

Weekly Economic Update

19 December 2011

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Summary

David Cameron's decision to veto the proposed EU Treaty changes and the prospect of credit rating cuts for several countries, including heavyweights such as France, Italy and Spain, set off a chain of events, which eventually degraded into political bickering between the UK and other EU countries. Thus, unsurprisingly, markets remain unconvinced that there will be a 'quick-fix' solution to the Eurozone crisis and this has been evident by market volatility, with investors flocking to the safe haven that is the US Dollar.

Economy

Chancellor's Autumn Statement

In his Autumn Statement 2011, Chancellor George Osborne updated MP's on the state of the economy, public finances and future plans. Broadly speaking, the Chancellor focused on a competitive tax regime, planned spending on housing and infrastructure, as well as credit-easing measures. The government also underlined its commitment to the Green Deal, and in order to encourage early uptake, it pledged some £200m of additional one-off capital resource. Furthermore, there was confirmation that the main rate of corporation tax will reduce to 25% for 2012-13. However there was no mention of reviewing the 50% top rate of income tax or the current 20% standard rate of VAT. Highlights:

- UK economic growth for 2011 has been revised down to 0.9% from 1.7%, while the 2012 forecast was revised down to 0.7% from 2.5%. Growth in 2013, 2014 and 2015, is forecast to be 2.1%, 2.7% and 3%, respectively.
- Against this weaker economic backdrop, the government will have to borrow an extra £111bn over the next five years. The new borrowing forecast for 2011-12 is now £127bn, falling to £120bn, £100bn, £79bn and £53bn in following years.
- Public sector pay rises will be capped at 1% for two years after the end of current freeze next year. The rise in state pension to 67 to be brought forward to 2026 from 2034.
- The OBR forecasts that total public sector job losses will now be 710,000.
- On the business side, the Chancellor announced that the credit easing programme will underwrite up to £40bn in low-interest loans to SMEs; that a £1bn business finance partnership will raise money for medium-sized firms, and that the Regional Growth regeneration fund will get £1bn in extra funding.
- The housing sector will see a £400m scheme to kick-start stalled construction projects in England
- On the infrastructure side, £5bn of new spending over three years was announced, including £1bn for the rail network. The go-ahead for 35 road and rail projects across England was given and the government aims to unlock a further £20bn in investment from pension funds.

Interest rates

The Bank of England's Monetary Policy Committee (MPC) voted to keep the bank base rate at 0.5% during its December meeting, and maintain its programme of asset purchases at £275bn.. This move came as no surprise, with the MPC indicating that more QE is probable but not until the new year, as the current £75bn extension of the QE program that was announced in October is not due to be completed until early February.

Inflation

Annual consumer price inflation eased for the second month in a row in November to 4.8%, from 5% in October. The largest downward pressure came from food and petrol prices, while

upward pressure came from domestic heating costs. Retail price inflation also ticked down from 5.4% in October to 5.2% last month. CPI inflation seems to finally heading down due to the waning impact from past VAT hikes, substantially higher energy, commodity, and food prices 2010 and early 2011, and the Pound's previous sharp depreciation. Weak economic activity and subdued wage growth are also containing any inflationary pressures.

