# UK MARKET VIEW

## 2024 TO BE ANOTHER YEAR OF WEAK ECONOMIC GROWTH

Q4 2023

> *With forecasts pointing to ongoing weak economic growth, 2024 looks like it will be another tricky 12 months. While interest rates are likely to have now reached their peak, the expectation is that they will only start to come down gradually in the second half of next year. Higher borrowing costs are having a significant impact on a number of sectors, most notably housing, and these challenges will persist for some time. By making it harder to secure credit, the Bank of England has contributed to one of this year's biggest problems for construction, which has been the high number of insolvencies. Similarly, as the Monetary Policy Committee is unlikely to start easing interest rates anytime soon, we expect insolvencies to remain a problem for projects. As a result, the importance of managing the supply chain must still be treated as a priority by consultants, as well as clients and the wider project team.*

**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.

**Material prices continue to ease slowly and were...**

# 1.1%

**lower in Q3 than Q2.**

**Offsetting this support were another strong rise in construction earnings, up 1% on the quarter, and...**

# 5.8%

**higher than last year.**

# 0%

**There was no change in the size of the economy in the third quarter as GDP growth flatlined.**

**Interest rates have also not changed in the past three months and look to have peaked at...**

# 5.25%

**After a very weak second quarter, new orders rising...**

# 3.9%

**in Q3 still leaves them 20% down on a year ago.**

# SETTING THE SCENE

The first nine months of the year show construction growing at around twice the rate of the wider economy. Whereas GDP is 0.5% larger than it was in the final quarter of last year, construction output has risen by 1%. This, despite the problems in the housing market, is a definite success, but low economic growth looks set to continue into next year, and possibly beyond. Probably the most negative of forecasts come from the Bank of England, which is forecasting GDP will finish no higher in 2024 than it ends 2023. It also expects growth of just 0.2% in 2025. This is much lower than consensus forecasts which have GDP going up 0.4% next year and 1.4% in 2025, as well as those from the Office for Budget Responsibility (OBR). However, even these growth rates are less than ideal, and show the economy will continue to struggle going forward. For construction, as well as another year of falling housing investment, the OBR is forecasting declining business investment. Corroborating the likelihood of a downturn is the recent weakness in new orders in private industrial and private commercial. The OBR is also forecasting sizeable reductions in government investment from 2025 onwards. As with new orders in the private sector, public sector new orders have also declined this year and the drop is likely to hurt output in 2024.

Weak growth next year is the reason we expect tender price inflation to ease somewhat. Forecasts for GDP in 2024 have been consistently poor and, while the Bank of England's predictions of a flatlining economy stand out as especially negative, there is not enough new evidence to change our expectations on tender price growth. Having already squeezed margins as far as they can go, many firms continue to take a view that there are considerable risks and uncertainties in delivering schemes. As such, they are often being highly selective about what they tender for. Added to this, most material prices have only started to fall recently and are coming down slowly, wage pressures and skills shortages are still prevalent, and rising insolvencies are reducing the number of available subcontractors. All of these factors point to developers having to accept modest inflation. We recognise that there are many downside risks to next year's tender price forecasts, but with a rise of 2.5% lower than the Treasury's collection of forecasts believes CPI will be, there currently appears little room for a smaller increase.

Beyond the OBR forecasts and the headline announcement of a cut to national insurance, November's Autumn Statement included the start of much needed planning reforms. Delays to major infrastructure projects have noticeably lengthened over the past decade and, if these reforms are successful in bringing consenting times back to two and a half years, it could provide a major boost to construction. Even though these changes are likely to take time before they become effective, we discuss some of the proposals, as well as other key components from the Chancellor's speech.

