theconstructionindex

Davis Langdon

Weekly Economic Update

11th April 2011

Summary

Tensions in the Middle East, rising oil prices, the aftermaths of the Japanese earthquake/tsunami/nuclear disaster, and the Eurozone sovereign debt crisis are the main issues currently impacting on the world economy and financial markets. Inflation is certainly a key topic globally, and the focus last week was on central bank policy meetings in the UK and the Eurozone. Despite inflation in the UK running well ahead of its 2% target, the Bank of England decided to keep interest rates unchanged at a record low of 0.5%, citing uncertainty over the growth outlook. In contrast, rising inflation led the European Central Bank to raise interest rates last week by 25 basis points to 1.25%, the first tightening in more than 2½ years.

Economy

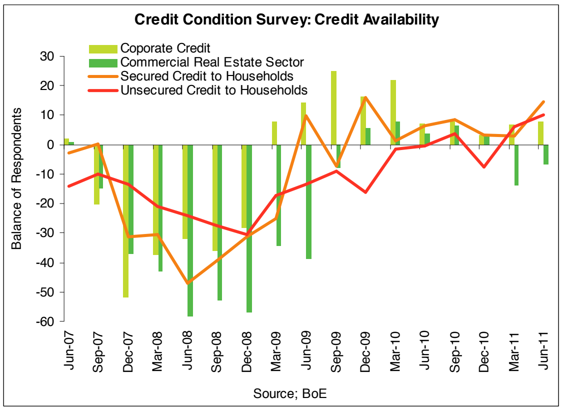
Interest rates

Despite elevated inflation, the Bank of England, during April's MPC meeting, kept interest rate on hold at 0.5%, due to significant concerns and uncertainties over the growth outlook.
In addition, the MPC has kept the asset purchase programme unchanged at £200bn. The Bank of England faces a substantial policy dilemma in setting interest rates, as inflation is consistently and significantly above the 2% target, but growth remains sluggish.

In contrast, the European Central Bank raised interest rates for the first time in more than two years from 1% to 1.25% at its policy meeting last week to cool inflation, which had risen to 2.6% in March. Other central banks, especially in Asia and South America, but also in Europe, had already started tightening monetary policy.

Credit conditions

The Bank of England's credit conditions survey for the first quarter of 2011 reveals a modest improvement in the availability of credit to most households and businesses.

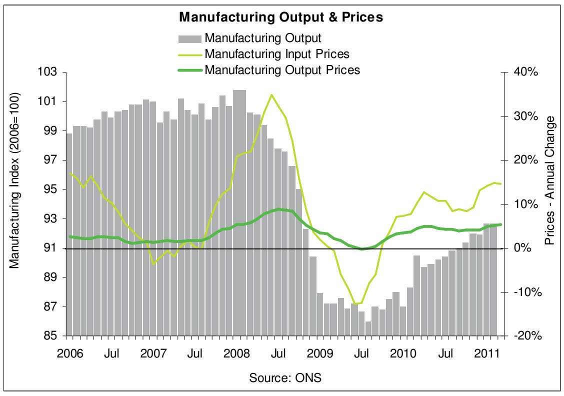


- The availability of secured credit to households was broadly unchanged in Q1 2011 compared to the preceding three months. Availability of unsecured credit to households increased modestly in Q1 2011.
- Overall availability of credit to corporates increased slightly in Q1 2011, but again there were large differences between corporates. Availability increased for large corporates, including an increase in the availability of trade credit instruments, but availability was unchanged for small businesses and medium-sized firms.
- Availability of credit to the commercial real estate sector fell in Q1 2011 and is expected to fall a little further in Q2. Lenders commented that refinancing requirements and uncertainty over future prices had acted to constrain availability.

- Demand for credit increased from large corporates. An increase in M&A activity was cited as the main factor contributing to increased demand. Capital investment intentions are still not a major factor contributing to corporate credit demand.
- In Q1 2011, default rates on loans fell for medium and large companies, but rose for small businesses. Similarly, losses given default fell a little for medium and large companies, but increased for small businesses.
- Spreads on lending to medium and large companies were reported to have fallen over the previous quarter, but increased for small businesses.

