

## WEEKLY ECONOMIC UPDATE

26<sup>TH</sup> APRIL 2009

### Summary

The very poor state of the UK's public finances meant that the Chancellor, in his 2009 Budget, was not able to deliver any major new fiscal boost to help the economy. Instead, public investment is set to decline sharply from 2011, which will have major implications for the UK construction industry. Meanwhile, the UK economy shrank by 4.1% year-on-year during the 1<sup>st</sup> quarter of 2009.

### Statistics

- The IMF revised downwards its growth outlook for all major economies and regions. The global economy is expected to contract by 1.3% this year and rebound only modestly by 1.9% in 2010, according to the latest **World Economic Outlook**. Advanced economies are forecast to contract by 3.8% in 2009, while developing economies will grow by 1.6% in 2009. Any recovery will depend on governments sustaining fiscal stimulus, as well as on more decisive efforts to clean up the banking system. Once the crisis is over there will be a difficult transition period, with growth below rates seen in recent years. The IMF warns that any turnaround, however shallow, will convince the world things are going to be the way they were before, which will not be the case. The world economy cannot go back to where it was before the crisis - it was demonstrably unsustainable. The de-leveraging in some highly indebted countries has not begun, the needed re-balancing of global demand has barely started and a return to sustained, private-sector-led growth will take a while to emerge.

World Economic Outlook			
GDP - Annual %	2008	2009	2010
US	1.1	-2.8	0
UK	0.7	-4.1	-0.4
Germany	1.3	-5.6	-1
China	9	6.5	7.5
India	7.3	4.5	5.6
Russia	5.6	-6	0.5
Brazil	5.1	-1.3	2.2
Middle East	5.9	2.5	3.5
Oil - Annual %	36.4	-46.4	20.2

The IMF does not expect *commodity prices* to rebound quickly to high levels seen in 2007 and the 1<sup>st</sup> half of 2008. There is some upside potential from supply retrenchment. Over the medium term, the main factors that have supported high prices in recent years – emerging economies demand and the need to tap higher-cost resources – are likely to re-emerge in the future.

- In its latest **Global Stability Report**, the IMF now estimates that overall losses from the financial crisis will total \$4.1 trillion. The global financial system remains under severe stress, as shrinking economic activity has added to pressure on banks' balance sheets, threatening their capital adequacy and further discouraging lending. Credit growth is still slowing, adding even more downward pressure on economic activity. Substantial private sector adjustment and public support packages are being implemented, but more needs to be done to restore confidence in financial institutions to normalise conditions in markets.

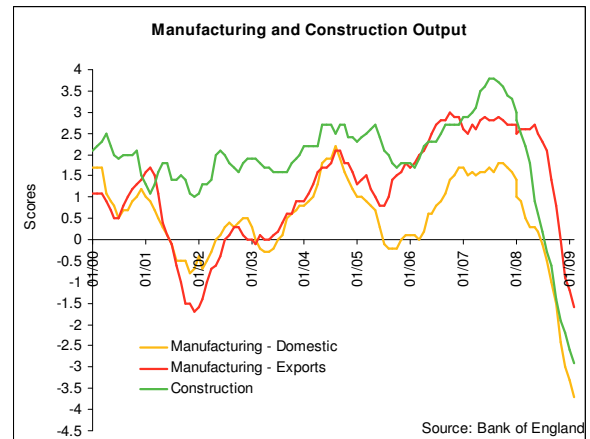
The *costs of the financial crisis* are adding to the fiscal burden of many countries. The IMF has made initial estimates, including three elements: net costs of direct support to banks, expected eventual costs of guarantees, and costs of central bank liquidity provision. The US, UK and Ireland face some of the largest costs of financial stabilisation given the scale of mortgage defaults. In addition, the projected *issuance of government and government-guaranteed bank securities* will be very large in 2009, due to increased budget deficits and continuing bank refinancing needs. One of the *risks* associated with this is that the higher quality of government or government-guaranteed paper in a risk-averse environment will crowd out private sector issuers.