Another topic we look at is the ongoing problems with data. Recently, the Office for National Statistics (ONS) stopped publishing its labour market statistics and made substantial revisions to GDP numbers in 2021. Such moves make policymakers' jobs even more testing and there are also questions around the accuracy of construction output. The Construction Products Association is forecasting that the industry will shrink considerably this year, suggesting serious problems with the official figures. Whether output is rising or falling, many in the industry are facing considerable hardship. While not quite as high as Q2's record, Q3 was another quarter with a large number of insolvencies. Unfortunately, it is far too easy to imagine these troubles persisting. Interest rates peaking doesn't mean there will be a meaningful loosening in credit conditions and, after weathering so many other problems, rising debt costs are now biting hard, as they will continue to do in 2024. As well as supply chain risks, supporting subcontractors is an important consideration for the industry. In a recent analysis, we suggested several ways to do this. These included considering ways to improve payment positions and acting with a sense of urgency on contentious issues, treating the supply chain fairly and taking the time to understand subcontractors' health. Fairer payment terms, notably reducing the use of retention, could unlock billions for the industry, instantly improving cashflow positions across the supply chain.

# FAIRLY QUIET QUARTER WITH FEW SEEING LARGE MOVES

## New orders

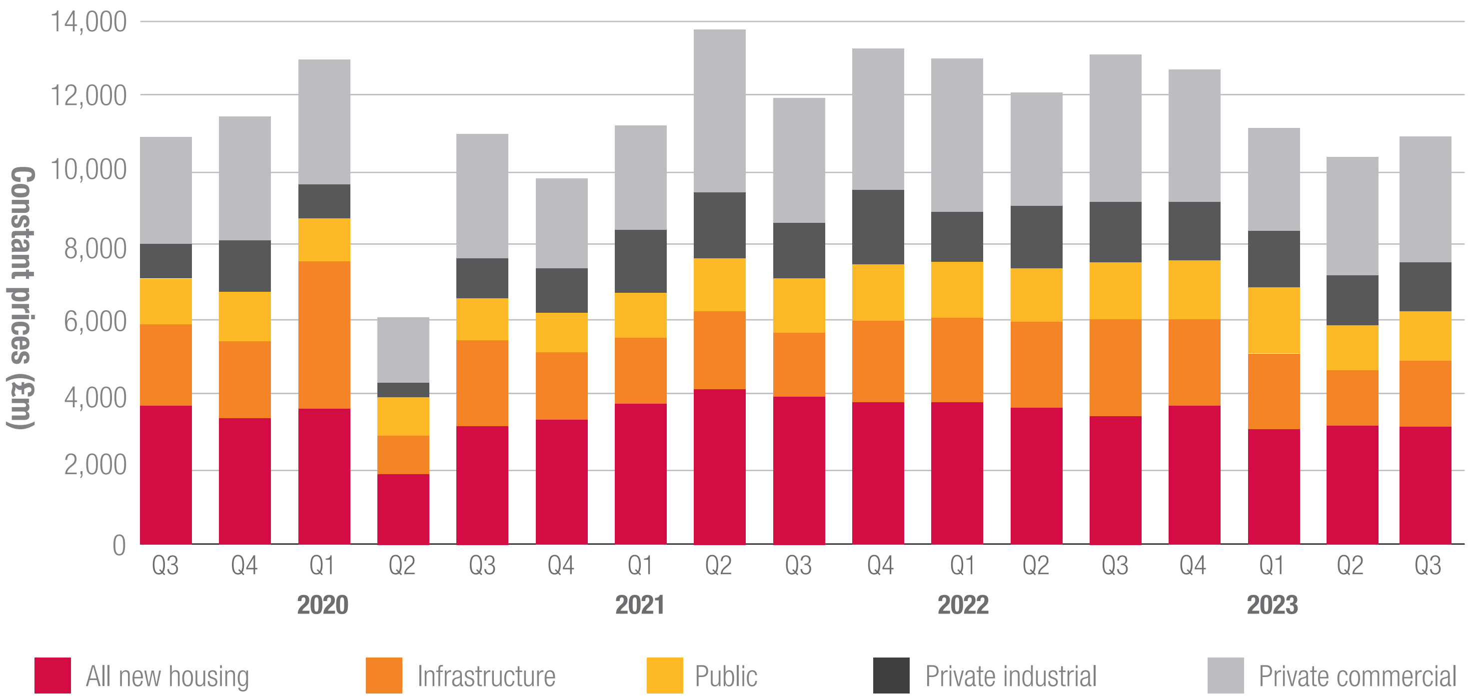
After a terrible second quarter, there was a small increase in new orders in Q3. Rising by 3.9%, all sectors bar private industrial saw some growth, but from such a low base it still points to significant challenges across the board. Furthermore, total new orders are down 20% compared to a year ago. On a rolling four-quarterly basis, which avoids some of the volatility that often occurs with the new orders numbers, there was also a significant drop, with new public housing the only sector in a better position than in Q3 2022. Given some of the difficulties facing construction output this year, this set of poor new orders data doesn't bode well for the next 12 months.

