

Weekly Economic Update

24th October 2010

Summary
PAGE 1

2010 Comprehensive Spending Review
PAGE 1

Economy
Public finances
PAGE 3

Trends in lending
Business conditions
Retailer survey
PAGE 4

Retail sales
Labour market
Inflation
Housing market
Exchange rates
Commodities
PAGE 5

Construction
Commercial property returns
Housing starts
PAGE 6

Market Watch
PAGE 7

Summary

The main event in the UK last week was the Government's Comprehensive Spending Review (CSR), which provided details where the squeeze on public spending, set out in June's Emergency Budget, will be felt most keenly. The government presented a strong case for the cuts, placing reducing the UK's large fiscal deficit as its top priority. However, as nearly half a million public sector jobs are likely to be lost over the next four years, tough times lie ahead for the UK economy. On balance, the outcome of the CSR is probably somewhat better than the construction industry might have expected. The cuts in capital expenditure are slightly less severe than that set out in June. Transport investment has been one of the winners, with the £30bn of capital investment proposed over the next four years slightly more than investment over the last four. Nevertheless, there will still be £20bn less public capital investments in the next four years compared with the four years ending March 2011.

2010 Comprehensive Spending Review

The CSR sets out the government's spending plans for the next four years, against the background of returning public finances to a sustainable path by eliminating the structural budget deficit by 2014/15.

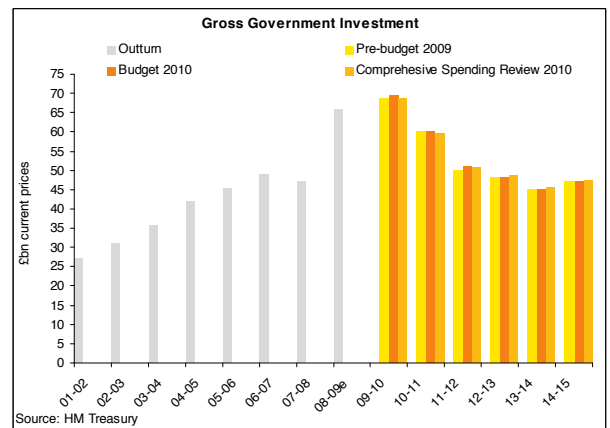
Chancellor Osborne looks to slash costs in government departments by an average of 19%, announcing for example an increase in the retirement age to 66 by 2020 and the reduction of 490,000 public-sector jobs over the next four years. Overall, current expenditure is set to rise from £637.3bn in 2010/11 to £692.7bn in 2014/15. In contrast, capital spending is set to fall from £59.5bn in 2010/11 to £47.2bn in 2014/15, a real decrease of 29%.

All government departments are expected to save up to a third off their administration budgets, which includes the sacrifice of some 490,000 civil service posts, the abolition of 24 quangos and 30-40 arms length bodies (for example the Commission for Architecture and Built Environment (CABE) is to be wound up, after the Department for Culture, Media and Sport (DCMS) stopped its funding), and the movement of Diplomats out of Whitehall.

More departmental details will be provided in the National Infrastructure Plan published this week, and the Business Plans for the next four years published next month. Interestingly, the industry will have an opportunity to comment on these Business Plans before they come into effect in April next year.

Education

- o Capital spending to fall from £7.6bn in 2010/11 to £3.4bn in 2014/15, a real cut of 60%.



- Capital spending of £15.8bn over next four years will be focused on providing new places in areas of demographic pressure and addressing essential maintenance needs. The government will meet its commitment to rebuild or refurbish over 600 schools from the BSF and Academies programme. The focus will clearly be on refurbishment.
- Funding has been protected for Sure Start Children's Centres in cash terms.
- Five quangos in the area of education are set to be axed, but no names were declared.

Health

- Total health spending is set to rise from £104bn in 2010/11 to £114bn by 2014/15, but the Treasury is looking for some £20bn efficiency savings across the period.
- Capital spending to fall from £5.1bn in 2010/11 to £4.6bn in 2014/15, a real cut of 17%.
- Spending will be prioritised on essential maintenance and equipment as well as priority hospital schemes including St. Helier, Royal Oldham and West Cumberland.

