Advisory Notice #5 - Rebuilding Cost-Inflation Review

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This **'Inflation Review'** is provided by our specialist team of Consultants.

Critique & Review

- Inflation was anticipated to be 4.1% in 2010 and 3.6% in 2011and would generally remain in a range between 3% and 5%. However, in 2011 inflation peaked at over 5% and is expected to fall to around 3% during 2012. This unexpected high in 2011 was largely caused by the high cost in consumer goods and day to day essential items like food, fuel and the effects of continuing unease and troubles in the Middle East.
- GDP was expected to rise by around 1.5% per annum in 2010 and 2% in 2011 and 2012. However, due to the continuing economic issues in America and in the Euro zone GDP has grown at a slower rate of around 1.2% in 2011, and shows signs of creeping up to 1.8% in 2012.
- It was expected that fixed investment would rise by 2% in 2010 and 3% in 2011. However, fixed investment grew by just 0.7% in 2011 but is forecast to rise quite dramatically to 4.9% in 2012.
- It was envisaged that material prices would increase quite sharply over 2009, rising considerably faster than general inflation and in 2010 and 2011 it was anticipated that material price rises would 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 starts to recover from recession. However, due to the continuing economic issues in America and in the Euro zone and the slower than expected recovery in China and India material prices will rise further, but are expected to settle down to a level behind general inflation. Material prices are then forecast to rise at around the level of general inflation.
- As anticipated, the average level of wage awards was well below the rate of general inflation over 2010, with a number of trades having had a wage freeze in 2010 and 2011. Over 2012, the averages of wage awards are expected to again rise behind general inflation. However, wages are then expected to increase rapidly in the medium term to recover some of the lost income following the expected return to long term growth in 2013.
- Also as projected due to the continuing economic issues in America and in the Euro zone and with public sector spending cuts set to continue. 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 that any growth in new work output will be 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.
- As anticipated, It would appear that tender price falls bottomed out in 2010, and rose in 2011, although new work output is forecast to fall in 2012 tender prices are expected to remain on an upward path, driven by input cost increases.

Summary

- Inflation should generally remain between 5% and 3% from its peak towards the end of 2011 falling to around 3% towards the end of 2012. This is still, however, above the Government target of 2%.
- The Treasury report that the average of independent forecasts for GDP shows it had grown at a slower rate of around 1.2% in 2011, creeping up to 1.8% in 2012. However, the downward revision of the 1st and 2nd quarter 2012 GDP figures points to an even slower growth rate.

- According to the Treasury, the average of independent forecasts predict fixed investment to grow by just 0.7% in 2011 but by 4.9% in 2012.
- Material prices continued to rise in the final quarters of 2011, although at a slower pace compared to 2nd quarter 2011. Over the year to 2nd quarter 2012, material price rises are expected to settle down to a level behind general inflation. Materials prices are then forecast to rise at around the level of general inflation.
- It is anticipated that the deteriorating economic outlook is going to keep wage inflation at bay in 2010. Wage awards are expected to rise well behind the rate of general inflation, with workloads still well below pre-recession levels. However, wages are expected to increase rapidly in the medium term to recover some of the lost ground following the expected return to growth in 2012 and 2013.
- It is anticipated that new work output will fall in 2012, with growth returning in 2013. Over the next few years, the construction industry will be hit hard by the severe public spending cuts. Private sector growth is only expected to start mitigating the decline in public spending in 2012 and 2013. However, despite the cuts in public sector investment, it is anticipated that the infrastructure sector will grow, with relatively modest growth in 2012. The increase in VAT may have some dampening effect on new work output. However, with new housing being zero-rated and with some clients likely to pass on part or all of the increase, the effect on new work output is not expected to be significant. With public sector spending cuts set to continue, 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.
- It would appear that tender price falls bottomed out in 2010, and rose in 2011. Although new work output is forecast to fall in 2012, tender prices are expected to remain on an upward trend over the forecast period, driven by input cost increases. The tender price forecast has been revised downwards to that expected in June 2011.

General Overview

The predictions for the UK economy have deteriorated. Global demand slowed. And concerns about the solvency of several Euro-area governments intensified, increasing strains in banking and some sovereign funding markets. Household and business confidence fell, both at home and abroad. At the time of writing there have been some well publicised failures on the high street e.g. Peacocks and further afield e.g. Kodak.

