

InflationWatch

December 2025

About this publication

After the Covid-19 pandemic, inflation rose more sharply and persisted for longer than market participants expected in many countries, including the UK. Expansive monetary and fiscal policies, supply-chain disruptions, and a pandemic-driven shift in demand from services to goods all contributed to inflation. The Russia-Ukraine conflict exacerbated these price pressures by causing a global supply shock.

Since peaking in October 2022, headline inflation has declined substantially as supply-side disruptions have eased, commodity prices have moderated and tighter monetary policy has filtered through to the economy. The brief return of headline CPI inflation to the Bank of England's (BoE's) 2% target in spring 2024 was largely due to disinflation in goods, food and energy prices. As this effect faded, and with core inflation (which excludes volatile energy and food prices) still elevated, headline CPI rose again in 2025. Although annual wage growth remains too high to be consistent with the inflation target, ongoing loosening in the labour market – characterised by falling vacancies and a rise in unemployment – paves the way for further sustained disinflation.

We continue to publish InflationWatch to help our clients assess the outlook for inflation. We include updates on the latest inflation data, market-based and consensus forecasts, and our assessment of the balance of risks to inflation and interest rates.

Our focus remains on the UK and the inflation outlook over the next two to three years. The primary measure we monitor is the year-on-year change in the headline Consumer Price Index (CPI). Inflation in a modern, open economy is driven by a dynamic set of macroeconomic factors, including aggregate demand, input costs, inflation expectations, labour market conditions and monetary policy decisions.

Highlights: May to September 2025

- ◆ Annual headline CPI held steady at 3.8% from July to September, up from 3.5% in May. Core CPI (excluding energy and food) declined from a July peak of 3.8% to 3.5% in September, matching May's level. Both measures eased slightly in October to 3.6% and 3.4%, respectively, as house and utilities (gas and electricity) prices slowed due to a change in the Ofgem's energy-price cap.
- ◆ Inflation exceeded June's forecast due to higher goods, food and energy costs, combined with wage-driven services inflation. However, inflation fell short of expectations in September and is judged to have peaked at 3.8%, sparking a sustained rally in gilt markets. Inflation is set to gradually decrease, though stay modestly above, the BoE's 2% target for the rest of 2025 and over 2026.
- ◆ Domestic price pressures persist but are easing, with the labour market loosening quicker than anticipated. Rising unemployment and falling vacancies should allow for further sustained disinflation. Average weekly earnings growth slowed to 4.6% in the three months to September, while services-sector inflation fell to 4.5% in October.

- Recent business survey data indicate weaker growth momentum, with firms continuing to reduce headcount. What's more, output price inflation has fallen to its lowest level in five years, as heightened competition and fragile demand place further pressure on businesses.
- The BoE cut rates by 0.25% pa to 4.0% pa in August and held interest rates at that level in November. Both decisions were narrow, but policymakers signalled the intention to gradually lower rates, contingent on continued disinflation.
- Slowing growth and demand, alongside moderating but ongoing price pressures (reflected in recent PMI data), support further easing of monetary policy restraint. The smorgasbord of tax hikes announced in the autumn budget reinforces this outlook. Markets once again expect two more 0.25% rate cuts in the next 12 months. Regardless, we think interest rates are only moderately restrictive and nearing a 'neutral' stance.