Transport

- Capital spending to fall slightly from £7.9bn in 2010/11 to £7.8bn in 2014/15, a real cut of 11%. £1.5bn to be provided for major transport schemes, of which £600m to be spent on existing transport commitments and £900m on new schemes. £560m to be allocated on local sustainable transport.
- The department's resource budget will peak at £5.3bn in 2011/12 before falling to £4.4bn in 2014/15. Local road maintenance is funded out of the resource budget.
- The Highways Agency's average annual maintenance budget on existing road network will be £714m over the CSR period, compared to £748m in 2010/11.
- A number of road improvement and extension programme will go ahead, including improvement work on the junctions between M4 and M5, and congestion relief on M1. However a number of schemes have been cancelled, including A21 Kippings Cross to Lamberhurst, Flimwell to Robertsbridge and Baldslow Interchange; A19 Moor Farm and Seaton Burn interchange; A1 Leeming to Barton; A47 Blofield to North Burlingham.
- The £16bn Crossrail will go ahead, but will be cut by around £1bn, with savings to include lengthening the delivery programme for the central tunnel works by approximately one year. The \$430m Mersey Gateway projects will go ahead.
- Capital spending to improve key London underground lines will be protected.
- The expansion of Midland Metro and funding of £500m for the upgrades of the Tyne and Wear Metro announced by the previous government were confirmed.
- £14bn for the Network Real for maintenance and improvement work including work on the East Coast Mainline, and the upgrade of Birmingham New Street Station. Major station upgrades will be carried out totalling £2.1bn over the next four years.
- Subject to consultation, the government will be spending £750m on a new high speed rail network over the CSR period.
- Proceed with PFI schemes to deliver improvement to the highways maintenance in Sheffield, Hounslow and the Isle of Wight and extend the Nottingham tram network with two new lines.

Communities and Local Government

- Housing has seen some of the most severe budget cuts, with capital spending to fall from £7.4bn in 2010/11 to £2.6bn in 2014/15, a real cut of 74%.
- Up to 150,000 new homes could be delivered over CSR period, with £4.4bn allocated to affordable housing. However, the government has not set out how to achieve this and given that the Homes and Communities Agency in the past financial year spent £3.3bn on its National Affordable Housing Programme to complete 53,000 homes, the funds available – grants for social housing - will be spread thinner.
- Decent Homes programme will continue to improve the existing social housing stock, with £2bn allocated to complete the programme
- The New Homes Bonus (NHB) will be equivalent to matching the additional council tax from every new home for each of the following six years. £900m have been set aside to fund the NHB, which will be introduced in April 2011.

Energy and Climate Change

- Capital funds to rise from £1.7bn in 2010/11 to £2.7bn in 2014/15, a real rise of 41%.
- Revenue raised from the CRC Energy Efficiency Scheme (previously called Carbon Reduction Commitment) will be used to support public finances, rather than being recycled back to participants. The scheme is a mandatory carbon emission trading

scheme, covering all organisations consuming more than 6,000MWh per year. The first allowance sales for 2011/12 emissions will take place in 2012 rather than 2011.

- £1bn of funding, plus proceeds from sale of public assets, to be made available to capitalise the Green Investment Bank. In addition, £250m are provided for Scotland.
- Up to £1bn investment to create a commercial scale Carbon Capture and Store (CCS) demonstration plant.
- Over £200m to be invested in manufacturing facilities at port sites and technology innovation to support the development of offshore wind power and energy efficiency technology for building.
- Incentives for low carbon generation through the Renewables Heat Incentive, to be introduced in 2011/12, with £860m available. This will not be funded under renewable heat levy as set out by the previous government.
- Green deal to enable households to improve energy efficiency of their homes without upfront costs together with additional requirements by energy companies. The Warm Front public spending programme will be phased out by 2013/14 saving £345m.
- The efficiency of feed-in tariffs will be rebalanced in favour of more cost effective carbon abatement technologies at the next review in March 2013, saving £40m, unless higher than anticipated deployment required in early review.

Defra

- Capital spending to fall from £0.6bn in 2010/11 to £0.4bn in 2014/15, a real cut of 34%.
- £2bn to be allocated on flood defences and coastal erosion. Expected 15% efficiency saving to be made in the procurement strategy for flood and coastal defences
- Funding will be stopped for seven waste PFI projects, saving £3bn by 2014/15.

Other

- Maintain the existing prison estate and fund essential new build projects. Plans for a 1,500 new-for-old prison will be deferred to the next CSR, while the government develops a cost effective prison capacity strategy.

