Bradbrook

Report | Spring 16

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Headlines

- UK growth forecast cut for 2016
- Concern about China's economy and its currency plans
- UK construction slows in H2 2015 - but outlook good for 2016.
- 2016 has potential to see large increase in Chinese UK leisure sector investment
- Special Comment - Uncertainty and the Risks of 2016

Bulletin #04
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UK Economy

The start of the new year has coincided with more unsettled economic conditions as activity slows. GDP for Q4 2015 came in at 0.5% with growth driven almost entirely by services as every other major sector saw growth fall (construction contributed -0.4% less than the previous quarter). The Q4 data brought growth for the whole of 2015 to 2.2%, slightly down on forecasts of 2.3% and a notable drop from the 2.9% seen in 2014.

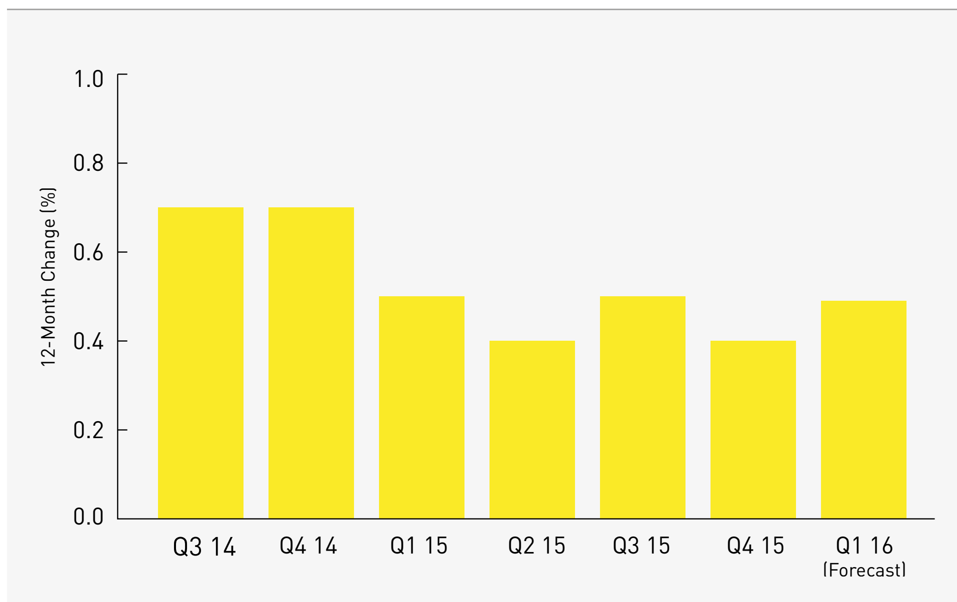
While the figures were far from terrible, George Osborne was still moved to make an early statement in January saying that 2016 would serve up a "dangerous cocktail". The main ingredients are likely to be the UK EU referendum, a general global slowdown, uncertainty over China's currency plans, and commodity prices (mainly oil) – we'll cover these later.

Independent forecasters surveyed by the Treasury have already revised down estimates for GDP growth in 2016 from 2.3% to 2.2%.

However, it's not all doom and gloom; growth above 2% in the current global climate is still pretty good, wages are growing, which should boost demand, and unemployment is still very low at 5.1%.

Inflation is still very low at just 0.3%, which is cited as another factor that might boost spending. However, this rock-bottom inflation a double-edged sword. Wage growth slowed at the end of 2015 and the Bank of England suspect this is largely due to companies responding to the low inflation environment. Continued super-low inflation could start to drag on wages more in 2016, which could cause a damaging disinflationary feedback loop.

UK GDP Growth



Another consequence of the continued low inflation is the Bank of England's long-mooted interest rate rise has now been pushed back even further. There was a view that the BoE could follow the American Federal Reserve and raise rates in the first half of 2016. However, the economic and financial turmoil seen since the start of the year, combined with the uncertainty that the EU referendum will bring, means rates will stay lower for longer. We don't expect rates to rise until the second half of 2016 at the very earliest.

The main risks to UK growth are largely external; domestically, the environment looks fairly good. Investment is robust, vacancies are still rising, even in this tighter labour market, and wages are rising above inflation. There is one significant domestic risk however - the EU referendum.

