EY ITEM Club Winter Forecast

A year of gradual improvement

February 2026

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Foreword

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The opening weeks of 2026 have been marked by continued geopolitical volatility from regions around the world, setting the tone for what is likely to be another challenging year for businesses to navigate. While the US decided against introducing further tariffs on the UK and other European countries, persistent uncertainty on trade represents a headwind to business investment and activity.

In this context, the EY ITEM Club forecast remains relatively subdued for 2026, with GDP growth of 0.9% expected. Elevated tariffs will increasingly impact UK exporters, while ongoing uncertainty is forecast to result in a 0.2% contraction in capital expenditure as some businesses postpone investment decisions. This contrasts with a likely outturn of 1.4% GDP growth in 2025, although that is largely a reflection of a strong H1, with the economy slowing in H2. The longer-term growth outlook looks more positive, with growth expected to improve to 1.3% and 1.4% in 2027 and 2028 respectively.

Continued uncertainty and the impact on business confidence is also affecting the labour market – unemployment steadily rose through 2025 to 5.1% as some firms cut back on hiring. However, the labour market may be at a turning point; unemployment is expected to peak at 5.2% as the impact of the increase to employer National Insurance contributions will have largely fed through.

There are some grounds for optimism. While inflation picked up to 3.4% from 3.2% in most recent figures, this was largely due to tax increases in the Budget on some products such as tobacco. Once this impact has faded, inflation should continue its downwards path and reach 2% as early as the summer. This should open the door for another (and perhaps final) cut in interest rates by the Bank of England, currently expected to happen in April.

It remains to be seen whether a reduction in interest rates will lead to a revival in the housing market; current mortgage rates largely price in any further expected movements on the Base Rate, and while house prices in real terms have fallen from their 2022 highs, affordability continues to be constrained. A slow pick-up in house price growth and transactions seems more likely than a rapid recovery.

There are tentative signs of improvements to consumer confidence, particularly amongst those earning over £50,000, with these higher income groups tending to be relatively larger spenders in the economy. If this leads to a corresponding recovery in consumer spending – which has been particularly weak in the UK compared to the US and other European countries – it could represent some upside to the forecast, set against the obvious downsides of the heightened geopolitical risk.

For UK businesses in particular, the question of how to unlock consumer confidence remains the big challenge. If management teams are able to point to a more robust demand-side, it could help release the marginal spend currently tied up in investment committees.

Businesses, consumers and indeed policymakers face yet another uncertain year in 2026. The economic themes of the early 2020s – of subdued growth in the face of broad geopolitical uncertainty – are set to continue. However, there are some signs of economic slack in the UK system which, if met with the right combination of policy and ambition, could offer a route towards stronger, more resilient growth.

Highlights

- After a good start, the UK economy lost momentum through the middle of last year, with growth slowing sharply in Q2. Based on slightly weaker growth data than we envisioned three months ago, we have revised our 2025 growth forecast down to 1.4%. But with signs that activity picked up a little at the end of last year, we continue to expect modest growth in 2026. We think GDP will grow by 0.9% this year before picking up to 1.3% in 2027 and settling at 1.4% from 2028 onwards.

- Fiscal policy will continue to drag on growth over the coming years. Although the tax rises announced at the Budget were towards the bottom end of expectations, the Government now looks to have a healthier margin for error against its fiscal rules. But we will have to wait to see if all the measures are fully implemented. The big tightening measures will not come into effect for a couple of years and there is still scope for them to be cancelled or delayed.

- Having looked like it had bottomed out over the summer of 2025, the downturn in the labour market has re-accelerated. And we expect it to carry on in the first half of 2026 (H1). Firms' hiring remains weak and there are tentative signs that layoffs may be rising slowly. With some of the support from the public sector fading, we expect the unemployment rate to rise a little further to 5.2% in H1.

- Inflation reached a peak of 3.8% in July, August and September, and has since edged back down. Underlying price pressures remain elevated, although declining food price inflation is a big positive. Inflation will fall quite sharply as measures to reduce utility bills come into effect in April 2026. With pay growth slowing over the course of this year and businesses having adjusted to the rise in employer National Insurance contributions (NICs), we think inflation will stabilise at 2% by the end of 2027.

- For the first time, the Monetary Policy Committee has indicated that it is close to the end of its cutting cycle. Having skipped a cut in November, falling inflation and a worsening outlook for the jobs market prompted a majority of rate setters to cut Bank Rate again in December. The Committee is divided over the timing and the extent of future rate cuts. We expect the Committee to wait to see the size of pay rises offered early this year before delivering a final rate cut at its April meeting as it gets more confirmation inflation is on a path towards 2%.

- Slowing pay growth, rising unemployment and frozen income tax thresholds will act as headwinds to growth in real incomes. However, with the highest spenders looking more confident and with the slowdown in income growth more marked amongst the lowest spenders, we expect households to reduce saving, which will support consumption growth over the next couple of years.

- Investment growth is going to go through a soft patch at the start of this year. Capex growth over most of 2025 has been revised up. So, there is less scope for catchup, and lingering uncertainty will still result in investments being postponed. Looking beyond this year, we expect investment growth to pick up as businesses exploit a healthy balance sheet position and the lower cost of new and existing finance.

1

Introduction

Since our autumn forecast, growth has softened more quickly than we expected. With wider global headwinds persisting, we expect recent modest growth to continue into this year. Fiscal policy is set to tighten; interest rates are close to the end of the cutting cycle and uncertainty lingers as the world economy continues to muddle through recent shifts in trading arrangements. Policies announced at the Budget aren't expected to have a large impact on growth (positive or negative) over the next couple of years with the significant tightening measures backloaded.

Our winter forecast sets out where we expect the economy to head through 2026 and into 2027 and beyond. It will look at what might support the labour market over the next few years and what drivers might underpin consumption as real income growth slows.

2

Modest performance to continue

We have nudged down our GDP forecast for 2025 to 1.4% as the economy lost momentum in the third quarter of the year. But GDP data for most of Q4 suggest an improvement in growth, and we think that there is scope for modest but steady growth throughout this year. The package of tax rises delivered at the Budget was towards the bottom end of expectations, with the largest impact towards the later years of the forecast period. Although the Bank of England lowered interest rates in December, having skipped a cut in November, with the Monetary Policy Committee (MPC) divided on the pace and extent of future cuts, any further reduction in Bank Rate will be cautious. This year we forecast GDP to grow 0.9% before picking up to 1.3% in 2027 and settling at 1.4% from 2028 onwards.

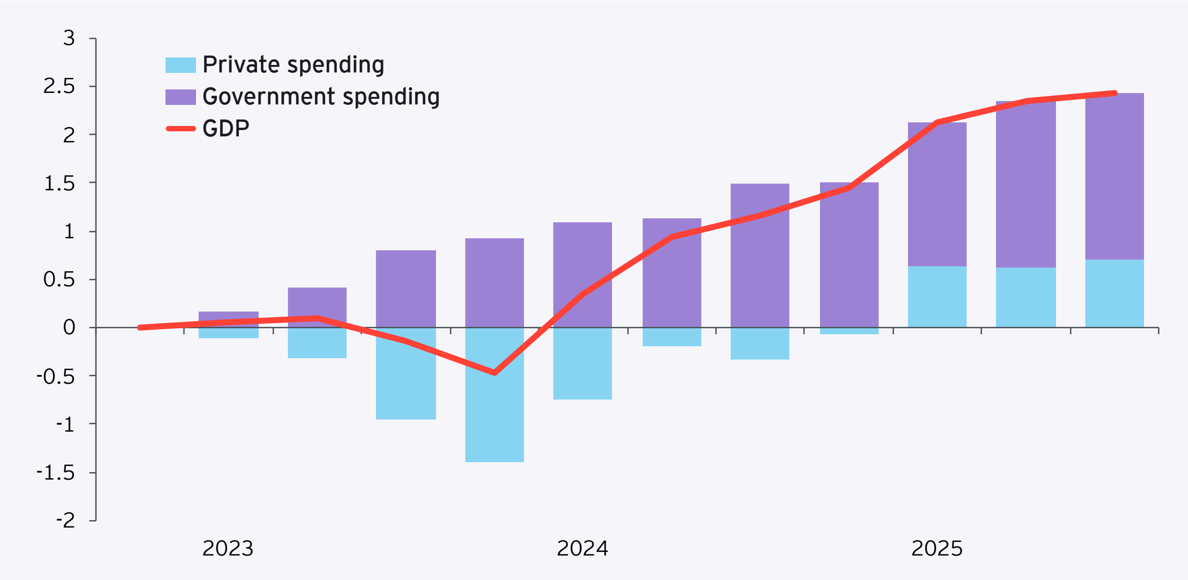
The economy lost momentum in the second half of last year

Having made a strong start to 2025, the economy lost momentum through the spring and into the summer. After growth of 0.7% in Q1, revisions to the back data made the slowdown into the second quarter a little more marked with Q2 growth revised down by 0.1 percentage points (pp) to 0.2%. Although growth dipped to 0.1% in Q3, a little below the 0.2% that we had pencilled into our previous forecast, early indications are that growth bounced back into Q4. Monthly GDP estimates showed activity picked up by 0.3% in November, lifting output to its highest level since June, as the effects of a cyber-attack at a large car manufacturer unwound. Over the three months to November, growth has picked up to 0.2%, and we think quarterly growth will rise to 0.3% in Q1 2025.

Our base case is that modest growth will continue through the early part of this year. But ongoing uncertainty around the seasonality of the GDP data leaves the risk that growth picks up by more than we expect in Q1. Since the pandemic, GDP estimates have consistently recorded strong growth in the first quarter before slowing throughout the rest of the year. We have previously set out how we think that this might be because the official data is unable to pick up a post-pandemic shift in seasonal activity. This residual seasonality leads official estimates to overstate 'true' growth early in the year and 'understate' growth in the latter half. Nonetheless, the ONS argues that its GDP estimates are not impacted by residual seasonality, so we have not built a Q1 bounce or some Q3/Q4 weakness into our projection.[1] Still, it provides an upside risk to our forecast for the start of 2026.

UK: Cumulative GDP growth

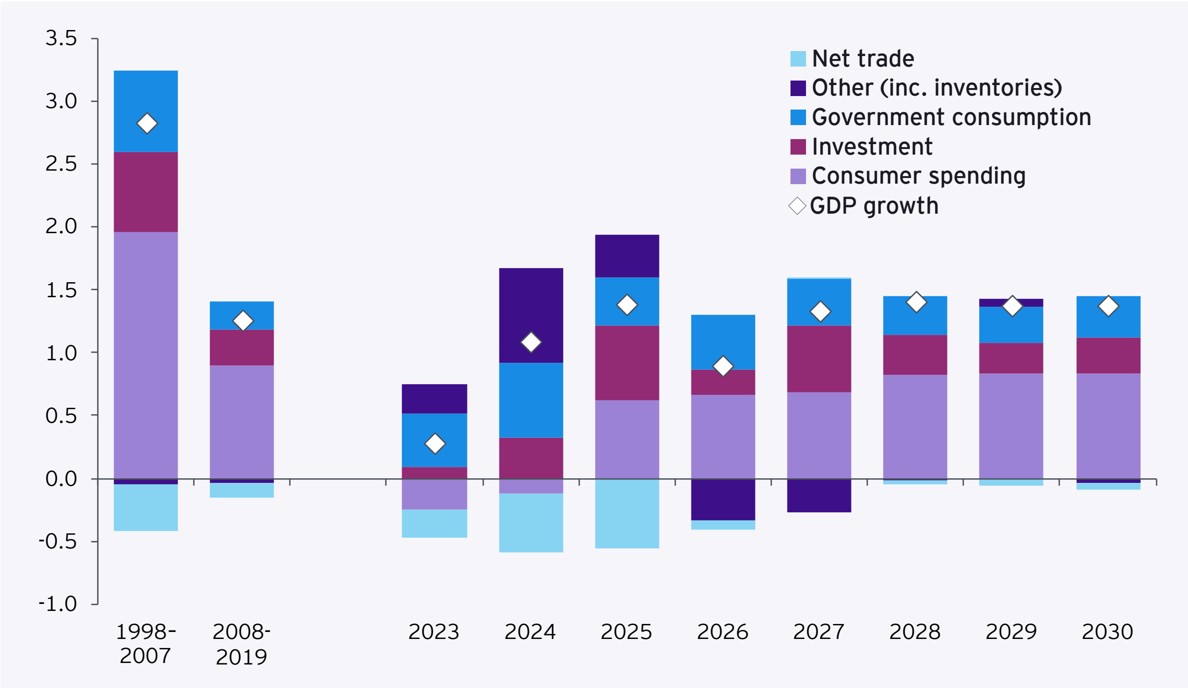
% change since Q4 2022



Source: EY ITEM Club, Haver Analytics

UK: Contributions to GDP growth

%pts



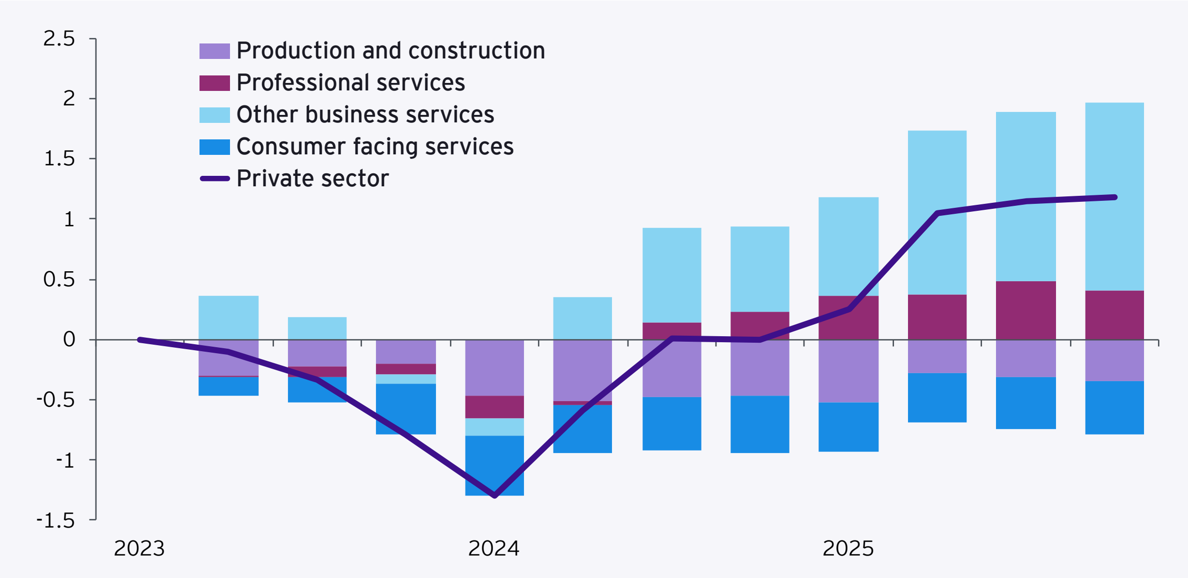
Source: EY ITEM Club

Demand still relies heavily on the public sector. Overall, the latest Quarterly National Accounts data paints a slightly less downbeat picture of private demand than in the previous report. Consumer spending growth was 0.4% in Q3, 0.1pp higher than we expected three months ago, while a string of upwards revisions to business investment have left the level of capex looking much healthier. But, zooming out, it's clear that growth has been dependent on government spending over the last couple of years. Public expenditure will continue to support growth this year, with the slowdown coming from a more modest picture of private demand.

