.0% if sustained. The impact will differ across economies in the following way:

- **US:** as a substantial oil producer, the effect on US activity may be more modest. [Fed analysis](#) from 2024 indicates the total hit to GDP in 2026 could be 0.2%, if those levels of energy prices were sustained.
- **Euro area:** as a significant natural gas importer, the euro area is particularly exposed to the recent rise in oil and gas prices. If energy prices roughly match the increase above, the impact on GDP growth could be roughly 0.3%, based on [ECB analysis](#).
- **UK:** the UK may be worse hit, given its reliance on natural gas. Based on [BoE analysis](#), the hit to GDP could be as large as 0.5%. This is consistent with recent OECD forecasts, which have downgraded their estimate for GDP growth in 2026 by 0.5 percentage points (pp).

The conflict in the Middle East poses significant challenges and uncertainty for economic growth, but we have not assumed recessions in the central case. The estimates above likely to be overestimates if oil and gas prices decline over the coming months. However, these studies won't also build in broader supply chain disruptions resulting from the Strait of Hormuz for example.

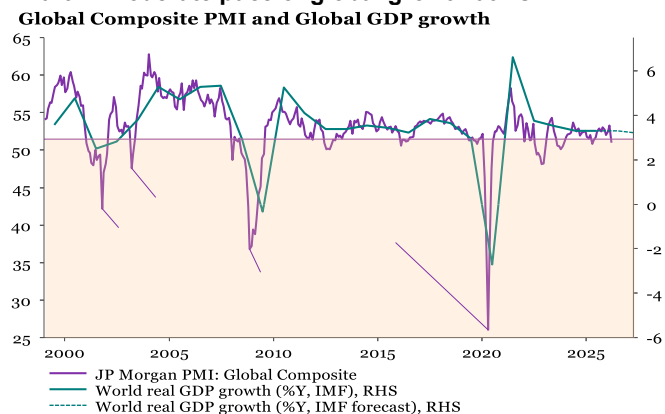
Clearly, though, the conflict in the Middle East remains in flux, and worse outcomes are possible. Prolonged disruption to shipping through the Strait of Hormuz, broader supply disruptions and long-term damage to energy infrastructure could all worsen the outlook for growth. Strong price and supply impacts on some refined products are already visible, as are impacts on commodities beyond energy. Concerns also exist on the availability of fertiliser, which may see future problems for food availability. The ECB have modelled a severe scenario in which 60% of oil and LNG flows through the Strait of Hormuz are disrupted, and energy infrastructure damage limits supply capacity; oil prices peak at \$145/pb, before declining but remaining relatively elevated. In this scenario, euro area GDP enters a technical recession with GDP 0.8% lower in 2026 than in the pre-conflict baseline.

There are several sources that could provide some offsetting support though:

- 1) Some governments are already using fiscal policy to mitigate the damage to consumers and the economy from higher energy and fuel costs e.g. fuel subsidies. More seems likely the longer the conflict and its impacts persist.
- 2) Fiscal policy had already started to become more supportive in a number of major economies, albeit not uniformly. German fiscal loosening should be more of a boost to GDP growth in 2026 than in 2025, given the lags involved in infrastructure and defence spending. Looking at the US, fiscal policy changes from the "One Big Beautiful Bill" and tariff refunds look set to have a more positive effect on GDP growth in 2026.
- 3) Private sector balance sheets continue to look relatively robust which could limit the impact of the conflict on businesses.
- 4) Household real pay growth was positive pre-conflict in the US and euro area (Chart 4), consumer savings rates are high in Europe (which could provide a shield for some) and household leverage is relatively low (pre-conflict soft labour markets and confidence are weak spots though).
- 5) Strong AI investment looks set to continue into 2026, despite the softer outlook.

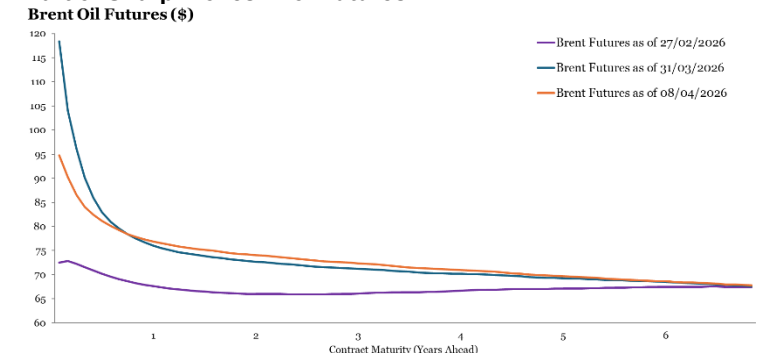
Higher inflation and tighter monetary policy than previously expected: We expect inflation to rise significantly in 2026, led by higher energy inflation (Chart 5). Partial offsets include labour market slack helping to keep wage growth contained. AI should ultimately lower inflation, but this is likely to be more of a medium-term factor. Central banks seem likely to keep monetary policy tighter than they would have done otherwise with the high-inflation experience of 2022 fresh in their minds.

Chart 2: Moderate pace of global growth at risk



Source: LSEG Datastream; IMF, S&P Global. PMI data is to March 2026. IMF series was updated in October 2025.

Chart 3: Sharp moves in oil futures

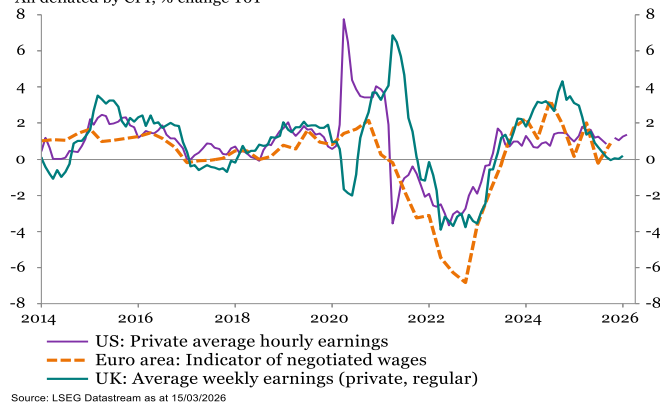


Source: Bloomberg data. Data last updated 08/04/2026

Chart 4: Positive pre-conflict real pay growth

Selected real pay growth measures

All deflated by CPI; % change YoY

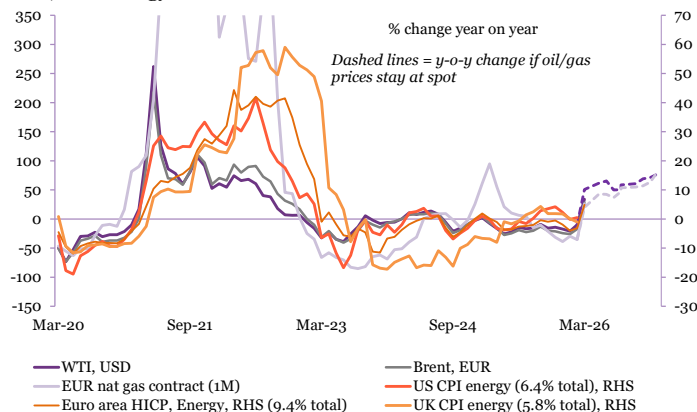


Source: LSEG Datastream as at 15/03/2026

Source: LSEG Datastream, BLS, ONS, ECB, Eurostat. Data is to February 2026 (US), January 2026 (UK), Q4 2025 (Euro area).

