SUMMER 2026 FORECAST: MIDDLE EAST FLARE UP COULD LEAD TO A CHALLENING H2

KEY MESSAGES

- Renewed hostilities in the Middle East have put pressure on wholesale energy prices, particularly natural gas prices, and are expected to weigh on growth in the second half of the year. Momentum is expected to remain modest into next year as the ongoing conflict forces the UK into a sustained soft patch.
- Following the recent rise in energy prices, we now anticipate inflation rising towards 3.5% later this year, despite Prime Minister Andy Burnham's announcements on measures intended to ease the cost of living. Squeezed household incomes and tighter financial conditions will weigh on growth. We expect GDP growth to slow from 1.3% last year to 0.9% in 2026 and 0.7% in 2027.
- We expect this period of weak growth to push up the unemployment rate, with more than 200,000 additional people out of work, taking the total number of unemployed people to just over 2 million.
- A change in prime minister is unlikely to lead to a significant shift in fiscal policy in the near term, given recent jitters in the bond market. However, history suggests that spending reviews, the next of which comes in 2027, typically result in higher day-to-day government spending.

The geopolitical situation in the Middle East will shape the economy's performance this year and make the outlook unusually uncertain. Peace agreements suggest that some of the worst-case scenarios are becoming less likely. But the recent flare-up has caused another bout of disruption in the Strait of Hormuz and a sizeable rise in energy prices.

The UK's growth prospects remain fragile, and the recent rise in wholesale energy prices will weigh on growth in the latter half of this year. On the domestic front, the UK government has new leadership, with Andy Burnham taking over from former Prime Minister Keir Starmer. We do not expect a significant loosening of fiscal policy in the near-term, as the UK's structural challenges remain.

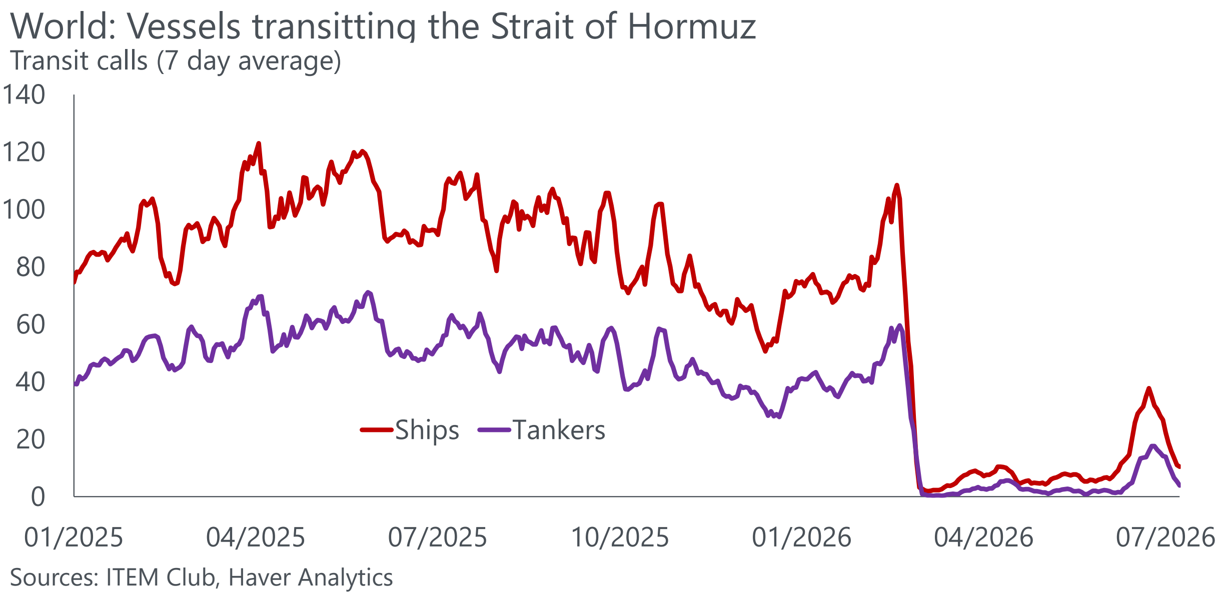
HAVING FALLEN ENERGY PRICES HAVE RISEN AGAIN RECENTLY

Following the outbreak of the conflict in the Middle East, energy prices jumped, with both oil and natural gas becoming significantly more expensive. After the end-June ceasefire between the US and Iran, prices fell sharply. However, the ceasefire proved fragile, and over the last couple of weeks attacks from both sides have intensified. And the Strait of Hormuz has effectively closed. In response, energy prices have picked back up.

