

# Weekly Economic Update

14<sup>th</sup> February 2010

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## Summary

The Bank of England's latest Inflation Report revealed what many had expected before: the UK economy will recover much slower than previously predicted, while inflation is set to overshoot its target in the near term. Construction new order volumes stabilised during the final quarter of 2009, but values in cash terms continue to fall.

## Statistics

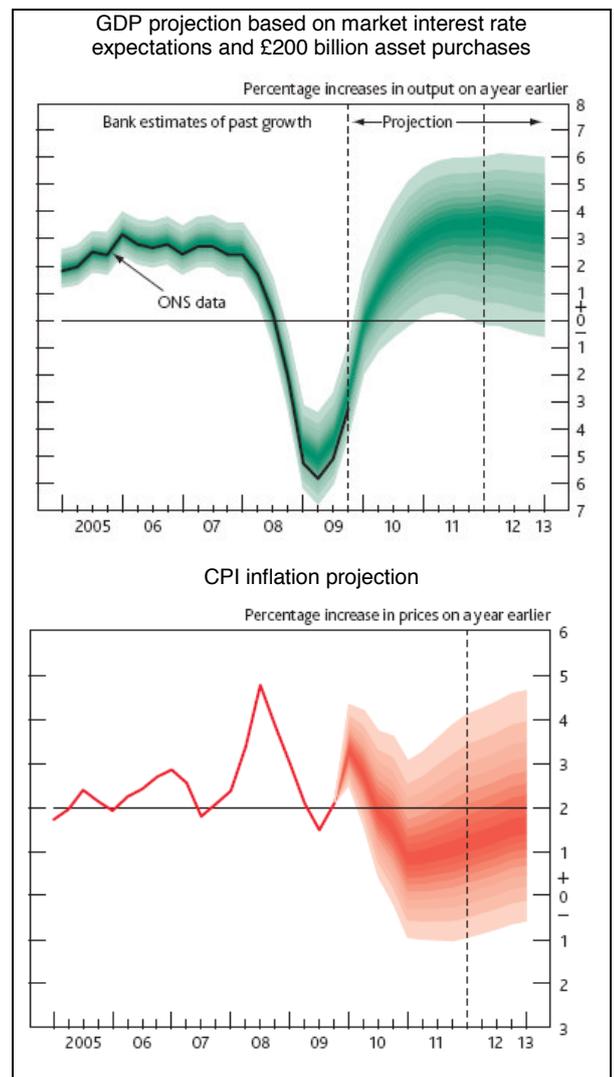
### Bank of England

The **February 2010 Inflation Report** provides the Bank of England's latest assessment of the UK's growth and inflation outlook. The Governor, Mervyn King, was cautious on the UK's prospects, saying that the British economy is continuing to "bump along the bottom". He also stressed that the option of resuming quantitative easing (QE) remains open should the recovery falter markedly over the coming months. He also suggested that interest rates will be kept below 1% by the end of this year.

The Bank has lowered its 2010 growth forecast to 1.5%, compared with 2.2% expansion envisaged in November. Despite the downward adjustment for growth in 2010, the Bank is still expecting growth to accelerate to more than 3% by the end of this year - still more optimistic than most other independent forecasts. According to the regular survey conducted by the Treasury, the average growth rate expected by 28 independent forecasters is 1.4%.

Despite some recent signs of recovery, the Bank has pointed out that global activity still remains well below pre-crisis trends. Credit conditions will remain restrictive for some time and the need to strengthen public and private sector finances will weigh on spending. A degree of spare capacity is likely to persist over the next 2 years, although its extent remains highly uncertain.

On the inflation front, the Bank noted that the immediate prospect for consumer price inflation was to remain well above the 2% target. The downward pressure from the persistent margin of spare capacity was likely to cause inflation to fall back to below the target over the course of this year, before gradually returning to



around the target as the recovery proceeded. On a note of caution, the Bank of England's growth and inflation forecasts are based on current fiscal policy and it seems very likely that major fiscal tightening will be announced after the general election.

### Manufacturing Output

Manufacturing output grew by 0.9% in December compared with November, but remained 1.9% down on a year ago. Over the final quarter of 2009, manufacturing output was 0.8% up on the preceding three months, with the sector helped by an improvement in demand from key overseas markets and a weaker Pound. However overall, sector activity remains sharply lower compared to levels seen two years ago, indicating a large amount of spare capacity in the UK economy.