	Public Debt and Stabilisation Costs		
	Gross Government Debt		Financial Stabilisation Costs
	% of GDP		% of GDP
	2008	2010	
US	71	98	12.7
UK	52	73	9.1
Germany	67	87	3.1
Japan	196	227	1.7

Source: IMF

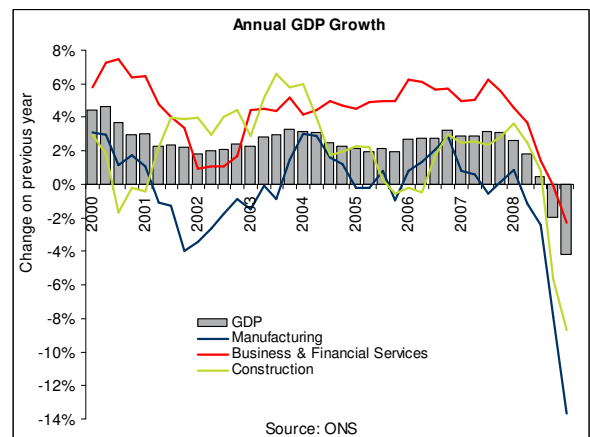
## Bank of England

- The Bank of England's monthly **Summary of Business Conditions** shows that there are little signs of a rebound in UK economic activity in March.
- **Consumer spending** remains weak, but there are tentative signs that the decline in retail sales may be easing.
- **Housing market** activity appears to be picking up, but from very low levels. First time buyer activity remains depressed, due to financial constraints.
- **Manufacturing output** continues to fall sharply. Export demand is reported to be somewhat stronger than domestic demand. The automotive, construction and capital goods supply chains remain the weakest sectors. **Construction** activity contracted again in March across all sector. There was little evidence as yet that public sector projects had been brought forward, but there were reports that the recent tick up in housing market activity has prompted the slow resumption of some building work in the sector
- **Business investment** continues to fall and investment intentions remain low. Pessimism surrounding the demand outlook remains the main deterrent to capital expenditure, as well as cost and availability of project finances, and the availability of working capital.
- **Labour** demand is shrinking. Firms are reducing labour costs by cutting staff or average hours.
- **Manufacturing input costs** did not change much in March, largely due to higher import costs offsetting falls in global material prices.

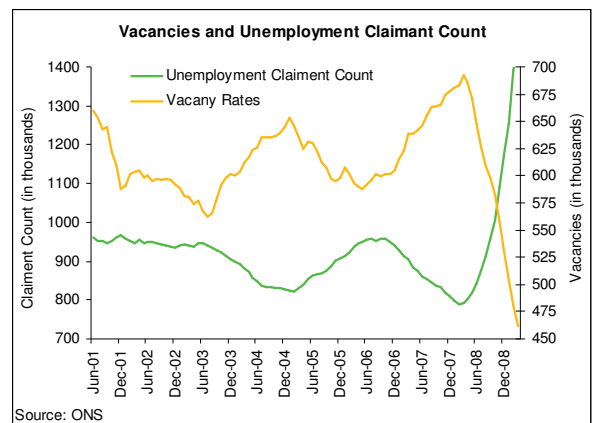


## Economy

- **UK GDP plunged** by 1.9% during the 1<sup>st</sup> quarter of 2009 and was down 4.1% year-on-year, the sharpest decline since 1979. The economy is being hit hard by both the global crisis and additional problems in the UK, namely the sharp housing market decline, high consumer debt and the relative importance of the financial sector. Manufacturing activity fell 6.2% during the quarter and down 13.7% year-on-year, the deepest decline since records began in 1948. Construction output declined by 2.4% quarter-on-quarter and 8.6% year-on-year. The services sector was down 1.2% during the quarter and 2.1% lower than last year. There are some signs that the pace of decline in economic activity may be starting to ease and it is likely that the fall in the 1<sup>st</sup> quarter will prove to be the deepest during the current recession.