Chart 5: Energy prices expected to feed through

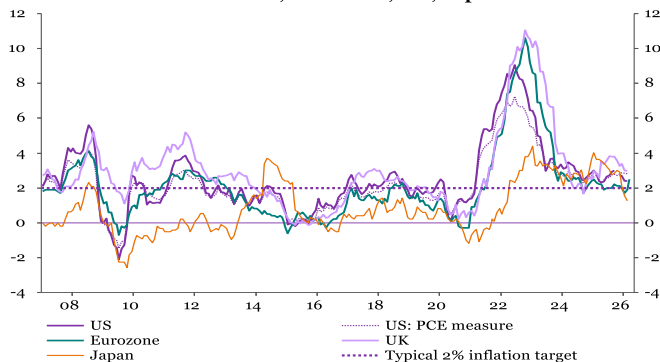
Oil, CPI (energy) and base effects



Source: LSEG Datastream, ONS, Eurostat. Spot energy prices to 30 March 2026. CPI figures to February 2026 (except Euro area which are to March 2026)

Chart 6: Inflation in the process of jumping (ex-Japan)

Headline CPI Inflation: US, Euro area, UK, Japan



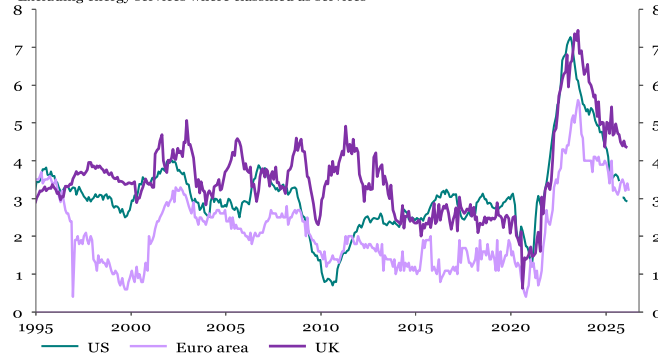
Source: LSEG Datastream as at 15/02/2026;

Source: LSEG Datastream, BLS, Eurostat, ONS, Japan Statistics Bureau. Data as at March 2026 (Euro area), February 2026 (US, Japan, UK).

Chart 7: Services inflation still high

CPI: Services (%YoY)

Excluding energy services where classified as services



Source: LSEG Datastream as at 15/02/2026;

Source: LSEG Datastream, ONS, BLS, Eurostat. Data as at March 2026 (Euro area), February 2026 (US, UK).

Inflation outlook: Higher in the near term

Prior to the war in the Middle East, inflation was already above target in the US, UK and Japan (Chart 6) and services inflation was relatively elevated (Chart 7). Now economies will need to contend with unexpected inflationary pressures stemming from elevated energy costs and supply chain disruptions. Despite looser labour markets (Chart 8), risks of pass-through into broader prices, inflation expectations (Chart 9) and wages are higher than they would be if we hadn't all gotten used to higher inflation in the post-pandemic period. We have revised up our base case for inflation across the board in 2026, pencilling in some modest second round effects (with risks of these skewed towards being larger). Using futures market pricing for oil and gas prices as a guide we haven't pencilled in sustained inflation into 2027 and beyond.

US: In the US, headline inflation has remained above target for five years. Tighter immigration policy is likely to restrain labour supply, and the effects of tariffs are still feeding through to prices. Against this backdrop, the recent increase in oil and gas prices is expected to add upward pressure to inflation; extrapolating [Fed research](#), the increase in energy prices seen at the time of writing could push inflation up by a further 0.8pp.

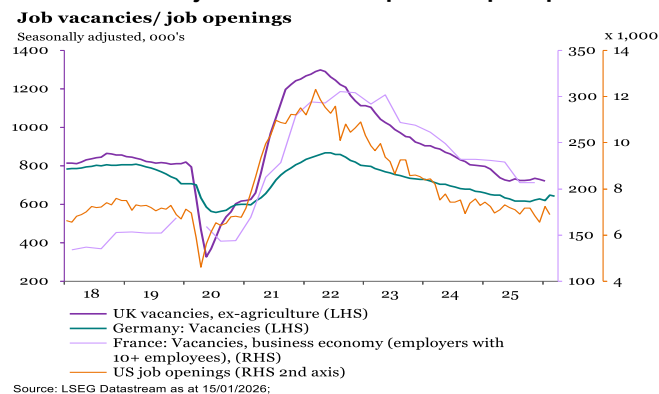
Euro area: Heading into the conflict, the euro area was, in the words of ECB President Christine Lagarde, "in a good place". Inflation was broadly at the 2% target and expected to stay there. However, the sharp rise in oil and gas prices is expected to drive inflation higher in the coming months. Based on information to March 11th, the ECB revised up its inflation forecast by 0.7pp to 2.6%yoy in 2026. In the [ECB's severe scenario](#), involving sustained damage to energy infrastructure in the Middle East, inflation rises to 4.4% in 2026 and 4.8% in 2027. Our central forecast falls between these two figures.

UK: The UK labour market continued to loosen and pay indicators were cooling in the build-up to the conflict. That should help limit the pass-through of higher energy prices into broader prices and wage growth. However, we are reluctant to build in too much optimism given the UK's recent history of elevated inflation pressure. The BoE expected inflation to fall to 2.0% year-on-year in Q3 2026 pre-conflict but March staff projections indicated CPI could rise to 3 1/2 % year-on-year in Q3. The effect on medium-term inflation (which the BoE will consider when setting the stance of monetary policy) will depend on the second-round pass-through of energy prices to wage and price setting. Inflation expectations had remained stubbornly high in the UK (Chart 9). Building in some second-round effects and using some model-based estimates of the impact on CPI over the next 12 months, our central CPI forecast moves a bit above this initial BoE estimate. This could easily prove an under or over-estimate given uncertainty around pass-through in the UK (on top of uncertainty around the conflict itself).

Japan: In Japan, evidence continues to accumulate that inflation is at *sustainably* higher levels than pre-pandemic. As a net energy importer, Japan is exposed to higher oil and gas prices, which should push up inflation in the near term. However, Japan's energy efficiency has improved, the government has started releasing crude oil reserves and has implemented fuel price caps, all of which will limit the impact on inflation.

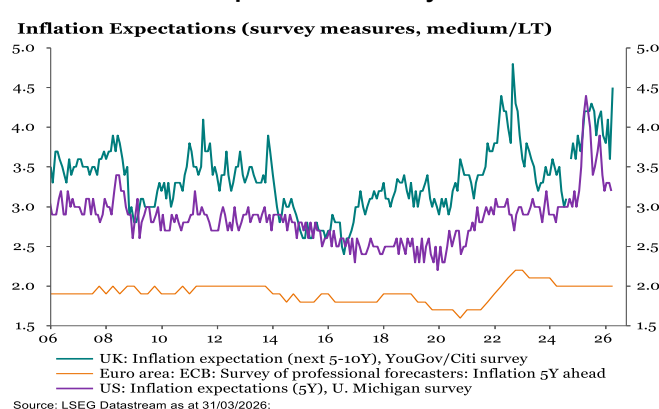
Medium-term upside risks to central forecast? Beyond the energy price shock, medium-term risks to global inflation still look skewed to the upside. We expect factors such as climate change, tighter immigration policies, and ageing populations leading to tighter labour markets to all have upward pressure on inflation in the medium-term. AI could prove a significant negative offset, however.

Chart 8: Looser job markets compared to post-pandemic



Source: LSEG Datastream, ONS, Deutsche Bundesbank, Eurostat, BLS. UK data to January 2026, US data to February 2026, France to Q4 2025, Germany to March 2026.

Chart 9: Inflation expectations survey measures



Source: LSEG Datastream, YouGov, ECB, University of Michigan. Data as of March 2026 except ECB figures which is Q1 2026.

Central bank policy: A little bit of hiking

In light of the Iran conflict, the outlook for monetary policy is in flux. Central banks will be closely monitoring the upside risks to inflation, as well as potential weakness in demand (and therefore potentially medium-term inflation), aiming to position the monetary policy stance to balance both risks. In particular, central banks will be watching closely for indications of inflation expectations become unanchored. The likely rise in inflation if the shock were to persist is sufficient to mean that – for now at least – it makes sense to pencil in one or two “insurance” rate hikes for the ECB and BoE profiles (Chart 10) and to continue expecting rate hikes in Japan. We have pencilled in a flat profile for US rates in 2026.

