Bradbrook

Research Bulletin | Autumn 2015

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Headlines

- UK forecast to be 2nd fastest growing economy in G7 in 2015
- Signs of slowdown in China, USA and Germany
- UK construction output turns negative for first time since May 2013
- 2015 set to be record year for hotel deals in the UK
- Special Comment - Are we heading for recession in 2016?

Bulletin #03
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UK Economy Overview

We might be heading deep into autumn, but the UK economy at the end of summer seems to paint a fairly sunny picture. GDP is rising and on course to post around 2.5% for the year. Unemployment is steady at around 5.4% and wages grew at a healthy 3% in August. Unsurprisingly, consumer confidence is relatively high.

Away from the service sector, construction output has been low in 2015, and July saw output actually fall by 0.7%

Business confidence also rings with a positive note, although it has dipped recently. And in the last 3 months we have (finally!) seen the UK's lamentable productivity surpass its pre-recession peak in 2008 – to put into context how poor UK productivity has been, the Eurozone, even with all its problems, surpassed pre-recession productivity levels way back in 2011.

However, there are worrying signs that the economy is starting to wobble. Retail sales have been on a downward trend this year, barely staying above growth levels in month-on-month terms. The service sector PMI (which measures level of activity), has also been on a downward trend, with September posting the lowest number in two and a half years

Away from the service sector, construction output has been low in 2015, and July saw output actually fall by 0.7% - the first year-on-year fall in almost 2 years. Manufacturing output has also been in decline and contracted in the last quarter.

Inflation is proving stubbornly low. The consensus was that inflation would be firmly positive again by the end of the summer driven by a rise in oil prices. Yet summer is over and inflation is negative at -0.1% with oil prices still around $55, which is something we predicted in our summer report.

One cause for this slowdown could be the disappointing summer, reducing consumer spending. However, a larger cause could be a general slowing of global economic activity. If it's the former then hopefully the recent disappointing figures are a blip, if it's the latter, then watch out. Either way, an interest rate rise is off the cards for 2015.

In spite of some negative data, forecasts for GDP in 2016 average at 2.5%, which matches forecasts for 2015.

Further ahead, the outlook for GDP growth is 2.4% in 2017, 2.4% in 2018 and 2.3% in 2019.

	GDP	CPI	RPI	Interest Rate	Unemployment
2015	2.5%	0.3%	1.2%	0.5%	5.4%
2016	2.5%	1.7%	2.8%	1.0%	5.2%

Forecasts: HM Treasury Survey

Forecasts for GDP in 2016 average at 2.5%, which matches forecasts for 2015.

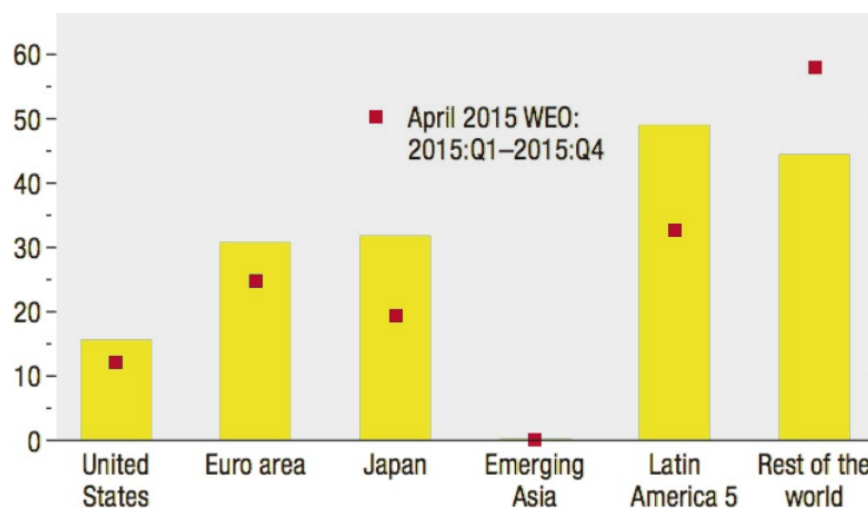
Global Economic Overview

In the major economic areas around the world activity signals are mixed and the IMF head has recently warned that global growth in 2015 will likely be the slowest since the financial crisis six years ago.

In the Eurozone, Spain and Italy are now growing healthily, although France has stagnated and Germany has slowed slightly. Unemployment, which has been stubbornly high in many countries, is also gradually improving, and PMI's for manufacturing and services are above 50, which means activity is still expanding.

While Eurozone GDP is growing - increasing by 0.9% in the first 6 months – it is forecast to slow in the third and fourth quarter. This combined with negative inflation (-0.1% in September) has made further quantitative easing by the ECB a strong possibility in the first half of 2016.