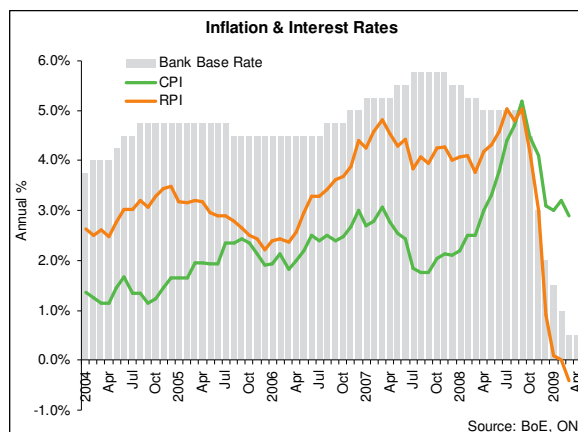


- The recession is taking its toll on the **UK labour market**. The number of unemployed rose to 2.1m in the 3 months to February, up from 2.03m in the preceding 3 months. The unemployment rate increased to 6.7%; this figure is forecast to rise to 10% next year. Unemployment claimant count increased to 1.46 million in March, up 74,000 on the previous month. Average earnings for the whole economy fell by 1.7% in the 3 months to February compared to the preceding 3 months. Compared to a year ago, average earnings remained unchanged.
- There are some signs of improving conditions on the **UK high street**. A number of retailers are reporting better than expected earnings and retail sales



volumes are holding up stronger than expected. Overall retail sales in the first quarter were up 1% on the preceding three months and 1.9% higher compared to the same period last year.

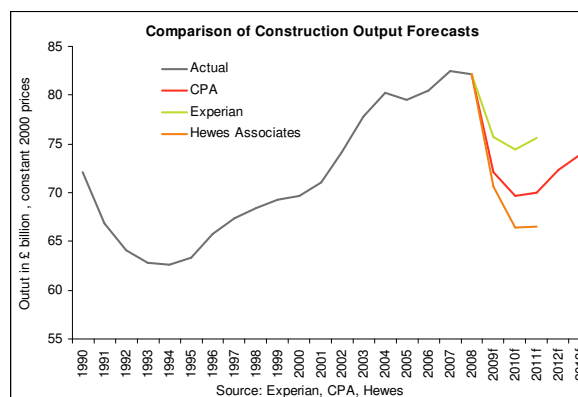
- **Consumer price inflation** eased to 2.9% in March, down from 3.2% in February, but still markedly above the Bank of England's 2% target. Consumer price inflation is proving stickier than expected, due to the sharp depreciation of the Pound since summer 2007, which increases import costs. The retail price index fell 0.4% in March, the first time that the index showed a decrease since the 1960s. The decline in RPI reflects falling mortgage interest payments, as well as lower gas and heating oil prices.
- The **Sterling** came under pressure last week after the poor state of UK public finances was confirmed. The Pound lost 2% against the Euro to £/€1.11 and 1% against the Dollar at £/\$1.47.



- **Oil prices** weakened last week, due to high US stock levels and weak demand. A barrel of "Brent" crude cost \$51.92, 2% less than a week earlier. **Copper** dropped 5% to \$4,540/ tonne, while **aluminium** slipped 2% to \$1,426/ tonne. According to the International Aluminium Institute, global aluminium output has declined to its lowest levels for 2½ years, with production in March down 7% year-on-year.

### Construction

- **Experian** published an update to its forecasts for the construction industry. It now expects output in 2009 to decline by 7.8% and by 1.7% in 2010. Construction is expected recover modestly in 2011, rising by 1.6%. This is a sharp downward revision from the report released in January, but Experian remains the most optimistic among the three main construction forecasters. The main differences are in the views about the commercial sector. Experian expects a far shallower drop in commercial work of about 15% in 2009. This compares to a 23% decline forecast by the CPA. Experian is also more optimistic about the fortunes of the infrastructure sector, predicting markedly stronger growth than the CPA and Hewes.



