UK MARKET VIEW

ECONOMY PROVES RESILIENT AS CHANCES OF A RECESSION FADE

Q2 2023

We are in a much more hopeful position than we were a quarter ago. The economy has held-up better than seemed likely at the start of the year, and prices have reacted accordingly. Notably, pay in construction is currently going from strength-to-strength, leaving us with little option but to increase tender prices for this year. Whereas much of the past two years was focused on materials, skills shortages have re-emerged as arguably the biggest challenge facing the industry.

We are also seeing growing evidence of outperformance from outside London, with several key growth areas not centring around the capital. This is primarily in developing sectors, such as life sciences, pharma and advanced manufacturing, alongside priority sectors such as defence and a transition to clean energy, which are more commonly located outside London. Positively, such projects can drive more widespread regional growth.

Nonetheless, significant risks remain. Recent suggestions that interest rates could rise as high as 5.5% need careful watching. With the economy still incredibly fragile, such a shift could trigger a recession. Similarly, problems around insolvencies persist and, while material price inflation is cooling, its descent is minimal, leaving pressures still elevated.

Andy Beard
Global Head of Cost and Commercial Management

	2023	2024	2025	2026	2027
National	3.5%	2.5%	3.0%	3.0%	3.5%
London	3.0%	2.0%	2.5%	3.0%	3.5%

The table gives our current tender price inflation forecast. The figures should be treated as averages and there will always be variations due to procurement methods, project type and local factors.

The economy grew...

0.1%

in Q1 and is now forecast to rise this year.

The annual rate of material price inflation continues to cool, easing to

8.7%

in March, with base effects meaning they could soon become negative.

Interest rates continue to increase, and they now stand at...

4.5%

Regular pay in the construction industry reaccelerated, rising...

1.8%

in Q1, up 6.2% compared to a year ago.

While construction output rose in Q1, this was due to the repair and maintenance sector, and all new work declined

1.9%

SETTING THE SCENE

Data from the first quarter of the year has shown the UK economy to be holding up much better than previously forecast. As such, it is only right that we upgrade our tender price forecasts to reflect these developments. Our new 2023 forecast has increased from 2.5% to 3.0% in London and 3.5% elsewhere, while we have also nudged up our forecasts for the following two years. Recently, many organisations, including the IMF and Bank of England have made sizeable, positive adjustments to their GDP forecasts. HM Treasury, which compares many independent forecasts, now on average has GDP growing 0.2% this year compared to almost a 1% decline in January's release. It needs remembering that this is still a terrible figure, and the economy is essentially flatlining, but that GDP shouldn't now shrink this year is enough for us to revise our forecasts.

The main reason for the increase in the GDP forecast is a rise in private consumption expectations. In May, the consensus forecast was for there to be no change in consumption, whereas in January, the forecast was for it to drop 1.3% this year. First and foremost, justifying this shift is the drop in the price of natural gas. Spot prices are now around the level they were in mid-2021, noticeably lower than they were throughout last year. For construction materials, lags and hedging may mean it takes time for all of the benefits to appear. However, for households, most now on variable energy tariffs, these should happen sooner. On the energy side, the Spring Budget also helped consumers, with the extension of the Energy Price Guarantee, saving a typical household £160. A final reason that households are likely to maintain their expenditure is due to the tight labour market, with employed people much less likely to cut back on spending.

Whereas the wider economy is barely growing, the housing market is undergoing more considerable troubles. House prices have started to fall, and housebuilders are noticeably cutting back. In Q4 2022, starts were 7.5% lower than 12 months previously, while Q1 was the worst for private housing output since the global financial crisis. Added to this, the announcement that CPI inflation was 8.7%, along with an associated increase in likelihood of another interest rate rise, as well as a delay to when cuts will happen, resulted in a sell-off in housebuilders' shares. Yet it is not all unwelcome news, as housebuilders themselves have reported. Many are finding that sales are not falling as much as they thought they might, and that completions this year are likely to be towards the top end of guidance ranges. That they also anticipate moving into next year in a relatively positive fashion helps explain the thinking behind why we have increased our forecasts for the next two years. Nonetheless, the risk of more substantial interest rate rises and larger drops in house prices pose a risk to some of this analysis and is why we have only made a small adjustment to the forecasts. If the Monetary Policy Committee feels forced to raise them above 5%, the chances of a recession will increase significantly.

We also believe that London will perform worse than the other regions in the near term. Recent new orders figures show the capital struggling, and seeing large falls, in particular in infrastructure and housing. With much of the delays to HS2 centring around Euston, and potentially due to greater desire for houses than flats, there is a strong likelihood of greater tender price rises in the rest of the country. Moreover, private industrial – the current sectoral standout – accounts for a smaller share of expenditure in London. Additionally, some of the fastest growing sectors such as clean energy, technology, life sciences and advance manufacturing are all much more focused outside London.

In order to explain the economy's resilience, this report provides a detailed analysis of a number of official statistics, highlighting how it is performing better than earlier forecasts. Alongside this, we also take a look at the ONS's experimental survey statistics, which help complement some of these interpretations. As well as confirming suspicions that construction is one of the sectors facing the biggest skills shortages, the wide-ranging questionnaire also provides evidence that it still has a long way to go with regards to reducing its carbon emissions.

