Economic Update

Issue #37, July 2026

After the shock

The outlook for the economy isn't a static thing. Currently this feels truer than usual as the conflict in the Middle East continues to prompt volatility in oil prices. If we really are past the worst and oil prices stay at lower levels (a big if), then the economic effects are going to be smaller than we expected in April, as are the chances of interest rate rises. But things are not yet fully normalised and there is a risk of further escalation. Some of the economic impact (including on inflation) will come through with a delay. Meanwhile, we continue to anticipate a year of modest growth, with a still significant risk of rate hikes. Next year is shaping up to be stronger but there are plenty of risks.

Summary

Resilience a persistent feature: Despite experiencing yet another significant supply shock, the hit to growth has been relatively limited for major economies, with recessions avoided. Central banks have been restrained in their responses (which has helped) and fiscal policy and AI have provided a fortuitously timed partial offset for global growth. Still, there is a growing view that shocks of this kind are likely to become more of a feature of the global economy, given the change in geopolitical, fiscal, demographic and climate backdrop. Next time, the offsets may not be there.

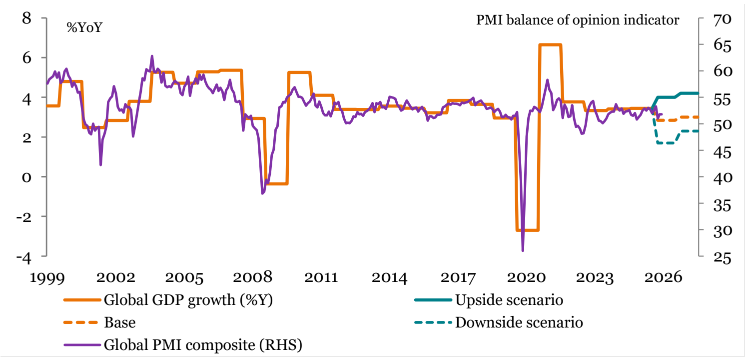
Inflation – don't relax too much: High inflation tail risks look less likely as the oil price has fallen closer to prewar levels. However, outcomes in the Middle East remain uncertain and there is a risk of further escalation. We continue to worry about the potential for higher food prices in the wake of the energy price shock. Second-round effects remain a concern, though we continue to expect them to be relatively modest. Medium-term, we still see outcomes for inflation as skewed to the upside in coming years given the climate, geopolitical, fiscal and demographic backdrop.

Don't rule out rate rises: Further rate hikes this year have become less likely as oil prices have fallen from their peak. However, not all of the pass-through is complete and central banks could still see enough risk of persistent inflation to hike; the new US Federal Reserve (Fed) chair Kevin Warsh sent more hawkish signals than we expected at the Fed's June meeting and the US labour market has been more robust than expected. We take a rate hike out of the profile for the European Central Bank (ECB) and Bank of England (BoE) but add one for the Fed. However, for all these central banks, much depends on what happens now to oil prices and on how far we see the echoes of the energy price shock in other inflation components and evidence of second round effects.

It's all relative: Strong AI capex in the US feeds the US exceptionalism story. But we think it is easy to overstate its role in boosting the US economy and still worry about its potential as a disruptive force. Meanwhile, a lower oil price improves the outlook for Europe where there is still plenty of potential for consumers to play a bigger growth boosting role.

The **multi asset team** de-risked equity exposure at the start of the year as the conflict began but moved overweight again on sentiment grounds and have since been positive. The team remains tilted towards technology stocks and emerging markets at the tactical level, where earnings are showing the greatest strength. For more, see the Our Views section at www.rlam.com.

Chart 1: Global growth central case: Still some oil damage in 2026



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

Multi asset

Royal London Asset Management manages £206.1 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 30 April 2026

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US: US growth remained resilient in H1, though this continues to be an economy not firing on all cylinders and AI brings risks on both sides. The Federal Reserve sounds more likely to hike than it previously did, despite lower oil prices.

China: Another economy with K-shaped characteristics, domestic demand continues to lag. Medium-term risks include trade relations and demographics.

Euro area: The energy price shock has dampened activity and raised inflation. But the economy should fare much better in 2027 if oil prices stay at lower levels, with a little help from fiscal policy too.

UK: The odds are stacked against the UK economy recording strong growth this year and we still wouldn't rule out a Bank of England hike given UK inflation vulnerability. Lower oil prices will help though.

Japan: A robust fiscal policy response has helped shield the economy from the energy shock, but the debt build comes with risks. We expect more Bank of Japan hikes.

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

Economic forecast summary

July 2026 base case

Region	2025			2026e			2027e			2028e			2029e			2030e			2031e		
	GDP growth	CPI Q4	Policy Rate Q4	GDP growth	CPI Q4	Policy Rate Q4	GDP growth	CPI Q4	Policy Rate Q4	GDP growth	CPI Q4	Policy Rate Q4	GDP growth	CPI Q4	Policy Rate Q4	GDP growth	CPI Q4	Policy Rate Q4	GDP growth	CPI Q4	Policy Rate Q4
US	2.1	2.8	3.75	2.2 *1.9*	3.7 *3.4*	4.00 *3.75*	1.9 *1.9*	2.4 *2.2*	4.00 *3.50*	2.0 *1.8*	2.5 *2.3*	3.75 *3.50*	2.0 *2.0*	2.4 *2.4*	3.50 *3.50*	2.1 *2.1*	2.4 *2.4*	3.50 *3.50*	2.0 *–*	2.5 *–*	3.50 *–*
China	5.0	–	–	4.4 *4.3*	– *–*	– *–*	4.3 *4.1*	– *–*	– *–*	4.2 *4.2*	– *–*	– *–*	4.0 *4.0*	– *–*	– *–*	3.9 *3.9*	– *–*	– *–*	3.8 *–*	– *–*	– *–*
UK	1.3	3.4	3.75	0.8 *0.7*	3.2 *3.7*	3.75 *4.00*	1.1 *1.0*	2.3 *2.5*	3.50 *3.25*	1.4 *1.4*	2.3 *1.8*	3.25 *3.25*	1.4 *1.4*	2.4 *2.2*	3.50 *3.50*	1.4 *1.4*	2.3 *2.2*	3.75 *3.75*	1.4 *–*	2.2 *–*	3.75 *–*
Euro area	1.5	2.1	2.00	0.6 *0.8*	2.7 *3.0*	2.25 *2.50*	1.4 *1.3*	2.0 *1.9*	2.00 *2.00*	1.3 *1.3*	2.1 *1.8*	2.00 *2.00*	1.2 *1.2*	2.0 *1.9*	2.25 *2.25*	1.2 *1.2*	2.0 *2.1*	2.25 *2.50*	1.2 *–*	2.0 *–*	2.25 *–*
Japan	1.1	2.7	0.75	0.8 *0.8*	2.0 *1.9*	1.25 *1.25*	0.9 *0.9*	1.7 *1.9*	1.50 *1.50*	0.7 *0.7*	1.9 *1.8*	1.75 *1.50*	0.6 *0.6*	1.9 *1.9*	2.00 *1.75*	0.5 *0.5*	2.0 *1.9*	2.00 *1.75*	0.5 *–*	2.0 *–*	2.25 *–*
Global	3.1	– *–*	– *–*	2.8 *2.5*	– *–*	– *–*	3.0 *2.9*			3.2 *3.3*			3.0 *3.0*			2.8 *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 April 2026 forecast update are in grey and italics. 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 now conditioned on oil prices settling around $75 per barrel from July 2026, in line with market pricing (Chart 3). Despite the signing of an MoU between the US and Iran, and increased shipping flows through the Strait, the outlook for energy prices remains highly uncertain.

- Inflation has jumped, reflecting the steep increase in energy prices since the start of the Middle East conflict. Despite the subsequent fall in energy prices from their peak, we expect earlier price increases to continue feeding through into broader prices over the rest of the year. As such, on our forecasts, inflation remains above central bank target measures at the end of this year. We now expect the BoE and ECB to keep rates on hold this year, assuming we don't get another significant oil price spike, but we expect the Bank of Japan (BoJ) to adhere to a policy tightening path.
- Beyond 2026, we would expect the BoE resume easing policy as inflation subsides against a weak labour market backdrop. We now assume the Fed hikes rates once in 2026, despite lower oil prices, reflecting signs of less slack in the labour market and stronger core inflation than expected and Warsh being somewhat more hawkish than expected. 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 2.25% for the ECB).
- While shipping flows through the Strait of Hormuz have increased, we don't expect a smooth normalisation of energy markets. Potential setbacks to shipping flows or increased escalation in the Middle East present upside risks to inflation and rates.
- Scope is limited for additional fiscal support given government debt levels and higher post-pandemic interest rates. Fiscal policy support is ongoing in the euro area, offset by higher energy prices in H1 2026. Japan looks set to see more fiscal support. US tariff refunds are ongoing.

Global economic scenarios (Chart 1)

Upside scenario (20% probability): Energy prices lower than base case

- Energy prices fall more than assumed in the base case and supply chain disruption is rapidly resolved, with elements of a supply glut in the near-term. Past rises in oil prices show fewer signs of leading to second round effects than in the base case. Central banks cut rates.
- US GDP growth surprises on the upside, helped by stronger consumer spending than in the base case and robust AI capex. AI adoption steps up and productivity rises beyond just the US, but AI does not lead to significant net job losses. China's policy efforts see GDP growth stabilise.
- Headline inflation runs somewhat below the central case over much of the forecast, reflecting lower oil prices and stronger productivity growth.

Base case (60%): 2026 not a great year, but growth improves on lower oil prices; central banks do little

- Elevated oil and gas prices over the past few months lead to higher inflation and lower growth in 2026, despite energy prices falling closer to pre-conflict levels. Monetary policy remains tighter than would have been the case to contain potential second-round inflation risks.
- Fiscal policy supports activity in some economies, as does past monetary policy easing. Lower real income growth and confidence weigh on consumer spending in 2026. Uncertainty weighs on business investment, but AI-related investment remains a support.
- 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 Japan and largely unchanged elsewhere, falling a bit in the UK in 2027.