Having risen to more than $115 per barrel in early April, oil prices fell back to around $72 per barrel, roughly the level seen before the conflict in the Middle East escalated. Energy prices have risen again more recently, as the ceasefire has frayed. Oil prices have picked back up to more than $90 per barrel but remain below the highs seen in April. However, the shift in natural gas prices has been more notable, with European prices rising to around the highs seen at the onset of the conflict.

After initially recovering, the number of ships transiting the Strait of Hormuz has fallen back following the breakdown in the ceasefire between the US and Iran. In February, on average, there were around 85 ships and 49 tankers passing through the Strait every day. Shipping had recovered slightly, peaking at around 35 ships and 18 tankers making the passage in June. But following the breakdown in the ceasefire, shipping numbers have fallen back to closer to zero (**Chart 1**).

Chart 1: Shipping through the Strait of Hormuz has started to recover a little



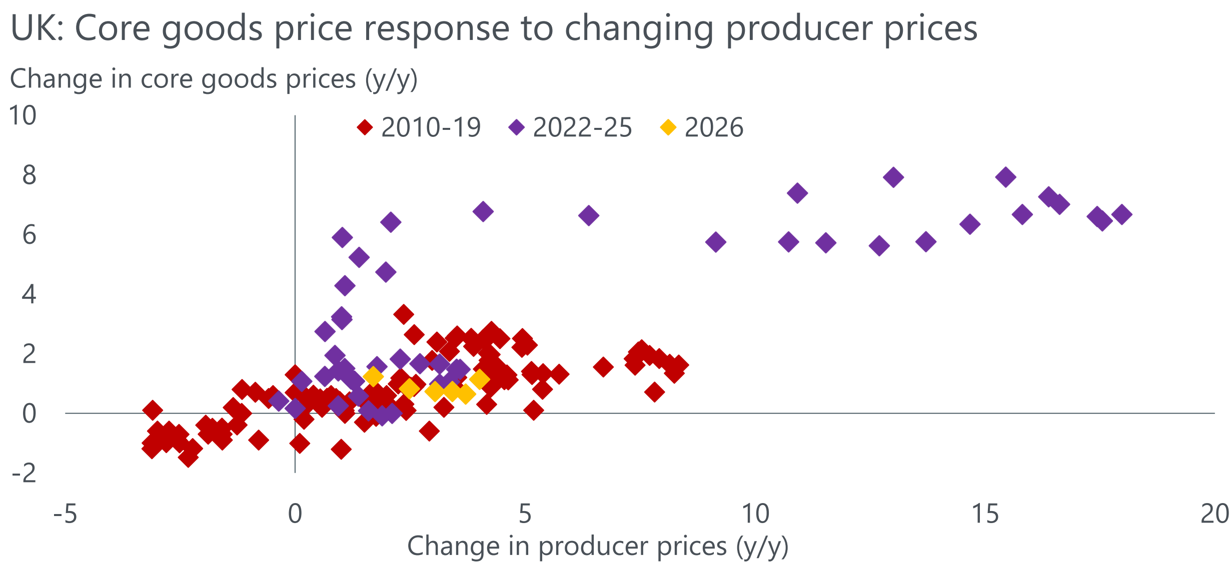
INFLATION STILL LOOKS SET TO RISE

Inflation still looks set to rise as the effects of higher energy prices are partially offset by new cost-of-living measures. We expect inflation to rise towards 3.5% in the second half of this year, leaving inflation at 3.1% for 2026. Although we think there will be some persistence from the indirect effects of the increase in energy prices and some margin rebuild, particularly in the services sector, we think inflation will fall back to 2% by the end of next year, delivering inflation of 2.5% on average across 2027.

