Weekly Economic Update

9th May 2010

Summary

Last week's UK general election was the closest for decades, with the Conservatives winning the most seats but falling short of the number required for an overall majority. At the time of writing it is still unclear which parties will form the coalition parliament, but we should have an idea later this week.

The PMI surveys confirm recovery in construction, manufacturing and services activity, but higher input price inflation is putting pressure on margins.

Concern about Greece's debt situation continues to hit market sentiment. The announcement of a 110bn rescue package, after much haggling between Greece and other Eurozone countries (mainly Germany) and the IMF, did little to calm the turmoil. In contrast, it has fuelled speculation of crisis contagion to other peripheral Eurozone countries.

UK General Election

The result of the general election was not entirely a surprise, with the Conservative Party winning the most seats, but failing to win enough for a majority government. The heightened uncertainty generated by a hung parliament (the first since 1974) reflects concern over the big question of how this is going to effect spending and investments over the near to medium term.

In the run up to the elections, all three parties avoided making statements on public spending cuts and tax increases, which are likely to be inevitable in order to bring the large UK fiscal deficit under control.

The Conservatives pledged to cut most of the UK's structural debt within five years, mainly through cutting some £6 billion in public spending. There has been no breakdown of where these cuts would be made, but the party promised that healthcare and foreign aid spending would remain untouched. The Conservatives' tax pledge is that they would eliminate Labour's planned 1% increase in National Insurance for those earning less than £35,000 per year. The Labour Party argued that economic recovery was their main priority, promising to increase public spending until 2011 to stabilise the economy, as well as reducing the fiscal deficit by more than half by 2014. This would be achieved by cutting low priority public spending. The Liberal Democrats manifesto has been fairly vague, in particular with regards to spending and deficit reduction. The party pledged to cut £15 billion from lower priority spending per year and efficiency improvements, while promising to prioritise spending on front-line services. The Liberal Democrats also promised to expand tax-free income.

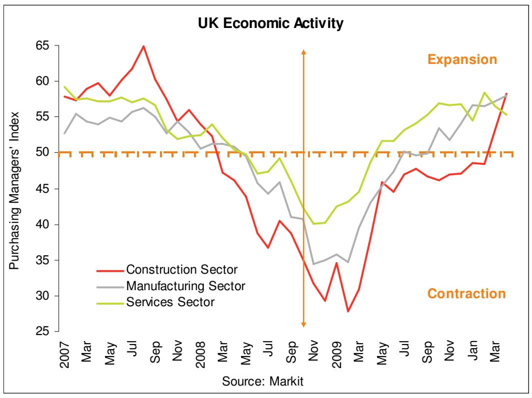
The pressure for fiscal consolidation in the UK is such that some plan is likely to emerge regardless of the political structure and coalition. What is likely to differ is the timing and depth of capital spending cuts in the near to medium term.

Statistics

Economy

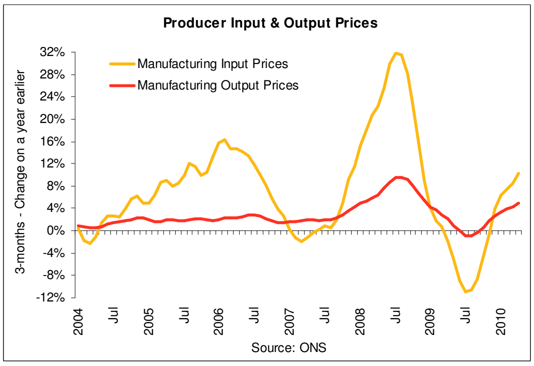
Sector activity

UK manufacturing activity continued to rise in March, according to the latest CIPS/Markit purchasing managers' index (PMI). The index recorded a reading of 58, up from 57.2 in March. Output rose on the back of improving economic conditions, increased new work and efforts to reduce backlogs. The weaker Pound is benefiting exports. Employment growth in April rose to a 3-year high. However, inflationary pressures continued to rise, putting margins under pressure. The service sector PMI slipped back in April, due to business disruption caused by the volcanic ash, particularly in the travel and transport sectors. The index still points to steady growth.