These factors, along with the fiscal consolidation and squeeze on households' real incomes, are likely to weigh heavily on UK growth in the near term. Thereafter, the recovery should gain traction, supported by continued monetary stimulus and a gentle recovery in real incomes. Implementation of a credible and effective policy response in the Euro-area would help to reduce uncertainty and so support UK growth, but its absence poses the single biggest risk to the domestic recovery.

CPI inflation rose to 5.2% in September. Inflation is likely to fall back sharply through 2012 as the contributions of VAT, energy and import prices decline and downward pressure from slack in the labour market persists, but how far and how fast inflation will fall are uncertain. Under the assumption that Bank Rate moves in line with market interest rates and the size of the asset purchase programme remains at £275 billion, inflation is judged more likely to be below than above the 2% target at the forecast horizon.

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 predicted retail prices inflation remaining at around the same level by the end of 2011 at 5.0%, falling sharply to 3.1% by the end of 2012.

Inflation to Date

The Consumer Prices Index (CPI) inflation rate remained well above the Government's 2% target. CPI annual inflation rose by 0.6% between July and August 2011 to 4.5%. The rise is also mirrored in the Retail Prices Index (RPI) which stood at 5.2% in August, up from 5% in July. The high levels of inflation reflect the increase in the standard rate of VAT in January and the impact of higher energy and import prices.

According to the Office for National Statistics (ONS), the most significant contributions to the one month change in CPI are transport, up by 11.2%, and clothing and footwear, which rose by 3.7%.

In the year to September 2011, the total input costs of materials and fuels purchased by the UK manufacturing industry rose by 17.5% compared to a rise of 16.2% in August. The 1.7% rise mainly reflects the increase in the cost of crude oil and other imports. Manufacturing input costs (excluding food, beverages, petroleum and tobacco) rose by 2.3% in the same month.

Manufacturing output prices (excluding excise duty) rose by 6.3% in the year to September compared to a 6% rise in August. This is the highest annual increase since October 2008.

Retail prices continued to rise in 2011 fuelled by the increase in utility prices and the likely effect of the monetary policy.

Inflation Forecast

Table 1. Inflation Forecast

Forecast	Date of Forecast	RPI Inflation % Year to Q4	
		2011	2012
OBR	Mar 2011	4.7%	3.4%
Average of Independent Forecasts	Sep 2011	5.2%	3.1%

Source: Treasury

The Treasury report the average of independent forecasts showed retail prices inflation remaining at around the same level by the end of 2011 at 5%, falling sharply to 3.1% by the end of 2012.
Other issues to be considered are Growth, Interest Rates, Materials, Labour, Tender prices.

Growth

Gross Domestic Product (GDP) barely grew in the 1st quarter 2011 as consumers stopped spending and industrial production weakened. According to the ONS, GDP in volume terms increased by 0.1% in the 2nd quarter 2011, down from 0.4% in the 1st quarter 2011.

Revised figures also show that the 2008-2009 period was worse than originally reported. Although the recession is now one quarter shorter, it was deeper by 0.5 percentage points, with the peak to trough fall in output from 1st quarter 2008 and 2nd quarter 2009 now estimated at 7.1%.

Historically, a fairly strong relationship has existed between the annual percentage change in total construction output and GDP (Fig E). The annual percentage change in total construction output rose by 10.6% in 2010, following a contraction of 13% in 2009. This compares with a 1.8%

rise in GDP in 2010 following a fall of 4.4% in 2009. Seasonally adjusted figures also show that output increased by 6.7% in 1st quarter 2011 compared to the same quarter in the previous year, but contracted by 0.3% in the 2nd quarter. According to the average of independent forecasts, growth in the whole economy was expected to rise at a sluggish pace in 2011 and in 2012. Assuming the relationship between total construction output and GDP holds, this would imply that total construction output should show growth in both 2011 and 2012. However, the most recent data points to a slowing economy and fewer orders with forecasts of total construction output falling in 2011 and 2012.