Within the private sector, growth has been concentrated amongst B2B services. Professional services have grown particularly well. Notably, marketing and advertising services have seen greater demand as consumers' and businesses' preferences shifted after the pandemic. By contrast, consumer-facing services, the production and construction industries have all been weak over the last few years with activity declining in real terms. This reflects the sharp rise in energy costs that have squeezed consumers' spending power and the cost of producing manufactured goods.

UK: Private sector output

% change since 2022 Q4



Source: EY ITEM Club, Haver Analytics

Forecast for the UK economy, winter 2026

% changes on previous year except borrowing, current account and interest and 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	1.1	1.6	-0.2	1.7	1.4	2.7
2025	1.4	1.9	1.0	3.1	2.3	3.9
2026	0.9	1.0	1.1	1.0	0.1	0.3
2027	1.3	1.3	1.1	2.7	1.3	1.2
2028	1.4	1.4	1.3	1.6	1.6	1.6
2029	1.4	1.4	1.4	1.2	1.6	1.6
2030	1.4	1.4	1.4	1.5	1.6	1.6
	Net govt. borrowing (*)	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2023	4.8	-3.6	7.1	7.3	4.7	80.5
2024	5.2	-3.0	5.4	2.5	5.1	83.6
2025	5.2	-2.3	4.5	3.4	4.3	84.7
2026	3.5	-1.7	3.5	2.3	3.6	85.1
2027	3.0	-1.5	2.9	2.2	3.5	85.1
2028	2.4	-1.4	2.8	2.0	3.5	85.1
2029	1.8	-1.4	2.9	2.0	3.5	85.1
2030	1.8	-1.4	2.9	2.0	3.5	85.1

(*) Fiscal years, as % of GDP

Source: EY ITEM Club

Fiscal policy continues to weigh on the growth outlook

Keeping the UK's public finances on an even keel requires fiscal policy to tighten further over the next five years. The build-up in public sector debt through the pandemic and energy price crisis, combined with a sharp rise in bond yields and a track record of relatively modest growth, means that the Government will have to reduce borrowing to improve the UK's fiscal position. We expect this to weigh on growth over the next few years as public spending (relative to GDP) remains steady, but taxes rise.

We don't necessarily expect more tax rises this year, but unless the UK's growth potential improves, fiscal policy will have to be tightened further in the medium term. We think that, based on our forecast, the Government could meet its fiscal rules by a little more than the OBR expected at the Budget.

Although we have a similar growth forecast, we have a stronger pay projection, which is more revenue rich. While not a fully fledged fiscal event, the Spring Statement on 3 March will give an early indication on how the Government is faring against its fiscal targets.

Moving beyond the end of this Parliament, the UK's ageing population means that its fiscal position will become even more challenging.[2] So, unless the public provision of welfare and key services is to become much less generous, additional tax revenue will have to be generated. Without stronger long-run growth this will have to be delivered through higher tax rates.

UK: Tax revenue and public spending

% of GDP

Source: EY ITEM Club, Haver Analytics

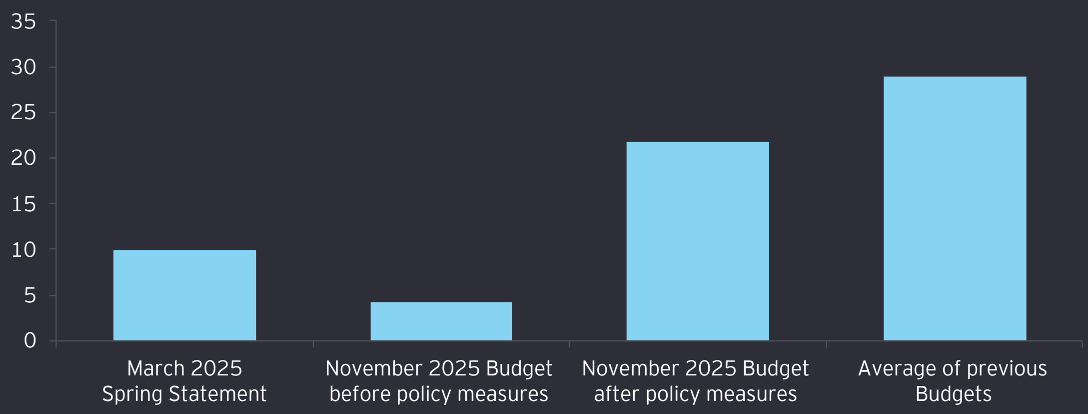
The Autumn Budget will have little impact in the near term

Despite the large increases in tax and spending at the Government's first Budget, the Government's second Budget was hotly anticipated. However, the broad contours of the Budget were largely as expected. The combination of a weaker growth outlook, U-turns on previous welfare commitments and some new spending commitments left the Chancellor with a fiscal shortfall to make up.

While the shape of the Budget was not unexpected, the size of the revision to the OBR's borrowing forecast was smaller than most commentators anticipated. This allowed the Chancellor to implement a set of tax rises that were worth £21bn in 2029-30. The policy package, while towards the smaller end of expectations, was still able to deliver a large increase in headroom against the Government's fiscal rules. The OBR estimated that the Government would have £22bn of wiggle room, more than double the £10bn headroom left at the Spring Statement, but a little smaller than the average headroom that had been left at previous fiscal events.

UK: Fiscal headroom

£bn



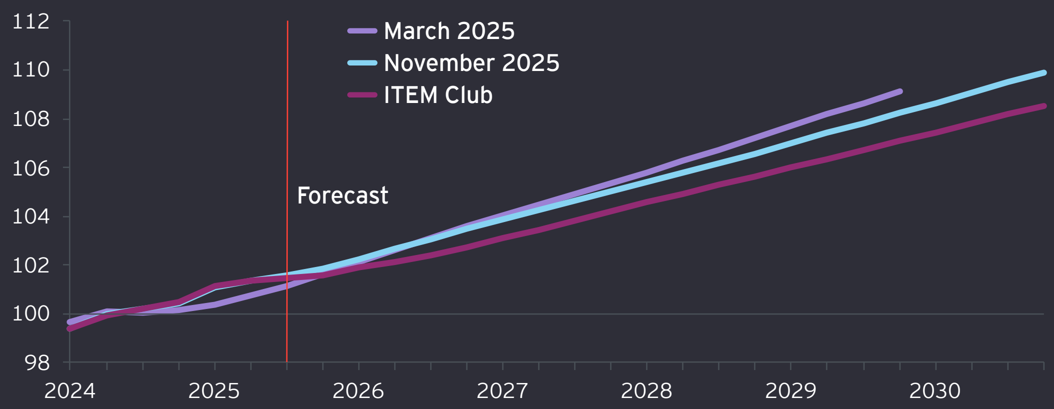
Fiscal policy is now based on much more plausible economic assumptions

It was heavily trailed pre-Budget that the OBR would lower its medium-term GDP growth forecast. Having previously been much more optimistic than all other forecasters about the prospects for productivity growth, the OBR's revised forecast looks much more plausible and is comparable to our expectation that output-per-hour growth will settle around 0.8%. However, it remains overly optimistic about the UK's growth prospects this year, in our view.

An upwards revision to pay and inflation offset some of the impact on the public finances of the downgrade to the OBR's growth projection. Although the big changes were concentrated in the near term, it meant that even before any tax changes were accounted for, the OBR expected the government to just meet its fiscal rules.

UK: OBR GDP forecasts

2024 = 100



Source: EY ITEM Club, OBR

Tax choices could limit fiscal credibility

On the face of it, by increasing the amount of headroom against its fiscal rules the Chancellor used the Budget to outline a more credible set of plans, particularly given they're now based on more plausible economic projections. By giving itself more wiggle room, the Government has reduced the chances that 2026 will be a repeat of last year with it being widely expected months in advance of the Budget that the Government will have to increase taxes.

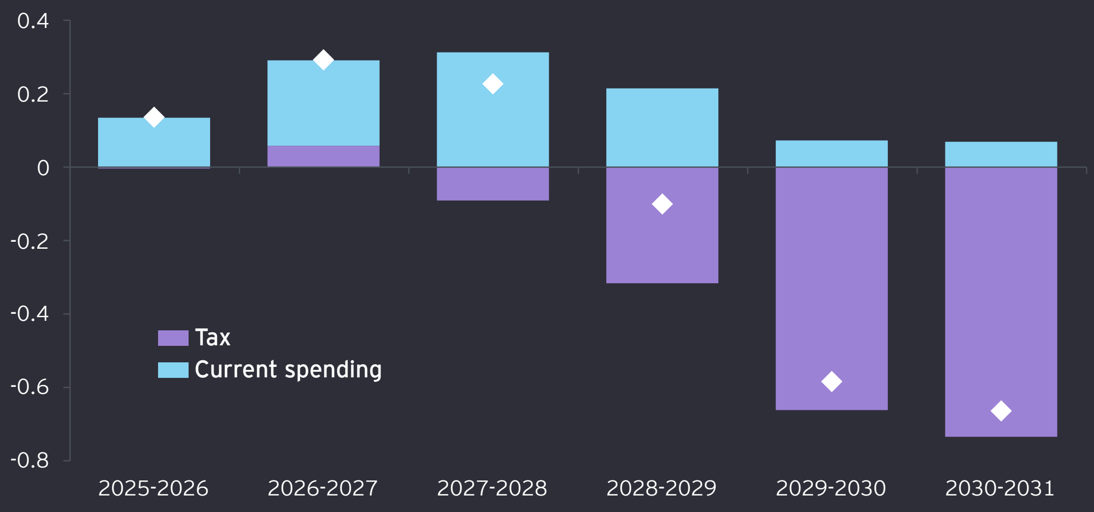
Nonetheless, some question marks remain over the current fiscal approach. A lot of the tightening is backloaded with the measures that raise most of the new revenue not coming into effect for a couple of years. Notably, there is a significant fiscal tightening of £17bn pencilled in for 2029–30. A large chunk of this revenue comes through the extension of the freeze on income tax thresholds and changes to salary sacrifice arrangements, which there will be a temptation to postpone given the next general election is scheduled to take place in 2029–30.

Other than the freeze to income tax thresholds, the Government announced a wide range of large tax rises on small revenue streams to make additional savings. These revenues are notoriously hard to forecast and can fall disproportionately on certain parts of the economy. Indeed, since the Budget, the Government has already announced plans to water down how business rates for pubs will be calculated.[3]

Finally, the Government is relying on generic 'efficiency savings' in 2029–30 and 2030–31 to deliver its spending plans. But without a concrete plan for improving efficiency, there's a risk that spending will rise more quickly than planned to deliver the services that the government has committed to.

UK: Impact of Budget 2025 measures

% of GDP



Impact on the growth outlook

With most of the measures backloaded and with our autumn forecast already including the extension in income tax thresholds, the Budget has had little impact on our overall growth forecast. Slightly more borrowing in the near term offers a little impetus to growth and supports our view that we will continue to see modest growth this year. But there was little in the way of measures to boost medium-term growth potential. Previously announced planning reform will be supported by the Planning and Infrastructure Act, which gained Royal Assent at the end of 2025.[4] But its impacts are uncertain, and it's hard to tell if and when they might support growth. The Budget included some measures to support youth employment, which we will look at more in Section 4.