HOW THE ECONOMY IS FARING BETTER THAN EXPECTED

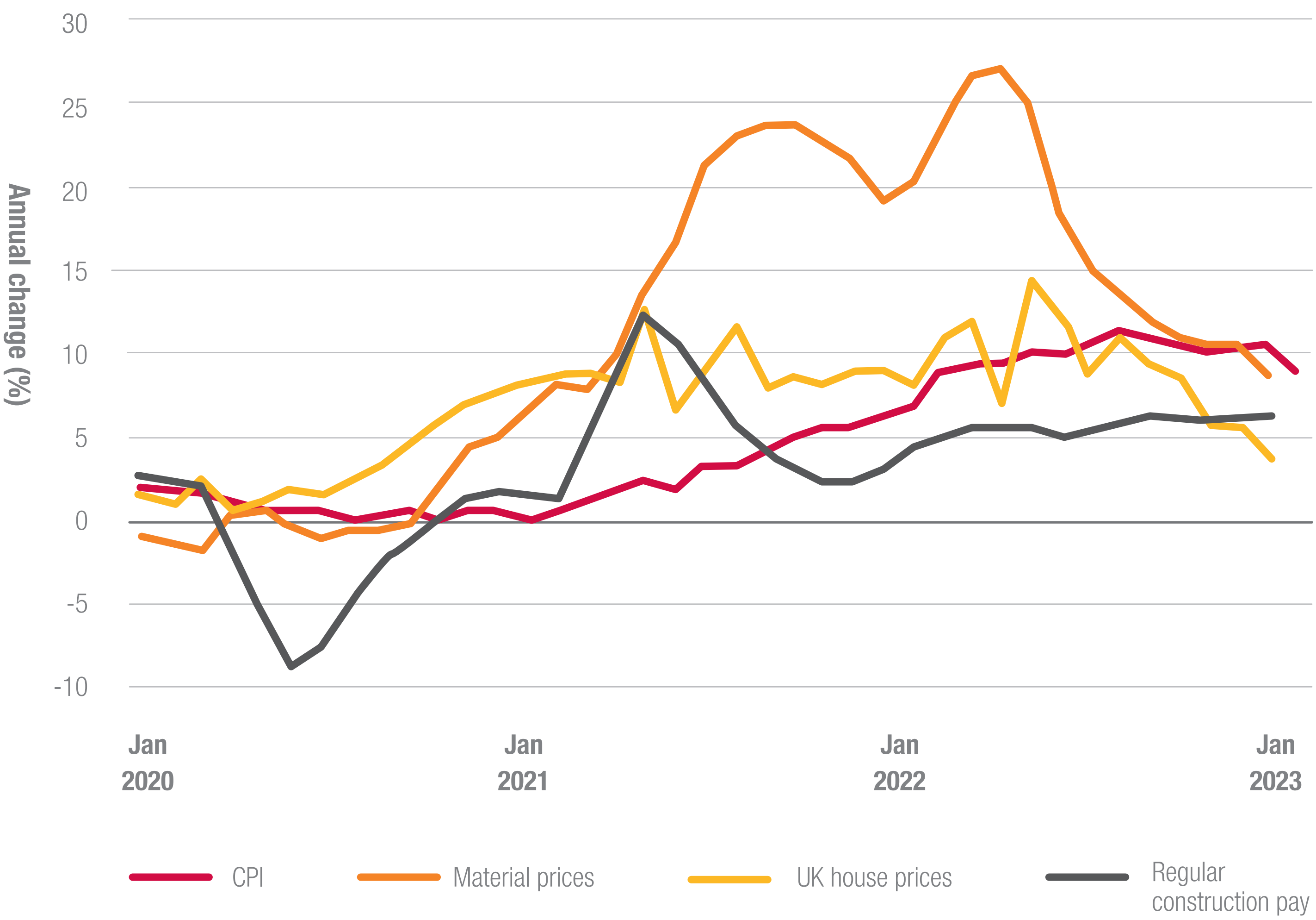
Against the start of year consensus, GDP managed to grow in Q1. Admittedly, it was the bare minimum to register as growth at just 0.1%. Yet against the challenging backdrop as well as expectations, it is encouraging. In particular, that there was no change in household consumption, despite the severe reductions in real incomes, suggests an unwillingness to scale back by consumers, which can only be positive for the economy. As mentioned, stronger levels of private consumption are the primary reason for revisions to GDP forecasts, and as long as people continue to spend, we should avoid becoming too pessimistic. Within the sectors, construction output expanded 0.7%, with services up 0.1% and manufacturing increasing 0.5%. Looking ahead, the ongoing industrial action, combined with the extra bank holiday, will stifle growth in Q2. However, the second half of the year should be more positive as inflation slows and confidence improves.

Another good indicator of the economy's strength is the labour market. While unemployment has ticked-up, it is only at 3.9%, and the modest drop in vacancies similarly implies only a slight loosening in conditions. Due to an increase in the economic activity rate, it was also a quarter where employment and unemployment could rise simultaneously. With 182,000 more people in work in the first quarter, the employment rate is at its highest since the pandemic. Such robustness has contributed to nominal pay continuing to rise, albeit growth is negative in real terms, as inflation erodes away the gains. As with the GDP forecasts, there have also been respectable improvements as far as unemployment is concerned. Rather than finishing the year at 4.6%, the latest suggestion is that it will only rise to 4.2%. Marginally higher than where we currently are, such a small movement is unlikely to materially hinder the potential for economic growth.

