Bradbrook

Economic Update | Winter 2016

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Headlines

- UK economy outperforms post-referendum expectation in Q3
- Construction output continues to decline as higher input costs bite
- Radical change in type and origin of hotel investors seen in first half of 2016
- Inflation could be set for a big return in 2017

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UK Economic Update

The data for Q3 2016 was watched with more interest than usual. It represented the first full quarter of post-Brexit data, covering July to September. Hopes were not high and growth of just 0.3% was forecast, but the economy delivered a pleasant surprise and beat expectations with 0.5% growth.

The positive showing was largely attributed to the service sector, which grew by 0.8%. The data from other sectors was less encouraging though. Industrial production fell by -0.4% while manufacturing fell by -1%, even in spite of the export boost from the cheaper pound. Construction contracted by an even larger -1.1%.

So while the headline figure was a welcome surprise, the detail leaves some cause for concern.

The last quarter has also seen the return of something that's been absent for what feels like an awfully long time; inflation. CPI had been hovering around the 0.3% to 0.5% level in the run up to June. Since the Brexit vote and the fall of the pound, CPI has broken out of that range and in September hit 1%, the highest level since November 2014. There was a surprise fall to 0.9% in October, but this is likely only a temporary respite from increasing prices. Markit report that producer prices rose 4.6% in October alone, which is the largest one-month rise they have ever recorded. We expect to see more of these higher producer prices passed onto buyers in the coming months.

In spite of the uncertainty around Brexit, and some of the mixed economic data from various sectors, employment has held up well. The number of people employed was at an all-time high in September with the unemployment level still at an 11-year low of 4.8%.

The recent better than expected data has seen forecasts upgraded. The most recent survey of independent forecasters by the Treasury saw growth expectations upgraded to 2.0% for 2016 and 1.1% for 2017. Similar to the Bank of England's forecast, they also see inflation rising above the 2% target next year to around 2.7%. In spite of the higher inflation the forecast is for interest rates to remain low in 2017, at around 0.3%

	GDP	Inflation	Interest Rates
2016	2.0%	1.3%	0.2%
2017	1.1%	2.7%	0.3%
2018	1.5%	2.6%	0.2%
2019	1.8%	2.2%	0.4%
2020	2.1%	2.1%	0.8%

Forecasts: HM Treasury Survey

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UK Construction Update

There has been a clear slowdown in construction over the past six-months, as shown by the 1.2% fall in output between April and September according to the Office of National Statistics (ONS). The data shows decline in repair and maintenance work is dragging the sector down, but that new work has risen slightly thanks largely to infrastructure output.

However, there is some cause for optimism, as the Markit/CIPS construction PMI for Q3 came in at 52.6, which shows activity increasing (anything above 50.0 signals expansion) at the fastest rate since March. Housing is the main driver of work, but there was a sliver of good news for the commercial sector, which saw activity stabilise following significant contraction after the referendum result in June.

One of the challenges for the construction industry that has emerged in the last few months is rising input costs. The weak pound, coupled with already rising oil prices, has seen material costs rise significantly. The prospect of the pound being weaker for some time means higher material costs are likely to remain a factor at least for another 12 months and quite possibly longer.

The combination of a potentially flat or contracting sector and higher costs means times could get tough for contractors. A recent survey by the consultancy Leading Edge asked contractors what they expected to be the main barrier to winning new work, more than 70% cited 'more aggressive pricing by competitors' as the number one issue.

These tougher market conditions are also reflected in another survey looking at business confidence amongst contractors over the next 12 months. 43% of respondents expected workload to increase versus 19% expecting it to decrease. And while this does show a majority expecting growth, it's the lowest level in three and a half years.

This outlook tallies with the CPA's forecasts for the next two years. Their measure of output has generally been higher than the official one produced by the ONS, but in spite of this they are forecasting output declines of 0.3% in 2017 and 0.2% in 2018. The largest contractions are expected in the infrastructure and the commercial sectors, particularly for office construction, which is forecast to fall by 3% in 2017 and 10% in 2018.

