



Inflation Update

February 2010

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 **sense**

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Economists believe the UK officially exited its longest recession since World War II in 4Q 2009, but construction still has further to fall before the impact of six quarters of negative growth and a highly constrained lending environment has delivered in full. Commercial output plunged by a quarter in 2009 and a substantial £13bn was wiped off construction output in just 12 months. The worst of the contraction may be behind us but no discernable recovery is likely before 2012.

Output, and hence level of work, may still be falling but commodity price inflation, governed by production levels and the global market, is already beginning to resurface. As cost pressures mount, quite how contractors can reconcile falling tender prices and rising costs remains to be seen and the situation for many over the next 12 months will be precarious.

Analysis of the recent tender returns within Sense Cost

Consultancy and the wider Mace Group, a survey of the Mace Group supply chain and a comprehensive review of industry and wider macroeconomic data have presented no reason to change the Sense Tender Price Forecast from November.

Sense predicts that following a 10% contraction in 2009, tender prices will fall by a further 5% in 2010. The rate of decline should moderate to 1% in 2011 before demand in the industry is sufficiently strong to support a modest 1% increase in 2012. Short term risks to this projection are weighed to the downside but upside risks prevail in late 2011 and 2012 as demand strengthens.

Key points

1. Economists believe that the recession ended in the fourth quarter of 2009 and the consensus among independent forecasters points to an increase of around 1.4% in 2010. The main engines of buoyant pre-crisis growth, financial services, consumers and the public sector, are no longer in a position to lead, and growth over the medium term is expected to be well below trend.
2. Unemployment decreased for the first time in 18 months in the three months to November, by 7,000 to 2.46m, helping allay fears that unemployment could peak at 3.5m. Modest as this fall is, it strengthens hope that what stands to be a very fragile recovery will ultimately be a sustainable one. Construction employment news has been less positive. 187,000 construction jobs were lost in the year to September, one in four of every job lost economy-wide.
3. Industry output contracted by an estimated 13% in 2009 and a further moderate fall is in prospect in 2010. Signs that the housing market is emerging from its slumber are becoming more frequent. Mortgage lending and prices are both rising and forecasters expect levels of private housebuilding to increase modestly from their historic low in 2010. The rate of recovery will, however, be slow. Tight mortgage lending criteria, relative to two years ago, will constrain demand and the recession led to a significant loss of capacity in the sector which will take time to reinstate. Commercial construction will face even greater challenges in 2010, and another double-digit decline in output is predicted. Leisure schemes and privately financed health and education schemes will be scarce but occupier interest in London's grade A space is strengthening. Developers are looking to 2012 and the expected dearth of new space coming to market at that time with increasing interest. Some agents predict rents will return to growth in 2Q 2010 and some landlords have reportedly removed space temporarily from the market in the hope that higher rents will be achievable in the near future.
4. Public sector activity has been a rock in an otherwise unstable industry. With levels of government indebtedness at a peacetime high, sharp cuts are inevitable and how the industry will fare when the public stabilisers are removed remains to be seen. Consensus forecasts still expect the public sector to compensate for the further contraction in commercial output for one more year before the public sector retreats in 2011. But with political pressure and international concern about the UK's default risk mounting, action may be forced sooner rather than later and if this occurs the consequences for construction will be severe.
5. World trade volumes declined sharply in the aftermath of the liquidity crisis but with the recovery in some emerging economies gaining pace, the outlook is significantly improved in 2010. Whilst this is undoubtedly good news for exporters, users of imported goods will face a double whammy of higher prices and a poor exchange rate.

Key points continued

Despite very recent gains, on account of Greece's predicament, sterling remains critically weak against the euro. With public finances set to deteriorate before they improve, significant respite for users of imported goods is not as yet on the horizon. Some forecasters do not expect sterling to strengthen noticeably prior to 2011 and even expect it to remain depressed relative to its long-term average level. Against the dollar sterling has been broadly stable since our last report. Having averaged 1.64 over the past six months, however, it continued to be weak compared to the long term average.

6. Oil prices have stabilised following the cold weather induced spike in early 2010 and prices have retreated below \$80 a barrel. Immediate pressure may have eased but the reprieve will be brief and the underlying trend going forward is unlikely to be anything but up. Moderate annual increases in oil prices are likely over the next few years as the global economy strengthens. Crucially, however, with projected demand across the Eurozone and in North America more subdued than 24 months ago, the pace of inflation is expected to be moderate and a return to the highs reached before the credit crisis hit is thankfully highly improbable.