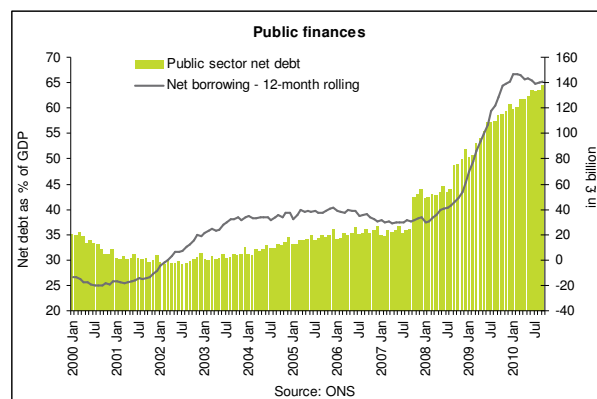
CSR 2010 - Departmental Capital Budgets							
	2009/	2010/	2011/	2012/	2013/	2014/	Cumulative real
£ billion	10	11f	12f	13f	14f	15f	growth 2010/11 -
Defence	9.2	8.6	8.9	9.1	9.2	8.7	-8%
CLG Communities	9.2	7.4	3.9	3	2.5	2.6	-74%
Transport	8.3	7.9	8	8.3	7.7	7.8	-11%
Education	7.6	7.6	4.9	4.2	3.3	3.4	-60%
Health	5.4	5.1	4.4	4.4	4.4	4.6	-17%
Energy & Climate Change	1.9	1.7	1.5	2	2.2	2.7	41%
Defra	0.7	0.6	0.4	0.4	0.4	0.4	-34%
Other	26.4	20.5	18.7	17.1	15.9	17	-34%
Total	68.7	59.5	50.7	48.5	45.6	47.2	-29%
Public construction spend	28.2	24.4	20.8	19.9	18.7	19.4	

estimated 40% of capital expenditure was public sector construction in 2009/10

Economy

Public finances

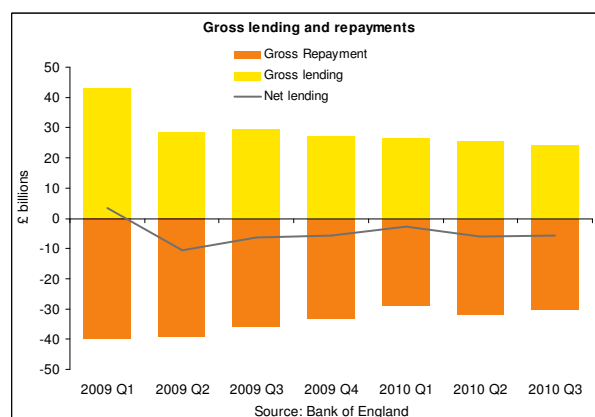
Public sector net borrowing in September was higher than expected at £16.2bn, up £0.7bn on a year ago. The rise was mainly due to higher interest payments and social benefits spending. Borrowing in the first six months of this financial year stood at £73.5bn, on track to meet the 2010/11 target of £149bn. Net debt (excl. financial interventions) stood at £842.9bn in September or 57.2% of GDP (£952bn, or 64.6% incl. interventions). The latest data highlight the still very high public debt, which will maintain pressure on the government to continue fiscal consolidation.



Trends in lending

The latest Bank of England lending survey shows that:

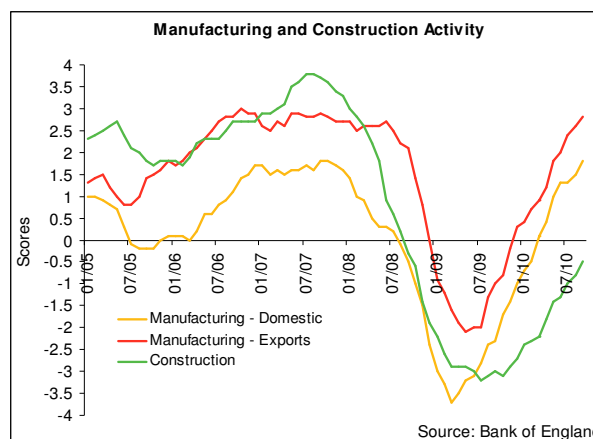
- Net lending to UK businesses remained subdued in August and weakened in September.
- Demand for credit was broadly unchanged for medium and large businesses, though it fell for small businesses. Generally, businesses continue to pay down debt as they reduce leverage and improve working capital management. Some major UK lenders report that, more recently, some businesses were using retained earnings to repay bank debt.
- Availability and terms of credit improved for larger companies outside property and construction, though credit availability for small businesses generally remains difficult.
- Spreads on lending to larger corporates fell further. Looking forward, spreads are expected to be broadly unchanged for all businesses, regardless of size.
- The flow of net mortgage lending increased in August, but gross mortgage approvals for house purchase declined slightly in September. Demand for secured credit for house purchase fell unexpectedly in Q3 2010 and the lenders expect demand for secured lending to remain subdued. Net consumer credit was slightly negative in August.