Source: EY ITEM Club, OBR

The labour market continues to deteriorate

As the economy emerged from the pandemic, the labour market was very tight, with significant skills shortages leading to wage pressure. However, slower growth and employment tax rises have seen the jobs market loosen and indeed some signs of slack are starting to emerge. The unemployment rate rose to 5.1% across the three months to November. With the labour market typically lagging growth slightly, we expect a further increase in the rate of unemployment to 5.2%, before falling back to 4.7% by 2028. While there has been a notable rise in the jobless rate, which at its lowest point recently was 3.9% in 2023 Q3, it remains a long way off the levels we have seen in major recessions. For example, in the global financial crisis the unemployment rate topped 8%, an increase of more than 3pp.

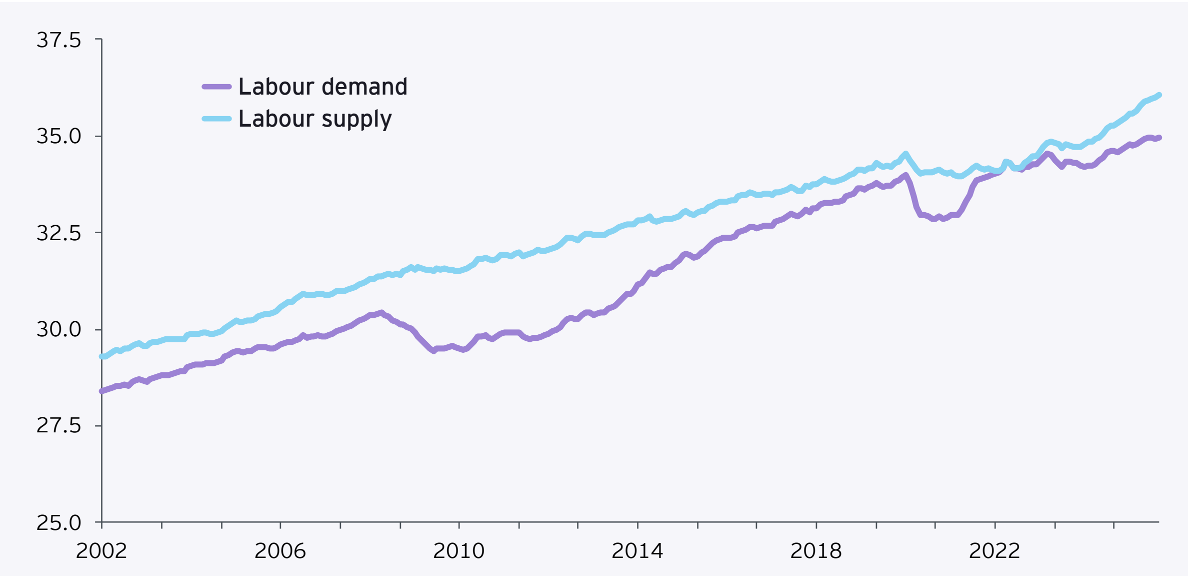
Businesses have reduced headcount since the end of 2024. This, in part, reflects weak demand, but also an increase in their costs, on the back of the rise in employer NICs. Since the Government's first Budget, there's been a notable reduction in employees amongst the lower-paying private sector industries, such as hotels and restaurants, where the impact of the tax change has been most severe. Over the same period, higher-paying private sector employment has been flat, with growth in public sector employment effectively propping up the labour market. There are some signs this is starting to fade as the number of public sector employees declined over the last three months.

To date, the change in the labour market has come through reduced hiring rather than large-scale layoffs. But there are tentative signs that some businesses are also starting to actively reduce the size of their workforce. The number of job openings declined throughout 2025, ending the year below its pre-pandemic level, while vacancies compared with people looking for work picked up quite markedly towards the end of the year. This has been echoed in firms' hiring intentions, with respondents to the Bank of England's Decision Maker Panel (DMP) for the first time indicating that they expect to reduce employment over the coming 12 months. Having been stable for much of 2024 and 2025, towards the end of the year redundancy notifications rose a little. However, in the grand scheme of things, redundancy notifications don't look particularly high. With weak hiring intentions and signs of some job shedding, we expect the unemployment rate to rise a little further in H1, peaking at 5.2%, after which we think the unemployment rate will edge back down to 4.7% as growth slowly picks back up.

Earnings growth has slowed compared with the highs seen immediately after the pandemic. This is due to some of the unusual strength in pay growth that we saw at the end of 2024 unwinding. However, we have seen reports that private sector pay settlements have also decreased with the Bank of England's DMP indicating that pay rises offered to employees at the end of 2025 are down about 1pp on the previous 12 months. Businesses indicate that over the coming year, pay rises will be about another 0.7pp smaller again. We think this is consistent with pay growth slowing back to around 3% this year as businesses respond to easier hiring conditions and become fully adjusted to the change in employer NICs.

UK: Labour demand and supply

mn



Source: EY ITEM Club, Haver Analytics

Inflation to fall sharply later this year

Having peaked at 3.8% in July, August and September, inflation fell back through the final quarter of 2025 slowing to 3.4% by December. While inflation is heading in the right direction, the all-important services inflation, remains much higher than historical rates. More positively, food inflation has fallen from its peak. Having previously spiked in response to pressure in wholesale markets, a normalisation in prices further up the supply chain has been passed through to the prices on the shelves relatively quickly. Food inflation fell back from 5.3% in August to 4.7% in December.

Inflation's downwards trajectory will gather pace in early 2026. The announcement at the Budget that some levies on utility bills will be removed will reduce energy prices from April. The impact of this measure alone will be to reduce headline inflation by around 0.3–0.5pp.[5] But on top of that, households will also benefit from lower wholesale energy prices at the end of last year contributing to a reduction in the Ofgem price cap. Indexed and regulated prices that are often set once per year in April will see smaller increases this year than last in response to lower inflation over the twelve month period.

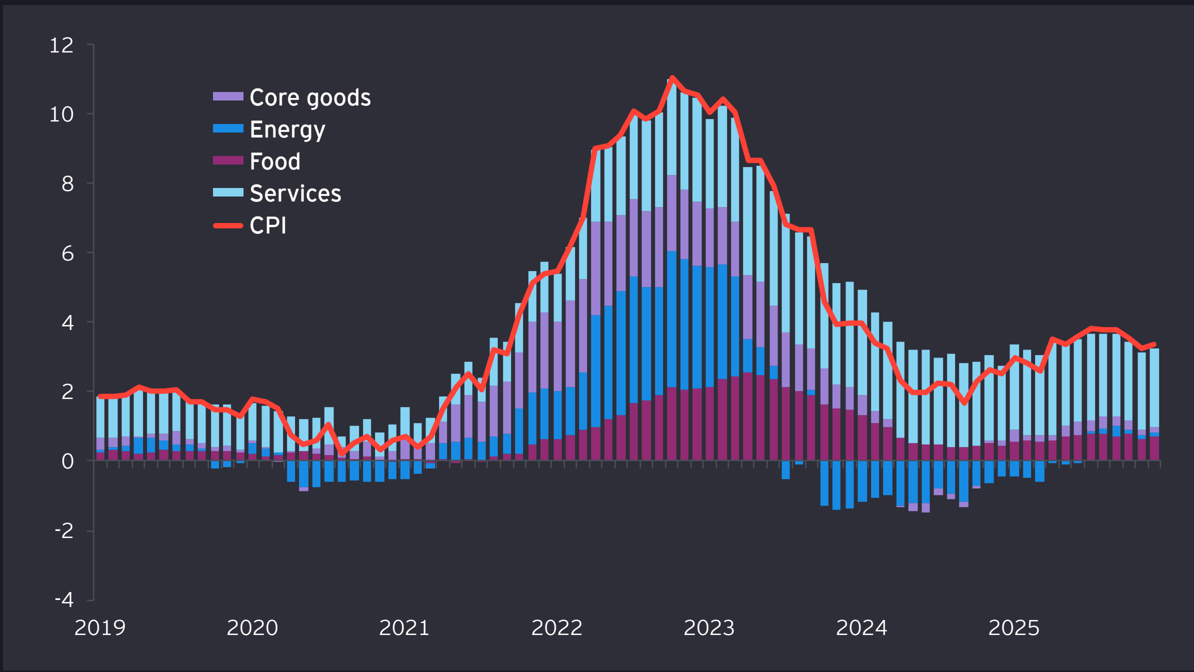
But looking past the temporary impact of changing levies on inflation, we do think that there will be some genuine, but steady, progress too. We think that food price inflation will cool further as prices continue to recover from the earlier disruption in wholesale markets. With the effect of the NICs change now likely passed through to prices, we think that cooling pay growth will result in falling labour cost growth. We expect this to translate into slower services price inflation over 2026 and 2027.

We think inflation will temporarily get close to 2% in the middle of 2026, before settling there sustainably towards the end of 2027. In the near term, the change in utility bills will drag down inflation and could see inflation hit 2% in Q2. However, this effect will be temporary, and, at that stage, underlying pressures will still be above the rates we think consistent with inflation at the 2% mark. Cooling pay growth will see labour cost pressures fall back to the level consistent with inflation holding steady at 2% by the end of 2026. This will take a little time to feed through to consumer prices, and we think the last bit of sticky inflation will be squeezed out in 2027, with inflation falling back towards target in the second half of next year.

We expect inflation at 2% from 2028 onwards.

UK: Contributions to inflation

% year



Source: EY ITEM Club, Haver Analytics

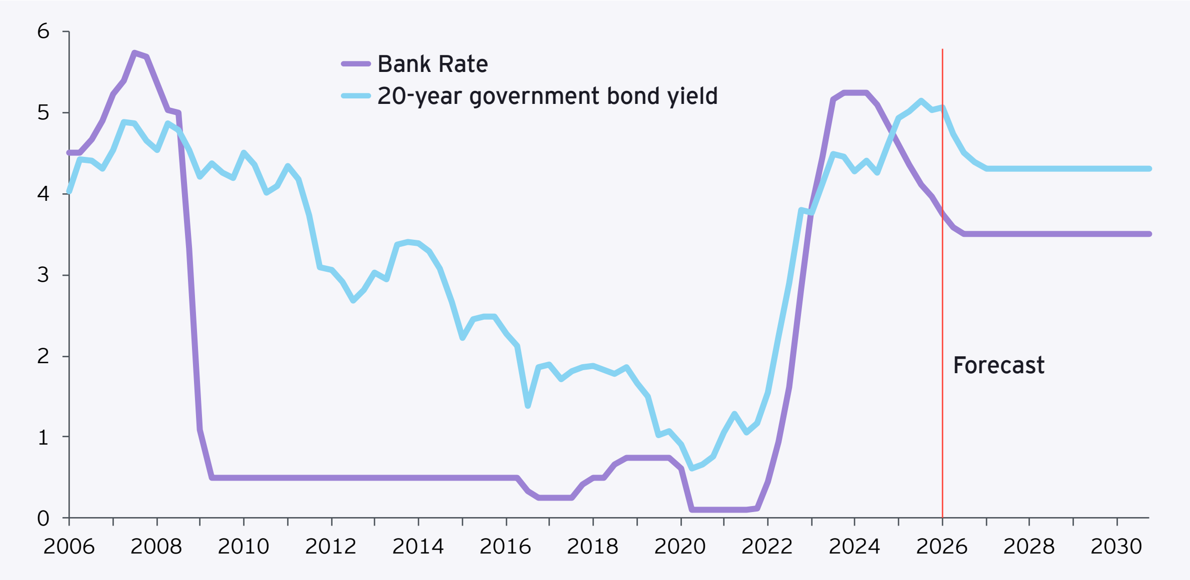
Bank of England getting close to the end of the cutting cycle

The Bank of England cut interest rates at its December meeting but indicated it's likely getting close to the end of the cutting cycle. Faced with the dilemma of sticky inflation but a weak growth outlook, the MPC opted to reduce interest rates gradually, lowering Bank Rate once per quarter between August 2024 to August 2025. But with interest rates having fallen from 5.25% at their peak to 4%, most of the MPC viewed Bank Rate as approaching neutral. With inflation rising and signs that the deterioration in the jobs market may have bottomed out over the summer of 2025, the MPC decided to give itself a little more time to judge whether more cuts were necessary, leaving rates on hold in November. But a more marked slowdown in inflation than had been expected and a reacceleration in the labour market's loosening saw another interest rate cut delivered in December, with Bank Rate cut to 3.75%.

Looking ahead, we expect one more interest rate cut, likely to come at the Bank of England's April meeting. At its December meeting, the Bank of England indicated that, on balance, it will cut interest rates further. But, while the MPC is divided on the timing and the extent of future rate cuts, for the first time it nodded towards the fact that it was approaching the point where it would bring interest rate cuts to a halt. We think that with inflation and pay growth both above target consistent rates, the MPC will hold off until its April meeting to lower interest rates further. At this point, it will have a better read on the size of the pay rises offered in the early-year settlement season and how 2026's indexed price rises might play out. We expect this to be the final cut as after this point, inflation and pay growth will be closer to target consistent while growth will be settling around trend. Financial markets expect Bank Rate to be cut to between 3.25% and 3.50% with the first cut almost fully priced in for the Bank of England's April meeting.

UK: Bank Rate and 20-year bond yield

%



Source: EY ITEM Club

Housing market set for continued modest performance

For the housing market, 2025 was a year of two halves. The first half was characterised by volatility around April's change in Stamp Duty thresholds. With the thresholds about to be lowered, some purchases were brought forward to beat the deadline. With some activity pulled forward, the housing market went through a lull during the spring. Housing market transactions in March were more than double the year before. But in April, transactions dropped off to the extent that they were 27% lower than a year earlier. Over the summer the market normalised, and entering the second half of the year, transactions and mortgage approvals picked back up to above pre-pandemic levels.