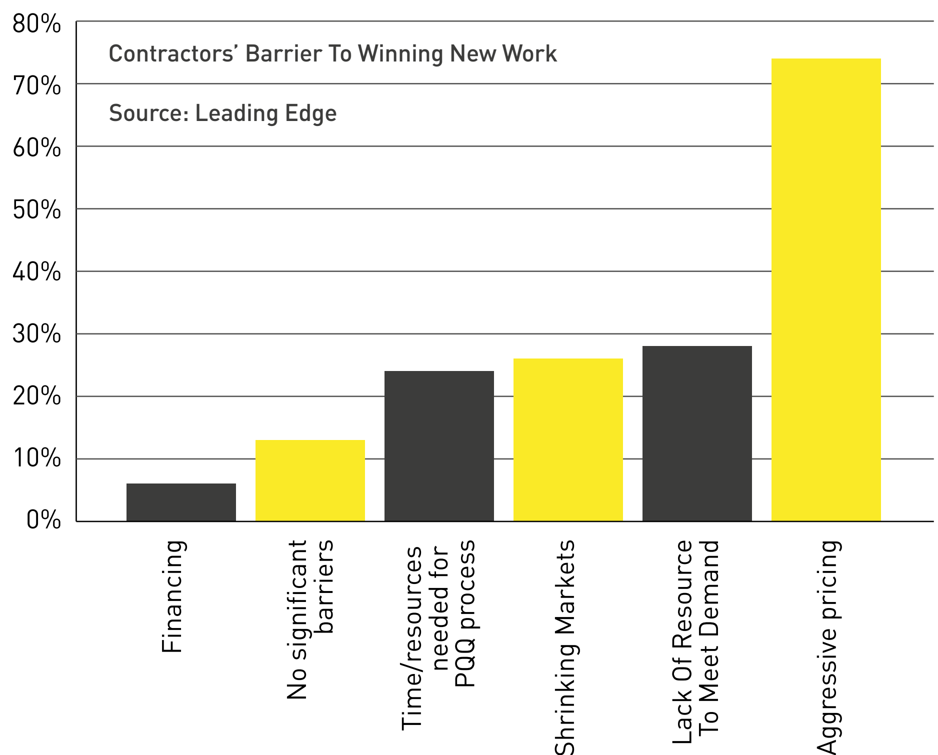
However, these are very uncertain times and there are a couple of factors that could see these declines averted or at least mitigated. The weaker pound, while pushing up costs, could also attract investors, especially those from the middle east and far east who might now view Britain as a more welcoming prospect than America following the election of Donald Trump.

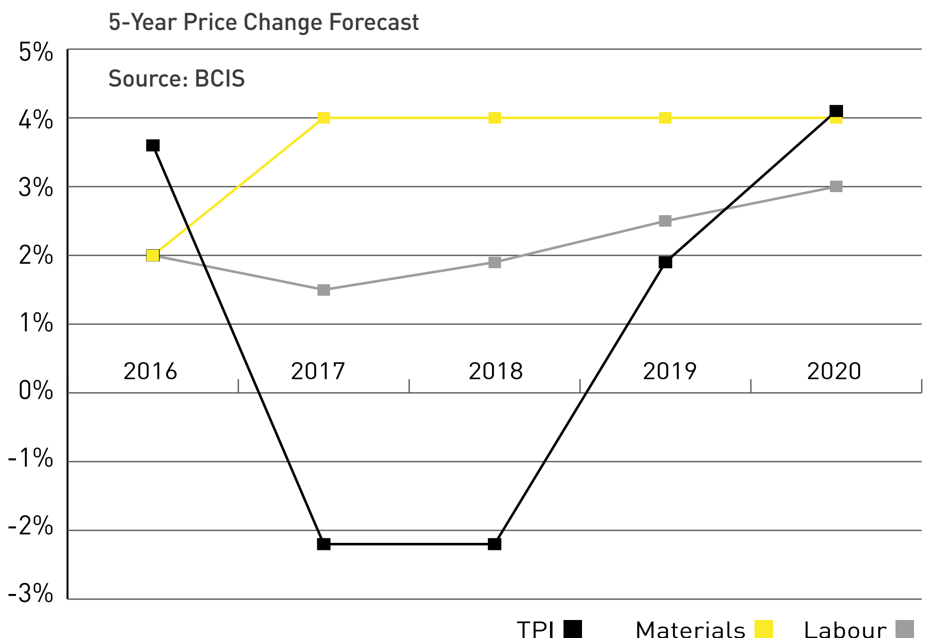
The Chancellor of the Exchequer revealed new spending plans in his Autumn statement on November 23rd. Fairly modest in its ambitions, it did however include boosts for infrastructure (£2.3bn for local projects) and house building (£1.4bn for affordable housing).