UK business activity

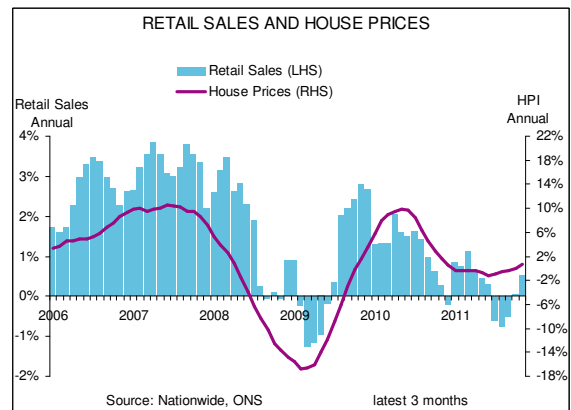
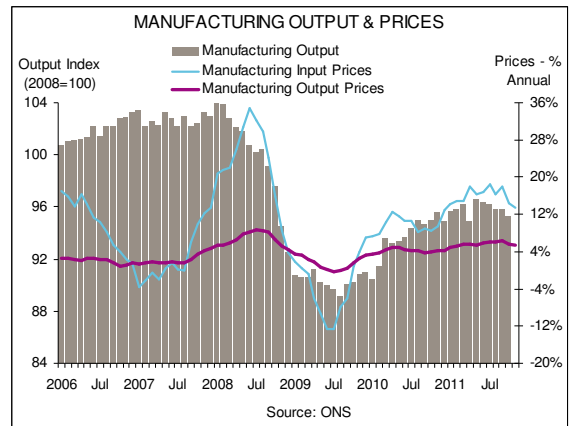
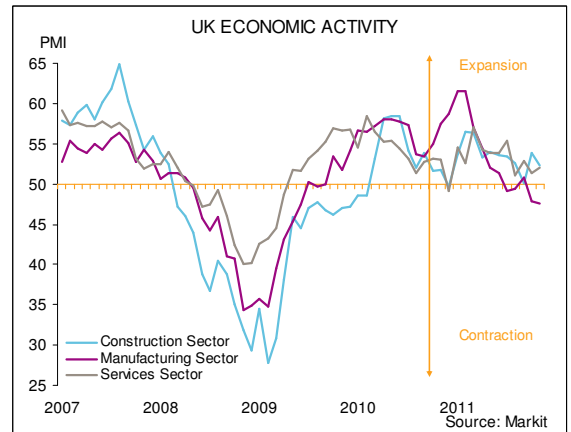
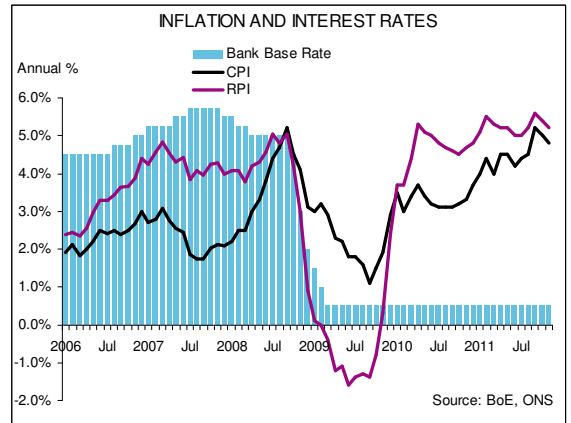
In November, the Markit/CIPS PMI Services Activity Index recorded a modest improvement in business activity, with the index edging up to 52.1, compared to 51.3 in the preceding month. However, incoming business rose at the slowest rate so far this year, as activity was dampened by the difficult economic situation. Growth was also reportedly curtailed by low bank lending and public sector spending cuts. Furthermore, employment fell at the quickest pace in 15 months. UK manufacturing activity fell for a second consecutive month, according to the latest PMI survey. The manufacturing PMI dropped to 47.6 in November, a near two-and-a-half year low.

Manufacturing output

In October, manufacturing output fell 0.6% month-on-month, but remained up 0.3% on a year ago. In November, manufacturing output prices rose 0.2% and input prices increased by 0.1% on October. Despite the recent ease in input price inflation, manufacturers' profit margins remain under pressure, as significantly weaker demand is raising the need to price competitively to retain business.

