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# UK Economy & Markets Outlook

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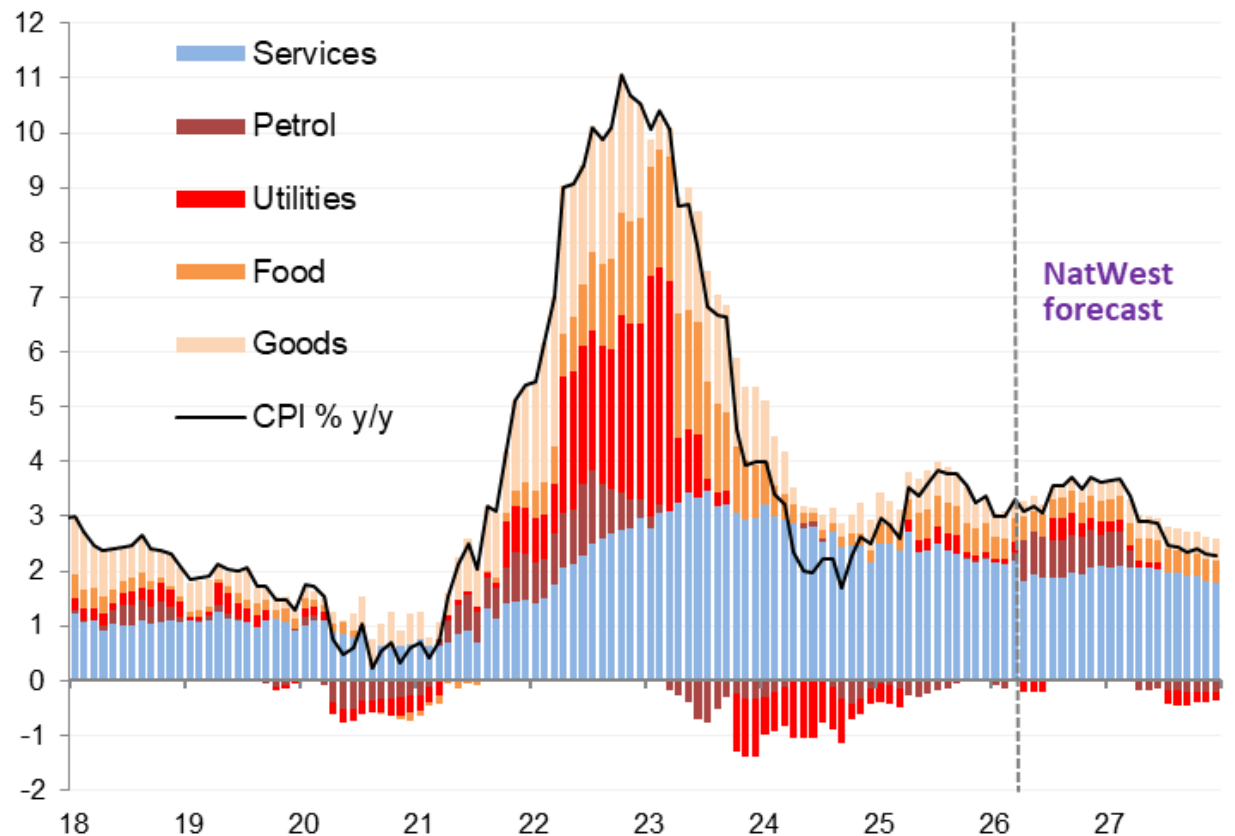
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# UK CPI inflation – *This time is (somewhat) different*

## CPI inflation & main sub-components

Source: BoE, NatWest



**UK headline CPI inflation** is forecast to peak at 3.7% in Q1 2027, principally on higher energy costs.

**Core CPI inflation** is projected to be close to 3.0% for much of the period from late 2026 into H2 2027. There is inevitably significant uncertainty around the scale and persistence of second-round effects but the experience of recent years cautions against assuming a speedy, automatic return to target-consistent levels.