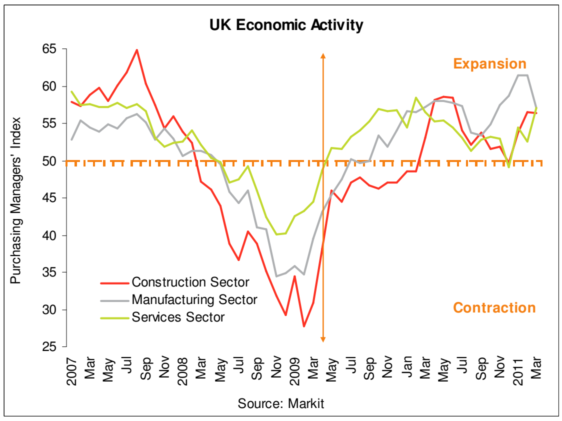
Manufacturing output and prices

Official data show that manufacturing output in February was unchanged compared to January. The annual rate of expansion slowed to – a still very solid – 5% from 6.6% in the preceding month. Manufacturers are still benefiting from solid orders growth, in particular from overseas and a competitive exchange rate. However, rising input costs are a serious threat to manufacturing activity, substantially squeezing firms' margins. Producer input prices spiked 3.7% in March, after rising 1.4% in February, due to higher oil, commodity and food prices. The annual rate of input price inflation stood at 14.6%. Output prices rose by 0.9% in March and up 5.4% year-on-year.



UK sector surveys

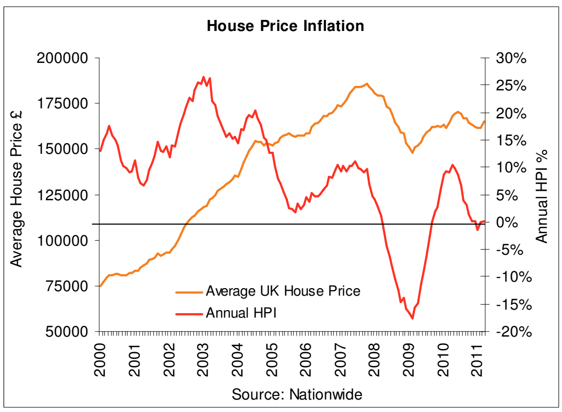
In contrast to the weaker than expected official data, survey evidence suggests more buoyant UK industry and services activity, raising hopes that the underlying growth momentum is stronger than official numbers suggest. Manufacturing growth decelerated somewhat from the strong pace seen at the start of the year, though the PMI index at 57.1 is still well above average. Output expanded solidly in March. However, new orders growth slowed down markedly, mainly in the consumer goods sector, reflecting expectations of subdued consumer spending in the year ahead. In particular domestic orders were weaker, while export orders remain buoyant. Manufacturing growth is being challenged by sharply rising input prices. Chemicals, cotton, energy, food products, fuel, metals, oil, timber and other commodities prices increased sharply in March. As manufacturers seek to pass on higher costs, factory gate inflation in March increased at the fastest pace since data were first collected in November 1999.



UK service sector activity growth picked up in March, with the services PMI increasing to 57.1, up from February's 52.6. Companies benefited from improved business conditions, higher sales and increased enquiries. However, cost pressures also intensified in the services sector, with the rate of inflation only slightly lower than January's two-and-a-half year peak.

Housing market

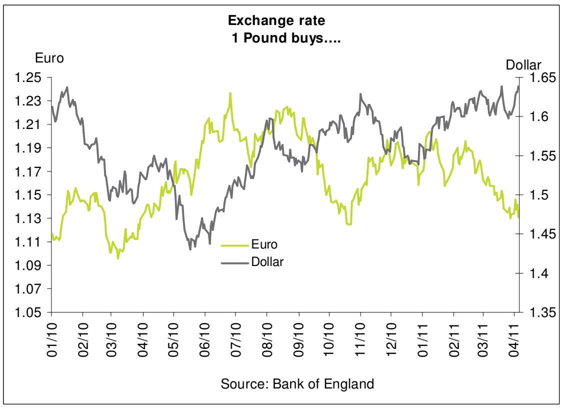
UK housing market activity and house prices stabilised in recent weeks, but not to an extent that would suggest a substantial improvement in market conditions. Mortgage approved for house purchase stood at nearly 47,000 in February, up 2% on January, but still well below historic averages of 70,000 to 80,000 a month. Meanwhile, the Nationwide reported that house prices rose marginally by 0.2% in



March, with house prices relatively unchanged compared to a year ago. The Halifax saw house prices largely static in March compared to February, but year-on-year prices were on average 3.4% lower. The majority of commentators still expect house prices to fall by a single digit number this year.