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

- Energy prices are higher for longer than in the base case with renewed disruption to supply chains and shortages prolonged. Higher inflation shows more signs of leading to second round effects than in the base case, prompting central banks to hike rates. Recessions follow.
- Elevated uncertainty and higher inflation are followed by tighter monetary policy and market downturns. That weighs heavily on hiring and global growth. Over the next five years, AI proves more disruptive in the central case to the labour market than expected. However, relatively strong balance sheets temper the risks of more substantial recessions.
- Inflation falls more sharply than in the central case beyond 2027 as labour markets and growth weaken, resulting in 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: Less worried, not unworried

Global growth still looks likely to slow significantly in 2026 given H1 energy prices, supply chain disruption and central banks keeping policies tighter than they otherwise would have done. However, with oil prices now lower than they were and lower than we had expected to be at this point, we have revised up the central forecast somewhat and see recessions as even less likely than before. However, we still view the global outlook at this point as highly uncertain. Fiscal policy and AI-related investment are likely to provide some support globally and the consumer outlook should brighten as inflation falls. But we still worry about second-round inflation effects and the risk of a food price spike, among other things, and can't rule out rate hikes.

Slower growth and high inflation in H1

In the wake of the conflict and resulting higher oil prices, business surveys suggested global activity growth slowed (see Chart 2), measures of consumer and business confidence fell and employment surveys have weakened. This reflects a backdrop of elevated uncertainty and higher energy prices. With oil prices now well below their peak and closer to prewar levels, risks have eased and expectations components of some business surveys are showing improvements, although we are starting to see an unwinding of precautionary stock-building which will be a temporary offsetting drag. The direct impact of higher energy prices on inflation was swift, driven primarily by a sharp rise in motor fuel prices. Evidence of indirect and second round effects has been more limited so far, but we expect higher energy prices in H1 to continue feeding through to inflation in H2.

Summary outlook: Past the worst (probably)

Lower energy prices provide some relief for the outlook: At the time of writing, oil and gas prices are closer to pre-conflict levels, which is a lot better than the 50% higher we faced when updating our forecasts in April (Chart 3). Having assumed a 0.5% hit to GDP growth in February (pulling our forecast at the time down to 2.5%), based on IMF analysis we now think assuming a 0.2-0.3% hit is more appropriate, with risks on both sides depending how things evolve from here. Even in April, we had not been assuming recessions in major economies and, with oil prices now down from their peak, we see the probability of recession as having dropped again.

But hard to assume a straight-line improvement: There are plenty of ways that things could evolve in a more worrying direction. We have seen many false starts in the peace process and communication around the US-Iran negotiations has been mixed enough that it is not particularly surprising to see the MoU fall apart. At the time of writing, flows through the Strait had picked up, but fell after strikes on vessels in the Strait. There is significant uncertainty around the path of flows through the Strait and around conditions once the backlog of oil in the Gulf clears. We are watching inbound flows to the Gulf as a key indicator of confidence in shipping through the Strait; so far these are lower than outbound flows. At the same time, efforts to rebuild inventories may also create some upward pressure on prices. If traffic stays well below levels seen pre-conflict, it is hard to assume that $70/bbl is a market clearing price and we see risks to energy prices and inflation as skewed to the upside. We find it hard to assume a central case where events in the Gulf follow a straight-line path to complete normalisation; setbacks seem likely as we have already seen.

We still see multiple factors as likely to support growth:

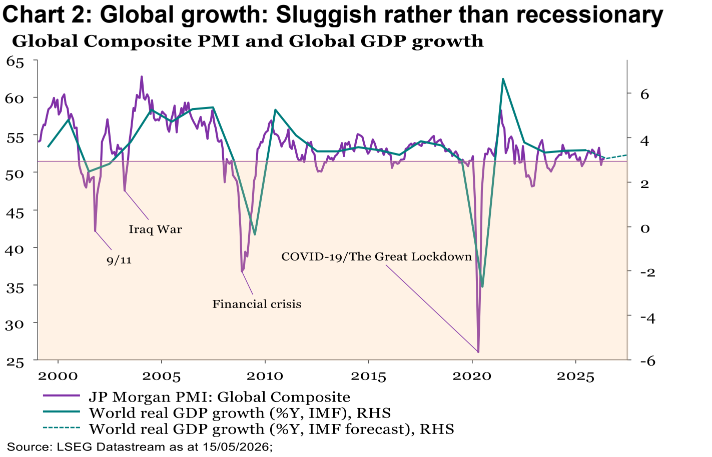
1) Going into the crisis, levels of private sector leverage had not been at worrying levels. Risks of recession would be greater if leverage had reached high levels, such that higher interest rates could have been a stronger trigger to tip the economy into a downturn.
2) Fiscal policy had already started to become more supportive in the euro area (Germany) and the US (tax and now tariff refunds).
3) Some governments (Japan in particular) have used fiscal policy to mitigate the most severe effects of higher energy and fuel prices to the economy.
4) Consumer savings rates are high in Europe, which could provide a shield to higher prices and translate into higher spending if confidence improves.
5) Based on company reports, strong AI-related investment looks set to continue through 2026 and beyond.

But it isn't all business as usual: Uncertainty is likely to have weighed and continue to weigh on firm and household investment decisions, real pay growth has slowed (Chart 4) and consumer confidence remains weak. In the US, the household savings rate is already low, meaning any further shock to real incomes is likely to be met with lower spending. We continue to worry about the potential for second-round inflation effects, which increases the risk of central bank tightening (see page 8).

Lower inflation than expected and risks to our rate profiles: We expected the high energy prices in H1 to continue feeding through to inflation in H2, particularly in the UK where rises in household energy bills will only be felt in July when the Ofgem price cap rises. Our work also suggests that there is a sizeable risk of seeing moderate second round effects, especially in the UK (see pages 6 and 7). Labour market slack also looks set to be a less constraining effect than expected in the US. However, with a steeper decline in oil prices over June than we had anticipated, our inflation forecasts have fallen since April (Chart 5). AI should ultimately lower inflation, but this is likely to be more of a medium-term factor.

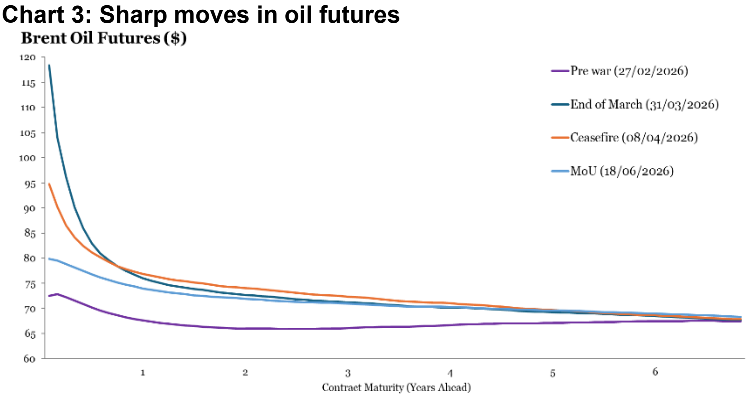
Central banks seem likely to keep monetary policy tighter than they would have done in the absence of conflict in the Middle East, but risks are increasingly skewed towards no further European rate hikes this year, where lower oil and gas prices lower the risk of strong second round effects.

Chart 2: Global growth: Sluggish rather than recessionary



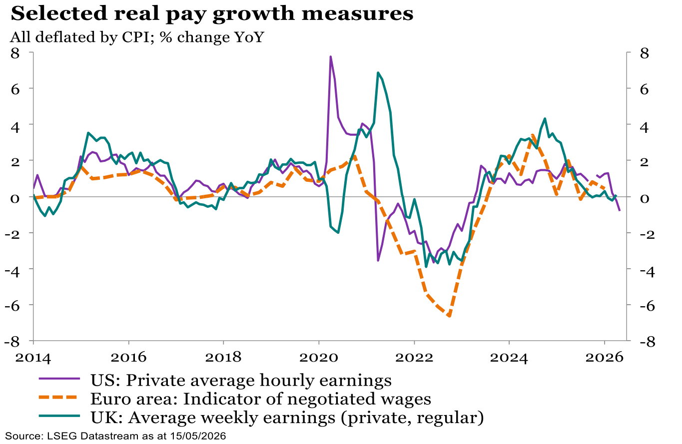
Source: LSEG Datastream; IMF, S&P Global. PMI data is to June 2026. IMF series was updated in April 2026.

Chart 3: Sharp moves in oil futures



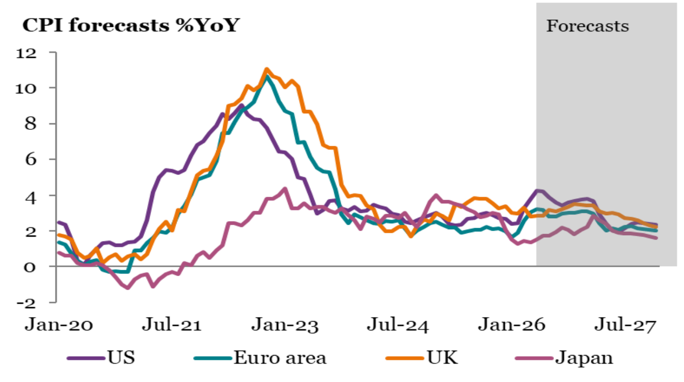
Source: Bloomberg data. Data last updated 19/06/2026

Chart 4: Weak post-conflict real pay growth



Source: LSEG Datastream, BLS, ONS, ECB, Eurostat. Data is to May 2026 (US), April 2026 (UK), Q1 2026 (Euro area).