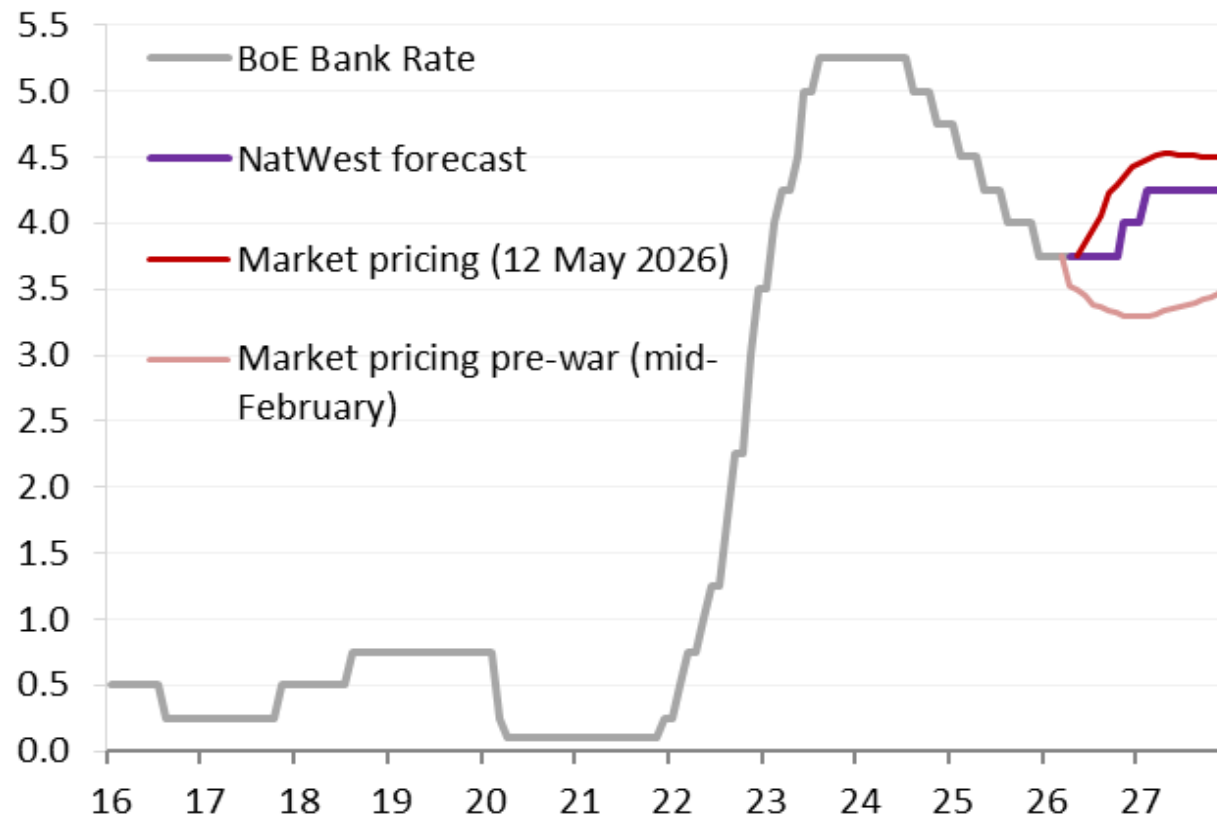
**Services CPI inflation** is forecast to remain sticky (>4% in H1 2027, easing to ~3½% at end-2027), reflecting typical lags from the energy shock).

Services inflation has proved much more persistent in recent years than had been expected

# BoE Bank Rate – *Rate hikes before end-2026?*

## BoE Bank Rate & expectations, %

Source: BoE, Bloomberg, NatWest



We forecast **BoE Bank Rate** to be maintained at 3.75% into H2 2026 **with the first rise finely balanced between Q3 & Q4.**

We do not expect extensive rate rise – we forecast a 4.25% peak in. Current policy settings are probably marginally restrictive.

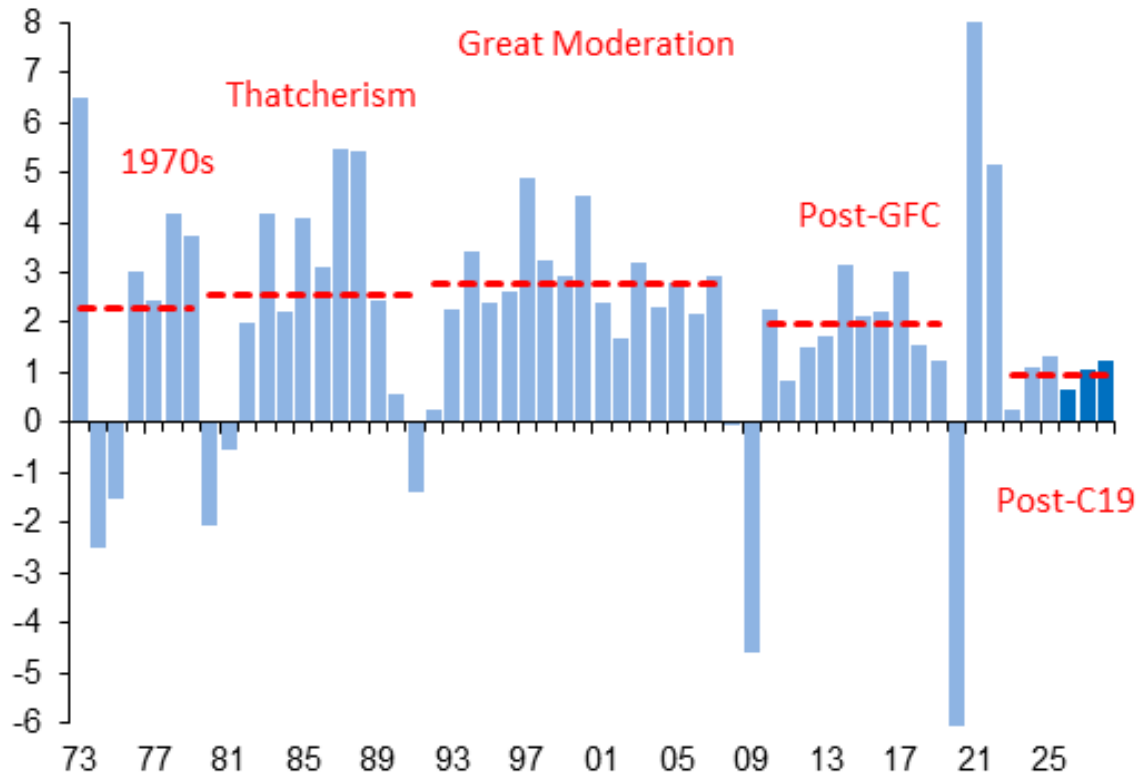
**Our Bank Rate hike expectations are highly conditional on inflation persistence.** If the BoE does cross the Rubicon and raise rates, it will probably do so more than once.