Exchange rates

The Dollar continued to weaken against major currencies last week, as the prospect that US interest rates would stay at ultra-low levels weighed on the greenback. In contrast, the Euro shrugged off the Portuguese bail-out request. The resilience of the Euro partly reflects the decision by the ECB to raise Eurozone interest rates. The Sterling looked vulnerable last week, amid weaker than expected industrial production data and high inflation. Against the Euro, the Pound fell 0.2% to £/€1.131. However, against the Dollar, the Pound touched a 15-month high, before ending the week up 2.2% at £/$1.6382.



Source: Bank of England

Commodities

Commodities rallied last week, amid Dollar weakness and the ongoing political crisis in the MENA region. Oil prices rose 6% to $125.2/ barrel of Brent crude. Metals prices surged, with copper up 5% at $9,853 ton and nickel gaining 7% to $27,405. The global steel price index continued to hold stable.

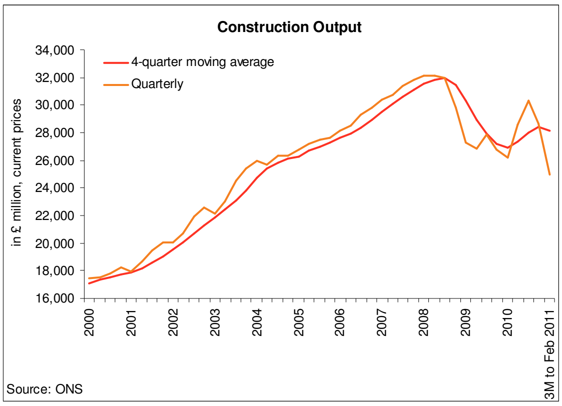
Commodity Prices (8th Apr 2011)				
	Price	Weekly change	Monthly change	Annual change
"Brent" Oil ($/ barrel)	125.2	6%	8%	43%
Copper ($/tonne)	9,823	5%	4%	24%
Aluminium ($/tonne)	2,672	3%	5%	13%
Nickel ($/tonne)	27,405	7%	3%	9%
Global Steel Price (Index 04/1994=100)	223.0	0%	0%	17%

Source: FT, LME, Cruspi

Construction

Construction output

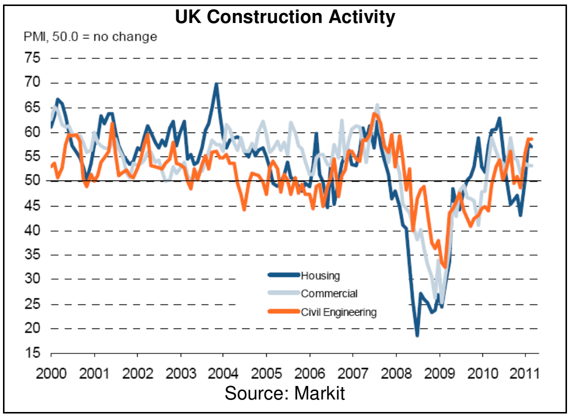
Construction output in February, at £8.57bn in current prices, was up 9% on January, but unchanged compared to a year earlier (in real terms). In the three months to February, output was down 18% compared to the preceding three months, due to a poor December and January. All sectors recorded stronger output in February compared to the start of the year. However, the public sectors are starting to show signs of weakness, in particular on the repair and maintenance side, with workload lower than a year ago.