Chart 5: Inflation forecast



Source: LSEG Datastream, BEA, Eurostat, ONS, Japan Cabinet Office. Data as of Q1 2026

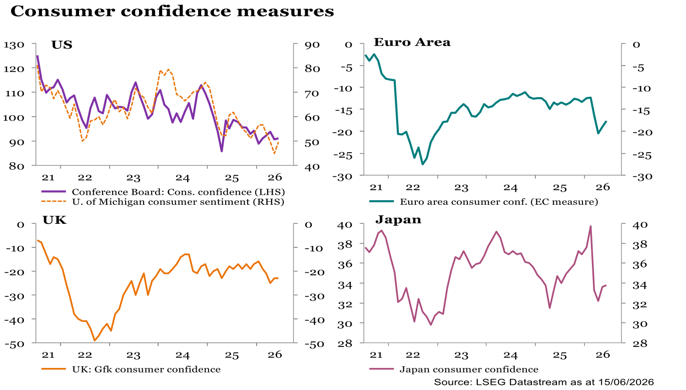
Consumer spending: Headwinds and divergence building

Consumption growth has held up relatively well through the first quarter and into the early months of the conflict in the Middle East. Support has partly come in the US at least from sizeable US tax refunds, and strength in equity markets and associated wealth effects. The middle of 2026, however, has seen real pay growth in multiple economies hit by higher inflation. We expect some divergence across economies ahead:

- **Labour market and real incomes:** After a hit this year, real pay growth should turn more supportive again next year. If we were to assume steady nominal pay growth from here in the US, euro area and UK, but overlay that with our forecasts for inflation, in the second half of next year real pay growth would be significantly higher than it is now. Labour markets are showing divergent trends, however. In the US, after a year of subdued employment growth, there have been signs employment momentum may be picking up again, albeit slowing in June. A firmer labour market would support real income growth and consumption. In the euro area, the labour market has, so far, held up reasonably well, with unemployment near historically low levels (although broader labour market indicators are less positive with PMIs, for example, indicating falling employment). The UK labour market still appears weak, pointing to softer wage growth and consumption.
- **Consumer confidence:** Since the start of the war in the Middle East, consumer confidence has diverged between the US and elsewhere (Chart 6). In the US, consumer confidence has softened, but the decline has been relatively modest. Elsewhere, however, the hit to consumer confidence has been much more pronounced and may weigh more on consumers' willingness to spend. We think some of the divergence may be due to differing economy-wide exposure to higher oil prices and US tax refunds among other factors. However, with oil prices having fallen from the peak, there is potential for a sharp rebound in consumer confidence, which could support consumption growth into 2027.
- **Wealth effects and savings rates:** As we outlined in April, household savings rates continue to diverge across economies (Chart 7). In the US, savings rates have fallen back to pre-pandemic levels, whereas they have remained elevated in the UK and Europe. We think part of this divergence reflects US households being more exposed to equity markets and therefore have benefitted from stronger wealth effects. However, absent another year of exceptionally strong equity market performance, it seems less likely the US consumer will continue to lower their savings rates. In the UK and Europe (and elsewhere, including Japan), the sharp reduction in consumer confidence caused by the conflict in the Middle East points to a more cautious consumer and savings rates remaining relatively elevated. However, if oil prices remain at lower levels and confidence gradually rebuilds, resulting in lower savings rates, the European consumer could see a substantial boost.

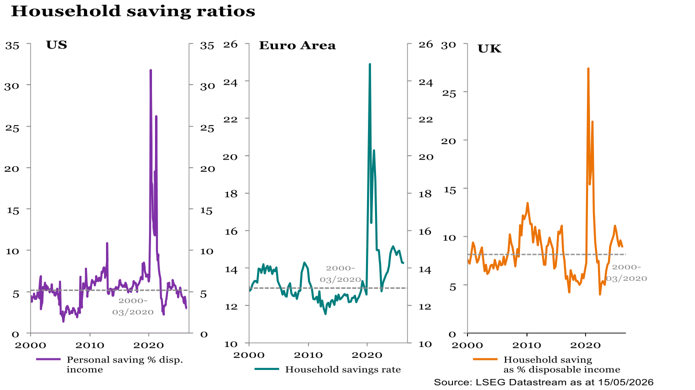
Overall, our central case is for softening, albeit still positive consumption growth in the second half of 2026, with the potential for stronger consumption in the US than elsewhere, then for broadly stronger consumer spending growth in 2027. However, risks to the outlook remain two sided. Further disruption in the Middle East could provide an additional hit to consumer confidence and push inflation higher, weighing on real incomes and consumption. Equally, if inflation falls more quickly than expected alongside a sharp improvement in consumer confidence, the squeeze on real incomes will be more limited, supporting consumption growth.

Chart 6: Diverging consumer confidence



Source: LSEG Datastream, The Conference Board, University of Michigan, GfK, YouGov, ECB, University of Michigan, Cabinet Office. Data as of May 2026

Chart 7: Diverging household savings rates



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

AI: How much is it really driving GDP?

One of the factors underpinning the resilience of US activity through 2025 and into Q1 2026 has been AI-related spending. Firms are expected to continue expanding AI infrastructure and investment in H2 2026, supported in part by tax incentives in the OBBBA. Hyperscalers' capital expenditure is expected to rise to around $700bn in 2026, providing a further boost to growth. However, the current impact of AI investment on US GDP growth is likely to be much smaller than headline capex figures suggest.

In the short run, AI-related spending supports GDP primarily through three investment channels:

- **Equipment:** Capturing physical capex on AI-related hardware, including advanced chips, semiconductors, storage systems and servers
- **Software and intellectual property:** This reflects spending on AI-related software and services such as AI models and R&D investment in software and AI models
- **Structures:** Captures physical construction activity associated with the build out of AI datacentres. Importantly, the hardware installed within the structures (such as chips, storage devices etc) are captured separately within equipment

However, some of the investment is directed to intermediate goods and not reflected in GDP figures. For instance, firms purchasing semiconductors and chips to develop in-house AI models and applications aren't directly captured within GDP figures.

These investment channels suggest a marked increase in AI-related gross fixed capital formation within GDP since 2022 (Chart 8). Investment in our proxy for AI-related structures has steadily increased, with a notable acceleration in 2023, coinciding with the peak acceleration in datacentre construction. Expenditure on equipment has also increased dramatically, more than doubling between 2024 and the end of 2025, as the price of AI-related equipment has surged.

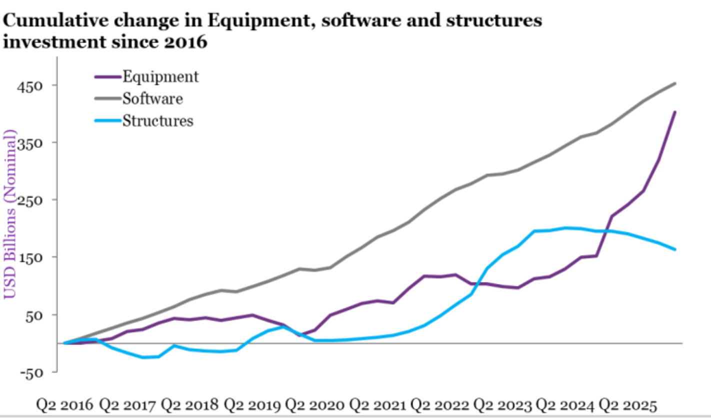
Despite the surge in hyperscaler AI capex, its contribution to US GDP growth is easy to overstate:

- **Imports:** Almost all the investment in equipment and goods, particularly semiconductors and chips, is imported from abroad (Chart 9). As these imports are deducted from GDP figures, the overall net contribution to GDP is much smaller.
- **Price effects:** Part of the increase in investment is attributable to surging costs of semiconductors and chips, diminishing its contribution to growth in real terms.

Taking into account these factors, our analysis suggests that AI may have contributed 'just' 0.4pp to US GDP growth in 2025 (i.e. about a quarter of the total growth). When considering the potential displacement of other technology-related investment, we estimate the impact of AI spending on GDP growth could be negligible. Overall, our analysis suggests the impact of AI investment on US GDP growth is likely to have been in the range of 0 to 0.4pp in 2025. However, indirect channels like the impact of higher AI-related stock prices on wealth and productivity improvements resulting from AI may add more.

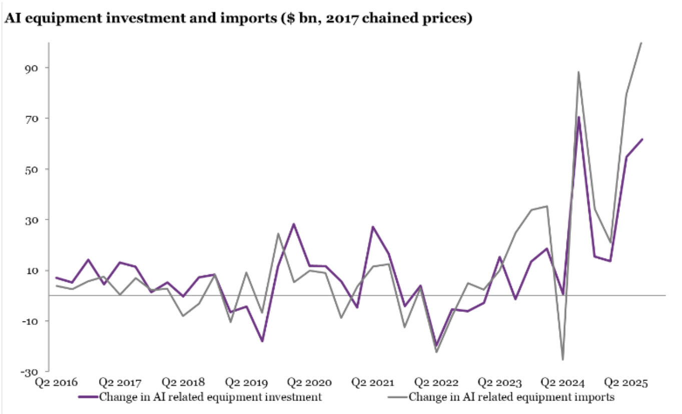
To sustain the positive contribution to GDP growth, AI capex will need to continue growing each year. In the medium term, maintaining that pace of capex seems unlikely to be sustainable. Eventually, the US economy will need to rely on productivity growth to support longer-term sustainable growth. However, historically there has typically been a long lag between advances in general purpose technologies (GPTs) and productivity growth as such gains have come from innovation of new activities, rather than simply making existing processes more efficient. For example, it took around four decades for electricity to make a substantial impact on productivity, as highlighted by BoE Governor Andrew Bailey in a recent speech. Companies gained modest productivity benefits replacing steam-powered engines with electric ones, but the large productivity benefits came from the reorganisation of factories to better exploit the new workflows offered by electric power. For now, most of the academic literature indicates that AI has yet to deliver substantial productivity gains.

Chart 8: Growth in AI-related investment



Source: LSEG Datastream, BEA. Data as of 2026 Q1

Chart 9: AI investment, mostly imported



Source: LSEG Datastream, BEA. Data as of 2026 Q1

Fiscal policy: More support, more of an offset than a boost

Coming into 2026, growth in the US (in the early part of the year) and in the euro area (throughout the year) was expected to get some (modest) additional support from fiscal policy, reflecting stronger tax refunds in the US and higher defence and infrastructure spending in Germany after debt brake reform. That will have helped provide some offset to the impact of higher energy prices in H1. Higher energy prices and conflict in the Middle East have themselves prompted some additional measures (see OECD). Those have included temporary cuts to fuel tax (e.g. Germany, Spain), lowering the price of public transport (e.g. Sweden), fuel price caps (e.g. South Korea, Japan) among others.

