mace

MARKET UNCERTAINTY CONTINUES TO IMPACT UPON FUTURE INVESTMENT GROWTH

TENDER COST UPDATE UK

ECONOMY

Third quarter growth slows to 0.5%, beating expectations, but still lower than during the second quarter.

PROPERTY

Confidence in the construction industry rebounds and now points to a growing sector

HOUSING

8% yearly housing growth underpins new construction output.

COMMERCIAL

Activity in commercial sector drops for fourth consecutive month.

BUSINESS INVESTMENT

Business investment rose by 2.9% in the second quarter.

0.6%

INFLATION

Effects of deprecation start to be felt as CPI rises to 1%.

INFRASTRUCURE

17.4% quarter-on-quarter drop in new orders in second quarter.

SURVEYORS' WORKLOAD

Slight pick-up in current activity but expectations for next year rebound.

LABOUR MARKET

Slowdown in earnings in the construction sector.

EXCHANGE RATE

Further falls in pound following suggestions of "hard" Brexit.

Due to the large depreciation in the pound, Mace Cost Consultancy believes national tender price inflation will rise 1.5% in 2017. However, with increasing business rates hitting an already expensive market along with stamp duty changes continuing to dampen top-end residential demand, prices in London will remain unchanged. We expect the construction sector, which saw output fall 1.4% in the third quarter and is now in a technical recession, to weaken next year as Brexit drags on growth and there is some stabilisation in the industry following several years of strong increases. This weakness, will result in increasingly competitive bidding with margins potentially taking a slight hit, helping to temper the impact of the falling pound. Tender prices could drop in 2018 as the uncertainty caused by Brexit continues but we see less inflationary pressure from imports.

"In recent months we have seen contrasting fortunes between different sectors. Residential property, particularly mid-range homes, has performed well with a number of large projects coming on stream. However, due to the uncertainty caused by Brexit, we have seen a drop-off from the commercial sector as they hold back on investment, waiting for more clarity around leaving the European Union. The Government's decision to give the go-ahead for Hinkley Point C as well as reaching a decision on expanding Heathrow are both very positive moves, providing short-term support for the construction industry and a longer-term boost to the economy. However, uncertainty is set to continue with economists still to decide whether the market will flourish or flounder."

Chris Goldthorpe, Managing Director
Mace Cost Consultancy

Economic conditions

Three months after Britain voted to leave the European Union, many of the more negative forecasts have not come to pass: the economy continues growing, unemployment is still below 5% and confidence which initially fell by record levels, has bounced back. However, Article 50 (which will formally start the two year negotiating process resulting in leaving the EU) is still to be triggered and until more is known about what deal the UK is likely to get, there will be considerable uncertainty. This uncertainty could act as a significant drag on construction along with the wider investment area, where timeframes are often long and the amounts involved large.

Growth

Q3 GDP beat expectations of 0.3%, growing by 0.5%. This was solely due to the service sector which grew 0.8% during the period compared to falls in agriculture (-0.7%), production (-0.4%) and construction (-1.4%). Services are also by far the most important sector making up almost 80% of the economy and whilst a falling construction sector is a worry, robust growth in services could feed through and help the industry. The greater than expected Q3 figure may lead to economists revising up their 2017 growth forecasts, which on average currently stand at 1%.

Labour market

The three months to August saw unemployment stay steady at 4.9%, its lowest level in over a decade. As a result of a larger number of economically active people, an increase in both employment and unemployment, by 106,000 and 10,000 respectively, meant there was no overall change in the unemployment rate. Between March and June, the sectors contributing most to the larger workforce were information and communication, real estate activities and the automotive sector. There were also 190,000 new jobs in the construction sector. Along with an improving labour market, average weekly earnings were up 2.3%, in part due to strong bonus growth. The strength of the labour market however, may have peaked with a consensus among economic forecasts now pointing to a slight pick-up in unemployment before the end of 2016 before further rises in 2017, finishing the year at 5.4%, still considerably lower than its recent high of 8.5%.

Exchange rates

On 24 June, the day after the referendum, the pound depreciated 6% against the euro and almost 8% against the dollar. Following the initial drop, the exchange rate stabilised just over 10% lower against both currencies for a number of months but recent announcements from the Government, pointing towards a “hard” Brexit, have resulted in the pound coming under renewed pressure. This fall will have a substantial impact on UK construction, dependent on imports for many of the materials it uses. Additionally, with 60% of imports coming from the EU, not only will there be the short-term impact of rising prices, but the industry may also suffer depending on the trade deal agreed once the UK finally leaves, with restrictions on free trade damaging those reliant on such goods.