Low unemployment and high wages are also driving the Bank of England's decisions to raise interest rates to 4.5%. In each of the past 12 meetings, the Monetary Policy Committee have voted for interest rates to rise in an attempt to curb inflation and bring it back to their target of 2%. So far, it is not having the desired effect and, in April, the CPI basket rose by 1.2%. While base effects mean that annual inflation slipped to 8.7%, this is stubbornly high, and if it doesn't start to come down quicker, another, if not several more interest rate rises could be in the offing. Where higher interest rates are having an impact is on house prices. These have now declined 1.2% from November's peak, with further falls likely. Additionally, higher financing costs are having an effect on viability assessments and getting projects off the ground. Similarly, they are damaging valuations for large commercial landlords, forcing many to make noticeable write-downs. With inflation unlikely to drop to 2% until the second half of next year at the earliest, high interest rates, and thus challenges for developers, will persist.

SOME INFLATION RATES COOLING FASTER THAN OTHERS

Source: ONS, Department for Business and Trade, HM Land Registry



HOW CONSTRUCTION IS ALSO SHOWING SIGNS OF RELATIVE STRENGTH

Labour

We considered one of the bigger risks to tender prices this year being the labour market, and the first three months have reinforced these concerns. Regular construction pay rose 1.8% in the first quarter, and the annual growth rate remains above 6%. While, vacancies have come down, and are almost 10,000 lower than from last year's peak, at 40,000 they are still much higher than before the pandemic. With output holding up better than expected, the problem of labour shortages will continue to put pressure on pay.

Nonetheless, construction employers have not lost complete control of pay packages. Bonus payments in Q1 slumped, falling almost 10% compared to the final quarter of last year and down 26% relative to the same period in 2022. In large part, this is due to the previous 12 months being an exceptional one for bonuses, and it always seemed likely that employers might have to move from offering one-off incentives to increasing fixed pay. One problem with this is that if there is a more severe downturn than now looks likely, higher regular pay could tempt employers to make more significant job cuts than otherwise. Overall, the weakness in bonuses has led to total pay growth easing from 5.6% to 3.7%; much closer to the long-run average of 3%. However, for tender price considerations, it is regular pay which matters, and until this starts easing, contractors will have little choice but to pass on higher costs.