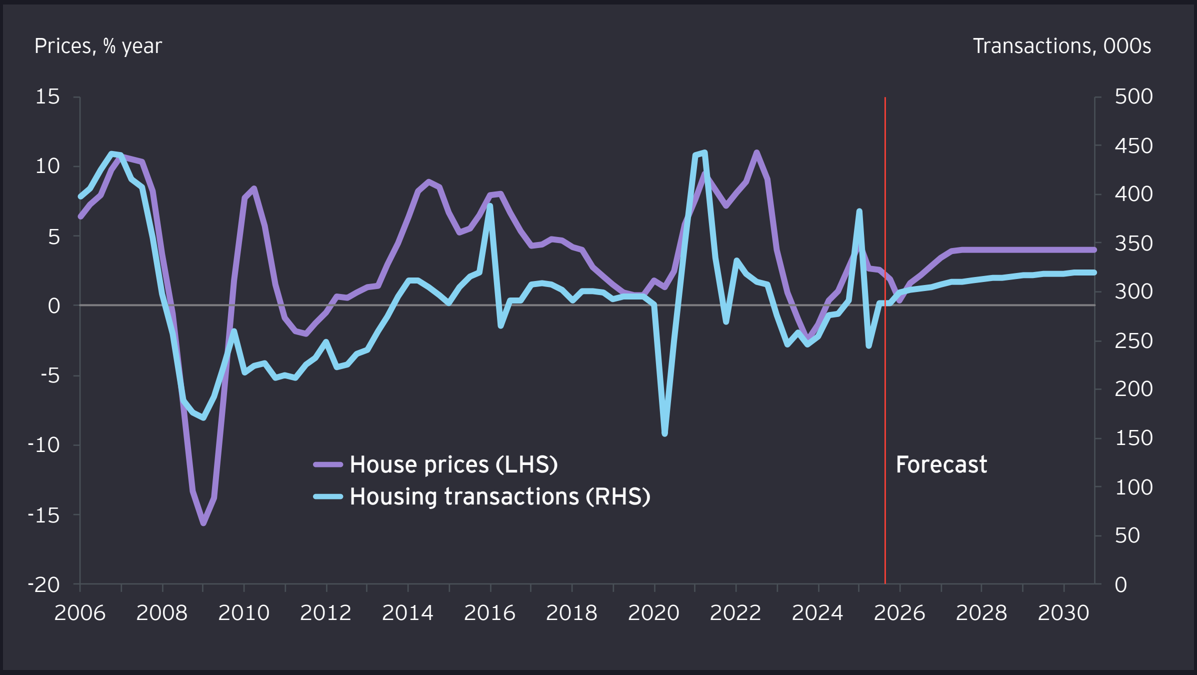
Looking to 2026, the housing market will be driven by fundamentals. The property taxes announced at the Budget will have little immediate or material impact on the housing market. The high-value council tax surcharge will only apply to properties in England valued at £2mn or above in 2026. It's estimated that this will be around 1% of households in England and it will not be brought into effect until 2028.[6]

The coming year looks to be another unspectacular year for the housing market. Having made a soft end to 2025, house price gains are likely to be modest this year. After a couple of years of strong pay growth and relatively small rises in house prices, housing affordability has improved.

But the big improvements in housing affordability now look likely to be a thing of the past. With the jobs market deteriorating against a backdrop of weak growth, house prices compared with income are going to see a smaller fall this year than last year. There is also little scope for mortgage rates to fall a lot with the Bank of England likely to cut interest rates less this year than they did in 2025. Money market expectations for interest, which banks use to price mortgages, are in line with our Bank Rate view over the next twelve months or so. Looking three to five years out, interest rate expectations gradually rise as risk premiums build in. We expect house prices to grow by 1.7% over the course of this year before settling around 4% from 2027.

UK: House prices and transactions

% year



Source: EY ITEM Club

Consumption growth will be similar this year despite slowing real income growth

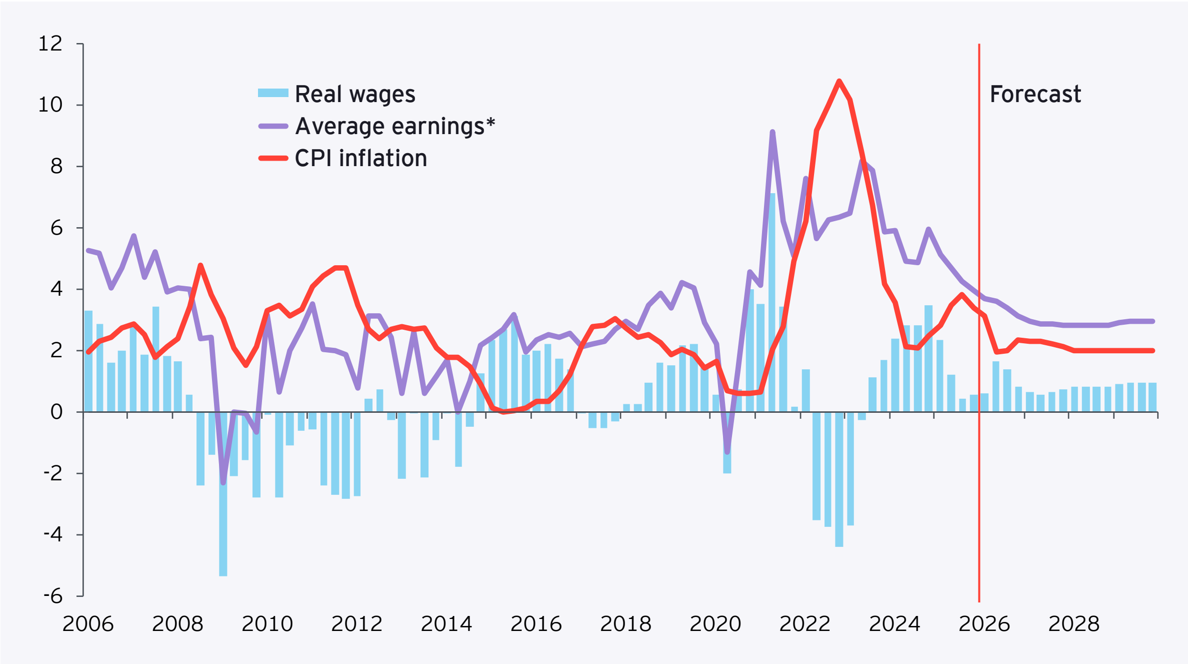
We think that consumption grew by 1% in 2025 and that it will grow by 1.1% in 2026, even though household income growth will slow.

Despite the cost-of-living measures introduced at the Budget, we think that real income growth will be weaker this year than next year. With pay growth slowing, income tax thresholds frozen and the unemployment rate rising slightly, we think that households' real take home pay will slow from around 1% last year to 0.8% this year.

We think that falling saving rates will support consumption growth and cushion the impact of softening real income growth. As we set out in Section 4, confidence has risen amongst the biggest spenders, while they will also see the smallest slowdown in real income growth. Combined, we think this points to the household saving rate continuing to fall from around 10% to 9%, which is a little above its long-run average of 8.2%.

UK: Average earnings and inflation

% year

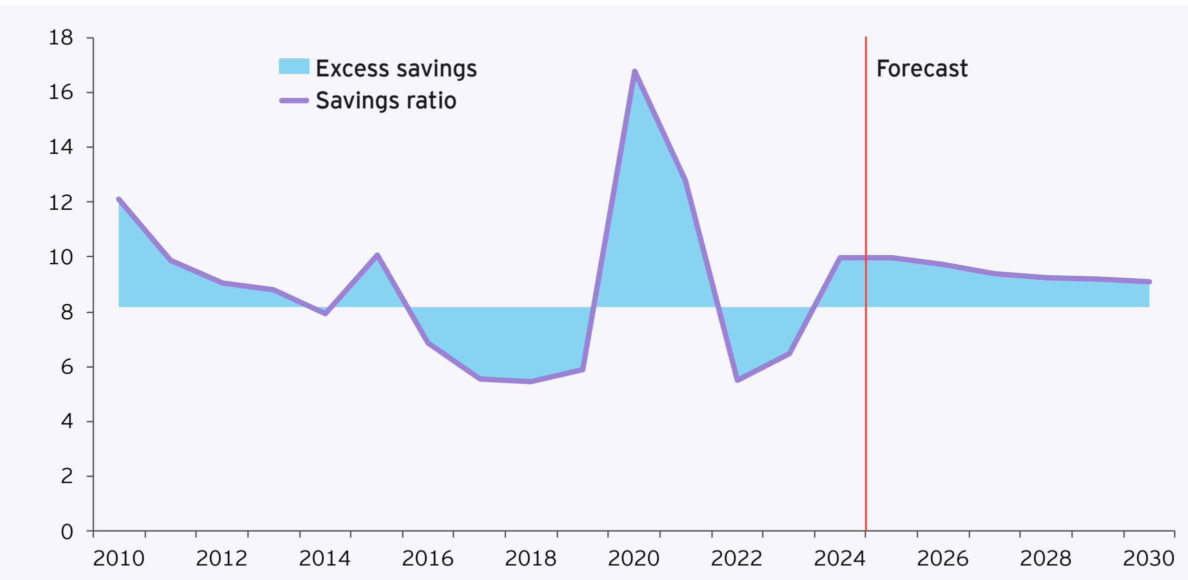


* National Accounts measure

Source: EY ITEM Club

UK: Excess savings

% of disposable income



Source: EY ITEM Club, Haver Analytics

Uncertainty will continue to weigh on investment through 2026

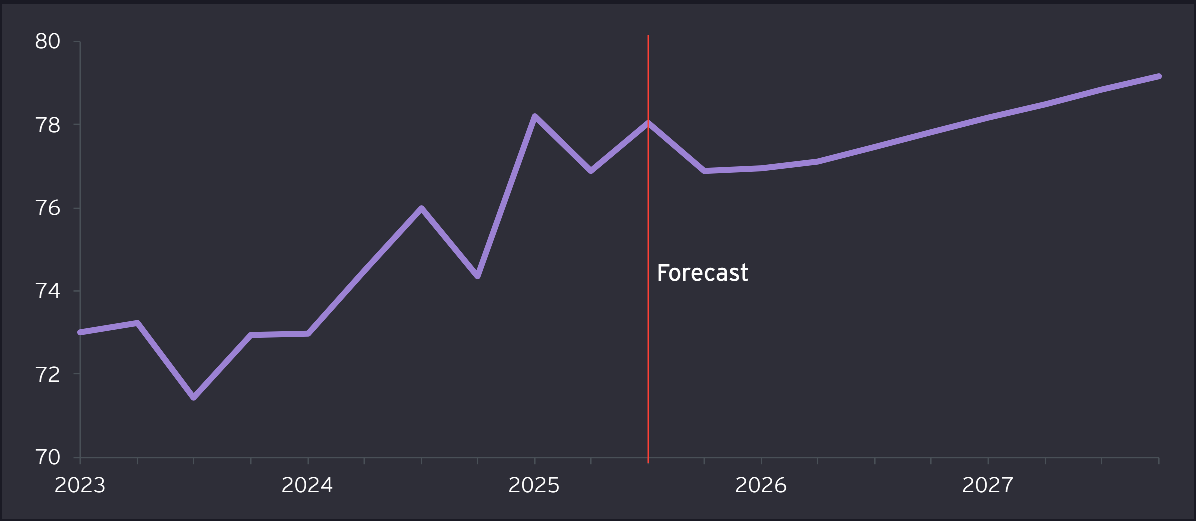
Despite the spike in uncertainty in the middle of last year, we estimate that business investment grew by 4.1% in 2025. Revisions to official estimates have left the level of capex in a much healthier position than we previously thought. The big change was early last year with investment now expected to have picked up by more than 5% in Q1 2026 alone. In part, this is the unwind of some weakness in Q4, but it also reflects some large transactions early in the year. There was some volatility throughout the rest of last year, with business investment falling by 1.7% in Q2 before picking back up in Q3 by 1.5%.

We expect business investment to go through a soft patch at the start of this year. Recent data revisions suggest that business investment was stronger in 2025 than previously thought, so there is less postponed capex to come through at the start of this year. On top of that, recent tariff threats around the US taking control of Greenland illustrate how rapidly international trading arrangements could change and the ongoing uncertainty that businesses must operate under. One of the consequences of sustained uncertainty is that the return on new capital projects is less well understood. So, some investment projects will either be delayed or cancelled as firms wait for more clarity on their operating environment. In addition, improvements in businesses' debt service costs – around 80% of corporate is floating rate – and new finance are now largely in the past, so the hurdle to starting capex projects remains high.

Having grown by 4.1% in 2025, we think that business investment will fall by 0.2% in 2026. We think that with uncertainty lessening, the reduced cost of finance and healthy corporate balance sheets investment will come back up to 1.7% in 2027.

UK: Business investment

£bn



Source: EY ITEM Club, Haver Analytics

Soft global economy and trade barriers will weigh on demand

Shifts in trade policy and a changing geopolitical landscape continue to pose a risk to the UK outlook. The US is the UK's most significant trade partner, so it will be impacted by US tariffs even if the changes are smaller than the changes facing other countries. We think that the effective tariff rate has risen from around 1% to 8%. This has resulted in a fall in UK goods exports, which dropped by 3.5% and 2% in Q2 and Q3 respectively. So far this has been compensated for by a rise in services exports. But going forwards we do think export growth will slow while services exports soften. The UK is a significant exporter of professional services to the US, so modest performance in the world's largest economy will also weigh on UK services exports.

The Government has indicated that it would like to pursue a closer trading relationship with the EU. But we think that this will be a slow-burning issue that will have a gradual effect on the economy if implemented.