Inflation

The pound’s depreciation started to push consumer prices higher in September, reaching 1%, its highest level in almost two years. Having averaged just below 0.4% in the first half of the year, more expensive imports are likely to drive this up in the coming months. Helping companies pass on higher costs are the strongly performing labour market along with solid earnings growth.

Interest rates

At the start of August, the Bank of England voted unanimously to cut interest rates by 25 basis points along with introducing several other measures, including expanding quantitative easing, in an attempt to stimulate the economy. Due to the weakness the Bank expects Brexit to cause along with risks associated with it, they decided the need to provide support outweighed the risks of higher inflation from such a move. The Bank may view the solid Q3 GDP number as well as improving survey data, which in July had pointed to a sharply shrinking economy, as vindicating its decision. Members of the Monetary Policy Committee (MPC) have also hinted that there may be a need for an additional cut but with rates so low, they will be limited in their ability to act.

Global

Having spent most of 2015 hovering around 2%, real GDP slipped again in the Eurozone from 1.68% to 1.62%. Increased uncertainty due to the UK referendum could act as a headwind against growth whilst French and German elections due to be held next year will increase complications in negotiating a British exit.

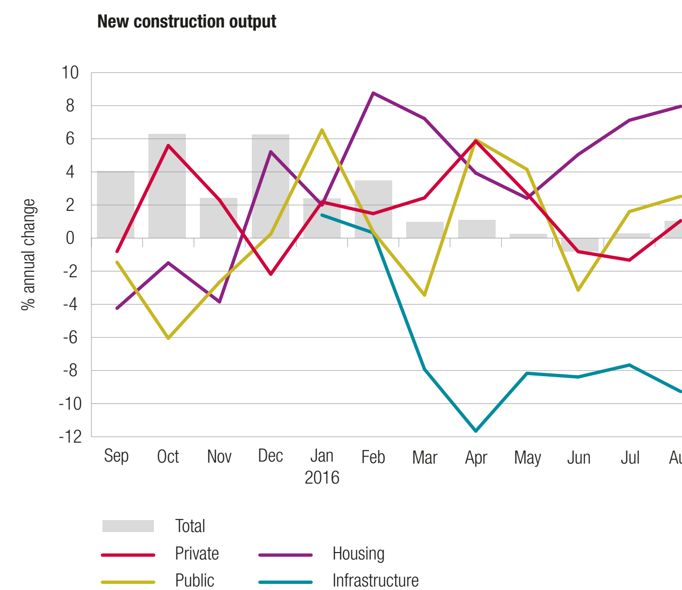
The yearly growth rate in the US fell for the fifth quarter in a row as imports continued to outpace exports. Growth is expected to gradually increase in 2017 and with robust consumer spending and improving job market conditions, the Federal Reserve will need to increase interest rates.

Growth in China stayed steady at 6.7% in the third quarter, matching its first and second quarter levels having grown at 6.9% in 2015. A slowdown in consumer expenditure resulted in real GDP growth in India falling to 7.1%, its lowest level since 2014.

Construction output and orders

Monthly output for new construction work fell 1.4% in August due to a sharp drop off in infrastructure. This sector has been particular volatile over the last three months, down 3.5% in June, rising 6.1% in July before a 5% reduction in August. Year on year growth for infrastructure is 9% below 2015 with data up to the second quarter pointing to drop offs in roads and rail as the leading cause. Annual growth for all new work is more positive, up 1.1%, helped in particular by housing and to a lesser extent private construction. Housing, however, has seen month on month falls in six of the first eight months this year, so once the very large jump of December 2015 falls out of the data, yearly growth may turn negative. The private sector is also likely to be particularly vulnerable to changing business plans in the next year.

Whilst not including any detail, the top level figure for construction from the Q3 GDP data release from the Office for National Statistics (ONS) showed the industry had fallen into a technical recession with a 1.4% drop following the second quarter’s 0.1% decline. With the industry already performing poorly and the expected headwinds from Brexit, next year will be tough for firms and subdued growth may be the best that can be hoped for. Covering a much broader category than construction, the Treasury’s forecasts for the UK economy – a comparison of independent forecasts – highlights similar issues, showing an average fall of 2% of gross fixed investment for 2017.



There were healthy new construction orders in the second quarter, helped by strong growth in the housing sector and over 50% growth in the public sector. Within the housing sector, the East of England and the North West performance was particularly strong but slowing orders in London, which has accounted for more than a fifth of all orders over the last year, will be of concern. One potential bright spot is the government’s decision to row back on their austerity targets and new Chancellor Philip Hammond may choose to increase investment spending. This however is unlikely to be enough to keep new construction orders growing and the levels set in Q2 2016 could well prove to be a peak.