The direct impact of the sharp rise in gas prices is yet to fully feed through to consumer prices. The changes will only be reflected in households' energy bills from July as the Ofgem price cap rises by 13%. The regulator has yet to finalise the price cap for the final quarter of the year, but based on our calculations, we expect a further rise of around 5%. Given the likelihood of continued disruption to energy markets, we think it's unlikely that the price cap will fall back to its Q2 2026 level until the second half of next year. Some of the effects of the rising price cap will be offset by new Prime Minister Andy Burnham's announcement to remove VAT on domestic electricity bills between October and March. The decision to remove the 5% levy will temporarily lower the average annual household energy bill by around £45, lowering inflation by around 0.1 percentage points.

We expect the indirect effects of rising energy prices and supply disruptions to continue feeding through to core goods inflation over the remainder of this year. In response to the disruption, businesses' input prices have risen sharply. But this can take some time to pass through the supply chain, with the Bank of England estimating that this process can take around six months to fully play out. Nonetheless, we don't expect a repeat of the exaggerated core goods inflation seen during the 2022 and 2023 inflation bout. So far, rises in goods prices have been much more consistent with the typical rise in input prices (**Chart 2**). We expect core goods inflation to increase from -0.3% to around 0.1% by the end of this year.

Chart 2: Rising input prices are being passed through normally to consumer prices



Sources: ITEM Club, Haver Analytics

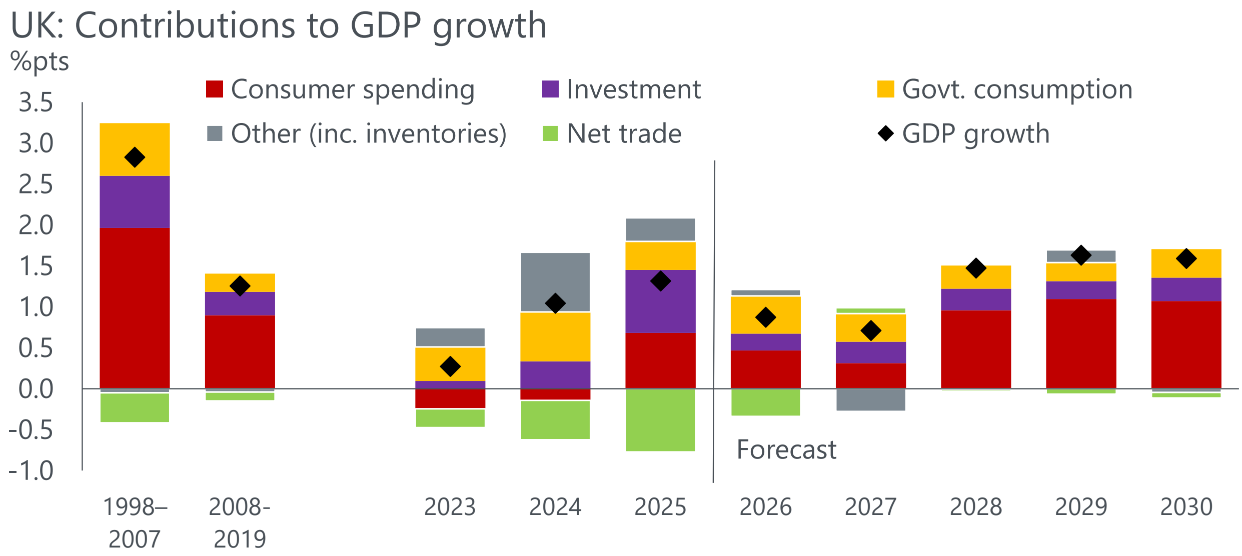
Services inflation will remain sticky for the rest of this year, but we think this is more likely because businesses are trying to increase prices relative to labour costs, rather than because second-round effects from elevated energy prices have become embedded. As they have navigated the twin shocks of the pandemic and the energy price crisis induced by the Russia-Ukraine conflict, businesses in the services sector have increased prices by around 33% compared with 2019. At the same time, pay growth, which is many service providers' most significant cost, has increased by more than 38%. These costs have been further inflated by rising employer NICs and elevated energy prices. We expect services inflation to pick back up towards 4% by the end of this year, before slowly falling back towards 3% next year as companies' price-setting eventually responds to more modest pay growth.

SETTLING INTO A SOFT PATCH

As the conflict in the Middle East rumbles on, we think modest growth this year will likely be followed by another year of soft growth in 2027. We now expect growth to slow from 1.3% in 2025 to 0.9% this year and 0.7% next year. That represents a more gradual, but more prolonged slowdown than expected in our Spring Report, when at the height of the conflict, we expected growth of 0.7% and 0.9% in 2026 and 2027, respectively.