More generally, the rapid shifts in the geopolitical landscape can present a risk to the UK. Importantly, it can influence commodity prices and supply chains that can have an impact on UK inflation. But there are also emerging signs that some Chinese goods are being diverted away from the US and towards the UK and Europe, offering lower-cost alternatives and providing some disinflation.

3

The labour market will soon reach a turning point

With the Government having promised to ‘kick-start’ growth, potential output is likely to come under the microscope this year.[7] Last year’s Budget didn’t deliver the deregulation that some commentators had expected, placing the emphasis on rising labour market participation as the key means for supply-side improvement.

Rising participation improved the supply side before the pandemic

Over the two decades before the pandemic, rising labour force participation had improved the supply side of the UK economy. Between 2000 and 2019, the proportion of the population that is active in the labour market increased by more than 1pp to almost two-thirds. This was the result of a sharp rise in engagement amongst the working age population (16–64), where the proportion active in the labour market increased by more than 2.5pp to over 79%.

The big pre-pandemic improvement in labour market participation bucked the UK's demographic trends. Over the 20 years before the pandemic, the UK's ageing population saw the proportion of individuals that are of prime working age (25–49) fall from 45.4% to 40.8%. On the face of it, this would result in a 2pp to 3.5pp decline in the participation rate as a larger proportion of the population approach or pass retirement age. But over the same period, older workers (50–64) have stayed more attached to the labour market with that age group's participation rate increasing from around 63% to 75%. Part of that reflects the increase in the female State Pension age (SPA) from 60 that started in April 2010. But greater educational attainment and a move towards less physically intensive roles have also contributed to workers remaining part of the labour market for longer.[8]

Participation has been going sideways

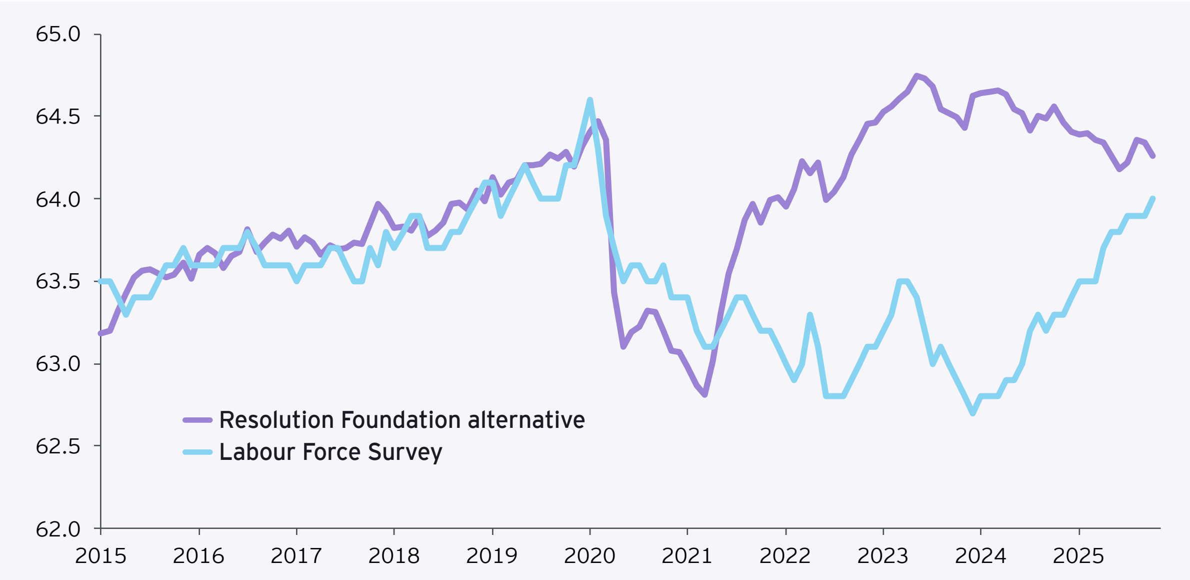
Since the pandemic, labour market participation has at best been going sideways and, at worst, outright declining. Either way, the pandemic certainly seems to have brought a halt to the rise in participation that we saw in the previous couple of decades.

Official labour market estimates indicate that participation declined during and immediately after the pandemic, before recovering a little in more recent years. Participation estimates based on the Labour Force Survey (LFS) dropped from 64.1% in 2019 to a trough of 63.0% in 2022. Encouragingly, labour market engagement has ticked up in the last two years but remains below pre-pandemic levels. The decline in participation has been largely amongst older workers who have either retired early or dropped out of the labour market due to poor health.[9] This is a trend that has been corroborated by the increase in claims of health-related benefits. Younger workers have also become more detached. This will unwind as it largely reflected young people entering further education when the jobs market was shuttered during the pandemic.

Alternative estimates of labour market participation don't necessarily point to a decline, but nor do they point to a rise in participation. The pandemic has shone a light on issues with the LFS sample, with LFS employment estimates diverging from headcount estimates based on administrative data. The Resolution Foundation has tried to correct the sampling issues and estimates that employment and participation moved sideways over the last few years.[10]

UK: Estimates of participation rate

% of 16+ population



Source: EY ITEM Club, Haver Analytics

Participation could be about to take a downturn

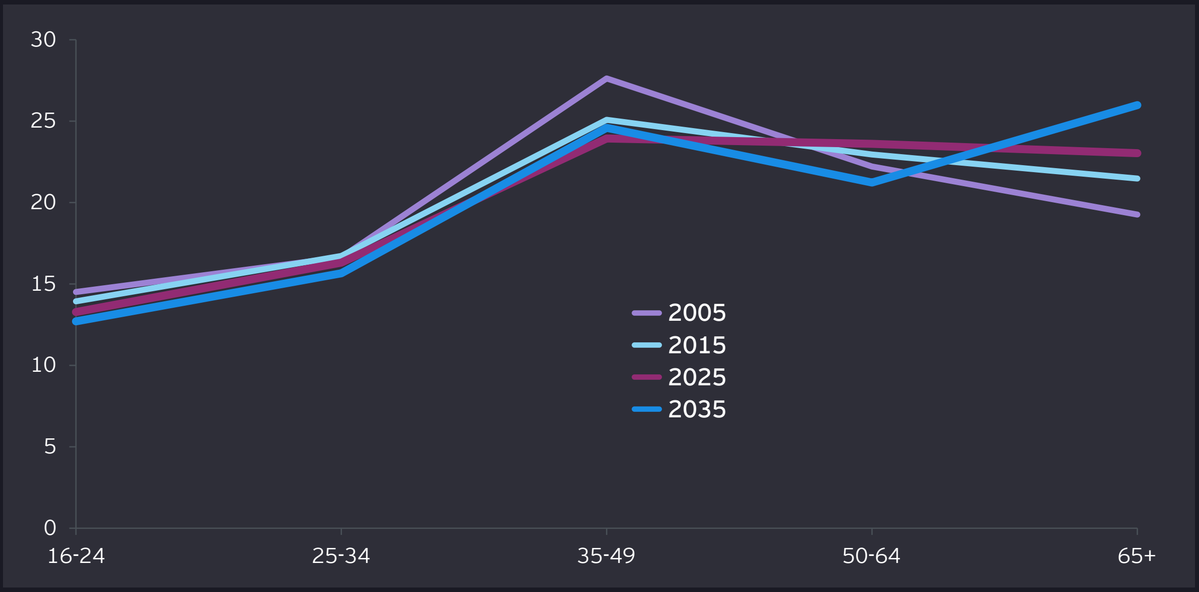
Like many advanced economies, the UK's population is set to continue to grow older over the coming years. Looking back 20 years, the population was most heavily concentrated towards the top end of prime working age, with 28% of the 16 and over population between 35 and 49 years old. But since then, the effect of the sustained decline in birth rates through the latter half of the twentieth century began to ripple through to the labour market. As the population has aged, the share of the population that is 35 to 49 has fallen, and the proportion that is 50 to 64 and 65 and over has increased.

The labour market is about to reach a turning point. So far, the most concentrated part of the population has been of working age. But with the UK's birth rate having peaked in the mid-60s and fallen sharply through the 70s, the most concentrated part of the population is reaching the age that people typically exit the labour market. We estimate that in 10 years' time the over 65 section of the working age population will clearly be the densest for the first time in at least the last 30 years.

The consequence is that from this point onwards, we expect that labour market participation will gradually edge down. We think that by 2030, the 16+ participation rate will have fallen back to around 63.4% from 63.8% now. By comparison, the OBR estimates that the participation rate will have slipped to 63.3% by the same time. In the US, where population dynamics are not dissimilar, the Congressional Budget Office estimates that labour market participation will decline by 1pp over the next five years.[11]

UK: Concentration of working age population

% of 16+ population



Source: EY ITEM Club, Haver Analytics

Youth participation will not be enough to reverse the fall

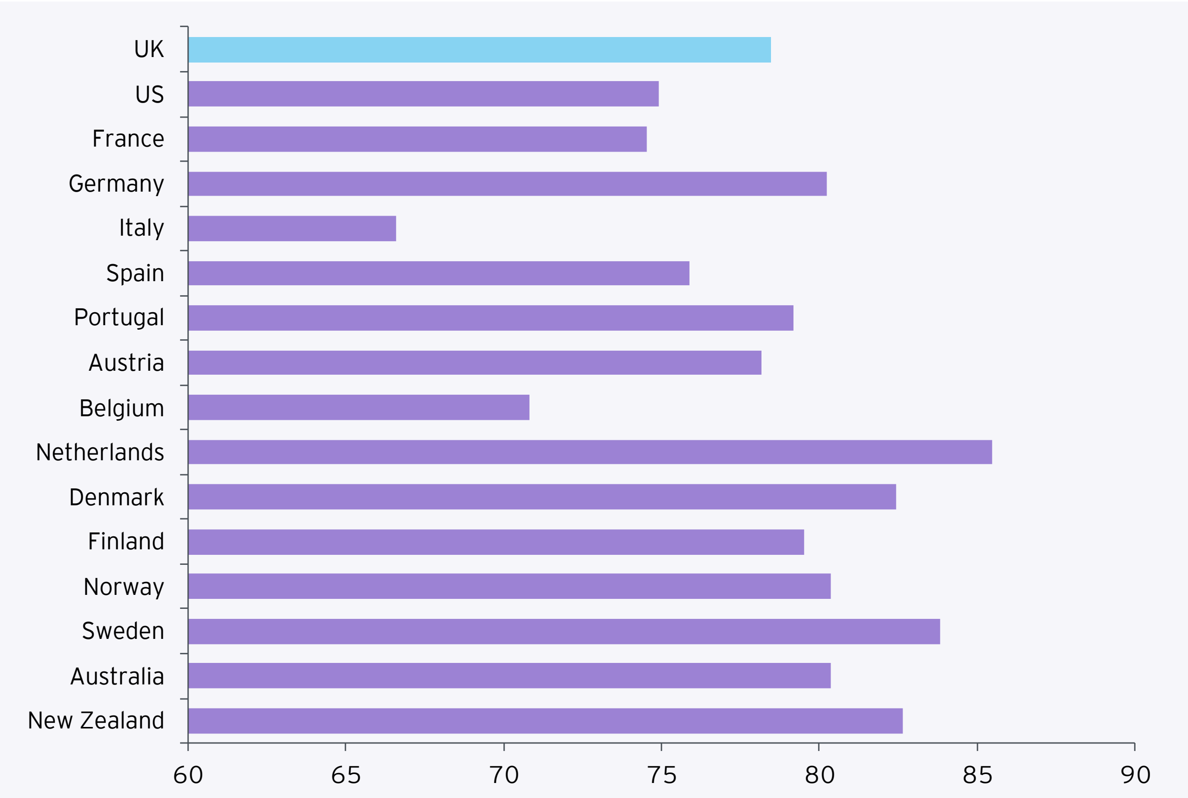
There isn't a lot of scope for the UK to increase labour market participation in the working age population without policies that encourage more engagement in the labour market. Amongst people of working age, the UK already has relatively high labour market participation. The UK participation rate is above the US and a lot of major European economies, although it lags the Nordic economies as well as Australia and New Zealand. The SPA is currently in the process of rising to 67 by 2028 with another step up to 68 planned for 2044 and 2046. This will offer some support, but a change of this magnitude in the SPA will have a relatively modest impact.

To boost labour market engagement, the Government's focus is currently on youth participation. The Youth Guarantee Scheme starts early this year, while the Milburn Review into the causes of low labour market participation amongst younger workers is scheduled to be published this summer. However, we are sceptical that this alone will be sufficient to offset the broader effects of the UK's demographic shifts. Over the last 25 years, participation amongst those who are aged 16 to 24 has declined from around 72% to 60.4%.

In part this reflects the increase in the age at which people must remain in full-time education, but also the increase in the number of school leavers that move into higher and further education. If the 16 to 24 participation rate were to increase to its pre-pandemic (2010-19) average of 62.8%, this would only add around 0.7pp to the participation rate.