Market view

Savills’ Commercial Development Activity recovered strongly in August to -3.5% having collapsed to an 89-month low of -18% in July with only new build public and industrial/warehouse worsening. The three month outlook also improved but only slightly, rising from -6.6% to -4%. London’s poor performance continued with a -12.5% drop whereas regions outside the capital and South East returned to positive territory.

Having fallen to an 85 month low in July, Markit/CIPS UK Purchasing Manager’s Index rose to 52.3 in September, indicating an expanding sector for the first time since May. Key to the improved figure, was residential activity, rising to its highest level since January on renewed confidence. On the other hand, commercial activity continues to perform poorly, having decreased for the fourth consecutive month, its worst period since early 2013. Of particular importance for tender prices are the reports that domestic suppliers have passed on higher imported raw material costs, an issue that will either feed through into higher bids or reduced profits.

The Bank of England’s third quarter agents’ report showed modest growth starting to slow, in part driven by slower housebuilding. The Brexit vote didn’t seem to have any significant impact on ongoing projects but contacts were concerned the pipeline could weaken over the next six to 18 months. In both the commercial real estate and the housing market, demand had fallen in London but held-up better elsewhere.

The Construction Products Association second quarter Trade Survey showed expanding sales over the period but increasing fears and an expectation of a decline in Q3, even though few responses arrived following the referendum. One positive was the prospect of rising exports due to the weaker pound and one of the few areas likely to receive a further boost given the substantial depreciation since the vote. Feeding through into tender prices, both heavy and light side manufacturers reported increasing costs.

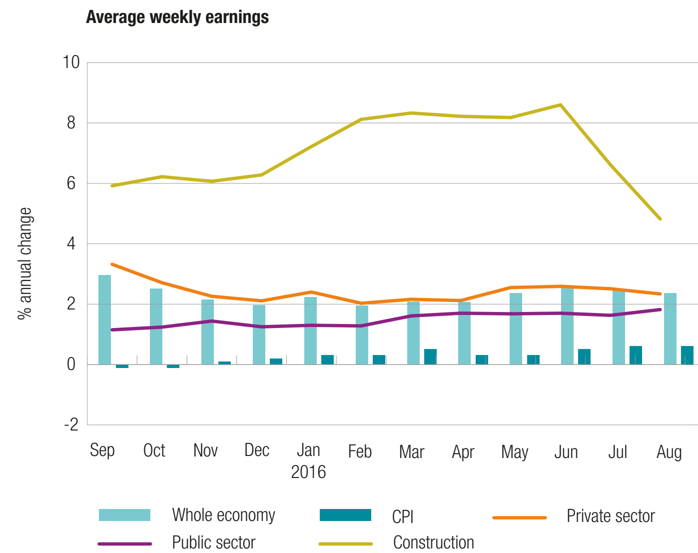
There was a slight recovery in workloads in the third quarter according to the RICS Construction Market Survey with the net balance of respondents reporting rising activity, increasing to 19% from last quarter's 17%. The best performing sector was private housing, with a net balance of 28%. By contrast public housing was the worst performing sector with only 4% more respondents giving a positive response than negative one. Expectations for the next 12 months have improved substantially since the second quarter, which took place immediately following the referendum, now standing at 49% as opposed to 23%.

Overall, the decision to leave the European Union has had a noticeable impact on confidence within the construction industry with a number of surveys and reports pointing to a weakening sector. These concerns have been backed up by the weak third quarter construction figure and even with confidence no longer standing at very low levels, firms are still cautious about the months ahead. A number of reports highlighted the weakness in London and surrounding areas compared to the rest of the country, in line with ONS figures for new orders, potentially marking a much-needed shift away from the capital.

