

UK in Focus

Economics United Kingdom

A resilient economy in the face of uncertainty

- ◆ UK economic activity has been resilient despite a challenging backdrop
- ◆ Confidence has improved alongside business investment, but households are more cautious
- ◆ Prolonged inflationary pressure could drive rate hikes, while the economy braces for another uncertain Budget

UK growth has proved more resilient – the economy grew 0.5% q-o-q in Q2, following a 0.6% rise in the first quarter. That momentum seems to have continued over the summer, albeit at a slower pace with surveys of both the services and manufacturing sectors citing more modest activity gains over the quarter. Nonetheless, with a robust 0.4% m-o-m growth rate in July alone, we expect the UK economy to post a third consecutive quarter of growth at or above half a percentage point.

Underlying growth dynamics have also improved, despite significant uncertainty so far in 2026. Business investment has grown 5.2% y-o-y, the majority of which is centred around AI investment, most notably within the professional services sector. Manufacturers have also cited an uptick in demand from AI-related manufacturing. AI adoption is still in its infancy and yet to broaden out meaningfully across the economy – 45% of firms that use AI use free-to-use platforms, and hence, investment in the technology should continue and provide a demand impulse to growth. That being said, the speed at which the investment translates into productive capacity may be modest, with global AI supply constraints and prices ratcheting higher.

Households move from squeezed to cautious...

Elsewhere, households saw real household disposable income per head rise 1.0% q-o-q in Q2, reversing the 0.8% fall in Q1. Meanwhile, retail sales volumes increased 0.9% in the three months to August – 2.4% higher than a year earlier – and confidence improved for a third consecutive month to a two-year high.

However, at the same time, the household sector has continued to show signs of caution – the household saving ratio rose from 8.6% to 8.8% in Q2, perhaps driven by precautionary saving. Meanwhile, direct debit defaults have continued to tick higher and credit card usage has risen strongly, which may be more indicative of budget stress. Overall, despite a broad-based improvement in activity and sentiment, households continue to show pockets of stress as they still adjust to the prior inflationary period. As such, consumers enter the latest shock in different starting positions and with exposures to energy costs and interest rates. A continued recovery in consumer sentiment will be more difficult over the near term.

KEY UK DATA

▶ **0.4%**

GDP growth in 3M to July*

▲ **3.1%**

Consumer Price Inflation, August y-o-y

▶ **4.9%**

Unemployment rate, 3M to July

▶ **3.75%**

Bank of England Base Rate

Source: HSBC *before upward revision to Q2 is accounted for

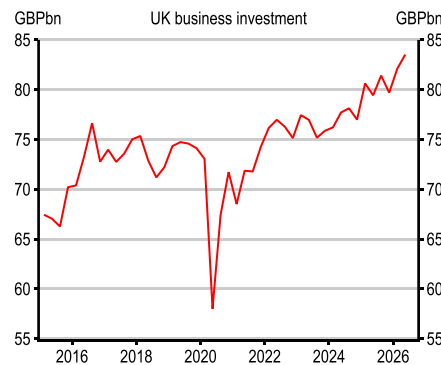
Ultimately, the Monetary Policy Committee (MPC) is keenly watching for evidence that the energy shock translates into greater domestically driven inflation, primarily via higher wages. In our view, given the projected path of inflation, and with inflation and wage expectations on the edge of tolerable levels, the MPC will opt to hike rates before wage inflation materialises. We pencil in a 25bp hike before the end of 2026 and a second hike in February 2027, before cuts resume in H2 2027.

Autumn Budget season set to be crisp and uncomfortable

Higher interest rates and inflation concerns have pushed yields on government debt higher across the world, alongside concerns over issuance and fiscal sustainability risks. That sees 10-year rates around 75bp higher than the Office of Budget Responsibility (OBR)'s forecasts in March 2026 that were set prior to the conflict. Indeed, higher debt servicing costs so far in the current fiscal year have pushed public sector net borrowing cGBP8.0bn higher than OBR expectations.

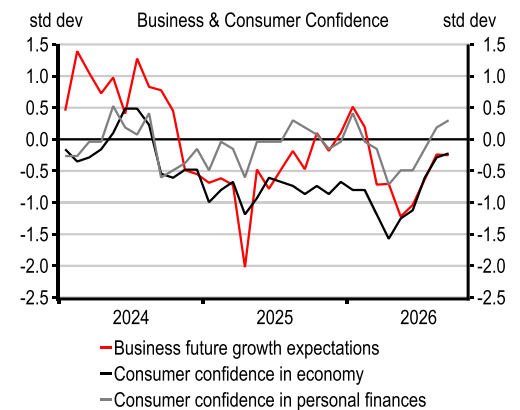
In effect, the economic backdrop contributes to an erosion of the headroom against the government's fiscal target to have the current budget balanced by 2029/30. So, again, the UK finds itself in a position of policy uncertainty in the lead up to the Autumn Budget, 28 October 2026. The government has also raised the prospect of giving households and businesses 'breathing space' but with little to suggest public spending cuts are on the table, it will fall to higher taxes and borrowing to rebuild headroom and fund some 'give-aways'. On that basis, small, temporary, and targeted relief seems most likely.

1. Business investment has found some momentum...



Source: ONS, Macrobond, HSBC

2...with higher confidence across the board, despite renewed price pressures



Source: GfK, S&P Global, Macrobond, HSBC

Disclosure appendix

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