Current energy futures strips suggest headline CPI inflation will overshoot its 2% target by ~1½%-points in 2026. The extent of expected ‘second-round’ effects will determine the extent to which Bank Rate is raised.

# UK economic cycles – *Growing pains*

## UK GDP, % y/y

Source: ONS, NatWest



The UK and other advanced economies appear to be in a slower growth cycle. The UK grew by 1.4% in 2025, close to our estimate of **potential: ~1¼%**

NatWest forecasts 'post-war' (pre-war in parentheses):

|      |        |      |
|------|--------|------|
| 0.8% | (1.1%) | 2026 |
| 1.1% | (1.4%) | 2027 |
| 1.3% | (1.3%) | 2028 |

Previous cycle average GDP growth rates:

- 1970s (1973 - 79) 2.3%
- Thatcherism (1979 - 1990) 2.5%
- Great Moderation (1992 - 2007) 2.8%
- Post-GFC to Pre-C19 (2010 -19) 2.0%
- **Post-C19 (2023 - 2028) 0.9%**

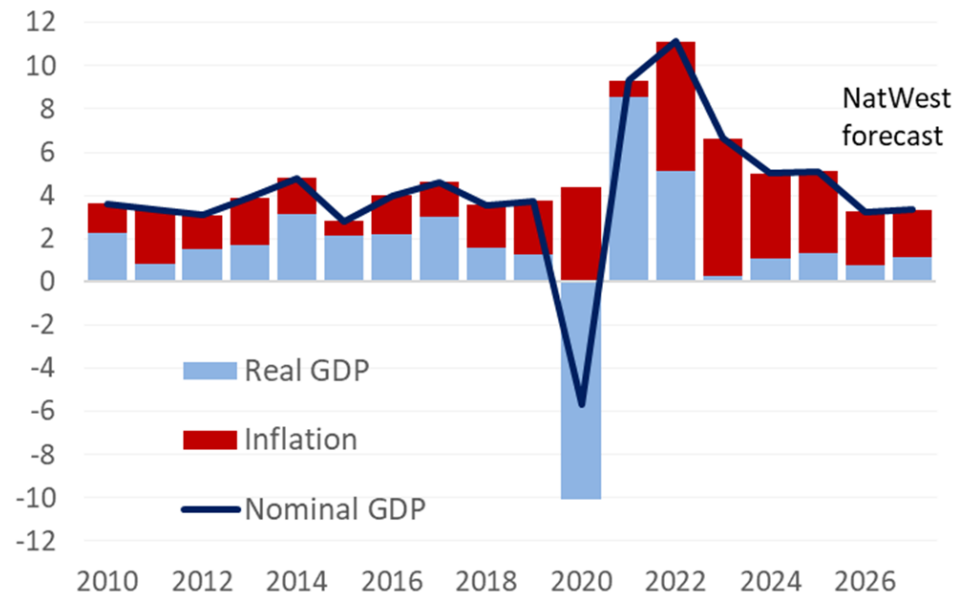
Why has UK growth slowed?

- Adverse labour participation
- Depleted capital stock
- Brexit dislocations
- Excessive tax & regulation?