Input costs

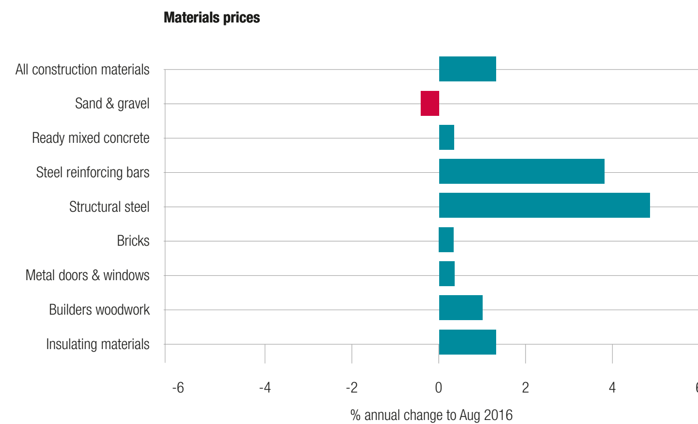
Labour

August saw another sharp drop in earnings growth in the construction sector but it continues to grow far faster than the overall economy and with consumer prices only recently picking-up, construction workers have done very well over the last 12 months. Driving wage growth are high levels of employment in the industry along with ongoing skills shortages. Employment in the sector is now at its highest point since early 2009 and whilst RICS are showing slight improvements, around half employers are still reporting skills shortages. Brexit is likely to have caused the slowdown in growth but with initial concerns following the referendum proving to be unfounded, wages should continue to outpace inflation for the rest of the year and into early 2017.



Materials

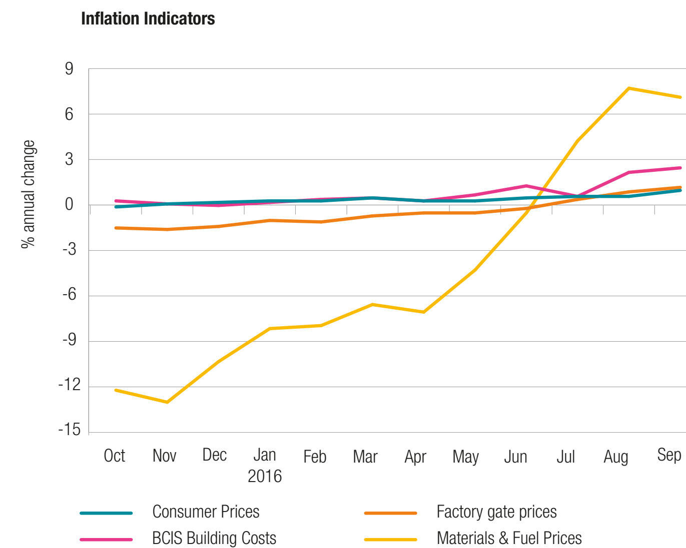
The year on year all work construction index has finally returned to a positive level, the first time since November 2014. The all work index started the year 3.7% below its January 2015 level but eight consecutive month on month increases has resulted in yearly growth reaching 1.3% in August. In particular, steel products have seen fast growth with imported sawn and plywood also pushing higher over the last quarter. Upward price pressure due to sterling's depreciation, which so far has not fed into a large rise in headline inflation, can be expected to result in a substantial boost to material prices over the coming months as new contracts are negotiated. Highlighting the risks of sterling's fall is the £2 billion trade deficit the UK faced in Q2 from all building materials and components although as a proportion of construction output this is under 6% and slightly better than the overall economy which is closer to 7%. In particular large amounts of electrical wires, sawn wood and aluminium are imported so a small rise in prices could feed through into a large increase in a contractor's costs.



On 28 September, Opec announced plans to cut oil production from November, resulting in a large jump in the price of oil. This has led to prices jumping more than 10%, rising above US$50 and edging towards a 52-week high. However, higher prices could prove a double-edged sword by helping the shale industry and with inventories still touching record levels, further significant increases are unlikely.

Steel prices are unchanged from June when they jumped from US$50 to US$300, its highest level since early 2015. With almost 50% more steel imported than domestically produced, buyers are likely to face further additional cost rises due to the weaker pound. This is an issue likely to affect all metal products with both aluminium and zinc having also seen large price rises this year.

Unlike consumer prices, which have remained fairly steady in 2016, producer prices have changed substantially. From falling 1% year on year in January, they are now growing by 1.2% having risen above 0 for the first time since June 2014 in July. Input prices fell back from their August high of 7.6% but still stand above 7%, driven by strong increases in crude oil and imported metals. Increases in the price of imported goods are likely to result in substantial producer price inflation over the coming months with low unemployment and an expanding manufacturing sector also contributing.