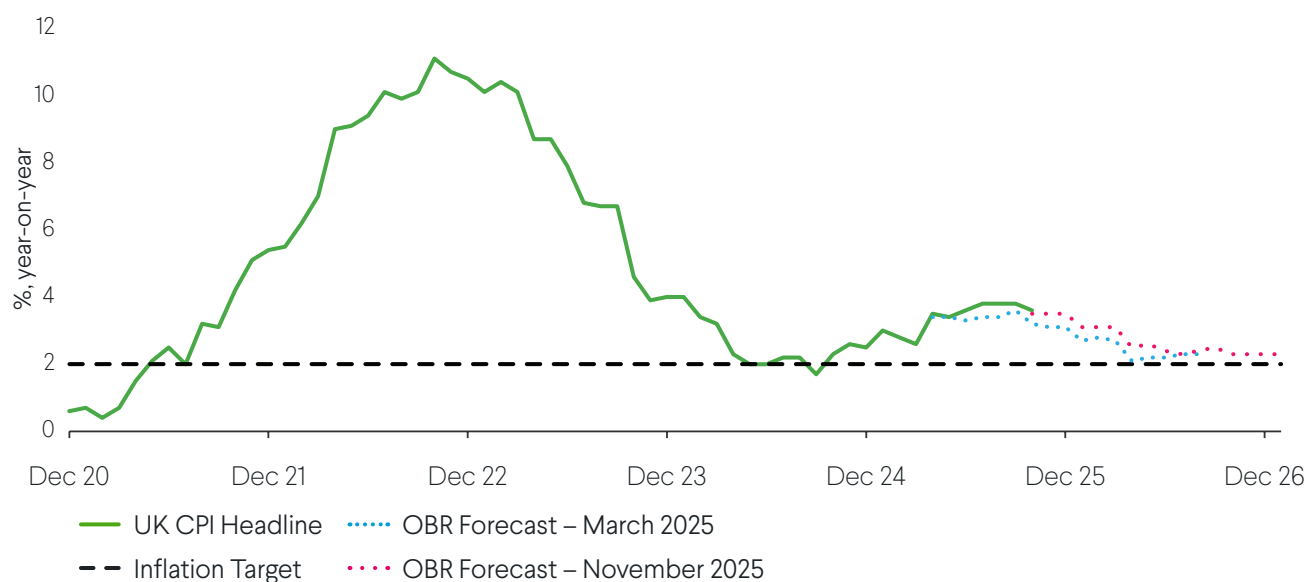
The story to date

The global shocks that previously drove UK inflation have unwound. The sharp fall from the 11.1% peak in October 2022 was mainly due to lower food, energy and non-industrial goods prices. However, their effect has faded in 2024, and these categories contributed to inflation rising in 2025. Moreover, core inflation remained high throughout that period, due to ongoing price pressures in domestic wages and the service sector. While inflation has surpassed earlier forecasts, it is judged to have peaked at 3.8% in September (see chart 1).

The solid progress on inflation by mid-2024, alongside higher interest rates, enabled the BoE to reduce interest rates by a cumulative 0.5% pa to 4.75% pa during 2024. With part of 2025's inflation attributable to temporary energy-price effects and monetary policy still restrictive, the BoE delivered three 0.25% cuts, reducing the base rate to 4.0% pa.

Although the BoE narrowly maintained interest rates at 4.0% pa in November, policymakers set the scene for more gradual cuts. Easing price pressures and slowing growth, as indicated by recent business surveys, are likely to help the bank's decision-making. Further weakening in the labour market and the smorgasbord of tax hikes announced in the autumn budget could weigh on already fragile demand and pave the way for further disinflation (and rate cuts). That said, policymakers will need to see more evidence of disinflation to implement interest-rate cuts.

Chart 1: Inflation is projected to have peaked and is set to fall near the BoE's target in 2026



Sources: Bloomberg and Office for Budget Responsibility (OBR).

Outlook indications

Driver		Metric	Latest	-3m	Median/ neutral
Inflation		UK headline CPI, % y-o-y	3.8	3.6	2.1
		UK core CPI, % y-o-y	3.5	3.7	1.8
Aggregate demand		Quarterly UK GDP growth, % y-o-y	1.3	1.4	1.5
Input costs	Goods	UK PPI, % y-o-y	3.5	2.5	2.1
	Energy	Gas prices, £/MMBTU, % y-o-y	-17.2	6.5	4.3
	Energy	Oil prices, \$/barrel, % y-o-y	-8.1	-13.1	3.2
	Labour	UK unemployment rate (%)	5.1	4.7	5.4
	Labour	Average weekly earnings, 3m average, % y-o-y	4.6	5	3.4
	Labour	UK vacancies (index, average = 100)	104	104	100
	Exchange rates	UK £ effective trade-weighted index, % y-o-y	0.0	2.9	0.0
Expectations	Consensus forecast	UK headline CPI in 18m, % y-o-y	2.2	2.4	2.1
	Consensus forecast	UK GDP growth in 18m, % y-o-y	1.1	1.0	1.5
	Market-implied inflation	UK 5y spot inflation in 5y, % pa	3.1	3.1	2.5
	Inflation surprises	UK Citigroup inflation surprises, > 0 = upside surprise	12.9	-1.3	0
Monetary policy	Money supply	UK M4 ex-IOFC (12m growth rate %)	3.6	3.3	5.7
	Current interest rates	Base rate % pa	4.0	4.3	3.8
	Market-implied interest rates	UK overnight index swaps, % pa in 24m	3.7	3.5	3.8

