Bradbrook
Economics Report | Summer 2016

Bradbrook

Headlines

- Vote to Leave EU expected to weigh on growth
- Construction activity falls to 7-year low ahead of vote
- Up to £5bn of real-estate expected to be sold following vote
- Weak pound provides opportunity for overseas investors

Bulletin #05
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Introduction

We can't start this report without mentioning the referendum. The vote on 23 June has proven to be the catalyst for a period of rapid and potentially far-reaching change.

Normally when we present a summary of the last quarter or two it provides a good indicator of what we can expect in the coming quarters. But in this instance we expect the data for Q3 (July to September) will be markedly different for what we have seen for Q2 (April to June). As such there will be fewer forecasts than normal as there is very little post-referendum data available. Even the OECD (Organisation of Economically Developed Countries) has cancelled their report for Q3 2016 due to the current level of uncertainty.

We will still summarise recent developments and try to provide some forward guidance, but all of this will be subject to greater change than usual.

UK Economy

GDP for the first quarter of 2016 fell to 0.4% from the 0.7% seen at the end of 2015. This was slightly below expectations of 0.5%. Growth was largely supported by consumer spending as business investment and exports both declined, part of which can be attributed to caution ahead of the referendum. The Q1 GDP figure also showed a continued weakness in construction output and manufacturing, which fell by 1.8% and 1.3% respectively.

GDP for Q2 (April to June) is due out at the end of July and is forecast to be 0.3%. We note that this figure will only contain one week of data from after the referendum. We will have to wait until the Q3 data released at the end of October to understand the impact of the referendum on trading and investment.

The first 6 months of the year saw unemployment fall to 4.9%, the lowest rate in more than a decade. And while job vacancies have also remained relatively high, wage inflation remains fairly low at just over 2%.

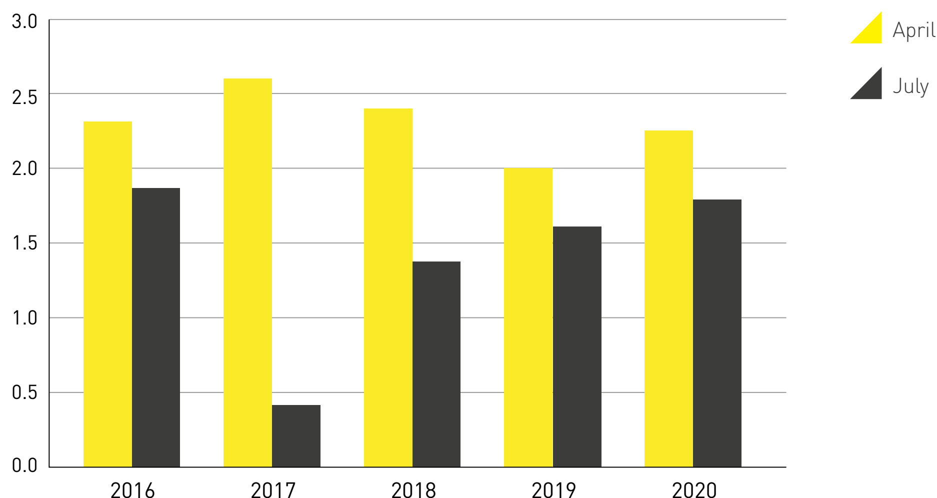
Overall inflation remains low, averaging around 0.4% for the first 6 months of the year.

Further ahead we could see the effect of the very weak pound push up inflation to around 1.3% by the end of 2016 and around 2.5% by the end of 2017.

In spite of inflationary pressures the Bank of England is expected to cut rates from 0.5% to 0.25% and/or expand its quantitative easing programme in August to try and boost lending and economic activity. Any rise in rates now seems to be in the distant future.

We have seen a few post-referendum forecasts, which have about 3 weeks of solid data. So far, from this very limited snapshot, it suggests a contraction in Q3 and zero growth - or possibly another contraction - in Q4. However, the consensus is that GDP will fall with a risk of recession by the start of 2017. Those forecasting this expect it to be shallow and short-lived. However, this assumes the rest of the global economy does not also slowdown significantly.

EY ITEM Club GDP Forecast



Construction

As expected, construction activity dropped off in the run up to the referendum as investors waited to see the outcome. Activity in June, as measured by the Purchase Managers Index (PMI), dropped to 46, which meant activity actually contracted for the first time in 3 years and was in fact the lowest level seen in 7 years. Amongst this, the vital commercial sector saw activity fall to its lowest level for 6 and a half years.

The picture was also predictably dour for new orders with invitations to tender declining at the fastest rate since 2012.

We expect the data for July to be equally disappointing (if not more so). There is a chance that the swift appointment of a new Prime Minister along with the rebound in the stock market may encourage some to push ahead with paused projects in August. But this is a best-case response.

The BCIS have released some revised forecasts following the June 23 vote, with a base case of a recession in the construction industry with falling output, falling tender prices but building costs still rising.

Their view, which they call "optimistic", sees new work output fall by 2.9% next year, 2.8% the year after, then recovering slightly in 2019 to 0.3% and firmly back in positive territory at 4.8% by 2020.