Insurance hikes on track if things don’t improve significantly: Inflation will rise significantly in a base case that assumes some persistence of current conditions with market-implied oil prices that do not fully return to pre-Iran-conflict norms. The high inflation of the post-pandemic period is a relatively fresh memory for consumers, firms and central bankers. Given the price level has not fallen back, things still feel “more expensive than they used to” and firms may find it easier to pass on higher costs than they used to pre-pandemic. Inflation expectations are at risk of rising.

To contain risks around inflation persistence it therefore makes sense for inflation-targeting central banks to at least consider precautionary or insurance rate rises. In the ECB’s case, it would likely be more comfortable if they felt they were sitting with slightly restrictive monetary policy (as per the US) rather than neutral policy. In the BoE’s case, inflation dynamics were stronger going into the conflict than they were in the euro area and worries around inflation persistence risks were already prominent.

Central bank signalling, as far as it goes, also supports there being a relatively good chance of rate hikes. ECB staff forecasts in March built in an inflation shock and a return to target – but that reassuring profile also built in rate hikes. Messaging from the March meeting was no longer that the bank was “in a good place”, but that it was “well positioned” to face this shock. ECB President Lagarde has said that “if the shock gives rise to a large, though not-too-persistent, overshoot of our inflation target, some measured adjustment of policy could be warranted”. On the BoE side, new medium-term forecasts won’t be published until late April, but the bank was already worried about inflation persistence risks heading into the Iran conflict. It was also notable that the four (out of nine) MPC members who had previously voted for a rate cut changed their vote to an on-hold decision in March (although one said he thought the bar to a *hike* was high).

But more substantial rate hikes look unlikely for now: Financial conditions are already tighter, doing some of the work of central banks for them. This is a supply rather than a demand shock driving prices higher – there is little central banks can really do to lower oil prices. This shock will also hit activity as well as bolster inflation leading to a trade-off for central banks: raising rates significantly now risks an inflation undershoot in the medium-term by slowing the economy and opening up labour market slack (where, for example, in the UK, the unemployment rate is already well off its lows and the US economy has been seeing tepid job generation for some time).

We could then see a return to cuts: Our forecasts currently assume that the ECB and BoE cut rates once things calm down and at least aim to get rates back to neutral. The starting point for the UK economy in particular was not a strong one and we would expect the bank to return to a gradual rate cutting path once it felt that inflation risks were significantly reduced.

The Fed seems further away from hikes, but that could change: Rate hikes look less likely in response to this energy shock in the US than they do in Europe with Federal Reserve officials indicating that policy is currently in a good place. For now, the Fed’s messaging has been pointing more towards delayed rate cuts than hikes and the median participant forecast is still for a rate cut this year. The Fed’s dual mandate also puts them in a slightly different position than the ECB and BoE. However, the Fed was already alert to upside inflation risks pre-conflict. Less immigration and more fiscal support could be domestic fundamentals that end up pushing them over the edge. The energy shock is also expected to have smaller effects on the US economy than on European economies reflecting its status as the world’s biggest oil producer.

Personnel changes are something of a wildcard, with a new Fed chair due to start in May. Kevin Warsh was expected to push for rate cuts. Still, even the Fed’s uber-dove, Stephen Miran, has rolled back some of his proposed rate cuts (albeit reflecting pre-energy shock inflation outcomes).

Medium-term anchors: Medium-term forecasts are still anchored by our estimated medium-term neutral rates: 3.50% in the US, 2.50% in the euro area, 3.75% in the UK and 2.0% in Japan.

Fiscal policy: More support

Different economies face different fiscal and political realities when it comes to support packages to mitigate the impact of higher energy prices. However, even the UK, which arguably has some of the least fiscal leeway, announced a package to help vulnerable heating oil customers in March. It would be no surprise, if energy prices stay elevated, to see a broader support package for vulnerable households and for the government to drop the Autumn increase in fuel duty.

In the **US**, retrospective provisions in Autumn 2025's fiscal bill look set to provide a boost for consumers in the first half of 2026. The Supreme Court's tariff ruling (that the existing basis for much of the tariffs was illegal) could inadvertently also provide additional fiscal support for businesses as and when refunds are granted. However, movement towards this has been slow so far and, as for future tariffs, the Trump administration continues to pursue alternative tariff avenues beyond the already announced temporary 10% global tariff.

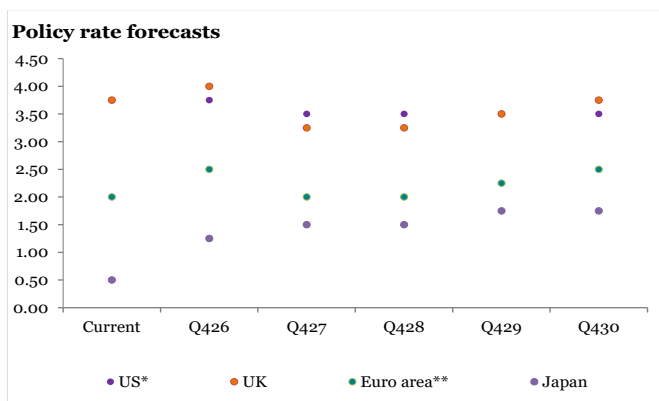
Euro area fiscal policy should move from a drag to a *moderate* support for growth, largely reflecting higher German fiscal spending. Without further debt brake reform, this boost may prove short-lived and vulnerable to shifts in German politics. Still, the Middle East crisis is likely to maintain pressure for further defence spending and energy initiatives.

UK fiscal policy looks set to drag on the outlook, but with some further short-term mitigation from energy bill support. However, we would expect any sizeable support package to be close to fiscally neutral. Funded, for example, via more windfall taxation.

In **China**, fiscal policy is likely to be deployed further, but potentially much will be in the form of delayed deployments from 2025.

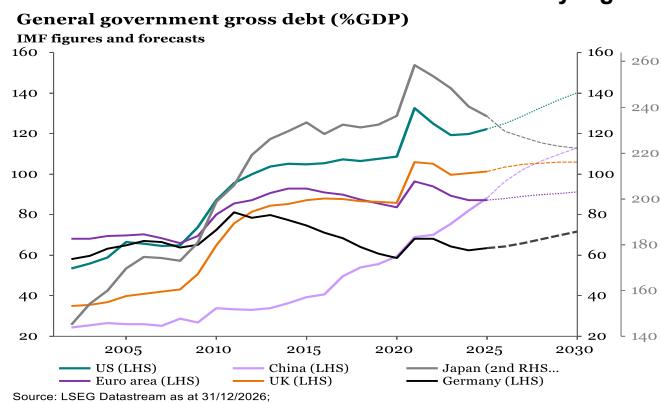
Fiscal sustainability concerns: We still worry that fiscal sustainability may become a bigger market concern, especially considering the Middle East crisis should cost-of-living initiatives meet shortfalls in revenue as growth cools. Government debt levels are already relatively high (Chart 11) and ageing populations in Europe and Asia (with their higher dependency ratios and pressures for more spending on health and pensions), leave fiscal trajectories looking even less sustainable. Economies may duly face tight market-based discipline with resulting bond market volatility.

Chart 10: Central policy rate trajectories



Source: National central banks/LSEG Datastream (past actuals). All forecasts (from Q4 2026 onwards) are RLAM estimates.

Chart 11: Government debt to GDP levels already high



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

Alternative scenarios for Middle East shock

The Iran conflict has resulted in substantial increases in oil and gas prices. Any spike in energy prices is bad news for consumers globally. However, clearly the impact of higher energy prices on overall GDP differs across countries, with oil and gas producers shielded in relative terms. More generally, the duration of hostilities, supply chain disruptions, and damage to energy infrastructure will determine the extent of the economic impact.

