

Weekly Economic Update

28th February 2011

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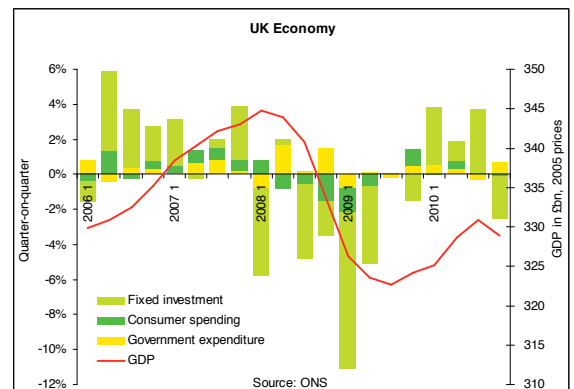
Summary

Policymakers and markets around the world are nervously watching escalating tensions in the Middle East, in particular in Libya, assessing what it will mean for inflation and economic growth. There are certainly worries that rising oil prices – which hit a 2½-year high last week - will soon feed through to higher inflation, increasing the pressure on central banks to hike interest rates. In the UK, where CPI inflation is already at an elevated 4%, high oil prices is having a “double whammy” effect – raising the costs to businesses and reducing spending power at a time that the economic recovery remains fragile.

Economy

UK economy

The UK economy contracted slightly more in the final quarter of 2010 than previously estimated, with GDP down 0.6% on the third quarter. Much of the decline has been attributed to December’s bad weather and a bounce back during the first quarter of 2011 is generally expected. However, there are concerns over the underlying strength of the economy. Government spending was the only positive growth driver in the fourth quarter, rising 0.7% during the quarter and up 1.2% year-on-year. Given the wave of fiscal cuts about to kick in, public spending is unlikely to make a positive contribution to growth in the near term. Consumer spending contracted slightly by 0.1% during the fourth quarter, while fixed investment saw a larger drop of 2.5%. On the positive side, data now show that construction output fell 2.5% in the fourth quarter, which was less than the 3.3% drop previously reported. After the likely first-quarter 2011 rebound, UK growth is generally expected to moderate, as the fiscal squeeze kicks in and some temporary growth drivers – mainly re-stocking – wane. Consumer spending in particular is expected to be subdued in the face of low wage growth and high inflation curbing spending power, high unemployment and a weak housing market. Given the uncertainty over the demand outlook, businesses are likely to remain cautious regarding their investment plans.



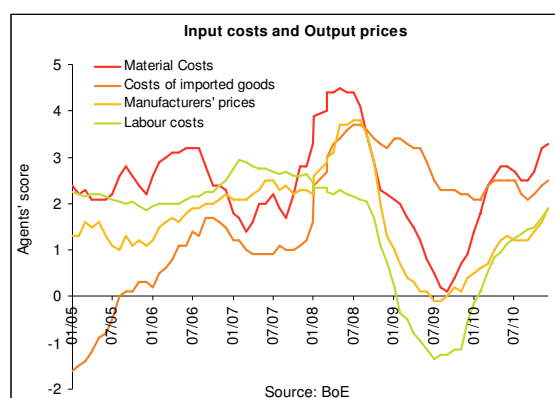
Bank of England minutes

In last week’s quarterly Inflation Report, Bank of England Governor King appeared to go out of his way to play down market expectations that the MPC is considering to hike interest rates, despite the Bank revising upwards its inflation forecast. The minutes of the MPC’s February meeting reveals the divisions on the Committee over the need to react to elevated inflation – annual CPI came in at 4% in January – with yet another member voting for a rate rise, which left the voting split at 6-3 in favour of holding rates.