IMF Forecast For Percentage Chance Of Recession



The US continues to grow steadily, but there are signs that the world's largest economy is slowing. September's new employment numbers were a massive 30% lower than expected.

Other indicators, such as manufacturing PMI, capacity utilization and transport stocks have all declined recently, suggesting manufacturing is slowing.

The stall in American growth was one factor in the Federal Reserve's decision not to raise interest rates in September at a meeting which many thought would produce the first rate rise in 82 months and herald the start of some sort of return to monetary policy normality. Rates remained at 0.25% and are now unlikely to rise until 2016.

The other factor causing the Fed to put off rate rises is the weakness of emerging markets, and in particular, China.

The IMF has recently downgraded its forecast for China to 6.8% for 2015. However, more and more analysts dispute the official figures coming out of China, which report current growth of 7% - which still counts as the country's lowest growth in 25 years – and say that actual growth is probably around 5%.

The continued slump in commodity prices and news that the likes of Caterpillar, the world's largest construction vehicle company, is slashing its workforce, while Glencore, the world's largest commodities miner and trader, (which has seen its stock price drop a dizzying 30% in one day!), suggests that the formerly resource hungry economic giant has lost some of its appetite.

On the currency front, the settling down (for now) of the crisis in the Eurozone has pushed the Euro up, from €1.43 to the pound in July to around €1.35 now. The dollar has also strengthened significantly, from $1.58 to $1.52 in the last 3 months. We expect the dollar to further strengthen in 2015, but for the Euro to fall back due to likely further quantitative easing by the ECB.

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UK Construction Overview

Construction is one of the most sensitive parts of the economy when it comes to confidence and changes in sentiment, and output and new order data reflect the slowdown we're seeing in the wider economy.

Total construction fell by 0.7% in July 2015 compared to 12-months earlier – this is the first decline since May 2013 – while construction orders for new work grew at just 2%.

The picture is worse if we look at the private commercial sector (which is traditionally the largest construction sector). Output was down -3.2% in July – the fourth month in a row to show a decline - while new orders for Q2 2015 were down -12% on 12 months ago.

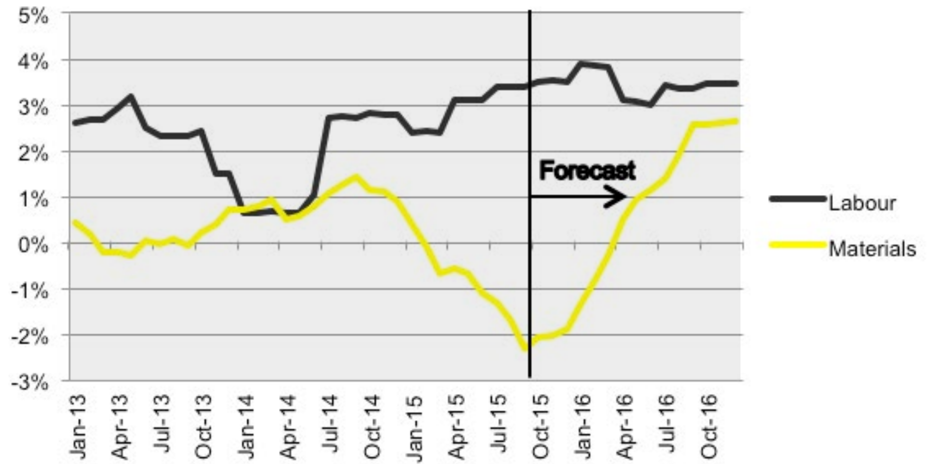
Before we all panic we need some perspective on these figures. For one, they're a comparison with activity a year ago, and 2014 proved to be a stellar year, with output touching almost 10% and the value of new orders in the private commercial sector up 20%. Given these sky-high figures it's hardly surprising that the equivalents for this year don't quite measure up.

Another reason to be optimistic is that the construction PMI, which measures whether the industry is expanding or contracting, was at 59.9 in September, well ahead of the long-term average of 54.7. Furthermore, a survey of construction companies revealed 52% expect an upturn in business over the next year – only 6% expect a decline.

So we're not heading into the abyss, but there are signs that the market is getting tougher for contractors. Tender prices, which are very responsive to market conditions, are still rising, but in the 2.5% to 4% range, rather than the 5% to 9% that was seen last year. We have been expecting this as contractors increase capacity to meet demand.

Contractors are also reportedly struggling with a hangover from projects won prior to about 2013 when the market was much tougher and very low tenders were issued in order to secure work. What is more, margins, which were cut very fine, have not expanded as quickly in the better trading conditions. The CEO of Kier recently said that market conditions would likely lead to mergers between large contractors, and speculated that the top 10 contractors could be reduced to just five in the next 2 years.