### Retail Sales

According to the British Retail Consortium, retail sales weakened in January as the country was hit by heavy snowfall. The value of retail sales in stores was 0.7% weaker than a year earlier, a sharp turnaround from December's 4.2% gain. Total retail sales were only 1.2% higher in January compared to a year earlier, after rising 6% in December. The upbeat December figures were probably boosted up by shoppers, who brought purchases forward in December ahead of the increase in VAT. Currently customers are becoming more cautious again, amid uncertainty about the economy. The UK economy grew only 0.1% in the final quarter of 2009, disappointing expectations of a bigger rebound.

### Mortgage Lending

First-time buyer mortgages hit a two-year high in December as buyers rushed to beat the end of the stamp duty holiday. According to the Council of Mortgage Lenders, 24,900 loans were granted to first-time buyers, the highest number since November 2007 and a 26% increase on November. However, the CML said that 2009 was very weak overall, with transactions at a historic low. Total lending stood at £143.6 billion in 2009, down 43% from that in 2008.

### Housing Market

Housing market activity slowed in January due to bad weather, according to the latest RICS housing market survey. Buyer interest, new instructions to sell and agreed sales fell amid the cold snap. The sales to stock ratio, a measure of market slack and a lead indicator of future prices, fell for the 2<sup>nd</sup> consecutive month. Nevertheless, almost a third of surveyors reported that house prices rose again in January. London, the South East and South West saw most house price rises, while in Wales, Yorkshire and Humber and the North saw more price falls. Looking ahead, an increasing number of those surveyed expect prices to rise in the months ahead, though the majority continues to see stagnant prices at best.

### Exchange Rates

The Sterling remained relatively unchanged last week, both against the Euro and the Dollar, despite the Bank of England suggesting in its Inflation Report that the door remained open to further quantitative easing and that interest rate rises were still some way off. One Pound bought €1.149 and \$1.564 on Friday. The Euro stabilised somewhat over the course of last week amid talks of a rescue package for Greece.

### Commodities

Cold weather and heavy snow supported crude oil prices last week. A barrel of Brent crude cost \$72.3, 4% more than a week earlier. Base metals also rose last week after China reported an unexpected easing in inflation in January and stronger than expected lending data. However, reports that China took further steps to cool its economy limited the upward movement. Over the week, copper gained 8%, aluminium 3% and nickel was up 6%.

Commodity Prices (12th February 2010)				
	Price	Weekly change	Monthly change	Annual change
"Brent" Oil (\$/barrel)	72.3	4%	-10%	63%
Copper (\$/tonne)	6,766	8%	-9%	102%
Aluminium (\$/tonne)	2,004	3%	-11%	36%
Nickel (\$/tonne)	18,455	6%	4%	82%
Global Steel Price (Index 04/1994=100)	162.48	-2%	2%	7%

Source: FT, LME, Cruspi

The **Global Steel Price Index** recorded a 2% fall last week, though prices are now 7% higher year-on-year. **Iron ore producers** are reported to be pushing steelmakers into accepting a sharp increase in prices in their 2010/11 annual contracts. According to reports, miners are looking for a settlement of \$90/ tonne or higher, the same as in the 2008/9 annual contracts. Prices in 2009/10 were agreed at \$60 a tonne. However, even higher prices are not excluded, given that the iron ore costs \$120 in the spot market. Producers believe that prices will be supported by strong Chinese demand, the reactivation of global steelmaking capacity and a new ore export tax in India, the third largest exporter.

## Construction

UK **construction new order volumes** were flat during the final quarter of 2009, but up 5% compared to the same period a year earlier. The value of new orders however was 11% lower compared to the preceding three months and 2% down on a year ago. Construction has been one of the hardest-hit industries in Britain's recession. For the year as a whole, order volumes were 13% lower compared to 2008, while order values in cash terms were down by 19%. This means that in 2009 at £33.6bn there were £17bn less new orders compared to 2007 (£50.6bn).