Business conditions

The Bank of England's survey of Business Conditions for September reveals that:

- Retail sales growth moderated further, but consumer services growth remained steady.
- Housing market activity remained weak, with house prices expected to fall or stabilise at best, partly reflecting higher stocks of houses for sale.
- Investment intentions picked up in manufacturing. Capital spending mainly financed from internal resources.
- Availability and terms of credit are improving for (mainly larger) companies outside property and construction with lower levels of debt.
- Services sector activity continued to rise modestly in September. Manufacturing output growth for the domestic market strengthened, but at a slower pace than for exports. A small but increasing number of manufacturing exporters note that output is back on a par with pre-recession levels, although for most manufacturers there remains a marked, albeit narrowing shortfall.
- Construction output in September was reported to be roughly on par with last year's weak levels. However, public sector work has started to edge down and the decline is expected to accelerate in 2011. Tight finance conditions for companies linked to the sector remains a constraint.
- Pay settlements continued to rise modestly during the month. Non-labour costs inflation eased slightly in September, but costs remain higher than a year earlier.
- Retail goods price inflation eased slightly, but inflation picked up for consumer services. The 2011 VAT rise is likely to be passed on in full in January by a majority of contacts.



Retailer survey

The British Retail Consortium reports that total retail sales in September were 2.2% higher than a year ago, while like-for-like sales were up by 0.5%. Total sales growth was weaker than in August, and sales of 'big-ticket' items were particularly slow, suggesting that consumers are not yet bringing forward major purchases to beat the VAT increase in January.

Retail sales

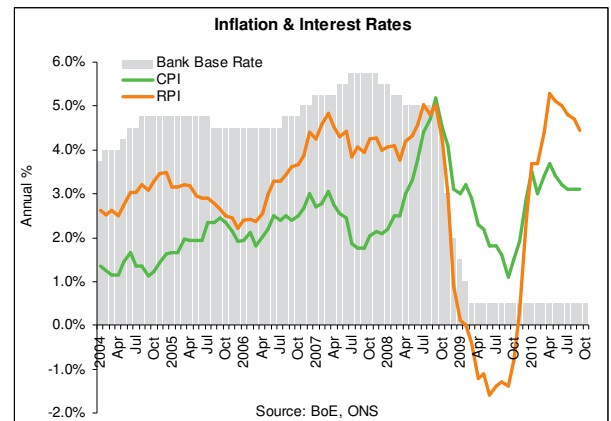
Official retail data were weaker than expected in September, with the volume of sales virtually unchanged compared to the preceding month. The three-month growth rate, a better indicator of the underlying trend, slowed to an annual 2.2%, compared to 2.5% last month.

Labour market

Latest news from the labour market remains mixed. Unemployment fell by 20,000 in the three months to August compared to the preceding three months, while the number of people employed rose by 178,000 over the same period. The increase in employment was once again mainly driven by a rise part-time work. At the same time, the number of benefit claimants increased again slightly by 5,300 to 1.47 million. Annual earnings growth (excluding bonuses) picked up to 2% in the three months to August, from 1.6% in July.

Inflation

Consumer price inflation in September remained sticky at 3.1% for the third consecutive month. However, whilst the headline figure was steady, this masks significant differences among the different components. The main downward pressure came from transport and petrol prices, while upward pressure came from food and beverages, and clothing and footwear. The rise in the clothing and footwear component was the first positive reading since the CPI index started in 1997. The RPI measure of inflation slowed marginally to 4.6%, from 4.7% in August.

