Bradbrook

Research Bulletin | Summer 2015

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Headlines

- UK GDP falls short of expectations in Q1
- Inflation turns negative in April
- Official construction output figures disputed
- Tender prices average 6.7% in 12 months to April
- Budget end of hotel market outperforms top end

Bulletin #02
Written by: David Price
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www.bradbrook.london
info@bradbrook.london

UK Economy Overview

GDP data for first quarter 2015 showed the economy grew by 0.3%. This was slightly disappointing as analysts were expecting growth of 0.5%. The Q1 figure is also half what was seen in Q4 2014 (0.6%) and represents the lowest growth for 3 years. A large portion of the blame for the lower growth was laid on construction, which the ONS said shrunk by -1.1% in Q1 2015, which follows a decline of -2.2% in Q4 2014.

The Bank of England forecasts inflation to be positive again by the end of the summer

However, a dispute is growing between the Office of National Statistics (ONS), which produces the output figures, and other construction industry economists who say their data shows the industry actually grew in Q4 2014 and Q1 2015. We have more detail on this in the construction overview section.

Unemployment in Q1 fell to just 5.5%, and there was positive news on the wage front, with earnings increasing 1.9% compared to a year earlier (2.2% incl. bonuses). It is expected that wage increases will start to pick up as the low unemployment rate tightens the labour market.

There was big inflation news this month as CPI turned negative, as prices fell in April by -0.1% compared to a year earlier. The country has not experienced negative inflation for 51 years.

Some have labelled it deflation, but that's not strictly true in economic terms. Deflation is a sustained fall in prices across virtually all items, which becomes self-perpetuating and gives central bankers nightmares. What we have in the UK is a small fall in a few items, largely attributed to the collapse in the price of oil and 'price wars' driving down the cost of food.

The Bank of England forecasts inflation to be positive again by the end of the summer, with rising wages and a rebound in oil prices being the driving force.

I would add a couple notes of caution to this; first, a strong rebound in the oil price is not certain. OPEC and the IEA have highlighted large production surpluses, so prices may not rebound with the kind of vigour many expect. Second, while a tightening labour market will almost certainly see wages rise, this might be at a low rate if the economic slowdown seen between Q4 14 and Q1 15 carries over to Q2.

With inflation at rock bottom levels a rise in interest rates has been pushed further back and the Bank of England kept rates at an unchanged 0.5% in May. Forecasters now do not expect rates to rise until the very end of 2015, but it is more likely to be in 2016, when forecasters average them at 1.3%

In spite of the disappointing data for Q1, GDP is still expected to expand by more than 2% for 2015. The Treasury's survey of independent analysts in May has GDP forecast at 2.5% for 2015, down from 2.6% in their April survey. Meanwhile, the Bank of England's own forecast has been revised down from the highly optimistic 2.9% to the more consensus bound 2.5%.

Further ahead the outlook for GDP growth is 2.5% in 2016, 2.3% in 2017 and 2.5% in 2018.

	GDP	CPI	RPI	Interest Rate	Unemployment
2015	2.5%	0.6%	1.4%	0.5%	5.3m
2016	2.5%	1.8%	2.9%	1.3%	5.0m

Forecasts: HM Treasury Survey

It is expected that wage increases will start to pick up as the low unemployment rate tightens the labour market.

Global Economic Update

The big global economic headline at the moment, and for the foreseeable future, is once again Greece. The Greek Syriza government has been locked in talks with the European Central Bank for weeks as they try to reach an agreement to have more funds released in exchange for economic reforms.

It looked as if things were going to reach a crescendo on May 12th when the country said it had no funds to repay the IMF €762m. Fortunately at the eleventh hour the money was found... in an IMF emergency fund. Between June 5th and June 19th a further €1.5bn of payments to the IMF become due, and there is no emergency fund this time.

The ECB have agreed to provide a rescue package of €7.2bn to Greece, but only in exchange for more austerity measures. The ECB could release the funds without the reforms, but Germany, which is basically bankrolling things at this point, will not accept that.

The question is who will concede ground first? A Greek government that was elected on the promise of ending austerity, or a German backed central bank that feels it is being punished for its own past prudence? And even if Greece makes its June payments there are more large obligations due in July, August, September, etc...

If Greece does leave the Euro in the next 12 months, which is eminently possible, the impact on the UK is unclear as this situation hasn't arisen before. It is hoped that the banking reforms that followed the financial crisis would help to limit contagion of a Greek default, but an exit could well tip the Eurozone back into recession, and as the UK's main trading partner that would obviously be damaging.