Economic background and industry overview

The publication of unexpectedly bullish construction repair and maintenance (R&M) output figures for the third quarter of 2009 was instrumental to the upward revision to the change in Gross Domestic Product (GDP). It is now estimated that GDP fell by 0.2% in 3Q 2009, meaning the economy had contracted by 5.1% year on year through to the end of September 2009.

A return to growth in the fourth quarter is widely anticipated when provisional figures are published in late January and the consensus view among independent forecasters reporting to the HM Treasury is for an increase of 1.4% in GDP in 2010. Recent positive news on the employment front reinforces hope that the recovery will be sustainable. The number of people unemployed in the UK fell for the first time in 18 months in the three months to November, by 7,000 to 2.46m, helping to allay fears that that unemployment could rise to 3.5m.

Consumer Price Inflation (CPI) inflation recorded the strongest monthly increase on record in December 2009, climbing by 1% to 2.9% on an annual basis and serving to remind that the road to

Key economic indicators 2009-2012 (annual % change)

	2009	2010	2011	2012
GDP	-4.7	1.4	2.0	1.8
Private consumption	-3.0	0.4	1.8	2.1
Fixed investment	-14.3	-1.4	1.5	3.3
CPI	1.9	1.9	2.1	2.4
Interest rates (Q4)	0.5	1.1	2.8	4.1

Source: HM Treasury, Experian,

recovery will be plagued by surprise. Deflationary events in December 2008 which were not repeated in December 2009: the VAT reduction, falling fuel prices and aggressive price cutting by retailers, meant that an increase in inflation was anticipated. The magnitude of the rise, however, was not. Inflation will probably moderate in the second half of 2010 as downward pressures on prices at the height of the recession fall out of the comparison. Risks that this will not be the case and inflation will be persistent remain. Should this happen pressure will mount on the Monetary Policy Committee to raise interest rates, an action that would threaten to destabilise the recovery.

Elsewhere economies with a proportionally smaller reliance on

financial services have already emerged from recession. Eurozone output rose by 0.4% in 3Q 2009 and consumers helped the US to follow suit. Emerging markets, especially China and India continued to perform relatively strongly and are forecast to grow by 9.5% and 7.6% respectively in 2010, with equally strong growth in prospect for 2011.

Industry output totalled £25bn, in 2005 prices, in 3Q 2009, 9% down on 3Q 2008 but surprisingly 2% higher than in 2Q 2009. Output in the private new work sectors, commercial, housing and industrial, remained extremely depressed, but the strength of publicly funded non-residential and to some extent growth in infrastructure work mitigated the private sector fall out.

Economic background and industry overview continued

The unexpected strength of R&M output (10% up quarter-on-quarter) in the third quarter is however perplexing and contradicts evidence from recent state of trade surveys.

An unusually cold start to 2010 presented construction firms, for whom maintaining steady cashflow is essential, with yet another obstacle to negotiate and new work orders figures are less than encouraging with respect to 2010 workloads. In 3Q 2009 new work orders continued to slide. In the first nine months of the year they were down by 18% on the corresponding part of 2008, with commercial and private housing orders down by 48% and 37% respectively.

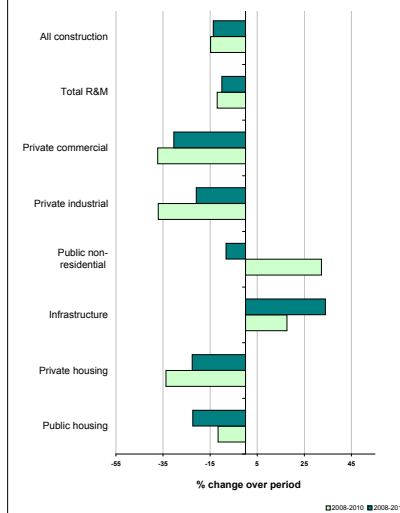
No discernable recovery is in prospect for the commercial construction sector until 2012 according to Experian and the Construction Products Association's latest forecasts, by which time the sector's value is predicted to have shrunk by around a third. Short term prospects for private house building are marginally stronger. Recently there have been signs of a stabilisation in the housing market which should revive housebuilding levels from their current historic low. A housebuilding recovery isn't

without risk. Although improving, mortgage lending remains relatively constrained and sellers opting to sit tight rather than sell, the true strength of demand is difficult to ascertain.