This scenario, if it comes to pass, poses a huge challenge to an industry that has taken a long time to regain confidence following the last recession. The BCIS forecast that contractors will have to deal with the double trouble of revenue falling with tender prices while building costs rise.

A shrinking market will force contractors to compete harder for work, hence lower tender prices. But building costs will rise mainly due to the tight labour market, and higher costs for imported materials due to the loss of value for the pound. This could mean contractors are once again forced to cut their margins, which have only really begun to recover in the last 2 or so years. We expect this will lead to further consolidation in the market.

Commercial

The commercial sector will see output fall in the short term as private investors wait to see what shape the UK's negotiations with the EU are going to take and how severe any recession that hits is.

But fear about the impact has also resulted in a small sell-off of assets – five property funds were forced to block clients withdrawing cash and are now unloading some of their portfolios. It's been suggested that £3bn to £5bn of commercial property could put up for sale by funds seeking liquidity.

A post-referendum sell-off would be a great opportunity for foreign buyers capitalising on the cheap pound and big discounts offered by funds forced to sell, as long as they're happy to take some risk of course.

House building

We've already seen the market expectations for the house building sector expressed through the plummeting share prices of Britain's biggest builders with Barratt, Persimmon and Berkley all down by 20% to 30% from their June 23 value.

The problems in the sector started before the referendum though, with output dropping by 3.2% in May, which we expect will drop further in the coming months. The Royal Institute of Chartered Surveyors (RICS) has also warned of a downturn in house prices over the next three months, with buyer demand hitting an eight-year low. The property website Rightmove have reported that asking prices for houses coming onto the market since June 23 have already dropped by almost 1%.

Infrastructure

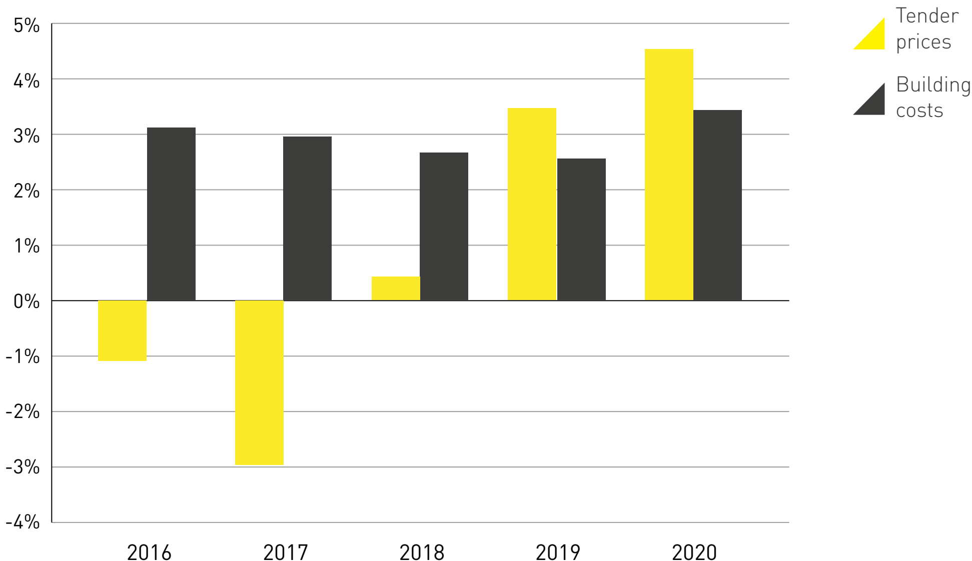
Infrastructure was the construction sector that faired best during the last recession, but it faces greater challenges this time around. Three big headline projects – HS2, new runway in the south east, Hinkley Point C - at early stages face great uncertainty now over when, or even if, they will start.

The new minister for transport, Chris Grayling, has come out to reaffirm the government's commitment to the £55bn HS2 train line and expressed a desire for a decision on whether to be build a new runway at Heathrow or Gatwick to made quickly.

These public statements are encouraging, but the country and its finances face significant challenges that might obstruct these big projects.

There is a possibility that the government will use current super-low borrowing rates to invest in infrastructure to boost growth, and Theresa May has pledged to issue more government backed 'infrastructure bonds'. This would be welcomed, but could also cause problems given the current high level of the deficit.