Tender price inflation forecast

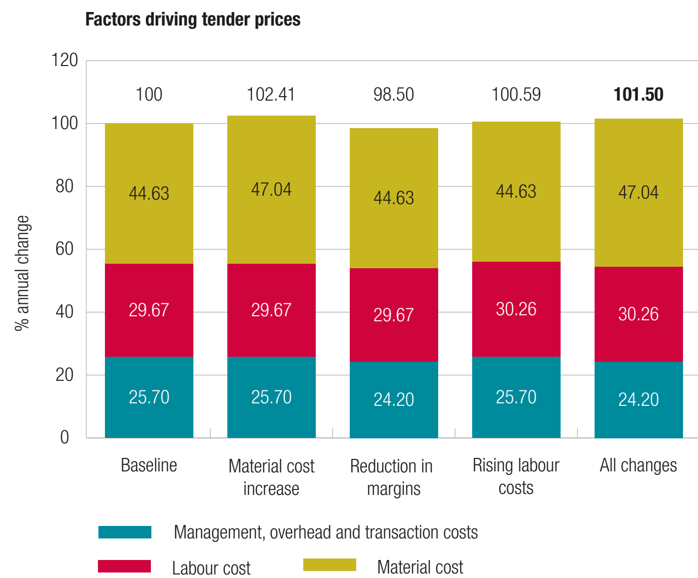
In the current economic climate, uncertainty rules and all forecasts are subject to a number of assumptions which could easily change. Tender prices are no different as can be seen through our changing forecasts. We have now revised our forecast for inflation of 1.5% in 2017 nationally while remaining at 0% in London as opposed to -1% and 0% respectively in our last forecast. On the other hand, our forecasts for 2018 are more bearish, and we now expect tender prices to fall 1% in London and 0.5% in the rest of the country.

What is currently unknown is how Brexit will progress and what sort of deal the UK will achieve. As it stands, the UK is expected to trigger Article 50 in early 2017. Analysts have split the potential deal into two main types: a "hard" Brexit that involves leaving the single market but having complete control over immigration or a "soft" one, where the UK retains some form of membership of the single market, but in return is limited in its ability to manage free movement. Whilst possible to dispute the long-term impact of each deal, in the short-term most forecasters anticipate the harder the exit, the greater the shock to the economy due to more rule changes and a larger shift in the environment businesses will have to adapt to. Construction could then be hit especially hard as businesses try to cut costs and delay investment. So far, the government has kept its cards close to its chest on the type of deal they're aiming for but recent indications are it will be for more of a hard Brexit than had previously been hoped.

Driving inflationary pressure next year will be rising import costs due to the pound's depreciation. One piece of anecdotal evidence recently provided is the cost of plasterboard going up 12%. With imports accounting for such a large proportion of building materials and some City economists expecting the pound to continue falling, these forces may carry on affecting the sector throughout the year. Pressure from wages, which have risen substantially in the past year, should subside as the labour market weakens. However, with skills shortages still high and employment currently at record levels, employees can still expect pay rises.

However, due to Brexit we are expecting a considerable amount of uncertainty next year leading to downward pressure on prices across the supply chain. Fears around order books, which currently look strong, will increase and firms will become more competitive in their bids. Due to the number of tiers in the supply chain, a small reduction in margins at each level could result in a much larger impact than anticipated on the final tender price. We feel this will slow inflation but prices will still rise nationally.

To illustrate how we expect prices to change over the next year, we have taken a typical large project and examined what happens to total costs based on various changes likely to take place. In a typical large project, material costs account for just under half of the total, labour costs make up 30%, and 26% goes to management, overhead and transaction costs. Using this distribution, we can see what effect certain changes will have next year. Of most importance are material costs - if we assume 60% of goods are imported and half of the 18% the currency depreciation feeds through into higher prices, total costs will increase by 2.4%. This is a quick calculation and does not take into account how domestic prices may change but it is useful to highlight the impact the pound's fall will have. Secondly, due to the deteriorating economy and reduction in business opportunities, firms are likely to take a reduction in profits. If at each point throughout the supply chain a small reduction takes place, total costs could end up 1.5% lower. Finally, wage growth will continue to slow, rising by only 2% next year pushing overall costs up 0.6%. We can then combine these three forecasts, resulting in seeing costs increase nationally about 1.5%.



* Based upon a Large 'National' Project. Major Central London projects may attract project specific premiums.

Moving into 2018, we are forecasting that prices will fall as the impact of Brexit really starts to bite and construction output falls further. As a result, firms will become more competitive in their bidding processes and will be prepared to accept lower margins. Just as importantly, the inflationary effects of the pound's fall will dissipate with companies also potentially finding new suppliers or using alternatives. Similarly, the labour market is likely to be in a weaker position resulting in, if not outright reduced earnings, at least substantially slower growth.

Over the period, price rises will be larger outside London as factors such as recent changes in stamp duty hurt residential property in the capital. Large price differentials between the city and elsewhere may lead to cost conscious businesses looking elsewhere as well as the world's most international city suffering from the uncertainty following the decision to leave the European Union.

London			National		
2016	2017	2018	2016	2017	2018
2.8%	0%	-1.0%	3.0%	1.5%	-0.5%

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