Cardinus Advisory Notice #3 - Inflation Review

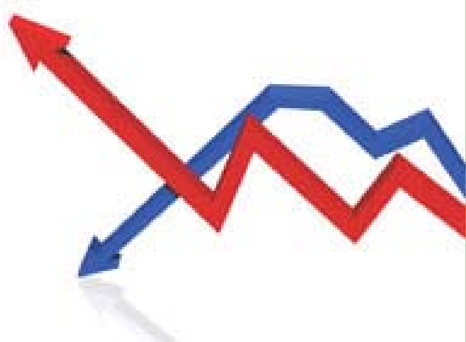
For over 10 years Cardinus has supplied innovative on-site survey/ assessment, training and consultancy safety solutions to some of the world's largest organizations…protecting people, property and businesses. Throughout that time we have gathered a wealth of information from customers and colleagues including research, case studies, articles and testimonials.

This **'Inflation Review'** is provided by our specialist team of consultants in addition to our Advisory Notice #2 Rebuilding Valuations and will be produced twice a year.

Summary

- Inflation should generally remain between 3% and 5%. Independent forecasts show retail prices inflation rising by 4.1% in 2010 and by 3.6% in 2011.
- GDP is expected to rise by around 1.5% per annum in 2010, 2.0% in 2011 and 2012, and by 2.5% in 2013 and 2014.
- Fixed investment, which includes new construction, fell by 15% in 2009 compared with 2008. Fixed investment is expected to rise by 2% this year and 3% next year.
- Material prices are expected to rise quite sharply over the first year of the forecast, rising considerably faster than general inflation. Over each of the remaining years of the forecast, it is anticipated that material price rises will move at or a little ahead of general inflation, some upward pressure being applied by strong demand from the emerging economies, such as China and India, as the world recovers from recession.
- It is anticipated that the average of wage awards will rise well behind the rate of general inflation over the first year of the forecast period, with a number of trades having had a wage freeze in 2010. Over the second year of the forecast, the average of wage awards is expected to again rise behind general inflation, albeit not that far adrift. Over the remaining years of the forecast, the average of wage awards is likely to rise at around the level of general inflation.
- The BCIS forecast of new work output shows quite strong growth in 2010, with output growth remaining virtually unchanged in 2011, as public sector funding starts to fall away, but private sector output starts to come back more strongly. With public sector spending cuts set to continue over the remainder of the forecast period, slow growth in new work output is expected in 2012, with the rate of growth rising steadily in 2013 and 2014. It should be borne in mind than any growth in new work output is from a very low base, and in 2014 new work output is expected to be in the order of 6% below the pre-recession levels of 2007.
- Despite new work output now expected to grow in 2010, tender prices are forecast to remain unchanged in the year to 1st quarter 2011, with the rate of growth in new work output slowing to a position of virtually no change in 2011. A recent BCIS survey of contractors shows that the majority of contractors expect tender prices to remain unchanged up to the end of 2010. With only slow to steady growth in new work output over each of the remaining years of the forecast, tender prices are anticipated to rise more or less in line with input costs. Tender prices in 1st quarter 2015 are forecast to be around 6% lower than the pre-recession peak in 4th quarter 2007.

Historical Inflation



Double digit inflation, as measured by the Retail Prices Index, has only occurred once for a sustained period since the late 1940s. This happened between 1974 and 1981, with the exception of 1978, with inflation peaking at 24.2% in 1975. After this period, there was a period during 1983 to 1988, where inflation stayed within a fairly tight band of between 4% and 6%.
However, in 1989, inflation rose to 8%, followed by a 10% rise in 1990. Inflation

then fell back to 6% in 1991, and since then it has remained fairly low and stable, generally running at between 1% and 4%.

In 2009, inflation turned negative at -0.5%, but 2010 to date has seen inflation rising relatively rapidly, rising by 4.8% in July 2010 compared with a year earlier. According to the Treasury, the average of independent forecasts shows retail prices inflation slowing to 3.9% at the end of 2010, slowing a little further in 2011 to 3.5% and falling further to 2.7% in 2012, before rising slightly to 3.0% in 2013 and 3.2% in 2014.

Inflation to Date

The annual rate of inflation in August 2010, as measured by the Retail Prices Index (RPI), fell to 4.7% from 4.8% in the previous month. The Consumer Prices Index (CPI), the Government's measure of inflation, remained unchanged at 3.1% in August 2010, still well above the Government's target level of 2.0%.

The Office of National Statistics report that manufacturing input costs (excluding food, beverages, petroleum and tobacco), fell by 0.4% in August 2010 compared with the previous month, but rose by 6.4% compared with the same month in 2009. Manufacturing output prices (excluding food, beverages, petroleum and tobacco), rose by 0.1% in August 2010 compared with July 2010, and by 4.6% compared with a year earlier.

