

Resilient growth, rising risks: Investing through the energy shock

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Key points

- Global growth has not only been resilient this year in the face of a significant energy shock; it has accelerated. Year-on-year nominal growth is running at 5% – 6%, its strongest pace for 20 years.
- Loose monetary and fiscal policy, as well as a broadening AI investment boom, have underpinned growth and are ingraining higher, more persistent inflation.
- The outlook for Q4 and early 2027 hinges on two critical factors: the size of the energy shock, including how high and for how long energy prices spike and whether there are second-round effects; and the forcefulness of the policy response.
- Our team's base case is that global nominal growth will slow into the fourth quarter and early 2027 but remain at or slightly above trend. At current oil prices, the energy shock is likely to slice around 1.5 – 2 percentage points from growth. Monetary and fiscal policy are tightening at the margin too. But as the policy response is unlikely to be commensurate with the size of the inflation shock, low real rates should continue to support growth and stoke inflation. AI investment growth will remain supportive too.
- However, the distribution of outcomes is widening and increasingly skewed to the downside. The longer the Iran conflict remains unresolved, the larger the energy shock is likely to be. A more sustained energy shock would risk a more forceful tightening of policy or a sharper repricing of term premia by the market if the response were deemed inadequate. It could also weigh on consumption, which has so far proved resilient despite the squeeze on real incomes. The outlook for AI capex is also critical to the cyclical outlook. The recent debate on safety and regulation is important to monitor in that regard if it leads to a slowdown in investment growth.
- There are also positive tail risks, notably a resolution to the conflict in the Middle East that pushes down energy prices and/or a significant rise in productivity growth that offsets the negative supply shock from oil.
- Monitoring these tail risks over the remainder of the year will be crucial given their potentially meaningful impact on yields and risk assets.

Rapidly accelerating growth despite the energy shock

Global growth has not only been remarkably resilient this year in the face of a significant energy shock; it has actually accelerated. Our growth leads suggest nominal growth is running at 5% – 6% year on year, its strongest pace for 20 years.

Loose monetary and fiscal policy have underpinned growth and accommodated the energy shock, ingraining higher, more persistent inflation. AI has also contributed significantly to growth in a rising number of countries, both directly through capex and potentially through spillover effects given its potential to lift returns on capital and labour in the economy. It is notable that we have seen a significant

and relatively broad pick-up in manufacturing leads, while global trade volumes are growing at their fastest pace in 15 years. Finally, the deleveraging of private sector balance sheets over the past 15 years has also reduced sensitivity to higher rates.

Where do we go from here?

The outlook for the remainder of the year and into 2027 hinges on:

- the scale of the energy shock, especially how high and for how long energy prices spike;
- the scale of any second-round effects; and
- the forcefulness of the policy response.

Nominal growth slowing but likely to remain above trend

My base case is that nominal growth will slow into the remaining quarter of the year and early 2027 but remain at or slightly above trend. At current oil prices, the energy shock is likely to slice around 1.5 – 2 percentage points from growth.

Monetary and fiscal policy are tightening at the margin too. The market is currently pricing an average of 100 basis points of tightening across the G10 economies. While I am sceptical that most central banks will deliver hikes of that magnitude, we are seeing a growing rate response to the latest rise in energy prices. The G10 fiscal impulse, meanwhile, is set to swing from +0.6% of GDP this year to a small drag in 2027, in large part due to the US.

However, as long as the policy response is not commensurate with the size of the inflation shock, accommodative policy will act as a support to growth and stoke rather than moderate inflation. Most G10 central banks have also allowed inflation expectations to de-anchor relative to the 2% target, further pushing down real interest rates. This still loose policy stance should keep growth at or slightly above trend. While this would be a less favourable environment for risk assets than that of recent quarters, it would remain broadly supportive.

Wider outcomes with increased downside risk

At the same time, it is important to note that the distribution of outcomes is widening and increasingly skewed to the downside.