However, all this comes against a backdrop where fiscal policy risks are more elevated than they were pre-pandemic. During the pandemic, governments took on debt and funnelled money to firms and households to keep the economy from experiencing significant longer-term damage. While that was largely successful, it has left the global economy with a legacy of relatively high levels of government debt (Chart 10). Substantial government resources are now being spent just servicing debt with post-pandemic interest rates also higher and rising further during the conflict amid higher energy prices. At the same time, market discipline, which felt absent for much of the post-GFC pre-pandemic period, has revived. Government tax and spending decisions that sustainably increase the deficit seem more likely to result in higher bond yields than in the earlier period (in the absence of quantitative easing and persistent low inflation). That itself decreases government room for manoeuvre.

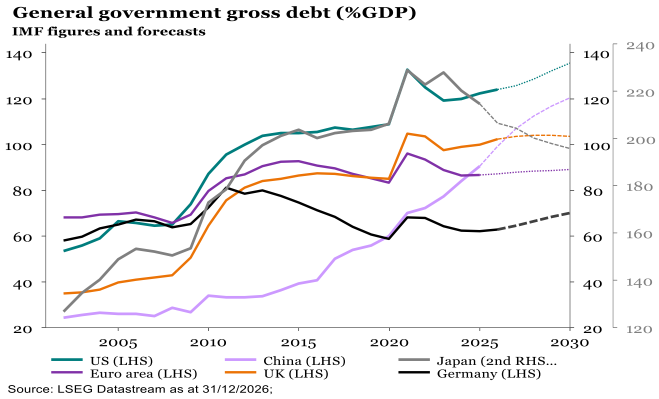
In the **US**, the bulk of the fiscal boost to growth from autumn 2025's fiscal bill was expected to come through in the first half of 2026. Tariff refunds are also being paid, the US treasury announcing in June that it had started to make the first tariff refund repayments ($22bn in May). A total of $166bn were collected under the IEEPA tariffs. Refunds may provide a temporary one-off boost for companies, though given the degree of uncertainty around the outlook – including future tariffs where the Trump administration is pursuing alternative tariff avenues – the windfalls may only be spent with a delay. Fiscal policy more broadly remains relatively loose, with the CBO's 2026 budget projections forecasting an ongoing US fiscal deficit around 6.0% GDP.

Euro area fiscal policy moves from a drag to a *moderate* support for growth this year, largely reflecting higher German fiscal spending. Temporary fiscal support has also been offered in some parts of Europe to support consumers and businesses face higher energy costs.

UK fiscal policy looks set to drag on the outlook, but with some short-term energy bill support. Given that a chunk of this is in the form of delayed tax increases this does not seem likely to significantly boost growth (or worsen the fiscal outlook in the medium term). A change in prime minister (highly likely to be Andy Burnam) may bring fiscal policy change, but the UK government has already seen its fiscal headroom erode as a result of events in the Middle East and higher bond yields and Burnham has reaffirmed his commitment to the fiscal rules. Given recent experience, signs of loose fiscal discipline would likely be met by sharply higher bond yields, reinforcing the UK's limited room for manoeuvre.

In **China**, fiscal policy is likely to be deployed further, but appetite for significant fiscal stimulus to support weak domestic demand appears to remain constrained. However, the reduction in Middle East tensions could see policymakers focus increase on domestic matters.

Chart 10: High levels of government debt to GDP



Source: LSEG Datastream, IMF. Data updated in April 2026

Inflation outlook: Oil price falls, but risks of second-round effects

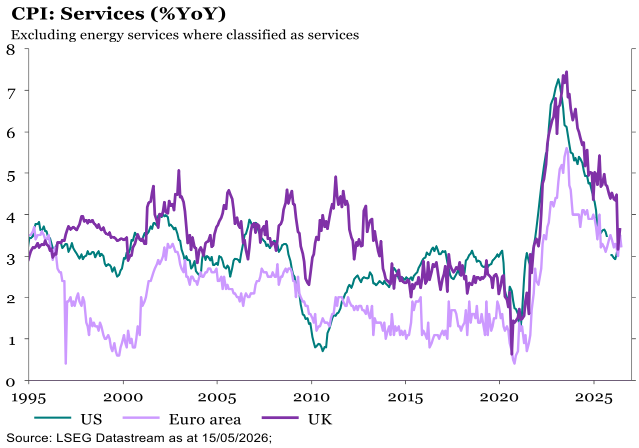
Prior to the war in the Middle East, inflation was already above target in the US, UK and Japan and services inflation looked relatively sticky in several economies (Chart 11). Since the start of the war, higher energy prices have been feeding through to higher headline inflation, mostly via fuel and energy-related components (Chart 12). Oil prices have since dropped from the peak, which should limit the direct impact of higher energy prices on inflation in H2 and moderate any second-round effects. However, the outlook remains uncertain. While oil prices have fallen, uncertainty remains following strikes on vessels in the Strait and around shipping conditions once the backlog of oil in the Gulf clears. Efforts to rebuild inventories may also create some upward pressure on prices crack spreads (the difference between crude and refined products prices) remain elevated, meaning the impact of lower oil prices on inflation may be lagged. There are also downside risks. Iranian oil (which was temporarily exempt from sanctions until a reescalation in early July), increased OPEC+ quotas, and the potential for increased supply from the UAE, could lower energy prices further.

Despite the drop in oil prices in June, we still expect earlier higher energy prices to continue feeding through somewhat into inflation in H2. For now, our central case incorporates some broadening out of inflation through indirect and second-round effects, though not close to the scale of 2022. Beyond energy prices, the emergence of an El Niño adds to upside risk to food prices in 2027 (see details below in our El Niño section on page 7).

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.

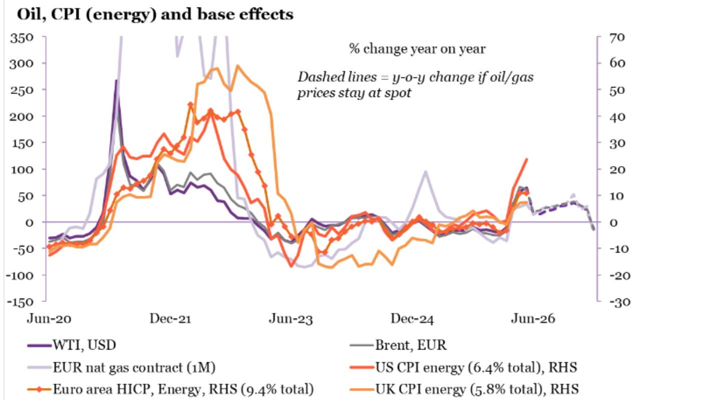
US: Following the conflict, US inflation rose more than a percentage point, reflecting higher energy and fuel prices in H1. Tariff effects on inflation seem to have largely passed through, but services inflation remains sticky. We expect more limited second-round effects in the US than the UK and euro area, given relatively well anchored inflation expectations in the US. However, with labour supply constrained by immigration policies, robust growth in the demand for labour would raise the risk of higher wage growth and more persistent inflation. For now, we expect inflation to return to around target-consistent levels during 2027 but to struggle to stay at or below those levels.

Chart 11: Services inflation still high



Source: LSEG Datastream, ONS, BLS, Eurostat. Data as at May 2026

Chart 12: Energy prices are feeding through to inflation



Source: LSEG Datastream, ONS, Eurostat. Spot energy prices to 22 June 2026. CPI figures to May 2026.

Euro area: While inflation was broadly at target before the conflict, higher energy prices in H1 pushed inflation to 3.2% in May. Despite oil prices falling from their peak, our central case incorporates modest indirect and second-round effects owing to the relatively tight labour market and the jump in some measures of inflation expectations. This was acknowledged by President Chrstine Lagarde in recent ECB commentary, indicating the ECB is starting to see signs of inflation broaden out throughout the economy. The ECB baseline scenario forecasts inflation to average 3.0% in 2026, which is in line with our central case.

UK: Inflation has risen sharply, driven by higher energy and fuel costs. We expect the weakening labour market and recent fall in energy prices to limit second-round effects compared to 2022, though elevated inflation expectations increasing tensions in the Gulf remain key risks. Our central case incorporates modest second-round effects, with inflation peaking at around 3.5% this year, falling much closer to the 2% inflation target over 2027.

Japan: The direct impact of higher energy and fuel prices in H1 has been less pronounced in Japan than other economies, reflecting fiscal support, substantial oil reserves and a lower energy weight in the CPI basket. In the medium term, we expect solid fundamentals will support Japanese inflation to settle sustainably higher than pre-pandemic levels.

Energy shock pass-through: Risks remain

The conflict in the Middle East resulted in a substantial increase in energy prices, alongside increases in other commodity prices. Headline inflation jumped in many countries. Following the signing of the MoU, oil prices have fallen, which has lowered our inflation forecast. However, we continue to think that the earlier rise in energy prices may result in second-round inflation effects.

When setting the monetary policy stance, central banks will watch for the indirect impact of higher energy prices in H1 – for example higher electricity and transportation costs feeding through into the price broader goods and services. They will also be watching for so-called ‘second round’ effects, where higher energy costs feed through into wage and price setting with a lag.

Our econometric modelling suggest such second round effects are influenced by the prevailing macroeconomic environment, in other words, how worried central banks should be is ‘state dependent’. Using our econometric model, we find three factors to be especially relevant in determining the persistence of the impact of the energy shock on inflation and wage growth:

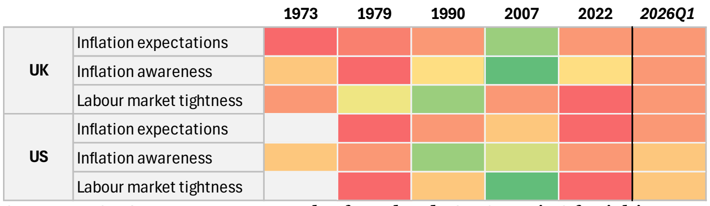
- **Inflation expectations:** Elevated inflation expectations may prompt workers to negotiate higher wages, accept higher prices, make firms less willing to accept margin hits, and encourage consumers to bring forward large purchases, intensifying inflationary pressures.
- **Labour market tightness:** In tighter labour markets, workers tend to have more bargaining power over their wages, thereby increasing wages.
- **Inflation attentiveness:** Following periods of high inflation, consumers may be more attentive to renewed inflation, allowing shocks to transmit more quickly into wage and price setting dynamics.