Retail sales

In November, the volume of retail sales (excluding fuel) fell 0.6% month-on-month, indicating that retailers faced a weak start to the critical Christmas sales period. Year-on-year, sales volumes were up 0.5%. In the three months to November, sales volumes were up 0.8% when compared with June-August and increased by 0.6% on a year ago. With inflation continuing to outpace wage growth and fears that the UK economy may follow the Eurozone into recession, cash-strapped consumers appear to choose to save rather than spend, despite heavy discounting from retailers. Survey evidence also points to a marked drop in retail sales. The latest BRC retail sales survey shows that retailers saw the largest contraction in like-for-like sales since May, with widespread discounts failing to bring in pre-Christmas shoppers. The value of retail sales on a like-for-like basis was down 1.6% than a year ago, after a 0.6% fall in October. Total sales grew by just 0.7%, down from a 1.5% annual rise in October.



Housing market activity

The November RICS Housing Market survey continues to show that more surveyors were seeing house price declines than rises – the balance rose from -24 in October to -17. Almost three-fifths of respondents said that prices remained steady, while of those that did report a fall, a vast majority indicated it was in the range of 0-2%. Somewhat more positively, new buyer enquiries recorded their third consecutive monthly increase and new instructions also edged up. The regional disparity remains, with London the only region to record a positive net balance for both current prices and price expectations.

House price inflation

According to Nationwide, house prices increased by 0.4% in November, with the typical price of a home 1.6% higher when compared with a year ago. In contrast, the Halifax figure showed that house prices declined by 0.9% in November and were down 1% year-on-year. Broadly speaking, the trend has been that house prices have remained relatively stable over the course of 2011, despite the difficult economic environment and pressure on household incomes.

Labour market

Between August to October, the unemployment rate stood at 8.3% of the labour force - up 0.4% on the quarter. The last time this figure was higher was in January 1996. The total number of people unemployed rose by 128,000 over the quarter to reach 2.64 million. There were 1.6 million people claiming Jobseeker's Allowance in November, up 3,000 on October. Average earnings (including bonuses) rose by 2.1% in the three months to October, compared to a 2.8% increase in the preceding three months.

Trade deficit

The UK's deficit in goods and services was £1.6 billion in October – down from £4.3 billion in September and the lowest level since April. This was driven by a surge in exports, which rose by 9.0% (when excluding oil and erratic items), or £2.1bn to £26.5bn. This was made up of increased exports to EU countries of £13.9 billion (up £0.8 billion from September) and higher exports to non-EU countries of £12.6 billion (up £1.3 billion from September). Imports fell £500m to £34.1bn.

Commodities

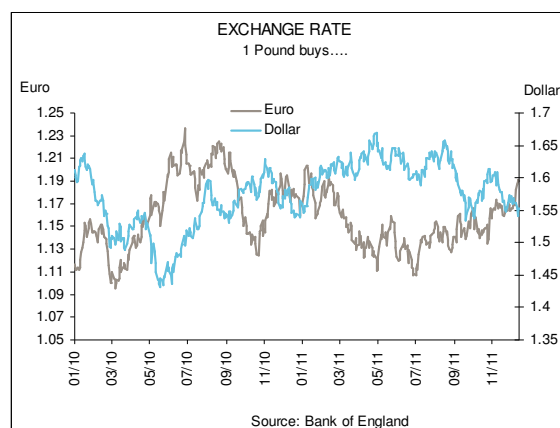
With the exception of steel prices, which held steady, commodity prices fell last week, as the prospect of weaker global growth weighed on demand expectation and investor sentiment. Oil prices were down 4% and 8% on a weekly and monthly basis, respectively, but remained up 13% on a year ago. Copper (-3%) and aluminium (-4%) prices were down on the previous month, but nickel prices were up 2%, although the latter was down 25% year-on-year.

COMMODITY PRICES (16 DECEMBER 2011)				
	Price	Weekly change	Monthly change	Annual change
"Brent" Oil (\$/barrel)	103.4	-4%	-8%	13%
Copper (\$/tonne)	7,340	-6%	-3%	-19%
Aluminium (\$/tonne)	2,004	-3%	-4%	-13%
Nickel (\$/tonne)	18,075	-1%	2%	-25%
Global Steel Price (Index 04/1994=100)	186.8	0%	-2%	4%

Source: FT, LME, Cruspi

Exchange rates

The US Dollar continues to strengthen amid general risk aversion on the back of Eurozone concerns. Negative Euro sentiment also benefited the Pound, which rose by 1.8% to €/\$1.190 last week, though the Sterling weakened against the Dollar, down 0.6% to £/\$1.553.