Source: ONS

Construction activity survey

Following a rebound in January and February, construction activity continued to expand solidly in March, according to the latest Markit/CIPS construction PMI. The index stood at 56.4, marginally down on 56.5 in February. All three sub-sectors - commercial, residential and civil engineering – saw another rise in activity last month. Civil engineering was again the best performing sector. Sub-contractor usage decreased in March, leading to a further rise in availability. Input cost inflation intensified further last month, reaching its highest level since mid-2008, driven by higher raw material prices, particularly for fuel, oil and steel. The outlook for the sector remains challenging and there are widespread expectations that construction output will fall overall this year, given the



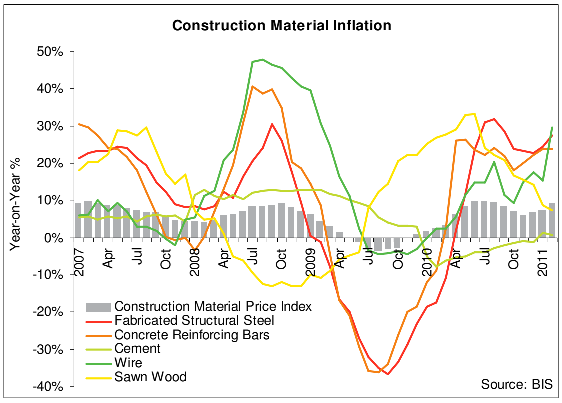
Source: Markit

cut in public sector capital funds and the slow recovery of private demand. Consequently, slower new orders growth in March did not come as a surprise.

The latest industry forecasts by Hewes and Associates paints a gloomier picture for the construction sector than previously assessed. Hewes predict construction output to fall by 3.4% this year, 8% in 2012 and a further 3.4% in 2013. The total value of construction is forecast to decline from £113.5bn in 2012 to £104.1bn in 2013 – a 16% fall from the peak in 2007. Unsurprisingly, public work is forecast to see the largest declines, while the private sector is slow to recover.

Building material prices

Construction material prices jumped by 2.1% in February month-on-month and up 9.2% on a year ago, as higher energy and raw material prices pushed up costs. The price of copper wire was up 13.6% in February and 30% higher compared to a year ago, due to the hike in global copper prices. Fabricated structural steel was 2.3% up on the month and rose 27.5% year-on-year. Concrete rebar also increased 2.3% in February and up 23.7% compared to a year ago. Plastics prices rose 2.1% during the month and up 8.4% on last year.



Schools capital investment review

Last year Education Secretary Michael Gove announced a complete overhaul of capital investment in schools. The Sebastian James review of Capital Investment in Schools was published last week to provide an independent assessment into the way that capital funds are spent on schools in England. The review covers Building Schools for the Future (BSF) and Devolved and Targeted school capital programmes, and makes recommendations for capital delivery models for 2011/12 onwards. The report is critical of the BSF process and also criticises the devolved and targeted capital programmes, stating that the capital allocation process is complex, expensive and time consuming, and has not targeted money where it is most needed; concluding that there is a need for reform throughout the system.Key recommendations include:

- New school buildings should be based on a clear set of standardised drawings and specifications that will incorporate the latest thinking on educational requirements and regulatory needs. This will allow for continuous quality improvements and cost reduction. The review suggests that savings in both time and money of up to 30% could be made in the schools capital funding process.
- The review calls for a centralised approach to capital funding and an end to multiple funding streams of investment. Capital allocation should be determined using objective information on demand and the condition of local premises.
- A clear goal for capital expenditure on schools in England should be set to create sufficient fit-for-purpose schools. Currently there is ambiguity with regards to the goals of capital spend.
- There should be a Central Body for school procurement, responsible for negotiation with the construction industry and monitoring contracts.

The James review is meant to guide future capital spending decisions on school buildings.

Looking ahead

Consumer price inflation is expected to have risen further in March, due to higher petrol prices and utility costs. This will further increase pressure on household finances, as average earnings growth is expected to be unchanged compared to February and remains low compared to past norms. The latest labour market data are expected to show a mixed picture, but the underlying trend is likely to weaken over the course of this year, due to public sector job cuts. The RICS' March housing market survey will offer evidence about the supply-demand dynamics in the UK housing market, which will be a key to determine house price prospects. The British Retail Consortium's retail sales monitor for March is likely to show that retail sales growth slowed over the past month, as consumers reign in spending..

Market Watch

Despite the many challenges facing the world economy – from MENA unrests, mounting concerns over inflation, the Japanese disaster and the Eurozone sovereign debt crisis - investor risk appetite appears to remain intact.

In fact, financial markets last week shrugged of Portugal's decision to finally seek financial aid, becoming the third Eurozone country requesting a rescue package from the EU, as well as the European Central Bank's decision to raise interest rates for the first time in more than two years.

Equity indices after they had been hit by the events in Japan in mid-March. The FTSE 100 rose 0.8% over the week to 6,055.8 points, as higher commodity prices benefited mining stocks.

