



Economic Update

Issue #38, October 2026

Multi asset

Royal London Asset Management manages £212 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 June 2026

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US: Private consumption remains the workhorse of US GDP growth. Our central case for the US consumer is benign, but there are vulnerabilities. Domestically driven inflation risks are tilted to the upside, as is the risk to rates.

China: Domestic demand remains soft and while export growth has been strong, we expect domestic demand to continue to weigh on lower GDP growth over the coming years.

Euro area: H1 GDP growth has held in surprisingly well. However, the ECB have been quick off the mark in raising rates too. We expect a bit more ECB tightening, with risks to the upside of our forecast for now.

UK: The H2 backdrop looks less supportive with higher energy bills and moderating pay growth. The labour market continues to look subdued, but elevated inflation leaves BoE hiking likely.

Japan: We expect further rate rises from the BoJ and a faster pace. Over the medium term, underlying fundamentals remain in place to support sustainably higher inflation.

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

Oil, Chips and Hikes

The energy price backdrop remains volatile and uncertain leaving plenty of uncertainty around the economic forecasts too. So far, global growth is showing surprising resilience, partly reflecting the AI buildout. Although several supports for growth from H1 remain in place, we would not be surprised to see somewhat slower growth in H2 as higher inflation weighs on real incomes and given higher market interest rates since we last updated our forecasts in July. Our inflation forecasts are higher than they were and we have added a few more rate hikes into our central bank profiles. However, this is still not the kind of booming, demand-driven inflationary backdrop that warrants central banks going on a major hiking spree. Risks to the outlook remain two-sided.

Summary

Resilience still a feature: Higher energy prices do not seem to be significantly holding back major developed economies. That is less surprising in the US than in Europe, but we would have expected consumers in particular to have shown more sign of strain given the hit to real incomes. Central banks haven't hiked much (which has helped activity growth) and fiscal policy and AI have provided well-timed offsetting support for global growth. We still see downside risks to the consumer outlook, but our central growth forecasts recognise the resilience seen this year and the likelihood of that continuing in the near-term.

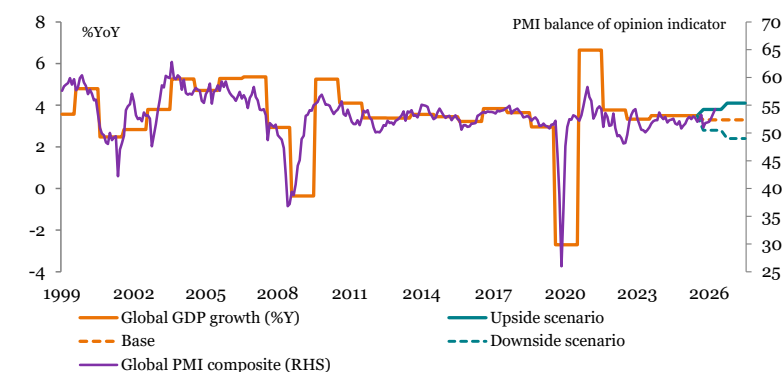
Inflation – uneven risks: However, outcomes in the Middle East remain uncertain resulting in sizeable two-sided risk for the inflation outlook. The outlook for refined product supply is as important as crude and even if crude prices fall, we worry about how long it will take to normalise supply and prices for the oil-derived products that are actually consumed by businesses and households. We continue to worry about the potential for higher food prices in the wake of the energy price shock. However, we still expect the second-round effects of higher oil prices to be relatively modest based on evidence so far. Medium-term, we still see outcomes for inflation as skewed to the upside in coming years given the climate, geopolitical, fiscal and demographic backdrop.

More, but not many, rate hikes expected: Further rate hikes this year have become more likely as inflation has remained elevated. Central banks perceive enough risk of persistent inflation to hike or sound on the brink of hiking; alongside relatively resilient global growth, there is little to stand in the way of central banks raising rates into restrictive territory to reduce inflation risk. However, there isn't the justification in their forecasts for the economy, or in the incoming data (at least not yet), for a more significant hiking cycle.

Risks are two-sided to the outlook: Beyond energy prices, there are a host of other risks that we are monitoring, from the impact of AI on inflation, the potential for labour market tightening and risks from tighter financial conditions, to broader worries around fiscal sustainability.

The **multi asset team** remain moderately positive on equities and commodities and negative on government bonds. The team recognise that corporate earnings, like business confidence, have also been resilient this year and continue to prefer equities in regions where earnings show greatest strength, such as the US. For more, see the Our Views section at www.rlam.com.

Chart 1: Global growth tracking: More bull case than central case



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

Economic forecast summary

October 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	2.3	2.8	3.75	2.3	4.0	4.25	2.3	2.3	4.50	2.0	2.2	4.25	2.0	2.2	3.75	2.1	2.2	3.50	2.0	2.2	3.50
				2.2	3.7	4.00	1.9	2.4	4.00	2.0	2.5	3.75	2.0	2.4	3.50	2.1	2.4	3.50	2.0	2.5	3.5
China	5.1	–	–	4.6	–	–	4.6	–	–	4.2	–	–	4.0	–	–	3.9	–	–	3.8	–	–
				4.4	–	–	4.3	–	–	4.2	–	–	4.0	–	–	3.9	–	–	3.8	–	–
UK	1.2	3.4	3.75	1.6	3.7	4.00	1.4	2.8	4.50	1.3	1.7	3.75	1.4	2.3	3.75	1.4	2.3	3.75	1.4	2.2	3.75
				0.8	3.2	3.75	1.1	2.3	3.50	1.4	2.3	3.25	1.4	2.4	3.50	1.4	2.3	3.75	1.4	2.2	3.8
Euro area	1.3	2.1	2.00	1.1	4.1	2.75	1.6	1.9	3.00	1.3	1.9	2.25	1.2	2.0	2.50	1.2	2.0	2.50	1.2	2.0	2.50
				0.6	2.7	2.25	1.4	2.0	2.00	1.3	2.1	2.00	1.2	2.0	2.25	1.2	2.0	2.25	1.2	2.0	2.3
Japan	1.2	2.5	0.75	1.1	2.3	1.25	1.0	1.4	2.00	0.8	1.9	2.25	0.7	2.2	2.25	0.5	2.0	2.50	0.5	2.1	2.50
				0.8	2.0	1.25	0.9	1.7	1.50	0.7	1.9	1.75	0.6	1.9	2.00	0.5	2.0	2.00	0.5	2.0	2.3
Global	3.1	–	–	3.3	–	–	3.3	–	–	3.2	–	–	3.1	–	–	2.9	–	–	2.9	–	–
				2.8	–	–	3.0	–	–	3.2	–	–	3.0	–	–	2.8	–	–	2.8	–	–

Source: LSEG Datastream, national statistics offices, Bloomberg Finance L.P. for past actual data. All forecasts (e) are RLAM. Current data and forecasts are in black. Forecasts from the July 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 gradually falling from around \$100 to around \$75 a barrel by late 2027, roughly in line with market pricing (Chart 3) (staying at higher levels for longer than assumed in July). The outlook for energy prices remains highly uncertain and therefore so does the economic outlook.

- 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. In our central case, inflation remains above central bank target measures at the end of this year in the US, euro area, UK and Japan. However, with strong base effects – assuming that energy prices fall and that we don't see a significant pick up in pay growth – inflation ends 2027 below, or at least much closer to, target. Against the currently elevated inflation backdrop, we expect (further/faster) rate rises for the Fed, ECB, BoJ and BoE.
- We expect some policy easing in the middle of the profile as inflation subsides. Our estimate of medium-term neutral rates helps anchor the medium-term rate forecast: 3.50% for the Fed, 3.75% for the BoE and 2.50% for the ECB and BoJ.
- Further disruption to shipping flows and increased escalation in the Middle East present upside risks to inflation and rates and vice versa. We see the balance of risk as skewed to the upside (partly reflecting less benign scenarios evolving for natural gas, refined products and food prices).
- The scope remains limited for additional fiscal support given government debt levels and higher post-pandemic interest rates. Consumer spending is assumed to grow a little faster *next year* as energy prices fall, supporting overall GDP growth. Risks there are skewed to the downside.

Global economic scenarios (Chart 1)

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

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

Base case (60%): Relative resilience story holds; central banks do not move policy dramatically

- Elevated oil and gas prices over the past few months lead to higher inflation in 2026 but doesn't derail activity growth. 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 the AI build out, though the scope for additional fiscal policy support remains limited. Lower real income growth and confidence mean that consumer spending is modest over the rest of the year and non-AI capex does not grow strongly either, but prospects improve over 2027 on lower energy prices even as the contribution to growth of the AI build out slows.
- High 2026 inflation is followed by much weaker inflation on energy base effects and relatively contained domestically driven inflation pressure, despite higher food price inflation. Into 2028 we see some central bank cuts as inflation cools.

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 with shortages prolonged. Higher inflation shows more signs of leading to second round effects than in the base case, prompting central banks into more rate hikes. Recessions follow.
- Consumer and business confidence and spending weaken. Hiring slows. The AI build out slows rapidly, causing increased volatility in the financial markets. Inflation falls more sharply than in the central case beyond 2027 as labour markets and growth weaken, resulting in more substantial eventual rate cuts than in the base case.

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

Global economy: Further resilience in the face of shocks

With energy prices now higher than they were when we last updated the forecasts in July, we have revised up 2026/H1 2027 inflation forecasts and interest rate forecasts. We also now factor in higher food price forecasts, partly reflecting the development of a very strong El Nino. Global growth has shown surprising resilience in the face of energy price shocks and at this stage we do not mechanically revise down those forecasts, despite higher oil prices. Several factors (from fiscal policy to AI) have helped the global economy to hold up and some look likely to continue being a support over the remainder of the year. Downside risks to the outlook for activity should fall with energy prices, but the risks are two sided.

Status update

Global growth is showing surprising resilience in the face of renewed higher oil prices with the PMI business surveys, for example, strengthening rather than weakening during Q3 (Chart 1). There have been more signs of a role in this resilience for AI capital expenditure and defence spending. Fiscal policy is helping too (Chart 2), including in the euro area and Japan. The impact of higher energy prices on inflation, however, remains visible and the outlook has deteriorated following this summer's further rise in in energy prices (higher bond yields won't be helping either). Against that backdrop, more central banks have raised rates.

Summary outlook: Higher 2026 inflation, higher rates

Higher 2026 inflation forecasts: At the time of writing, oil and gas prices are significantly higher than when we finished our last forecast update in early July (Chart 3). These higher prices – alongside the market-implied forward path which assumes around \$100 per barrel before settling at around \$70 – are now embedded in our forecast alongside modest assumptions of second round effects. However, we have also raised our food price forecasts following higher energy prices, the very hot and dry European summer, and emergence of a very strong El Nino.

Annual growth forecasts higher too – but expecting H2 to slow a bit: Despite a stronger path for oil (and food) prices, our annual GDP growth figures are somewhat stronger in 2026 and 2027. That, to a large extent, reflects better than expected GDP outturns/nowcasts for Q1-Q3 2026. We've also had some further loosening of the fiscal stance in the euro area, some more policy stimulus in China and an apparent broadening out in the AI story with even the recent UK GDP figures showing signs of possible AI-related gains. In terms of pace, however, our forecasts show some slowing in growth rates going into 2027 reflecting weaker real pay growth and higher market interest rates.

More central bank tightening than in the July forecast: Almost inevitably given higher oil prices, higher inflation forecasts and more resilient growth than we envisaged in July, we have also pencilled in more rate rises. These are not steep and sizeable hiking cycles, but policy tightening now takes rates more clearly into restrictive territory (to bear down on risks of persistent inflation).