Occupier interest in Central London's grade A space is increasing and agents have called the bottom of the market. Availability remains high but new space coming to the market in the next 18 months is relatively limited. Land Securities' decision to progress three speculative commercial schemes, shelved in the wake of the crisis, is undoubtedly an encouraging development but the offices sub-sector has still been severely affected and nominal offices orders were down by over 65% in the first three quarters of 2009. Agents predict rents on high specification space will return to growth in 2Q 2010 and some landlords have reportedly removed space temporarily from the market in the hope that higher rents will be achievable in the near future.

Public sector activity has been a rock in an otherwise unstable industry. With levels of government indebtedness at a peacetime high, sharp cuts are inevitable and how the industry will fare when the public stabilisers are removed remains

Growth in construction output by sector 2008 to 2013 and 2008 to 2013



Source: CPA

to be seen. Public non-residential orders rose by 11% in the first three quarters of 2009 and consensus forecasts still expect the public sector to compensate for the further contraction in commercial output for one more year before the public sector retreats in 2010. But with political pressure and international concern about the UK's default risk mounting, action may be forced sooner rather than later and if this occurs the consequences for construction will be severe.

Materials

World trade volumes declined sharply in the aftermath of the liquidity crisis but with the recovery in some emerging economies gaining pace, the outlook is significantly improved in 2010. Whilst this is undoubtedly good news for exporters, users of imported goods will face a double whammy of higher prices and a poor exchange rate. Commodities price inflation is expected to strengthen throughout 2010 but at a modest rate relative

to the inflation levels in 2007 and 2008. The Department for Business, Innovation and Skills' all work construction material price index has been climbing month on month since August and prices are almost back on a par with a year ago.

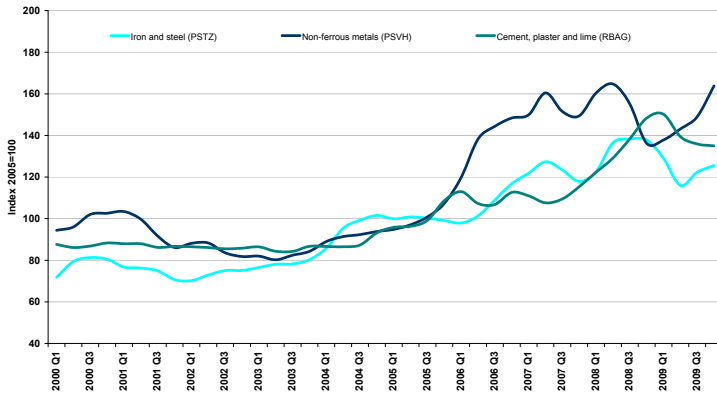
Faced with weaker demand prospects, producers of construction materials scaled back sharply and production levels remain low. Production of slate for cladding

and decorative purposes is 40% down on a year ago and 14% fewer concrete blocks are being produced. Brick manufacturers, hard hit by the rapid and severe contraction in levels of housebuilding, produced 32% less output in 3Q2009 than in the same quarter just a year ago. Across the board, stocks of materials continue to fall.

Sales levels, however, are subdued. Figures from the Minerals Products

Materials

Selected input prices



Source: ONS

Association show aggregate and cement sales were down by 20% in the 3Q 2009 year on year. Ready mixed concrete sales contracted by 26% during the same period and asphalt by 17%. Prices, however, have been reasonably resilient. With only a few exceptions construction materials prices are now higher than a year ago. In November, for example, cement prices increased by 2.8% year on year, pre-cast concrete products by 2.2% and bricks by a staggering 12%.

Metals prices fell much more sharply but in some instances have rebounded rapidly. World Bank figures suggest that aluminium prices stood 10% higher year on year in 4Q 2009, but remained 22% down on the average throughout 2008. Lead prices have risen by 84% over the 12 months to December 2009 and in 4Q 2009 stood 10% higher than the average throughout 2008. Copper prices have been rising rapidly since April and in 4Q 2009 climbed a further 13% quarter-on-quarter to stand 70% higher year-on-year. Even in the current climate copper prices are only 7% down on their absolute peak in 2007. China's influence is being keenly felt in international copper markets, which are currently trading at a discount compared to those in Shanghai.