As mentioned, the CPA is forecasting a decline in construction work in 2017, this combined with the likelihood of further input cost rises will make the next 12 months a challenge for the sector.

Tender prices could well fall next year as demand falls and contractors reduce their prices. The BCIS has forecast tender prices will fall by -2.2% in 2017 and a further -2.2% in 2018 before recovering.

However, due to the cheap pound and tight labour market, material and labour costs will likely rise ahead of tender prices over the next couple of years, putting pressure on contractor margins.





Hotels Update

High supply and economic uncertainty combine to weigh on London hotel revenue in 2016 and 2017, although the picture is slightly brighter in the regions.

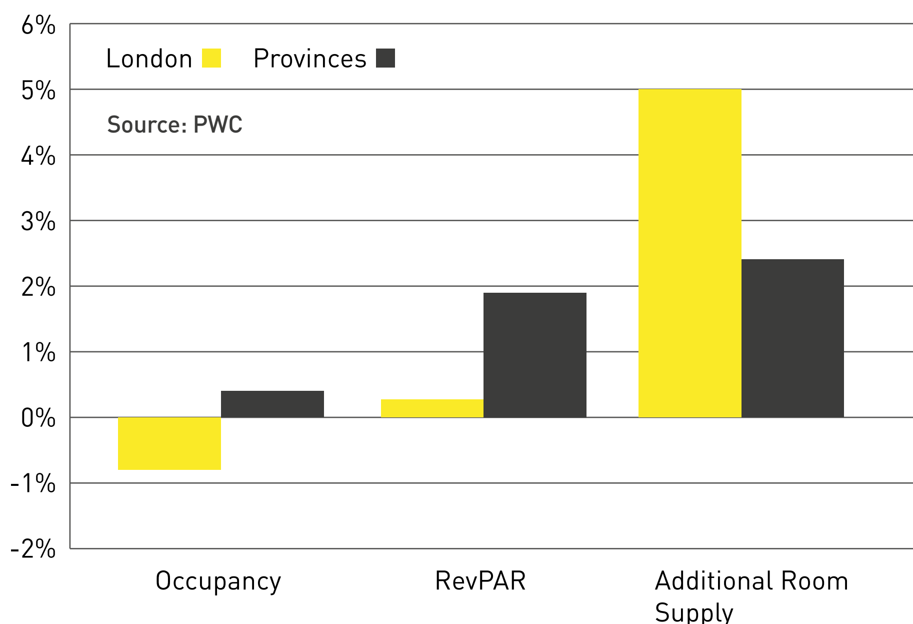
Data for the first half of 2016 was disappointing for hotels in London, and the outlook for the next 18 months is precarious. As we've noted in previous reports, new room supply in London has been running high for the last couple of years, and this combined with a small fall in demand has seen revenue per available room (RevPAR) fall in the capital. Outside of London, growth in occupancy and revenue has continued, although this will be challenged over the next couple of years.

The main issue is Brexit. While the fall in the pound appears to have boosted tourism slightly, it also appears to have contributed to a reduction in business travel. Continued uncertainty generated by the Brexit process will likely continue to weigh on business custom.

London hotels will continue to be challenged by an ever-growing supply of rooms over the next couple of years. PriceWaterhouseCoopers expect room supply to increase by 4.5% in 2017 and 5% in 2018, which is more than double the average annual increase between 1995 and 2015. PWC's survey of hoteliers found 66% thought high room supply would drag on trading throughout 2017.

The bulk of these new rooms, not just in London but throughout the UK, has been in the budget sector, and this will continue to be the main area of growth over the next two years.

Forecast Change For 2017



Matching the slowing growth in revenue is a decline in deals. 2015 was a bumper year with over £9bn worth of hotel deals. 2016 was never likely to come close to matching that, but the decline has been larger than expected. By the end of July the value was almost 70% lower than at the same point in 2015.

Some of this fall is due to the uncertainty around the result of the EU referendum, and it's interesting to see how the type and origin of investors has changed this year. UK based investors now account for around 70% of deals compared to just under 40% three years ago. Over the same time individual investors and hotel operators have come to account for over 70% of deals compared to around just 10% in 2013, when sovereign wealth funds and private equity funds dominated the market. This appears to be an early indicator that less foreign money is entering the UK in 2016. Whether the better than expected state of the economy in Q3 will tempt some back remains to be seen.