The longer the Iran conflict remains unresolved, the larger the energy shock is likely to be. A more sustained energy shock would risk a more forceful policy response. The doubling in energy prices this year could add as much as four percentage points to headline inflation, and a more prolonged increase would risk a larger pass-through to core inflation. Many central banks have made clear that how they will respond to a larger energy shock may not be linear, implying that the bigger and more persistent the energy shock, the larger and faster the series of hikes.

A more persistent and larger energy shock could also lead to a sharper repricing of term premia in the bond market if the monetary and fiscal tightening is deemed inadequate. The starting point for government finances is already stretched — the average G10 deficit this year is close to 6%, a level normally associated with crises rather than periods of exceptional nominal GDP growth. If the market suspects central banks aren't serious about fighting inflation and governments aren't safeguarding debt sustainability at a time when high yields are eroding fiscal space, investors could deliver the tightening policymakers don't want to undertake via a sharp rise in term premia. Increasing term premia have already driven around half the rise in G10 yields since the start of July.

Growing doubts about select countries' debt sustainability

Countries with the most challenging public finances — France, the UK and the US — are the bellwethers to monitor. We are getting to levels on yields where, for some countries, the sell-off is becoming self-perpetuating without a clearer commitment to conservative fiscal policy. If these yields persist, their governments would need to improve their primary balances by three to four percentage points to stabilise the debt-to-GDP ratio, even at these high nominal growth rates. Such an undertaking seems extremely challenging in the current political climate.

Consumption has so far proved resilient despite the squeeze in real incomes from higher energy prices. Consumers have been willing to run down savings to smooth the energy shock, even amid some of the weakest consumer confidence levels on record and the lowest labour share of GDP in at least 30 years. Low real rates have encouraged households to pull forward consumption. But if wage growth and employment do not lift into year-end to alleviate the squeeze in real incomes from higher inflation, the gap between confidence and spending could resolve to the downside.

Other than a longer, larger energy shock, the most significant downside risk to growth to monitor is the risk of a slowdown in AI capex driven by a reassessment of the returns AI will create or that can be captured by firms. The potential for the recent debate on safety and regulation to weigh on AI investment is an important risk to monitor in that regard.

If the disruption to Middle East oil supply were resolved, oil prices could fall rapidly. Another positive tail risk is the potential for a positive supply shock from rising productivity growth, which could help to offset the negative supply shock from oil, if large enough. The productivity leads have been pointing in that direction for some time but, so far, any increase has been limited.

Market response likely to drive growing divergence

The market may increasingly reward credible policy and penalise inappropriate policy. It is striking that in this latest leg higher in yields since July, there has been an almost indiscriminate repricing of rate expectations higher across the G10 and a sell-off in yields — in lockstep with rising oil prices. But the rise in energy prices has very asymmetric implications across countries, depending on whether they are net energy importers or exporters. The risk of second-round effects differs by country too. And policymakers will respond with different degrees of orthodoxy. We expect the market to increasingly price this divergence. Bond markets and currencies in countries with orthodox central banks and relatively favourable fiscal starting points — like Germany and Australia — should outperform those with less credible central banks and more unstable debt dynamics.

A sensitive moment for the global outlook

In short, we are at a sensitive moment for the global outlook. So far this year, loose policy and AI-related growth have more than offset any drag from the energy shock and amplified the inflationary implications. Private sector balance sheets are strong and less sensitive to rate increases. The rise in energy prices to date and the policy response will weigh on nominal growth but should not undermine it.

But we are not at a stable equilibrium for the oil market or the consumer. If the energy shock keeps growing and the policy response becomes more forceful, the downside risks will grow, potentially exposing unstable fiscal dynamics in some countries. The longer and larger the shock, the more challenging it will be for consumers to keep spending in the face of a squeeze on real income. Conversely, an easing of oil prices or a significant lift in productivity could quickly return us to the positive dynamics of the first half of the year. Investors need to keep a close eye on the evolving macro

conditions in the months ahead.

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