Although the worst-case conflict scenarios appear less likely than we thought three months ago, it is still a tricky period for consumers. Rising inflation and slowing pay growth will see real wage growth slow over the year, and we expect real household disposable income to flatline as the labour market cools. The saving rate is elevated, so households have some scope to save a little less to support their spending. With inflation still sticky and pay growth lacking momentum, we expect this to feed through to next year and weigh on consumer spending. We expect consumption to slow to 0.8% this year, after growing by 1.1% last year. We expect consumption to remain soft next year and grow by 0.5%.

Chart 3: UK GDP growth will slow in 2026 and remain weak in 2027



Sources: ITEM Club, Haver Analytics

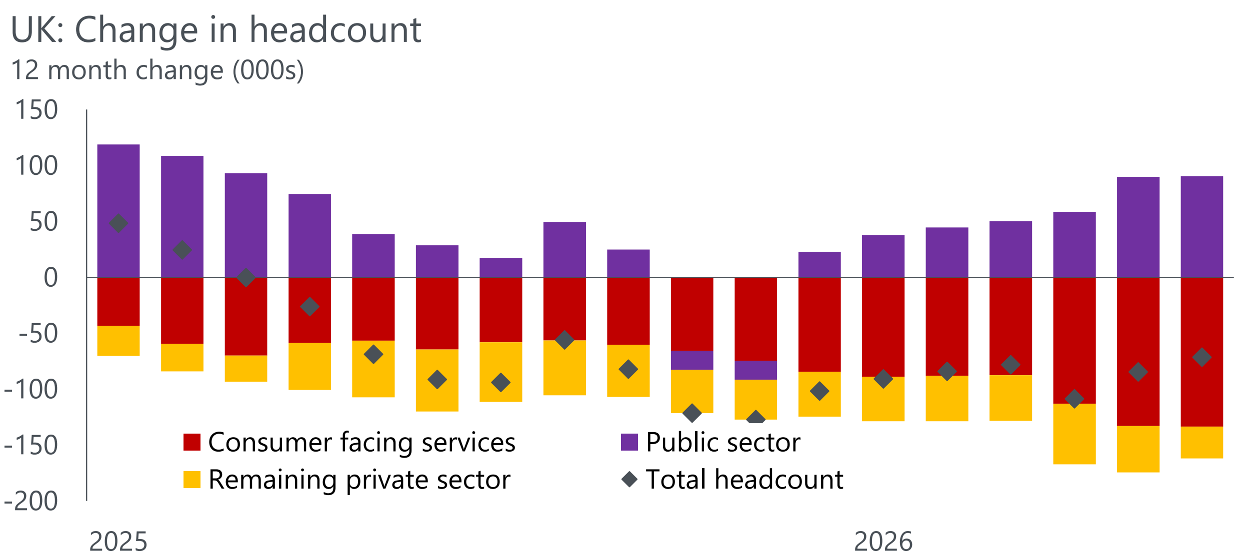
The housing market will remain weak through 2026 and into 2027. Higher energy prices over the last few months have caused financial markets to reappraise their view of the future path of interest rates, with markets pricing in higher interest rates. In response, banks have increased the interest rates charged on new fixed-rate mortgages, and we expect that to weigh on affordability. Combined with less household spending power, we expect housing demand to remain weak. A meaningful improvement in housing supply looks unlikely, so we do not expect outright falls in house prices. But we think a sluggish market will see growth slow from 2.7% last year to 1.3% this year and 0.7% in 2027.

The outlook remains similarly tricky for businesses. Financial conditions remain tight, increasing the cost of new finance and the cost of servicing existing debt. Energy price rises over the last few months will have eaten into some businesses' profitability. Layered on top of that, continued uncertainty and the potential for supply-chain disruption arising from the conflict in the Middle East mean that the business investment outlook remains challenging. We forecast that business investment will fall by 1.7% this year and by 0.1% next year.