Construction

Construction new orders

The value of construction new orders totalled £11.7bn in the third quarter of this year – up 12.8% (in real, seasonally adjusted terms) when compared with the previous three months, but down 5.5% year-on-year. In volume terms, infrastructure orders were up 28% on the quarter and increased by 12% in public non-residential construction – suggesting a short-term uplift may be on the cards across the two sectors. When compared with the previous year, public and private housing saw new orders decline by 17% each in the three months to September. In the case of the former, orders fell by 5% on a quarterly basis – not surprising considering that funding for social housing is around half of what was allocated in the 2008-2011 period. Finally, the stage appears set for the commercial sector to continue its recovery, with construction new orders rising by 21% quarter-on-quarter and up 8% year-on-year.

CONSTRUCTION NEW ORDERS - Q3 2011			
	Value	Volume	
	£ million, current	% Q-o-Q	% Y-o-Y
Public Housing	474	-5%	-17%
Private Housing	2,485	0%	-17%
Infrastructure	1,672	28%	8%
Public non-residential	2,415	12%	-17%
Industrial	555	-3%	-4%
Commercial	4,061	21%	8%
Total Construction	11,662	13%	-6%

Source: ONS

Construction output

In October, the value of total construction output reached £10.4bn (in current prices) – down 2% when compared with the preceding month. In volume terms, construction output fell by 2.5% month-on-month and decreased by 2.7% year-on-year. In the three months to October, output held steady compared to the preceding three months, but was down 1% on the corresponding part of 2010. When compared with the May-July period, activity levels over the three months to October fell across all of the new work sectors with the exception of commercial construction, which grew by 5%. Year-on-year, commercial output held relatively steady. The annual comparison also highlights the difficulties being faced in public construction due to government cuts, with output in the public housing and public non-residential sectors down 10% and 13%, respectively. Industrial construction output fell 14%, not surprising considering the ongoing Eurozone crisis and weak levels of domestic manufacturing activity continuing to undermine investment confidence. On the repair and maintenance side, output was up 5% in the three months to October when compared with the May-July period.

CONSTRUCTION OUTPUT - 3M to OCT 2011			
	Value	Volume	
	£ million, current	% Q-o-Q	% Y-o-Y
Public Housing	1,209	-6%	-10%
Private Housing	4,221	-6%	0%
Infrastructure	3,988	-8%	11%
Public non-residential	3,398	-4%	-13%
Industrial	880	-4%	-14%
Commercial	6,589	5%	0%
Total new work	20,285	-2%	-2%
Total R&M	11,562	5%	0%
Total Construction	31,847	0%	-1%

Source: ONS

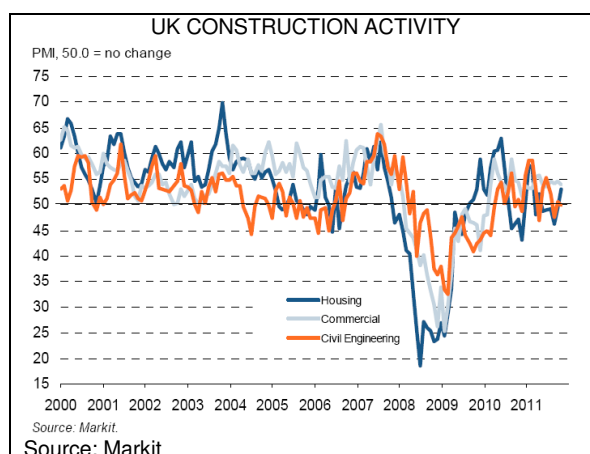
Construction activity survey

The Markit/CIPS Construction Purchasing Managers' Index (PMI) posted a reading of 52.3 in November, down from 53.9 in October. This suggests a modest deceleration in the pace of construction activity growth. However, an expansion in new business and higher workloads led to another increase in employment.