The **commercial sector** was the hardest hit last year, with order volumes down 44%. In the final quarter of 2009, new orders were 18% higher compared to the preceding three months, but remained 23% lower compared to a year earlier. Within the sector, the value of offices related work totalled £547m in the 4<sup>th</sup> quarter, down 35% on last year, but 43% higher compared to the previous quarter. Retail projects totalled £303m in the 4<sup>th</sup> quarter, more than a third lower compared to a year ago and 10% down on the 3<sup>rd</sup> quarter.

The flow of PFI education and health projects continued to dwindle in the 4<sup>th</sup> quarter. **Industrial new orders**, both for warehouses and factories also stalled last year, with order values totalling £1.44bn in 2009, compared to £2.56bn in 2008. Somewhat more positively, new orders in the 4<sup>th</sup> quarter rose by 24% on the 3<sup>rd</sup> quarter, though volumes remained down 22% on the same period a year earlier. **Residential** new orders have been on a slight upward trend in recent months, but remain low overall to date. The drop in new orders last year would have been even worse without the support of the public sector. **Public non-residential** work, the majority of which education and health related, rose by 9% in 2009. However, some momentum seems to be lost, with orders in the final quarter of 2009 down 15% on the preceding three months. In addition, orders in cash terms were 9% lower in the 4<sup>th</sup> quarter compared to a year ago and down by almost a quarter on the preceding three months, meaning that contractors are doing more work for far less cash. **Infrastructure** order volumes also fell back on the previous three months, but remained more than a third higher compared to last year. The flow of projects has been firm in the water industries, electricity and roads related work.

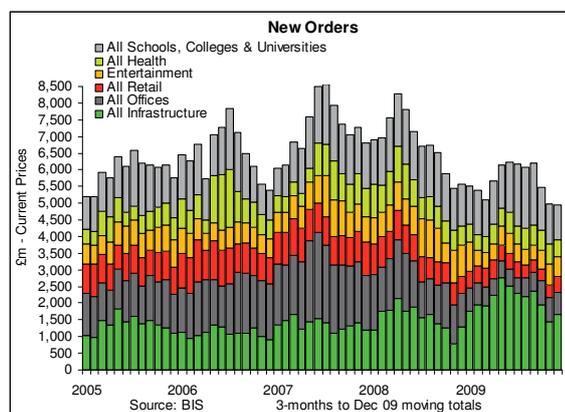
In contrast to recent official figures that showed that construction stabilised in recent months, the **RICS latest construction market survey** paints a gloomier picture of industry workload. According to the survey, construction workloads fell in all sectors in the 4<sup>th</sup> quarter, amid signs that the impending general election is stalling the flow of new projects. Construction work has now fallen for the 7<sup>th</sup> consecutive quarter. The continued lack of development finance is cited as another main obstacle to sector activity. Overall expectations for workload, employment and profits for the next twelve months are all fairly downbeat.

## Looking ahead

**Consumer price inflation** figures for January will show that inflationary pressure has accelerated. The spike is expected to be due to VAT rising from 15% to 17.5% at the start of the month and

	Value, current prices		constant 2005 prices	
	in £ million		% change on previous 3 months	% change on year
Public Housing	615		-19%	38%
Private Housing	1,543		41%	20%
Public Non-Residential	2,050		-15%	6%
Industrial	403		24%	-22%
Commercial	1,683		18%	-23%
Infrastructure	1,656		-13%	35%
<b>Total New Work</b>	<b>7,950</b>		<b>0%</b>	<b>5%</b>

Source: ONS



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## WEEKLY ECONOMIC UPDATE

unfavourable base effects from the falls in oil prices last year. Looking further ahead, inflation is expected to fall back markedly over the course of this year, contained by a slow recovery, substantial spare capacity and wage moderation. The number of **unemployed** for January is likely to continue to stabilise following the recent signs of recovery. The **minutes from the Bank of England's Monetary Policy Committee** interest rate meeting in early February will be released. With the Central Bank suspending its Quantitative Easing programme, the balance of the nine member votes may give some hints for the programme's future. **Retail sales volumes** are expected to have fallen in January, being hit by bad weather and the VAT hike. Finally, the **public finances** data will probably show another month of dismal reading.

## Market Watch

Equity markets stabilised last week, after much volatility caused by sovereign debt problems in Europe. Talks of the EU crafting a bailout for Greece helped investor confidence and sent stock markets higher.

The **FTSE 100** gained 1.6% over the week to Friday. Construction related firms did not benefit much from the rise, with the majority of listed companies seeing their share prices fall.