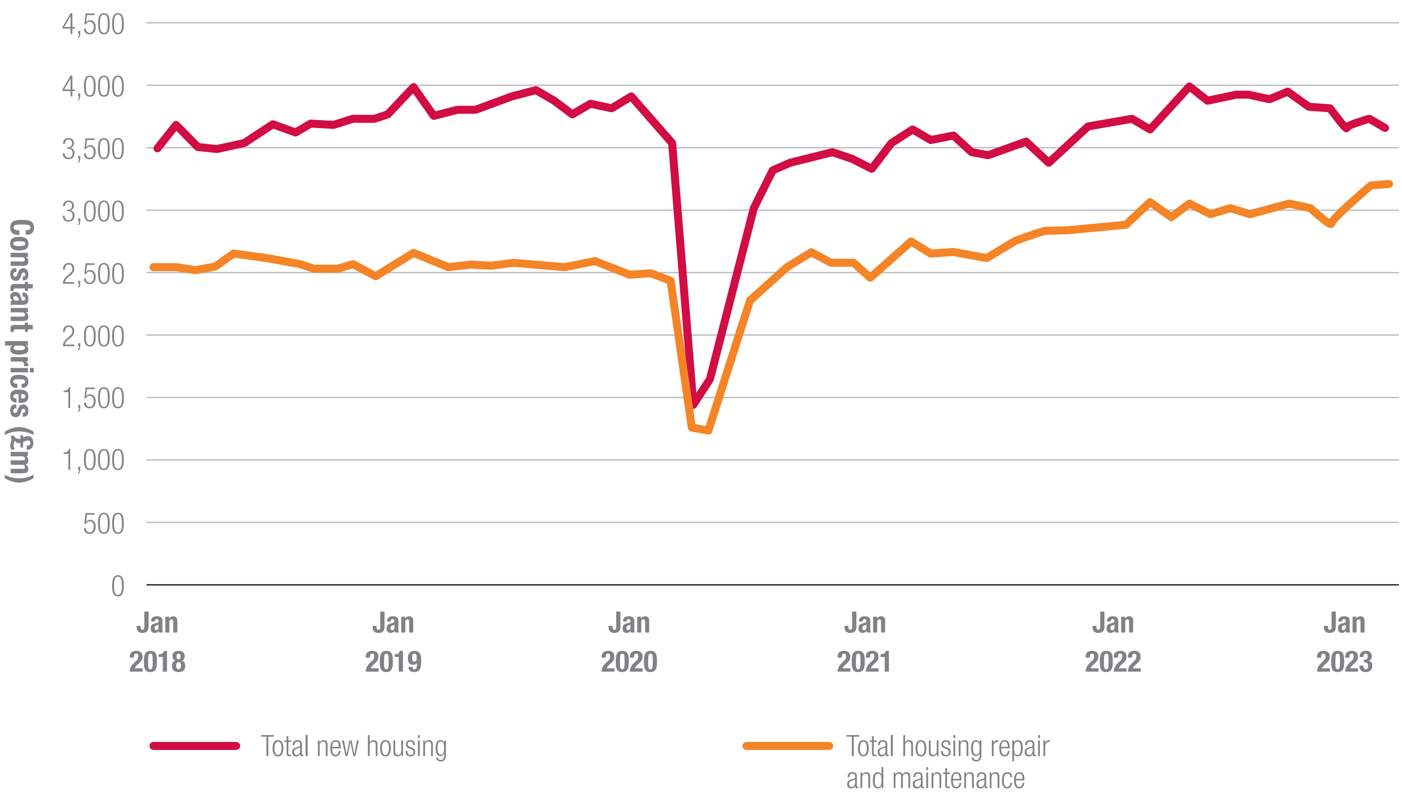
Output

It was a mixed quarter for output, with January proving tough due to the weather, but overall industry growth reaching 0.7%. Driving this growth was the repair and maintenance sector, with public housing up 6.7% and private housing rising 5.7%. Both sectors are also substantially higher than a year ago, and in the case of private households especially, the increase is hard to justify. Given the challenges surrounding falling real incomes, it would be reasonable to expect a slowdown on spending on such projects. Additionally, the sector surged following the pandemic, as many people, having made considerable savings, looked to improve their properties. As such, some easing might be expected, but the recent jump has left the sector almost 50% bigger than immediately before the pandemic. By contrast, new private housing is now declining precipitously. In the first quarter of the year, output dropped 5.3%, and further falls seem almost inevitable. Relative to Q1 2022, output is marginally higher, suggesting there is considerable scope for the sector to shrink. With house prices falling, interest rates rising and steep real income declining, it is no surprise new orders are down and housebuilders expect completions to fall. As an example, Taylor Wimpey anticipates completions dropping by a third this year, and against this backdrop, it is a question of how much will output drop.

Elsewhere in Q1, infrastructure output shrank 1.9%. Unable to recover from January's poor weather, decisions such as the one to rephase elements of HS2 have also hurt the sector. However, within all new work it was not wholly bad news. The three other sectors: non-housing public, private industrial and private commercial all rose. Growth of 4.2% in private industrial meant it had another strong quarter, rebounding from Q4 2022's decline. And, despite the slowdown in its annual rate, the sector is still almost 20% higher than a year ago and 25% larger than just before the pandemic. At the other end of the spectrum, private commercial is still down over 25% compared to Q4 2022, and while the sector did grow 0.7% in the first quarter, it will take considerably more than this before we get close to seeing a full recovery. The Deloitte London

REPAIR AND MAINTENANCE OUTPERFORMING NEW HOUSING

Source: ONS



Office Crane Survey Summer 2023 provides some optimism, with a significant number of new starts and a noticeable increase in the volume under construction occurring in the first few months of the year.