OECD: Working age labour market participation

% of 15-64 population



Source: EY ITEM Club, OECD

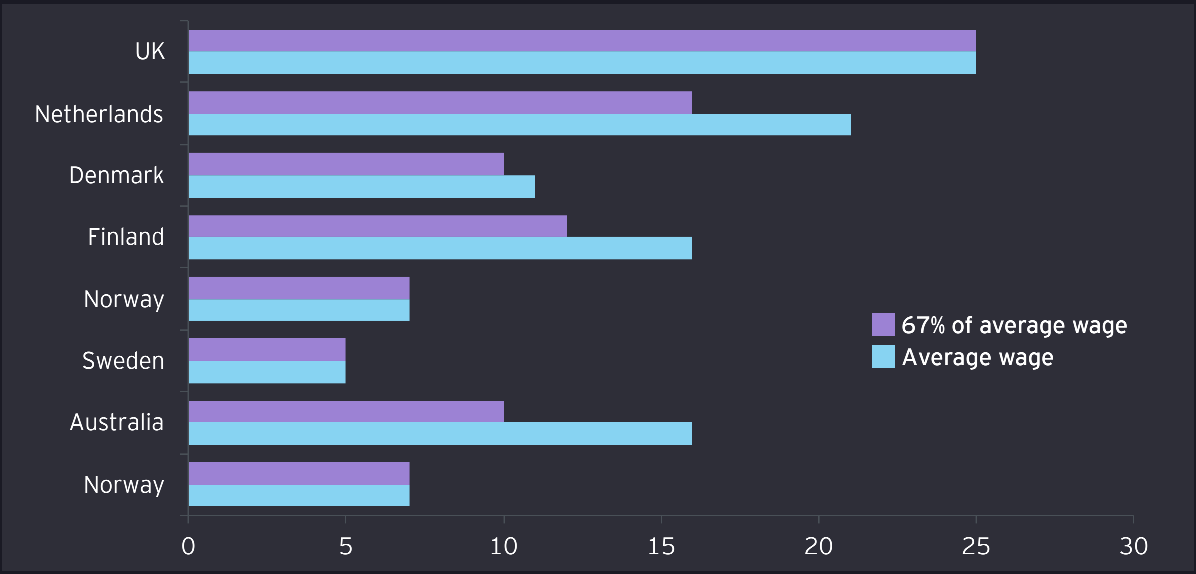
More support for childcare might help

Compared with the countries where labour market participation is higher than in the UK, the gap is larger for females than males. One potential reason for this is that the cost of childcare in the UK is significantly higher, even after state support. Between 2010 and 2021, the cost of childcare in the UK increased by 60%, more than double the increase in average earnings.[12] Recent government initiatives to offer either 15 or 30 hours of free childcare to working parents with children aged from nine months to four years old have helped to reduce the cost of pre-school childcare. But, even so, the OECD estimates that childcare costs are around 25% of earnings. While this is below the US, where childcare could be as much as 40% of earnings, it's significantly higher than the countries where total and female labour market participation (e.g., the Nordics, Australia and New Zealand) are higher than in the UK.

It doesn't appear to be the case that other welfare payments are incentivising people to remain outside of the labour market. The UK already has one of the least generous out-of-work welfare provisions amongst advanced economies. Overall welfare spending (relative to GDP) is in the middle of the pack compared with other OECD countries. However, the value of welfare offered, compared with average wages, is the third lowest. It is estimated that welfare would have covered essential living costs in only two of the past 14 years.[13]

OECD: Childcare cost based on level of primary earner

% of average income



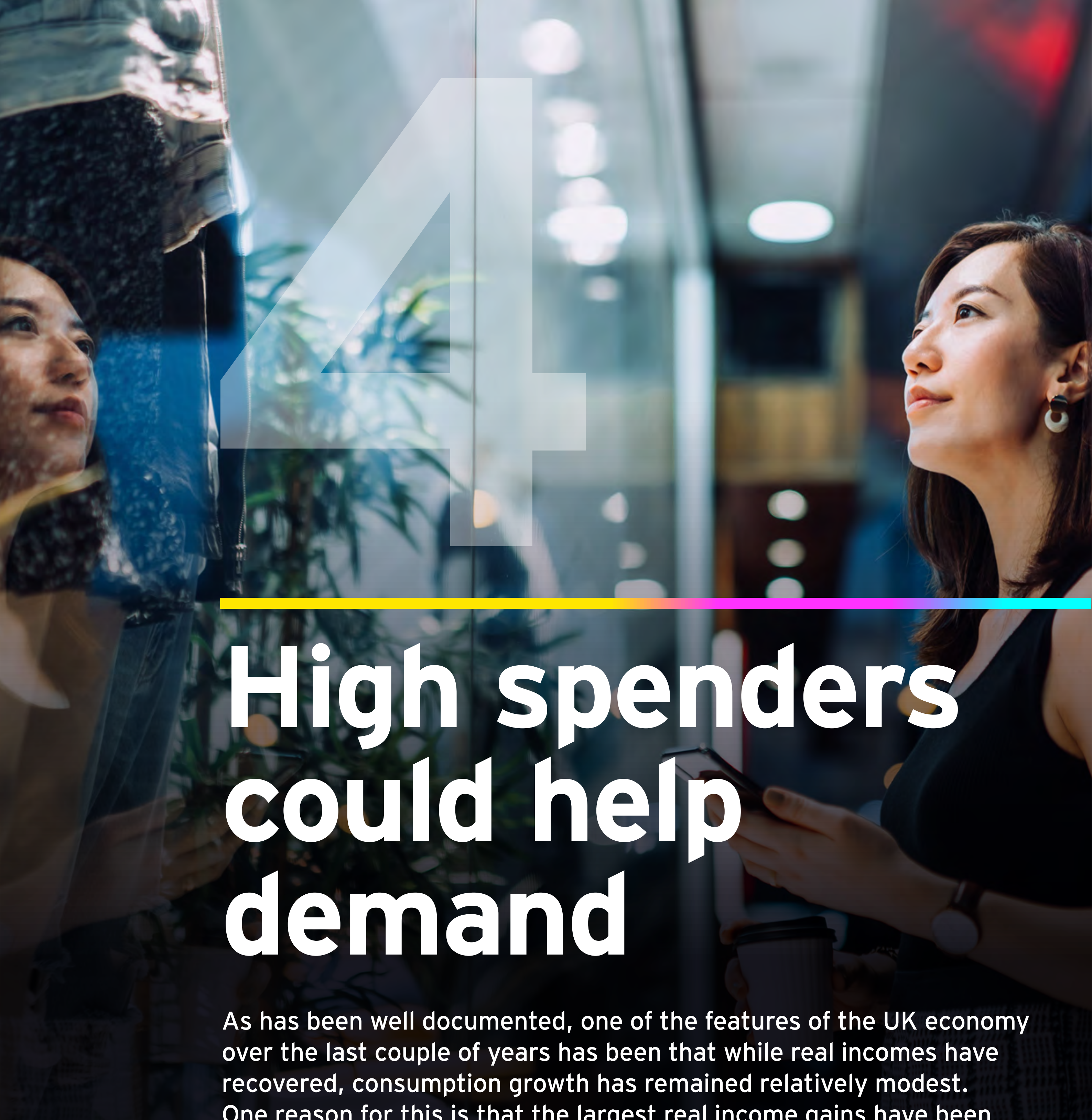
Source: EY ITEM Club, OECD

Migration does not look like it will be able to prevent a fall in participation

One way to increase labour market participation is to bring in individuals of working age, and the UK has proved to be an attractive destination for economic migrants over the last 20 years. As it stands, it is estimated that around 15% of the UK population is foreign-born, which is comparable to the average across OECD countries.[14]

Since the EU referendum, the UK has continued to attract workers from overseas. Over the last couple of decades, the bulk of migration into the UK has been amongst those who have secured or are looking for work. Although there has been no discernible change in the total number of individual workers over the last 10 years or so since the referendum was held, the composition has changed. Looking at National Insurance number registrations, there's been a significant drop in the allocation to EU nationals. But there has been a large rise in the number given to people from outside of the EU. However, allowing for a fall then surge during and immediately after the pandemic, new National Insurance numbers issued to foreign nationals have stabilised around historical averages. Given the ongoing issues with the LFS, it's been difficult to assess whether this shift has changed participation patterns amongst non-UK born workers.

If migration continues at pre-pandemic rates, it won't be sufficient to stop the decline in labour market participation. Instead, economic migration would have to be increased if it were to lean against the effects of Britain's ageing population. Signs from the end of 2025 are that migration may slow, with a significant drop in visa applications in Q4. The number of applicants for skilled worker visas stood at 85,000, down from 133,000 in 2024 as stricter immigration rules came into force.



4

High spenders could help demand

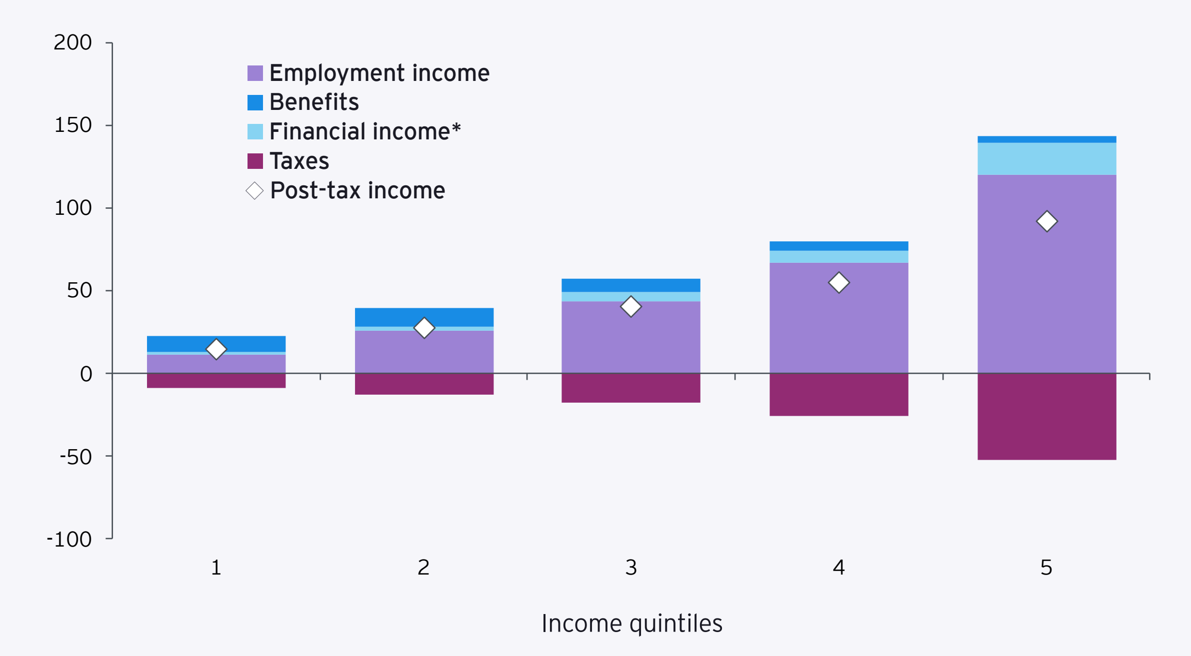
As has been well documented, one of the features of the UK economy over the last couple of years has been that while real incomes have recovered, consumption growth has remained relatively modest. One reason for this is that the largest real income gains have been felt by the lowest spenders. A significant increase in the National Living Wage and falling energy bills have meant that the largest improvement in spending power has been at the bottom of the income distribution. However, low earners spend proportionally less than high earners, so total consumption has not been as responsive. Going forwards, slowing real income growth will be more noticeable amongst low earners, but we don't think it will translate into slower consumption growth.

Employment income is the biggest determinant of household income

Across the income distribution, employment is clearly the main source of income, even at the top. The ONS estimates that the top 20% earning households have a post-tax income of around £91,000 per year. Within that, pre-tax employment income is estimated to be £120,000. That figure dwarfs the contribution from financial income – which includes income from both pensions and investments – which was found to be £19,000. While this is much greater investment income than households further down the income distribution tend to receive – the fourth quintile receives £7,000 – it's still a small part of the incomings of the average higher-income household. High-income households have benefitted more from the rapid increase in asset prices that we've seen since the global economy pulled out of the pandemic. But those effects are much smaller than the impact of several policy interventions over the last few years.