While Greece may be reaching its end game in the Eurozone, there has been more positive data from the other countries. GDP for the whole area was up 0.4% in Q1 2015, the largest increase for almost 2 years. France and Italy both posted better than expected numbers at 0.3% and 0.6% respectively, while Germany disappointed slightly growing by 0.3%. Employment and job creation in Europe also hit a 4 year high.

Recent data from America has been slightly disappointing, with GDP in Q1 2015 growing by just 0.2%. This has been blamed on the weather and a strike at ports on the western seaboard. With these two issues not being a factor for Q2, analysts expect growth to snapback data. The overall outlook for 2015 is still positive.

Q1 2015 saw the Eurozone record its highest growth in almost 2 years at 0.4%

In our last report we highlighted the importance of currency trends in 2015. The pound has continued to appreciate against the Euro – something that has been cited as another factor in the UK's falling inflation as the cost of European imports fell. The Euro is currently around €1.41 to £1 and is expected to fall further.

The pound has appreciated slightly against the dollar to $1.53 to £1 after bottoming out around $1.46 at the beginning of April. The disappointing US data from Q1 has tempered the rise of the dollar, but it is still expected to strengthen against sterling in 2015, albeit with more fluctuations and fall backs.

The strength of the pound is likely to weigh down on exports and boost imports, which will likely drag down UK GDP in Q2. Hopefully that will be offset by increased consumer spending, which rose in April and May.

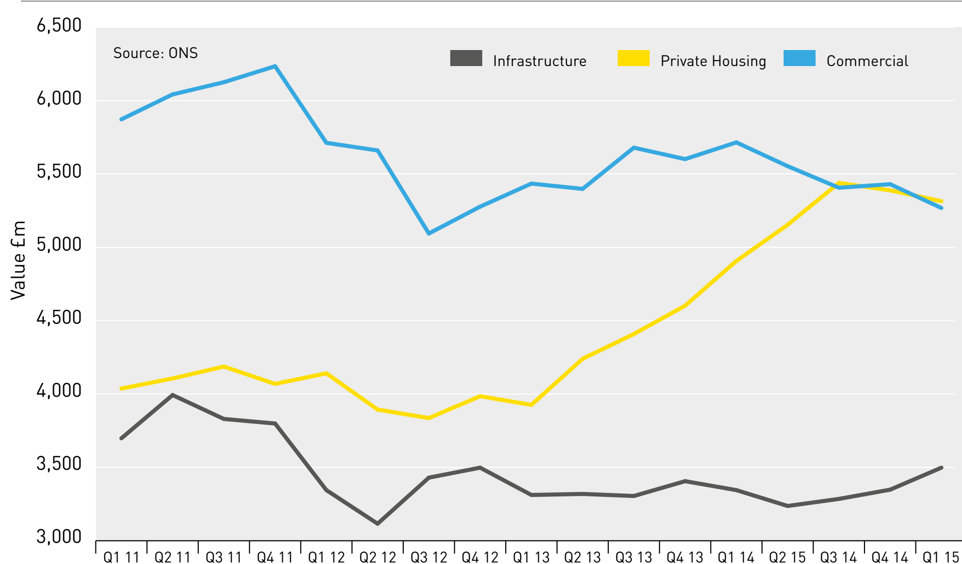
Construction Overview

As mentioned in discussion of UK GDP figures, construction output recorded a fall of 1.1% in Q1 2015 to add to the fall of 2.2% in Q4 14 according to the ONS, which puts the industry in a technical recession.

Private commercial output continued a disappointing downward trend and has now fallen 8% since its last peak in Q2 2014. Meanwhile, house building, which has been the engine for growth in construction in the last couple of years, also dipped in the last 6 months, falling 2%.

All new construction output (which also includes industrial, public housing and public non-housing) fell by -2% since Q3 14. But it's not just new work that has fallen over the last 6 months, data shows repair and maintenance work has also fallen by -5.2%

New Construction Output



A dispute has emerged between the ONS and other economists who say the national statistics body's data is inaccurate and underreporting activity. The ONS has said little on the issue so far, maintaining that it is "the biggest and best measure of the UK construction sector". The ONS has access to more data than any other statistics gatherer in the UK, however, they are being criticised for lacking specialist knowledge of the construction sector and misreporting outputs. It's alleged that the huge £1.5bn Heathrow Terminal 5 was never recorded in output statistics.
It's reported that the statistics body has met with the CPA to discuss the disputed output figures.

But until there is more clarity on the issue we will have to view the ONS figures with some caution.