Annual Change in Labour and Material Prices



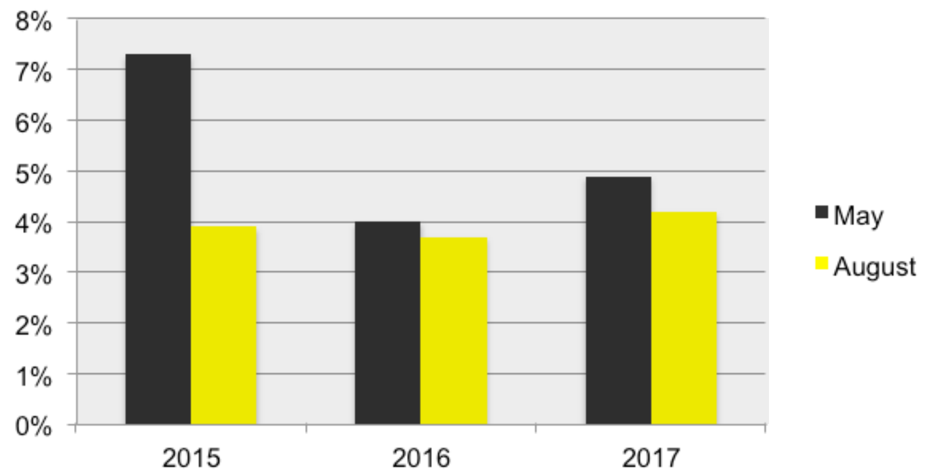
Source: BCIS

Aside from these challenges, the cost of labour is a growing issue as a result of a skills shortage. Labour costs rose by about 3.4% in the second quarter, well ahead of inflation and average wage rises for the wider economy. These costs are forecast to rise even more at the end of 2015 and beginning of 2016.

While labour costs are heading up, material costs are heading in the other direction; down -1.7% in August and forecast to continue falling until the start of 2016.

The outlook for construction output is still positive, albeit tempered for 2015. Experian has made significant downward revisions to its forecast since May, (see below). The Construction Products Association has also revised down its forecast for 2015 from 5.5% to 4.9%. They forecast output to be 4.2% in 2016.

Experian Construction Output Forecasts



Source: Experian

Hotels

Performance for UK hotels has been mixed in 2015. London has experienced lower growth in occupancy and revenues in the first half of the year, with budget and high-end hotels outperforming mid-market ones. In the regions outside of London though it's a different story.

Growth in occupancy and revenues in regional hotels has far exceeded London over the past 3 years (see graph, right). This is partly due to the regions suffering more during the recession, therefore having more ground to regain.

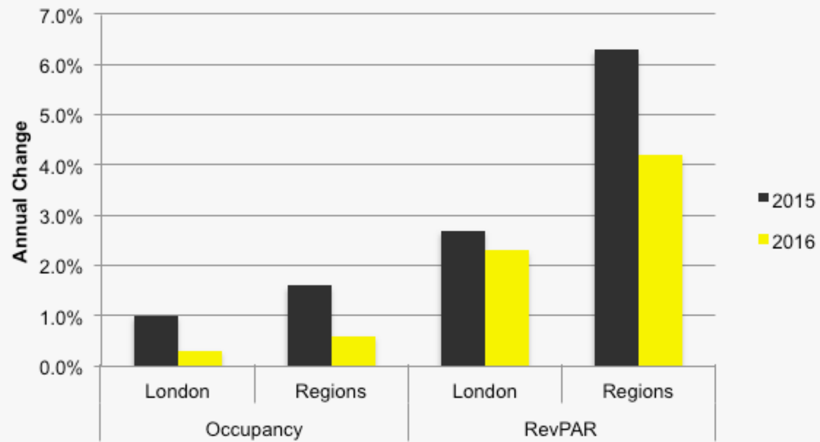
Occupancy rates in regional hotels is now pushing past 75%, which provides a stronger basis for raising rates, which should help continue the growth in ADR (Average Daily Rate).

The supply of rooms is scheduled to continue to grow strongly, with around 14,000 new rooms expected to come online in 2015, 16,000 in 2016 and 8,000 in 2017. Most of these will be in London, which has already seen a net increase in rooms of almost 24% between 2008 and 2014. The biggest increases have been seen in branded budget and 4-star hotels.

Hotel trade is forecast to continue to perform well in 2016, however there are risks in the form of a further weakening in the Euro, recessions in Russia and Latin America and problems with Chinese and other emerging economies.