### Looking ahead

- This week's data are likely to show that UK housing market activity is improving modestly from very low levels, but house price inflation will still be deeply negative. Other data releases to look out for are the CBI's distributive trades survey for April, an advance indicator for retail sales and the GfK/NOP consumer confidence index. The manufacturing purchasing managers' index for April is likely to show that the pace of decline in sector activity may be starting to ease. Overall however, manufacturing will continue to suffer from depressed demand, stronger competition, worsened cash flows and tight credit conditions.

## Focus on...Budget 2009: Public investment squeeze underway

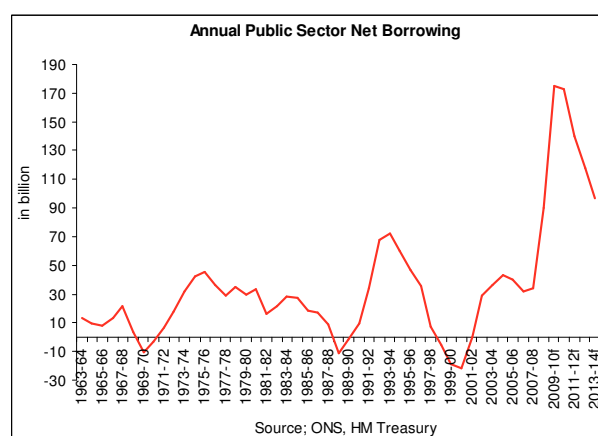
Last week's 2009 Budget revealed that economic growth forecasts were revised markedly lower for this year, while government net borrowing was projected to surge, with markets being asked to digest £220bn of gilt issuance this year. The very poor state of the UK's public finances meant that the Chancellor was not able to deliver any major new fiscal boost to help the economy.

There were three main topics in the Budget:

1. The shocking state of UK public finances
2. The Chancellor's gambling on a very rapid rebound of the economy to make his numbers add up
3. The construction industry will have to hope for private sector demand to return by 2011, as from then public capital investment will be fiercely squeezed.

### Economic and Public Finances Overview

The big numbers in the Budget were almost exclusively reserved for public borrowing and government debt. The Chancellor forecasts **net borrowing** to jump to £175bn (12.4% of GDP) this year, a figure unthinkable only a year ago, when the forecast was for £38bn. The Chancellor expects that economic growth will bounce back quickly from 2010 onwards, boosting tax revenues and returning public borrowing in 2013/14 to around £97bn (5.5% of GDP). This is possible, but borrowing may well remain higher than the government expects. Net public debt is forecast to rise to 79% of GDP in 2013/14, including the potential losses from financial sector interventions. Public finances would not return to comfortable levels until 2017/18. The risk is that financial market concerns about UK public debt (to around £1.4 trillion by 2014) could lead to higher long-term UK gilt yields in the medium-term.



Net public borrowing - £ bn	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Pre-Budget 2008	36.6	77.6	118	105	87	70	
Budget 2009	34.6	90	175	173	140	118	97

There are already very serious doubts about the Government's ability to regain control of public finances as planned, in particular as this relies on a swift economic recovery. The Chancellor forecast the **economy** to shrink by 3.25-3.75% in 2009 – which is in line with the general consensus - but to rebound quickly thereafter. Annual growth would reach 1.25% in 2010 and rise by 3.5% per annum from 2011. The key question is whether this is credible. Most other forecasters are much more cautious. For example, the IMF now predicts the UK economy to continue to contract – albeit marginally – in 2010 and forecasts a substantially slower recovery to trend growth of 2.8% in 2012.

Gross Domestic Product – Ann. %	2008	2009	2010	2011	2012	2013
Pre-Budget 2008	3/4	-1 1/4 - -3/4	1 1/2 - 2	2 3/4 - 3 1/2		
Budget 2009	3/4	-3 3/4 - -3 1/4	1 - 1 1/2	3 1/4 - 3 3/4	3 1/4 - 3 3/4	3 1/4 - 3 3/4
IMF April forecast	0.7	-4.1	-0.4	2.1	3	2.8

**Consumer expenditure** is forecast to decline by 2.75-3.25% this year, before stabilising in 2010. **Business investment** is set to decline sharply by 11-11.5% in 2009 and to fall further in 2010, before rebounding sharply thereafter. **Government capital investment** is forecast to increase very modestly this year and next, but to start declining sharply from 2011 as fiscal consolidation starts.