Regardless of outcome the mere presence of the vote on June 23 will cause uncertainty, which will likely see investment curtailed until the result is clear. We have more detail on this in our Special Comment section at the end.

	GDP	Interest Rates	Inflation
2016	2.2%	0.6%	0.7%
2017	2.3%	1.0%	1.7%
2018	2.3%	1.5%	2.0%
2019	2.3%	1.9%	2.1%

Forecasts: HM Treasury Survey

Global Economy

Performance on a global level was disappointing at the end of 2015 and the outlook is poor for 2016.

The major economic areas of the US, China and the Eurozone all saw growth drop in the second half of 2015. The IMF has downgraded global growth for 2016 from 3.6% to 3.4% and from 3.8% to 3.6% for 2017 - A further downgrade is expected in April.

The main drag on growth appears to be falling demand leading to a decline in manufacturing and exports, with levels in the three main economic areas all declining in the second half of 2015.

In spite of this, the US economy performed reasonably well overall in 2015, with unemployment falling and inflation rising slightly. These factors convinced the Fed to raise interest rates in December, but the wisdom of this is being heavily questioned. Strengthening headwinds means the next rate rise could be months away, and some are even speculating that the next move will actually be a cut back to the old rate.

If the Fed does raise rates again that will strengthen the dollar and this is going to cause significant problems for emerging economies.

China is arguably the biggest problem right now in the global economy. Activity has slowed slightly while its stock market bubble has well and truly burst. The Chinese currency, yuan, is under serious pressure and it's speculated that it could be devalued this year. Such a move will dump even cheaper products onto global markets at a time when many countries are already facing deflationary problems. We have more on this in our Special Comment section.

Other emerging economies are being hit by the double-whammy of falling exports and a strong dollar that is putting pressure on debt repayments.

The Quantitative Easing that followed the crash in 2008/09 led to very cheap credit being made available to emerging economies, and most of this was denominated in dollars. As the value of the dollar rises the cost of this debt rises. In the last recession in 2008/09 emerging economies were part of the solution and helped to drag developed economies out of the slump. Right now, they seem to be part of the problem.

The seemingly perennial economic problems of the EU are still flowering. Inflation has dropped back from +0.3% to -0.2% - its lowest level in 12 months. Further intervention from the European Central Bank in the form of more quantitative easing and/or further negative interest rates seems highly likely in the next 6 months. GDP for Q1 2016 is also expected to be low at 0.2%.

One story that's bubbling away and could blow up in the next 6 months is that of Italian banks - they have tens of billions of Euros in non-performing loans and no clear plan for how these are going to be written down or offloaded. It's more than likely they'll bumble through, but it's something that has the potential to cause serious problems on the continent.

The other headline grabber over the past few months has been oil. OPEC (basically Saudi Arabia) is engaged in a market share war with American shale producers, Russia and others. Its policy of "pumping more for longer" has led to a massive over-supply in oil (somewhere in the region of 3 million barrels per day). But as the price has dropped other producers haven't been forced out of business as the Saudi's had expected. Cheap credit has allowed American producers to stay in the game for longer than anticipated, while countries like Russia can't afford to cut production and loose market share.

The price per barrel is hovering around $30-$35 and is more likely to go down (some are predicting $10 oil!) than up in the short term. Top end estimates for 2016 are $44.

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US Oil Price - Last 12 Months

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UK Construction

After a strong start to 2015 construction stalled in the second half of the year. By the end of the year, new work output was -2.2% down on the peak seen in Q2. For the private commercial sector meanwhile output was down almost 2%, but Q4 did see a slight increase on the previous quarter.

Figures for Q4 15 will be released next month, but early indicators suggest output will drop again. This is being partly blamed on the very wet December, which disrupted construction activity. But industry analyst Glenigan believe that new starts in 2015 were 4% lower than in 2014, and in the 3 months to January new starts were down 20% on a year ago. Glenigan have described construction activity as being in "the worst period of decline since crashing in 2009."

Analysts at Experian forecast commercial output to rise by 4% in 2016, 5% in 2017 and 3% in 2018.