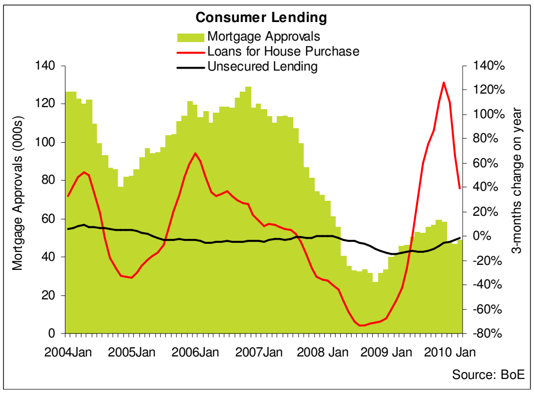
Producer prices

Manufacturing input price inflation accelerated in April, rising 0.6% during the month and up 13.1% year-on-year. The rise mainly reflects price increases of crude oil and imported metals. Manufacturers' output prices jumped 1.4% in April and the annual rate of "factory gate" inflation rose to 5.7%, up from 5.0% in March. Both rates were the highest since October 2008.



Consumer lending

Mortgage approvals picked up very modestly in March, after hitting a 9-month low in February. At the same time the value of loans for house purchase remained low, suggesting that underlying demand remains relatively subdued. The Halifax reports that house prices were a touch lower in April, falling 0.1% compared to March.



Insolvencies

The number of personal insolvencies in England and Wales rose to a new high of 35,682 in the 1st quarter of 2010, an increase of 18% year-on-year. In contrast, business insolvencies, which totalled 4,082 in the 1st quarter, were 18% lower than a year ago.

Exchange rates

The Sterling came under pressure last week, following a sharp sell-off in global equity, currency and commodity markets, and a much closer UK election result than hoped. The Pound lost 4% against the Dollar falling to £/$1.477. The Pound did strengthen against the Euro though, gaining 1% to £/€ 1.161.

Commodities

Commodities plunged together with equities last week, as the Greek bailout plan sparked investor fears of further sovereign debt contagion in Europe. Oil prices fell 10% to $78.1 per barrel of Brent crude. Copper declined 7% to $6,872 and aluminium fell 5% to $2,065. Nickel plunged 14%. In contrast, the global steel price index recorded a 4% rise in the week to Friday.

Commodity Prices (7th May 2010)

	Price	Weekly change	Monthly change	Annual change
"Brent" Oil ($/ barrel)	78.1	-10%	-8%	37%
Copper ($/tonne)	6,872	-7%	-13%	44%
Aluminium ($/tonne)	2,065	-5%	-11%	33%
Nickel ($/tonne)	22,170	-14%	-10%	70%
Global Steel Price (Index 04/1994=100)	203.38	4%	7%	60%

Source: FT, LME, Cruspi

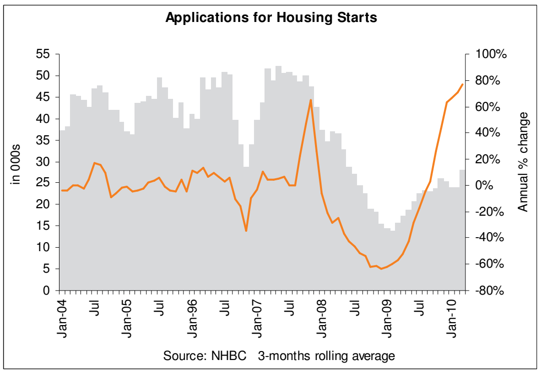
Construction

Construction activity

UK construction activity increased for a 2nd consecutive month in April, according to the CIPS/Markit purchasing manager's index (PMI). The construction index recorded a reading of 58.2, up from 53.1 in March. The survey suggests that activity in the residential and commercial sectors has increased, while the decline in civil engineering work has eased. However, growth comes from a low base and business conditions remain difficult. Construction firms are positive about their near term workload, expecting to win more contracts this year. Whilst the rise in workload over the past two months is encouraging, it remains questionable whether this upturn can be sustained. In particular, optimism is being tempered by uncertainty over potential cuts in public investment. In addition, cost pressures are building due to the increase in raw materials and commodities prices. Despite the rise in activity, construction companies reported a further reduction in headcount in April.