# Low growth but high inflation... It's the *nominal* economy, stupid

## UK nominal GDP, real GDP & inflation, % y/y

Source: ONS, NatWest

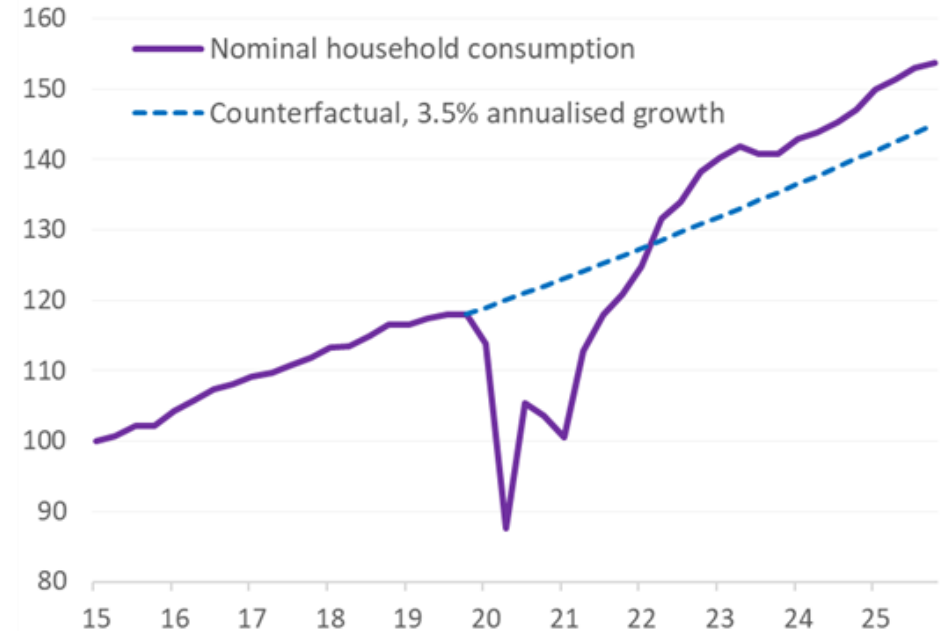


In recent years, the UK economy has seen a combination of **lower real GDP growth and higher inflation**. This mix alludes to structural problems in the economy and limits the extent to which monetary and fiscal stimulus can be deployed (without igniting inflation).

2025:      Nominal GDP 5.1%    Real GDP 1.4%    Inflation 3.7%  
 2010-19:   Nominal GDP 3.8%    Real GDP 2.0%    Inflation 1.8%

## Excessive nominal demand (levels, index Q1 2015=100)

Source: ONS, NatWest

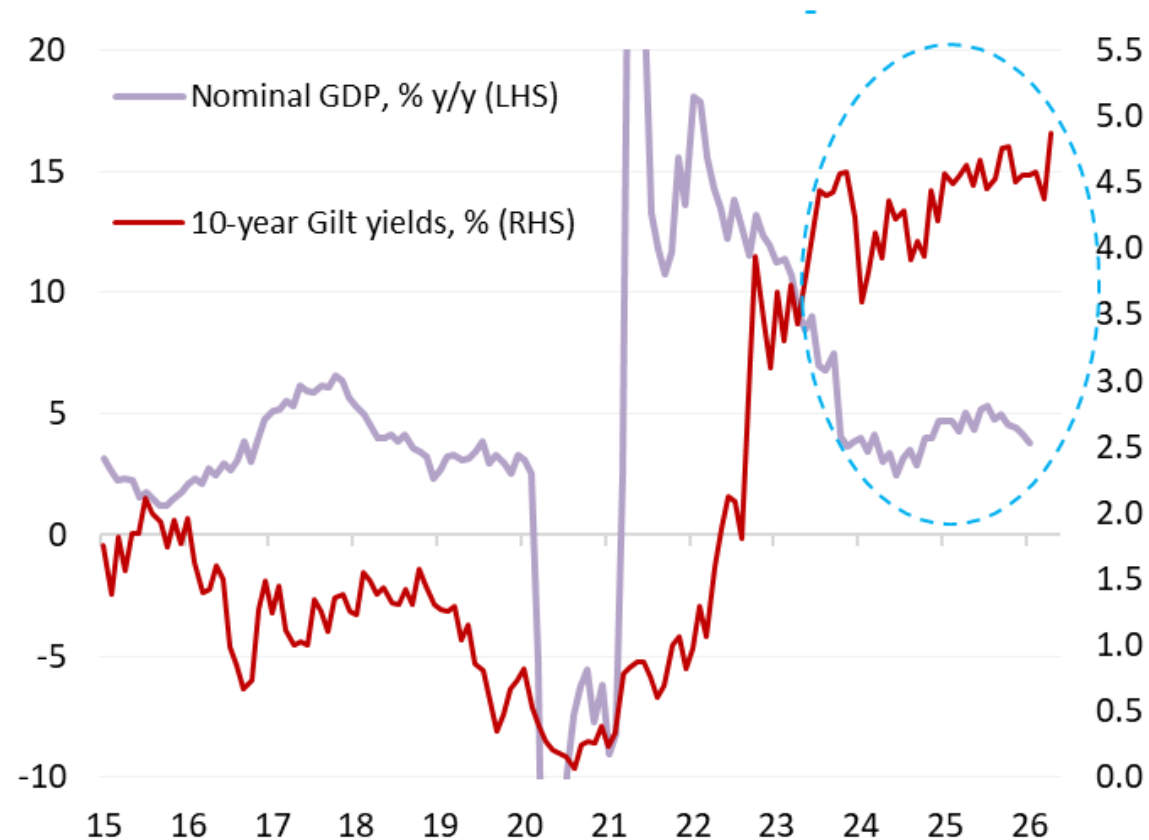


A false (or overly narrow) narrative appears to have taken hold: that weak real GDP growth has opened-up material amounts slack in the economy, necessitating further Bank Rate cuts (BoE estimates supply exceeds demand by 0.9% of GDP, OBR output gap estimate is -0.9%). Trends in **nominal GDP (and nominal household consumption)** tell a different story: **demand has been excessive for several years** (excessive relative to supply and constrained potential GDP) and, consequently, inflation has repeatedly overshoot its target and forecasts.