UK: Household income distribution

£000s



* Includes both interest and pension income

Source: EY ITEM Club, ONS

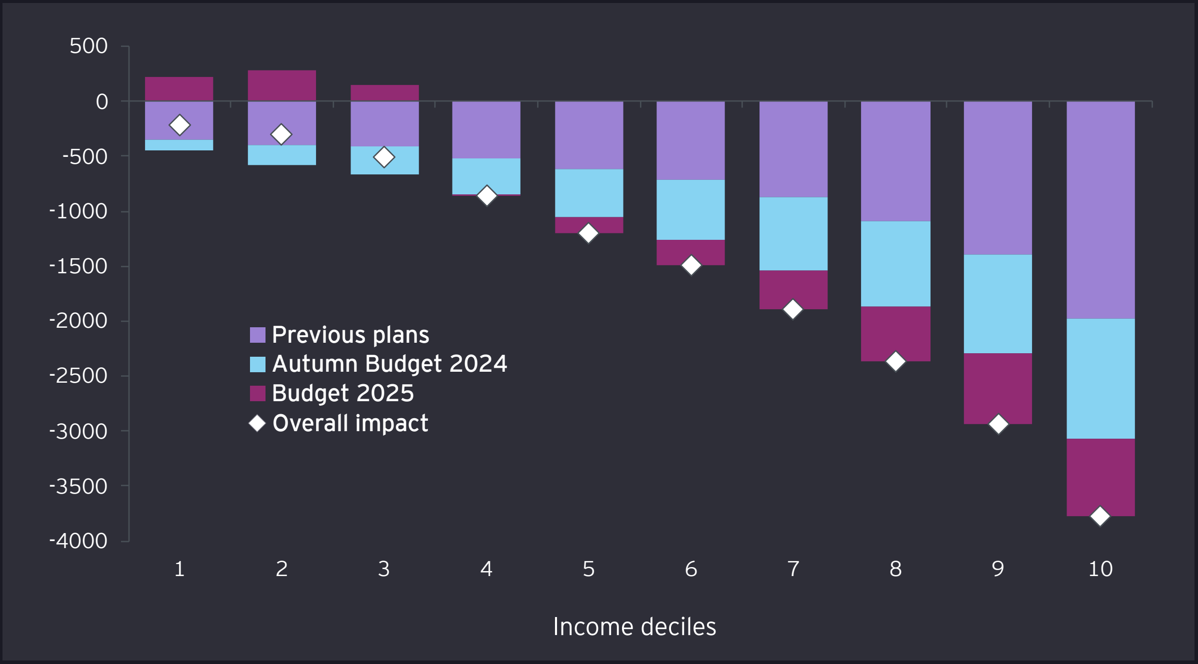
Policy changes have meant lower income households have seen the largest gains

Households with lower earnings have seen the largest improvement in their real income in recent years. From an earnings perspective, rises in the National Living Wage have been larger than private pay settlements. With the government's commitment to set the level of the National Living Wage at two-thirds of median earnings, it increased by more than 9% in 2023 and 2024 and by more than 6% in 2025.[15] With changes of this magnitude spilling up the pay distribution, estimates of pay growth at the bottom of the earnings distribution have grown more quickly than towards the top end. Based on employee earnings estimates derived from PAYE tax data, pay growth in the second income quintile remains above 7%, whereas income growth has slowed to a little above 4% in the fourth quarter. The contrast is even more noticeable if we compare the very top and bottom of the distribution. Pay growth looks likely to slow over the coming year, with the drop likely to be more noticeable in the lower parts of the pay distribution.

The government has confirmed that the National Living Wage will increase by 4.1% in April 2026. The rise in the National Living Wage is much closer to the pay rises CFOs expect to give their employees than it has been in recent years.

UK: Impact of personal tax and benefit changes

£s between 2024-25 and 2030-31



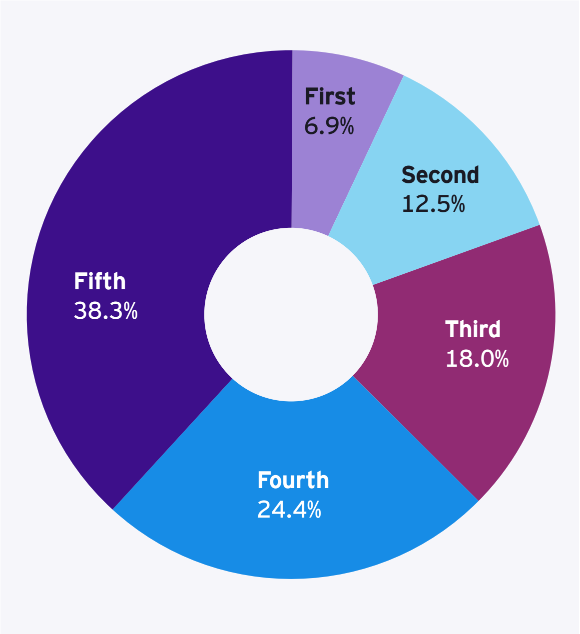
Source: EY ITEM Club, IFS

Although pay growth at the bottom of the distribution will slow, upcoming welfare and personal tax changes will have a smaller impact on lower income households. Having offered significant fiscal support during the pandemic and the energy price crisis, subsequent governments have tightened fiscal policy to keep the UK's public finances on a sustainable footing. The effects on households have been mixed. On the one hand, one of the most significant tightening measures that has been introduced is the freezing of income tax thresholds initially to 2027-28 and then extended further to 2030-31 at the 2025 Budget. This will have had a larger impact towards the top of the income distribution, given the relatively small number of earners who pay the top rate of income tax. On the other hand, reductions in employee NICs will have had a greater benefit to higher income households.[16] Going forwards, IFS analysis estimates that the impact of the upcoming welfare and personal tax changes will be larger towards the top of income distribution. The IFS expects current policy changes will reduce annual household income by around £300 in the bottom couple of income deciles between 2024-25 and 2030-31. The effect at the top of distribution is thought to be almost 10 times as big, with policy changes predicted to reduce household income by around £3,000 over the same period.

High earners are the biggest spenders

The households with the highest incomes are disproportionately the largest spenders. Based on the latest data from the ONS, the top 20% of the highest-income households are responsible for about one-third of all consumer spending and around 40% of discretionary spending.[17] So even though lower-income households typically spend more of any additional income they receive – they have a higher marginal propensity to consume – total household spending is less responsive. The net effect is that with lower-income households seeing much larger increases in spending power than higher-income households, the rise in real incomes has not necessarily fed through one-to-one into spending.

UK: Discretionary consumption by income quintile



Source: EY ITEM Club, ONS

Slowing income growth will not translate into softening consumption growth

We expect real income growth to slow over 2026 and 2027, slipping below 1% in both years. Nonetheless, we expect consumption growth to tick up 10bp to 1.1% this year and next.

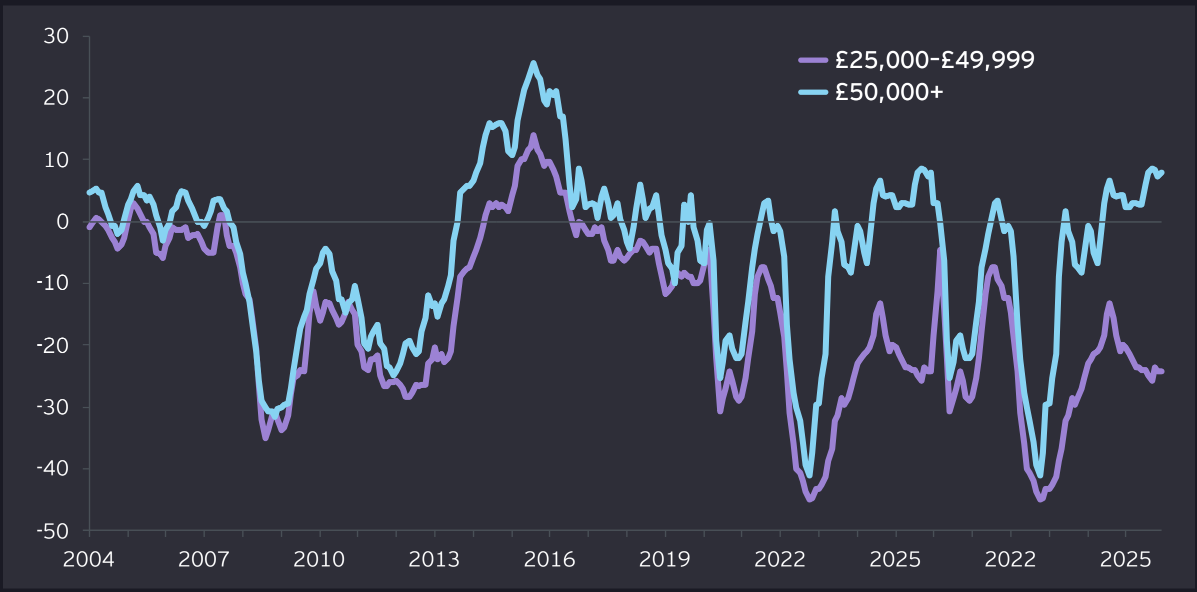
In the near term, the slowdown in income growth will likely represent a more significant fall at the bottom of the pay distribution than it does at top. With lower-income households consuming less than higher-income households, this would mean that the slowdown in income growth would have less of an effect on consumption than may otherwise be the case.

On top of that, consumer confidence has firmed on the back of improved sentiment amongst high earners. Typically, high earners are more confident about the economic outlook. But currently, the confidence gap between high and low earners is unusually wide. Indeed, sentiment diverged over 2025, with low earners becoming more downbeat. But high earners' mood improved through 2025, taking it back to the level seen before the pandemic.

With the high-spending, high-earning households feeling more upbeat, it supports the view that the effect of slowing real income growth will be cushioned by reduced saving. Since the pandemic, consumer spending on durable goods has lagged other categories. With some scope for dissaving amongst the highest earners who disproportionately spend on discretionary goods and services, there is space for durable goods spending to increase.

UK: Consumer confidence

Balance statistics, 3 month average



Source: EY ITEM Club, Haver Analytics

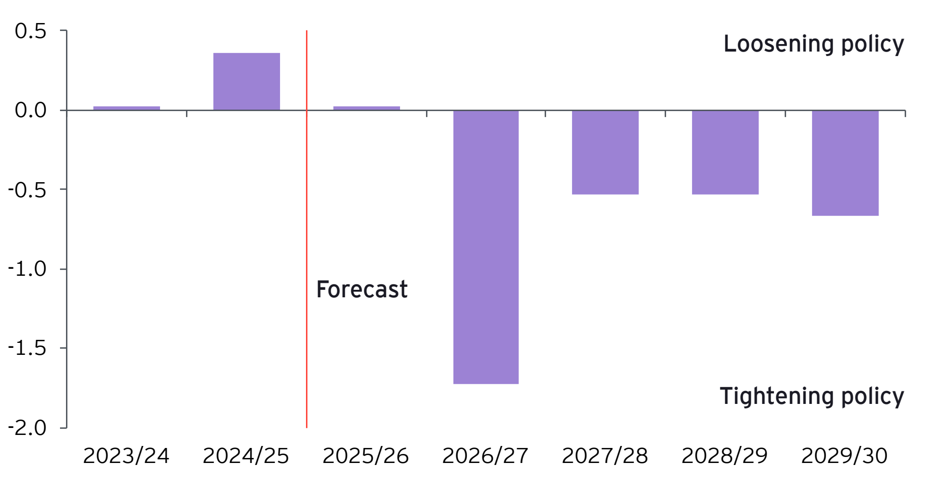
Forecast in charts

Fiscal policy

- Through the pandemic and energy crisis, UK public debt rose sharply. With an increase in the interest rates on government debt and a track record of poor growth, government borrowing must be reduced to keep the public finances on a stable footing.
- Fiscal policy will weigh on growth over the next few years. Following the Budget, tax revenues (relative to GDP) are set to rise over the next five years. Spending will remain broadly flat (as a share of GDP).
- The Government's fiscal plans are now based on more plausible growth projections. Following the Budget, the OBR now estimates that there is a healthier margin for error against the Government's fiscal targets of £21.7bn.

UK: Fiscal impulse

pp of GDP



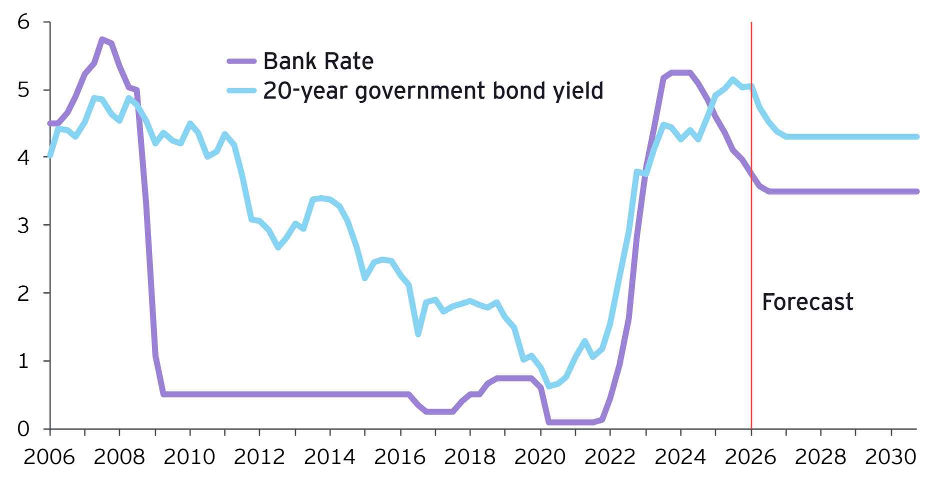
Source: EY ITEM Club, Haver Analytics

Monetary policy

- Having skipped a rate cut in November, the Bank of England cut Bank Rate to 3.75% in December. But for the first time, the MPC indicated that it was getting towards the end of its cutting cycle.
- The MPC is divided on the timing and extent of future rates. But we think the prevailing mood will be one of caution and the MPC will want to see how the early-year pay settlement season plays out before cutting again.
- With inflation having fallen back to around 2% and with signs inflationary pressures are still on a gradual downwards trajectory, we expect a final Bank Rate cut in April to 3.5% as growth settles around trend.