There are many potential adverse scenarios that may stem from a prolonged conflict, that could see more adverse growth and inflation outcomes. The following scenario outlines where, at least for a while, *both* growth and inflation outcomes are significantly worse than in our central case:

- Adverse scenario:** Extended conflict and lasting damage to oil infrastructure contribute to persistent inflationary pressures. Having recently experienced a period of high inflation, consumers and businesses display heightened sensitivity to a renewed surge in inflation. As a result, inflation expectations become de-anchored from target, leading to notable second-round effects despite shortages and higher prices pushing many economies into recession. In response to inflation risks, central banks sharply hike interest rates, however tighter monetary policy weighs on global activity, which later falls even further below trend.

It is not implausible to see more positive (or rather less negative) outcomes than our bear case:

- Swift reopening scenario:** Despite war ending swiftly and the Strait of Hormuz reopening alongside a rapid fall in crude oil prices, there is still a significant, though smaller impact on the global economy. Lasting damage to energy infrastructure in the Gulf, delays in restoring full production capacity and higher insurance premiums for oil tankers keep oil prices somewhat above pre-conflict levels for an extended period. Additionally, the disruption of fertilizer transiting through the Strait, essential for upcoming harvests, raises food prices in the near term (more than 20% of the global fertilizer supply transits through the Strait and has been disrupted over the past month). Consequently, higher-than-pre-conflict inflation levels persist beyond just a short-lived spike in March 2026. Central banks, however, maintain rates and look through the uptick in inflation rather than proceed with rate hikes.

For now, the risk of these (and other) alternative scenarios fluctuates with the various incoming headlines.

Households: Diverging savings rates and the outlook for real incomes and spending

While in the US, household savings rates have sunk back to pre-pandemic norms (even somewhat below), that is not the case for the UK or the euro area (Chart 12). That continues to represent potential European consumer spending firepower and could help cushion households from the inflation shock. However, there is a risk that European savings rates are now structurally higher, or at least sticky at high levels. The recent experience of high inflation may have raised household expectations of future high inflation episodes (unlikely to be helped by a renewed shock to energy prices). Additionally, households are sensitive to price *levels*. Even though inflation has cooled, households will still be aware that things are more expensive than they were pre-pandemic. In a world where households are worried about jumps in bills (let alone throwing AI into the mix with associated job security worries for some), it makes sense to be putting more money aside.

This doesn't feel quite sufficient to explain the divergence in savings rates though. The inflation shock in Europe was larger than the US, but US

For professional clients only, not suitable for retail clients.

households, being more exposed to equity markets, may have felt less pressure due to strong post pandemic equity returns. Cash and deposits account for 15% of US financial assets compared to 31% of EU financial assets. Possibly encouraging consumers to increase savings, ECB analysts note that real household net wealth in Europe has declined since 2022. Additionally, aging populations and higher interest rates, are among factors that could raise concerns about future tax rises, encouraging more precautionary saving.

If we can't rely on falling savings rates to boost consumer spending (Chart 13), then the outlook for real income growth is all important. In the US, the timing of last year's Trump tax cuts should be helpful and tax refunds are expected to be significantly larger this year. However, some of this could be saved rather than spent (especially considering the US' comparatively low savings rate and worries about affordability issues). Morgan Stanley for example estimates that tax refunds are likely to be around 20% larger this year. However, strong US consumer spending has reportedly been driven by high income households, who are more likely to be sensitive to equity market setbacks. These households may also prove to be more likely to worry about AI-related job insecurity. In Europe, higher inflation this year will be unhelpful for real disposable incomes and spending and helps explain why we have lowered our central case GDP forecasts (page 2).

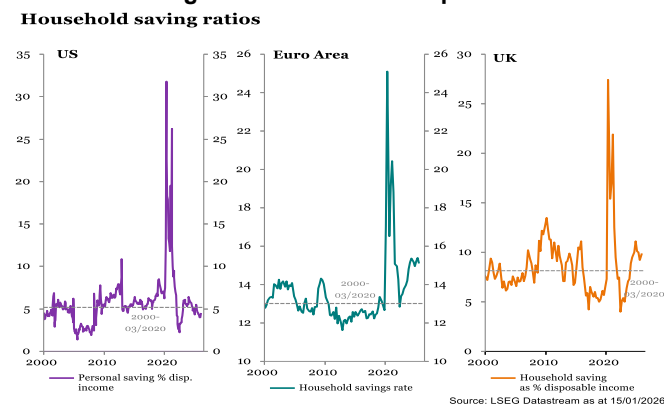
AI: Tracking the impact

One of the reasons US activity seemed to hold up well in 2025 was AI-related spending. Estimates of the impact vary and those at the upper end are exaggerated by not subtracting imports, but the impact is significant. Announcements of additional capex spend from large technology-oriented companies suggest that we will again see sizeable support to GDP growth from AI-related spending this year and there remains plenty of upside for productivity growth as AI adoption spreads.

Even as business surveys picked up at the turn of the year, employment indicators were soft (Chart 14). Some of that may be attributable to AI. Chart 15 shows in lilac the smoothed path of US job gains since the start of 2022 through to March. The green line shows the path for one of the most AI exposed sectors. We know there was over-hiring there in the pandemic, but if you pull this together with comments from business surveys, there is evidence of AI playing some role in constraining hiring (even if not significant outright layoffs). There are clearly scenarios where AI technology brings substantial labour market disruption. It is relatively easy to imagine a scenario where AI becomes a source of blame for struggling groups and where populist leaders and mainstream counterparts are increasingly pressured into taking anti-AI positions.

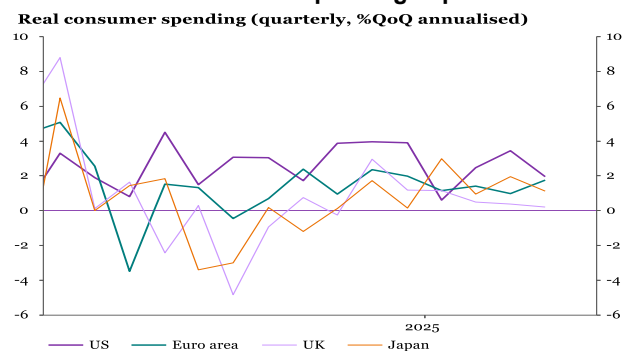
AI is a significant wildcard for the UK economic outlook; you could argue that given the importance of services and especially business services to the economy that the UK is in line to be one of the biggest 'winners' as a user of AI, with big boosts to productivity possible. However, that could also mean significant disruption to the labour market and by extension to consumer spending. It is also not clear at this stage whether the financial benefits of AI will accrue more to the users than the 'producers'.

Chart 12: Savings rate 'shield' in Europe?



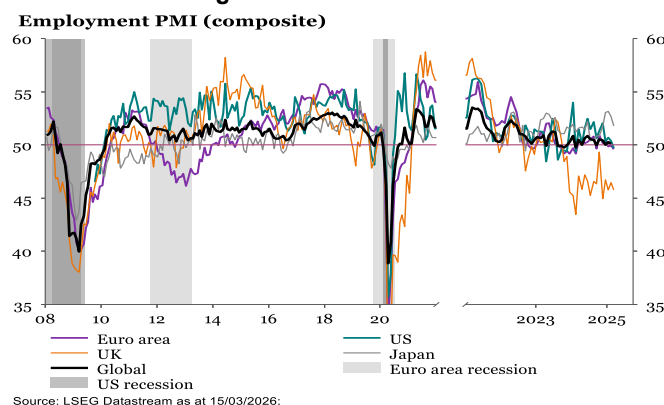
Source: LSEG Datastream BEA, Eurostat, ONS. Data to Q3 2025 (Euro area), Q4 2025 (UK) and January 2026 (US)

Chart 13: Real consumer spending in peril?