While Brexit is the headline issue for hotel deals, there is a second factor restraining the market and that's a lack of supply of prime London hotels and quality hotel portfolios. As always in uncertain times, quality assets will continue to attract buyers.

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Global Economic Update

The second half of 2016 has heralded an improvement in the global economic picture compared to the start of the year when markets were very volatile. The USA, Euro area and China – the three main economic blocks – all posted reasonable GDP growth figures in Q2 and Q3, with the USA growing at its fastest pace for two years.

The IMF's most recent global forecast in October suggested growth would be steady from 2016 to 2017 for the US, Eurozone and China (but a slowdown in the UK from 1.8% this year to 1.1% next year).

The cautious outlook reflects the problems bubbling under the surface of the large economic areas, the biggest one being debt. The IMF warned that with global debt at an all-time high of $152 trillion – with $100 trillion of that belonging to the private sector – and growth at lower than average levels, public and private institutions were struggling to grow their way out of the burden. While interest rates remain low this might not be an immediate problem, but with inflation looking to make a comeback – and with it, rising interest rates – this huge debt could become a serious problem in 2017.

Much of this depends on the policies of President-elect Donald Trump. After his shock win on November 8 – which also saw the Republicans win majorities in the House of Representatives and the Senate – it was predicted that markets would plummet, but that didn't come to pass. The policies he outlined on the campaign trail range from vague to infeasible. But two economic ones that he will almost certainly pursue are cuts to corporation tax and increased fiscal spending. Both of these bode well for American businesses, which explains some of the stock market's positive response to Trump's victory.

However, they also point to a future of higher inflation. His colossal infrastructure spending plan requires about a trillion dollars, while the cut in corporation tax will reduce tax revenues (in the short term at least and in the longer term too if there isn't a huge growth boost from the policies). This means the government will be borrowing a lot more and spending more.

While the stock market rose in response to his win, the bond market saw a big sell off and yields jumping on American government debt. This signaled that the bond market sees higher inflation in the US as a virtual certainty, with higher interest rates also a likely to follow. Whether the growth will come too remains to be seen.

We won't speculate anymore on what Donald Trump's time in office might mean for the global economy in terms of trade and growth. We'll wait until he is inaugurated in January when hopefully the world will have a better idea of what the future might look like under President Trump.

Special Comment – Return of inflation And What Comes Next

Inflation has been largely absent in developed economies – especially the UK, USA and Eurozone - since the end of 2011. 2015 even saw inflation hit 0% and then dip into negative territory.

Over the last 12 months inflation has been creeping back in the UK. This has been due to a number of factors, including; a historically high employment level causing wages to rise; the fall in oil prices from 2015 dropping out of the 2016 data; the recent rise in oil prices; the large decline in the pound following the EU referendum result.

Similar factors – excluding the UK's referendum vote obviously – are causing prices to rise in other countries.

Inflation is something most countries will welcome as it reduces the value of debt and more importantly it should allow central banks to raise interest rates. This rise, which has been put off repeatedly over the last two years (not totally unreasonably either) is needed to remedy the damage of ultra low rates:

- The ultra low rates in developed economies have punished those who don't invest in assets and traditionally put excess income in a savings account, which is the majority of the working population.
- It has created an ultra-low cost of capital, which reduces the need for businesses to improve productivity in order to generate higher returns. In essence, it allows inefficient companies to survive.
- It has led to increased investment in various assets as cheap money searches for better than low-interest returns. Much of this will have gone into riskier assets, which offer higher returns.
- It has reduced the options available to central banks to stimulate the economy when there is a downturn.

Some sort of return to monetary normality is needed to address the issues above. However, there is also a substantial risk in this.

After the financial crisis trillions of dollars were printed to try and stimulate the global economy, debt became incredibly cheap. At some point though the cost of this debt will start to rise. When it does, those companies, institutions and governments that have invested poorly will be caught out as their investment returns do not cover the cost of servicing the debt.

Then of course there is your average citizen who has taken out low interest loans for houses, cars and other things. A rise in interest rates from 0.25% to 0.5% effectively doubles the interest amount. How many people will find themselves in trouble when this happens?

The world has seen a change in the political landscape with the Brexit vote and the Trump win in 2016. In 2017 we'll see the economic impact of these political changes, likely in the form of higher inflation and interest rates. How many will be caught out by their return?

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