Risks to the outlook are two sided: In the July update we flagged several factors likely to support growth this year and next including fiscal policy, the AI build out and the state of private sector balance sheets. These sources could all continue to provide more support and underlying resilience than we have pencilled into our forecast. On the downside, we flag several areas of risk to the outlook in this report including:

- US consumer vulnerability to shocks (with the savings rate still below pre-pandemic norms)
- The risks AI poses through multiple channels (in this report we look at inflation, the labour market and financing)
- Fiscal sustainability concerns (and the risk from tighter financial conditions as bond yields continue to rise)
- The risk of a food price shock (following higher energy prices and with a very strong El Nino event underway)
- The risk of rapid and inflationary tightening in the US labour market (with labour supply dynamics changed by tighter immigration policy).

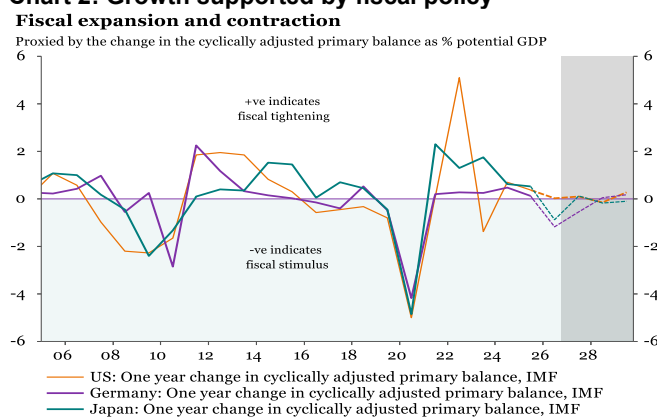
Oil prices, however, remain the main source of both upside and downside risks with the capacity to lurch up or down depending on difficult to predict developments in the Middle East. US President Trump has already threatened to attack Iran after the November mid-term elections.

Rate path sensitivity: We still see energy prices as the main point of sensitivity in the forecasts. If energy prices don't fall from here then, despite some likely demand destruction, we would expect to be adding another rate hike or two into the profiles for the main central banks. On a much steeper than envisaged fall, we would anticipate central banks hiking one or two times less than we currently pencil in.

We would see a higher barrier currently to the Fed *not* hiking rates, compared to the ECB. Although growth has been surprisingly resilient in both the US and Euro area, US economic growth has been more consistent. The US consumer has been more willing to increase spending out of income than the European consumer and AI has been more of a direct driver of the US economy than the euro area. On inflation, before the energy shock hit, the euro area economy had started to record inflation around the 2% target (unlike the US).

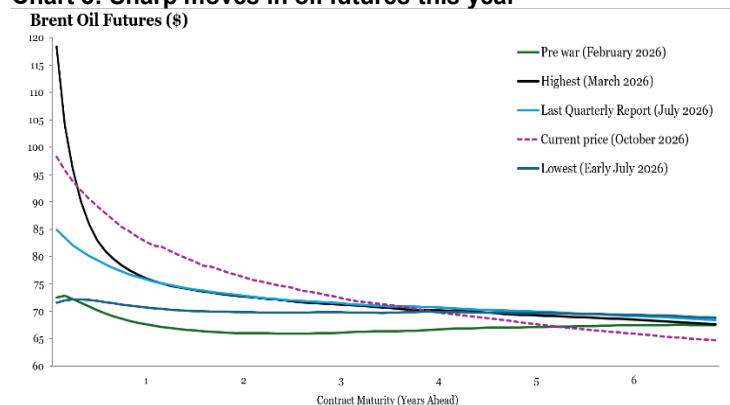
Japan is also on a somewhat different path and appears to have shifted to a structurally higher inflation norm. We find it difficult to see the BoJ *not* hiking towards 2%, almost regardless of the oil price.

Chart 2: Growth supported by fiscal policy



Source: LSEG Datastream, IMF. Data to April 2026

Chart 3: Sharp moves in oil futures this year

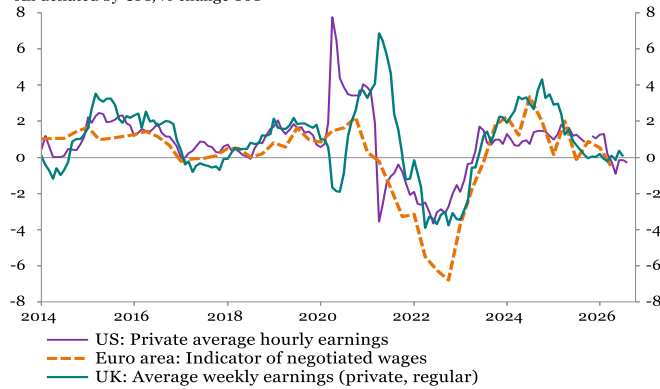


Source: Bloomberg. Data last updated 6th October 2026

Chart 4: Weak real pay growth

Selected real pay growth measures

All deflated by CPI; % change YoY

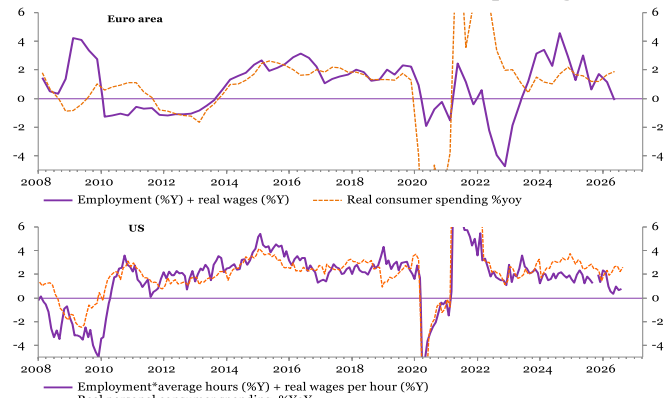


Source: LSEG Datastream as at 15/09/2026

Source: LSEG Datastream, BLS, ONS, ECB, Eurostat. Data is to August 2026 (US), July 2026 (UK), Q2 2026 (euro area).

Chart 5: Consumer spending held up in H1

US and Euro area: Labour income & consumer spending



Source: LSEG Datastream as at 15/05/2026

Source: LSEG Datastream, Eurostat, ECB, BLS, BEA. Data as of Q2 2026 (euro area), August 2026 (US)

Consumer spending: GDP workhorse facing challenges

Real consumption growth has held up relatively well through the first half of the year, despite the rise in inflation and the consequent slowing in real pay growth/sluggish real disposable income growth. In the US at least, support has likely come from sizeable US tax refunds, wealth effects and a willingness to save less/borrow more. We expect that to hurt consumer spending more, the longer energy prices remain high. If prices evolve in line with our central case, however, the outlook should brighten later next year.

- **Labour markets mixed and real pay growth slow:** After a hit this year (Chart 4), annual real pay growth should turn more supportive again later next year as inflation falls. For now, however, real labour income growth (see Chart 5 which uses a proxy for labour income for the euro area and US) has slowed sharply and with consumer spending having held up well relative to that, there are risks to the downside for consumer spending growth over the rest of this year and into next year.
- **Consumer confidence damaged:** Consumer confidence is weaker than it was at the start of the conflict in the US, euro area, UK and Japan, damaged by higher energy prices and related worries around the economy (Chart 6). The lack of rate hikes from the Bank of England alongside a modest 'honeymoon' period for the new Prime Minister helped to boost consumer confidence in September, but this subsequently unwound in October. The ongoing decline in the US from levels at the start of 2025 is especially noticeable. We would expect UK confidence to fade further if energy prices remain elevated – not least reflecting a likely large household energy bill increase in January 2027. For all these economies, a significant *fall* in energy prices from the peak could lead to a sharp rebound in consumer confidence, which could support consumption growth into 2027. Still, elevated energy prices and central bank rate hikes leave risks skewed on the downside for now.
- **Wealth effects and savings rates – (US) vulnerability to shocks:** In the US, savings rates have fallen below pre-pandemic norms, but remained more elevated in the UK and Europe. That continues to imply more consumer firepower for European consumers should confidence improve (alongside an end to rate hikes) but leaves US consumers looking more vulnerable to shocks, especially ones that also dent the equity market – a significant source of US wealth effects.

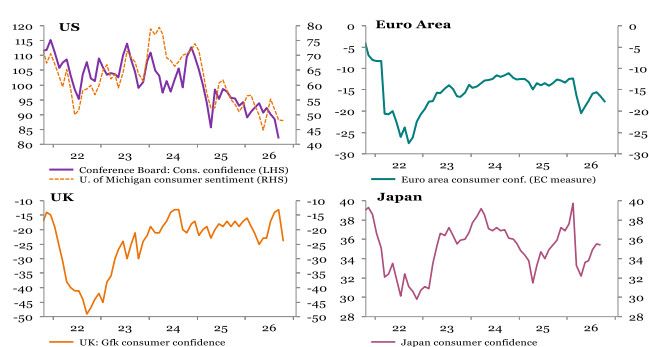
Overall, our central case is for softening, albeit still positive consumption growth in the second half of 2026 into 1H 2027, then for broadly stronger consumer spending growth in 2H 2027. Risks to the outlook remain two sided depending on how things evolve in the Middle East and how central banks respond to them.

Fixed investment: GDP bright spot, supported by AI build-out

Gross fixed investment (Chart 7) partly explains why activity indicators are holding up well and can, in part, be traced back to the AI build out. As highlighted in previous reports, we question for how long the pace of investment in this sector can be maintained. With the US, a key part of the story will be the AI buildout (see too page 6 on hyperscaler issuance). In the euro area, increased infrastructure and defence spending will be providing some support. In the UK drivers of business investment have been mixed over the last couple of quarters.

Chart 6: Soft US consumer confidence stands out

Consumer confidence measures

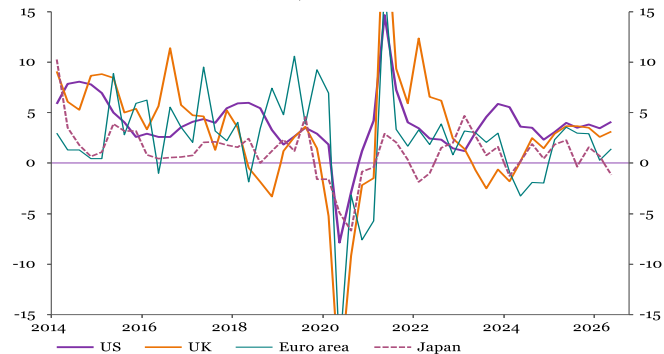


Source: LSEG Datastream as at 15/09/2026

Source: LSEG Datastream, The Conference Board, University of Michigan, GfK, YouGov, ECB, University of Michigan, Cabinet Office. Data as of September 2026, euro area and UK as of October.

Chart 7: Fixed investment strong, especially in the US

Gross fixed investment (real, %Y)



Source: LSEG Datastream as at 15/05/2026;

Source: LSEG Datastream BEA, Eurostat, ONS, Cabinet Office. Data to Q2 2026.