PAY TO COOL AS THE LABOUR MARKET BUMPS ALONG

A period of unspectacular growth will likely see the labour market continue to loosen over the coming quarters. Having been below 4% in late 2023, the unemployment rate has risen to around 5% in the latest data. While the accuracy of the Labour Force Survey remains in question, other, more reliable indicators of labour market conditions – such as HMRC payroll data – point to a loosening. So far, the shift in the labour market reflects slower hiring in the face of weak customer demand and elevated cost pressures, particularly in consumer-facing services, such as bars and restaurants, which are typically lower paying and have felt the effects of the changes in employer National Insurance contributions most acutely (**Chart 4**).

Chart 4: Consumer facing services have seen the largest changes in headcount



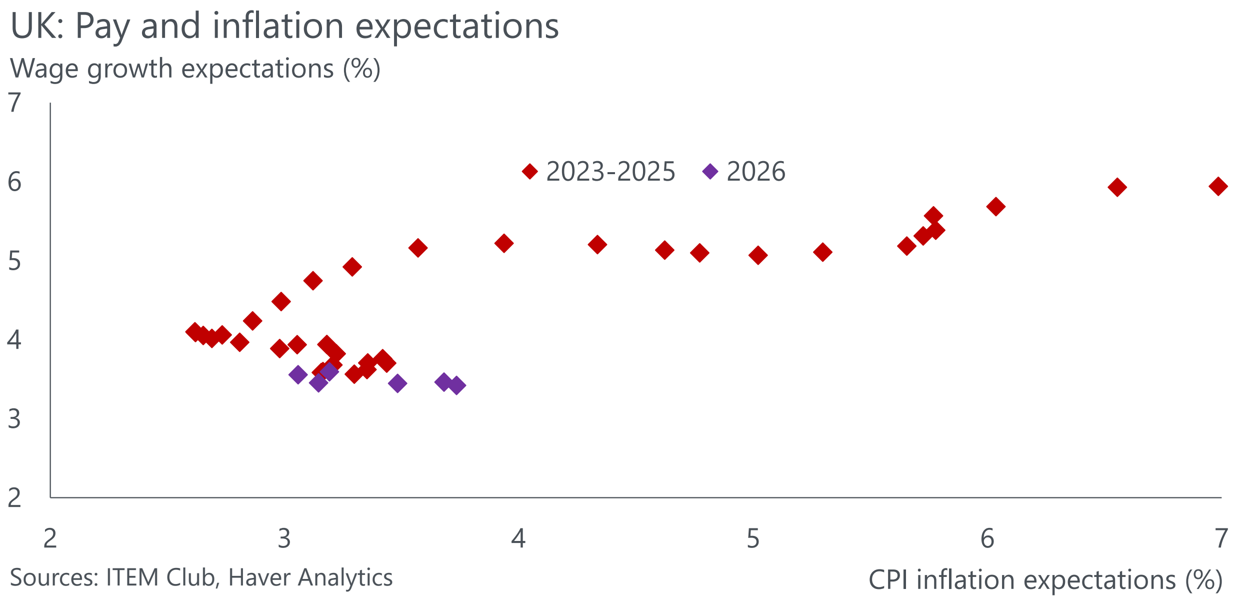
Sources: ITEM Club, Haver Analytics

Faced with a string of quarters where growth is likely to be below trend, we expect the unemployment rate to rise further, peaking at 5.7% early next year. While this is a slightly smaller rise than we anticipated a couple of months ago, it still represents about a further 200,000 people becoming unemployed, leaving the total number of people unemployed a little above 2 million. The ongoing weakness in consumer spending will continue to put roles in consumer-facing services most at risk.

As the labour market softens, pay growth should slow and we do not anticipate significant second-round effects over the next few years, although we will not get a definitive steer on their extent until the middle of next year. As it stands, the private sector labour market is not generating much inflationary pressure. Looking past bonuses, pay growth has slipped below 3% after being close to 3.5% at the end of last year. Given even less momentum in pay growth, earnings are increasing by just over 2% on a 3m/3m annualised basis, it looks likely that pay growth will slow further over the course of this year. The big question mark remains the extent to which workers will be able to push for large pay rises on the back of another period of above-target inflation.

The current weakness in the labour market means we are not expecting a repeat of 2023, when businesses offered chunky pay rises. The Bank of England's survey of corporate decision makers indicates that they anticipate giving relatively small pay rises, given their expectations for inflation (**Chart 5**). We will not know for sure until the middle of next year, given that most pay rises are offered in the first four months of the year. For now, we expect 3.4% pay growth this year and 2.7% next year.