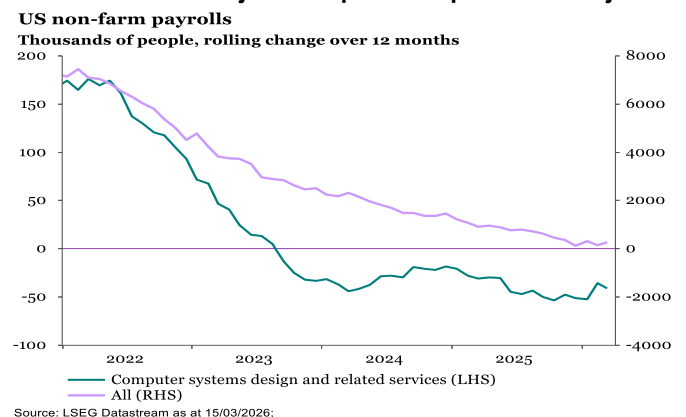
Source: LSEG Datastream, BEA, Eurostat, ONS, Japan Cabinet Office. Data as of Q4 2025

Chart 14: Softening labour markets indicators



Source: LSEG Datastream, S&P Global. Data as of March 2026

Chart 15: AI-related job disruption? Exposed sector jobs lost



Source: LSEG Datastream, BLS. Data to March 2026.

United States: Resilience and risk

US growth slowed in Q4 2025 as the government shutdown hit growth, and is likely to have done better in Q1 2026 despite events in the Middle East. However, the US economy continues to be multi-speed rather than broadly outperforming. Higher oil and gas prices will bite for consumers, but fiscal policy should be supportive for growth this year. AI is a wildcard: with large sums of planned spending, it could boost GDP growth again this year, but also brings additional risk.

Progress update: Solid start to the year

US GDP growth slowed to 0.5% in Q4 quarter-on-quarter, down from a robust 4.4% in Q3, largely due to the disruption caused by the government shutdown. The January and February PMI and ISM business surveys pointed to moderate activity growth, but deteriorated in March. The labour market showed further signs of stabilising in Q1, with March payrolls increasing sharply, albeit offsetting a large decline in February. As expected, CPI inflation jumped in March when the initial effects of the Iran conflict on energy prices took effect.

Economy likely to hold up better than many

Sources of resilience: The US is, at least on the surface, less vulnerable to oil and gas price shocks than many other large economies. It is the world's largest oil producer and a net exporter. AI-related spending looks set to remain a support to the economy based on the announced spending plans of major tech firms. Private sector balance sheets don't make the US look obviously recession-vulnerable (Chart 16) and fiscal policy should boost GDP in 2026. The Trump administration's 'One Big Beautiful Bill' largely extended existing tax cuts but did introduce new tax breaks. US households tend to get their tax refunds in Q1 into Q2 and with some of the tax provisions retrospective that should bring additional income in H1, helping offset the impact of higher prices at the pump prices (see earlier section on global savings). The mid-terms are approaching too, arguably making Trump more likely cushion energy costs with fiscal support. The Supreme Court ruling on tariffs might provide some relief if provision of refunds proceeds in more than a piecemeal way.

Rates on hold, but rate moves not off the table: We expect the Federal Reserve to keep rates on hold this year. With a new (likely more dovish) Fed Chair in May and low levels of job growth on average, a rate cut is very much not out of the question. Rate cuts were still pencilled into the median participant forecast in March. The Fed does seem further away from rate hikes than other central banks. However, with the Fed already alert to upside inflation risks pre-conflict after five-years of above target inflation and higher trade tariffs, with less immigration, more fiscal support, and now a surge in energy prices, the Fed might be minded to hike rates later in the year if the growth and labour market outlook remains robust.

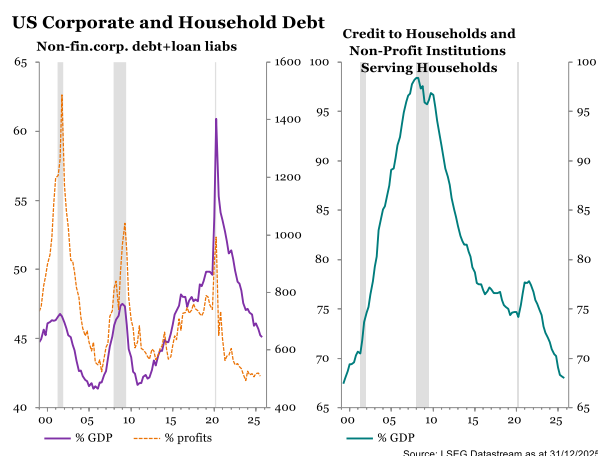
Multi-speed growth and the need to watch consumer spending: Data continue to suggest a multi speed economy (Chart 17) rather than one characterised by broad resilience, e.g. with residential investment still subdued but AI-boosted investment spending strong. Real consumer spending held up surprisingly well in 2025 – driving activity growth forward. It is probably this strand of the US outlook that needs watching most closely. Real consumer spending growth could well be dented by higher prices (delayed tariff impact plus impacts of Iran war) and a soft labour market. The already low level of savings rates arguably leaves US households looking more vulnerable to income shocks than in Europe.

K-shaped growth risks: To the extent consumer spending is being held up by higher income consumers, there is also some vulnerability to any stock market correction where housing and equity wealth will generally be more important drivers of spending for higher than lower income consumers. Work by the [Boston Fed](#) in 2025 showed that resilient credit card spending since 2022 had been driven by higher income consumers. Work by the [Dallas Fed](#) found that the top 25% of earners were responsible for 57% of overall consumption on average from 2020 to 2Q 2025 and found evidence to support an increase in consumption concentration since the 1990s.

Risks for the US from the AI boom

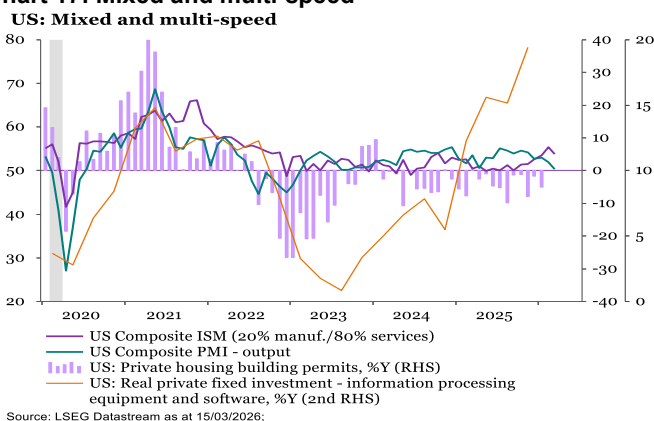
The AI build-out has boosted US GDP (though less than it appears given the import-content of the spending); enormous spending plans announced by US 'mega-tech' corporations suggests more of the same in 2026. AI more broadly is very likely to enhance productivity in the medium-to-long term. However, we worry from a number of angles: 1) possibility of a 'bust'; 2) crowding out; 3) labour market disruption. On 1) not all companies investing massively in data centres can be winners. With valuations so high, the multi asset team have raised concerns that AI in stock market terms is both a boom and a bubble. If such bubble bursts, we would worry about broader effects on the US economy including via wealth effects on consumers. On 2) a great deal of capital seems to have been absorbed by the AI sector. So-called hyperscalers have increasingly been taking to debt markets to raise financing. Given the scale of capital needs, there is some risk this ends up crowding out other borrowers. On 3) the potential for substantial labour market disruption could see the consumer engine of the US economy falter as AI-adoption progresses (alongside a strong swing towards anti-AI populist positions).

Chart 16: Lowering recession risk: Healthier leverage



Source: LSEG Datastream, BEA, Federal Reserve, BIS. Data to Q3 2025 except corporate liabilities as % GDP (Q4 2025)

Chart 17: Mixed and multi-speed



Source: LSEG Datastream, BEA, S&P Global, ISM, US Census Bureau. Data to Q4 2025 (IT fixed investment), January 2026 (building permits), March 2026 (ISMs), March 2026 (PMI).

China: Well-positioned for now, but long-term challenges persist

The Chinese economy showed some signs of improvement at the start of 2026, despite the challenges posed by US trade relations. The government has announced a minor loosening of fiscal policy in 2026, which should be modestly supportive for growth. Meanwhile, despite being the largest global oil importer, China appears well positioned to weather an energy shock compared to some other economies given China's large strategic oil reserves and favourable energy mix. However, longer-term challenges remain. In particular, China's aging population and ongoing trade tensions with the US pose significant longer-term challenges.