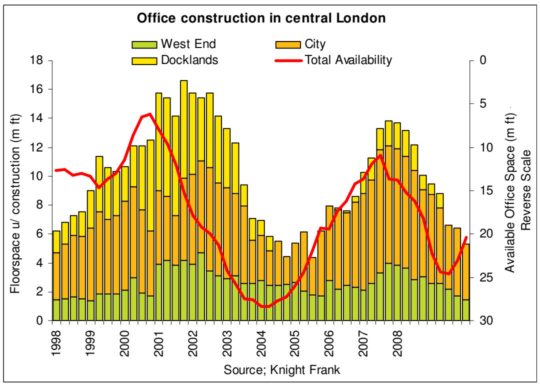
Housing starts

Applications for housing starts totalled 11,018 in March, according to the NHBC. This is the highest level of starts since April 2008. Starts in the 1st quarter totalled 28,000, up 11% on the preceding quarter and 78% higher year-on-year. Whilst housing starts are rising, they remain at a historical low level. Quarterly housing starts totalled around 40,000 on average between 1997 and 2007.



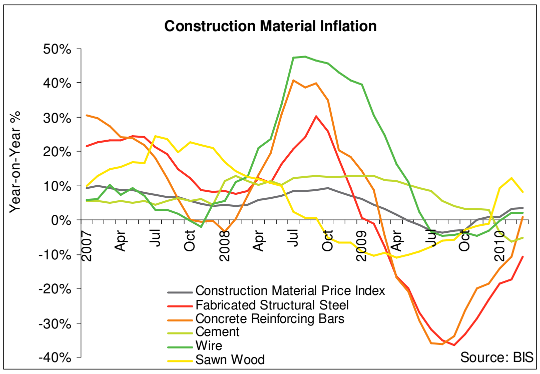
Central London Offices

Activity in the key Central London offices market has improved since the start of 2010. According to Knight Frank, take-up increased to 4.2 m sq ft in the 1st quarter, the highest quarterly level since 2007. Supply of office space fell for the 5th consecutive quarter, due to higher take-ups and limited new developments. The volume of new and refurbished available space stands at 5.5 m sq, a decline of 30% over the last 9 months. At the end of the 1st quarter, the Central London vacancy rate was 9.0%, down from 10.2% in the final quarter of 2009. Floorspace under construction continued to fall. In particular, there is a lack of speculative development under construction, as availability of development funding remains tight. Some speculative development is expected to begin over the next few months, but construction levels are set to remain this year. On the back of increased investment demand, there was a further yield compression in the 1st quarter. In the City, prime yields are estimated to be at 5.50%, while in the West End prime yields have fallen to 4.50%, down by 150 basis point in the last 12 months.



Construction material prices

Construction material prices rose by 0.1% in March compared to February and up 3.5% on a year ago. Imported iron and steel prices rose 3% in March, but remained down 7.3% on a year ago. Concrete reinforcing bars rose 6% in March and up 0.6% year-on-year. Fabricated structural steel prices rose 2% in March, but were lower compared to a year ago (-11%). Sawn wood prices fell 2% in March, but compared to last year they were up 8.3%. Sand, gravel & roadstone increase 4.5% year-on-year. Wire and plastic products prices rose 2.1% and 2.8% respectively year-on-year.



Looking ahead

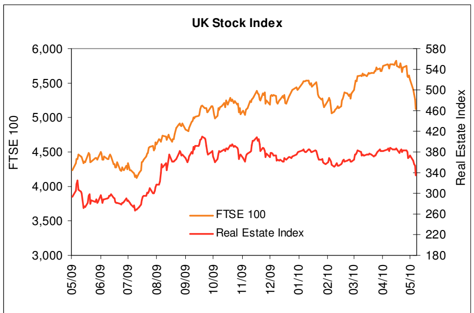
The Bank of England's MPC is expected to keep interest rates at 0.50% during its May meeting. Of greater interest will be the Bank's quarterly inflation report. Matters have become more complicated for the MPC in recent months: Consumer price inflation jumped to 3.4% in March and economic activity is improving, but official GDP data revealed meagre 0.2% growth in the 1st quarter. There is uncertainty over the timing and extent of the expected UK fiscal tightening, while the Greek crisis is fuelling fears over sovereign debt contagion in Europe.