Despite rising for the second consecutive quarter, housing remains in a very weak position. The growth rates have been low, 3.9% in Q2 followed by 0.8% this quarter. This is nowhere near high enough to create any sort of noticeable rebound in output. Often, we can use new housing starts to provide additional support in analysing the sector, but due to changes in regulation, there was a surge in starts in Q2, which doesn't accurately reflect the market. Increasing by 75% compared to Q1, many of these projects are unlikely to be built-out soon, and so won't push-up output. Based on statements from many of the largest housebuilders, we would also expect further drops in housing completions which, excluding the pandemic, were at their weakest since the start of 2018 in Q2 2023. Given housing's outsized share of construction output, this ongoing weakness will continue to drag on the industry next year.

Fewer new houses not only exacerbates the housing crisis, but hits the wider ecosystem. Brick manufacturers are cutting back significantly, with both Ibstock and Forterra either closing or mothballing plants. Meanwhile, Travis Perkins, the UK's largest builders' merchant, has reported lower sales, and is revising headcount accordingly. As with construction insolvencies,

### ANOTHER WEAK QUARTER FOR NEW ORDERS

Source: ONS



these are not only a challenge for today, but also storing up problems for the future.

Private industrial also reflects the problems of higher interest rates. Following significant growth, the sector has now shrunk in each of the past five quarters. Rising financing costs have significantly affected demand for new warehouses and, for the first time since 2020, factories accounted for a larger share of total industrial new orders.

## Construction output

Q3 was another poor quarter for construction output but, once again, this weakness was down to problems in the housing sector. Overall, the sector rose 0.1%, with all new work shrinking by 0.3%. However, if we were to exclude new housing work from the figures, all new work would have risen 1.1%, with the whole industry expanding 0.9%. Compared to Q3 2022, private housing output is down 13.4%, but private industrial is the only other sector to see a decline over this time. This downturn is what has caused all new work to drop over the last 12 months. However, from an encouraging perspective, several of the other sectors have grown strongly.

While new orders numbers create some concern for next year and the OBR is forecasting a large drop in government fixed investment in 2025, the non-housing public sector is the best performing one over the past year. Unfortunately, although the sector has grown 13.7% since Q3 last year, an almost 10% year-on-year drop in 2022,means output in the sector was still 9.5% lower in Q3 2023 than it was before the pandemic. Furthermore, output has been falling in recent months and, after a 6.6% reduction in September, was down 1.4% in Q3. Infrastructure seems to be going through a similar slowdown. It is over 10% larger than it was in the third quarter of last year but has seen a month-on-month drop in output in each of the last three months. It is quite possible that both sectors are now suffering from a lack of new work.

## Interest rates

The past quarter has seen both good and bad news about interest rates. On the positive side, they have not changed since September and have now almost certainly peaked at 5.25%. Less helpful for construction is the impression the Bank of England is very keen on giving, which is that it may be some time before it starts cutting interest rates. Latest forecasts from the Treasury's collection of independent forecasts suggest that rates are likely to be cut twice next year. This would leave them at 4.75%, higher than they were throughout the first half of this year and providing little respite to those refinancing or looking for new credit.