Sources: HM Treasury, Office for Budget Responsibility (OBR), Office for National Statistics (ONS), Bloomberg, Bank of England, US Energy Information Administration (Oct 2025). The data are to 30 September with some exceptions. The -3 months columns show the data three months earlier, ie June 2025.

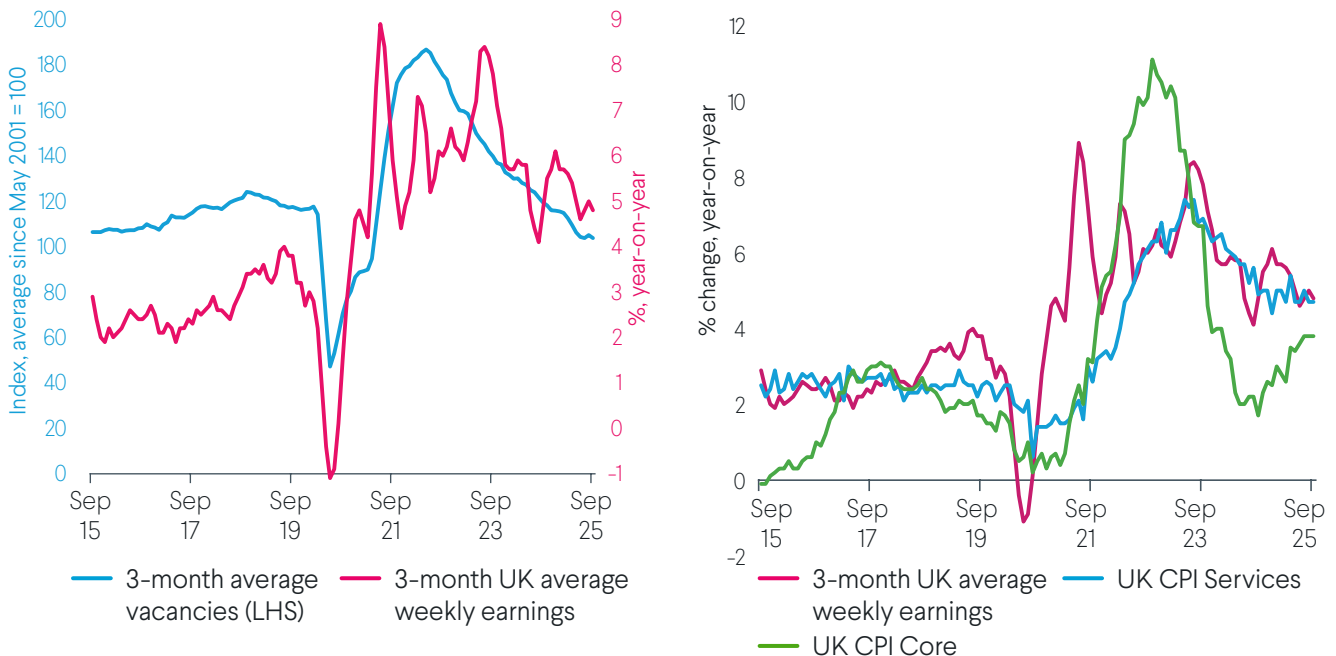
In our dashboard above, you'll find the end-October reading for each indicator, alongside the reading three months ago. For figures where data is only available as of end-September, we've compared this to the figure three months prior. We compare them with the long-term median, or assessed neutral, value. The tone of colour represents the strength of the signal: a darker tone indicates either a stronger inflationary or disinflationary signal, depending on whether red or blue, respectively.