Chart 5: Expected pay rises are low given, decision makers' inflation expectations



Sources: ITEM Club, Haver Analytics

CHANGE OF PM DOESN'T MEAN A BIG FISCAL CHANGE

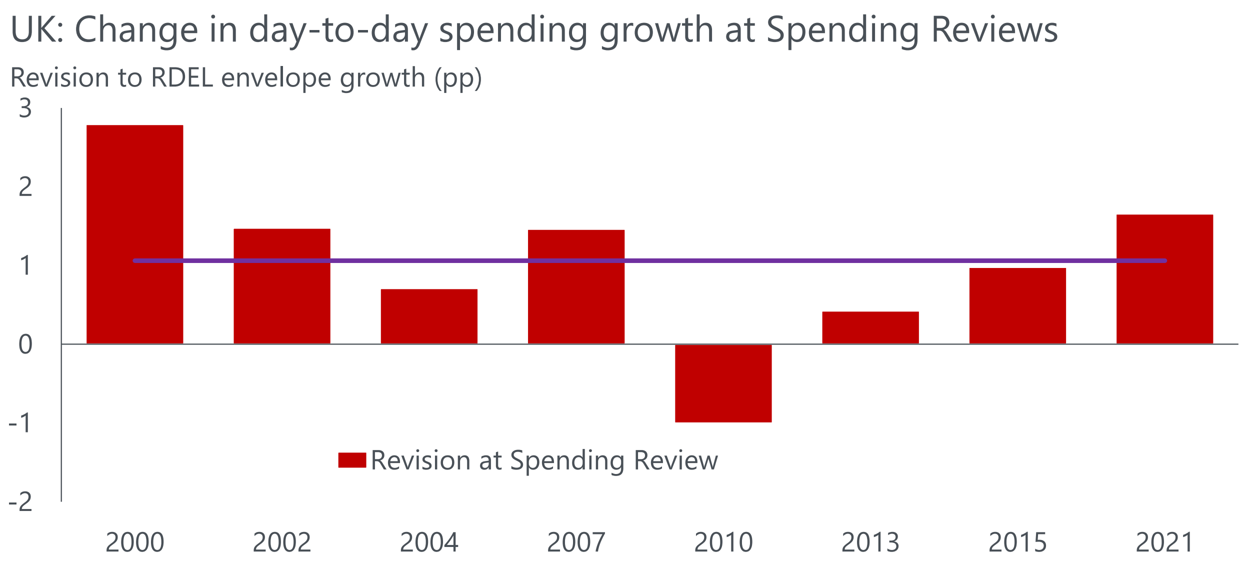
On 20 July, former Mayor of Greater Manchester Andy Burnham took over as prime minister. So far the details of his updated economic strategy remain unclear. However, the strategy is likely to focus on the cost-of-living and devolution.

A change in prime minister is unlikely to materially alter the near-term growth outlook. We do not expect a major shift in fiscal policy or borrowing, while the bond market's focus remains firmly on the sustainability of the public finances. Any new prime minister would therefore have little incentive to risk destabilising gilt yields – and the current fiscal framework leaves little room for a significant increase in spending. If market interest rates remain elevated until the autumn budget, they could wipe out around a quarter of the headroom identified in the OBR's March 2026 Spring Forecast. Weaker near-term growth would squeeze the remaining fiscal space further. Even so, if current conditions persist, we do not expect further fiscal tightening to be needed to meet the fiscal rules. The cost-of-living measures announced so far – including the temporary cut in VAT on electricity bills and reductions in bus fares in some parts of the country – are small in the context of the public finances and should be absorbable within existing departmental budgets.

There is a chance that the government will announce higher spending at the Spending Review, currently pencilled in for 2027. OBR analysis shows that governments of both political stripes have revised up real day-to-day spending growth in seven of the eight Spending Reviews since 2000 (**Chart 6**). The only exception was in 2010, when the government was consolidating the public finances in the aftermath of the

Global Financial Crisis. With unprotected departments facing a particularly tight spending settlement, the pressure to increase day-to-day spending at the 2027 Spending Review is likely to be significant.