The Treasury report that the average of independent forecasts for GDP shows it growing at a slower rate of 1.2% in 2011, and creeping up to 1.8% in 2012. However, the downward revision of the 1st and 2nd quarter GDP figures points to an even slower growth rate.
According to the Treasury, the average of independent forecasts expect fixed investment to grow by just 0.7% in 2011 and by 4.9% in 2012.

Interest Rates

The Bank of England's Monetary Policy Committee (MPC) agreed to keep interest rates unchanged at 0.5% at its last meeting. The last change in interest rates was a reduction from 1% on 5 March 2009.

The bank also launched a second round of quantitative easing in Autumn 2011 by injecting a further £75 billion pounds into the economy in an effort to stimulate growth. This brings the total amount used for the asset purchasing programme to £275 billion.

Although other countries are freezing rates which will further delay inflation, The Bank of England did not promise that it would be doing the same. Currently they are at a record low, 0.5% and would likely only see a 0.25 rise in rates by the end of this year. These statements drove Sterling even lower.

The end result is that the government will need to remain fluid as world economies fight to achieve a healthy balance and a modicum of recovery over this year and the next. In fact, according to one UK economist, the official rates will need to be kept low not only into 2013 but probably even beyond that.

The Treasury report that the average of independent forecasts for interest rates remains unchanged at 0.5% for the rest of the year, rising to 0.8% by the end of next year. However, the deteriorating outlook points to no change in interest rates in the medium term, with rate rises expected in mid 2013.

Materials

Demand and Supply

The Builders Merchants' Federation report that builder's merchants' sales were down by 4.7% in 2nd quarter 2011 when compared with the same quarter a year earlier, but were up 12.5% when compared with the previous quarter. Almost all regions reported falling sales in 2nd quarter 2011 compared with 1st quarter 2011, with South East (North of Thames) showing a fall of 6.6%. Wales and the Northern region were the only areas to report modest increases.

According to the department for Business Innovation and Skills (BIS), brick production rose by 20% and deliveries by 14% in the 2nd quarter 2011 as stocks fell by 5%. Stocks were marginally down, equivalent to 20 weeks of current deliveries in 2nd quarter 2011 compared to 24 weeks in the previous quarter.

Prices

Construction materials prices (excluding mechanical and electrical engineering inputs) rose quite sharply in 2nd quarter 2011, jumping by 3.2% compared with the previous quarter and by 7.3% compared with a year earlier. General inflation (RPI) rose by 5.1% between 2nd quarter

2010 and 2nd quarter 2011.
According to ONS, there were some notable increases in materials prices in 2nd quarter 2011 compared with 1st quarter 2011, namely fabricated steel up by 9.4%, ceramic sanitary ware up 8.5%, insulation up 5.4%, taps and valves for sanitary ware up 3.7%, concrete reinforcement bars up 3.5%, particle board up 3.4% and sawn wood up by 3%. Only a handful of materials recorded an insignificant decline in price.

The Price Adjustment Formulae Indices show the prices of most materials rose in the 2nd quarter but slowed down in the 3rd quarter. Aluminium pipes recorded a 6% increase in the 2nd quarter but held their price in the 3rd quarter.

The London Metal Exchange (LME) also reported that the price of lead fell by 3% in 2nd quarter 2011 whilst copper and zinc fell by 7%. The trends continued in the 3rd quarter with aluminium and lead falling 3% and copper and zinc falling by just under 1%.

Brent crude oil prices rose by 11% in the 2nd quarter of 2011 compared with the previous quarter, and by an annual 47%. After reaching a new peak of US$123 a barrel in April, the price of oil has eased off to settle at an average of US$110 and US$111 in August and September respectively. Oil prices have been rising since September 2010 when they stood at around $75, with the first fall occurring in May 2011. According to the Treasury, the average of independent forecasts shows oil prices remaining at around the current level.

Materials prices continue to rise in 2011, although at a slower pace compared to 2nd quarter 2011. Over the year to 2nd quarter 2012, materials price rises are expected to settle down to a level behind general inflation. Materials prices are then forecast to rise at around the level of general inflation over the second year of the forecast period.

Table 2. BCIS Forecast of Materials Prices

Period	Forecast
3Q2011 to 3Q2012	2.7%
3Q2012 to 3Q2013	3.4%

Source: BCIS

Labour

Demand

Construction employment fell by 2.3% in 2nd quarter 2011 compared with the 2nd quarter of 2010, bringing the annual fall to 8.7%.

