theconstructionindex

Davis Langdon

Weekly Economic Update

25th July 2010

Summary

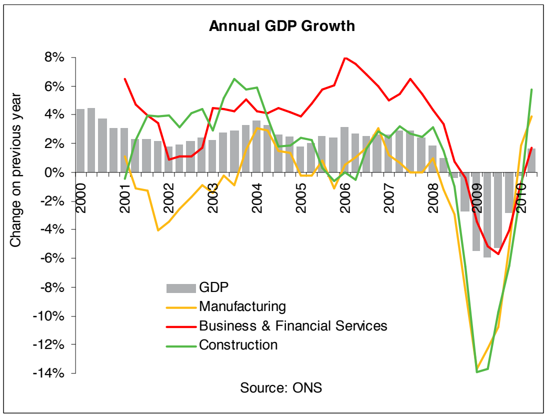
The UK economy rebounded strongly in the second quarter of this year, led by private sector growth – including construction. However despite the surge in activity, near term the upside for growth will be limited by the substantial fiscal tightening that will increasingly kick in. The EU banking "stress test", undertaken to assess the overall resilience of banks to absorb further possible shocks to the sector, were another key focus last week. Of the 91 European banks tested, seven failed to meet the 6% tier 1 capital ratio threshold. All UK banks exceeded this threshold with over 3% headroom.

Economy

MPC Minutes

The minutes of July's MPC meeting show that the decision to keep interest rates on hold at 0.5% and to maintain the asset purchase programme at £200m was made by seven votes to one. The sole dissenting vote came from Andrew Sentance who argued for a 25 basis point rise in interest rates, due to stronger UK growth and CPI inflation consistently above 2%.

UK growth



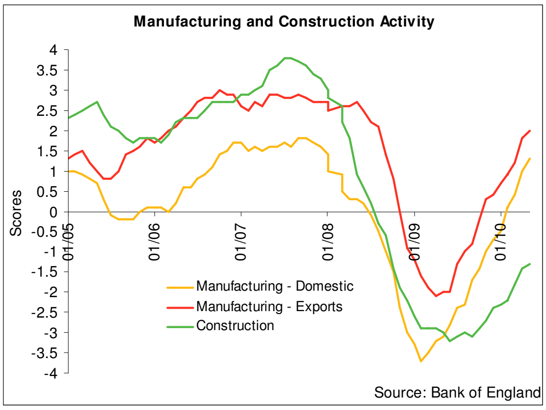
Preliminary estimates of GDP show that the UK economy grew by a surprisingly strong 1.1% during the second quarter of 2010. This is the third consecutive quarter of expansion following the deep recession. Year-on-year GDP rose by 1.6%. Growth was widespread across all sectors – services, manufacturing and construction. The services sector rose 0.9% during the quarter and up 1.7% year-on-year. Within this, business services and finance rose 1.3% quarter-on-quarter and 1.7% on a year ago. Manufacturing output was up 1.7% during the quarter and up 3.9% year-on-year, with the sector benefiting from re-stocking, improved UK competitiveness due to the weaker Pound and a pick up in domestic and export demand. Construction output jumped 6.6% during the quarter and up 5.8% on a year ago. Whilst this is a welcome performance, construction output growth comes from a low base, as the sector contracted by some 15% during the downturn. Looking ahead, the majority of analysts believe that growth is likely to slow in the second half of 2010 and could remain subdued in the year ahead. In particular, the upside for growth will be constrained by the substantial fiscal tightening that will increasingly kick in, as well as subdued consumer spending and business investment.

Business conditions

The Bank of England's survey of Business Conditions in July reveals that:

- Consumer spending growth appears to have slowed during the month.
- Housing market activity also eased back. Demand continues to be constrained by restrictions on mortgage finance, while the decision to suspend Home Information Packs appears to have boosted the supply of properties in the market.

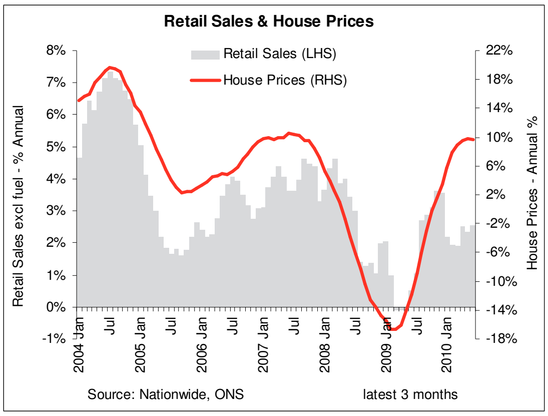
- Investment intentions picked up modestly, though on balance there are few reports of investment in new capacity. The exceptions are some supermarkets and major retailers, which are expanding. Capital spending is funded mainly by internal resources.
- Manufacturing output rose further in June, on the back of stronger external demand and, to a lesser extent, domestic demand. The services sector continued to grow modestly.