**British Land** in a trading update reported a positive turn in the value of its property portfolio during the 3<sup>rd</sup> quarter of its financial year (3 months to end December), benefiting from the rise in property share prices over the past month. The portfolio value increased 8.2% to almost £8bn. Net asset values per share rose to 438p, up 18%. Profits amounted to £611m, compared with a loss of £1.6bn last year. Earnings per share were 60p, compared with a loss per share of 470p in the period last year. Rental values continued to decline, by 0.5% for retail assets and by 1.2% for offices.

**St. Modwen Properties** posted a fiscal pre-tax loss of £97.7m in 2009, due to revaluations mainly incurred in the 1<sup>st</sup> half of the year. This compares to a pre-tax loss of £30.5m in the same period a year ago. Revenues fell to £113.7m from £146.5m, but net debt narrowed to £319m from £422m. Cash management remains priority and it will not be paying a dividend this year.

According to Property Week, HSBC has set up a €1 billion commercial property fund (European Active Real Estate Fund), to buy property in the UK and Europe. The bank is apparently negotiating to purchase Valad's Industrial Investment Partnership for approximately £50m and has already carried out investment, including acquisition of Nottingham's Victoria retail park and the Parkway Industrial Estate near Heathrow over the Christmas period.

Share Prices	Market Cap, £mn	Friday 12 <sup>th</sup> February 2010		
		Week	Month	Year
<b>FTSE100</b>		1.6%	-6.5%	22.4%
<b>Real Estate</b>				
British Land	3,840	-0.1%	-6.3%	16.4%
Hammerson	2,710	1.0%	-3.8%	42.8%
Land Securities	4,760	-0.3%	-9.3%	6.5%
Liberty Intl.	2,820	-0.7%	-7.7%	29.1%
Shaftesbury	857.3	1.2%	-4.2%	64.7%
Great Portland Est.	874.2	-1.8%	-5.2%	62.1%
Derwent London	1,280	-2.6%	-4.6%	106.5%
Segro	2,220	-0.7%	-11.2%	19.2%
Quintain Estates & Development	321.4	2.9%	-8.9%	225.5%
St. Modwen Properties	340.6	-2.6%	-11.4%	94.8%
TR Property Investment Trust	577.7	4.5%	-3.0%	38.9%
Unite Group	447.4	-0.6%	-3.7%	280.7%
Workspace Group	241.4	-2.3%	-6.7%	92.7%
Minerva	127.3	0.0%	12.9%	426.7%
<b>Average**</b>		<b>-0.2%</b>	<b>-7.0%</b>	<b>42.5%</b>
<b>Contractors</b>				
Balfour Beatty	1,770	-1.3%	-5.9%	-18.5%
Carillion	1,090	-3.1%	-11.7%	18.1%
Morgan Sindall	233.2	2.7%	-4.6%	-3.5%
Kier Group	355.1	4.3%	-11.1%	-5.3%
Lend Lease Corp*	2,201	0.4%	-9.6%	66.9%
<b>Average</b>		<b>-0.5%</b>	<b>-8.7%</b>	<b>23.3%</b>
<b>Material Suppliers</b>				
Wolseley	3,850	0.4%	-6.4%	48.6%
SIG	645.8	-3.3%	-6.4%	-3.7%
Marshalls	161.4	-2.6%	-6.1%	28.1%
Kingspan	814	-5.1%	-18.4%	136.2%
BSS	335.7	1.9%	-3.0%	-9.1%
<b>Average</b>		<b>-0.8%</b>	<b>-7.9%</b>	<b>51.1%</b>
<b>House Builders</b>				
Persimmon	1,230	-2.5%	-14.6%	24.0%
Taylor Wimpey	1,140	-6.0%	-15.9%	175.7%
Barratt	1,070	-2.7%	-18.7%	110.2%
Bovis Homes	498.1	-4.8%	-15.9%	-6.5%
Bellway	856.4	-3.3%	-11.5%	10.8%
Berkeley	1,020	-2.7%	-12.4%	-14.7%
<b>Average</b>		<b>-3.6%</b>	<b>-14.9%</b>	<b>58.3%</b>
*Lend Lease Corporation Limited is listed on the Australian and NZ stock exchange				
**Sector averages are weighted according to current market capitalisations				