# The fiscal landscape – *Unprecedented*

## 10 year Gilt yields & Nominal GDP

Source: ONS, Datastream, NatWest



Fiscally, the UK's challenges are by no means unique, but they are significant. An historically unprecedented combination of:

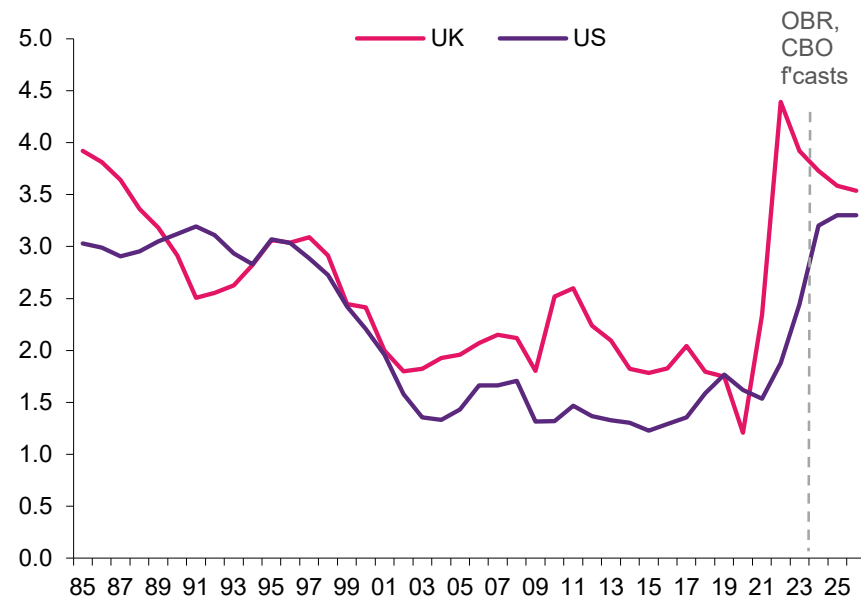
- **High public sector debt** levels close to 100% of GDP.
- **Excessive fiscal deficits** for the forecastable future.
- **Funding costs** exceeding tax-generation capacity (and by a widening margin, chart).
- **No central bank QE** to absorb supply; end of the ZIRP era.

These fiscal fundamentals should keep upward pressure on Gilt yields, reinforcing the effects of policy rate pricing