If the industry was in recession we would expect to see prices and costs fall in other areas as the industry reacted to the contraction.
This is what is being reported from those areas:

1. Tender Prices and Market Conditions

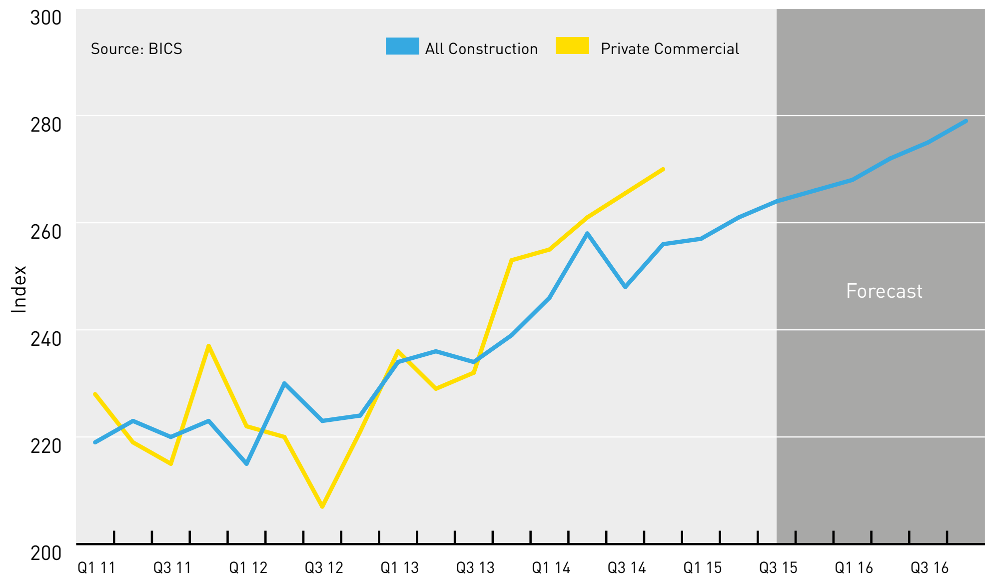
In a recession tender prices would fall at the same time or even ahead of output data, as contractors start dropping prices to win work in a shrinking market. This is most definitely not the case at the moment.

As you can see, tender prices for commercial work and overall construction have been on an almost unstoppable rise since mid-2012. Tender prices for all construction averaged a 6.7% increase in the 12 months to Q1 15. The BCIS forecasts prices to continue to rise year on year by 4.3% by Q1 2016, 5.6% by Q1 2017 and 4.9% by Q1 2018.

The rise seen over the last couple of years has not been fuelled by material or labour price increases, which have been fairly subdued, which suggests it is due to contractors increasing add-ons including profit as they seek to rebuild margins slashed during the recession. This is not the activity of a contractor working in a shrinking market.

The BCIS also produces a Building Market Conditions Factor, which looks at tender prices minus costs to tease out contractor add-ons, which are then taken as a proxy for confidence. The most recent release shows that in Q1 15 the index hit its highest level in more than 7 years.

New Work Tender Prices



Tender prices for all construction averaged a 6.7% increase in the 12 months to Q1 15

2. Labour and Materials

An industry in recession would see more available labour as well as falling or stagnant wages and material costs. What we're hearing from contractors and seeing in the data released by the BCIS and others is quite different.

Data from the CPA shows that in Q1 2015 22% of contractors reported difficulty in recruiting labour, with bricklayers in particular being in very short supply. Admittedly the Q1 data was a drop from Q4 2014 when 31% reported recruitment difficulties, but nevertheless it is still higher than at any other time since early 2008.

The difficulty with recruitment is naturally pushing up labour costs. Construction industry wage awards for 2015 have been agreed at around 2.5%. This is expected to increase by about 3-4% per annum between now and the start of 2018, which is slightly ahead of expected general wage increases for the wider economy.

In the short-term, material prices are expected to remain subdued thanks to the strong pound and relatively low global construction activity. Forecasters have materials rising by between 2-3% per annum between now and 2018.

Contractors are reporting that labour availability is at its tightest since 2008.