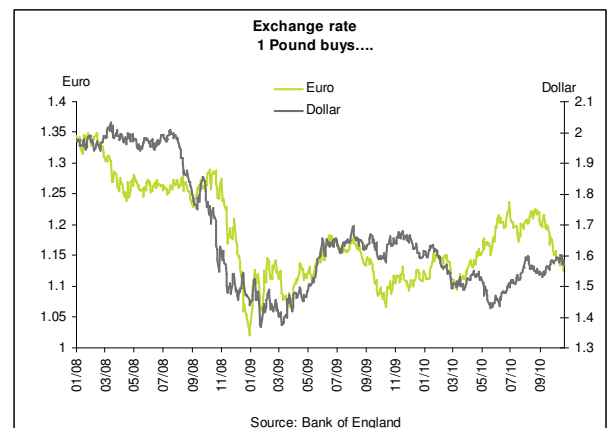


Housing market

The RICS' housing market survey for September reveals that sector activity continued to weaken last month. For a third consecutive month, the majority of those surveyed reported that house prices fell on average, as increased supply of property acts as a drag on prices. The survey suggests that new buyer enquiries stabilised, but as new instructions to sell are rising, prices are expected to remain under downward pressure in the coming months.

Exchange rates

The Dollar strengthened for the first time in six weeks against the Euro, as the G20 finance ministers debate a plan to ease exchange rate tensions. Nevertheless, the Dollar remains weak overall, due to expectations that the Federal Reserve will further ease monetary policy in support of the fragile US economy. The Pound fell 2% against both the Euro and the Dollar. One Pound bought £/\$1.567 and €1.1288. The Pound is at its lowest against the Euro since beginning of April 2010.



Commodities

Commodity prices edged back last week. Oil prices fell 2% to \$82.1/ barrel of Brent. Base metal prices, whilst firmly up compared to a month ago, fell last week, with copper down 1% at \$8,309/ ton and aluminium down 2% at \$2,326/ ton. Steel prices rose slightly, with the global steel price index recording a 1% increase.

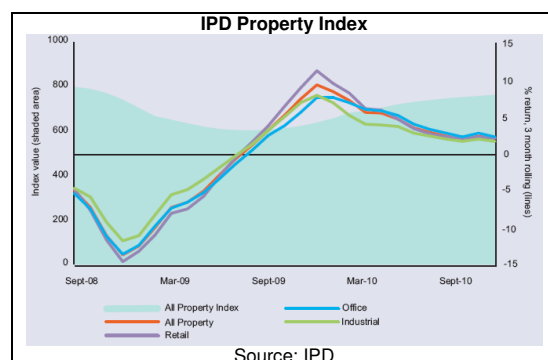
Commodity Prices (22nd Oct 2010)				
	Price	Weekly change	Monthly change	Annual change
"Brent" Oil (\$/ barrel)	82.1	-2%	6%	4%
Copper (\$/tonne)	8,309	-1%	8%	32%
Aluminium (\$/tonne)	2,326	-2%	8%	19%
Nickel (\$/tonne)	23,405	-3%	5%	20%
Global Steel Price (Index 04/1994=100)	178.7	1%	-1%	15%

Source: FT, LME, Cruspi

Construction

Commercial property returns

Commercial property capital growth stood at 0.2% in September, marginally up on 0.1% growth in August. Together with a 0.6% income return, this delivered a monthly total return of 0.7%. 12-month capital growth is now 14.2%. Income returns have resumed the role of principal component of total returns, as they were last in Q3 2009. Retail and office capital values rose 0.2% in September, while the industrial sector saw a second consecutive month of capital depreciation, at -0.1%. Rents continued to fall in the retail and industrial sector, but the office market has now seen five consecutive months of modest rental growth.



Housing starts

The NHBC housing market report reveals that private housing starts totalled 9,033 in September, down 9% on the month, but 16% higher compared to a year earlier. In the third quarter of 2010 there were 29,625 homes started in the UK, 28% more than during the same period last year, but 3% less than during the preceding quarter. According to the NHBC, a strong performance of the housing market in spring was followed by a weaker summer and there has not been the traditional autumn uplift that the industry was hoping for.

Market Watch

Financial markets were relatively unfazed by the public spending cuts set out in the CSR, as the overall direction of fiscal policy was in line with that outlined in June's "Emergency Budget".

The FTSE100 index climbed for a third consecutive week, rising 0.7% to 5,741.4 points. The real estate index underperformed, falling 0.6% in the week to Friday.