# The high rate / inflation – borrowing nexus

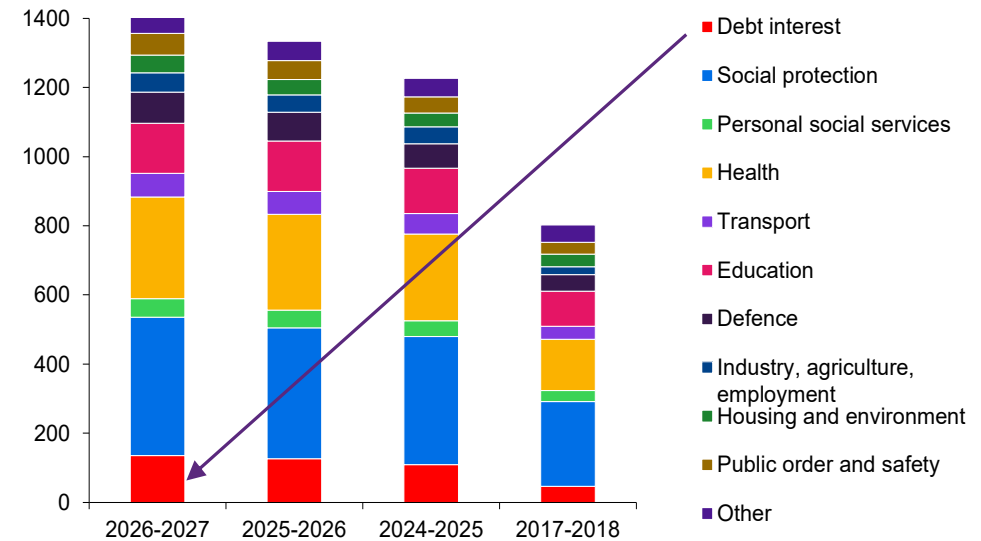
## Net interest expense, as a % of GDP

Source: NatWest, OBR, CBO



## Public spending by category, % total spend

Source: NatWest, OBR, HMT

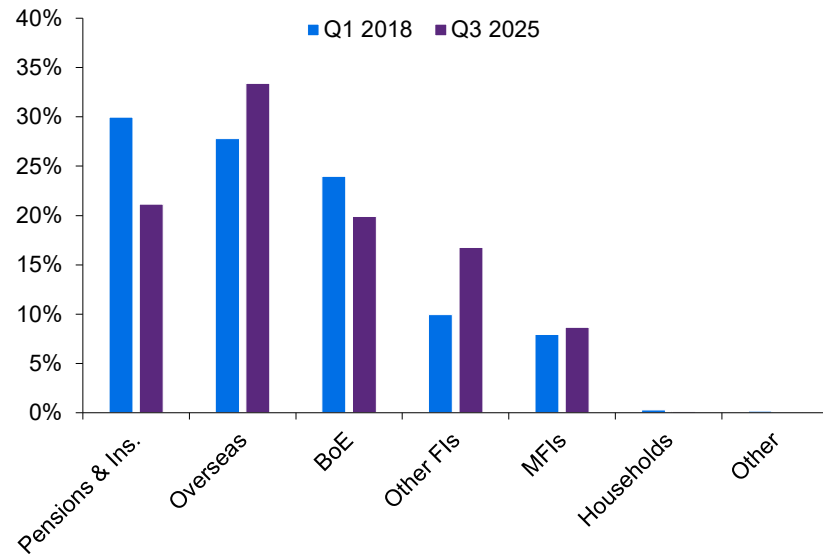


Higher front-end rates has knock-on effects across the rest of the curve too, as it adds to an already eye-wateringly high interest bill. To put the UK's interest expense into context, the UK currently spends 1.5x more each year on servicing its debt than it does on defence. It is projected to make up 10% of the government's overall public spend in FY 2026-27; as much as it spends on education.