AI: Inflation, labour market and financing risks

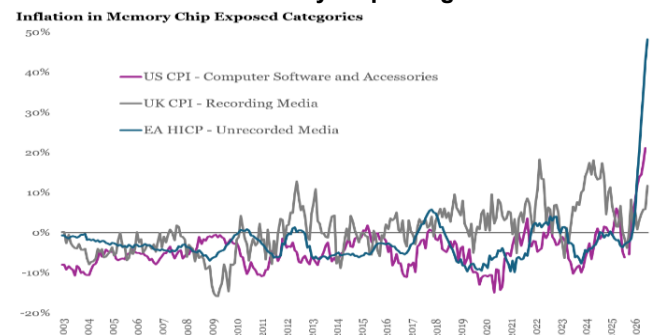
AI is already affecting the global economy through multiple channels, and will likely continue to do so. Focusing on the near-term implications, we can already see some impacts on GDP, inflation, the labour market and financial conditions (albeit in some of these areas the impact will have been overshadowed by the impact of higher energy prices). Focusing on three of these:

AI and inflation

The inflationary impact of AI is not clear cut. Past episodes of general-purpose technologies have ultimately helped *reduce* inflationary pressures through productivity gains. However, in the shorter-term, we expect the AI build-out to add some inflationary pressure through three main channels (with some impacts already visible): i) Higher chip and memory card prices feeding into consumer technology products; ii) Input cost spillovers into broader prices; iii) Increased data centre demand for electricity. So far, however, evidence supports a relatively small impact on headline CPI.

Inflation data suggests the clearest effects are in categories most exposed to memory chip prices (Chart 8). However, these categories have low weights in inflation indices. Weighting together the categories we think are most exposed to AI related price pressures, including consumer technology products, suggests a relatively small but growing impact on headline inflation in the US and euro area for example. The one exception is US PCE, where prior to methodological changes in September, we estimate that AI was contributing around 0.3pp to headline inflation on the PCE measure. However, the BEA's September methodological revisions broadened the set of price series used to measure this category. As a result, software and accessories inflation was revised materially lower, bringing its contribution to headline inflation closer to that in US CPI and in other countries. Beyond these categories, evidence of significant direct AI inflationary pressures remains limited for now.

Chart 8: Inflation in memory chip categories



Source: LSEG Datastream, BLS, ONS, Eurostat. Data to August 2026.

AI and the labour market

AI is expected to have a significant impact on the labour market (though economists disagree directionally). Although there has been plenty of discussion around near-term labour market disruption from AI, we think the effects are likely to have been relatively modest so far.

In the US, some have pointed to college graduate hiring as early evidence of AI-related labour market disruption. The argument is that recent graduates are more likely to perform tasks easily automated with AI, and therefore are most exposed to replacement by AI. Chart 9 shows that the unemployment rate for recent college graduates has increased more sharply than the workforce average. However, it is not clear how much of this can be attributed to AI: Recent college graduates have been more exposed during cyclical labour market downturns. The recent rise in graduate unemployment may also reflect a normalisation following Covid-era over-hiring. [NY Fed](#) analysts suggest the rise in remote working may have made employers less willing to hire inexperienced workers, given that training and development can be more challenging virtually than in person. Meanwhile, [Indeed](#) job postings data point to a sharp rise in vacancies containing AI related terms. Similar results are also found in [University of Maryland data](#) where active postings for roles requiring AI skills have been rising. However, the cross-sector evidence of AI displacement is also not especially compelling. We map sectoral exposure to AI, using the OECD AI risk index, against the average change in non-farm payrolls since 2024 (Chart 10); There is little evidence of a clear relationship.

AI may be having more of a role for now in labour market *sentiment*. The euro area measure of consumer fear of unemployment in the next 12 months has risen sharply since 2022, despite a historically low unemployment rate (Chart 11). Fear of AI job displacement may be one of the factors explaining this. Regardless, AI and its labour market impact seem likely to become a more prominent feature in political debates and elections over the coming years. There are already signs that job security concerns and the impact of datacentres on electricity prices are beginning to negatively shape public opinion.

AI financing and financial stability risks

The pace of AI investment has been extraordinary strong in recent years. Investment and debt issuance also stretches beyond hyperscalers to the broader tech sector and the infrastructure supply chain, but here we focus on the so-called hyperscalers (effectively incorporating all the large-scale cloud computing companies). Hyperscaler capital expenditure has risen sharply, is closely associated with the AI build-out and is expected to rise to more than

Chart 9: AI impacting recent graduates?

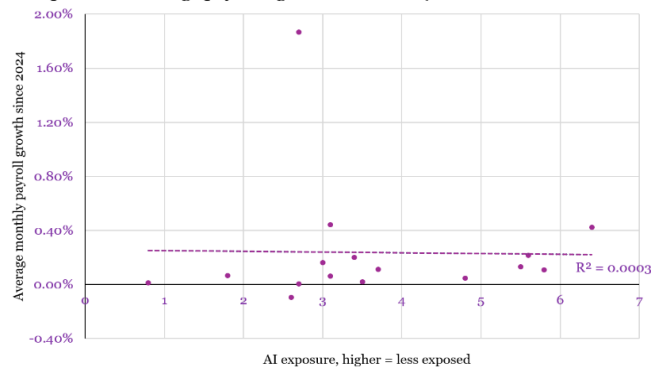
Unemployment rate for recent college graduates (%)



Source: LSEG Datastream, New York Fed. Data to June 2026.

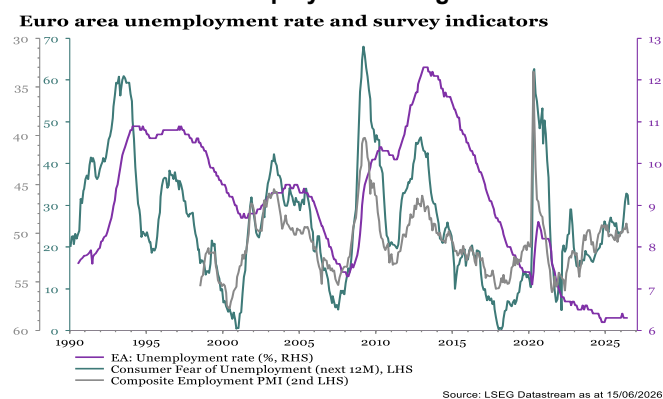
Chart 10: Limited sign of AI hiring effect

AI exposure vs average payrolls growth since 2024



Source: LSEG Datastream, BEA, OECD. RLAM calculations. Data to July 2026.

Chart 11: Fear of unemployment rising



Source: LSEG Datastream, Eurostat, S&P Global, European Commission. Data to August 2026.

\$1 trillion by 2028 according to the [BoE](#). While this investment was initially funded predominantly from cash flows, hyperscalers are increasingly turning to debt markets to finance renewed investment. While this AI investment has been contributing to resilient global GDP growth in the first half of 2026, we think there could be macroeconomic risks from the increasing role of debt in AI financing

Hyperscaler bond issuance in 1H 2026 has already surpassed the total issuance throughout the whole of 2025, with issuance increasingly stretching beyond just the US dollar (Chart 12). Hyperscaler financing also encompasses private credit and off-balance sheet financing (e.g. the FT report growing use of special-purpose vehicles to finance new data centre infrastructure projects, with a [complex web](#) of lease agreements and guarantees backing debt).

The sharp rise in AI-related debt issuance, growing use of private credit markets and complex web of financing structures could make it harder to assess the total leverage in the system and where it resides. As the rise in debt financing continues, investors are likely to focus on the sustainability of earnings growth. A material earnings shortfall could therefore have significant market, and by extension, macroeconomic consequences.

Fiscal policy: Cushioning the blow

Fiscal policy has remained broadly supportive in both the US and euro area so far this year. In the US, tax refunds earlier in the year, together with tariffs refunds in Q2 and Q3, helped to underpin resilient consumer spending and bolster corporate finances. In the euro area, increased defence and infrastructure spending looks to have provided a modest fiscal impulse through government consumption and fixed investment (see euro area section below). Governments have also introduced a range of fiscal measures in response to the conflict in the Middle East, helping to cushion consumers and the economy from the energy price shock. In developed economies, fiscal support has largely taken the form of energy subsidies and price controls.

In the **US**, much of the fiscal impulse this year is likely to be already behind us. Tax refunds were largely passed through to households in H1, while the bulk of tariff refunds have now been distributed. As of mid-September, around \$135bn of the total \$166bn IEEPA tariff revenues had been refunded. A [recent Fed survey](#) suggests these revenues amount to 1.7% of annual revenues, with more than 75% of recipient firms indicating they intent to retain at least some of the refunds as cash, providing a modest boost to finances. President Trump has floated the idea of a \$5,000 payment to every American should the Republicans win the mid-term election; but current polling suggesting that remains unlikely.

In the **euro area**, higher defence and infrastructure spending continues to provide a modest boost to growth. German Chancellor Merz recently announced a package of measures including tax cuts for middle earners and labour market reforms, alongside indications of potential pension reform and further defence spending, with recent reports indicating German plans to borrow more than €200bn in 2027 alone. Temporary fiscal policies have somewhat cushioned consumers and businesses from higher energy bills (see, e.g. [Reuters](#)).

UK fiscal policy looks set to continue to drag on the outlook in the next few years. With the fiscal headroom likely to have been degraded by higher interest rates and inflation, and the governments commitments to not raise income tax, VAT, corporation tax or employee national insurance, there is little room for manoeuvre in the October budget. As such, we expect a continuity budget with continued planned fiscal consolidation, providing a modest drag to the outlook. Bigger picture plans may become clearer with PM Burnham's 10-year plan, promised for later this year.

In **China**, recently announced mortgage subsidies and lending support look likely to provide some modest stimulus.

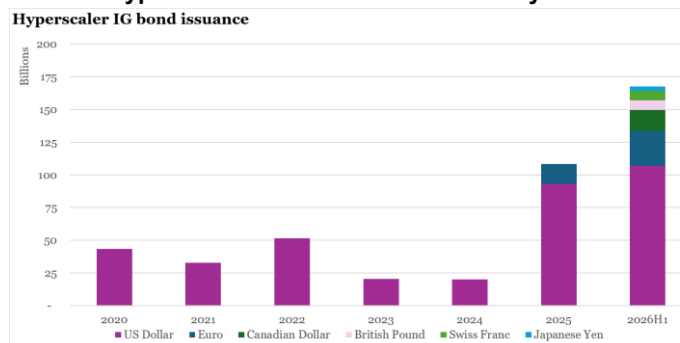
Fiscal sustainability and bond yields

Higher bond yields in major economies have been a growing discussion point. This recent move up can be mostly dated to the sharp rise in oil prices and effective closure of the Strait of Hormuz earlier this year, though looks to reflect more than just inflation concerns. While the proximate source of the recent move may fade over the next several months (dependent on events in the Middle East), we may have to get used to higher average bond yields:

- **Fiscal starting point is relatively poor:** Partly due to pandemic-related expenditure, governments are sitting with relatively high levels of government debt (Chart 13) and substantial government resources are being spent just servicing debt. Higher bond yields are raising debt servicing as existing debt matures. Even were government deficits zero, the debt/GDP ratio would continue rising where the rate of interest on the debt is higher than the rate of growth in the economy.
- **Lack of political will to improve fiscal situation:** Governments seem reluctant to go into fiscal repair mode and in some cases face significant political penalties if they do (see, for example fierce French protests against the 2023 rise in the retirement age or, in the UK, the Starmer government's u-turn on welfare cuts after pressure from within his own party). Despite the efforts of DOGE, the US deficit is forecast by the CBO to remain around current levels (between 5-6% of GDP for the next few years). The French deficit continues to overshoot the EU's 3% limit and Japan's deficit is rising after fiscal support measures in recent quarters. The UK is formally on a deficit reduction path, but successive Budgets have seen the planned path of deficit reduction softened (Chart 14).
- **Demographics unhelpful:** Ageing populations worsen the fiscal outlook by challenging the revenue base (where a large source of revenue is employment/income-based taxation) and increasing expenditure as % of GDP (e.g. social care, healthcare and pensions).