Inflation forecast

The Treasury report that the average of independent forecasts shows retail prices inflation rising by 4.1% in 2010 and by 3.6% in 2011. In the medium term, the average of independent forecasts shows retail prices inflation rising by 2.7% in 2012, 3.0% in 2013 and 3.2% in 2014.

Forecast	Date of Forecast	RPI Inflation % Year to Q4	
		2010	2011
OBR	Jun 2010	3.7%	3.2%
Average of Independent Forecasts	Sep 2010	4.1%	3.6%

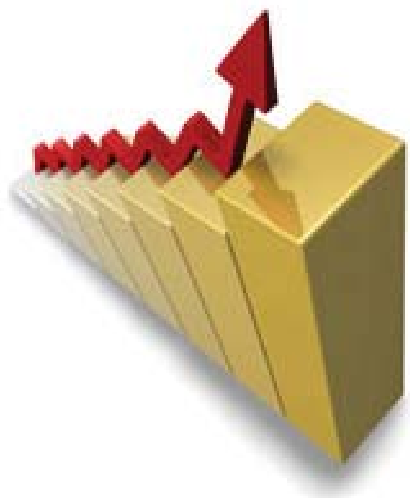
Source: Treasury

Other issues to be considered Growth, Interest Rates, Materials, Labour, Tender prices

Growth

The annual rate of growth, as measured by the changes in gross domestic product (GDP), rose by 1.7% in 2nd quarter 2010, following a fall of 0.2% in the previous quarter. GDP also rose for the third consecutive month in 2nd quarter 2010, rising by 1.2%, up from 0.3% in 1st quarter 2010.

In the past, there has been a reasonable close relationship between GDP and total construction output. The annual percentage change in GDP in 2009 fell by 4.9%, and the annual percentage change in total construction output fell by 11.4%. According to the average of independent forecasts, GDP is expected to return to modest growth in 2010, followed by stronger growth in 2011. If the relationship were to hold, this would imply that total construction output should either fall more slowly in 2010 or return to a small rise, followed by a stronger rise in 2011. However, the Construction Products Association are forecasting a small rise in total construction output in 2010 followed by a small fall in 2011(Table 12), as the swingeing cuts in public expenditure start to take their toll on construction output.



According to the Treasury, the average of independent forecasts shows growth rising by 1.5% in 2010 and by 1.9% in 2011.The average of independent forecasts for the medium term shows growth rising by 2.2% in 2012, and by 2.4% in 2013 and 2014.

Interest Rates

At its September 2010 meeting, the Bank of England's Monetary Policy Committee (MPC) decided to maintain interest rates at 0.5%. The MPC also agreed to continue with its policy of quantitative easing, maintaining the amount for purchasing assets at £200 billion. The last change in interest rates occurred on 5 March 2009, when rates were reduced from 1.0%.
According to the Treasury, the average of independent forecasts shows interest rates remaining unchanged in 2010, and then rising to 1.25% in 2011. In the medium term, the average of independent forecasts shows interest rates rising to 2.0% in 2012, rising further to 2.75% in 2013, and further still to 3.5% in 2014.

Materials

Demand and Supply

According to the Builders Merchants' Federation, builder's merchants' sales rose by 22.9% in 2nd quarter 2010 compared with the previous quarter and by 9.0% compared with a year earlier. Sales rose in all regions in the year to second quarter.
The Department for Business Innovation and Skills (BIS) report that brick production and deliveries rose in 2nd quarter 2010, and with deliveries outweighing production, stocks fell. Brick stocks were equivalent to 24 weeks of current deliveries, down from 33 in the previous quarter.

Prices

Material prices rose by 3.8% in 2nd quarter 2010 compared with the previous quarter, and by 6.5% compared with a year earlier. General inflation rose by 5.3% between 2nd quarter 2009 and 2nd quarter 2010.

According to BIS, there were some significant increases in certain materials costs in 2nd quarter 2010 compared with the previous quarter. These include concrete reinforcing bars, up 23%, ceramic tiles, up 6%, imported softwood, up 5%, imported plywood, up 15%, sawn softwood, up 7%, and fabricated steelwork, up 15%.

The London Metal Exchange (LME) show that steel rose by 7% in 2nd quarter 2010 compared with the previous quarter; copper fell by 3%, lead by 12% and aluminium by 3%.

The rises in steel prices, announced earlier this year by the British Constructional Steelwork Association, have now gone through, amounting to a £50 rise per tonne in March, a £60 rise in May, and a further £80 rise in June.