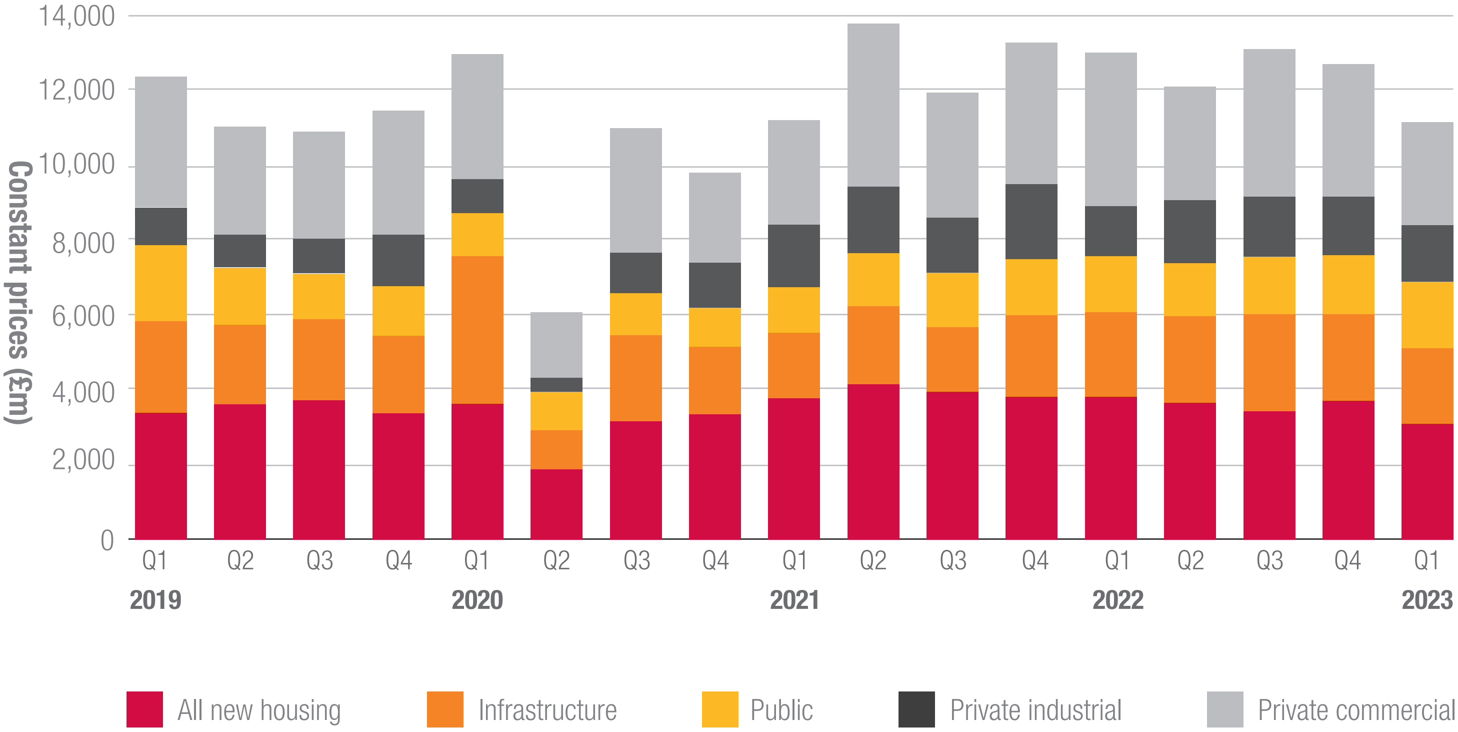
New Orders

After a relatively strong showing in 2022, it was a poor start to the year for new orders. Falling by 12.4% in the first quarter, public non-housing was the only sector not to decline. In particular, there were slumps in the two largest sectors, housing and commercial, both seeing a reduction in new orders of approximately 20%. Excluding Q2 2020, at the start of the pandemic, this was housing's worst quarter since 2012. While this should not come as a surprise, and indications from major housebuilders are that conditions may at best start improving in the second half of the year, it does cement the probability of further reductions in housing output. As the largest part of the industry, this shrinking sector will dampen tender price inflation.

The main bright spot within the latest data release came from the public non-housing sector. Growing for the fourth quarter running, it is now over a quarter larger than a year ago. Much of this increase has come from the health sector, which for the second quarter in a row outstripped schools and colleges. Health is a sector which has been rising in the past couple of years, and now, for the first time since 1999, its total new orders over the past four quarters is greater than that of the school sector. This also reflects a weakness in the school sector, which in cash terms are approximately the same as seven years ago. The ONS only provides information on these sub-sectors in nominal terms, and given the raised levels of recent inflation, in real terms, new orders for schools will be considerably down. Inevitably the result of this is fewer, or smaller schools being built.

SIZEABLE DROP IN NEW ORDERS IN Q1

Source: ONS



Material prices

The price of materials was 0.1% lower in the first quarter of the year than in Q4 2022. However, the vast changes in material prices in the past couple of years mean looking at one quarter in isolation is even less helpful than usual. Firstly, on a year-on-year basis, the 'all work construction material price index' is now 8.7% higher than in March 2022. This is far lower than the rate they were rising at previously, which peaked at 26.8% in June 2022, but remains significant. Relative to two years ago, prices are 30% up and, compared to March 2020(the start of the pandemic), prices have increased by over 40%. Such changes mean the drop of 3.3% since hitting a high last summer are at best modest, and at worst inconsequential. Worryingly, in February and March, material prices also rose. Increasing by 0.4% in both of the months shows renewed stickiness in prices and puts on hold hopes of a significant correction. By way of comparison, CPI and PPI are also coming down slowly in the UK, with inflation much higher than in many other countries, including the USA and Germany.

Recently, the price of Brent crude oil slumped below US$80 as fears of a US recession hit prices. Furthermore, European natural gas prices have sunk with a mild winter and gas storage going into the summer in a healthy state. The latter should provide some confidence that we won't see renewed price shocks later in the year, and both should pull material prices down. Additionally, in our previous report we highlighted the issue of China's reopening and what it might mean for commodities. The good news for UK construction is that, so far, a large part of the rebound in China has been in household consumption, with real estate and infrastructure having less of an impact. With demand not ramping up in the way it might, a number of metals, including iron ore, have fallen in price. Combined, all these factors indicate that construction material prices have the potential to drop in the coming months, but their current levels of stickiness mean that, even if they do, it is set to be limited rather. Manufacturers will want to keep prices high if they can, recouping previous losses when they may have been unable to pass on all of the initial spike in inputs.

WHAT THIS MEANS FOR TENDER PRICES

	Impact compared to last report	Summary
GDP	↑	While the lack of growth won't be boosting tender prices, that the economy is performing better than expected means it won't be acting as a drag either. Its relative strength is a key reason for our increase to tender prices.
Interest Rates	↓	Higher interest rates are having a negative effect on house prices, causing housebuilders to scale back. Similarly, they are impinging on viability assessments and making it harder for projects to get the green light. However, their upwards trajectory is roughly in line with where we expected, albeit the resilience of the economy and the strength of the labour market may push the Bank of England into further action.
Labour Costs	↑↑	Labour costs continue to rise rapidly. Base effects should lead to the annual pace of growth easing in the coming months, but unless the monthly rate also slows, they will exert further upwards pressure on tender prices. Low unemployment and sustained high vacancies and skills shortages also limit the potential for abatement.
Construction Output	=	Construction output did increase in the first quarter, but this was primarily on the back of the repair and maintenance sector. Nonetheless, the 1.9% reduction in all new work being down to the housing sector was fully expected and, as such, does little to change our view of how tender prices are moving.
New Orders	↓	Declining by more than 10% in the first quarter, most sectors struggled, with particularly noticeable drops in housing and commercial. Yet this movement hardly came as a surprise, and we had already factored much of this into our analysis. As a result, while still negative, that this was expected means it only has a limited impact on our forecasts.
Material Prices	=	That prices are not falling quicker is disappointing. With such large recent rises, the hope was that material prices might rapidly moderate. While the annual rate of inflation is slowing, prices rose in both February and March. Larger than expected drops in oil and gas should help, but we would have wanted to see more evidence of material price declines at the start of the year for them to trigger a shift down in our tender price forecasts.