Status update: Some signs of improvement

China's activity indicators picked up at the start of the year (Chart 18). GDP growth was a touch stronger than expected at 5.0%Y in Q1 2026, alongside stronger growth in industrial production and a sharp rise in fixed investment (reversing the trend of falling fixed investment 2H 2025). Following the easing of US tariffs, exports grew much stronger than expected over most of Q1, largely due to a surge in the exports of semiconductors. The NBS PMIs remained subdued though, consumer confidence remains soft and inflation weak.

China's new five-year plan: A bit disappointing

At the National People's Congress (NPC) in early March, China's government unveiled its policy proposals for the year ahead and a draft of its 15th Five Year Plan. The leadership's priorities have remained broadly unchanged. The government revised down its GDP growth target from 5% to 4.5%-5%, its lowest target since 1991, while continuing to target substantial urban job generation. However, it's unclear the extent to which the targets will influence policy and there was disappointingly little on rebalancing domestic consumption.

Fiscal policy: The deficit target was kept unchanged at a record high of 4% of GDP. However, the headline deficit gives only a partial view of the fiscal stance. Accounting for transfers and budgets not captured under the headline figures suggests a minor loosening in fiscal policy in 2026. The consumer goods trade-in scheme was reduced from RMB300bn in 2025 to RMB250bn this year, and there was only a minor increase in social security funding. The government also fell short of setting a target for consumption as a share of GDP, which some had hoped for.

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 GDP growth to steadily trend lower in coming years. The demographic challenges were acknowledged at the NPC, with the five-year plan having an entire chapter dedicated to a "childbirth-friendly society", but seem unlikely to turn the situation around anytime soon.

Well-positioned to weather an energy shock?

China is the largest importer of oil in the world, importing a significant amount from the GCC. Pre-conflict, China bought almost all of Iran's oil exports (roughly 10% of all of China's oil imports). China's smaller 'teapot' refiners, which rely on buying sanctioned Iranian oil below market prices, could be particularly vulnerable to a reduction in Iranian oil exports. However, despite this, China is well positioned to weather a more prolonged oil shock.

- **Strategic oil reserves:** Estimates suggest China has roughly 120 days of imports in their strategic petroleum reserve and commercial stockpiles (potentially 1.3bn barrels). This is a large strategic reserve relative to other nations. These reserves mean China is well positioned to release supplies and smooth the domestic supply and price of oil.
- **Energy mix:** China is considerably less dependent on oil and gas in its energy mix compared to the US and Europe; 18% and 8% of China's total energy supply comes from oil and natural gas, respectively, much lower than the US (oil: 36%, gas: 36%), UK (oil: 37%, gas: 38%) and Europe (oil: 33%, gas: 24%), see Chart 19. China's energy mix is dominated by coal (61% of total energy supply), most of which is met by domestic supply.
- **Net exporter of refined products:** While China is a net importer of crude oil, China has significant refining capacity and is a net exporter of refined oil products. This positions China well to help shield domestic customers from surges in refined products prices (e.g. diesel and jet fuel), while potentially also profiting from selling at higher prices in international markets.
- **Green technology leader:** China is the global leader in green technology. Over the longer term, China stands to benefit from a global shift in energy security, to the degree countries shift towards self-sufficient renewables from oil and gas imports.

Chart 18: Some signs of improvement, pre-conflict

China: Industrial production, retail sales, investment & GDP

% YoY, mix of real and nominal, series made to be continuous where there are gaps

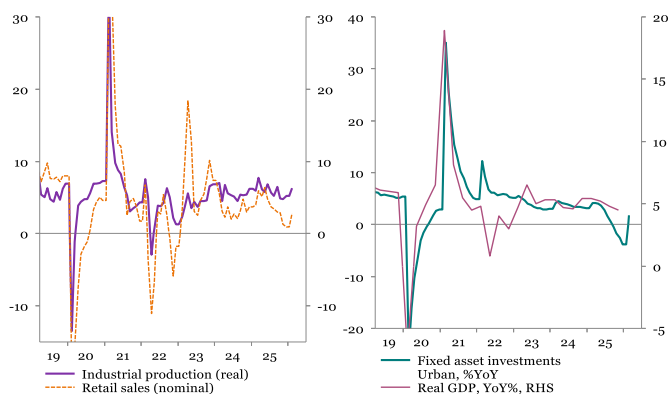
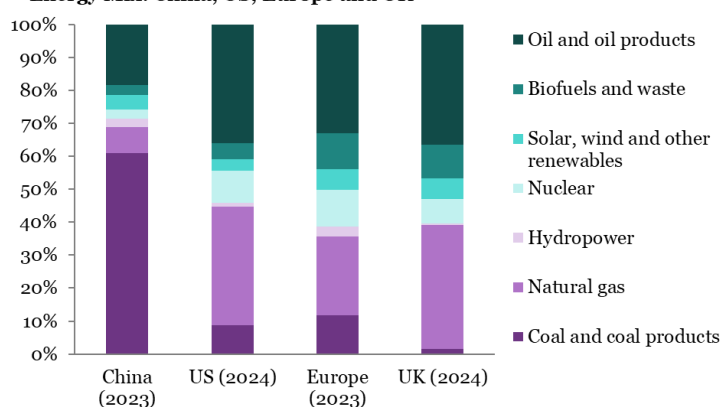


Chart 19: China's energy mix is dominated by coal

Energy Mix: China, US and UK



Note: Europe includes the UK

Source: International Energy Agency

Euro area: Challenged (again)

The euro area economy surprised on the upside in 2025 with a consensus forecast of 1.0% GDP growth at the start of the year beaten on the upside by 4-tenths despite external challenges. Prospects for 2026 were relatively good with the economy set to get a modest boost from more fiscal support. However, in addition to existing challenges (like US trade relations, regional politics, demographics, and a need for further integration and market reform), events in the Middle East pose a significant challenge to the outlook. The 2022 Russia-Ukraine war did not push the region into full-blown recession but did lead to a big spike in inflation and several quarters of minimal or slightly negative growth, although we are reluctant to draw too many lessons from that period given the uniqueness of the post-pandemic environment.

Status update: Not bad

GDP grew 0.2% quarter-on-quarter in Q4, following stronger than expected growth of 0.3% quarter-on-quarter in Q3. The composite PMI business survey indicator even remained above the 50 'no growth' level in March, although fell from 51.9 to 50.7. The conflict in the Middle East has therefore started to weigh and consumer confidence saw its largest fall since 2022 in March. The unemployment rate remains close to its historical lows though and the household savings rate remains high.

Challenged growth outlook (again)

Things had been shaping up relatively well this year. Fiscal policy looked set to provide a modest boost to growth (and still does) while consumer fundamentals were supportive and presented upside risk to the outlook. That has now been challenged by higher oil and gas prices and the disruption to global trade in a number of other commodities reflecting events in the Middle East. Our central case is for marginally positive GDP growth, but a mild recession is not hard to envisage if the energy situation gets worse.

- **Euro area fiscal policy** should move from a drag to a support for growth, albeit a moderate one (Chart 20), largely reflecting German fiscal spending following the debt brake reform that allowed for more infrastructure and defence spending, and with expectations of more defence spending across Europe. With the outbreak of renewed hostilities in the Middle East, pressure for more fiscal spending – for defence, for energy bill support and, potentially, for shoring up Europe's energy infrastructure – seems likely, with some governments already agreeing measures.
- **The consumer** is now a potential drag on the euro area growth outlook, depending on the scale of inflation hit that emerges. It is still the case that labour force growth has been strong in the post-pandemic period and that the household savings rate remains well above pre-pandemic norms (offering something of a shield). However, pay growth slowed significantly over 2025. Bond yields have risen, and financial conditions tightened. For now, rate hikes look more likely than rate cuts from the ECB this year.