Chart 6: Day-to-day government spending plans are typically revised up at Spending Reviews



Sources: ITEM Club, Office for Budget Responsibility

Since our previous forecast, the UK has published its updated Defence Investment Plan, announcing additional spending of around £4billion in 2029-30, the final year covered by current spending plans. Three quarters of the new funding will be covered by cuts to other areas of spending, with the remaining £1billion shortfall in 2029-30 to be funded at the upcoming budget.

The latest plans are estimated to increase defence spending (as defined by NATO) to 2.7% of GDP, leaving further increases required during the next parliament if the UK is to meet its existing commitment to achieve the NATO target of 3.5% by 2035. The UK's commitment to international security is therefore likely to remain a source of pressure on the public finances.

INTEREST RATES TO REMAIN ON HOLD

One striking feature of the economy since the escalation of the conflict in the Middle East has been financial markets' expectation that the Bank of England will raise interest rates. We think this repricing has gone too far. We expect Bank Rate to remain unchanged for the rest of this year, before the BoE resumes cutting rates in the middle of next year.

Markets may take some time to come around to this view. The likely catalyst will be the Monetary Policy Committee dropping its language that it stands ready to do whatever is necessary to bring inflation under control.

For now, the MPC is content to wait and see. The recent rise in energy prices will push inflation higher over the rest of the year, while the resilience of the labour market is not creating a significant trade-off for the committee to manage. But with inflation still expected to remain below the 4% threshold at which the MPC believes elevated inflation begins to have a significant impact on expectations, the cost of waiting for more information on the second-round effects of the energy price shock remains relatively small.

Indeed, the shift in market expectations has made the MPC's holding position more comfortable. Financial conditions have tightened, providing some of the restraint that a rate rise would otherwise deliver. With uncertainty unusually high, the Committee is likely to be content to let those tighter conditions do some of the work.

We therefore do not expect the MPC to drop its tough rhetoric on inflation until it is ready to signal further cuts in Bank Rate. Because the full extent of the shock's second-round effects will not be clear until the wage-setting season at the start of next year is complete, we expect any significant shift in communications to wait until the MPC's forecasts early next year.

Once cuts resume, we expect two further reductions in Bank Rate – one in mid-2027 and another towards the end of 2027 – before it settles at 3.25%.

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About the ITEM Club

The ITEM Club is the only non-governmental economic forecasting group to use the HM Treasury's model of the UK economy. Its forecasts are independent of any political, economic or business bias.

ITEM stands for Independent Treasury Economic Model. HM Treasury uses the UK Treasury model for its UK policy analysis and Industry Act forecasts for the Budget. ITEM's use of the model enables it to explore the implications and unpublished assumptions behind Government forecasts and policy measures. Uniquely, ITEM can test whether Government claims are consistent and can assess which forecasts are credible and which are not.

The ITEM Club forecast for the UK Economy, Summer 2026

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% changes on previous year except borrowing, current account and interest & exchange rates

	GDP	Domestic Demand	Consumer spending	Fixed investment	Exports	Imports
2023	0.3	0.4	-0.4	0.5	-2.3	-1.6
2024	1.0	1.7	-0.2	1.8	1.3	2.7
2025	1.3	2.0	1.1	4.0	1.9	4.1
2026	0.9	1.2	0.8	1.0	0.6	1.5
2027	0.7	0.6	0.5	1.3	0.7	0.5
2028	1.5	1.5	1.6	1.3	1.5	1.5
2029	1.6	1.7	1.8	1.1	1.5	1.6
2030	1.6	1.6	1.8	1.5	1.5	1.6

	Net Govt Borrowing(*)	Current account (% of GDP)	Average earnings	CPI	Bank Rate	Effective exchange rate
2023	4.9	-3.6	7.1	7.3	4.7	80.5
2024	5.2	-3.0	5.4	2.5	5.1	83.6
2025	4.2	-3.1	4.4	3.4	4.3	84.7
2026	4.1	-2.9	3.4	3.1	3.8	85.7
2027	3.3	-2.7	2.7	2.5	3.5	86.6
2028	2.7	-2.5	2.8	2.0	3.3	86.6
2029	1.5	-2.4	2.9	2.0	3.3	86.6
2030	1.5	-2.4	2.9	2.0	3.3	86.6

(*) Fiscal years, as % of GDP

Source: ITEM Club