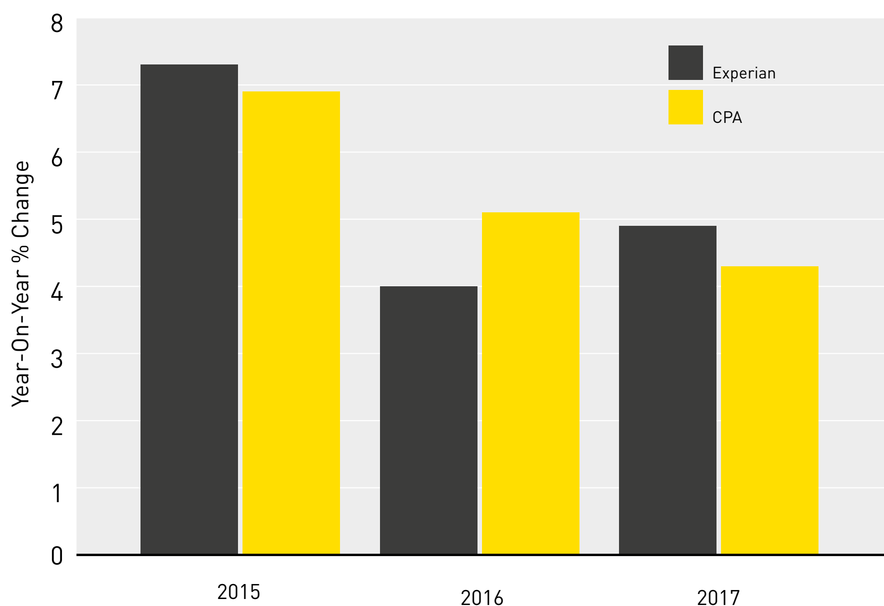
3. Construction Output Forecasts

The ONS doesn't issue forecasts for output but other economists do, and they are optimistic about the short to medium term outlook for construction. The BCIS is currently forecasting output to grow by 5.6% in 2015 then between about 3-4.5% to the end of 2017. Forecasts by Experian and the CPA are even higher as shown in the chart (right).

Rising tender prices, rising wages, labour shortages, strong forecasts: these factors suggest the ONS construction output data is not fully reflecting the state of the industry. It seems likely that there was a slowdown in the last 6 months, but a full-blown recession doesn't seem right.

The evidence we are privy to, both numerical and anecdotal, tells us the industry is not in recession, certainly not within the M25 and barring external shocks it should grow strongly over the next few years.

Construction Output Forecasts



Hotels

Visitor Numbers

Data for visitors to the UK for the whole of 2014 is now available and shows another year of growth with 34.8m visits, an increase of almost 6% on 2013. Holiday tourism is still the leader with 13.8m trips and it also posted the strongest growth, up 7.7%. Business visitors were also up by 5.5% to 8.4m. The main origin for these visitors is still overwhelmingly European, accounting for around three-quarters of all visits.

Forecasts for 2015 are strong, with an expectation that visitor numbers will increase by 2.5% and visitor spending will increase by 4.5%, or roughly £1bn in monetary terms.

Hotel transactions

Full year data for 2014 showed that the hotel sector is still very popular with investors. The overall value of hotel transactions was £6.1bn, with the average exchange around £60m, a remarkable 31% increase on 2013. The average value per room was £169k, a little up on last year's £160k. Accountants BDO suggest this indicates "investors moving out of primary locations to seek better value for money."

This chimes with what we reported last quarter; with the London market becoming more congested, there are potentially greater yields available and more revenue growth possible in regional hotels. Recent data from HotStats corroborates this view as they report Gross Operating Profit Per Available Room (GOPPAR) fell in London between April 2015 and April 2014 while the regions saw it grow. This may be attributed to regional hotels suffering more between 2008 and 2012 relative to London, therefore having more opportunity to make up lost ground.

However, London is still the most attractive location for new hotels. The number of new rooms in London is expected to increase by 9%, from 5,868 to 6,400. By comparison, the whole of the rest of the England saw 4,818 new rooms open in 2014.

Aside from the growing strength of the regions, the other big trend in 2014 was the strength at the lower end of the market. Research by BDO showed that the two segments with the strongest room yield growth in 2014 were Business (£75-£100) and Tourist (<£75) rooms, which saw yields up 4.1% and 9.9% over the year. Conversely, the top end of the market saw yield growth fall, with Superior (>£150) and Superior Deluxe (>£200) rooms dropping -1.8% and -3.3% respectively.

The turn in the market at both ends is attributed to new entrants. At the lower end new brands such as Citizen M and Qbic are delivering high quality, low cost rooms that are more attractive to short-stay and business tourists, while at the top end more expensive developments in London have created greater supply for a market segment that is not growing as quickly.

The outlook for 2015 is positive for London and the regions. Lower oil prices and cheaper transport may see an uptick in tourism, which is forecast to break through 35m in 2015. Another boon for tourism will be the Rugby World Cup, which is hosted in England and Wales in September and October.