Gross fixed capital formation – Annual %	2007	2008	2009	2010	2011
Business	9 3/4	0	-11 1/2 - -11	-4 3/4 - -4 1/4	9 - 9 1/2
Government	6 1/2	17 1/4	1 1/2	2	-16 3/4

The Chancellors **growth forecasts could prove somewhat optimistic** near term and wildly optimistic in the long term, especially given the sharp fiscal tightening that will be required sooner rather than later. The majority of the fiscal consolidation will come from public spending restraint rather than higher taxes. Public

spending is expected to be slightly above previously forecast levels in the short-term, but is set to grow significantly more slowly in the three years to 2013/14 at an average real rate of just 0.7% per annum. Out of that will come much higher bills for servicing government borrowing and much higher spending on unemployment benefits. Overall, this will be the most substantially squeeze in spending for decades.

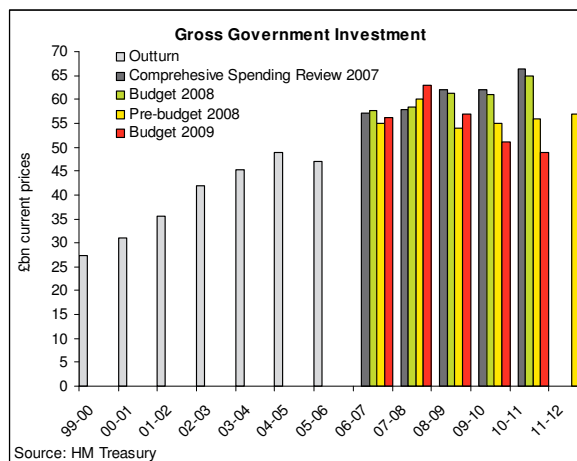
*Clearly, if growth is significantly lower than the Chancellor forecasts, his public finance targets are likely to be missed, which would require additional tightening measures further ahead.*

### Impact on Construction

Capital investment will bear the brunt of the spending cuts. Net capital expenditure in cash terms will rise from £37.7bn in 2008/09 to £44bn this year, as some spending is brought forward to boost the economy. But after that, **net capital investment will be halved** from £44bn this year to £22bn a year by 2013/14. This will have **severe implications for the construction industry** in the areas of education, health, transport and housing.

There was some good news for construction:

- A £600m package was announced to help housing with the addition of up to 10,000 new homes. Of this £400m has been allocated to assist stalled housing developments and development finance through reducing up-front costs, £100m for local authorities for energy efficient housing and £80m has been made available for the HomeBuy Direct mortgage equity scheme. £50m has been allocated for the provision of armed forces accommodation.
- An additional £300m of capital funding for investment in Further Education colleges up to 2011.



Disappointing is the failure to act on empty property rates – an unnecessary burden on companies already struggling to maintain their properties. In addition, whilst the Learning and Skills Council may have irresponsibly committed to projects in its Colleges for the Future programme for which it did not have the funding, these projects could start quickly, providing a boost to construction work. The additional £300m provided will only support about a tenth of additional schemes.

Net capital investment - £ bn	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Pre-Budget 2008	29.9	36.5	40	33	33	33	
Budget 2009	29.3	37.7	44	36	29	26	22

Overall, the direct measures aimed at construction-related activities were scarce and the additional funding allocated is very modest given the scale of the construction downturn we are currently witnessing. The UK construction sector is forecast to lose some 10-16% in output in the current downturn, or £12-20 billion, depending on which forecasters you believe.