One factor helping the Monetary Policy Committee avoid raising rates again is the continued cooling of inflation. In October, largely due to lower energy prices and a reduction in the Ofgem price cap, CPI inflation slipped from 6.7% to 4.6%. However, after this considerable fall, further drops will be less meaningful, and from now-on inflation is likely to come down much more slowly. Assuming forecasters are accurate that inflation will still be comfortably above 2% at the end of next year, there will be limited scope for the Bank of England to aggressively cut interest rates, thus supporting the higher for longer standpoint.

The MPC will also be pleased to see recent reports of house prices starting to recover. While house prices are down in annual terms, and significantly lower relative to a year ago once adjusting for inflation, that the Land Registry is reporting an annual drop of just 0.1% should give the MPC greater leeway with its decisions. Helping limit more significant falls are a lack of housing transactions, in turn supported by unemployment still being very low, and thus avoiding a spike in forced sales.

## Costs

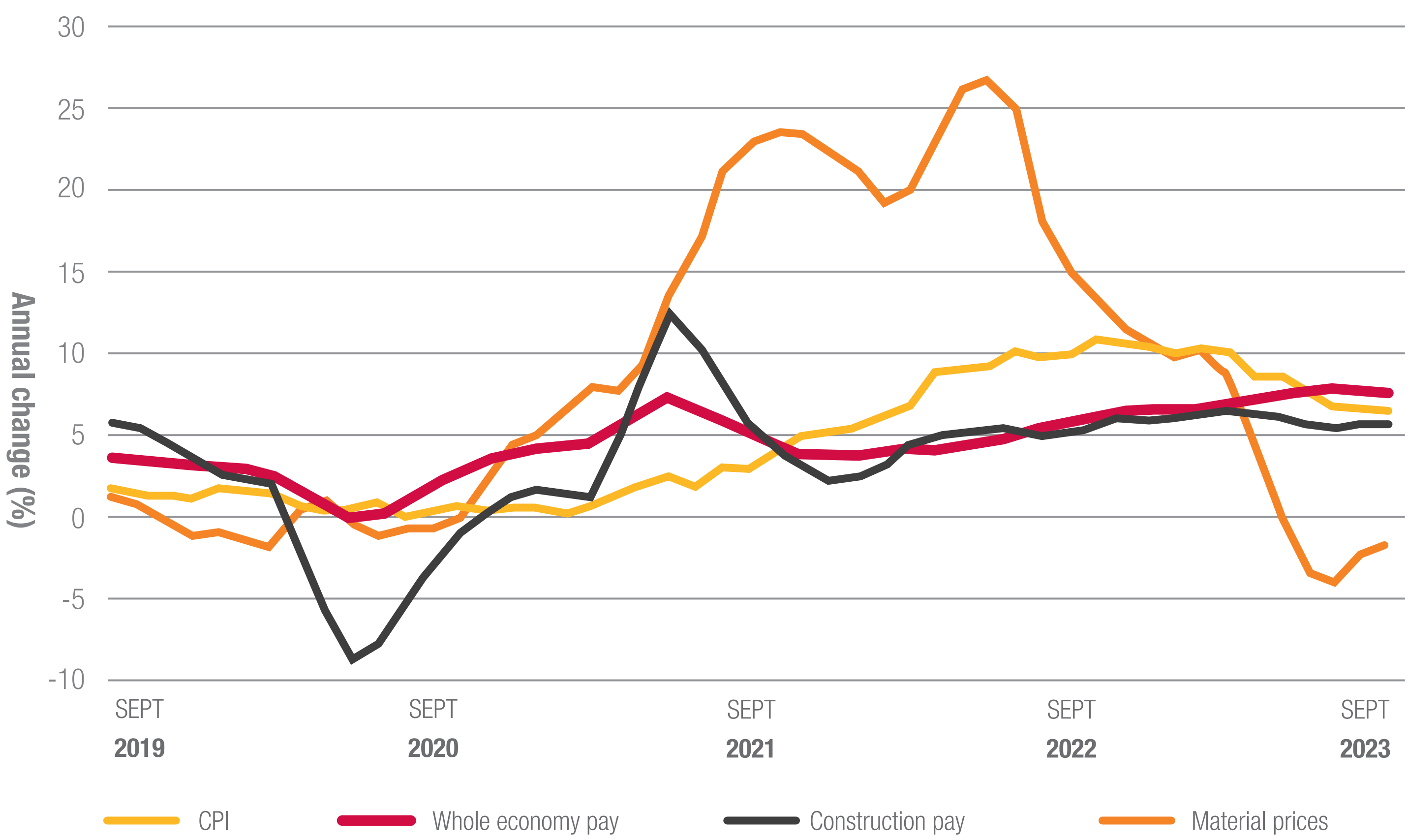
Construction pay pressures remain acute, with another 1% quarter-on-quarter rise in Q3. This left the annual rate of growth of regular construction pay unchanged from Q2 at 5.8% and, while it peaked at 6.5% in Q1, it is only decelerating slowly. Nonetheless, this robust rate of growth is much lower than those in the services sector are enjoying, where growth is 7.9%. Such increases are likely to be pushing up the cost of client teams and fees, and while this is less important for tender prices, it is potentially an issue for a project's overall viability. Another problem for construction earnings, is that inflation is also high. In September CPI inflation was 6.7%, meaning a fall in construction real pay. Despite the inflation rate having fallen considerably in October construction workers, if possible, will be aiming to regain their purchasing power. Helping boost their prospects are output which is rising in many sectors, and vacancies being still high by historical standards. Skills shortages are also a significant problem and, according to the Q3 RICS UK Construction Monitor, only financial constraints were a more problematic factor in limiting building activity.