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Chart 12: Hyperscaler IG bond issuance already above 2025

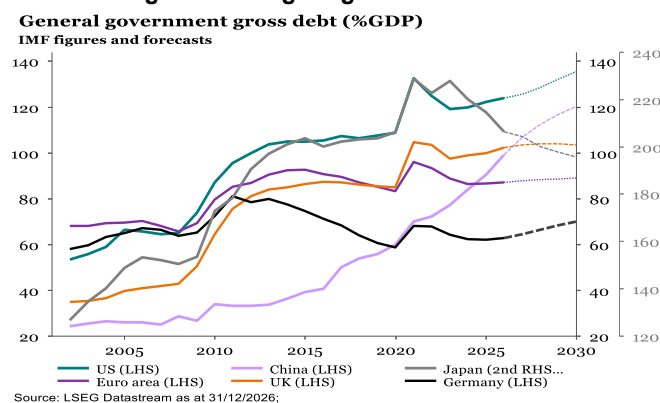


Source: Recreated from [Bank of England Financial Stability Report, July 2026](#).

- **Inflation is likely to have become more volatile:** Medium-term risks to global inflation look skewed to the upside and towards a 'spikier' pattern (see Multi Asset's Trevor Greetham on [Spikeflation](#)). We expect factors like climate change (both the cost of transition and the impact of more frequent extreme weather on food prices, supply chains and productivity); tighter immigration policies; and ageing populations (leading to tighter labour markets); to lead to upward medium-term pressure on inflation as well as more volatile inflation. AI could prove a significant negative offset, but productivity improvements from new general purpose technologies have historically taken a long time to materialise.
- **Higher neutral rate:** Economic theory suggests equilibrium real rates are determined in the long term by desired investment and savings (so that real rates should rise when desired savings are lower than desired investment). R^* may have risen in recent years, reflecting AI and the climate transition which can both be argued as having increased desired investment. An ageing population should see desired savings fall as those leaving the labour force start drawing on their accumulated savings. A rise in public debt can also be seen as raising R^* .
- **Hyperscalers:** A number of supply-demand imbalances may have impacted the curve, but at the shorter end, large-scale corporate debt issuance associated with the data centre build out may also be squeezing demand for lower yielding government bonds given the high credit ratings of hyperscaler issuers and their debt issuance across multiple currencies (Chart 12).

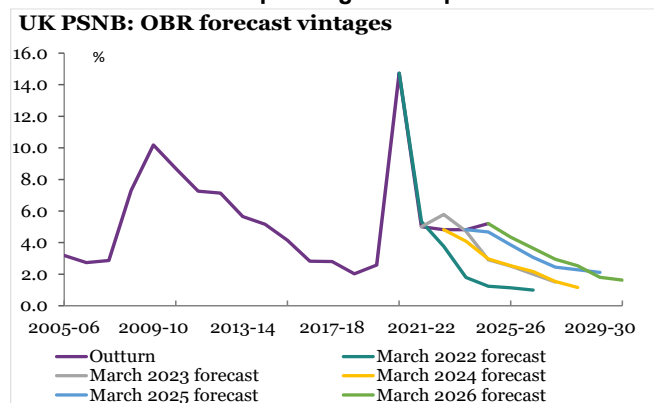
Since the beginning of the year, we have seen a shift up in the yield curve in major economies, rather than a move just focused at the long end. That increases the likelihood of significant economic impacts. Tighter financial conditions mean it is more difficult and expensive for companies and individuals to borrow. Higher bond yields can damage returns in other asset classes, notably equities in periods of positive bond-equity correlation.

Chart 13: Higher than higher government debt to GDP



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

Chart 14: UK deficit – pushing back repair



Inflation outlook: Upside risks increasing

We expect year-on-year inflation to get worse (rise) before it gets better (falls), see Chart 15. Since the start of the war, higher energy prices have been feeding through to higher headline inflation, mostly via fuel and energy-related components and core inflation seems to have flattened out at above target levels, or risen somewhat, in the US and Europe. We now pencil in higher food price inflation too (see 'Higher food inflation on the way' section below). Negative base effects should come into play in 2027 though; if energy prices were unchanged from here, that would imply a little more upside for year-on-year inflation, then a significant drag on headline inflation next year (Chart 16).

With energy prices having remained elevated for more than six months, and renewed pressure in refined products prices (see 'Geopolitics' section below), clearly inflation risks remain strongly skewed to the upside. So far, pay growth remains around target-consistent – or even below target-consistent – levels (Chart 17) in the US and Europe and we continue to pencil in relatively limited second round effects. However, the longer prices remain elevated, the greater the risk that higher energy costs feed through into broader prices and generate second-round effects. Pay growth could rise significantly in 2027 – a delayed response to this year's higher inflation. This element of 'second round effects' from higher oil prices is more likely where the labour market is tight and so less of a risk in the UK, for example where the labour market continues to look soft compared to the US or Japan.

US: US inflation continues to look sticky at above target consistent levels. For now, there is little evidence of second-round effects from oil prices, but with activity growth ticking along and AI capex surging, we wouldn't be surprised to see underlying inflation rise. With labour supply constrained, we don't think it would take much employment growth for the labour market to tighten and strengthen wage growth. For now, we expect inflation to return to around target-consistent levels during 2027 but for that to require more policy tightening and for inflation to struggle to stay at or below those levels.

Euro area: Inflation has jumped up from around target consistent levels prior to the conflict to 3.8% in September. Much of the increase in inflation reflects higher energy and fuel prices, though with some broadening out, and there are upside energy price risks from low European natural gas storage levels this winter. In our central case, inflation remains elevated into 2027, falling below target by the end-2027 as negative base effects feed through.

UK: As expected, inflation jumped up noticeably in July with the updated Ofgem price cap reflecting higher energy costs since the start of the war. Another jump in the price cap seems likely in January. Currently, we expect that will result in a jump in inflation above 4% early next year. We continue to pencil in only modest second-round effects as we expect the relatively soft UK labour market and hiring backdrop to limit the risk of more significant second-round effects. In our central case, inflation peaks above 4% early next year, falling below target in 2028 as negative base effects feed through.

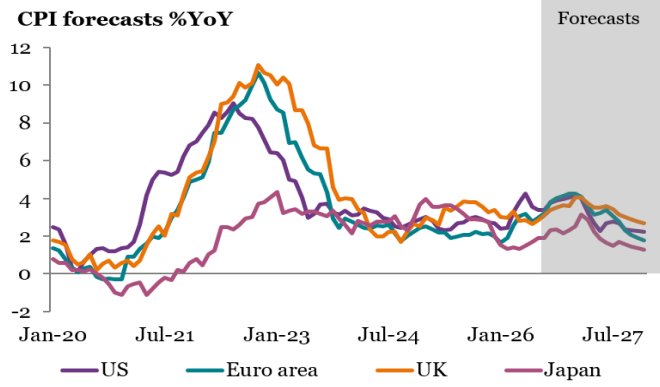
Japan: Planned consumption tax cuts significantly affect the forecast and the government continues to provide fiscal support to limit the direct impact of higher energy and fuel prices on inflation. Nonetheless, there is further evidence that Japan's inflation is now sustainably higher than pre-pandemic levels.

Geopolitics – Refined products pose upside risk to inflation

Crude oil prices elevated, but not as high as feared: So far, the rise in crude oil prices since the start of the conflict has been more muted than had been initially feared, despite a substantial fall in supply. Prior to the conflict, around 20mb/d (20%) of global oil supply transited through the Strait of Hormuz. The [IEA](#) estimates that oil flows through the Strait had fallen to around 7.6mb/d in August. Despite this 13.1mb/d shortfall, a number of mitigating factors help to explain why oil prices have risen less than initially feared. 1) Gulf nations have increased exports via pipelines; 2) higher oil prices have incentivised additional crude oil production outside the Gulf; 3) Inventory draws have helped, with more than 500 million barrels released

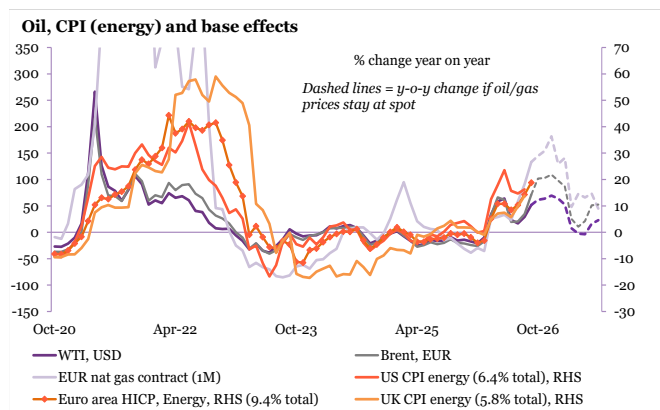
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Chart 15: Our headline CPI forecasts – dominated by energy



Source: LSEG Datastream, ONS, BLS, BEA, Eurostat, Ministry of Internal Affairs. Past actuals to August 2026 except euro area and US which are to September 2026. RLAM forecasts.

Chart 16: More energy price driven inflation to come



Source: LSEG Datastream, ONS, Eurostat. Spot energy prices to 8th October 2026. CPI energy figures to August 2026 (except euro area which is to September).

since the start of the conflict, equivalent to around 2.8mb/d; 4) Chinese oil imports have fallen sharply, reducing demand by around 2mb/d on average. Taking these factors together, the IEA estimates the effective supply deficit appears to be closer to 2mb/d.

But crude oil prices tell only part of the story: Households and businesses in the economy do not consume crude oil directly, but consume refined products, such as petrol, diesel and jet fuel, where price rises have been significantly more pronounced. Since the end of February, crude oil prices have risen around 50%, but gasoil (diesel) price have increased by around 100% (Chart 18). Natural gas prices have also risen sharply. The [IEA](#) estimates that while crude oil flows through the Strait of Hormuz are around 45% below pre-war levels, flows of refined products are estimated around 60% lower. Refined product supply has been impacted by a sharp reduction in Russian refining capacity following attacks on refining facilities by Ukraine and Russian-imposed export restrictions. China also introduced export restriction on refined products (though these have since been removed).

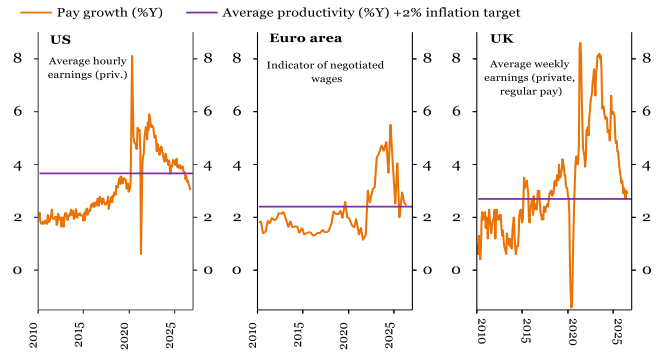
Upside risks to inflation, even if the Strait fully re-opens: Even if flows through the Strait normalise, refined product prices are likely to remain elevated for some time, as Russian refining capacity is unlikely to return quickly and there are fewer potential global offsets than for crude itself. In Europe, [gas storage](#) stands at 68% heading into peak winter seasonal demand, below the level seen at this point over the last 5 years.

Higher food inflation on the way

Still set for a significant rise in food prices: We expect higher food price inflation in 2027. Higher energy prices to date and the disruption in

Chart 17: Wage growth looks target consistent for now

Nominal pay growth measures vs 'target'



Source: LSEG Datastream as at 15/09/2026

Source: LSEG Datastream, ONS, Eurostat. Spot energy prices to 8th October 2026. CPI energy figures to August 2026 (except euro area which is to September).