- In contrast to the official data, the survey indicates that construction output was little changed in recent months. New residential construction is recovering slowly, although the level of activity remains low, and developers continue to report concerns about future economic activity and difficulties in accessing bank finance. Commercial construction remains weak. Some public sector construction projects (eg road maintenance and social housing projects) have already been put on hold or cancelled. The majority of those surveyed expect the further planned reductions in public spending to prompt a renewed fall in construction output over the coming year.
- There remains an ample degree of spare capacity in the economy, although increases in demand have led to an incremental rise in capacity utilisation.
- Pay growth remains muted overall, although the upward creep in wage settlements noted in the past couple of months continued.
- Businesses' input costs rose further in June, reflecting increases in global demand as well as some supply shortages for certain components. In some markets, such as those for fuel and timber, increased demand (particularly from emerging economies such as China) was the dominant factor pushing up prices. In other markets — including freight, paper, construction materials and electronics — supply shortages following reductions in global capacity during the recession also played a significant role.
- Consumer price inflation remains elevated.

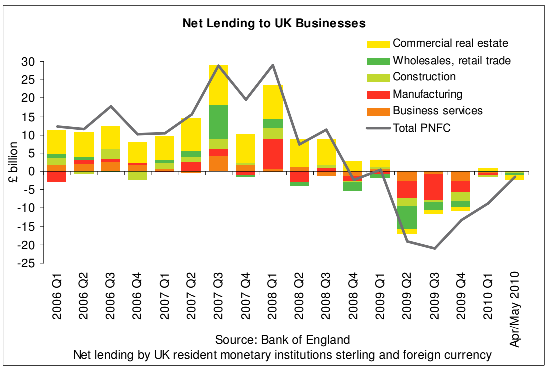
Retail sales

Total retail sales volumes (excluding fuel) rose by 1.6% in June and up 3.1% year-on-year. According to recent surveys, sales in June were boosted by the football World Cup, the good weather and some earlier discounting by retailers in the summer sales.



Manufacturing activity

The CBI's *Industrial Trends Survey* shows that the majority of manufacturers surveyed saw output rising during the three months to July, as export demand strengthened and firms rebuilt their stocks. Looking ahead, firms expect output growth to slow somewhat in the next three months. Costs rose sharply last quarter, but firms now expect that the pace of input price increases is likely to slow. The vast majority of firms said they have adequate capacity to meet demand, but a third plan to invest to increase capacity. However, overall investment intentions remain weak, with spending on buildings expected to fall in the year ahead.



Trends in Lending

- Net lending to UK businesses remained negative in May.
- Demand for bank finance remains muted, with many businesses continuing to pay down bank debt and reduce their leverage.
- Spreads over reference rates on new

lending narrowed for large, and to a lesser extent, medium-sized businesses. Looking ahead, lenders expect spreads, fees and commissions to be broadly unchanged in the next three months for SME's, with a modest improvement in pricing for large businesses, due to competitive pressures.

- Net mortgage lending increased in May, but gross mortgage approvals declined slightly.
- Net consumer credit was positive in May. Spreads between effective interest rates and Bank Rate and Libor remain significantly wider than in late 2008, particularly on interest-bearing credit cards, reflecting in part heightened credit risk.

Public finances

The UK entered the economic downturn with one of the largest structural budget deficits in the OECD. Coupled with an increase in benefit payouts and lower tax receipts during the crisis, as well as banking sector support and the fiscal stimulus, this led to a sharp rise in public sector debt. In June 2010, the current budget deficit was £13.3bn, compared with £12.1bn last year. In the financial year to June, the deficit was £34.6bn, £0.4bn lower than the one in the same period of 2009/10. At the end of June 2010 public sector net debt was £926.9bn, equivalent to 63.9% of GDP.

Exchange rates

The Sterling strengthened 1% against the Euro last week to £/€1.20 and held stable against the Dollar at £/$1.54, on signs that the UK recovery is firming and growing confidence that the new government will address the large budget deficit.

Commodities

Crude oil prices rose 3% in the week to Friday to $77.3 per barrel of Brent, amid supportive economic data and as the start of the hurricane season curbed production in the Gulf of Mexico. Copper rose 5% last week to $6,995/ton, while aluminium held stable. The global steel price index was unchanged last week.

Commodity Prices (23rd July 2010)				
	Price	Weekly change	Monthly change	Annual change
"Brent" Oil ($/ barrel)	77.3	3%	1%	12%
Copper ($/tonne)	6,995	5%	6%	28%
Aluminium ($/tonne)	2,008	0%	4%	18%
Nickel ($/tonne)	20,380	6%	5%	25%
Global Steel Price (Index 04/1994=100)	178.8	0%	-8%	22%
Source: FT, LME, Cruspi				

Construction

Commercial property

According to the RICS' *UK Commercial Market Survey*, sector activity slowed modestly in the second quarter of 2010. Tenant demand for offices declined across all regions. Demand in the retail and industrial markets also fell across most regions, with the exception in the North. The report points to uncertainty over public spending cuts weighing on investment decisions. The majority of those surveyed report that enquiries fell back and confidence in the outlook for lettings decreased - for the first time since Q2 2009. The availability of space picked up, in particular in the North and the Midlands. Offices saw the biggest increased in availability. Availability of retail space also rose, but at a more moderate pace than in the previous quarter. Regionally, office space continued to decline in central London, but at a slower pace and retail space availability is stabilising in London after a long period of reported increase. Rental expectations eased back. The only exception was office space in Central and Greater London, where rental expectations remain positive.