Mapping our three factors over time helps explain past inflation shocks. Focusing on these state-dependent factors, we can immediately see why the oil shocks of the 1970s, for example, were so problematic. During the oil shocks of the 1970s, surging oil prices were followed by persistently higher inflation (prompting central banks to tighten monetary policy). Our analysis shows that, at the time, inflation expectations were exceptionally elevated, and households, having recent experience of high inflation in the early 1970s, were particularly attentive to renewed inflation (Chart 13).

Compared with 2022, the risk of second-round pass-through currently appears more contained, but elevated inflation expectations remain a key vulnerability, and the UK looks more at risk than the US. Softer labour market conditions since the pandemic should limit the strength of second-round effects compared to 2022, when labour markets across the US, UK, and euro area were exceptionally tight. Since then, labour markets have gradually softened, with labour market tightness currently broadly around average levels in the US and UK. The recent decline in energy prices should also help to moderate second-round effects. However, elevated inflation expectations on some measures and the recent experience of high inflation still imply a risk of moderate second-round effects.

For now, we expect softer labour markets since the pandemic and lower energy prices than we initially expected to limit the strength of second-round effects but, with inflation expectations and our measures of inflation sensitivity where they are, some modest second round effects look likely – especially in the UK and euro area.

Chart 13: Scorecard: Second-round inflation risks?



Source: LSEG Datastream; Bank of England, ONS, Uni. Of Michigan Citi/YouGov, OECD, BLS; RLAM analysis.

Will the energy price spike be followed by a food price spike? Fuel, climate and El Niño

Energy prices have been the driver of higher inflation in H1. Although energy prices have now fallen from their peak, we think a food price shock could still follow. Higher energy prices in H1 and the disruption in the Strait have already driven up input costs in the agricultural sector (primarily fuel and, relatedly, fertiliser availability and cost); despite shipping in the Strait stating to normalise, disruption to fertiliser supply during the critical planting window means we may see less food harvested in the coming year or so. Combined with the backdrop of more frequent extreme weather episodes reflecting climate change and an El Niño event and the combination of these three factors mean higher food price inflation looks likely.

El Niño is a powerful climate pattern typically occurring every two to seven years, the last in 2023/24. The US National Oceanic and Atmospheric Administration (NOAA) have declared that El Niño conditions are now underway again with a 63% chance of a Super El Niño during November-January (as of early June). Strong El Niño events make different parts of the world more likely to experience extreme heat, high rainfall and cold winters and most strongly affect the Americas, Asia and Australasia.

What do El Niño and extreme weather events mean for prices? Although El Niño has varying effects on crop yields, there is (unsurprisingly) evidence that El Niño events boost food prices. In a 2023 Economic Bulletin article, the ECB pointed to evidence suggesting a 9% impact on global non-energy commodity prices peaking after 16 months for *strong* El Niño episodes. IMF researchers found that the impact of El Niño on inflation is upward for most economies (~0.1-1.0pp range), with the impact strongest where food is a higher proportion of the consumer basket.

The effects of extreme weather events on inflation goes well beyond food prices though. Episodes of extreme heat and drought, for example, can also have effects (again with cost/price implications) on the viability of transport routes (e.g., low water levels of river and canals), productivity (uncomfortable working conditions and ill health) and electricity production (less hydroelectricity and potentially more demand, and price impacts, for oil and gas).

Could the impact on inflation be worse given the backdrop? Extreme weather events are already more frequent against a backdrop of climate change. Throwing the Middle East and El Niño into the mix this year may add to a sense of persistent supply shocks. The oil price shock has already seen some measures of inflation expectations rise and people's acceptance of higher prices in response to shocks may already be elevated given the post-pandemic experience of high inflation. A food price spike against this backdrop has the potential to result in more persistent inflation (see also work on energy shock pass-through on page 7). Food prices are anyway more salient for setting inflation expectations where consumers tend to notice increases in their weekly food bill for example.

What happens to growth? Food price shocks are likely to be negative for activity growth, adding to cost-of-living pressures everywhere. Many developed economies are net importers of agricultural commodities (notably the UK, Japan and, to a lesser degree, the EU). El Niño events *in isolation* aren't necessarily bad for growth in all economies, however. The impacts are complex, with weather effects actually helpful in some areas and for some crops for example. However, this El Niño event *won't* be in isolation. Farmers, food producers and retailers will likely have seen margins shrink given higher energy costs and protecting consumers from price rises may not be possible. It is plausible that outcomes for growth are generally more detrimental against that backdrop, via the impact on consumer spending or supply, as the energy and food shocks compound.

What does all this mean for central banks? A food price shock, like an oil shock, can generate tension for central banks – raising inflation but creating challenges for parts of the real economy (especially for consumers). Given the risk of more persistent effects on inflation at the moment though, it may be hard for central banks to 'look through' any shock, keeping central bank rates higher than they would otherwise be.

Central bank policy: 'wait and see'

We expect fewer rate hikes than we did before oil prices fell from their peak. But we do not think rate hikes are off the table.

Following conflict in the Middle East and the impact on global energy prices, we have seen a smattering of developed economy central bank rate hikes, including in Australia, Norway, the euro area and Japan. Against a very uncertain backdrop, central banks have been navigating the risk that inflation overshoots more persistently, as a result of the rise in energy prices, against differing domestic economic backdrops and starting points in terms of degree of accommodation and restrictiveness of policy. At the start of the year, the Reserve Bank of Australia (RBA) and BoJ were already expected to raise rates, however the Norges Bank and ECB weren't. In Norges Bank's case, inflation had already been running higher than expected before the conflict. For the ECB, however, according to President Lagarde, a rate rise at the June meeting was justified partly on the grounds of signs that the inflationary impact of higher energy prices was broadening out. ECB policy rates were also around neutral rather than restrictive, putting them in a slightly different starting position to the Federal Reserve for example.

Despite the recent fall in energy prices, we think the risk of indirect and second round effects from the earlier increases in energy prices will keep most central banks on hold for much of the rest of the year and with a higher probability of a rate rise than a rate cut over that period, particularly given the increased tensions in the Middle East.

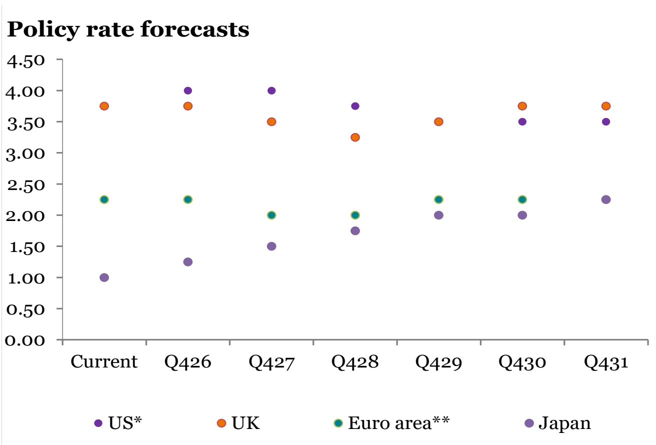
We are still pencilling in some modest second-round effects in the UK and euro area. That view is supported by our work on pass-through where the UK is 'flashing amber' on the three factors that drive whether or not an earlier increase in energy prices will lead to higher wage growth and have a persistent effect on inflation (see page 7). However, the fall in oil prices from their peak has reduced inflation risks sufficiently that we now expect both the BoE and ECB to keep rates on hold this year (rather than hike). In the US, we think the risk of second-round effects are more contained than in Europe, partly due to well-anchored inflation expectations. However, signs of the labour market regaining momentum, a touch stronger core inflation than we had expected and a more hawkish than expected Chair Warsh mean that the risk of a rate rise has risen, in our view, *despite* lower oil prices. Our central case now pencils in a rise in the Fed funds rate in 2026.

However, the outlook remains highly uncertain: The outlook for the oil price remains uncertain (see earlier points) and the degree of pass-through to broader inflation of earlier higher energy prices remains uncertain. For now though, as the inflation risk recedes with oil prices coming down from their peak, so too does the risk to central banks of waiting and seeing.

So, when can they cut? Our forecasts currently assume that the ECB and BoE will cut rates in 2027 as inflation concerns soften. For most central banks, our forecasts are anchored by our view on medium-term equilibrium rates and envisage rates moving towards those levels over the forecast: 3.50% in the US, 2.50% in the euro area, 3.75% in the UK and 2.25% in Japan

The Fed under Warsh: The Fed's messaging had already shifted into a more neutral place, rather than having an easing bias. But in his first press conference, new Fed Chair Warsh put a heavy focus on the price stability part of the Fed's mandate leaving a distinctly hawkish impression, which was emphasised in the June meeting minutes. The risk of a hike feels higher than we had anticipated under his chairmanship. Although inflation risks from the energy shock look somewhat lower, inflation is in its sixth year of being above target and the Fed's dual mandate does put it in a different place. With the labour market showing some signs of improving, labour market slack looks less likely to constrain second-round effects and may allow the Fed to continue to place more focus on the inflation side of the mandate. A sizeable cohort of FOMC participants continue to worry about the risk of more persistently above target inflation and nearly half of FOMC participants pencilled a rate hike into their forecasts in June (albeit likely without taking full account of the US-Iran deal and lower oil prices at that point). As we move through 2026 into 2027, the probability of further US rate rises may become elevated, reflecting outperformance of the US economy and persistently above target inflation.

Chart 14: Central policy rate trajectories



Source: National central banks/LSEG Datastream (past actuals). All forecasts (from Q4 2026 onwards) are RLAM estimates. *Upper end of Fed Funds range. **ECB refinancing rate.

United States: More than just AI

US growth remained resilient in H1 2026. PMI business surveys have held up well compared to other economies, although some of that resilience reflected stockpiling in the manufacturing sector. The AI capex boom has maintained its momentum. US consumption is increasingly looking bifurcated, but lower inflation and continued job growth would support the economy into and through 2027. For now, this is not an economy firing on all cylinders. Risks include a renewed surge in oil prices, more persistent than expected inflation and an AI/tech ‘correction’.