In the same RICS survey the share of respondents reporting shortage of materials as a factor limiting activity eased again. Having stood at over 80% last year, this slipped to around 35% in Q3. Improved supply is also being shown in the ‘all work construction material price index’, where prices are 1.8% lower than a year ago. This includes a 1.1% drop compared to the second quarter, with 15 of the 29 materials analysed in the release having fallen over the last three months. However, while many prices are now falling relative to a year ago, only eight products are down, and five of these relate to steel and timber. Even with steel’s recent collapse pushing rebar and fabricated structural steel down by around 30% on a yearly basis, both products are still up over 40% compared to the start of 2020. Similarly, the small drop in material prices over the past year does little when compared to previous rises and the overall index is also up 40% compared to January 2020. Underscoring the issue is the continued challenge around energy prices. Despite being lower than they were, energy intensive manufacturers are still reporting prices to be 3.5x more expensive than in 2019.

We discuss other problems with data later but one glaring concern with these figures comes from the difference between new housing and other new work. The downturn in housing would suggest that new housing material prices should be under significant pressure. As it is, the data is reporting that costs have risen by 1.2% over the last year, whereas other new work is down 4%. Steel’s incredibly large decline may in part explain this, but the discrepancy still stands out as odd.

## COSTS STILL A PROBLEM

Source: ONS, Department for Business and Trade



# AUTUMN STATEMENT: CHANGES TO PLANNING SYSTEM BUT NO MONEY FOR FUTURE INVESTMENT

One common complaint from the construction industry is that planning rules are too cumbersome and decisions can take too long. This can apply to all types of construction project, and the Autumn Statement had a number of proposals aimed at reducing these blockages. Alongside the Chancellor's speech, the government published a policy paper titled 'Getting Great Britain building again: Speeding up infrastructure delivery'. Highlighting how more litigation, the need for lengthier application reports and greater uncertainty were adding to costs and deterring investment, the paper came up with a number of areas for improvement. These included cutting the time taken for Nationally Significant Infrastructure Projects to pass through the planning process by increasing the number of planning inspectorates, and a new 'Star Chamber' to drive delivery. The Star Chamber will involve a ministerial appointment who will have strategic oversight of major projects and report into the Prime Minister or Chancellor. Deliberately focusing on such projects and having someone accountable for them should theoretically result in better outcomes. However, those in construction will be hoping this isn't another toothless government appointment. If it becomes like the housing minister, which has now had sixteen people doing the job since 2010, then it will be as unsuccessful as reaching the target of 300,000 homes a year.

While recognising many of the problems, definitive solutions were missing and instead we will need to wait until next year for these to be forthcoming. Notably, the government intends on looking into ways to discourage inappropriate legal challenges. As one of the costliest and most time-consuming obstacles, doing so could massively simplify the planning process. They will also investigate whether 24/7 working on large infrastructure projects would increase productivity, as well as looking into better and more efficient ways in which to use data. Another topic set to come out next year is a review of National Policy Statements and the hope is that, once released, these will provide greater certainty for investors. Similarly, a renewed National Infrastructure and Construction Pipeline, the last of which was published more than two years ago, is  highly desirable. There were a lot of interesting ideas in the policy paper and, despite being a good start, its aim of making considerable progress by the end of 2024 is likely to mean it is 2025 at the earliest before many of the ongoing difficulties can be overcome.