Looking ahead

The CBI's Distributive Trades Survey for July is expected to show that retail sales rose further, helped by good weather and retailers' discounting in the summer sales. Consumer lending data from the Bank of England are set to show that housing market activity eased further in June, with mortgage approvals and loans for house purchase expected to fall back modestly. The Nationwide is likely to report that house prices stagnated in July, or even declined on a month-on-month basis, as the increase in properties coming onto the market is moving the supply-demand balance more in favour of buyers. The GfK/NOP consumer confidence index is anticipated to show a further decline in July, due to increased caution over the general economic outlook and personal financial situation on the back of increasing fiscal tightening.

Market Watch

Amid mixed signals from the world's largest economies, equity markets were volatile last week. In the US, Fed Chairman Ben Bernanke's very cautious assessment of prospects for the US economy sent equity markets tumbling. By the end of the week, when figures showed that the UK economy bounced back much stronger than had been expected and the results of European banking stress tests were released, markets looked more settled.

The FTSE 100 ended the week up 3% at 5,312.6. The real estate index grew in line with the wider index.

With the exception of Minerva (-5.9%), Quintain Estates and Development (-4.2%) and the Workspace Group (-2.4%), listed real estate businesses saw their share prices rise last week. Among the top performers were St. Modwen Properties, up 7.6%, Capital Shopping Centres, up 6.9% and Land Securities, up 6.7%.

In an Interim Management Statement, Great Portland Estates plc gave an update on trading, as well as the quarterly valuation of the Group's properties as at 30 June 2010. Net asset value (NAV) per share rose 4.2% in the second quarter to 295p from 283p at the end of March. Its portfolio valuation rose 4.6% during the quarter. Rental values increased by 2.5% in West End offices and 1.8% in West End retail. During the period 27 new leases worth £1.1 million p.a. were signed. The void rate was stable at 3.6%. GPE has two West End development projects now on site.

Building contractors, material suppliers and house builders saw their share prices rise on average last week, with only a few exceptions.

Stock Market			Friday 23rd July 2010		
Index	**Index**		**Week**	**Month**	**Year**
FTSE100	5,312.6	▲	3.0%	2.6%	16.5%
EPRA/NAREIT UK	350.8	▲	3.1%	2.3%	15.7%
Stocks	**Market Cap, £m**		**Share Prices**		
			Week	**Month**	**Year**
Real Estate					
British Land	4,040	▲	4.4%	3.7%	12.2%
Hammerson	2,710	▲	5.8%	6.2%	16.9%
Land Securities	4,660	▲	6.7%	2.4%	22.3%
Capital & Counties	702	▲	0.6%	6.6%	
Capital Shopping Centres	2,150	▲	6.9%	4.4%	
Shaftesbury	911	▲	4.4%	8.2%	26.3%
Great Portland Est.	960	▲	3.0%	4.3%	38.4%
Derwent London	1,370	▲	4.6%	4.2%	42.0%
Segro	2,070	▲	3.7%	6.6%	8.6%
Quintain Estates & Development	206	▼	-4.2%	-9.7%	24.1%
St. Modwen Properties	356	▲	7.6%	-4.5%	-2.0%
Unite Group	293	▲	0.8%	-4.7%	52.2%
Workspace Group	230	▼	-2.4%	-7.0%	25.0%
Minerva	154	▼	-5.9%	-6.1%	558.6%
Average*		▲	4.9%	3.9%	21.4%
Building Contractors					
Balfour Beatty	1,760	▲	3.7%	5.0%	-3.2%
Carillion	1,310	▲	2.4%	1.5%	23.6%
Morgan Sindall	251	▲	1.8%	8.5%	-8.7%
Kier Group	395	▲	4.8%	3.9%	15.3%
Lend Lease Corp*	2,315	▼	-0.1%	-0.8%	3.0%
Average		▲	1.9%	2.1%	6.0%
Building material suppliers					
Wolseley	4,100	▲	5.7%	-2.6%	21.3%
SIG	615	▲	3.5%	-5.5%	-6.9%
Marshalls	167	▼	-5.0%	3.3%	-2.3%
Kingspan	775	▼	-6.1%	-12.1%	23.0%
BSS	546	▲	1.1%	-3.5%	73.2%
Average		▲	3.3%	-4.0%	22.6%
Housebuilders					
Persimmon	1,110	▼	-2.2%	-3.7%	-15.0%
Taylor Wimpey	864	▲	3.6%	-13.6%	-28.0%
Barratt	967	▲	0.9%	-7.2%	-18.6%
Bovis Homes	473	▲	2.1%	-2.3%	-21.6%
Bellway	709	▼	-0.7%	-11.0%	-18.5%
Berkeley	1,110	▲	0.7%	4.5%	-1.5%
Average		▲	0.5%	-5.1%	-16.0%

**Sector averages are weighted according to current market capitalisations