Progress update: Relatively resilient

US GDP growth accelerated to 2.1% quarter-on-quarter annualised from 0.5% in Q4 (hit by the government shutdown). Since the start of the conflict in the Middle East, PMIs have held up better than elsewhere. The manufacturing PMI increased from 51.6 in February to 53.9 by June, supported by firms bringing forward purchases to mitigate supply chain disruptions and anticipated price rises. Non-residential capex trends have been strong with a jump in Q1 and rising growth in core non-durable goods orders, all likely supported by the AI buildout. The labour market has started to show signs of gaining momentum, after a year of stagnant employment growth. However, the US hasn’t been immune to higher energy prices and supply chain disruptions: Inflation (CPI) has jumped up from 2.4% year-on-year in February to 4.2% year-on-year by May.

US consumer spending, continuing to deliver growth

US GDP, not AI: US GDP growth remained robust last year, expanding by 2.1%. While many economists and commentators credit this strength in growth to AI capital expenditure by technology firms and hyperscalers, as we have outlined above, we believe the impact on GDP growth has been overstated. This is largely due to the fact the majority of AI equipment, such as chips, semiconductors and storage devices, are imported. So, if AI isn’t at play, what has been fuelling US GDP growth? In our view, the answer lies with the US consumer.

Consumption has driven growth: Despite the focus on investment, consumption has been the primary contributor to US GDP growth, accounting for approximately two-thirds. Real consumption grew by 2.6% in 2025, with BLS data indicating it contributed 1.4% to the overall 2.1% GDP growth (Chart 15). That is significantly larger than our estimate of the impact of AI investment, which ranges from 0% to 0.4% of the total.

Wealth effects and the ‘two speed’ economy: The strength in US consumption is largely attributable to US consumers reducing their savings rates. As noted previously, US savings rates have sunk below pre-pandemic levels, while remaining elevated in the UK and euro area (Chart 7). One reason may be US consumers being more exposed to the equity market, where AI has indirectly contributed to significant wealth effects via the stock price of related companies. These wealth effects may have encouraged US consumers to continue reducing their savings rate despite real disposable income growth being relatively modest. Wealth effects have also contributed to an increasing divide in consumption between high- and low-income households. The June Fed Beige Book, for example, highlighted this growing divide, noting that consumer spending is becoming ‘increasingly bifurcated’ as consumption from higher-income households remains resilient while low-income households are showing greater financial strain.

Savings rates unlikely to decline much further; wealth effects on shaky ground: Lower savings rates and wealth effects seem less likely to drive consumption growth in the second half of 2026 and 2027. With the savings rate already nearing historical lows, further falls feel unlikely, particularly if real income growth remains soft. Moreover, the ongoing conflict in the Middle East has softened consumer confidence (albeit less than in Europe and Asia), which may limit the extent to which consumers will lower their savings rate. Additionally, the multi asset team have raised concerns that AI, in stock market terms, is both a boom and a bubble. If such a bubble bursts, we would worry about broader effects on the US economy and consumer spending.

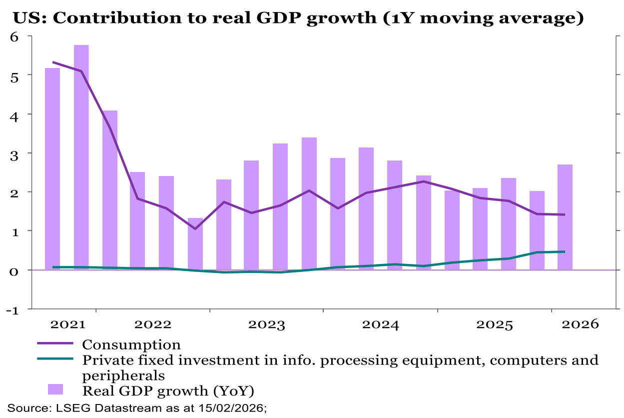
Labour market may drive spending: With wealth effects and lower savings rates less likely to drive consumption growth, we re-focus on the labour market as the primary consumption driver: Employment growth was low in 2025, but had recently shown improvement, averaging 111k new jobs a month over March, April, May and June. Given labour force growth looks set to remain weak, in part due to US immigration policy, sustained momentum in job growth could quickly reduce the unemployment rate and tighten labour market conditions. Alongside lower inflation, this would support wage and consumption growth. For now, consumer confidence remains weak though and AI risks (from a potential ‘bust’ and labour market disruption) remain.

Upside risks to inflation and risk of rate hikes

Underlying inflationary pressures already looked elevated pre-conflict. In particular, core services inflation has been persistently high, edging up in recent months. Tariffs had raised the cost of goods and, as outlined in the global section, pressure on food prices could follow the energy price spike. Surging semiconductor prices could provide further pressure, with some technology companies increasing electronic prices in the face of higher costs (e.g. Apple).

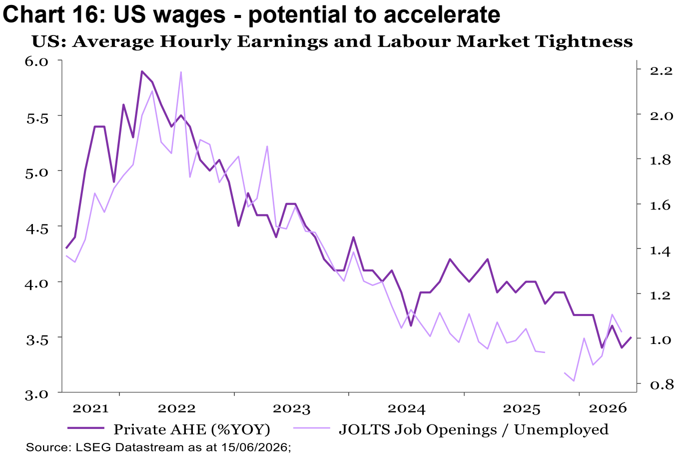
With oil prices falling from their peak, focus may turn to the labour market as the key determinant of inflation in H2 and 2027. While a strong labour market could support activity growth, it also raises the risk of second-round inflation effects from the earlier higher energy prices (see page 7). Chart 16 shows pay growth has been tracking labour market tightness (as you’d expect). Against the low immigration backdrop, it wouldn’t take much upside to demand to see wage growth re-emerge we think, raising the risk of multiple rate hikes (see page 8 for more on the US rates).

Chart 15: Consumption growth as the driver of GDP



Source: LSEG Datastream, BEA. Data to Q1 2026.

Chart 16: US wages - potential to accelerate



Source: LSEG Datastream, BLS; RLAM Analysis, Data to April 2026.

China: Domestic demand still a drag

While China was well placed to weather the energy price shock compared to many other economies, China's economy has been affected. Domestic demand remains a point of concern and Chinese economic policy remains more geared towards industrial policy than addressing a demand shortfall. Longer-term challenges remain, including demographics. In the medium-term, trade tensions are unlikely to fizzle out given China's industrial dominance. Taiwan remains a potential international flashpoint.

Status update: Could do better

GDP growth was a touch stronger than expected at 5.1% year-on-year in Q1 2026 and growth in industrial production has held up well given the backdrop, but retail sales has tended to disappoint, sliding into negative territory year-on-year in May. Fixed investment has also disappointed (Chart 17); after looking like it was turning upward, April saw a tip back into negative growth year-to-date. The NBS PMI business surveys have remained subdued and consumer confidence has weakened further. Inflation showed more signs of life after the rise in energy prices.

Energy shock: So far, so OK

Despite being the world's largest oil importer and importing a large amount from the Gulf, so far, as predicted, China seems to have weathered the energy shock in H1 reasonably well, likely helped by its energy mix (which still includes a prominent role for coal). China started this conflict with very large strategic petroleum reserves (see, for example, IEA); has significant refining capacity; and is a net exporter of refined oil products. As we discussed in April, 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. China is also looking well-positioned for the longer term by being at the forefront of fossil fuel alternatives (China's market share for solar panels over all its manufacturing stages exceeds 80%, according to the IEA).

Policy focus remains industrial

Industrial policy remains the focus. We continue to think China would benefit from a greater focus on domestic consumption.

Complications for corporates, even with industrial focus: Subsidies (and effective subsidies like favourable borrowing rates) have helped bolster industries in key sectors but have also encouraged overcapacity and low profit margins. A more inflationary backdrop as a result of the energy shock might end up being helpful for some firms *if* it helped them push through needed price increases; headline producer price inflation turned positive year-on-year in March. Meanwhile, analysts describe a significant divergence in industrial profits growth between equipment and high-tech manufacturers/raw materials compared to weak consumer products profits; weak domestic demand limits the outlook for this sector.

Policy focus is also an issue for overseas relations: China's overcapacity in certain areas is a source of tension for trading partners and those that compete with China, who come up against China's low prices and extensive subsidies (see, for e.g. FT on potential EU anti-China measures). OECD analysis of subsidies suggests that China's industrial firms receive more subsidies than their competitors and that the subsidies helped explain 60% of the gain in market share made by Chinese businesses between 2005 and 2023 (as reported by the WSJ).

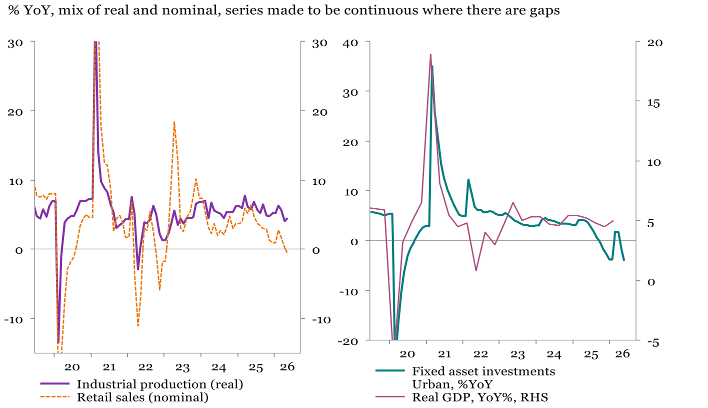
Even more needed on property? After years of intervention and clean-up, China's property market is still a problem, with the property bust already lasting five years. There have been improvements in top tier cities, but not broadly. The property backdrop has had lingering impacts across the Chinese economy, including suppressing potential wealth effects which has weighed on domestic demand.