Chart 18: Refined product prices have surged

Brent and gasoil futures



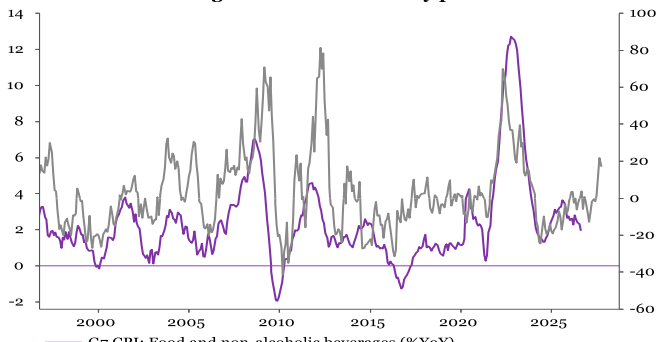
Source: Bloomberg. Data to 20th October 2026

the Strait have already driven up input costs in the agricultural sector (primarily fuel and, relatedly, fertiliser). Higher fertiliser costs mean we may see less food harvested in the coming year or so. El Niño conditions are also underway where, as we have previously written (see [The Next Inflation Storm?](#)) El Nino is expected to bring higher food prices as various parts of the world experience extreme heat, high rainfall or colder winters. Britain's [Met Office](#) have said that the developing El Niño has now exceeded previous records. That comes on top of a very hot and dry European summer which brought drought conditions and poor harvests.

We have already seen higher agricultural commodity prices. The food components of CPI in major economies have been falling rather than rising (Chart 19) but, given the lags involved, we expect this to affect CPI more in 2027 than 2026.

Chart 19: More food price inflation to come?

Food inflation and agricultural commodity prices



Source: LSEG Datastream as at 15/08/2026;

Source: LSEG Datastream, OECD. Spot commodity prices to 30 September 2026. CPI figures to August 2026.

A tendency towards more extreme weather is likely to bring more episodes like this: Climate change makes experiencing extreme weather more likely. The most obvious likely recurrent impact will be on food prices. Episodes of extreme heat and drought can also have effects (again with cost implications) on the viability of transport routes (e.g., low water levels of river and canals). This year we have seen some notable European rivers strongly affected (e.g. the Danube) and the Panama Canal cutting daily transits and raising fees as water levels fell. Energy prices can also be affected, e.g. as hydroelectricity becomes more scarce in hot dry weather and even solar panels lose efficiency in extreme heat.

Increasing the risk of persistent inflation? A food price spike has the potential to result in more persistent inflation by raising inflation expectations. Food prices are particularly salient for consumers and a succession of sizeable rises in first petrol, then household energy bills, then food prices would likely increase the sense of (and acceptance of) us now being in a higher inflation environment.

Central bank policy: More hikes ahead

We expect more rate hikes than we did in our July forecasts when oil prices had fallen significantly, but also compared to April after the conflict first broke out. While the implied oil profile we are using for the forecasts isn't all that different from April, a few things *are* different, including: Energy prices have now been elevated for a prolonged period; Natural gas prices are higher than they were at the start of the conflict and so are refined product prices. We are more worried about food prices (see above). Global activity has also proved more resilient than we'd have expected.

Central banks still balancing risks against a highly uncertain backdrop: We have seen several central bank rate hikes since July including in the euro area, Japan and the US. Most major central banks seem to be deciding meeting by meeting between a hold and a hike, where against an uncertain backdrop, central banks continue to balance the risk that inflation overshoots more persistently, against the risk of slowing the economy unnecessarily.

Central case: Predicated on a central path for oil prices described on page 2, we build more central bank rate rises into our central case. We pencil in three hikes from the BoE. After hiking rates twice, we expect two more hikes from the ECB. After hiking once, we expect two more rate hikes in the US, with risks skewed towards more. We are still pencilling in some modest second-round effects based on our previous work.

However, the outlook remains highly uncertain: The outlook for the oil price remains uncertain and the degree of pass-through to broader inflation of earlier higher energy prices remains uncertain. If energy prices don't fall from here then we would expect to be adding another rate hike or two into the profiles for the main central banks. On a much steeper than envisaged fall, we would anticipate central banks hiking one or two times less than we currently pencil in; as oil prices fall, so too does the risk to central banks of "waiting and seeing." However, at this point in time we see most upside risks to the US forecast given: 1) the Fed view monetary policy conditions as accommodative; 2) the US has entered its sixth year of above target inflation; 3) we worry about how quickly the labour market could tighten again and 4) a higher level of exposure to pressure from the AI-build out.

Will hikes even do much? There is a reasonable argument that rate hikes will do little if the domestic economy is being driven by things insensitive to policy rates (AI). Plus, if fiscal policy is working in the opposite direction of monetary policy (as it is in Japan and the euro area), monetary policy has more work to do. However, we think that even a few hikes are meaningful where worries about inflation and inflation volatility have gathered force.

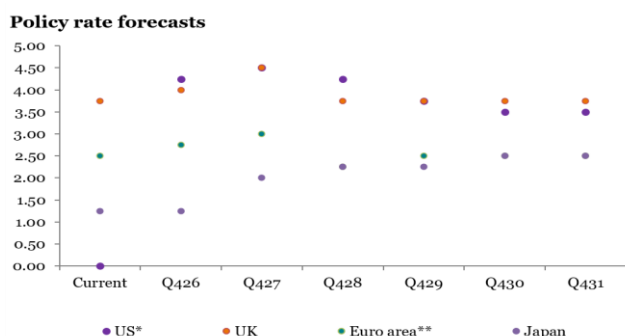
Fiscal dominance? While Trump clearly wants the US Federal Reserve to cut rates and Japan's PM Takaichi has added 'doves' to the BoJ's Policy Board, interference doesn't have to be direct for monetary policy subservience. With government debt levels high and bond yields higher than they have been for a long time, it is worth asking whether monetary policy is now limited by this. If the state of government finances is such that a rate rise would prompt financial stability issues for example, that is a problem. We have also been arguing for some time that fiscal sustainability issues risk more volatile bond yields, i.e. a tightening of financial conditions beyond the central bank's influence, that could then require an offsetting action from the central bank.

Will they ever cut? 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 2.50% in Japan. Our forecasts currently assume that the ECB and BoE are able to cut rates by early-2028 as inflation concerns soften.

Taylor-ing the path: Our new rate paths are roughly consistent with a Taylor rule determined path* for policy when plugging in our forecasts on the economy. With lower inflation ultimately expected as the impact of higher energy prices fade, these Taylor rule paths indicate rate cuts further down the line. Cuts could come sooner on a faster fall in oil prices. But a lower rate path would also be justified by more forward-looking Taylor rules which use forecasts more than a year ahead for inflation and the output gap to determine the policy rate. Translated into practical policymaking, should policymakers become more confident that inflation will drop significantly, even while inflation remains above target, then we may see rate cuts in 2027.

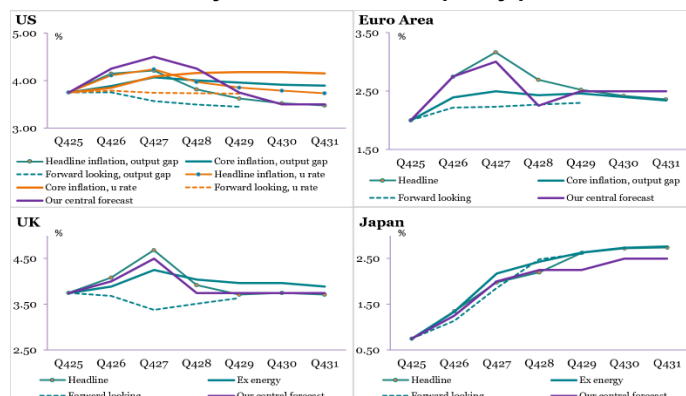
**We have used relatively standard formulation Taylor Rules (a popular monetary policy 'rule' where you assume that central bank rates follow a path determined by the weighted gap between 1) GDP and potential GDP or between the unemployment rate and an equilibrium unemployment rate and 2) the distance of inflation from target, all anchored by our estimate of the longer-term equilibrium rate. Clearly there is a fair amount of subjectivity when it comes to some of these inputs at any point in time, let alone the forecasts of them. The paths shown below, however, could be considered 'mechanically' consistent with our forecasts for inflation and economic activity.*

Chart 20: 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.

Chart 21: Our Taylor-rule consistent policy paths



Source: RLAM forecasts. Purple line is our current forecast and other lines reference difference Taylor Rule outputs when forecasts for different measures of inflation or activity gap are plugged in.

Politics: In focus in H2

There are several key approaching political events that are likely to be more of a focus over the coming year. Among them, November sees the US mid-terms, April next year sees the French Presidential election and an early UK general election shouldn't be ruled out.

- **US:** The most immediately consequential political event is the US mid-term elections which are expected to see Republicans lose control of Congress. Looking at current polls, we would expect Democrats to take control of the House, with a reasonable probability that Republicans lose control of the Senate too. That is likely to make legislation even harder to pass, bring even more difficult negotiations around the debt ceiling, government funding and fiscal issues more broadly, but is unlikely to see President Trump slow down in terms of executive action. We would assume that a strong desire to secure a legacy before leaving the Presidency would lead to more rather than fewer executive actions, although it may also see him even more focused on foreign policy.
- **France:** The French presidential elections will be held on 18th April, with a run-off election on 2nd May for the two most popular candidates if none win a majority in the first round. This election is seen as a key opportunity for the Far Right to take the presidency with strong polling for RN's Marie Le Pen and good support for the Far Left's Melenchon too. Legislative elections could then follow. A win for either would likely have implications for France's relationships abroad with both candidates saying that they want to pull back from NATO. Le Pen is no longer arguing that France should leave the EU but France's relationship with the EU is likely to become much less harmonious. For markets, French fiscal policy could again become a flashpoint with Le Pen having promised again to roll back Macron's reform to the pension age but not having explained in detail how she would make budget savings.
- **UK:** New UK PM Burnham may be tempted by an early election as a way to build support and legitimacy for an alternative policy platform more focused on his, rather than his predecessor's priorities and less hostage to previous manifesto commitments. However, the UK political environment looks relatively fragmented and there is no guarantee that, at the end of a campaign and election, the UK would find itself with a majority government. Even assuming the government sticks to the fiscal rules, promises made in an election campaign would ultimately likely imply more borrowing.

Political uncertainty is a drag on growth: Uncertainty around future policy is likely to limit business and household willingness to make significant spending decisions. 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.

More to come? Political uncertainty – or rather the risk of sharp swings in government policy election to election – seems more likely as populist parties and politics rise. Looking across [Europe](#), Germany's AfD is now its single most popular party, Reform UK has at times recently been vying to be the UK's and in France, RN's Le Pen garners the most support of any other candidate ahead of the French Presidential election.

In terms of economic impact, any trend towards populism could see a greater unwillingness to engage in fiscal retrenchment, a greater willingness to fragment longstanding alliances and to pressure and weaken organisations like NATO, the WHO, WTO etc. Authors at Germany's [Kiel Institute](#) found evidence not only of a rise in populist governments (which they define as those who place a conflict between 'people' and 'elites' at the centre of their electoral campaigns) but also a link with weaker economies in the longer-term (partly through undermining the rule of law and eroding political checks and balances).

United States: Mostly the consumer

US growth remained resilient in H1 2026. PMI business surveys have held up well compared to other economies and the AI capex boom continues. Despite AI, it is private consumption that remains the workhorse of the US economy. Our central case for the US consumer is benign, but there are vulnerabilities. More broadly, fiscal policy looks set to be less supportive in 2027 and monetary policy is likely to tighten further. Domestically driven inflation risks are still tilted to the upside where growth is proving resilient against a tight labour supply backdrop.