Global crude steel production through to November 2009 was 11% down on the equivalent part of 2008. Remove China from the equation, however, and production was down by 25%, according to the International Steel Statistics Bureau (ISSB). All major producing regions showed falls comparing January-November 2009 with the same period in 2008, with the EU27 down 33%, Non-EU Europe down 11% and the North America Free Trade Area down 38%. The combined output of the Asian majors, excluding China was contracted by 18% but in China production grew by 12%.

Inflationary pressures may have resurfaced in many metals markets, but steel is one exception. World Bank data suggests steel prices continued to decline in 4Q 2009

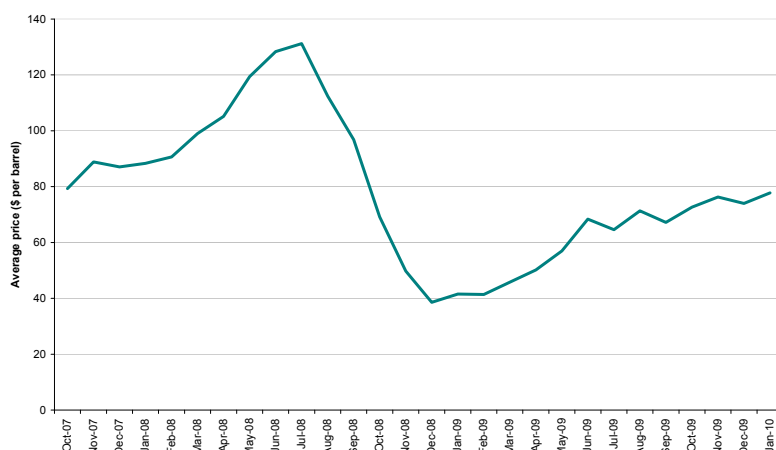
but that the rate of decline quarter on quarter slowed to 2%. On an annual basis, prices were down by 33% in the fourth quarter. The price of Mediterranean steel traded on the London Metals Exchange has, however, started to increase in recent weeks.

In late December BHP Billiton and Rio Tinto signed a binding \$116bn joint-venture agreement that, subject to competition clearance, would see the miners merge their Pilbara iron ore operations in Western Australia. Opposition to the merger is being voiced by competitors and clients alike, with heavy users such as China being particularly vocal. The merger is likely to take place in the second half of 2010 if approval is granted.

Almost half of BHP Billiton's clients have now shunned the annual contract price for iron ore in favour of pricing systems linked to the spot price. In its production report for the second half of 2009, 46% of its Australian ore shipments were sold on shorter term referencing pricing, mixing quarterly negotiations, spot market pricing and index based pricing, rather than on annually agreed pricing. In the first six months of the year only 30% of shipments were sold on this basis.

Oil prices have stabilised following the cold weather induced spike

OPEC Reference Basket (monthly average price)



Source: OPEC

Materials continued

in early 2010. Prices recently retreated below \$80 a barrel and the International Energy Agency's decision to leave its consumption forecast largely unchanged has allayed fears about further, very short term inflation. However, with the global economy forecast to strengthen throughout 2010, inflationary pressures will quickly resurface. Oil prices will average \$83 per barrel throughout 2010, according to Experian and will continue to rise steadily throughout 2011 and 2012. Crucially, however, with projected demand across the Eurozone and in North America more subdued than 24 months ago, the pace of inflation is expected to be moderate and a return to the highs reached before the credit crisis hit is thankfully highly improbable.

Sterling remains critically weak against the Euro due to concern about a combination of further

Monthly average euro/sterling exchange rate



Source: Bank of England

deterioration in the current account, rising government debt and the potential impact of quantitative easing. The Euro/Sterling rate was unchanged from November, in December, averaging 1.1 throughout the month. Experian's

latest forecast suggests that importers will continue to suffer during 2010. Rates are predicted to average 1.16 throughout 2010, 1.2 in 2011 and 1.24 in 2012.

Labour

Elsewhere in the economy, declining full time employment has been offset by part time working reaching unprecedented highs. A further sign that employers are trying to weather the storm and retain skills whenever they can. In construction, however, this trend is less pronounced and could mean the industry will be faced with a serious skills shortage when the recovery comes.

Construction Skills' interim forecast for industry employment is cause for concern. An 8% decline in construction output in 2009 could equate to the loss of 300,000 construction jobs according to the industry body's Construction Skills Network. With a significantly deeper contraction in output in 2009 now predicted, the prognosis

for employment is bleak. Out of the total number of jobs lost across the whole economy, one in four or 187,000 losses were in construction and the industry's recovery will lag the wider economic recovery by some horizon.