The strong level of transactions in the hotel sector seen in 2014 will likely be repeated in 2015. The UK's relatively strong economic performance coupled with the continuation of rock-bottom interest rates means investors will maintain their appetite for UK hotels.

The risks to the hotel sector at the moment are largely macroeconomic; further trouble in the Eurozone could dent investor confidence; the falling Euro and a stalling Dollar will make the UK more expensive for tourists; sluggish growth in the far-east will likely result in fewer UK visitors from the region.

Special Comment

The Conservatives And Construction

Against the divinations of the pollsters, the opinions of the commentariat and even the shrewd calculations of the bookies the Conservative party secured a governing majority in the general election.

This has largely been welcomed by the construction sector. The continuity of government should mean that new spending will be implemented faster and projects in progress won't be stalled.

The government outlined the policies it will look to legislate in last week's Queen's speech. There were some specifically relevant to the building industry, with the headline one being the extension of Right To Buy to Housing Association tenants. The policy was roundly criticised before the election for not being fully costed and not addressing the root cause of the housing problem, namely the lack of new houses being built.

The government says that the proceeds from Right To Buy sales will be used to build new houses on a one-for-one basis. This was tried before and saw about 1 in 10 council houses actually replaced, in some areas it was just 1 in 19. If I were a contractor I wouldn't see Right to Buy as a boon; it's a demand-side, vote winner that will have negligible impact on supply. I'd probably be rubbing my hands if I were an estate agent though.

A pledge to devolve more power to regions may have some effect on reforming local planning laws, which constrain new house building. But without detailed policies it is hard to say how effective this will be.

A less sexy, headline grabbing pledge is the creation of 3 million apprenticeships over the next 5 years. With the shortage of skilled labour in the construction industry, this is very welcome. The policy will take a few years to start bearing fruit, but it could make a big difference to building costs and productivity in the long term.

Other policies around small businesses and national insurance could tangentially affect the industry, but the one that was not about construction but could have the biggest impact is the issue that will dominate politics for the next year or so; the EU referendum.

The pledge to have a EU In/Out referendum by 2017 is one of David Cameron's longest standing pledges (although it will almost certainly be brought forward to 2016 now).

There is a strong anti-EU feeling for many in the country, as evidenced by the rise of Ukip. However, many predict that in a referendum a majority will opt to stay in the EU, something the bookmakers – who did a better job than the pollsters on the Scottish referendum and the general election – are reflecting with their short odds for 'In'.

It is impossible to know what the effect of Britain leaving the EU would be. Will EU nationals have to return to their home countries immediately? What about Brits living in the EU? Could we keep free trade? What about military and intelligence cooperation?

One thing is certain; it will be very messy and take years to sort out. As Dennis MacShane, Minister for Europe under Tony Blair, says:

"...two years of Brexit [British EU Exit] negotiations will be hell. It will be monumental and destabilising and will dominate our relations with all our trading partners."

If the UK did vote to leave, financial markets would react quickly. But the more pervasive demographic, fiscal and structural economic effects would take years to become clear. Some of what we could potentially expect:

Short-Term

- Save several billion pounds per annum in EU contributions
- Flight of money due to economic uncertainty leading to large falls in sterling and FTSE
- Fall in GDP (Centre for Economic Performance estimates a drop by as much as 9.5%)
- Stall or suspension of large projects, especially those with European partners (e.g. new power stations)

How many contractors and building projects would struggle if European investors and workers suddenly left?

Long-Term

- A smaller, older population
- Smaller tax base
- Less foreign investment in manufacturing in Britain
- Less pressure on housing, public services and infrastructure
- More freedom to negotiate trade deals with non-EU countries

Even if an exit is avoided there is still likely to be some economic damage in the run up to the referendum. Investors don't like uncertainty.

While the EU is far from perfect, the UK has gained more for being part of it. Access to the largest single market in the world has boosted foreign direct investment and has meant more people of working age coming to the country and keeping business costs down. How many contractors and building projects would struggle if European investors and workers suddenly left?

David Cameron will campaign for Britain to stay in the EU, and putting an 'In' result in as little doubt as possible is his most important job over the next 18 months. However, he also has to maintain the threat of Britain leaving the EU in order to secure reforms that Conservative backbenchers demand.

So on the one hand he has to convince the public that being in the EU is good for Britain, and on the other hand he has to try and secure reforms by telling European politicians that the current EU isn't good enough for Britain.

A very precarious tightrope. Good luck, Mr Cameron.