# Gilt demand – from price insensitive to price sensitive

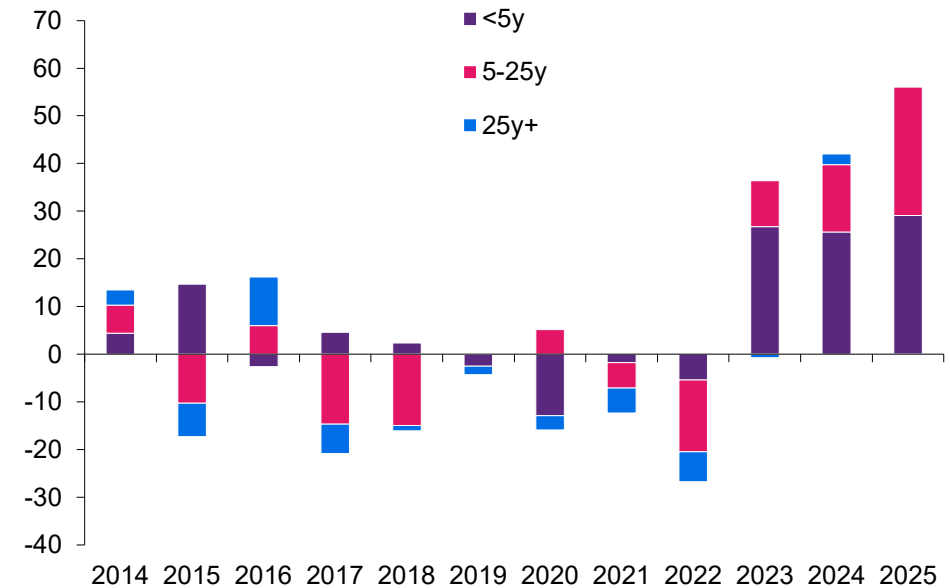
## Holders of gilts in % terms

Source: NatWest, DMO



## Domestic bank treasury buying of gilts, £bn

Source: NatWest, DMO, BoE

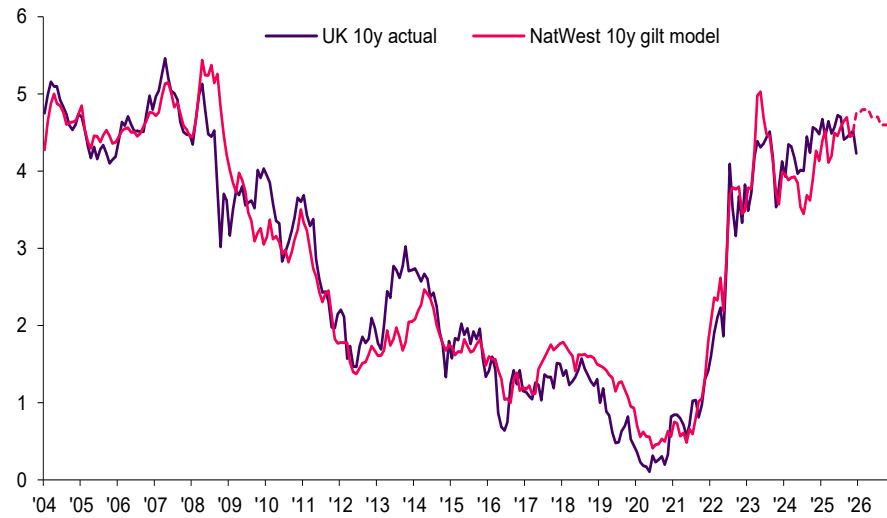


The demand shift in the UK has been well telegraphed in recent years. A shift from price insensitive, long-dated buying (mostly via pension funds) to much more price sensitive, shorter-dated demand from overseas investors (and bank treasuries) adds term premia to the curve. With overseas investors expected to remain the marginal buyers, this dynamic should persist.

# Gilts – 10y fair value 5%, with upside risks

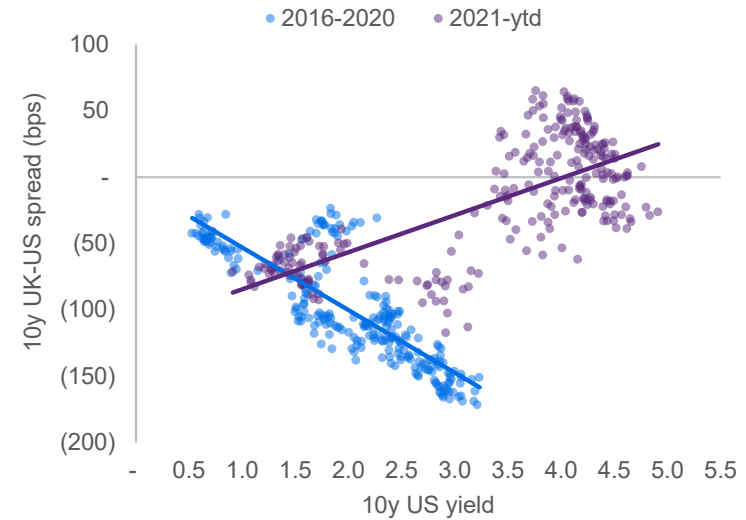
## NatWest 10y gilt yield fair value model

Source: NatWest, Bloomberg



## US yield levels vs the UK-US spread

Source: NatWest, Bloomberg



We entered the year with a target of 4.8% by mid-year, which we have recently revised up to 5%. Political risks could push this even higher; we target 5.25% in the event of a leadership challenge.

Our fair value model suggests gilts have reached their peak (at 4.5%), but we see upside risks to the model output given:

- i) The model doesn't perfectly capture the fiscal regime shift
- ii) The model doesn't capture the regime shift on the demand side
- iii) The model doesn't capture gilts new sensitivity to global risks
- iv) The model captures fundamental factors, which have become less important in driving gilt yields

# Conclusions

- Sluggish *real-terms* economic growth We forecast UK GDP growth of 0.8% in 2026 (1.1% 'pre-war') & 1.1% in 2027 (1.4% 'pre-war'). Nominal GDP growth, forecast at 3.9% in 2026, would remain above CPI target-consistent levels.
- Sticky domestic inflation BoE will rightly look-through the first-round effects of the energy shock but recent experience warns against complacency on second-round effects. Core CPI is forecast to remain above target-consistent levels until early 2028.
- BoE policy rates – modest rises in late 2026 / early 2027 No simple formula to resolve inflation vs disinflation risks. Ultimately, an inflation-targeting central bank grappling with 'stagflation' needs to prioritize controlling inflation.
- Rate rises will worsen the UK's fiscal position We estimate that higher Gilt yields have eroded roughly half of the fiscal 'headroom'. Pressure for accelerated defence spending, measures to cushion higher energy costs and rising political risks will keep upside pressure on interest rates. Tax rises – and a further dilution of the fiscal rules – seem likely.
- 10y gilts to hold above 5% - and possibly test 5½% This should account for fiscal, demand, and inflation risks.