Demographics and Taiwan remain issues for the medium-term outlook

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 are acknowledged by Chinese policymakers but look unlikely to turn around anytime soon. China is, however, shaping up to be able to benefit strongly from AI-related productivity gains via largescale use of industrial robots and strong official encouragement of AI application development. However, as elsewhere, adjustment to AI may also prove disruptive for employment.

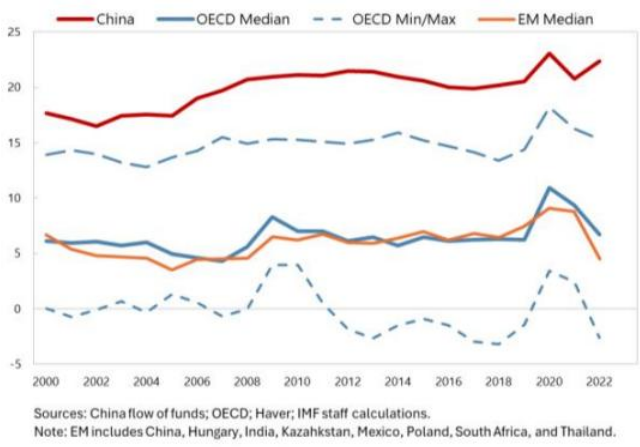
The nationalistic element of China's policymaking is also problematic in the shape of what that means for Taiwan in particular. The 2028 Taiwanese election is arguably the next most likely flashpoint for that relationship. Against the current demand for AI equipment, any action from China that resulted in trade disruption for Taiwan (e.g. a blockade) could have substantial implications for the global economy given the key role Taiwan currently plays in the supply chain for AI and the broader tech industry.

Chart 17: More signs of deterioration, post-conflict



Source: LSEG Datastream, NBS. Data is to May 2026 except GDP which is to Q1 2026.

Chart 18: China's household savings rate remains high



Source: IMF working paper (WP/25/259, December 2025)

Euro area: Softer growth, cautious consumer

Since the start of the conflict in the Middle East, business and consumer survey data has pointed to some loss of momentum in the euro area economy. The PMI's moved into contractionary territory, indicating falling activity and consumer confidence fell sharply, reaching some of the lowest levels since 2022. However, with oil prices lower – and the euro area a significant oil importer - the outlook has improved. While current above-target inflation will strain the consumer near-term, prospects for 2027 look better especially if higher consumer confidence follows lower oil prices and translates into (somewhat) lower household saving rates.

Status update: Could do better

GDP shrank 0.2% quarter-on-quarter in Q1 after a 0.2% quarter-on-quarter gain in Q4. Although the fall was exaggerated by GDP volatility in Ireland, the underlying growth picture remains weak. The conflict in the Middle East is expected to have weighed on growth, particularly with the euro area being a substantial net oil importer. PMI business indicators continue to indicate a sluggish picture for private sector activity growth, remaining below the 50 'no growth' level in June, indicating modestly falling private sector output (Chart 19). The unemployment rate remains close to its historical lows although the picture from broader labour market indicators is less positive. Headline inflation rose around a percentage point in response to the conflict.

Holding back

Fiscal policy boost…: Fiscal policy looked set to provide a modest boost to growth this year (and still does). However, that boost remains very German centric and initial reform of the debt brake to allow for more infrastructure and defence spending has not been followed by more generalised reform. Reports suggest that any further reform won't take place during the current legislative term (see, e.g. Reuters). With tensions still high in the Middle East and the US viewed as a less reliable ally, we may see more governments raise spending on defence and energy infrastructure, which would support growth.

…offset: While fiscal policy should be a mild support for growth, any impact so far has likely been offset by higher energy prices in H1 and the continued geopolitical uncertainty (not helped by the ongoing war on the Europe's Eastern border). Analysis in our April report suggested that the rise in oil prices would be consistent with 0.3% lower GDP growth. That scale of impact looks a little large after recent falls in oil prices back to prewar levels, but may still be enough to net off the impact of 2025's additional fiscal support (which was expected to feed through with a lag into GDP in 2026)

Consumer outlook weakened: There is still potential consumer spending 'firepower' available if confidence improves and savings rates normalise (US consumer spending has been helped by a falling US savings rate), now does not seem the obvious time for that to materialise. The consumer outlook remains more downbeat: higher inflation will weigh on real income growth (and ECB data points to slower wage growth this year); interest rates have risen; and uncertainty around job security has increased (see Chart 20). Taken together, these factors are unlikely to be conducive to households wanting to save less, although lower oil prices and associated potential for consumer confidence to improve, could moderate the negative effects in 2026 and support consumption growth in 2027.

Our central case is for subdued positive GDP growth in 2026. Annual GDP growth at the moment looks likely to exaggerate weakness though after an outsized correction in Ireland's GDP figures in Q1 – the main reason why our July forecast is lower than our April forecast. With oil prices falling close to prewar levels, we think a recession is even *less likely* than before. At its June meeting, the ECB laid out three alternative scenarios for the euro area economy, reflecting differing energy prices and pass-through to inflation. With the recent fall in oil prices, we are trending closer to the mild scenario. The outlook for oil prices remains uncertain of course and, in the ECB's adverse and severe scenarios, oil prices rise to over $120 and $160 pbl respectively, implying lower real GDP growth with trajectories for inflation that imply the ECB would need to hike rates again.

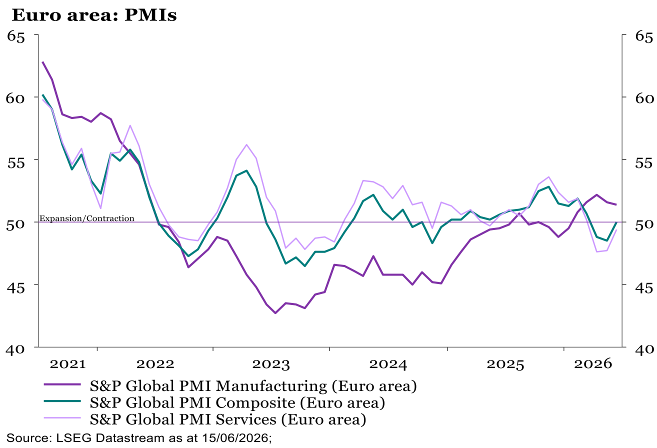
Politics on the radar: As we head into 2027, French presidential and Italian general elections will come into focus, presenting a source of uncertainty for businesses. Germany and Spain also present risk of political instability.

Longer-term challenges still include adverse demographic trends, incomplete capital markets union and a lack of harmonised regulation in some areas across the region which is still seen as holding back regional productivity gains.

ECB: Done with hiking? Maybe

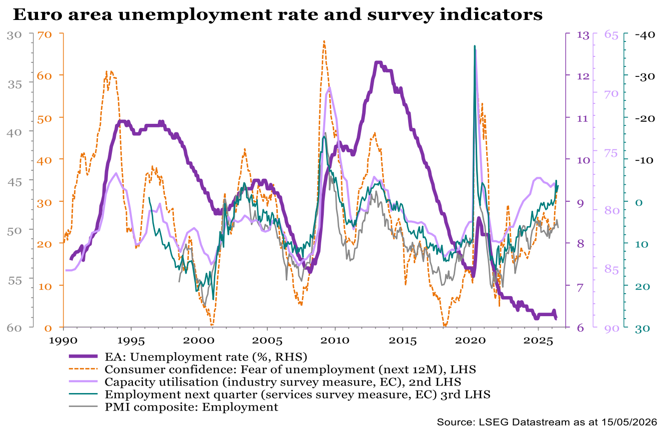
The ECB raised interest rates in June from a level around neutral, with President Lagarde noting a broadening of inflation effects beyond just energy prices. The subsequent fall in oil prices from their peak should help to moderate second-round effects and limit the risk of significant monetary policy tightening. However, we still worry that the relatively tight labour market and the jump in some measures of inflation expectations could see the earlier jump in oil prices feed through into more lasting impacts on broader inflation. Our central case now pencils the ECB remaining on hold for the rest of 2026, but with a significant risk of another rate hike later in the year should indirect and second-round effects materialise.

Chart 19: Euro area: Sluggish PMIs



Source: LSEG Datastream, S&P Global; Data to June 2026.

Chart 20: Uncertainty around job security



Source: LSEG Datastream; OECD; DG ECFIN; S&P Global; Unemployment rate to April 2026, consumer confidence and employment next quarter to May 2026; Capacity utilisation to 2026Q2 and PMI composite to June 2026

United Kingdom: Unsteady footing

Conflict in the Middle East has helped leave the odds stacked against the UK economy recording robust growth this year. AI is unlikely to boost growth much yet; the labour market remains soft; fiscal policy lacks headroom, as does monetary policy in light of above-target inflation. Domestic political uncertainty has been unhelpful, giving businesses more reasons to hold back on key decisions. Although GDP growth had a strong start to the year, that growth looks set to fade. Nevertheless, with lower oil prices, the risk of recession has faded, as has the risk of the BoE needing to hike rates significantly. AI and moves towards a closer trading relationship with the EU could be supportive of growth in the medium term.

Status update: Q1 looked good, but unlikely to be sustained

After budget-related uncertainty potentially dampened activity in Q4 2025, Q1 2026 saw GDP growth at a strong (by UK standards) 0.6%Q. PMI business surveys point to very slow growth in Q2. The consumer remains challenged as real pay growth slows on lower wage growth and elevated inflation, while consumer confidence weakened on conflict in the Middle East. The labour market continues to look soft across a range of indicators with falls in vacancies and payrolled employees.

The worst (this year) is yet to come, but it isn't all bad

At least in terms of GDP growth, we think that the worst is very much yet to come after a strong Q1 GDP growth belied conditions in the underlying economy and especially given the likely impact of conflict in the Middle East on Q2 into Q3. As a net energy importer, the UK has been exposed to rising energy costs and UK households and industry already face high electricity prices (Chart 21). Much of the impact of higher energy prices in H1 is only just being felt, with household energy bills rising to reflect higher wholesale prices only in July. GDP growth will likely be lacklustre for a while.