UK: Bank Rate and 20-year bond yield

%



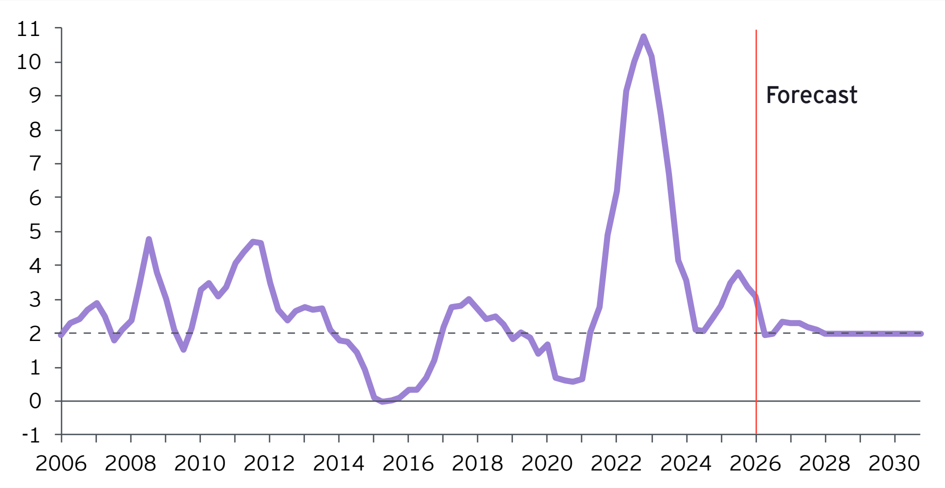
Source: EY ITEM Club

Prices

- Having peaked at 3.8% in July, August and September, inflation fell back to 3.4% in December. Declining goods – particularly food – inflation has been the main driver of the decline.
- Inflation will quickly fall towards target in the second quarter of the year. Measures to remove the levies on utilities bills will come into effect, reducing inflation by around 0.30pp to 0.50pp.
- For inflation to sustainably settle at 2%, services inflation will have to come down. With pay growth forecast to fall back to a rate that's consistent with at-target inflation by the end of this year, we think this will feed through to services inflation by the end of the following year.

UK: CPI inflation

% year



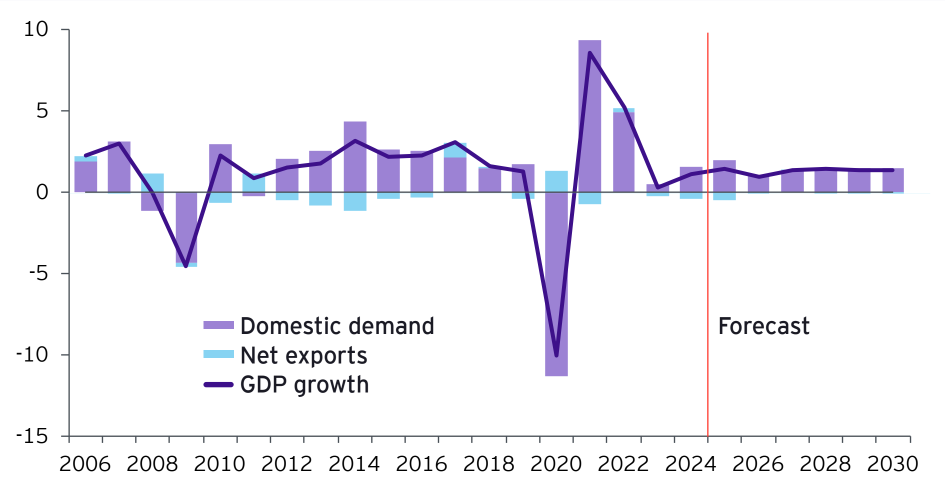
Source: EY ITEM Club

Activity

- GDP growth has slowed to 0.1% in Q3, having grown 0.7% and 0.2% in Q1 and Q2 respectively. Data revisions have left private demand looking healthier than we previously thought. But taking a step back, public spending has remained the key driver of growth over the last few years.
- Early signs are that growth improved a little in Q4, and we expect more modest growth in the near term. Fiscal policy continues to tighten; some households will still refinance mortgages to higher interest rates; and uncertainty lingers.
- We think that these headwinds will ease a little in 2027 and 2028, and growth will head back to around trend from 2028 onwards.

UK: Contributions to GDP growth

% year



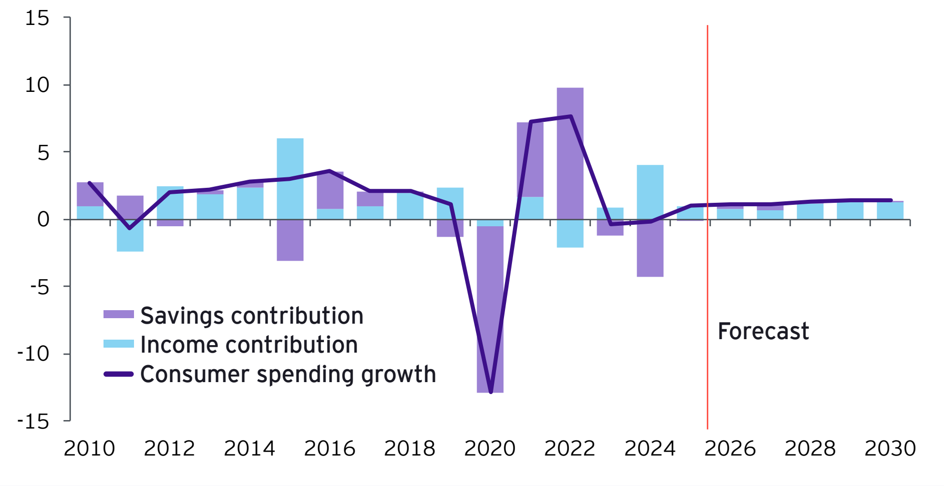
Source: EY ITEM Club

Consumer demand

- A feature of the economy over the last couple of years is that households have saved rather than spent a lot of the increase in their real income. Although there have been some signs the saving rate is starting to tick down in recent quarters, it remains very high by historical standards.
- Looking forwards, we think that consumption growth will remain around 1% in 2026 even as real income growth slows.
- Consumption will be supported by an improvement in confidence amongst the highest spenders – while slowing real-income growth will be largest amongst lower-spending households.

UK: Contributions to consumer spending growth

% year



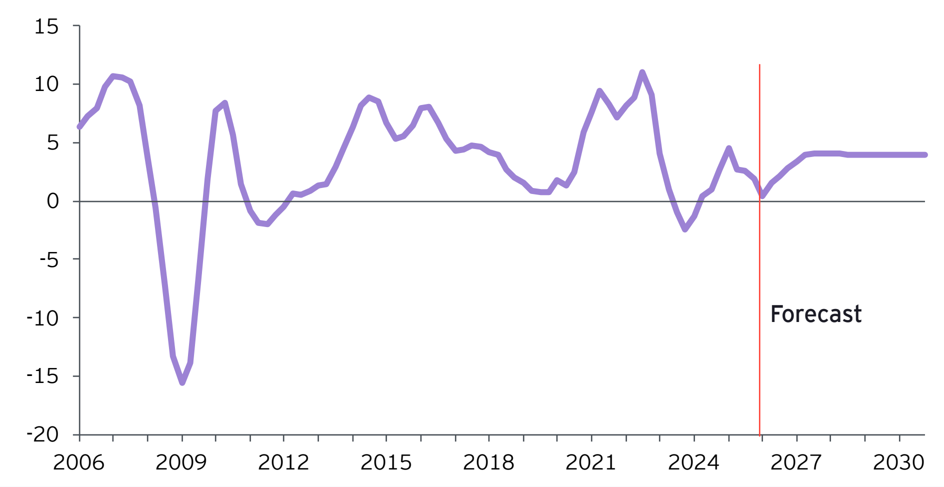
Source: EY ITEM Club

Housing market

- Last year was a year of two halves. The first half was volatile as April's change in Stamp Duty thresholds distorted the market. But the noise faded and the market normalised in the second half of 2025.
- This year the housing market will be driven by fundamental factors. Property taxes announced at the Budget won't have an immediate or material impact.
- This year will be another unspectacular year for the housing market. With slowing pay growth, big improvements in affordability are in the past and there is little scope for a big fall in mortgage rates.

UK: House prices

% year



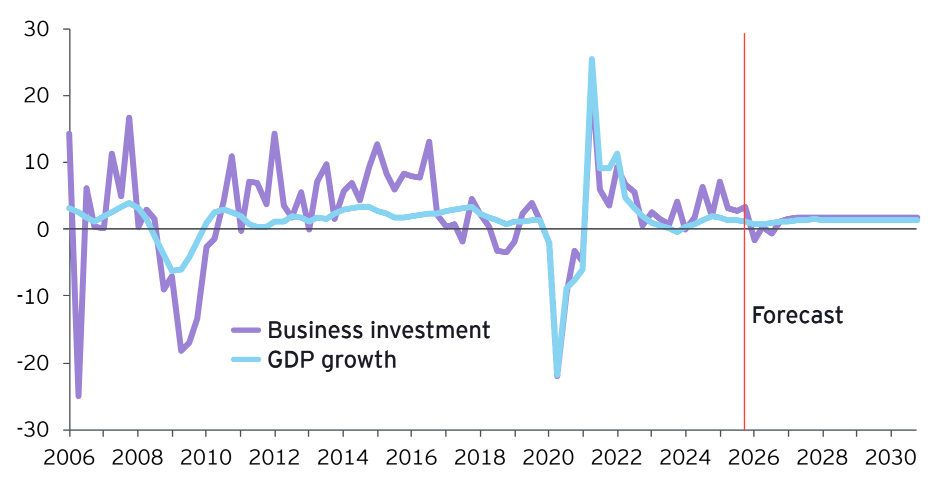
Source: EY ITEM Club

Company sector

- Revisions to the business investment data leaves it looking much healthier than we previously thought. That, in part, reflects a pickup of more than 5% in Q1 2025.
- With tariff uncertainty lingering, we think that capex will be soft through the first half of this year. But with some uncertainty receding, we think investment will pick up a little in the latter half of the year.
- Investment opportunities are still available to businesses. By next year, we think that firms will take advantage of lower new borrowing and debt service costs to lift capex.

UK: Business investment and GDP

% year



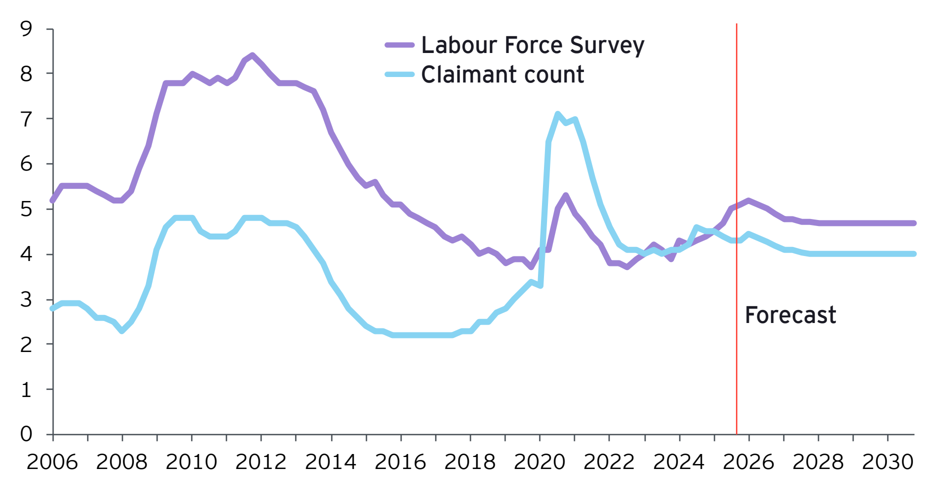
Source: EY ITEM Club

Labour market and wages

- The weak growth that we've seen over the last few years has caused the labour market to loosen, exacerbated by the increase in employer NICs.
- It looked like the deterioration in the jobs market had bottomed out, but in recent months the fall in headcount has re-accelerated. So far, the labour market loosening has come through reduced hiring. But there are tentative signs job losses may be rising.
- With firms reporting weak hiring intentions, we think the unemployment rate will rise a little further to 5.2% before falling back to 4.7% as growth picks back up.

UK: Unemployment rate

%



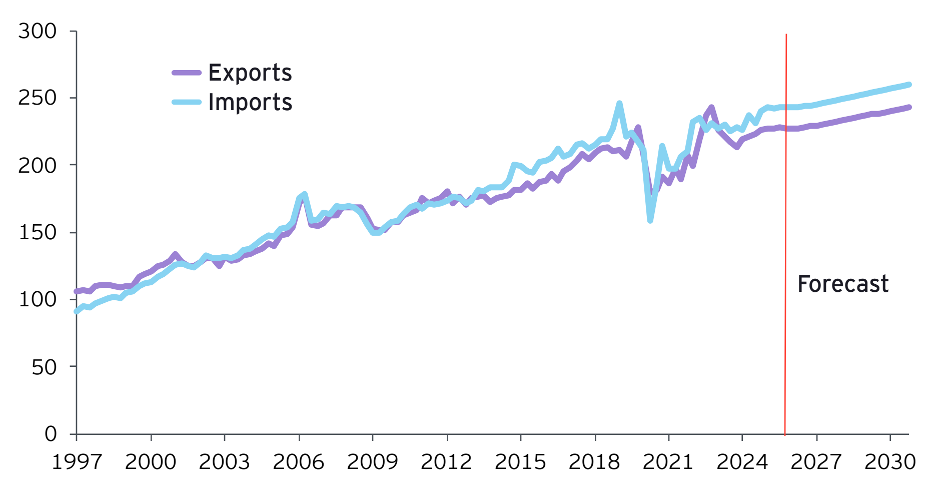
Source: EY ITEM Club

Trade and the balance of payments

- The UK has seen one of the smallest increases in US tariffs. But the rise is still material.
- The US is the UK's largest goods export market. And since the introduction of US tariffs, goods exports have fallen. However, they've been compensated for by services exports. Going forwards, we think there will be little improvement in exports this year, growing by 0.1%.
- With no direct response from the UK to the US government's tariffs, we do not see a big change in the UK's import share. But we do think imports will soften as domestic demand growth slows.

UK: Exports and imports

£bn



Source: EY ITEM Club, Haver Analytics

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17. Discretionary spending definition taken from "Discretionary household consumption expenditure in the UK: measurement and evaluation", Gausden and Hasan (2024)

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