## UK economy forecast summary

|                                | % q/q, non-annualised |             |             |             |             |             | % y/y       |             |             |
|--------------------------------|-----------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
|                                | Q1 26                 | Q2 26       | Q3 26       | Q4 26       | Q1 27       | Q2 27       | 2025        | 2026        | 2027        |
| Household consumption          | 0.3                   | 0.1         | 0.2         | 0.2         | 0.2         | 0.2         | 0.8         | 0.7         | 0.8         |
| Government consumption         | 0.6                   | 0.6         | 0.6         | 0.6         | 0.6         | 0.5         | 1.7         | 2.1         | 2.3         |
| Investment (GFCF)              | 0.4                   | -0.6        | -0.3        | -0.4        | 0.2         | 0.4         | 4.3         | 0.4         | 0.3         |
| Domestic demand                | 0.5                   | 0.1         | 0.3         | 0.3         | 0.3         | 0.3         | 2.0         | 1.1         | 1.2         |
| Net trade (%pt contrib.)       | 0.0                   | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         | -0.6        | -0.2        | -0.1        |
| <b>GDP</b>                     | <b>0.5</b>            | <b>0.0</b>  | <b>0.2</b>  | <b>0.3</b>  | <b>0.3</b>  | <b>0.3</b>  | <b>1.4</b>  | <b>0.8</b>  | <b>1.1</b>  |
| Nominal GDP                    | 0.8                   | 0.9         | 1.1         | 1.1         | 1.0         | 0.9         | 5.1         | 3.6         | 3.9         |
| Unemployment rate, %           | 5.2                   | 5.3         | 5.4         | 5.5         | 5.5         | 5.6         | 4.8         | 5.4         | 5.5         |
| Avg Weekly Earnings (ex-bonus) | 3.5                   | 3.3         | 3.2         | 3.3         | 3.7         | 3.8         | 4.8         | 3.3         | 3.8         |
| <b>CPI inflation, % y/y</b>    | <b>3.1</b>            | <b>3.1</b>  | <b>3.6</b>  | <b>3.6</b>  | <b>3.6</b>  | <b>2.9</b>  | <b>3.4</b>  | <b>3.4</b>  | <b>2.8</b>  |
| Core CPI inflation, % y/y      | 3.2                   | 2.7         | 2.7         | 3.0         | 3.0         | 3.0         | 3.5         | 2.9         | 2.9         |
| RPI inflation, % y/y           | 3.8                   | 3.8         | 4.3         | 4.3         | 4.2         | 3.6         | 4.1         | 4.1         | 3.5         |
| Services CPI inflation, % y/y  | 4.4                   | 3.8         | 3.9         | 4.2         | 4.2         | 4.2         | 4.8         | 4.1         | 4.0         |
| <b>BoE Bank Rate, %</b>        | <b>3.75</b>           | <b>3.75</b> | <b>3.75</b> | <b>4.00</b> | <b>4.25</b> | <b>4.25</b> | <b>3.75</b> | <b>4.00</b> | <b>4.25</b> |
| QE stock, £bn*                 |                       |             |             |             |             |             | 558         | 488         | 438         |
| Fiscal balance, % of GDP#      |                       |             |             |             |             |             | -4.3        | -3.9        | -3.3        |
| Current account, % of GDP      |                       |             |             |             |             |             | -2.4        | -2.2        | -2.1        |

\* September. # PSNB, Financial year

Source: NatWest, ONS, BoE

## UK interest rates & FX forecasts

|  | Current | Apr-26 | Jun-26 | Jul-26 | Sep-26 | Nov-26 | Dec-26 |
|--|---------|--------|--------|--------|--------|--------|--------|
| <b>BoE Bank Rate</b>                   | 3.75    | 3.75   | 3.75   | 3.75   | 3.75   | 4.00   | 4.00   |
|  | Current | Q2 26  | Q3 26  | Q4 26  | Q1 27  | Q127   | Q3 27  |
| <b>BoE Bank Rate</b>                   | 3.75    | 3.75   | 3.75   | 4.00   | 4.25   | 4.25   | 4.25   |
| <b>2y gilts</b>                        | 4.47    | 4.30   | 4.30   | 4.25   | 4.25   | 4.20   | 4.20   |
| <b>5y gilts</b>                        | 4.55    | 4.40   | 4.40   | 4.35   | 4.35   | 4.30   | 4.30   |
| <b>10y gilts</b>                       | 5.00    | 5.10   | 5.10   | 5.00   | 5.00   | 4.90   | 4.90   |
| <b>30y gilts</b>                       | 5.68    | 5.60   | 5.60   | 5.50   | 5.50   | 5.40   | 5.40   |
| <b>2s10s</b>                           | 53      | 80     | 80     | 75     | 75     | 70     | 70     |
| <b>5s30s</b>                           | 112     | 120    | 120    | 115    | 115    | 110    | 110    |
| <b>10s30s</b>                          | 68      | 50     | 50     | 50     | 50     | 50     | 50     |
| <b>Swap spread bps (bonds - swaps)</b> |         |        |        |        |        |        |        |
| <b>2s</b>                              | 14      | 20     | 20     | 20     | 20     | 20     | 20     |
| <b>5s</b>                              | 24      | 30     | 30     | 30     | 30     | 30     | 30     |
| <b>10s</b>                             | 45      | 50     | 50     | 50     | 50     | 50     | 50     |
| <b>30s</b>                             | 73      | 80     | 80     | 80     | 80     | 80     | 80     |
| <b>GBP/USD</b>                         | 1.362   | 1.39   | 1.42   | 1.41   | 1.41   | 1.41   | 1.41   |
| <b>EUR/GBP</b>                         | 0.864   | 0.864  | 0.864  | 0.864  | 0.864  | 0.864  | 0.864  |
| <b>EUR/USD</b>                         | 1.177   | 1.20   | 1.23   | 1.22   | 1.22   | 1.22   | 1.22   |

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