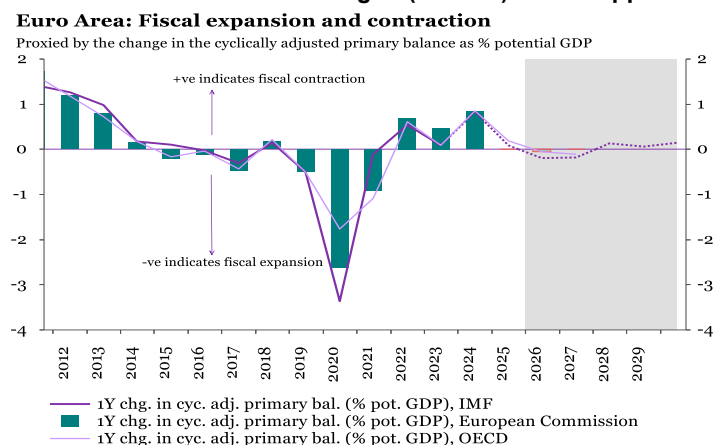
Energy price vulnerability: In ECB staff analysis from December, a sensitivity analysis where oil prices rose 14% and gas prices rose 20% (so around a third of what we have seen) lowered GDP by one-tenth and increased inflation by 0.5pp compared to baseline. Based on recent oil prices, that would be consistent with some 1.5pp higher inflation and 0.3% lower GDP growth, which look reasonable starting assumptions. In March ECB scenario analysis, its severe Middle East war scenario (60% of oil and LNG flows through the Strait of Hormuz are disrupted; energy infrastructure damage limits supply capacity; oil prices peak at \$145/pb but remain somewhat elevated over the forecast horizon and indirect and second-round inflation effects are bigger), inflation remained above target for the entire forecast horizon, increasing to 4.4% in 2026 and further to 4.8% in 2027 and GDP is 0.5% weaker than baseline. This scenario would presumably require multiple rate hikes from the ECB and even before incorporating that, assumes a technical recession.

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: Hikes?

With ECB policy rates now likely around neutral rather than restrictive, the oil shock is somewhat more likely to be met with rate hikes than would otherwise be the case. That is more so with the euro area's more supportive fiscal stance. While current underlying inflation dynamics don't look particularly worrying for now (Chart 21), given sensitivities like those highlighted above and with the recent inflationary period fresh in policymaker's memories, it wouldn't be surprising to see one or two 'insurance hikes' from the ECB this year, taking a small step into restrictive territory to lower medium-term inflation risks.

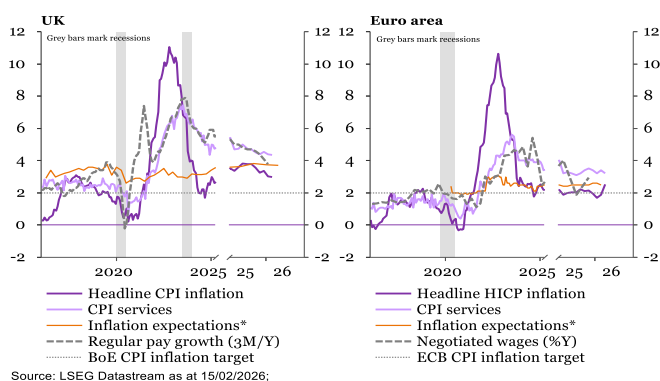
Chart 20: Euro area: Fiscal drag to (modest) fiscal support



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

Chart 21: Inflation watching; starting point better than the UK

UK & Euro area: Inflation and drivers
% year-on-year; * BoE/ECB surveys of consumers at ~5Y and 3Y horizons respectively



Source: LSEG Datastream; ONS, Eurostat, ECB. Data to March 2026 except UK inflation expectations (Q1 2026), UK CPI (February 2026), Euro area negotiated wages indicator (Q3 2025) and UK regular pay growth (January 2026)

United Kingdom: A challenging backdrop

Sentiment around the UK economy had felt overly gloomy prior to the conflict in the Middle East. However, the UK economy entered the conflict on an already unsteady footing. The growth backdrop in the UK had remained soft. GDP failed to grow in Q4 2025 and failed to grow in January. The labour market remained weak, with the unemployment rate having risen and various indicators pointing to slow (or negative) jobs growth. In the shorter term, the UK looks particularly vulnerable to an energy shock given the importance of natural gas in the energy mix, and there seems little fiscal room to provide support to households and businesses. However, AI and moves towards a closer trading relationship with the EU could be supportive of growth in the medium term.

Status update: Not the best starting point

Prior to the conflict, the UK remained an economy that wasn't growing much. GDP didn't grow in Q3 and Q4 2025. Growth remained subdued at the turn of the year, though picked up in January and February. Labour market data has been characterised by persistent softness and the unemployment rate remained at 5.2% in January, but there were some signs of stabilisation in the data pre-conflict. Inflation remained above the BoE's target pre-conflict. Following the onset of the war in the Middle East, the March composite PMI business survey indicator fell from 53.7 to 50.3, signalling slowing, very subdued, private sector activity growth.

UK economy, still overly pessimistic?

Prior to the conflict, the narrative around the UK economy had tended to focus on the negatives and with some justification given slow GDP growth and a soft labour market. The UK economy entered the conflict on an already unsteady footing – not a great position to withstand a sharp rise in energy costs and broader supply disruptions.

On the upside, the UK household savings rate has increased since the pandemic, which could translate to higher consumption if confidence improves (although that seems somewhat less likely considering recent events). There have also been moves towards a closer trading relationship with the EU and, as a services-heavy economy, the UK could well see a productivity boost from AI. Meanwhile, labour market slack which looks arguably larger than other major economies (Chart 8), should limit wage growth pressures and could give the BoE more leeway to look through the energy price supply shock.

The UK's vulnerability to the energy shock

As a net energy importer, the UK is exposed to rising energy costs. This vulnerability is particularly pronounced due to the reliance on natural gas in the UK's energy mix – making up 38% of energy supply (Chart 19). Typically, gas-fired power stations serve as the marginal source of supply and thus often set the market price. Partly as a result, UK households and industry face the highest electricity prices among the G7.

The knock-on effect of rising energy prices on the UK economy could be significant. According to BoE DSGE modelling cited in the August 2025 monetary policy report (see Chart 22 below), a 10% rise in energy prices (we've seen closer to 50%) could boost inflation by around 0.5% and, after a year, result in a 0.1% hit to GDP. In our central case, we do not expect the UK to fall into recession but have revised down our growth forecast for 2026.

Fiscal Policy: Tough decisions to come

The starting position for fiscal policy isn't the best (Chart 23). In the Spring Statement, Chancellor Rachel Reeves did manage to increase the fiscal headroom against the fiscal rules to £23.6bn from £21.7bn, largely driven by an upward revision to receipts, reflecting higher-than-forecast growth in UK equity prices since November. However, this improvement looks set to be short-lived. Since the statement, public sector net borrowing overshot expectations in February, and higher government bond yields and inflation should erode the headroom further.

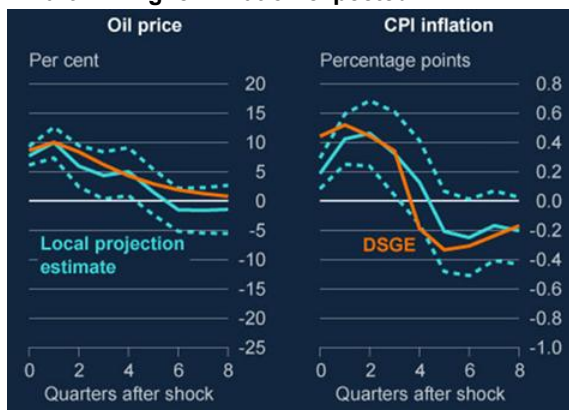
This could leave the government in a rather tight spot when it comes to supporting households and business through a potential new cost-of-living crisis. Should energy prices remain elevated, the government will be forced to weigh its fiscal options carefully. With the strained fiscal backdrop, the government has already signalled it won't offer a fiscal package on the scale of the one offered in 2022, which totalled near £50bn. If energy prices continue to rise, the government may find itself with the tricky task of balancing support for households and business and stabilising the public finances.