The rate of redundancies per 1,000 employees in construction eased marginally in 3Q, from 27.9 in 2Q to 26.0. The redundancy rate peaked at 32.8 in 1Q 2009. Data for the 3Q is certainly an improvement but the rate remains significantly higher than in early 2008 and the industry will continue to face challenging conditions for some time to come.

Average earnings in the construction industry recorded modest growth in 2009 according to the latest Annual

Survey of Hours and Earnings. Weekly gross pay averaged £572, 1.1% up on 2008 levels, marginally underperforming economy-wide wages growth of 1.6%. Approximately 20% less overtime was worked in 2008 than in 2009.

Wage agreements for some specialist contractors were already in place before the phrase "credit crunch" had been coined. Electricians in direct employment will see their wages rise by between 4.5% and 5% next year. Other specialist unions, however, are struggling to reach agreement for 2010 in the prevailing climate.

Outlook UK

The economy may be on the road to recovery but for many sectors of the construction industry a painful 12 months lay ahead. Consumer sentiment has stabilised and sterling's weakness has improved the UK's attractiveness as a trading partner but investment intentions and the corporate sector's appetite for lending both remain subdued. A dichotomy between willingness to supply and demand for credit, which has emerged in recent quarters, may offer some hope. The Bank of England's recent credit conditions survey showed an improvement in lenders' willingness to lend, which although still significantly weaker than it was pre-crisis, is still a positive step. Finance is the lifeblood of the economy and lack of availability could certainly hinder recovery as corporate demand returns.

Assuming no further shocks and a path to recovery which is broadly in line with predictions, industry demand should strengthen in 2011. However, inflationary pressures affecting the industry in the short term are likely to be disproportionately strong considering that workloads have further to fall. With prices for

many finite construction materials being determined both by global construction demand and the state of other industries, prices are set to rise. While anecdotal evidence suggests industry wages have reduced, official data suggests otherwise. Either way, should the current strength of the CPI fail to ease, pressure to increase wages at the next bargaining round will be high.

With inflationary pressures beginning to re-emerge, firms who entered into at or below cost agreements in order to secure work will find it increasingly challenging to deliver and insolvencies are certain to rise. The increased risk of insolvency means that clients must exercise greater caution when procuring construction work. From a cost perspective, however, 2010 is an opportune year in which to do it. Contractors are hungry for work and rates are extremely competitive. Taking a realistic stance will allow clients to benefit from current market conditions without excessively increasing the risk they bear.

Analysis of the recent tender returns within Sense Cost Consultancy and the wider

Mace Group, a survey of the Mace Group supply chain and a comprehensive review of industry and wider macroeconomic data has presented no reason to change the Sense Tender Price Forecast from November.

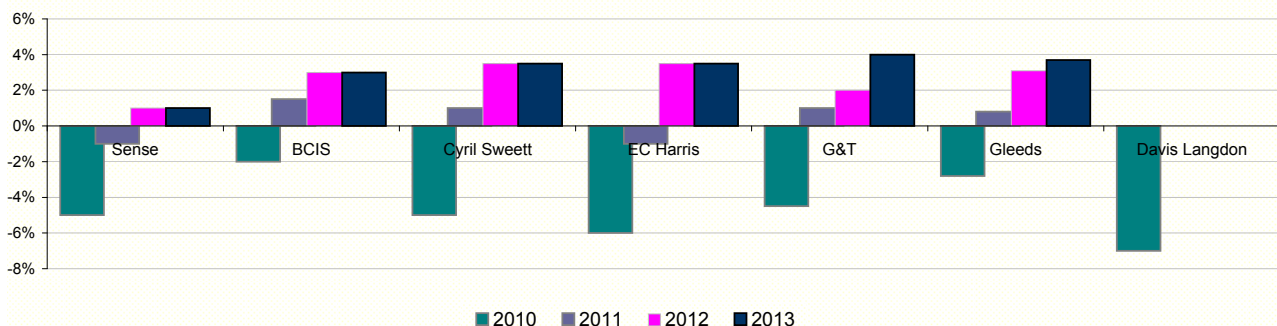
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Annual tender price inflation forecast (UK) - a selection of cost consultant forecasts



The Sense construction tender price projection is informed by tender returns from live projects, out-turn cost-data from Mace Group, feedback from the group's supply chain, a review of third party forecasts of general price inflation, and macroeconomic and construction industry analysis.

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