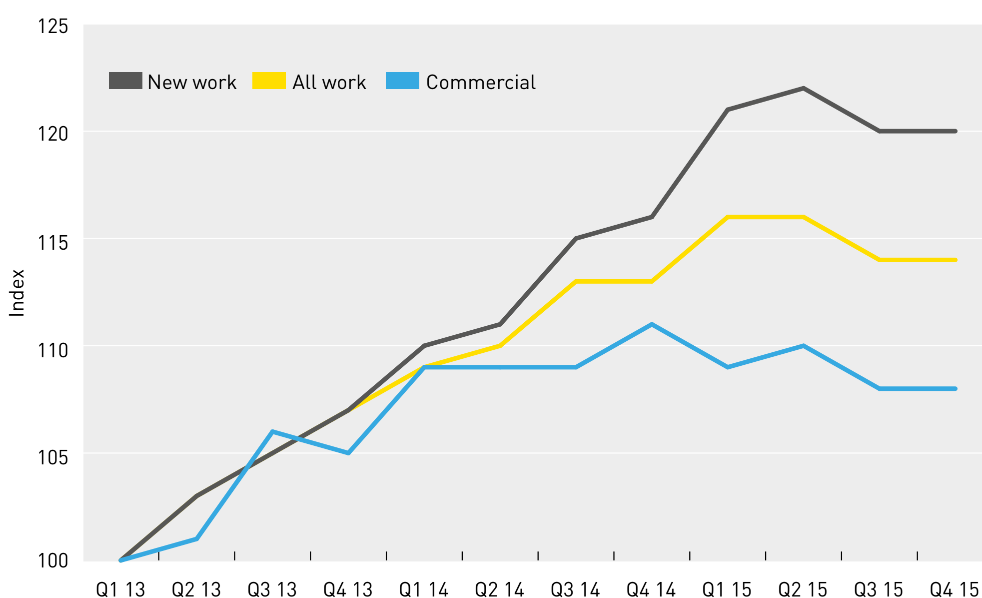
Order value for new work has been flat for the last 12 months. The picture for private commercial work has been worse though, which has been declining since Q3 14, although the most recent data for Q3 15, showed an uptick in orders a trend that analysts are predicting will continue into Q4 15. The BCIS forecast new orders to increasearound 3% to 4% over the next couple of years.

In spite of slight declines in output and orders, tender prices continue to rise significantly; around 7% higher than in 2014, which itself saw an increase of 8.5% on 2013. The main cost pressure has been with labour, with construction wages rising 6.5% in the second half of 2015 compared to around 2.2% for the economy at large. It also appears that the capacity in the industry, which shrank significantly between 2008 and 2012, has struggled to respond efficiently to the large increase in demand seen over the last couple of years.

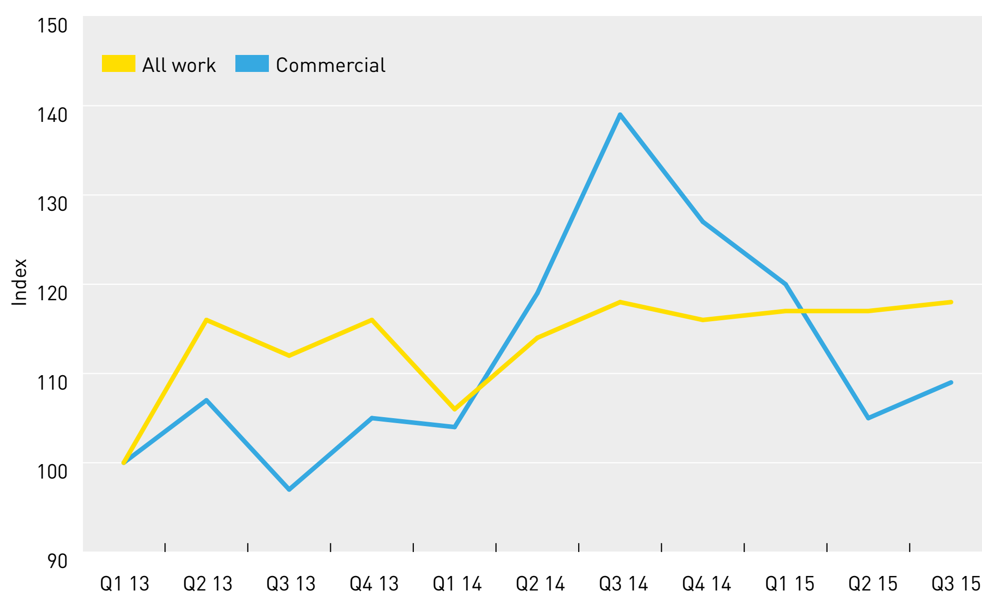
This capacity issue has been especially prominent in London, which was recently named the second most expensive city in the world for construction (New York was number one). The capital's rocketing costs are attributed to a combination of high tender prices and high land values. Clients are becoming more stringent on agreeing prices before work commences, and there is evidence that more projects are being delayed as clients struggle to justify starts in such a costly environment.