Commercial development activity

According to Savills' November 2011 Commercial Development Activity survey:

- Commercial development activity fell for a fifth consecutive month. Although the rate of decline was noted to have eased slightly, it remained sharp nonetheless. The level of work being undertaken on public projects decreased at the fastest rate in 13 months, while private sector development activity contracted for the fourth successive month. Exactly 30% of commercial developers were experiencing a fall in overall activity levels in the month, compared to around 15% seeing rises.

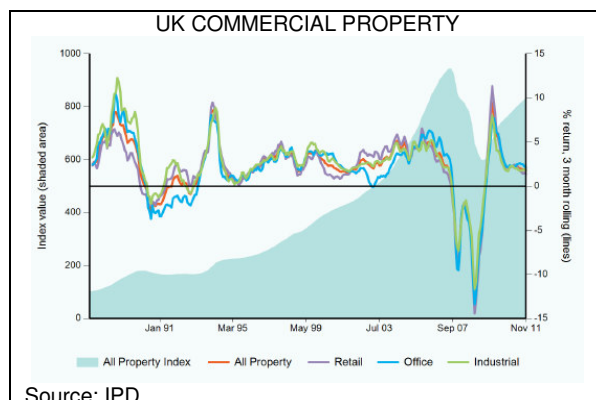


- Commercial developers' confidence levels fell to their lowest point in nine months. Survey respondents felt that tight credit conditions and subdued client confidence were the main drivers of pessimism, with approximately 26% expecting activity levels to decrease over the next three months and 12% forecasting a rise.

UK commercial property returns

UK commercial property values declined for the first time in 28 months in November. The recovery in UK property values saw 27 months of growth totalling 17.8%, which followed falls of 44.1% between June 2007 and June 2009. Retail property prices fell by 0.1%, as falling occupier demand and investors leaving the asset class eroded values. Offices saw an increase of 0.1%, with the sector being propped up by the Central London offices market. Industrial capital values held steady over the month.

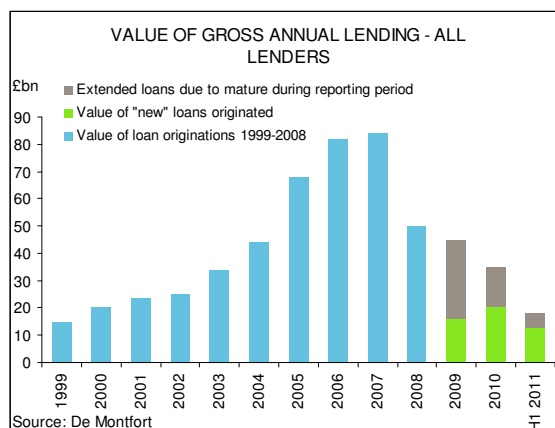
Total return on all property was reported to be 0.5% between October and November, within which retail returned 0.4% and office and industrial seeing total returns of 0.6%.



UK Commercial Property Lending

De Montfort University published its latest UK Commercial Property Lending report. Highlights:

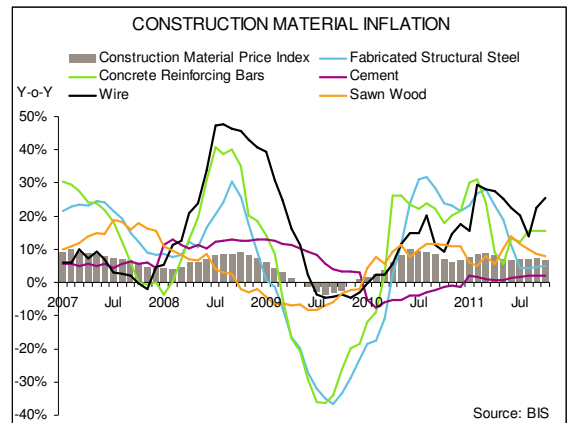
- Debt held against UK commercial property fell again in the first half of 2011, as the process of de-leveraging continued.
- Total UK commercial property debt stood at between £280-292bn at mid-year 2011 (down from £288bn to £298bn at the end of 2010), including £46bn outstanding in the CMBS market and an estimated £19.9bn held by NAMA – Ireland's "bad bank". The value of outstanding, on-balance-sheet debt decreasing from £208.4bn to £201.3bn in the six months to June.
- Around a half of this debt - £85-114bn - could not be refinanced on current market terms. Due to falling investment values, a quarter of this debt (24%) had a LTV ratio of above 100%, while just one fifth (21%) had an LTV ratio of less than 60%. An estimated £41bn, or 20%, of the £201.3bn total on-balance sheet loans were estimated to be in breach of covenants and in default by the end of June, which reflects a rise of £3.5bn from the end of 2010. Lenders have been willing to extend maturing debt on non-market terms.
- Lending intentions decreased in the first half of 2011. Two-thirds of lenders said that commercial property was an asset class against which they were willing to lend, but the proportion intending to increase the size of their loan books fell from around half to one third.
- During the first half of 2011, property lenders reported less competition in the market, while potential borrowers have been withdrawing from the market on the expectation of another correction in capital values of commercial property.
- Development finance remains challenging. The deepening Eurozone crisis and subdued UK growth is limiting liquidity and is increasing the costs of capital in the property lending market. The average level of arrangement fees reported at mid-year 2011 was higher for all sectors than at year-end 2010. For example, the average arrangement fee applied to loans secured by prime office property increased from 94.7bps to 97.8bps, while that for secondary office increased from 106.7 bps to 112.5 bps. Those willing to lend against a fully pre-let development fell from 52% to 31%, and those willing to lend against speculative development fell from 17% to 15%.



- The 12 most active lenders comprised five UK lenders and building societies, which are thought to include RBS, Lloyds Banking Group, Barclays Real Estate, HSBC and M&G Investments, a subsidiary of Prudential. The four German lenders are understood to be Deutsche Pfandbrief Bank, Eurohypo, Deutsche Bank and Aareal Bank, while the one North American lender is either Goldman Sachs or Citigroup. Two other international lenders make up the list, one of which is thought to be GIC, Singapore's sovereign wealth fund.
- Regionally, London and the South East were seen as being in "recovery mode" while "recovery in the provincial markets could take six years or perhaps longer to achieve."

Building material prices

After rising for nine consecutive months to July 2011, building material prices began to experience volatility. After a marginal decline in August and a small increase in September, prices (for all works) fell 0.8% in October, though the index remained up 6.8% on a year ago. Fabricated structural steel (-1.8%), concrete reinforcing bars (-1.1%) and sawn wood (-0.4%) prices were all down month-on-month in October, but remained up 5%, 16% and 8%, respectively, year-on-year. Meanwhile cement prices held steady compared with September, but were up 2% year-on-year. The price of wire saw the most significant increase on an annual basis - of more than 25% - although the month-on-month rise was a relatively modest 0.7%.



Market Watch

Fitch, the ratings agency, affirmed France's credit rating as AAA last week, but revised its outlook from stable to negative. This was prompted by the heightened risk of growing government liabilities (the agency has forecast that the country's debt will rise to a peak of 92% of GDP in 2014) as the Eurozone crisis continues to cast a shadow.

Fitch also announced that six other countries, including Italy, Spain, Belgium, Cyprus, Ireland, Slovenia, were at risk of having their ratings downgraded by a notch or two. However, there was some relief for the markets as the Italian government won a confidence vote in the lower house of parliament on a €30bn austerity package.