Business conditions

The Bank of England’s survey of Business Conditions for January reveals that:

- **Retail sales** rose slightly in January, reflecting in part some recovery of spending that had been postponed as a result of the bad weather in December, but growth remains very modest.
- **Housing market** activity slowed further, as concerns about future incomes and the possibility of further declines in house prices continue to weigh on the market.
- **Investment intentions** continue to rise, with the manufacturing sector expecting reasonably strong investment growth in the year ahead. There are reports that firms were looking to invest in additional capacity to keep up with rapid growth in export demand, but the majority of the investment plans are still driven by the need to maintain and repair existing capital, and to boost efficiency.
- The **services sector** grew moderately, supported by rising private sector demand, but there was still downward pressure on fees. **Manufacturing** activity continues to be boosted by foreign demand, while domestic demand remains much weaker.
- **Construction** activity remains subdued, hit by the winter weather. Activity is expected to recover as improvement in the weather permits work to be resumed. Construction work continues to be underpinned in part by large projects in London. There were also reports of construction work related to transport, utilities and renewable energy.
- **Input costs** continue to rise mainly due to raw materials price increases, i.e. coking coal, iron ore, which has fed through to steel prices. Global demand is keeping the cost of various raw materials elevated, i.e. agricultural commodities, metals and energy. The costs of imported finished goods are also rising, partly due to the increases in raw materials, but also higher labour costs in some emerging economies. Output price inflation ticked up in January, as businesses passed on some of the rise in their costs.



Retail sales

Official data show that retail sales volumes rebounded in January, after December's decline, rising 1.5% during the month and up 5.3% year-on-year. However, the CBI's latest Distributive Trades survey reveals that retail sales growth slowed markedly in February, with only a small majority of those surveyed reporting higher sales during the month. Retailers do not expect an increase in sales over the next month and retail sales are generally anticipated to be subdued in 2011, as consumers rein in their spending due to reduced spending power (higher inflation and muted wage growth), high unemployment, a weak housing market and the fiscal squeeze. Price inflation on the high street has risen considerably in February, with more than three quarters of retailers saying that average selling prices were up on a year ago. More positively, the survey shows that retailers' investment intentions remain positive for the year ahead.

Public finances

More positive UK public finances are offering some confidence that the UK's deficit consolidation plan is moving in the right direction. Public sector net borrowing was negative in January at £3.1bn, compared to an increase of £.13bn last year. Borrowing in the first ten months of this financial year stood at £113bn, compared to £127.2bn in 2009/10. Higher tax receipts and lower benefit payments are helping to trim the rise in public expenditure; though increasing interest payments on public debt remain a serious problem. Net debt excluding the temporary effects of financial interventions was £867.2bn in January, equivalent to 57.6% of GDP (£2244.2bn, or 149.2% of GDP including interventions). Whilst the public finances show a modest improvement so far in 2010/11, the outlook will depend on UK growth and labour market trends in the year ahead.

Commodities

The threat of supply disruption in Libya, where political tensions escalated over the past week, drove oil prices to \$111.1/ barrel – up \$18 since the start of the year and their highest level in two and a half years. Saudi

Commodity Prices (25th Feb 2011)				
	Price	Weekly change	Monthly change	Annual change
"Brent" Oil (\$/ barrel)	111.1	8%	15%	42%
Copper (\$/tonne)	9,700	-1%	4%	37%
Aluminium (\$/tonne)	2,530	1%	7%	23%
Nickel (\$/tonne)	27,730	-2%	8%	35%
Global Steel Price (Index 04/1994=100)	220.5	0%	10%	36%

Source: FT, LME, Cruspi

Arabia moved to calm mounting fears of an oil supply crisis, stating that OPEC will replace any lost Libyan oil if asked. However, oil prices are likely to remain high given that the events in the Middle East are still unfolding.

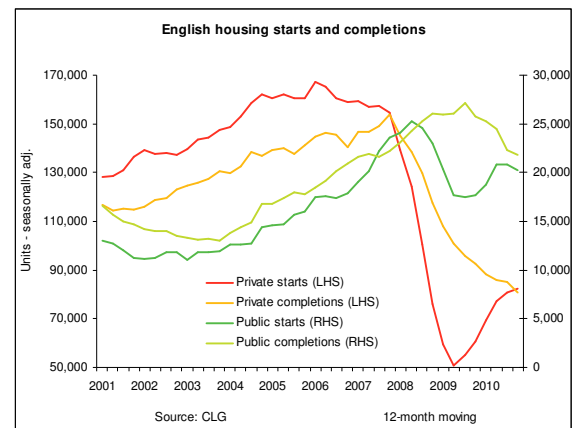
Exchange rates

The Sterling weakened last week, falling 1.6% to £/€1.169 against the Euro and down 0.8% to £/\$1.607 against the Dollar. The Euro remains remarkably resilient to bad news surrounding sovereign debt problems, with the common currency benefiting from robust economic growth in the “core” states, while the Dollar is gaining strength on the back of tensions in the Middle East, which is increasing “safe haven” demand.