However, the struggle to find value in central London is reportedly benefiting the outskirts of the capital and other UK cities, as investors look further afield for opportunities to provide long-term development value.

Construction output



Construction New Orders



For 2016 the main cost pressure for contractors will still be on the labour front. Expect to hear even more about the long complained about skilled labour shortage over the next 12 months.

2015 saw the price of virtually all commodities plummet so as expected building material costs have also fallen, albeit only around 2%. This is expected to continue in 2016, especially in the case of oil, steel and copper, and should help to offset some of the labour cost increases.

Forecasts for construction output in 2016 are still positive. Although there is concern that the impending EU referendum could see investment withheld until after the vote. Recently Land Securities said that their programme of speculative developments will end in September 2016. For a developer that has carried out £3bn of speculative development since 2010, their comments generate serious concern.

Overall, the forecasted slowing in the economy, coupled with the uncertainty generated by the EU referendum, means 2016 will likely bring tougher conditions than 2015, and could well be the most challenging year for the construction industry since 2012.

Hotels

As we get the year-end data, 2015 looks to have been a bumper year for hotel deals. Savills reported that UK hotel investment hit a record high of £8.5bn last year, which is more 30% higher than the £6.1bn that flooded into the sector in 2014. 2016, however, is likely to be a more challenging year.

As we mentioned in our previous report, investment in the hotel sector has been increasingly driven by sovereign wealth funds, high net worth individuals (HNWI's) and private equity funds. In 2015 these sources of investment accounted for 65% of hotel deals, up from just 20% in 2012. At the same time, the proportion of deals driven by traditional hotel operators has declined from 60% to around 30%.

The change in profile of hotel sector investors has likely largely been driven by billions of dollars of cheap credit created by low interest rates and quantitative easing looking for decent yields in a world where they are increasingly hard to find.

The current financial difficulties we are seeing will impact on the new hotel investment leaders. Sovereign wealth funds (which mainly invest profits from resource, i.e. oil rich countries) have been hit hard by the commodity slump, and we expect their investment activity drop as a portion of funds need to be repatriated. We are already seeing evidence of this in the London office sector, most notably in the case of the Qatari Investment Authority putting 1 Cabot Square in Canary Wharf on the market for £450m.

Private equity funds and HNWI's could also be hurt by a global slowdown, especially if investments have been credit driven, which could also lead to less money coming into the hotel sector.

However, in times of uncertainty investors will look for quality, so properties in prime areas may still be attractive in the event of a slowdown, even in spite of congested activity we've seen in that end of the market in London over the last 18 months – back in November Deloitte surveyed investors and found 57% thought the London market was overvalued, but the city was still the most attractive for new investment in Europe.

As we mentioned earlier in the report, China is facing some financial difficulties and around $750 billion has left the country in the last 12 months. Nervous investors are flocking to more mature, more stable markets in Europe and the US to protect their wealth.

There is some evidence that a Chinese investment invasion is already well underway in the UK. China Estates – owned by billionaire Joseph Lau – recently spent £270m on 88 Wood Street in the city, while a reported £1bn worth of Chinese funded deals for prime London office real estate is also in the pipeline. While London offices are currently the favoured asset we expect the hotel and hospitality sector to also prove attractive.

The UK hotel sector has seen significant growth since 2008 – hotel capacity in London alone has increased by a quarter in that time – but 2015 may be a peak, at least for the next few years. We believe that projects outside of London will offer better development value, but rising construction costs, especially in London, and a fall in international investments will likely make 2016 a more challenging year.