Changes to infrastructure planning sound far more comprehensive and well thought through than the parts devoted to housing. Local authority budgets have been slashed and this is one of the reasons why there is currently such a large planning backlog. In an attempt to cut the backlog, the government announced £24m of funding to help reduce this. This was bolstered in the Autumn Statement with an additional of £5m of funding. However, with over 300 planning authorities in England, funding of around £100,000 for each doesn't sound very generous. Another proposal which isn't without potential problems is a new system guaranteeing accelerated decision dates. The suggestion is that major planning applications, which could be as little as developments of more than 10 dwellings or over 1,000 sqm of floorspace, could pay for speedier decisions. Were the planning authority not to meet the deadline they would then have to refund the application fee. Yet, with the aforementioned challenges facing local authorities and without increasing planning capacity, it might simply end up forcing them to prioritise larger projects, leaving those working on smaller applications facing a much lengthier process. Such a two-tier system may benefit bigger businesses without necessarily boosting overall construction.

It was reassuring to note specific positive reference to the R&D tax credit and subcontracting within the construction industry in the Autumn Statement. Those investing in construction innovation will have been closely following this year's developments in relation to the new R&D tax credit scheme, set to launch in April 2024. With the government increasing the tax credit after 1 April 2023 from 13% to 20% of qualifying expenditure, it is a valuable incentive to boost construction productivity. Initial wording released this summer indicated a restriction to claiming the tax credit where the R&D stemmed from sub-contracting – this would have had disastrous consequences for SMEs and large businesses alike across construction.

Caution is still warranted on release of the draft 2023 Finance Bill, as the legislation wording could still pose problems in the construction industry where R&D activities had been "contemplated" further up the chain. Further guidance from HMRC is expected to provide reassurance that the tax credit remains a viable incentive for construction, as many will already have committed to innovative investment in 2024.

One disappointment with the Autumn Statement was the lack of new announcements for important construction sectors such as health and schools. Similarly, there was little new to say around levelling up. The Autumn Statement contained minimal mention of the allocation of the remaining £1 billion funding, despite it being announced a couple of days prior. That neither of these topics got much of a mention should not come as a surprise given the nation's finances. It does, however, mean the Conservative Party will need to find a new selling point next year, having won the 2019 election on a manifesto heavily reliant on increased spending. For construction, even with this year's growth, public non-housing output numbers have never given the impression that words are feeding into action. This simply means it will take longer to return to pre-pandemic output levels.