Highlights

Annual headline CPI inflation remained at 3.8% in each of the three months to September, up from 3.6% in June. This increase was driven by upward contributions from goods, food and energy prices. The market's consensus is that inflation peaked in September.

Annual core CPI inflation gradually declined to 3.5% in September from 3.7% in June as service-sector price inflation slowed. Despite this, the core measure is well above the BoE's 2% target.

Charts 2 and 3: Underlying domestic price pressures continue to ease modestly, but are still high



Source: Bloomberg.

Private sector wage growth continued to moderate in 2025, with average weekly earnings falling to 4.6% in the three months to September. Wages are expected to moderate further as slack in the labour market increases: vacancies continued to fall and the unemployment rate rose to 5.1% in September. This easing in wage growth, alongside softer demand, has contributed to a decline in services inflation, which dropped to 4.5% year-on-year in October. This moderation has reduced the risk of persistence in domestic prices pressures, a source of relief for the BoE.

The combination of a subdued outlook for growth and demand, a softening labour market and easing inflation – as indicated by business surveys – should give the BoE scope to relax its restrictive monetary policy stance. Furthermore, tax increases outlined in the autumn budget are likely to place additional strain on already fragile demand.

Nonetheless, wage growth and services inflation are still elevated, easing just gradually. This persistence means the BoE is likely to tread cautiously, requiring clear evidence of ongoing disinflation before cutting rates again. For reference, with productivity growth at 1.0–1.3% pa (which is arguably optimistic, given the trend of the last decade), wage growth in the region of 3.0–3.5% year-on-year would better align with the BoE's 2% inflation target.

Our view

Inflation surpassed June's forecast due to higher goods, food and energy costs, combined with wage-driven services inflation. However, inflation is judged to have peaked at 3.8% in September and is projected to gradually approach the BoE's 2% target for the rest of 2025 and over 2026.

Wage growth and services sector inflation are abating, albeit slowly, and remain elevated. That said, the risk of persistent domestic price pressure has decreased. Recent business surveys suggest that growth and demand momentum have weakened, and companies are continuing to reduce headcount. What's more, output price inflation has slowed to a five-year low as companies face increased competition and softening demand.

These developments point to further easing in wage growth and service-sector inflation. Additionally, while it's early to fully assess the impact of tariffs and the global restructuring of trade on UK inflation, the impact has been muted so far.

Given that the rise in inflation so far in 2025 partly owes to temporary supply-side-related factors, which the BoE can do little about, the base rate has been lowered three times to 4.0% pa so far this year. While the recent interest-rate decisions have been close, policymakers signalled openness to further cuts. This change in view follows progress on domestic price pressures, but is contingent on continued disinflation. In response, markets once again expect two 0.25% pa cuts by the BoE over the next 12 months, which would take the base rate to 3.5% pa.

The upside risk of persistent domestic price pressures has diminished and downside risks to growth, demand and the labour market have become more apparent. However, there is uncertainty on both sides: premature easing of monetary policy could stall disinflation, while too-tight monetary policy could deepen economic weakness. In our view, monetary policy is moderately restrictive and nearing a 'neutral' stance. Therefore, cautious, disinflation-dependent easing looks appropriate.

Looking ahead, we anticipate greater inflation volatility, driven by fragile supply chains, with diminishing returns from globalisation, disruptions due to climate change and geopolitics (including political opposition to immigration), and persistently tight labour markets. Demand-side factors include a shift towards more active fiscal policies in advanced economies like the UK, making a return to the loose monetary and tight fiscal policy that followed the global financial crisis (GFC) unlikely.

We expect central-bank mandates to remain intact and inflation, on average, to stay near targets, but with increased volatility. Inflation and rates should fall and may dip below targets, but a return to post-GFC ultra-low rates is unlikely. Nominal rates are likely to align more closely with real growth and inflation, with continued higher volatility in the coming decade.

If you'd like to discuss anything covered in this publication, please get in touch with your usual Hymans Robertson consultant or our authors, below.

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