BICS Tender Price And Building Cost Forecast



Hotels

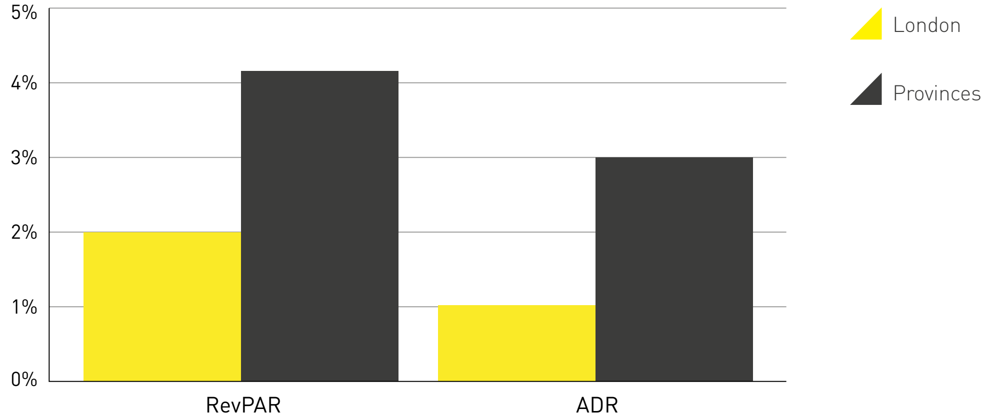
Expansion in the hotel sector slowed slightly in the first half of 2016, and in March PWC revised down their expectations for the year.

At the time they were still forecasting growth for both inside and outside of London, albeit at a lower rate than in 2015. They described the growth outlook for London as "solid but weaker" and as "modest" for the provinces, with the high pound and a general slowing in the global economy proving a drag on the sector.

For London they also highlighted the high growth in room supply - almost 7,000 rooms are due to come online in 2016 – as potentially putting more pressure on existing hoteliers.

These forecasts were made prior to the EU referendum, which they cited as having the potential to cause a shock that could damage growth prospects in the industry.

However, one benefit that could come from the 'Brexit' fallout is that the significantly cheaper pound could attract more tourism from the US, Europe and China which would be a big boost to the industry.



One Chinese travel firm reported that the number of searches for UK holidays tripled following the pound's collapse after June 23.

We could also see more oversees investment in the sector. PWC had forecast that deal making could top £6bn in 2016. We expect they will revise down that figure, but prime assets will likely remain attractive, especially given the currency differential for foreign investors.

JLL have actually reported an increase in inquires about UK hotels for sale since the referendum as they sense a rare opportunity to snap up hotels with strong yields at cut price.

The weak pound presents a good opportunity for those outside the UK - JLL report more interest from far east investors in buying UK hotels. There are even signs of a big increase in interest from foreign tourists looking to holiday in the UK.

Global outlook

The outlook for 2016 had been positive but with an expectation that there would be some slowing in growth although no outright contraction. Since the end of June this view has changed.

At the start of July the IMF cut its growth forecast for the EU to 1.7% for 2016 and just 1.4% in 2017, with Italy in particular being warned that it faces a "lost decade" of low-to-no growth. The downgrade was largely attributed to the volatility that the UK's vote to leave will cause and the probability that growth for the UK – a major trading partner for the EU – would slow in the second half of 2016 and start of 2017. The European Central Bank is expected to enact further loosening of monetary policy this summer, probably by expanding its quantitative easing programme, even though this strategy is clearly yielding diminishing returns.

The USA will now overtake the UK to become the fastest growing advanced economy in 2016. In recent months it has posted extremely high jobs numbers, industrial output gains and rising retail sales. The Dow Jones and S&P indices have also closed with record highs (although that probably says more about current monetary policy than business fundamentals). However, in spite of these conditions it appears unlikely that the Fed will move to raise interest rates this year. It would make the dollar even more expensive than it currently is and would be doing so in the face of some significant global risks.

The US may also face some slowdown in the run up to November's presidential election. This is actually a fairly normal occurrence as investors wait to see how the business environment might change depending on who gets elected. However, the effect may be larger this time around with the potential for Donald Trump to be president. As always, any slowdown in America will be bad news for the rest of the world.

After a shaky start (by their standards) to 2016, China's growth accelerated in the second quarter of the year, boosted largely by heavy government investment. The government is also allowing the Yuan to gradually depreciate, with a relatively large drop in its value to the dollar coming on June 24. As we mentioned in our last report there is a real risk of serious deflationary pressures if China continues to weaken its currency and forces others to do the same. Their next big move could come if Japan goes further with loosening its monetary policy and weakening of the Yen.

So with the US and China reporting some strong data global economic conditions appear slightly better than three months ago. However, there is a very significant problem brewing in European banks that could derail things.

Problems with Italian banks are receiving more and more coverage now, with the sector currently saddled with around €350bn of bad debt, a truly monstrous sum for a sector of that size. With the country's poor growth it seems there is no way the banks can handle this debt, but the EU's rules will not allow them to be bailed out either. At the moment there is no plan in place to fix this problem, and if the banks do fail, it will have a ripple effect that will have serious repercussions for the rest of the European banking industry as well as the world.

While the Italian banks are receiving most of the coverage there also appear to be problems at one of the continent's largest – Deutsche Bank. The German bank has seen its share value plummet and bond prices soar since the start of the year as the market worries about the amount of bad debt the bank is holding. Such is the concern around DB that the German finance minister was moved to make a statement saying everything was fine at the bank; a warning signal if ever there was one.

In our last report we noted there were a number of significant downside risks to the global economy this year and that a shock event – like the Brexit vote – could be a trigger for these risks to materialise. There is more uncertainty than usual at the moment and all we can do is hope that events unfold in a more positive manner.

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