Construction

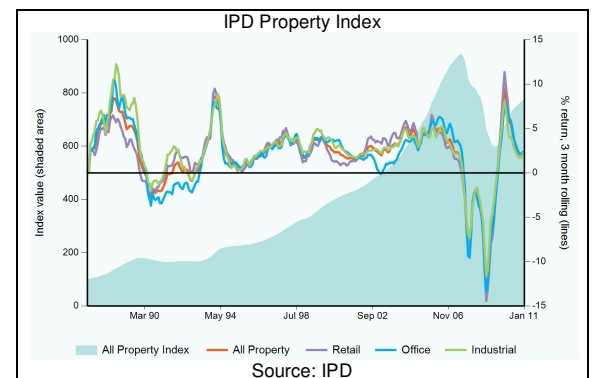
House building

House building activity declined in the 4th quarter of 2010, for a second consecutive quarter. Private housing starts, at 18,920 dwellings, were down 9% on the previous quarter, though up 9% on a year ago. Private completions totalled 17,960, down 18% on the quarter and 19% lower compared to last year. Overall in 2010 there were fewer than 81,000 homes completed in England, compared with almost 154,000 at the peak in 2007. Public housing starts totalled 4,080 dwellings, down 19% on the previous quarter and 14% year-on-year. Public completions, at 5,230 dwelling were 5% up on the preceding three months, but down 8% on the year. In total there were 21,840 public homes completed in England last year, down 15% compared to 2009.



Commercial property returns

UK commercial capital growth was relatively flat at 0.1% in January 2011, according to the IPD UK Monthly Index, as yields and rents continue to stagnate. An income return of 0.6% helped to deliver a 0.7% total return in January. The annual capital growth rate slowed to 6% compared to 6.9% in December 2010. There was little difference at the sector level last months, with retail and industrial posting 0.7% total return and the offices sector showing 0.6%. At the main sector level, there is little differential across the headline indicators as illustrated in the chart below.



Looking ahead

Survey evidence from the **manufacturing**, **services** and **construction** sectors will provide evidence as to whether the rebound in economic activity in January was sustained this month. Manufacturing activity is likely to have seen another month of robust growth in February, with businesses benefiting from firm domestic and in particular export demand. Service sector growth is likely to have softened slightly in February, held back by subdued consumer spending and cut backs in government spending. Construction activity is anticipated to have seen moderate growth in February, though the pace of growth is likely to have slowed compared to January’s bounce-back in activity. Construction this year is widely expected to decline, given the removal of fiscal stimulus and a still subdued private sector. **Consumer lending** is set to have remained constrained at the start of this year. In particular mortgage approvals for house purchase remain well below historic standards, given still tight lending conditions and muted demand due to the weak housing market. The Nationwide is expected to report that **house prices** fell month-on-month in February. Most commentators expect house price to decline this year, due to subdued consumer confidence, negative real income growth, high unemployment, and tight mortgage lending.

Market Watch

Equity markets dropped last week, as the crisis in Libya sent oil prices to a 2½-year high, though shares recouped some losses on Friday helped by reports that Saudi Arabia is prepared to increase crude supplies if needed. The Kingdom has entered "active talks" with European oil companies on how to meet the shortfall caused by the turmoil in Libya.

The FTSE100 ended the week just above the 6,000-mark, down 1.3% on the preceding week. The UK real estate index outperformed the wider market, posting a 0.7% gain.

Among real estate stocks, Minerva saw the largest gain, rising 2.1%. Derwent London rose 1.8%, Capital & Counties was up 1.5%, and British Land and Hammerson both advanced 1%.