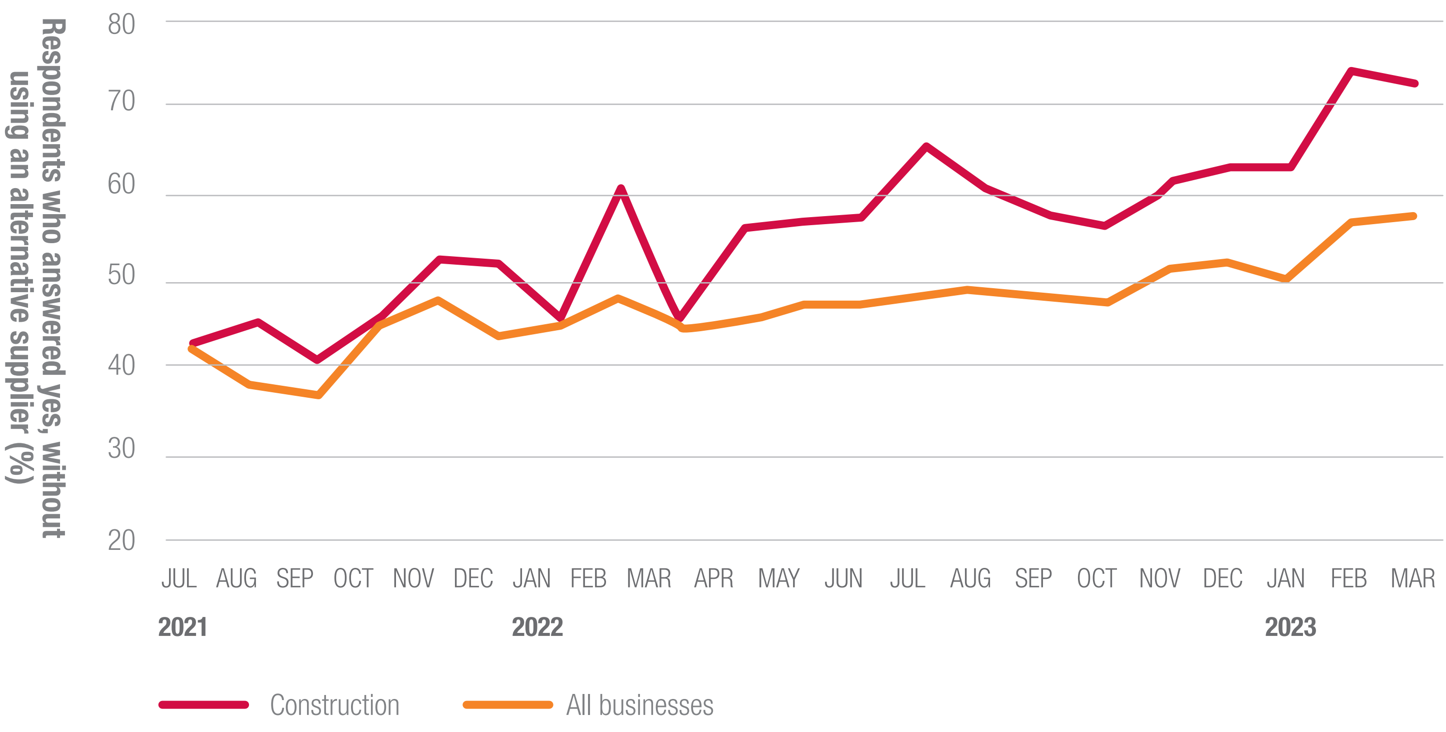
WHAT ARE BUSINESSES SAYING?

Since Covid, the Office for National Statistics has attempted to better understand the challenges facing the economy by conducting more frequent surveys. By sending businesses a fortnightly questionnaire, the hope is to gain a real-time gauge of the key issues they are having to deal with. Titled "Business insights and impact on the UK economy", many of the questions relate to subjects our Market Views regularly discuss, including worker shortages, material shortages and insolvencies. There are also a number of topics linked to Brexit, such as costs and time taken on importing and exporting, alongside UKCA Marking and Great Britain to Northern Ireland trade. While the survey is voluntary and, therefore, comes with problems, such as self-selection biases and a limited number of responses, it still comes with many interesting results that help shine a light on the construction industry and wider economy. The latest survey was sent to over 3,000 construction firms and almost 40,000 businesses in total. Of those, 662 construction companies responded with nearly 10,000 businesses providing information.

The biggest challenges for the industry over the past two years have related to materials, but conditions have improved immensely. The experimental survey statistics show the vast majority of firms are able to get the goods and services they require without using alternative suppliers, and after some challenges last autumn, this has been trending upwards since. Similarly, the number of firms experiencing global supply chain problems is noticeably down from previous levels, with EU disruption also noticeably down. Other indications that the worst is now someway behind us include the large drop in the number of construction businesses who increased prices relative to the previous month as well as those who will increase prices in the next month.

WAS YOUR BUSINESS ABLE TO GET THE MATERIALS, GOODS OR SERVICES IT NEEDED FROM WITHIN THE UK IN THE PAST MONTH?