Oil prices rose by 1% in 2nd quarter 2010 compared with the previous quarter and by 33% compared with the same quarter in 2009. Oil prices in 2nd quarter 2010 stood at around $75 a barrel.

The sharp rise in materials prices in 2nd quarter 2010 suggests that suppliers are now passing on pent up costs from 2009, together with the aforementioned rise in steel prices. Sharp increases in annual materials prices are expected through to 2nd quarter 2011, largely resulting from the significant quarterly increase in 2nd quarter 2010. It is then anticipated that annual price rises will slow to around the level of general inflation in the year to 3rd quarter 2011, rising a little above it over the following year. The continued weakness in Sterling is likely to make imported materials more expensive.

Labour

Demand

Employment in the construction industry rose by 2.6% in 2nd quarter compared with 1st quarter 2010, but fell by 3.3% compared with a year earlier.

The Construction Products Association report that only a few firms were experiencing difficulty in recruiting skilled labour in 2nd quarter 2010, with only 13% of firms reporting difficulty, although this is up on the previous quarter which stood at 7%. The survey also shows that there was little difficulty in recruiting bricklayers, plasterers or carpenters.

Earnings, Wages and Rates

Average earnings in the construction industry remained unchanged in 2nd quarter 2010 compared with a year earlier. However, average earnings in the economy as a whole rose by 1.1% over the same period.

There has been no agreement to date on a wage settlement for builders under the CIJC agreement, which was due at the end of June 2010. Negotiations have now been suspended until October 2010, when rates will be reviewed again.

The Demolition Industry Conciliation Board has agreed a two year wage settlement. An increase of 2.0% on the plain time hourly rates is effective from 20 July 2010, and a further 3.0% from 20 July 2011.

Operatives in the heating and ventilating industry received a 2.0% increase in wages from 4 October 2010, as the final part of a two year wage deal.

The average of wage awards is expected to rise a little behind general inflation in the year to 3rd quarter 2011, rising at around the level of general inflation over the following year. It is anticipated that wage awards will remain subdued over the forecast period following the deep recession in the construction industry, and the ensuing rocky recovery.

Tender Price

It is anticipated that material prices will rise at around the rate of general inflation over the first year of the forecast period, moving a little ahead of it in the final year. With the current weakness in Sterling, imported materials are likely to be more expensive.

The average of wage awards is expected to rise a little slower than general inflation over the first year of the forecast period, rising more or less in line with general inflation over the following year. It is anticipated that general inflation will remain between 3% and 5% over the forecast period.

New work output is expected to grow strongly in 2010, with output slowing to marginal growth in 2011 as public spending starts to fall away, but private sector output starts to recover more strongly. Slow growth is expected in 2012 as public spending cuts deepen, whilst the private sector recovery gathers pace. The infrastructure sector is expected to grow throughout the forecast period.

Although new work output is expected to grow strongly in 2010, it is anticipated that tender prices will remain unchanged over the second half of this year, with new work output growth in 2011 slowing to a little above a position of no change. Quite strong input cost rises coming through in 2nd quarter 2010, feeding through into tender prices in the remainder of the year, are also likely to prevent tender prices from falling further in 2010. Consequently, tender prices are only expected to rise modestly in the year to 3rd quarter 2010. Over the second year of the forecast, with subdued new work output growth in 2012, tender prices are likely to rise more or less in line with input costs.

The two year forecast of tender prices is virtually unchanged from that published in July 2010. However, the forecast is now based on a 2nd quarter 2010 index of 208, rather than the previously forecast figure of 2009.

Forecast of Tender Prices

Period	Forecast
3Q2010 to 3Q2011	+1.9
3Q2011 to 3Q2012	+3.3%

Source BCIS

Conclusion

Inflation

- The rate of general inflation will be around 4.0% in 2010 and 3.5% in 2011.

Demand

New work output will rise by 10.0% in 2010, by 0.5% in 2011 and by 1.0% in 2012.

Labour

- Building Workers: Increases of 3.0% from June 2011 and 3.0% from June 2012.
- Plumbers: Increases of 5.0% from January 2011 and 3.0% from January 2012.
- Glaziers: Increases of 2.0% from January 2011 and 2.5% in January 2012.
- Electricians: Increases of 2.0% from January 2011 and 3.0% from January 2012.
- Heating and Ventilating Operatives: Increase of 2.0% from October 2010, 3.0% from October 2011 and 3.0% from October 2012.
- Steelworkers: Increases of 3.0% from January 2011 and 3.0% from January 2012.

Materials

The annual rate of inflation for materials will be 3.2% in the year to 3rd quarter 2011 and 3.1% the year after.

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