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Special Comment

Uncertainty And The Risks Of 2016

The one thing investors and markets hate more than anything is uncertainty. Bad news isn't great either, but it can at least provide opportunities, especially if you have liquidity. Uncertainty on the other hand produces inertia (at best) and panic (at worst).

The major markets of the world – US, Europe, China, Japan – are all growing. There are reports of slowing activity, but none of them are in recession. As such, stocks and commodities should be on the up, and yet we're seeing major stock indices posting significant drops and oil seesawing around $30.

The problem is uncertainty as we see several large risk events converging at the same time. We believe these are the four key events to be mindful of in 2016.

China

China's stock market madness has grabbed the headlines, but it's the country's currency moves we should really be watching. Uncertainty in China has seen around $750 billion of capital leave the country in the last 12 months, with the vast amount of yuan being sold pushing down the value of the currency. As a pegged currency the government is committed to keeping it above a certain value, so China is now rapidly running down its estimated $4 trillion of reserves to do this.

What is more, China's commitment to the peg means its currency is remaining expensive at a time when manufacturing and exports – still the engine of China's economy – are declining. The expectation now is that at some point in 2016 China will let its currency fall.

The magnitude of the fall is uncertain (although some say the yuan is overvalued by around 15%-20%), but what it will do is cause cheaper Chinese products hit global markets at a time when many developed countries are dealing with 0% (or thereabouts) inflation.

What China will do with its currency is very unclear - and some believe that China will allow its currency to remain expensive for long-term gain – but it could be most significant economic event this year because for developed economies it could cause serious...

Deflation

The UK and other major economies have endured almost 12 months of around 0% inflation. OPEC's battle for oil market share and falling global demand have pushed core inflation way down, while cheaper Chinese goods could see inflation fall even further. This may be a short-term boon for consumers, but if it continues it will trigger serious problems.

Falling prices reduce company revenues and profits, which lead to lower wage growth, which will lead to lower consumer, which then leads to lower revenue and profits for companies.. It's an unpleasant spiral that is hard to reverse and could see large developed economies stuck in years of stagnant growth, much like Japan and its 'lost decade'.

The hope is that a tightening labour market in the UK and US (where unemployment is around 5%) will cause wages to start rising faster, increasing consumer spending and boosting inflation to something approaching normal levels and offsetting deflationary pressures from lower commodity prices and cheaper imports. However this will only come to pass if we're not facing a more serious...

Slowdown

There are signs that large economies around the world are slowing. Manufacturing and freight in America have dropped to levels usually seen during recessions. UK growth figures for 2016 have been revised down. The composite PMI in Europe – possibly the best measure of activity – fell to its lowest level in 12 months. Consumer spending is just about holding up, which is encouraging, but the other downward trends are cause for concern.

It is hoped that this slowdown is a blip and that confidence and expenditure will return, much like we saw in 2012/13. Hopefully as Q1 progresses the data coming out of major economies will improve and point to a turn in fortunes. However, any improvement could be derailed by an unforeseen shock, such as a large default, larger than expected currency devaluation, conflicts, or possibly...

EU Referendum

The UK EU referendum has been set for June 23. The reaction to David Cameron's renegotiations with Brussels has been less than enthusiastic and resulted in a boost for the leave camp.

However, polls still have 'remain' leading 'leave' by about 53% to 47%. The bookies however, who did much better at calling the general election and the Scottish referendum, have it much wider at about 70% vs 30% in favour of remain.

Regardless of the outcome the mere presence of the vote creates uncertainty, which will see some companies withhold investment until the outcome is known.

If the country votes to stay 'In' then it should be back to business as usual with the potential for a short-term boom as pent up capital is released.

If the country votes to get 'Out', then the UK could well enter a recession as companies pull out of investments and trade drops as investors and markets wait to see what shape new trade deals for the UK take.

The EU referendum is primarily a domestic issue for the UK, but an 'Out' vote could be the kind of shock that turns a global economic wobble into a fall.

In January, an RBS note to its clients summarised their investment outlook for 2016 as "Sell (mostly) everything". Slightly hyperbolic perhaps, but it indicates how precarious the global economic situation is right now. If we're going to get through 2016 relatively unscathed then we need all those key events to turn out favourably – and hope no other surprise shocks hit. 2016 could be a bumpy year.

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