Progress update: Continued resilience, continued inflation

US GDP growth held up well in H1, slowing to 2.2% quarter-on-quarter annualised in Q2 but with a strong contribution from consumer spending. Despite conflict in the Middle East, business surveys have held up relatively well too. Non-residential capex trends have also remained strong (whether looking at capex new orders, business survey investment intentions indicators or actual non-residential private capital expenditure growth), likely supported by the AI buildout. The labour market data point to modest job growth. Alongside that relatively resilient activity backdrop, however, inflation on the CPI and PCE measures remains above target-consistent levels with an important question mark around how much of this is just about energy prices.

US consumer: Benign central case, but some vulnerabilities to monitor

It's still mostly *not* about AI: While the global AI build out is a key explanation for the relative resilience of global growth, we still think it can't explain much US growth. Compared to 5-years ago AI is adding significantly to US growth but we still think that it explains around 0.4% or less of total growth (see: [After the Shock](#), July 2026) since so much of the US capital expenditure on AI is ultimately spent on imports. Meanwhile the real workhorse of the US economy remains the consumer (Chart 22). Our central case for the consumer is relatively benign, with lower inflation next year and a stable employment picture expected to see moderate consumer spending growth. But there remain some significant areas of vulnerability in that core piece of the US growth story that we will continue to monitor. We remain vigilant for evidence of labour force disruption coming from AI (limited so far) and worry that the low US household savings rate leaves the consumer vulnerable to further shocks. Meanwhile, monetary policy is likely to tighten further (albeit modestly in our central case) and fiscal policy is set to be less supportive in 2027 than 2026.

Growth helped by a low savings rate and wealth effects....: US consumer spending has been resilient to the rise in energy prices helped by a fall in the personal savings rate. That has kept consumer spending growing faster than real household disposable income but also comes despite relatively weak levels of consumer confidence. Unlike European consumers, as we've noted before, the US household savings rate is well below pre-pandemic norms. One reason may be that US consumers are more exposed to the equity market, gaining from wealth effects. Households' aggregate stock of assets has been rising since 2022 and according to [Fed](#) data, household wealth has grown for the bottom 50% wealthiest as well as the top 0.1%. There was a particularly large jump in the household sector's net worth in Q2 2026 driven by corporate equity, with a jump in pension entitlements alongside that. That followed a strong period of tax refunds.

...but savings rates are unlikely to decline much further; and wealth effects are arguably on shaky ground: With the household savings rate so low, it is hard to assume that it falls further as a *central case* (again, especially against a backdrop of soft consumer confidence). The multi asset team have also 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.

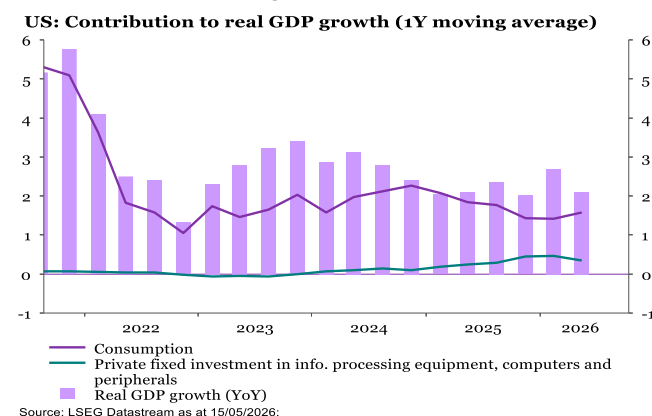
Labour market and lower inflation behind our benign central case: Our benign central case for the US consumer is predicated on there being no significant rise in the unemployment rate and on lower inflation in 2027:

- US labour supply growth looks likely to remain constrained, in part due to US immigration policy. In that context, it doesn't take much job growth to keep the unemployment rate low. See page 12.
- With inflation likely to decline sharply next year, assuming that energy prices don't keep rising, real disposable income growth should rise.

Upside risks to inflation and more rate hikes likely

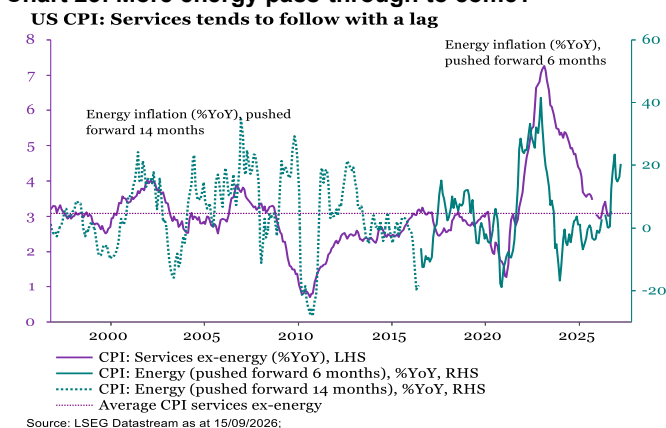
With the PCE measure at 3.4%Y headline and 3.0%Y core, neither PCE nor CPI are consistent with the Fed's 2% PCE inflation target, meanwhile the US has now entered its sixth year of above target inflation. CPI services (ex-energy) inflation is around post-2000 average levels, but is likely to experience more pass-through from higher energy prices (Chart 23) and we worry at a global level about a likely rise in food prices next year. Against a balanced labour market and resilient growth backdrop, with the government continuing to run substantial deficits (Chart 24), with the AI build-out increasingly seen as near-term inflationary and with Chair Warsh indicating that monetary policy is accommodative, it seems likely that the Fed will hike more than once in coming months (see page 9 for more on US rates). For the US in particular, we also worry that any return of strength in labour demand could tighten the labour market quickly against a more restricted labour supply, raising underlying domestically driven inflation pressure. That could see steeper future tightening cycles from the Fed.

Chart 22: Consumption growth as the driver of GDP



Source: LSEG Datastream, BEA. Data to Q2 2026.

Chart 23: More energy pass-through to come?



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

How tight is the US labour market?

The labour market remains central to the outlook for consumer spending, but labour market indicators have been sending somewhat mixed signals, while significant revisions materially alter the month-on-month narrative.

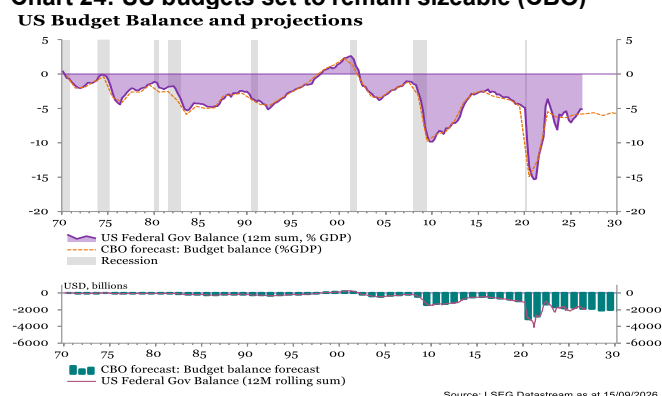
The unemployment rate is at relatively low levels despite very subdued (on average) growth in payrolls. Part of the divergence between payrolls and the unemployment rate reflect the unemployment rate being driven not only by hiring, but also changes in the labour force. Labour force changes reflect population growth, immigration, demographic trends and the participation rate. The participation rate has fallen over the last two years, helping to keep the unemployment rate relatively low. The participation rate tends to move gradually, and the significant fall in 2026 is unusually large by historical standards (Chart 25). Our analysis suggests that three factors are particularly important in explaining the fall:

- **Population revisions:** The BLS bases its labour force measures on the Census Bureau's population projections, which are updated annually. This year's revision was large, implying a shift of more than one million people from prime age population (25-54) into the 55+ age group. Because older cohorts have lower participation rates, this change mechanically reduces the aggregate participation rate (even when underlying labour market dynamics are unchanged). Our estimates suggest this accounts for about half of the drop in the participation rate.
- **Population ageing:** The share of the population aged 55+ has continued to rise since January while the share of prime age population has declined. As older cohorts have lower participation rates, this mechanically reduces the aggregate participation rate. Our analysis suggests that population ageing accounts for around 10% of the drop in the participation rate this year.
- **Cyclical labour market dynamics:** The remaining 40% reflects lower participation within each age group. Unlike the demographic factors, these movements tend to be more cyclical and provide a clearer picture of underlying cyclicity as unemployed workers become discouraged from actively looking for work. That said, some of the declines seen earlier in the year were unusually large compared to historical standards and have since reversed in recent months.

Breakeven payrolls rate is now much closer to zero: These developments in the participation rate have important implications for the underlying strength in the labour market. The breakeven payroll rate measures the pace of monthly payrolls gains required to keep the unemployment unchanged and the labour market broadly in balance. Historically, the breakeven rate has been in the region of 100k per month, however this has shifted markedly in 2026 (Chart 26). Our estimates suggest that the breakeven payroll growth rate has fallen sharply in 2026, reflecting falling participation rates and lower net migration, and may now be close to zero. As such, despite relatively modest payroll gains, we estimate the labour market to be broadly in balance.

Upside inflation risks: With breakeven payrolls much lower than has historically been the case, we don't think it would take much employment growth to tighten the labour market and stimulate a rebound in wage growth. This adds upside risk to our central inflation (and policy rate) forecast.

Chart 24: US budgets set to remain sizeable (CBO)



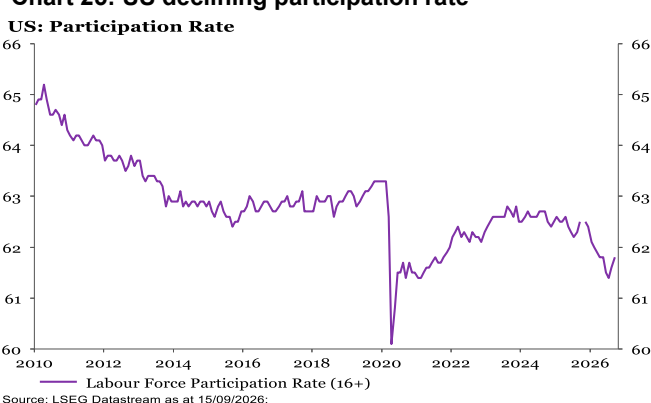
Source: LSEG Datastream, BLS. Actual figures show data to September 2026 (Q2 as % GDP). Forecasts updated in February 2026

Chart 26: Breakeven payrolls; near zero

US breakeven employment growth



Chart 25: US declining participation rate



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

China: Exports boom, but domestic demand remains a drag

China remains well placed to weather the energy price shock and, as a net exporter of refined products, could well see a short-term boost from higher petrol and diesel prices relative to crude. However, domestic demand remains a weak spot, and recently announced policies are unlikely to materially turn the tide on slow consumer spending. Chinese exports have been booming, but with increasing competition of exports with developed economies, in particular Europe, trade tensions and protectionism are likely to be a flashpoint in the medium-term.

Status update: Domestic economy is still weak

GDP growth was weaker than expected in Q2 2026, falling to 4.3% year-on-year, the weakest quarterly growth on record outside of Covid. Other hard data has also remained soft (see Chart 27), with retail sales trending downwards and negative in real terms, and fixed investment also falling. Industrial production has been a bright(er) spot, supported by strong export growth (discussed in more detail below). The NBS PMI business survey measures of activity remained subdued, reflecting the relatively weak domestic backdrop even while export growth remains strong.