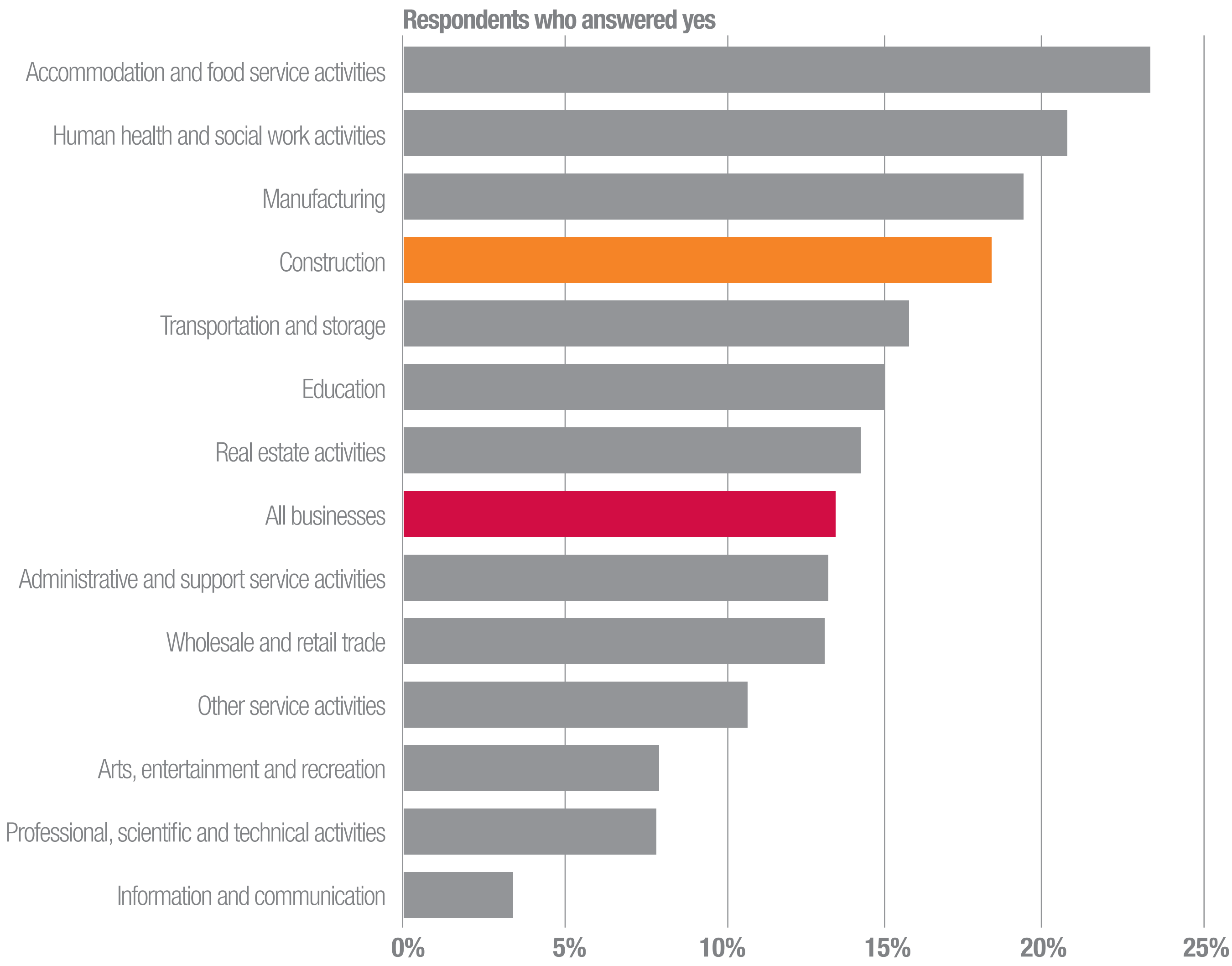
Source: ONS



Surveys such as the 'S&P Global / CIPS UK Construction PMI' regularly highlight the challenge of labour shortages in construction. Similarly, despite coming down, vacancies in the industry remain much higher than they were pre-pandemic. As the analysis we produce primarily focuses on construction, we don't always write about how other sectors are doing, and whether our industry is worse than others. The ONS survey data provides this level of detail, and it appears construction is one of the sectors suffering the most from worker shortages, although it is not the worst. In April, only three sectors: accommodation and food service activities, human health and social work activities, and manufacturing were finding recruitment more difficult. It also seems that, despite the recent drop in vacancies, there is not any firm indication that skills shortages are proving any less problematic.

IS YOUR BUSINESS CURRENTLY EXPERIENCING A SHORTAGE OF WORKERS?