The UK labour market was weak going into the conflict and subsequent uncertainty around the outlook is not conducive to hiring. Surveys suggest that redundancies and a lack of hiring are increasing slack in the labour market; vacancies have fallen, having shown signs of stabilisation last year (Chart 22). The adoption of AI gives companies additional fuel for claiming that they can function with fewer employees. AI adoption appears to be rising relatively fast at 43% of professional and business services firms in December 2025 from 31% the year before.

There are upside risks though. Falling oil prices in June point to less persistent inflation than otherwise would have been the case, however events in the Middle East remain uncertain. The household savings rate remains at relatively high levels, which could translate to higher consumption if confidence improves should oil prices stay at lower levels. There have also been some moves towards a closer trading relationship with the EU. UK firms are not at the forefront of gains from the first wave of AI-related investment (via a dearth of sizeable tech companies and chip manufacturers) but could be a big gainer from the adoption of AI within its large services sector (at least to the degree that AI does not also see overseas challengers take substantial market share).

UK political uncertainty strikes again

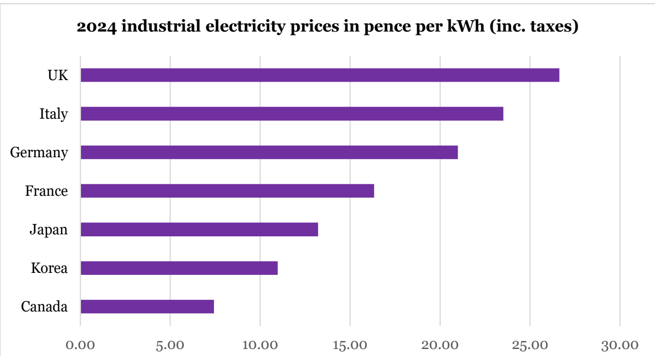
Over the last ten years, the UK has got through six prime ministers and will see its seventh soon. At the time of writing, former Greater Manchester Mayor Andy Burnham is set to take on that role. So far, we have limited information about what a Burnham government might bring. It would likely tack to the left and regional devolution will be a significant focus. However, policy options are constrained (see below); Burnham has already committed to the manifesto commitments on tax and; unless he calls for an early election (which seems risky given how well opposition party Reform UK are doing in the polls) he will not be seen as having a mandate for radical change. We will, however, be watching closely any new expressed views on fiscal policy and on the BoE remit (with some suggestions already being floated of reform there, despite the timing being unwise in our view given above target inflation and recently experienced very high inflation).

In the meantime, continued political uncertainty is turning into a medium-term drag on growth. Uncertainty around future policy is likely to limit business and household willingness to make significant spending decisions, although likely being outweighed for now by uncertainty around events in the Middle East. There has been some evidence from business surveys of an impact, with the May and June PMI survey seeing a number of firms cite domestic political uncertainty as a factor weighing on confidence. In a 2019 piece (summarised here) authors from the St Louis Fed concluded that large rises in policy uncertainty in the US hit output, especially durables consumption, residential investment and business investment that persist for longer.

Fiscal constraints for the incoming chancellor

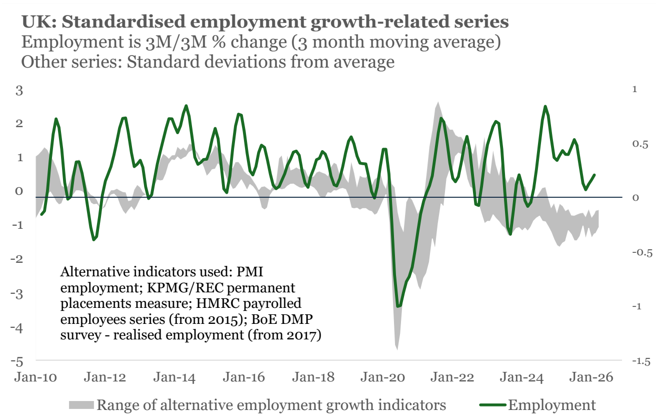
We do not yet know who a Burnham prime minister would pick as his chancellor, but any new chancellor will have limited room for manoeuvre. The fiscal headroom is likely to have been eroded by the impact of the Middle East conflict on bond yields and inflation. The bond market also seems increasingly willing to impose fiscal disciple, which will be a challenge for Burnham and his chancellor to navigate. Monetary policy is constrained by the potential for second-round effects, despite the fall in energy prices in June. On the plus side, renewed Bank of England rate cuts look likely to us later in 2027 assuming oil prices don't see a substantial, prolonged further rise and against a soft labour market backdrop.

Chart 21: Already high electricity costs



Source: Department for Energy Security and Net Zero, 2024.

Chart 22: UK hiring weak across measures



Source: LSEG Datastream, S&P Global, ONS, BoE (to April 2026)

Japan: Fiscal policy offsets energy costs

As a net energy importer, Japan has been exposed to higher oil and gas prices and energy supply disruptions, which will have weighed on activity. However, a robust fiscal policy response from the government has helped to cushion the economy from the worst of the effects, and with the announcement of a supplementary budget and the government growth strategy, we expect fiscal policy to continue to support activity in the second half of the year. Over the medium term, underlying fundamentals remain in place to support sustainably higher inflation and stronger potential growth.

Status update: Holding up ok

Japan's real GDP expanded by 1.1% in 2025 and continued its momentum in the first quarter, growing by 1.8% quarter-on-quarter on an annualised basis. Since the onset of the Middle East conflict, Japan's composite PMI has continued to indicate modest, albeit slowing, activity growth; the composite PMI easing from 53.9 in February to 51.1 in May but edging back up in June as lower energy prices improved the outlook. Nominal wage growth remained robust in the first quarter, growing at roughly 3% year-on-year, suggesting real pay growth has remained positive so far this year. Inflation remains elevated by Japanese standards, although Japan has experienced a less pronounced uptick in headline inflation from elevated energy costs than other developed economies (Chart 23), largely due to strong fiscal support from the government.

Fiscal cushion easing short term challenges

As a significant energy importer, Japan has been hit by higher oil and gas prices in the first half of the year. We expect previous high energy prices will weigh on national income via a negative term of trade shock, as import prices rise more quickly than export prices. Nonetheless, fiscal policy has helped to cushion the economy from the most severe effects. The Japanese government has implemented price control measures across almost all energy products, notably aside from Naphtha, and has announced a supplementary budget of ¥3 trillion providing fuel price support for the July to September period. The ¥370 trillion government growth strategy should provide a further fiscal impulse, although details on how it will be funded remain limited.

In addition to fiscal support, several other factors have helped to mitigate some of the effects on the Japanese economy. In particular, improvements in Japan's energy efficiency, significant share of long-term LNG contracts and substantial crude oil reserves have all helped to cushion the economy.

Fundamentals should support stronger potential growth

Despite near-term headwinds, underlying fundamentals suggest potential growth (currently around 0.5%) will continue to drift upwards:

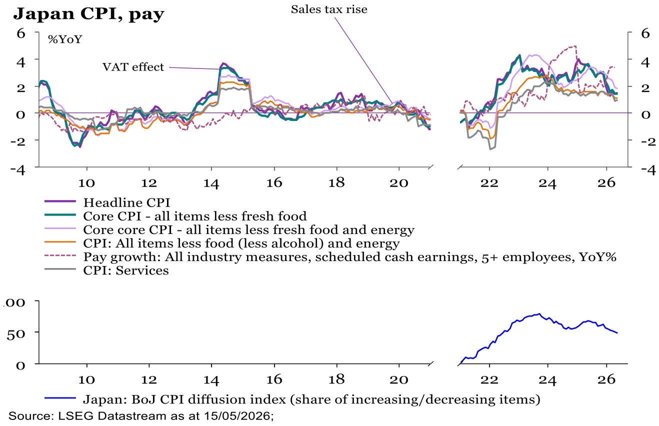
- **The labour market and wages**: The labour market continues to look relatively tight, reflecting demographic trends. Labour market tightness, combined with rising inflation expectations and increased labour market mobility (partly as views on lifetime employment evolve), should support real wage growth in the medium term. Wage growth has been most pronounced in younger cohorts, where mobility is higher (see BoJ), and in older cohorts (Chart 24). Older cohorts are surprisingly willing to change jobs (see WEF) and have benefited from labour shortages which have prompted firms to retain workers. That suggests stronger wage growth could become more sustained in years to come.
- **The consumer**: Rising real wages in the medium term, combined with rising consumer confidence, should support higher real consumption, especially with Japanese authorities having (so far) shielded consumers from the energy price spike.
- **Productivity:** Labour productivity growth in Japan has lagged that of the US, UK or euro area for much of the past two decades, despite Japan being one of the most robot-intensive economies in the world. We expect persistent demographic pressures to encourage investment in labour substituting technologies to address persistent workforce shortages. An openness to automation, the recent period of corporate reform and low real interest rates should all also encourage investment, which will increase productivity growth. Increased labour mobility could shift labour away from low-productivity firms to high-productivity firms, further supporting stronger productivity growth (See Governor Ueda).
- **Fiscal policy**: The landslide majority won by the LDP in February should give leeway to pursue more fiscal spending, in particular on cost-of-living support (as we have already seen during this energy shock) and the ¥370 trillion government growth strategy to 2041.

However, there are risks to the medium-term outlook: Loose fiscal and monetary policy could be met with higher inflation expectations and higher bond yields. Japan's declining working age population, which fell by 0.3% a year on average over the last five years, may also drag on activity growth if not met with productivity enhancements. And on productivity, Japan remains a slow adopter of AI and productivity growth lags behind peers.

Gradual rate rises

We continue to expect gradual rate hikes by the BoJ. We are pencilling in one further BoJ rate hike this year and a further hike in 2027. However, should the energy prices increase again and/or inflation surprise on the upside, against a resilient economic backdrop, then faster additional hikes seem likely.

Chart 23: 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 April 2026.

Chart 24: Wage growth unequal across ages

Source: Ministry of Health, Labour and Welfare. Data to 2025

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