Energy shock: Rebounding product exports

China has so far weathered the energy price shock relatively well, despite being the world's largest oil importer and relying on a large share of crude imports from the Gulf. This resilience reflects, at least in part, sizeable strategic petroleum reserves and a favourable energy mix. China's oil imports sank as prices rose. In July, Chinese oil imports were around 40%, or 5mbpd, lower than the year before. In August, however, oil imports rebounded from 40% below 2025 levels at the trough to around 20% below August 2025 levels. One possible explanation is the sharp rise in crack spreads and the relaxation of government restriction on oil exports. China has substantial refining capacity, which may be encouraging refiners to ramp up exports and could provide a near-term export boost. Over the longer term, as the leader in renewable technology, China continues to look well positioned to benefit from a greater focus on energy security and green technology.

Fiscal policy: Investment boost, but limited support for the consumer

At the end of September, China announced a package of fiscal measures aimed at delivering "practical and effective additional policies" to support growth. A key measure was a cut to loan rates for projects linked to the 'six networks' (water, electricity, computing, communications, and logistics and urban pipelines). While analyst estimates of the scale of investment is significant and should provide some support for idling fixed investment, the overall impact looks likely to be modest and unlikely to materially turn around the weakening trend in the domestic economy. Export sectors associated with advanced manufacturing are expanding rapidly; the main growth constraints remain weak domestic demand following the prolonged property downturn. The package did include mortgage subsidies for first time homes, but they were smaller than expected.

China shock 2.0: Implications for developed economies?

Property market remains a drag: China's property market remains in a prolonged downturn. The drag on the broader domestic economy has been substantial, as falling house prices have generated negative wealth effects, weighing on both household consumption and investment (Chart 27). Residential property investment has fallen in 2026, while retail sales growth has trended lower.

China's exports have moved further up the value chain: Weak domestic demand has prompted Chinese firms to cut prices and reduce margins, with excess production increasingly being directed to exports. There are parallels with the first China shock from the early 2000's, when Chinese exports to the rest of the world surged. Notable, this episode has seen a surge in high-tech equipment. Chart 28 illustrates this shift, with high technology products exports rising sharply, while growth in other export categories also continues to increase, though price rises will be playing a role.

Implications for developed economies and trade tensions: In contrast to the first China shock, when China was largely exporting low-cost manufactured goods and not seen as a direct rival, the current episode occurs as China moves up the manufacturing value chain. As such, Chinese exports are increasingly competing with manufacturing in the euro area, US, UK and Japan. The similarity between Chinese and euro area exports has risen from around 40% in the early 2000's to closer to 60% today. Between 2019 and 2025, This increasing competition is likely to be a source of tension with developed economy trading partners, which could prompt the use of trade barriers and protectionist measures. After reports of escalating tensions between the EU and China in relation to the EU's trade deficit, China agreed to limit exports of hybrid cars into Europe. However, we would not be surprised to see trade tensions re-escalate. Taiwan, however, remains a clearer potential source of a sharp deterioration in overseas relations on any attempt at violent takeover.

Chart 27: Domestic demand still weak

China: IP, Investment, Retail sales, Industrial profits & GDP
% YoY, mix of real and nominal, series made to be continuous where there are gaps

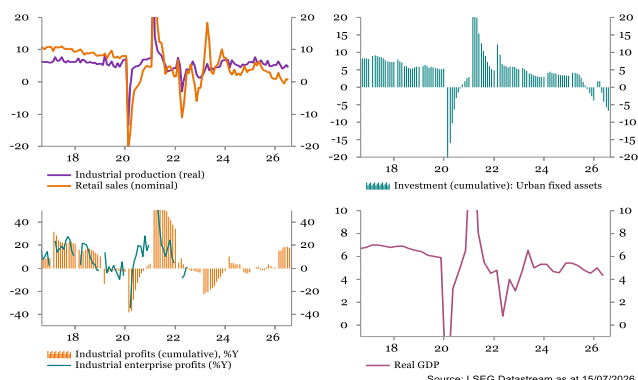
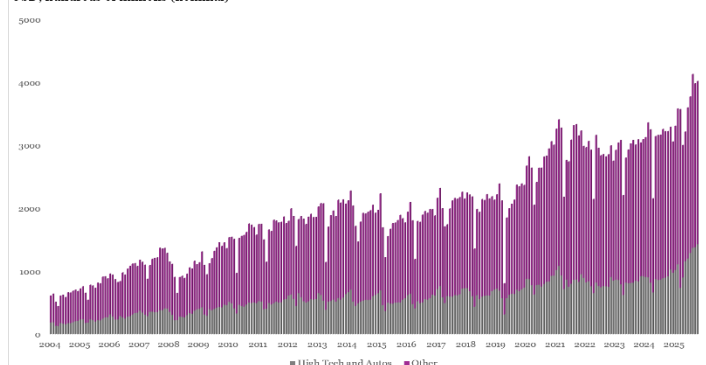


Chart 28: China's headline and high-tech exports are booming

Chinese exports
USD, hundreds of millions (nominal)



Euro area: Resilience and rates

After an initial dent in activity indicators following the outbreak of conflict in the Middle East, there has been some recovery in business and consumer sentiment and average H1 GDP growth was reasonable. Fiscal policy looks set to remain a support. However, the ECB have been quick off the mark in raising rates too. We expect a bit more ECB tightening, with risks to the upside of our forecast for now. The risks to the rate and inflation outlook, will largely rise and fall for now with oil (and natural gas) prices.

Status update: Surprisingly resilient

GDP rose 0.6% quarter-on-quarter in Q2 after 0.0% in Q1, striking given the exposure of the European economy to energy prices. PMI business survey indicators indicated a moderate positive growth picture by the end of Q3 and the unemployment rate remains close to its historical lows (although the picture from broader labour market indicators is less positive). However, headline inflation rose around a percentage point in response to the conflict and remains well above target. The ECB raised rates in both June and September.

Euro area growth: Not just fiscal

Euro area growth has been relatively resilient since the start of the Middle East conflict, despite being a big net oil and gas importer, growing 0.6%Q in Q2. Recent activity growth has been relatively broad-based across investment and household and government spending (Chart 29). Household consumption remained the main growth engine, contributing around 0.6pp to the 1.2pp year-on-year growth in Q2. Government consumption has been contributing more of late, but fixed investment has – on average – been a significant support to growth since the start of 2025 (coinciding with German debt brake reform and stronger defence spending across Europe). Our central forecast is for GDP growth to pick up above 1.0% in 2027:

- More recent fiscal announcements are likely to add some additional support. In July, German Chancellor Merz announced a package of measures including tax cuts for middle earners and labour market reforms, alongside indications of potential pension reform. These announcements appear to have supported consumer and business sentiment already.
- Consumption should also become more supportive in 2027. Lower inflation should boost real household disposable income growth and savings rates have some scope to come down from elevated levels and bolster spending as confidence improves.

Autos sector: Driving into defence?

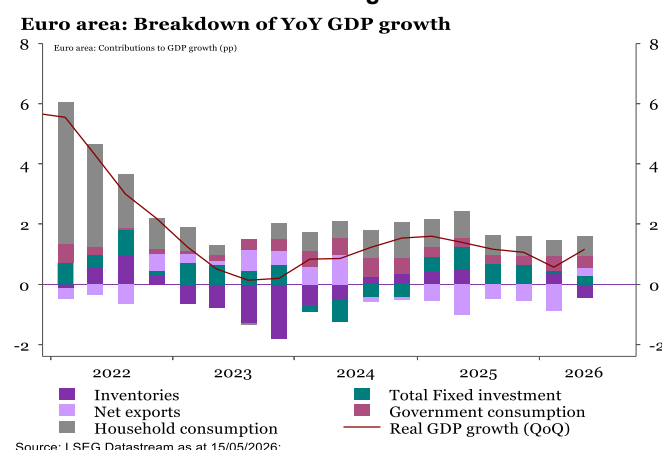
The euro area auto sector has been on a declining trajectory for several years, reflecting intensifying competition from China as it moves up the manufacturing value chain and focuses on high-tech exports (see China section). These challenges are increasingly visible in the macroeconomic data including in German industrial production which has remained subdued in recent years. As Chart 30 shows, auto production has been particularly weak and has acted as a drag on overall activity growth. The result has been a flurry of restructuring announcements and job losses across the sector. In contrast, defence-related manufacturing has surged (with a significant order backlog for weapons and ammunitions) following fiscal reforms and a broader increase in defence spending across Europe. For struggling car companies with overcapacity, pre-existing skilled workforces and production facilities, a shift towards defence production could be compelling. Indeed, there are already signs of this shift taking place. Renault has agreed to manufacture military drones and Volkswagen has agreed a deal for one of its plants to switch to defence production. Such a reallocation of productive capacity could help to address supply constraints in the defence sector and support euro area industrial production, while offering the opportunity for auto companies to reverse the downward trajectory.

ECB – more hiking ahead

The ECB were relatively quick off the mark compared to the Fed and BoE in hiking rates. We think that reflects a few things – 1) rather than still being in the process of cutting rates to a neutral setting when the conflict began, the ECB had got there already – they saw interest rates as “in a good place” at 2.0% on the deposit rate, with inflation around target and expected to remain so. Even now, having raised rates to 2.50%, monetary policy is likely at the upper end of what the ECB would have considered the neutral range rather than in clearly restrictive territory; 2) Inflation rose relatively sharply, relatively quickly, in response to the conflict. But core inflation quickly shifted a little higher too; 3) The fiscal backdrop had become more stimulative pre-conflict and was expected to have an impact starting this year, at least partly offsetting any impact from higher energy prices on economic activity.

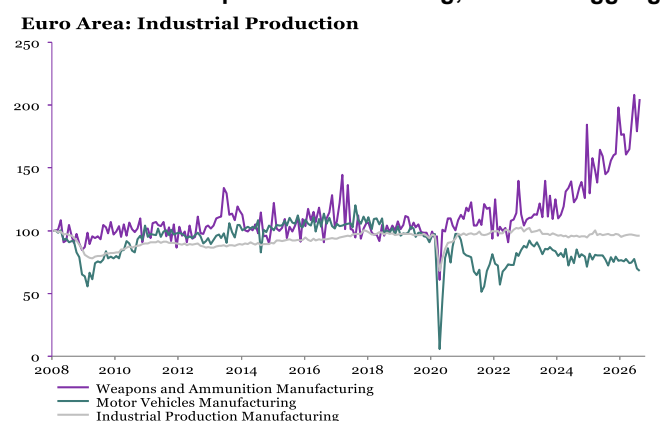
We expect another 2 ECB hikes in our central case, but don't expect them to continue pushing further and faster than other central banks: Interest rates are starting from a higher place (and financial conditions have tightened); Wage growth and longer-term inflation expectations look relatively well-behaved. However, risks at this stage are on the upside of our rates forecast: We worry about the potential for another wave of higher inflation from natural gas prices and from food prices (see page 8). The underlying domestic activity growth backdrop has also been surprisingly robust and looks set to be more supportive of price pressure than we'd expected.

Chart 29: Euro area: Drivers of growth



Source: LSEG Datastream, Eurostat; Data to Q2 2026.

Chart 30: Defence production booming; Autos struggling



Source: LSEG Datastream; Eurostat. Data rebased to 2008=100. Data to September 2026.

United Kingdom: Strong, for how long?

UK growth has been surprisingly strong in the first half of the year, with tentative signs of an AI-related boost and a revival in productivity growth. However, the backdrop looks less supportive ahead, with higher energy bills and with pay growth having slowed. The broader fiscal outlook remains uncertain medium-term under a new PM. The labour market continues to look soft. Growth has been stronger than expected, which could lead to rising job growth but it is unclear what the adoption of AI in a UK context will mean given the UK's sizeable business services sector. Meanwhile, high energy prices increase the risk of BoE hikes later in the year.