As well as not expecting new funding next year, there has been a lack of new orders this year. In our Q3 Market View, we highlighted the problem with large falls in both public non-housing and the public part of infrastructure. While both categories did rise in the latest figures, neither recovered to the levels seen either in Q1 or in any quarter of 2022. Infrastructure in particular is struggling, with Q3 almost 40% lower than a year ago and this is solely due to a drop-off in the public portion. Within this, road and rail are both weak and this doesn't even factor the parts of HS2 scrapped that won't appear in the numbers.

The likely downturn will do little to reverse the changes in apprentice training that happened in the last academic year. While the previous year was the first full academic one after Covid, and so potentially distorted, there are also significant concerns around the lack of females and ethnic minorities, as well as the many apprentices who fail to complete the course. With skills shortages already such an issue, apprentice figures are unlikely to improve unless there is greater stability.

Something worth keeping an eye on, particularly for whoever is Chancellor in 2025, is the condition of government finances and departmental budgets in the medium-term. Importantly, the Autumn Statement included no changes to departmental spending. By taking all the gains from inflation and accompanying higher tax revenues, but not reflecting these in spending, there was enough headroom for the two main tax cuts. Lower national insurance contributions will benefit workers, while full expensing will support businesses and should lead to greater investment in equipment, plant and machinery. Yet the catch to only taking the gains from inflation is that it requires a large real drop in departmental spending. The OBR is explicit in its analysis in saying "capital spending is fixed in cash terms". This creates obvious issues and, between 2025 and 2028, the OBR is forecasting that, in real terms, government investment will decline by more than 10%. This indicator covers all types of government capital expenditure, of which construction projects are a subset, and so are also likely to fall. Once again, some areas, such as local authorities will bear more of the brunt than others, but the direction of travel is clearly one of more problems across public sector schemes.

# DATA PROBLEMS COMPLICATE ANALYSIS

One major challenge currently facing economists and policymakers is a lack of confidence in data from the Office for National Statistics. Recently the ONS stopped publishing its usual labour market data, instead temporarily moving to a set of experimental figures. When moving from face-to-face to telephone interviews because of Covid there was a large drop in responses to the Labour Force Survey and this downwards trend has since continued. As a result, the ONS has decided that the basis for its unemployment numbers were no longer reliable and, for the time being, has moved to an alternative methodology. Alongside this issue, the ONS made substantial revisions to GDP data for 2021. It had previously estimated the economy was 1.2% smaller than before the pandemic at the end of the 2021, however the new numbers suggest it was actually 0.6% larger. While measuring the size of the economy is not a straightforward task, and one which was even harder during the pandemic, the extent of the adjustment is problematic for those whose decisions are dependent on it. Inaccurate data can also result in far reaching problems. If the true level of unemployment is higher than the data is showing then the Monetary Policy Committee may have chosen not to push interest rates up quite so much. This in turn could marginally lessen the challenges facing the housing market and, therefore, the wider construction industry. There are clearly serious implications with poor data.

Problems with data are also something the Construction Products Association (CPA) fear is happening with official construction output numbers. In its view the ONS is overestimating the size of a number of construction sectors, in particular housing repair and maintenance. Overall, the CPA believes construction is noticeably smaller than the data indicates. While the official data shows total growth of 3.3% in the first nine months of the year the CPA is forecasting the industry will shrink by almost 7% in 2023. This is a huge difference and, if we were seeing these output numbers, there is a good chance we might be forecasting lower tender prices. However, in our view, many firms are being selective around their bids and there isn’t the ultra-competitive tendering that would be happening in such a severe downturn. There are, however, grounds to doubt construction output is as strong as official statistics are reporting. Whereas output in Q3 was 6.4% larger than in Q4 2019, employment numbers have never returned to their pre-pandemic levels. Short of a substantial improvement in productivity, it isn’t easy to explain how the industry is producing more with fewer workers. Similarly, there are good reasons as to why insolvencies are so high but continued industry growth is not one of them.

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