The British Retail Consortium's retail sales monitor is expected to show that retail sales continued to increase in April, as consumer spending has firmed modestly in recent months. The RICS's latest housing market survey will provide further evidence as to whether the recent moderation in housing market recovery was a temporary blip or a renewed weakening. Manufacturing output is likely to have risen in March. There will be mixed signals from the UK labour market. Claimant-count unemployment is expected to have eased back in April, but the number of employed people is also likely to have fallen. Average earnings growth is expected to have risen modestly, but to remain subdued.

Market Watch

Equity markets dropped for a second consecutive week, as the European debt crisis continued and the UK election failed to produce a decisive result.

Markets saw their sharpest sell-off since the bankruptcy of Lehman Brothers in autumn 2008. The FTSE 100 fell 7.8% in the week to Friday a three-month low.



Source: FT

Construction and real estate related firms on average underperformed the wider index last week.

Among property firms, Minerva, Quintain Estates and the Unite Group saw the largest drop, down 15.3%, 13.4% and 13% respectively. Hammerson, Land Securities and British Land also saw their share prices drop in double-digit figures.

British Land and Blackstone announced their intention to develop a new £300 million UBS Building at Broadgate, on the site of 4 & 6 Broadgate, thereby retaining UBS as the key tenant on the Broadgate Estate. There is no announcement that a final deal has been signed as yet.

Share Prices		Friday 7th May 2010		
	Index	**Week**	**Month**	**Year**
FTSE100	5,123	-7.8%	-11.1%	16.5%
	Market Cap, £m	**Week**	**Month**	**Year**
Real Estate				
British Land	3,660	-10.0%	-11.6%	-12.7%
Hammerson	2,410	-11.5%	-15.0%	-0.6%
Land Securities	4,520	-10.2%	-13.9%	-0.1%
Shaftesbury	798.8	-9.9%	-9.6%	20.1%
Great Portland Est.	891.1	-9.3%	-10.2%	18.0%
Derwent London	1,300	-11.1%	-8.6%	33.4%
Segro	2,040	-10.9%	-13.5%	8.8%
Quintain Estates & Development	252.4	-13.4%	-14.2%	146.4%
St. Modwen Properties	328.4	-5.4%	-18.5%	-14.6%
Unite Group	305.0	-13.0%	-25.5%	78.2%
Workspace Group	241.4	-10.6%	-14.3%	40.0%
Minerva	156.3	-15.3%	-18.5%	660.8%
Average**		***-9.0%***	***-11.2%***	***10.9%***
Building Contractors				
Balfour Beatty	1,740	-8.3%	-15.1%	-17.0%
Carillion	1,260	-7.7%	-7.3%	11.9%
Morgan Sindall	230.5	-5.6%	-6.3%	-16.3%
Kier Group	401.0	-6.1%	-0.9%	-1.2%
Lend Lease Corp*	2,495	-9.2%	-10.8%	6.1%
Average		***-8.3%***	***-10.5%***	***-0.6%***
Building material suppliers				
Wolseley	4,010	-14.3%	-10.2%	0.4%
SIG	660.0	-15.3%	-7.8%	-23.6%
Marshalls	185.1	-8.5%	2.2%	-5.0%
Kingspan	908	-10.0%	-8.1%	47.3%
BSS	376.7	-2.0%	6.7%	-3.4%
Average		***-12.8%***	***-8.2%***	***4.3%***
Housebuilders				
Persimmon	1,260	-12.1%	-11.7%	4.3%
Taylor Wimpey	1,110	-14.7%	-9.5%	-5.5%
Barratt	1,010	-16.4%	-17.9%	-3.6%
Bovis Homes	496.5	-12.4%	-10.4%	-17.3%
Bellway	843.4	-7.4%	-9.8%	-2.7%
Berkeley	1,030	-8.4%	-7.1%	-21.0%
Average		***-12.0%***	***-11.1%***	***-6.4%***

*Lend Lease Corporation Limited is listed on the Australian and NZ stock exchange
**Sector averages are weighted according to current market capitalisations

Among building contractors, Lend Lease saw the sharpest fall last week, down 9.2%. Balfour Beatty shed 8.3%, while Carillion dropped 7.7%. SIG and Wolseley saw the largest decline among building material supplier, falling 15.3% and 14.3% respectively. All housebuilders also posted share prices declines last week, despite a modest improvement in house building activity in recent months.