

Quarterly Economic Bulletin

Summer 2009

The international picture

The global economy is starting to pull out of the worst recession since the Second World War. Financial markets have surged over the last three months and despite residual debt issues, banks are returning to profit. It seems the financial crunch could be abating. Nonetheless, the economic recovery is expected to be sluggish and uneven. For this reason, current activist monetary and fiscal policies may need to be continued over the short-term; however exit strategies will be essential once a sustainable upturn is assured.

The IMF has revised upwards its world economic forecast. A contraction of 1.4% is expected in 2009. Activity is expected to revive during 2010 with 2.5% growth. But different global regions and sectors have different outlooks. Growth paths are still uncertain and even with the evident stabilisation since the last QEB, risk levels remain elevated. A lot depends on an improvement in world trade and debt levels being managed adequately. The global economy also needs to rebalance between consumption and savings. Overall, the picture is one of improvement; data over the coming months should continue to confirm that the global recession is slowly retreating.

UK Snapshot

The economy shrank by 2.4% (revised from 1.9%) in the first quarter of 2009. This loss of output was as much as the whole of the 1990s recession and was aided by a plunge in construction activity. Whilst to some extent this is old news, it emphasises the weaknesses the UK must overcome. GDP is now 4.9% lower than the first quarter of 2008. Gross fixed capital formation (fixed asset investment) fell 7.5% in Q1 and is now 13.2% lower year on year. The ILO measure of unemployment rose by 244,000 to 2.2 million in the first three months of 2009 and is expected to rise until 2010 although labour flexibility is helping to limit job losses. It is highly likely that Q1 marked the deepest contraction of the current downturn. The economy could even have begun to grow again in July and August. Indicators are certainly improving; the PMI service index continues to signify expansion, house prices are slowly beginning to rise and the trade deficit is narrowing. Whilst a modest resumption of growth is expected in 2010, tax hikes, spending cuts and public balance sheet problems could trigger a double dip recession.

Challenges still lay ahead; even a return to economic 'normality' – the long run average – would mark a step change from the record growth of the past decade. It is possible then that the UK could undergo what economists call a 'mean shift' back to trend growth of around 2%. ▶



Jonathan Hook

UK & Global Engineering & Construction Leader, PwC

Some sector commentators are talking about 'green shoots' but they are primarily referring to the residential market where a number of the large housebuilders are reporting an upturn in visitors to sites and reservations. The outlook for much of the construction sector over the next two years is still very gloomy. I predict that there will be a lot of scrutiny around the robustness and timing of forward order books as projects shift to the right or frameworks don't deliver the volumes anticipated.

-2.4%

UK Q1 2009 GDP growth

-20%

Q1 2009 construction output y/y

-39%

Q1 2009 new construction orders y/y

First Quarter 2009 - Output and new orders in the construction industry:

Source: ONS

	Private housing	Public housing	Public non-residential	Infrastructure	Commercial	Industrial	Total new work
Output [y/y]	-32%	-12%	+7%	-5%	-26%	-40%	-20%
Output [q/q]	-10%	-8%	-3%	+2%	-16%	-21%	-10%
New orders [y/y]	-54%	-21%	-25%	-9%	-55%	-59%	-39%
New orders [q/q]	-19%	-13%	-26%	+15%	-33%	-45%	-20%

Inflation, interest rates and sterling

In line with expectations from the previous bulletin the CPI measure of inflation fell to an annual 1.8% in June, from 2.2% in May, as downward pressure on prices continued. The benchmark index undershot the Bank of England's 2% target for the first time since September 2007 and could remain there over the next 12 months at about 1%. Meanwhile, inflation on the RPI slid further into deflationary territory to minus 1.6% – the lowest since 1948 – and is expected to fall to around -2% over the next couple of months. By early 2010 both measures will face upward pressure from increases in VAT and petrol duty and as falls in interest rates and energy costs drop out of the system.

This monetary slack should enable the UK base rate to remain at 0.5% into next year and gradually tighten after that. Despite recent signs of improvement in the economy the Monetary Policy Committee has extended its Quantitative Easing (QE) scheme by an extra £50bn to £175bn. This underlines how fragile the capital markets remain. The decision will also have been helped by recent figures showing that growth in the broad money supply to non-financial firms fell to 3.1% from 3.8% in the second quarter.

The exchange rates of Sterling, the Dollar and the Euro moved around slightly in July but closed near to where they started the month. Since the last bulletin Sterling has rallied in response to rising market sentiment towards the UK. Analysts expect the pound to strengthen against the Dollar and the Euro over the medium term, but risks remain. Downside stress could come from the UK public deficit being part funded by overseas investors. On the upside, UK goods and services seem undervalued, but a lack of global demand is preventing exporters taking full advantage.

The construction industry

Construction activity in the first quarter of 2009 contracted by an annualised average of around 30%. New orders especially have fallen significantly and workloads remain in negative territory. Firms are still operating in a tough business climate. New contracts are limited and competition levels are increasing, as consultants seek work in new areas. Downward pressure on fee levels and cash flow continues as clients seek to reduce costs and take longer to pay. It is forecast that construction prices will decline between 3-5% over the 12 months to Q1 2011. 2010 will also see moderate falls in new work output. Nonetheless, the industry, while still in decline, is showing further signs of easing. The construction PMI indicated the slowest rate of contraction in 16 months; climbing to 47, albeit still below the +50 that denotes expansion. The Glenigan index – which tracks the value of new construction projects – saw the y/y decline ease to 20% in June from highs of 30% in recent months. Expectations are improving in line with the economic picture.

The outlook for the next 12 months remains challenging but noteworthy projects are still coming on stream such as the £2bn London Array. Over the near term forward visibility remains low, but the picture is different depending on sector and geography. The revival of private sector development is crucial. The infrastructure sector is once again expected to fare better than the industry as a whole and help lead the recovery. Globally, according to IHS, spending in the construction market is expected to contract by 3.7% in 2009. Looking ahead, Asia and North America will help drive construction growth close to 5% in 2011 and 2012. ■

For further information about ACE's market intelligence and bespoke research and advisory services please contact:

Adam Patterson

Economic Analyst

Tel: +44 (0)20 7227 1882

Email: apatterson@acenet.co.uk

Aggregate forecasts

See below for a consensus of independent forecasts for construction output [annual percentage change]