Building contractors had a mixed week, with Balfour Beatty, Carrillion and Morgan Sindall posting large losses. In contrast the Kier Group jumped 8%. In the six months to December 31, Kier posted a pre-tax profit of £29.6m, compared with £30.5m in the same period a year ago. Sales of £1.1bn were slightly up on 2009's figure of £1bn. Kier last week outlined plans to increase its market share in the £35bn facilities management sector (Source: FT).

Housebuilders had a good week, with only Taylor Wimpey falling 0.8%. Bellway was up 5.5%, while Persimmon advanced 5.3%. Barratt Developments reported that selling prices rose in the second half of 2010, but stressed that the outlook for 2011 remains very fragile. It reported a pre-tax loss in the half year to 31 December of £4.6m, compared to £178.4m over the same period the previous year, as revenues edged up to £877.6m from £872.4m. Barratt Development's share price ended the week up 4.2%, given it a market capitalization of £1bn.

In wider industry news, support services and construction group Interserve has confirmed that it is the potential bidder that is in advanced talks with services provider Mouchel.

Stock Market		Friday 25th February 2011			
Index	Index	Week	Month	Year	
FTSE100	6,001	▼ -1.3%	1.4%	13.7%	
EPRA/NAREIT UK	409.8	▲ 0.7%	4.8%	13.5%	
Stocks	Market Cap, £m	Share Prices			
		Week	Month	Year	
Real Estate					
British Land	5,040	▲ 1.0%	9.3%	28.0%	
Hammerson	3,190	▲ 1.0%	3.1%	17.0%	
Land Securities	5,770	▲ 0.6%	9.0%	18.3%	
Capital & Counties	920	▲ 1.5%	0.5%		
Capital Shopping Centres	3,330	▲ 0.3%	1.4%	-17.8%	
Shaftesbury	1,060	▲ 0.0%	6.0%	24.1%	
Great Portland Est.	1,200	▼ -0.8%	7.2%	36.5%	
Derwent London	1,680	▲ 1.8%	8.4%	28.8%	
Segro	2,350	▼ -2.5%	7.6%	-1.1%	
Quintain Estates & Development	229	▼ -1.1%	7.3%	-28.7%	
St. Modwen Properties	341	▼ -4.0%	-2.6%	-9.3%	
Unite Group	321	▼ -1.6%	-4.4%	-31.0%	
Workspace Group	291	▲ 0.0%	-1.9%	18.8%	
Minerva	158	▲ 2.1%	-3.9%	22.5%	
Average*		▲ 0.3%	6.2%	13.4%	
Building Contractors					
Balfour Beatty	2,360	▼ -3.6%	4.9%	26.8%	
Carrillion	1,510	▼ -5.4%	-0.4%	38.4%	
Morgan Sindall	292	▼ -6.0%	-0.4%	23.0%	
Kier Group	509	▲ 8.0%	4.8%	35.2%	
Lend Lease Corp*	3,234	▲ 0.7%	1.1%	-3.1%	
Average		▼ -1.5%	2.1%	17.1%	
Building material suppliers					
Wolseley	6,120	▲ 0.3%	-1.9%	41.5%	
SIG	767	▼ -2.0%	-7.9%	14.9%	
Marshalls	227	▼ -0.4%	-1.3%	34.9%	
Kingspan	939	▲ 1.6%	-6.7%	22.5%	
Average		▲ 0.2%	-3.0%	36.5%	
Housebuilders					
Persimmon	1,400	▲ 5.3%	10.5%	18.4%	
Taylor Wimpey	1,210	▼ -0.8%	5.4%	6.5%	
Barratt	1,000	▲ 4.2%	8.7%	-7.6%	
Bovis Homes	600	▲ 2.1%	3.7%	23.5%	
Bellway	806	▲ 5.5%	3.7%	-0.5%	
Berkeley	1,320	▲ 2.1%	10.0%	35.9%	
Average		▲ 3.0%	7.6%	13.7%	

**Sector averages are weighted according to current market capitalisations