Source: ONS



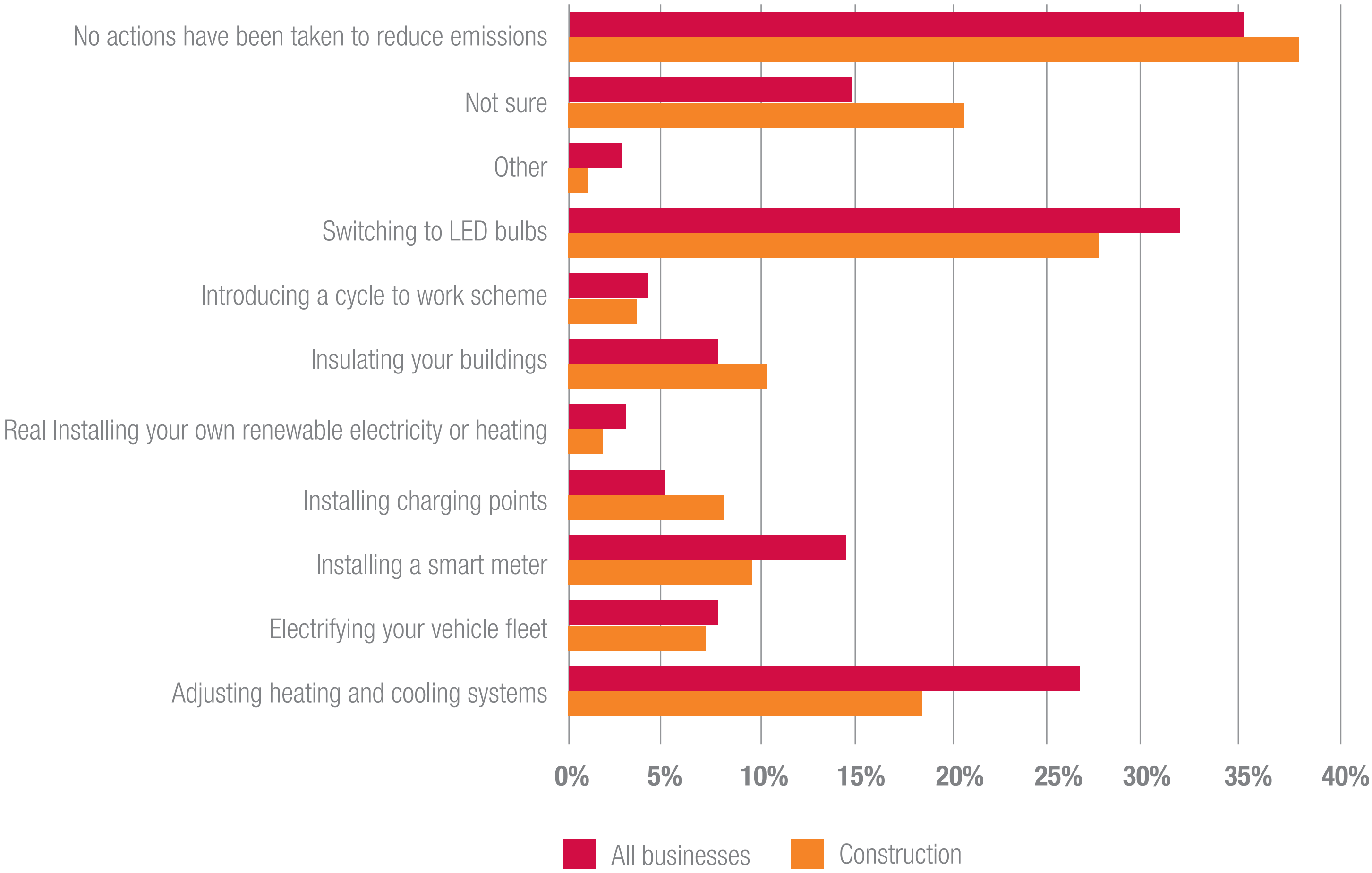
One of the more surprising results of the survey was responses to the question about a business's risk of insolvency. Over the past five quarters, since the start of 2022, official statistics produced by The Insolvency Service, have been fairly steady, with around 1,000 insolvencies a quarter. This is much higher than before the pandemic, with 800 insolvencies a quarter on average in 2019, and the previous high since the data started in 2013 barely topping 900. The natural interpretation of this is that the industry is currently going through a phase where the risk of insolvency is much higher than usual. Economic fundamentals such as a stagnant economy, rapidly rising costs, and higher interest rates also explain such problems. However, this is not borne out by those responding to the ONS survey. While the data is volatile, those reporting there was no risk of insolvency has increased from a little over 20% in spring 2021 to an average of 42% in the first five months of the year. Similarly, over this period, those reporting some risk of insolvency has dropped over time.

An inference from this is that some of the weakest firms have failed and that those still in operation are less vulnerable. The increase in those saying they are not at risk therefore comes as a result of stronger firms surviving and, as such, it should mean that insolvencies drop as the year progresses. However, there is a risk of self-selection within the survey. Those struggling may be less inclined to respond to such questions, potentially making them less reliable. Despite there not being an obvious reason for self-selection being more of an issue now when it wasn't two years ago, it does provide one reason to be cautious around these figures. We would also suggest it is far too early to stop paying very close attention to the supply chain. We would want to see several quarters of insolvencies falling according to official data, as well as improving economic fundamentals, before we become comfortable conditions and risks truly have changed.

Mace recently refreshed its Responsible Business Strategy, including the ambition to secure a pipeline of work that will save 10m tonnes of our client's carbon emissions. Focusing on a variety of ways to both decarbonise existing assets and ensure new builds are zero carbon, Mace is a market leader on this front and so questions around the actions businesses are taking to protect the environment and what they are doing to reduce their carbon emissions are of considerable interest to us. Compared to all businesses, the construction industry is performing marginally worse and, while behaviour is improving, there is still a long way to go. According to the latest survey, over a third of businesses were not taking any actions to reduce carbon emissions; noticeably lower than the 65% of construction firms and 58% of all businesses who were not doing anything when the question was first asked two years ago. However, more worryingly, barely any firms have a climate change strategy, a net zero target, or publish an annual sustainability report. There may not be a direct link between these factors and tender prices but, increasingly, such information is valuable in boosting the chances of winning a tender.

WHICH OF THE FOLLOWING ACTIONS, IF ANY, HAVE YOU TAKEN TO REDUCE YOUR BUSINESS'S CARBON EMISSIONS?

Source: ONS



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