On the deal front, 2015 could be a record year as PWC forecast hotel deals to top £10 billion in the UK. Regional hotel deals have been the most active so far this year, but there is still strong demand from overseas investors for prime-location London hotels.

Hotel Growth In London And Regions



Many deals are heavily leveraged thanks to continued low interest rates and availability of relatively cheap loans, and there has been an increase in private equity investment as bond yields remain low and investors look for dependable yields elsewhere.

Analysis by PWC has revealed a remarkable shift in the types of investors. In 2012 almost 60% of deals were by hotel operators, in 2015 they account for just 30%. The new lead investors are High Net Worth Individuals and sovereign wealth funds, which combined account for almost 40% of deals, up from about 10% in 2012.

Private Equity investors now account for about 25% of deals, up from just over 10% in 2012.

This huge shift is one of the effects of quantitative easing and low interest rates that have created a glut of cheap money that is looking for somewhere to go and earn a decent yield in a busy market. When interest rates finally rise it will be interesting to see whether the make up of deals swings back to the traditional hotel operators and investors.

There has also been a shift in the geographical origin of investors. In 2012 European investors accounted for almost 70% of deals, 3 years later they account for just about 20%. Taking their place as the top deal-makers are Middle Eastern investors, who accounted for less than 5% of deals in 2012 but are now behind almost 35%. Asian investors have also increased their share from less than 5% to about 15%.

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Special Comment

Recession Coming?

As you will have gathered from previous pages, while no major economic areas are currently in recession, a number of negative signals have popped up recently to suggest activity is slowing. Are these the omens of a new downturn, or just bumps in the road?

There will be a recession, at some point – that's stating the obvious, and we're not going to try and call the start of when the next recession will be – it's a great way to leave yourself looking stupid – but we will present some arguments for and against the possibility of one occurring in the next 12-18 months.

Reasons To Be Fearful

- China – The stock market plunge was dramatic, but that's not the real economy, for China the real economy is manufacturing and construction. Exports are down -5.5% in 12 months, while imports are down -14%, which helps explain why commodities are so low. It seems China just isn't making as much. Manufacturing PMI is at its lowest rate on record (back to 2011) – Conclusion: China is slowing.

- Commodities Prices – Oil has grabbed the headlines, but all major metal and energy commodity prices have been heading down for the last couple of years. This is hurting commodity dependent economies; Russia, Brazil and Canada are already in recession, while Australia is struggling. Until global demand picks up, they will continue to struggle.

- Eurozone – Greece has left the front-pages for now, but its structural problems (very high debt, low income) remain and there is still an existential threat to its place in Europe and the Euro itself. Germany, the powerhouse of Europe, is also struggling; GDP is down and exports are well below expectations, while France is flirting with contraction.

- Business Cycle – The business cycle is a period of expansion and contraction. The American National Bureau of Economic Research says there have been about 11 cycles since 1945, with the most recent one starting in June 2009, after the last recession. On average, expansion lasts 58.4 months; we are now 76 months into the current expansion, suggesting it's getting a bit long in the tooth.

Reasons To Be Cheerful

- The UK – Growth is relatively strong, employment is high and vacancies are rising, if there is a global slowdown, the country is reasonably well placed to deal with it.

- USA – The world's largest economy is still growing strongly and is forecast to be the fastest growing advanced economy in 2015.

- China – While the country does appear to be slowing, it's a long way from recession. What is more, it arguably has more tools at its disposal to boost the economy if the slowdown is worse than expected.

- Eurozone – Spain and Italy, which have lumbered along in recent years with low growth and high unemployment, appear to be on the up! The ECB will likely implement further QE in 2016, which may provide a further boost and increase confidence.

- Business Cycle – While this expansion maybe 76 months old, the previous one lasted around 120 months, while the one before that lasted almost 100 months, which could suggest changes to the global business environment (globalisation and credit availability) could be increasing the length of cycles, meaning 76 months may not be that old.

In summary; things are slowing down. China is the big issue and a number of indicators show it is manufacturing less. This is partly a symptom of the gradual re-focusing of its economy towards services and consumer spending. Nevertheless, China growing slower poses a problem for the rest of the world.

The question is, will the slowing in China, and other places, tip over into a recession? Not necessarily, but with interest rates at rock bottom around the world and vast amounts of quantitative easing already issued, central backs have less firepower to stimulate slowing economies. The hope is that after six years of recovery, the private sector is robust enough to ride out the slowdown. This is the real test to see how well we have recovered from 2008.

Some analysts (including large banks Citigroup and Daiwa) now see a 'global recession' in 2016 caused by slowdowns in emerging economies (mainly China) as a 'base case' scenario. There may be some stormy weather ahead, but if there's a ray of sunshine, it's that the UK is one of the better-placed economies to ride it out.

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