Status update: A strong first half; labour market still soft

GDP growth has been surprisingly strong by UK standards in the first half of the year. GDP rose 0.6%Q in Q1 and a further 0.5%Q in Q2. Business surveys have also held up well; the composite PMI has remained resilient despite the Middle East conflict and continues to point to modest growth into Q3. There are even some tentative signs that productivity growth could be beginning to revive (see below). In contrast though, the labour market remains soft across a range of indicators. Payrolled employment had fallen for 6 consecutive months (though stabilised in August); vacancies continue to edge down; and pay growth has moderated significantly over the last three years. That helps constrain, somewhat, the prospects for consumer spending but also rate hikes.

Growth has been resilient: Why, and will it last?

Surprising strong H1: In February, before the conflict in the Middle East, the BoE central forecast for GDP growth was 0.8%Y in both Q1 and Q2. Growth proved more resilient than expected, despite the surge in energy prices, rising to 0.9%Y in Q1 and 1.2%Y in Q2.

Consumption remains a support: Household consumption has remained a key source of support in the first half of the year, despite the backdrop of higher prices, moderating pay growth and softer consumer confidence. Consumption contributed 0.5pp and 0.7pp to year-on-year GDP growth in Q1 and Q2 respectively.

Tentative signs of an AI boost: There are also tentative signs that AI may be providing some support to activity growth (Chart 31). Output in computer programming, consultancy and related services rose by 3.9%Q in Q1 and 3.7%Q in Q2, well above the average 0.4%Q pace recorded in 2025. The PMI business surveys also point to some support, with firms increasingly citing AI related investment as a factor supporting growth. Notably, the AI related boost in the UK appears to be supporting services rather than solely manufacturing, in contrast to other countries where support has been concentrated in manufacturing. As a services-heavy economy, the UK could be well positioned to benefit from an AI productivity boost.

... but will the strength carry on? For the UK, there feels a degree of déjà vu in the growth outlook. Since the pandemic, growth has tended to start the year on a relatively strong footing before losing some momentum in the second half of the year. We think there is a risk this pattern could well reemerge again later this year, but carry into next year too, with several factors that have supported growth in H1 likely to face a less favourable backdrop. In particular, the outlook for consumption looks likely to be less supportive, with households facing higher energy bills (including in January), and tighter financial conditions. Meanwhile, uncertainty around the new government and fiscal plans could weigh on both investment and hiring. As a result, our central projection is for quarterly growth to slow in Q4. Even so, given the strong year so far, we still expect 2026 GDP growth of 1.6%.

Productivity revival

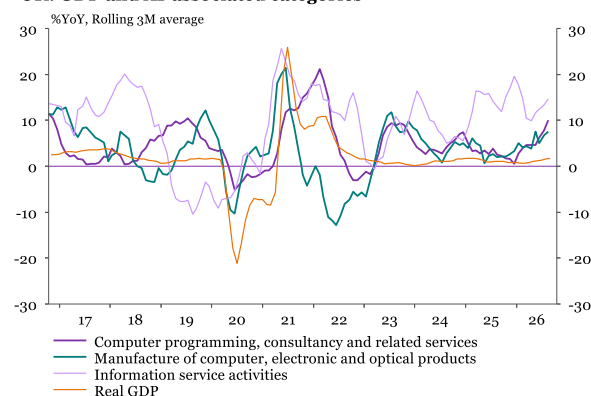
Recent UK data suggests that labour productivity growth has improved in the UK following a period of weak employment gains (especially if you use broader labour market data rather than the official employment series), see Chart 32. Any productivity revival would be a serious challenge to the prevailing narrative around relatively weak potential growth. Although the improvement is very welcome, we are cautious on turning optimistic: 1) the trend is too recent to have confidence in and much of the improvement could end up being revised away; 2) it depends which measure of labour input you use; 3) there isn't a satisfying narrative around why UK productivity has suddenly improved. AI can be part credited for some of the very recent better than expected UK GDP figures, but it feels too early for significant aggregate productivity gains to have been driven by AI for example; 4) After decades of puzzling over how low UK productivity growth is, it seems wise not to extrapolate too soon.

Fiscal constraints likely to limit support for growth

Without a wholesale revision of the fiscal rules, or willingness to disregard them, there is a limited amount of fiscal room for manoeuvre. This government have also reiterated manifesto promises that restrict them in terms of changing most of the main tax rates. Alongside that, bond investors have shown a willingness to impose fiscal discipline in the UK. A government attempting a significant unfunded increase in spending (or cut in taxation) would likely be met with significantly higher bond yields. We are not expecting much support for UK growth from fiscal policy any time soon.

Chart 31: GDP: AI-associated categories growing robustly

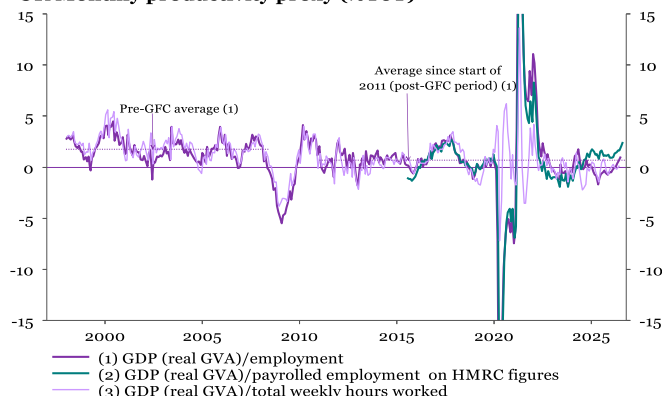
UK: GDP and AI-associated categories



Source: LSEG Datastream, ONS. Data to August 2026

Chart 32: Productivity improvement (early days)

UK Monthly productivity proxy (%YoY)



Source: LSEG Datastream, ONS. Data to June (3), July (1) and August (2).

Japan: Challenged but outperforming

Japan's economy has outperformed our expectations so far this year, showing considerable resilience in the face of higher oil prices. A robust fiscal policy response from the government has helped to cushion the economy from the worst of the effects. However, both events in the Middle East, and the policy response to that, have helped raise bond yields and weaken the JPY and bought US pressure (and intervention). With rates still lagging below neutral, we are expecting further rate rises from the BoJ and at a faster pace. Over the medium term, underlying fundamentals remain in place to support sustainably higher inflation and stronger potential growth.

Status update: Doing relatively well

Consistent with a robust pace of growth by Japan standards, real GDP expanded by 1.9%QoQ annualised and 1.4% respectively in Q1 and Q2 and consensus expectations are for a 1.1% gain in Q3. Japan's composite PMI is indicating moderate positive activity growth, as is the Tankan survey. Nominal wage growth has remained robust and inflation is close to target.

Ongoing fiscal support, but higher bond yields

With interest rates higher against a very large stock of government debt as % GDP (Chart 13), it is natural to raise questions around Japan's fiscal sustainability. It was one thing to finance such a substantial stock of debt when interest rates were roughly zero, but Japan's 10Y bond yield is now on a par with the likes of Germany and Sweden – back in the pack of more 'normal' looking government bond yields but with a stock of government debt (as % GDP) more than three times that of Germany or Sweden. Meanwhile, Japan's fiscal policy also remains stimulative – the Japanese government implemented price control measures across almost all energy products and we now pencil in a period of lower headline inflation on the planned two-year consumption tax cut on food and beverages in 2027.

However, before even considering the domestic ownership of Japan's debt, this is a relatively slow moving story; the effective interest rate on debt (i.e. reflecting what Japan actually pay in interest each year is well below the nominal growth rate having locked in a lot of financing at much lower rates (see, for example, [IMF](#)). Debt as a percent of GDP is expected to keep falling for now. However, as debt is refinanced at higher rates (and population ageing adds to age-related fiscal expenditures while challenging the revenue base), the window for repair is likely to close.

Stronger growth norm, but not without challenges

We expect potential growth (currently around 0.5% in our view) to drift upwards, but we worry about near-term headwinds given another bout of higher energy prices and higher bond yields:

Real wages and productivity – staying optimistic: Real wage growth could become more supportive over time reflecting demographic pressures which raise the relative bargaining power of the labour force alongside increased labour market mobility (partly as views on lifetime employment change) and productivity gains. Over the last 20-years, productivity gains have lagged, despite Japan already being a relatively robot-intensive economy. However, we expect ongoing demographic pressures to result in further adaptation and efficient use of robotics and AI. Corporate reforms, higher real rates and labour market mobility could also encourage growth at higher productivity firms (increasing aggregative productivity and real wage growth).

For now though, the consumer remains reluctant: Nominal pay growth appears to have settled at higher levels, and real wage growth has been pulled up with it. Rising real wages in the medium term should support consumer spending, but so far consumer spending trends have been relatively subdued as have levels of consumer confidence (Chart 33). With Japanese authorities having (so far) shielded consumers from the energy price spike it makes some sense if households have held off a bit, fearing that the cost of this will be incurred with a delay.

US attention – pressure for a stronger currency and higher rates: Alongside global drivers, loose fiscal and accommodative monetary policy has been met with higher inflation expectations and higher bond yields over the last year. The accompanying weak JPY attracted enough attention from the US to see the US join intervention in the currency, but also some more pointed commentary from the US administration on Japan's monetary policy stance.

Medium-term challenges: Japan's declining working age population, albeit recently declining at a lesser pace (Chart 34), should also drag on activity growth if *not* met with productivity enhancements. After a period of change and reform, Japan already has labour participation rates more in line with developed economy peers. But Japan remains a relatively slow adopter/user of AI according to figures collected by [Microsoft](#).

Faster rate rises, for a period

We have pencilled in a faster rate rise profile for the BoJ. That reflects further evidence that Japan's inflation is now sustainably higher, policymaker willingness to increase the pace of rate hikes and US pressure. However, with two more BoJ board member terms ending next year (the hawkish Takata and Tamura), and assuming oil prices fall, the pace may naturally slow in 2H 2027.

Chart 33: Real pay growth supportive, but confidence lags

Japan: Consumption, confidence and real wage growth

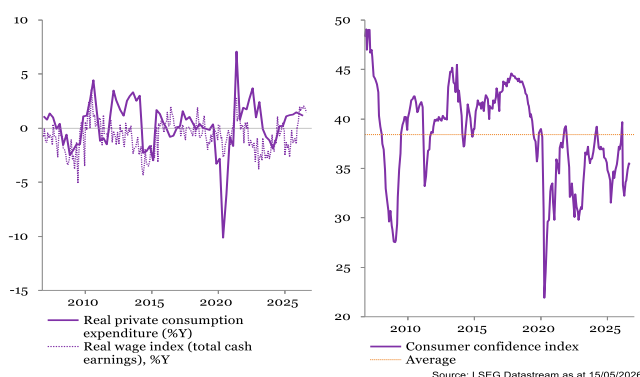
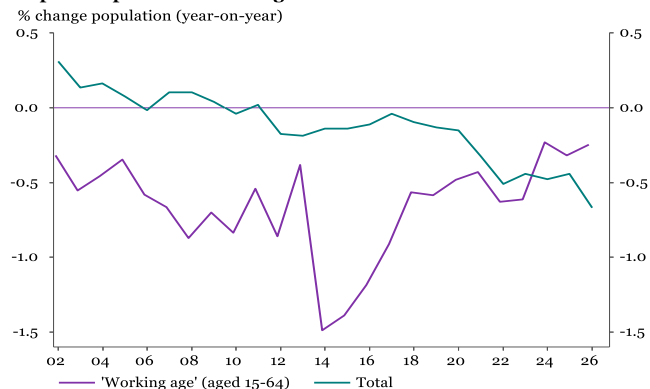


Chart 34: Ongoing challenge: Working age population falls

Japan: Population shrinkage



Source: OECD, Japan Statistics Bureau. Working age population data to 2025; Overall population data to 2024.

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