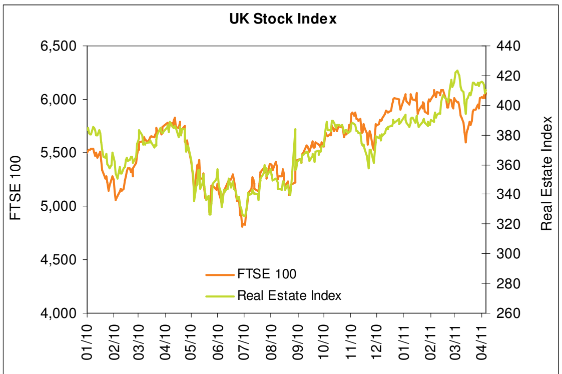
In contrast to the wider index, the real estate index dipped 1.2% last week.

Minerva (-4.3%), Segro (-2.7%) and British Land (-2.6%) saw the largest losses. The Unite Group reported a 1.7% increase in the net asset value of its UNITE UK Student Accommodation Fund (USAF) in Q1 2011, to £0.822 per unit. Unite's share price slipped 2% last week, given the group a market capitalisation of £344.74m. Quintain Estates & Developments saw the only real gains last week, rising 2.3%.

Housebuilders, building contractors and building material suppliers had a mixed week.

Stock Market		Friday 8th April 2011			
Index	**Index**		**Week**	**Month**	**Year**
FTSE100	6,055.8	▲	0.8%	1.4%	6.0%
EPRA/NAREIT UK	409.9	▼	-1.2%	-2.4%	6.6%
Stocks	**Market Cap, £m**		**Share Prices**		
			Week	**Month**	**Year**
Real Estate					
British Land	5,000	▼	-2.6%	-4.2%	16.5%
Hammerson	3,180	▼	-0.7%	-4.1%	13.1%
Land Securities	5,750	▼	-0.9%	-3.7%	10.1%
Capital & Counties	1,040	▼	-2.3%	1.9%	
Capital Shopping Centres	3,320	▲	0.0%	-3.0%	-24.9%
Shaftesbury	1,180	▲	0.2%	-3.1%	23.0%
Great Portland Est.	1,200	▲	0.1%	-3.5%	22.7%
Derwent London	1,670	▼	-0.2%	-5.1%	17.1%
Segro	2,490	▼	-2.7%	-3.7%	-0.5%
Quintain Estates & Development	229	▲	2.3%	4.7%	-20.4%
St. Modwen Properties	353	▼	-2.4%	-2.5%	-14.3%
Unite Group	345	▼	-2.0%	-1.0%	-14.6%
Workspace Group	314	▼	-1.8%	7.0%	8.1%
Minerva	151	▼	-4.3%	-8.2%	-22.0%
Average*		▼	-1.2%	-3.4%	6.3%
Building Contractors					
Balfour Beatty	2,340	▼	-1.8%	-5.3%	13.1%
Carillion	1,530	▲	0.6%	2.8%	13.1%
Morgan Sindall	281	▲	2.6%	0.6%	16.3%
Kier Group	506	▲	0.2%	2.3%	23.1%
Lend Lease Corp*	3,312	▼	-1.1%	-1.1%	4.9%
Average		▼	-0.8%	-1.3%	10.4%
Building material suppliers					
Wolseley	6,100	▲	1.0%	0.6%	37.9%
SIG	848	▲	0.0%	13.2%	17.7%
Marshalls	227	▼	-0.2%	1.1%	23.9%
Kingspan	969	▲	1.6%	-2.3%	-6.8%
Average		▲	1.0%	1.6%	30.1%
Housebuilders					
Persimmon	1,360	▲	2.4%	1.0%	-0.8%
Taylor Wimpey	1,310	▼	-7.0%	-6.5%	-0.2%
Barratt	1,090	▼	-4.1%	5.1%	-12.9%
Bovis Homes	589	▼	-4.2%	-5.2%	1.6%
Bellway	874	▼	-2.6%	5.9%	-8.9%
Berkeley	1,390	▼	-0.1%	1.9%	30.3%
Average		▼	-2.3%	0.5%	3.0%

**Sector averages are weighted according to current market capitalisations



Source: FT