In the week to Friday, the FTSE 100 fell by 2.6% to 5,387.3 points, while the real estate index saw a larger decline of 4.6% to 333.0 points. In real estate, all of the companies saw falls, with Segro (-8.8%) and Capital Shopping Centres (-7.9%) being the worst performing.

According to reports, Hammerson has struck a deal with the Kuwaiti government to purchase a £176m development on a site previously occupied by the London Stock Exchange. The 214,200ft², nine-storey building draws rents of £8.8m, representing an initial yield of approximately 4.75%.

Of the building contractors being tracked, Lend Lease was the only company which saw a rise – albeit of just 0.7%. Meanwhile, Carillion and Kier Group saw the sharpest falls, of 5% each.

All of the building material suppliers and housebuilders saw their share prices fall, with Kingspan declining 8%. Bovis Homes saw a 5.3% fall. Despite broadly being down across the board on a weekly and monthly basis, all of the housebuilders were performing better than a year ago, with Taylor Wimpey and Berkeley's shares up 26.6% and 39.1%, respectively.

EQUITIES						Friday 16th December 2011			
Index	Index	Week	Month	Year					
FTSE 100	5,387.3	▼ -2.6%	-7.6%	-8.4%					
EPRA/NAREIT UK	333.0	▼ -4.6%	-7.6%	-13.3%					
Stocks	Market Cap, £m	Share Prices							
		Week	Month	Year					
Real Estate									
British Land	4,040	▼ -3.0%	-7.5%	-10.7%					
Hammerson	2,490	▼ -5.8%	-9.6%	-16.2%					
Land Securities	4,770	▼ -5.8%	-10.6%	-7.1%					
Capital & Counties	1,170	▼ -0.7%	-1.2%	17.3%					
Capital Shopping Centres	2,500	▼ -7.9%	-7.1%	-30.5%					
Shaftesbury	1,170	▼ -5.7%	-7.1%	1.8%					
Great Portland Est.	994	▼ -5.1%	-9.4%	-9.6%					
Derwent London	1,560	▼ -2.8%	-8.2%	0.1%					
Segro	1,460	▼ -8.8%	-13.4%	-33.0%					
Quintain Estates & Development	187	▼ -0.7%	-2.7%	3.6%					
St. Modwen Properties	219	▼ -7.8%	-6.2%	-34.2%					
Unite Group	265	▼ -2.9%	-2.8%	-16.6%					
Workspace Group	317	▼ -7.4%	-10.2%	-5.8%					
Average*		▼ -5.1%	-8.5%	-11.4%					
Building Contractors									
Balfour Beatty	1,680	▼ -2.7%	4.7%	-21.6%					
Carillion	1,290	▼ -5.0%	-3.4%	-18.6%					
Morgan Sindall	240	▼ -3.0%	-0.2%	-16.2%					
Kier Group	505	▼ -5.0%	-8.3%	-5.1%					
Lend Lease Corp*	2,720	▲ 0.7%	3.1%	-11.7%					
Average		▼ -1.9%	1.2%	-15.3%					
Building material suppliers									
Wolseley	5,550	▼ -0.9%	4.5%	0.6%					
SIG	458	▼ -3.1%	-11.7%	-36.5%					
Marshalls	170	▼ -1.7%	-7.0%	-17.6%					
Kingspan	864	▼ -8.0%	1.4%	-8.0%					
Average		▼ -2.0%	2.8%	-3.3%					
Housebuilders									
Persimmon	1,390	▼ -4.5%	-7.5%	11.1%					
Taylor Wimpey	1,140	▼ -4.2%	-9.2%	26.6%					
Barratt	894	▼ -4.2%	-3.6%	7.8%					
Bovis Homes	586	▼ -5.3%	-3.2%	12.5%					
Bellway	864	▼ -4.5%	-1.2%	13.3%					
Berkeley	1,700	▼ -2.3%	0.0%	39.1%					
Average		▼ -3.9%	-4.1%	21.0%					

**Sector averages are weighted according to current market capitalisations