*The real concern is that the Chancellor's optimism about a strong rebound in UK growth will prove wrong and if this happens there will be even more severe cuts on public construction spend. Already there are voices that the scale of reduced public service spending planned is not going far enough to restore fiscal health and that more is to come. Once again, the industry is hoping for a return of the private sector by 2011 latest. Otherwise we could quite easily see a long construction industry recession.*

## Market Watch

Friday 23 <sup>rd</sup> April 2009				
Share prices	Market Cap, £	Week	Month	Year
<b>FTSE100</b>		1.5%	6.3%	-31.3%
<b>Real Estate</b>				
British Land	3.67	-4.0%	13.4%	-35.4%
Hammerson	2.17	4.1%	12.8%	-53.8%
Land Securities	4.09	0.4%	17.2%	-59.8%
Liberty Intl.	1.65	-2.9%	9.7%	-54.4%
Shaftesbury	478.0	0.2%	10.8%	-33.2%
Brixton	76.1	-14.5%	21.7%	-90.5%
Great Portland Est.	535.4	7.9%	18.0%	-34.6%
Derwent London	851.8	0.4%	31.5%	-37.9%
Segro	1.39	0.0%	-6.7%	-69.7%
Quintain Estates & Development	52.3	0.6%	109.1%	-90.0%
St. Modwen Properties	210.2	4.2%	135.1%	-60.3%
TR Property Investment Trust	458.0	0.8%	13.2%	-31.7%
Unite Group	125.7	-13.1%	31.8%	-64.5%
Workspace Group	151.7	-3.3%	31.8%	-91.6%
Minerva	22.6	1.8%	139.3%	-85.0%
<b>Average**</b>		<b>-0.4%</b>	<b>15.7%</b>	<b>-50.7%</b>
<b>Contractors</b>				
Balfour Beatty	1.59	-4.4%	-0.7%	-26.3%
Carillion	974.0	-5.1%	-5.1%	-32.2%
Morgan Sindall	263.2	-5.1%	-5.1%	-32.2%
Kier Group	344.3	2.5%	5.3%	-21.5%
Lend Lease Corp*	1.34	-5.2%	8.3%	-46.2%
<b>Average</b>		<b>-4.3%</b>	<b>1.2%</b>	<b>-33.5%</b>
<b>Material Suppliers</b>				
Wolseley	3.50	0.3%	23.2%	-46.7%
SIG	855.3	9.0%	28.1%	-76.8%
Marshalls	161.0	1.4%	11.7%	-52.2%
Kingspan	594.7	-2.1%	25.7%	-52.7%
BSS	398.0	14.3%	12.2%	-15.3%
<b>Average</b>		<b>2.4%</b>	<b>23.1%</b>	<b>-49.9%</b>
<b>House Builders</b>				
Persimmon	1.19	1.9%	10.0%	-34.7%
Taylor Wimpey	495.5	-7.9%	126.8%	-66.2%
Barratt	508.8	-0.8%	76.8%	-47.0%
Bovis Homes	558.7	0.5%	4.2%	-1.3%
Bellway	890.5	2.4%	10.0%	5.6%
<b>Average</b>		<b>0.1%</b>	<b>34.3%</b>	<b>-25.7%</b>
*Lend Lease Corporation Limited is listed on the Australian and NZ stock exchange				
**Sector averages are weighted according to current market capitalisations				

Last week, on Budget day, the UK government shocked markets with its plans to issue some £220bn gilts this financial year, as public finances are sinking deep into the red.

Global stock markets were volatile last week, but many gained. The **FTSE 100** rose 1.5% in the week to Friday, underpinned in particular by retail stocks amid signs that the sector may be holding up better than expected.

**Debenhams** reported that headline profits before tax in the six months to end-February were up 10.7% at £104.2m from £94.1m a year earlier. Like-for-like sales in the seven weeks to mid-April were up 1.9%. **Tesco's** underlying profits rose to over £3bn. In a trading update, the retailer confirmed that current trading is solid, with UK like-for-like sales up 3.4% in the first six weeks of its current financial year.

The **FTSE real estate index** slipped 0.5% over the last week, though the performance within the sector was mixed. Great Portland Estates, St. Modwen and Hammerson recorded the largest gains, up 7.9%, 4.2% and 4.1% respectively. Among the large real estate firms British Land and Liberty International slipped, down 4% and 2.9% in the week to Friday.