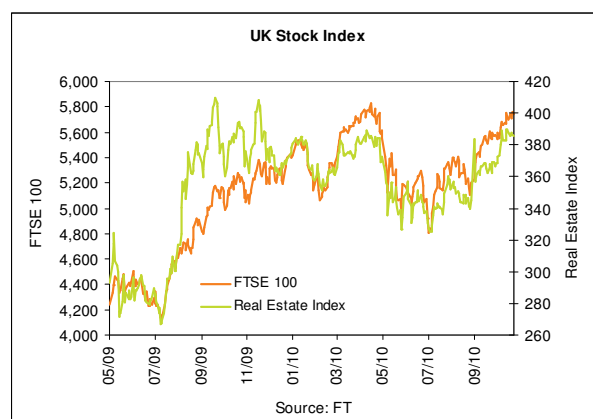
Shaftesbury, Minerva and Great Portland Estates saw the sharpest losses, falling 3.5%, 3.3% and 2.9% respectively. British Land, Capital & Counties and St. Modwen bucked the trend, rising 0.5%, 4.3% and 2.2% respectively last week.

Building contractors and material suppliers gained on average, with Lend Lease and BSS the only exceptions.

In contrast, amid more signs of a renewed slowdown in the UK housing market and spending cuts for social housing, housebuilders fell across the board. Taylor Wimpey shed 9.6%, Barratt lost 7.8%, and Persimmon fell 5.8%.

Stock Market		Friday 22nd October 2010			
Index	Index	Week	Month	Year	
FTSE100	5,741.4	▲ 0.7%	3.4%	10.3%	
EPRA/NAREIT UK	385.8	▼ -0.6%	5.5%	-1.2%	
Stocks	Market Cap, £m	Share Prices			
		Week	Month	Year	
Real Estate					
British Land	4,460	▲ 0.5%	9.3%	5.4%	
Hammerson	2,920	▼ -1.5%	6.6%	-0.7%	
Land Securities	5,220	▼ -0.2%	8.2%	2.5%	
Capital & Counties	918	▲ 4.3%	12.7%		
Capital Shopping Centres	2,400	▼ -0.7%	5.1%		
Shaftesbury	1,010	▼ -3.5%	1.7%	16.9%	
Great Portland Est.	1,060	▼ -2.9%	1.0%	29.2%	
Derwent London	1,540	▼ -1.6%	2.3%	20.1%	
Segro	2,190	▼ -0.5%	12.3%	-22.8%	
Quintain Estates & Development	217	▼ -1.2%	3.7%	-56.6%	
St. Modwen Properties	362	▲ 2.2%	11.2%	-21.4%	
Unite Group	345	▼ -1.3%	9.1%	-27.9%	
Workspace Group	256	▼ -1.1%	6.0%	2.3%	
Minerva	154	▼ -3.3%	0.3%	159.2%	
Average*		▼ -0.5%	7.4%	0.2%	
Building Contractors					
Balfour Beatty	1,860	▲ 1.8%	0.9%	-4.9%	
Carillion	1,400	▲ 2.1%	11.5%	16.3%	
Morgan Sindall	294	▲ 2.6%	-0.7%	18.0%	
Kier Group	468	▲ 0.8%	11.0%	23.8%	
Lend Lease Corp*	2,511	▼ -3.1%	1.1%	-25.6%	
Average		▲ 0.0%	3.9%	-5.2%	
Building material suppliers					
Wolseley	4,700	▲ 1.7%	11.3%	15.1%	
SIG	658	▲ 0.7%	13.3%	-13.6%	
Marshalls	210	▲ 0.2%	-0.2%	-8.4%	
Kingspan	890	▲ 0.8%	5.5%	-1.5%	
BSS	537	▼ -3.7%	-2.8%	60.5%	
Average		▲ 1.1%	9.3%	13.1%	
Housebuilders					
Persimmon	1,070	▼ -5.8%	-10.5%	-19.3%	
Taylor Wimpey	740	▼ -9.6%	-20.2%	-45.4%	
Barratt	774	▼ -7.8%	-21.1%	-47.6%	
Bovis Homes	475	▼ -1.3%	-6.4%	-19.2%	
Bellway	676	▼ -4.6%	-4.1%	-30.2%	
Berkeley	1,090	▼ -1.2%	1.4%	-8.3%	
Average		▼ -5.1%	-9.7%	-26.9%	

**Sector averages are weighted according to current market capitalisations



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