Monetary Policy: Rate hikes back on the table

On 19th March, the Monetary Policy Committee voted unanimously to maintain Bank Rate at 3.75% (with several MPC members no longer voting to cut rates), highlighted the fresh upside risks to inflation from increasing energy prices, but also warned of the potential for downside risks to growth.

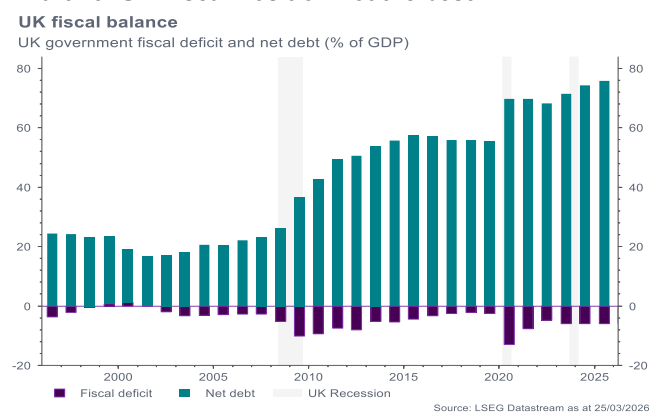
For now, monetary policy hangs in the balance. The Bank's next steps will depend on how long hostilities last, as well as the transmission of the energy shock through the economy. With worries to both inflation and growth, in our central case, we expect the Bank to make one 'insurance' hike in 2026, but then see rate cuts resuming in 2027 on the assumption of weaker outcomes for the activity and labour market.

Chart 22: Higher inflation expected



Source: [Bank of England Monetary Policy Report, August 2025](#).

Chart 23: UK Fiscal Position not the best



Source: LSEG Datastream, OECD data and forecasts (December 2025).

Japan: Landslide win brings two-sided risks

Political change, and now, higher energy prices, have raised uncertainty around Japan's economic outlook. We continue to pencil in further gradual rate hikes with inflation-related variables continuing to hold in at higher levels, additional fiscal stimulus, and despite Prime Minister Sanae Takaichi nominating two new Bank of Japan board members who are seen as 'reflationist'. Any positive impact on economic activity from fiscal stimulus, however, could easily be trampled on by events in the Middle East with Japan vulnerable to commodity price jumps as a large net oil importer.

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

Measures of inflation remain elevated in Japan by historical standards (Chart 24), with headline CPI and both main "core" measures of inflation well above pre-pandemic norms. PMI output prices eased in March and subsidies are likely to smooth the price impact of higher oil prices on the economy. However, we expect the conflict in the Middle East to increase inflation in 2026 with a lag. Real GDP grew by 1.2% in 2025. The March PMI, despite the Iran conflict, continued to signal moderate positive activity growth, although fell from 53.9 to 53.0.

Technology, fiscal policy and the consumer

Japan's 2025 GDP growth, at 1.1%, was significantly higher than our estimate of the country's potential growth (around 0.5%). There are good reasons to think that potential growth could be rising thanks to a more flexible-looking labour market (corporate reforms and changing attitudes to lifetime employment) and through adoption of new technologies. However, this is an uphill battle where Japan's working age population (aged 16-64) fell by 0.3% a year on average over the last five years. Over the next year or two there are several strands of the economic outlook we'll be watching.

- **The consumer:** Consumer confidence (pre-conflict) had been rising since spring 2025, rising sharply in the wake of the February election, and some measures of real wage growth had moved into positive territory year-on-year. The labour market continues to look relatively tight. All that will have helped support respectable rates of real consumer spending growth over much of 2025 and could continue to do so in 2026 if the oil price shock is relatively short-lived and the government continues to subsidise costs.
- **Technology and productivity:** Despite population pressures, labour productivity growth looks weaker on average over the last 20 years than in the US, UK or euro area (Chart 25). That comes despite Japan being one of the most robot-intensive economies in the world. An openness to automation and the recent period of corporate reform suggest that prospects for a period of improved productivity have risen. However, adoption of automation and technology (including robotics and AI) is uneven and, as elsewhere, will likely need to be accompanied by re-training efforts and organisational change to maximise productivity benefits.
- **Fiscal policy:** The snap Lower House election has furnished PM Takaichi with a landslide majority. In the aftermath of that win, Takaichi appointed two reflationists to the BoJ and a promise to cut VAT for food was part of her election platform following last November's fiscal stimulus package. Pressure for more fiscal spending – for cost-of-living support and for more defence spending – is likely given the international backdrop, and she has the leeway to pursue that given the size of her parliamentary majority. There are risks, however, that loose fiscal policy and a too-loose monetary policy stance are met with increased inflation expectations and more market discipline via higher bond yields. The weak yen might also become more of a source of tension with trading partners and competitors and where trade relations with both the US and China are already subject to tension.

Energy price sensitivity

Japan is a significant net energy importer and GDP growth will likely be hit by higher oil and gas prices. However, Japan's energy efficiency has improved and Japan's share of LNG contracts that are long-term is also relatively high – both of which should help shield the economy somewhat. Japan also has significant crude oil reserves and has begun releasing those. The government has introduced subsidies to cap petrol prices. Should high oil and natural gas prices persist, we would also expect the government to provide additional support. All of this looks set to mute the impact. However, there is arguably some evidence from the [BoJ](#) that the pass-through of import prices has increased. The BoJ also looks set to raise interest rates this year again reflecting already significant inflation pressure. Tighter financial conditions look likely to weigh on the outlook.

Gradual rate rises

Despite stronger inflation dynamics, an oil price shock, and more fiscal support, the forecasts still only pencil in very gradual BoJ rate hikes. That reflects revealed preference of the BoJ for moving very cautiously but also some of the political realities (PM Takaichi's reflationist preferences), and Japan's relatively low real activity growth rates.

Chart 24: Still strong inflation (by Japan's standards)

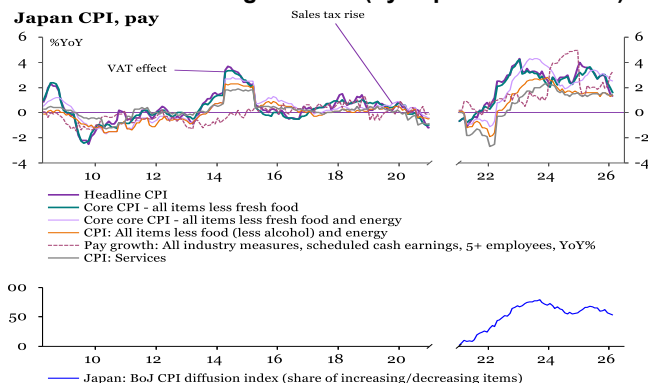
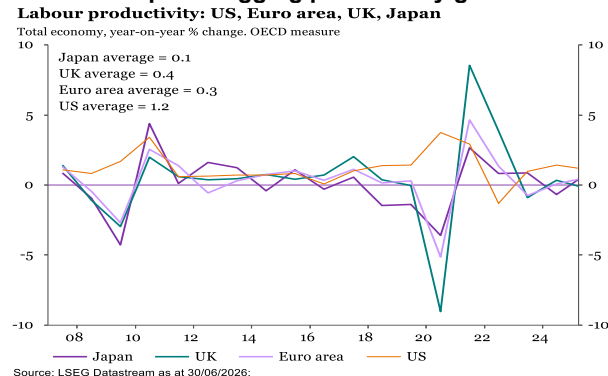


Chart 25: Japan's lagging productivity growth



Source: LSEG Datastream, Ministry of Internal Affairs & Communication, Ministry of Health, Labour and Welfare, Bank of Japan as of February 2026.

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