The Construction Products Association (CPA) report that less than 5% of construction firms were experiencing difficulties in recruiting skilled labour in 2nd quarter 2011. For 5% of the firms, recruiting plasterers was an issue, whilst only 3% reported difficulties in attracting bricklayers. Pre-recession levels stood at between 60% and 80%.

Earnings, Wages and Rates

Average weekly earnings in the construction industry remained unchanged in 2nd quarter 2011 compared with a year earlier. This contrasts to average weekly earnings in the economy as a whole which rose by 2.3% over the same period. Plumbers in Scotland received a 2% wage increase from 6 June 2011.

Operatives in the demolition industry received a 3% increase in wages from 20 July 2011, as the second and final part of a two year wage deal.

Builders in Northern Ireland received a 1.5% increase in wages from 1 August 2011.

Builders and civil engineering operatives under the CIJC agreement received a 1.5% increase in wages from 5 September 2011, following an earlier promulgation.

Builders under the BATJIC agreement received a 1% increase in wages from 12 September 2011.

Electricians failed to agree a wage settlement for 2011 and were set to have a wage freeze for this year. However, uncertainty remains as a breakaway body of the eight largest electrical contractors has issued a new wage agreement which is opposed by the unions.

It is anticipated that the deteriorating economic outlook is going to keep wage inflation at bay in the first year of the forecast period. Wage awards are expected to rise well behind the rate of general inflation, with workloads still well below pre-recession levels. However, wages are expected to increase rapidly in the medium term to recover some of the lost income following the expected return to above long term growth in 2013.

Tender Price

Materials prices were expected to rise quite sharply again from 2nd quarter 2011, but anticipated that the rate of increase would slow down over the second half of the year. Therefore, over the year to 2nd quarter 2012, materials prices are forecast to rise behind the rate of general inflation. Over the second year of the forecast, materials prices are expected to rise at a similar level to general inflation.

With workload well below pre-recession levels over the forecast period, increases in wage rates are likely to be subdued. It is likely that the average of wage rates will rise well behind the level of general inflation over the first year of the forecast period, rising a little behind it the year after. It is anticipated that general inflation will peak in the last quarter of 2011 and start falling sharply over the forecast period to just over 3%.

Following a 15% rise in new work output in 2010, new work output is expected to fall in both 2011 and 2012 before returning to growth in 2013. The construction industry will suffer from the sharp cuts in public sector investment over the next few years. Private sector growth in investment is only expected to start reducing the effect of the sharp decline in public spending in 2012 and 2013. It is anticipated that despite the public spending cuts, the infrastructure sector will grow over the forecast period, but growth in 2011 and 2012 will be relatively modest. The level of new work output in 2012 is expected to be around 10% below the pre-recession level of 2007, but 13% above the 2009 low point in the recession.

It would appear that tender price falls have bottomed out in 2010, and although new work output is forecast to fall 2012, tender prices are expected to remain on an upward trend over the forecast period, driven by input cost increases. The tender price forecast has been revised downwards to that published in June 2011.

Table 3. Forecast of Tender Prices

Period	Forecast
3Q2011 to 3Q2012	3.2%
3Q2012 to 3Q2013	2.2%

Source: BCIS

Conclusion

As stated above, the rate of general inflation was around 5% in 2011 and is forecast to be around 3% in 2012. Demand for new work output fell in 2011, but will rise by around 3.5% in 2012 and 3.5% in 2013. The annual rate of inflation for materials will be 4.4% in the year to 3rd quarter 2012 and around 3% over the following year. Labour costs as detailed below are expected to increase.

- Building Workers: Increases of 3% from June 2012 and 3% from June 2013.
- Plumbers: Increases of 3% in January 2012 and 3% in January 2013.
- Glaziers: Increases of 2.5% from January 2012 and 2.5% from January 2013.
- Electricians: Increases of 3% from January 2012 and 3% from January 2013.
- Heating and Ventilating Operatives: Increases of 3% from October 2012.
- Steelworkers: Increases of 3% from January 2012 and 3% from January 2013.

The net results for the building and construction industry is increased in the cost of material and labour. Therefore developers, owners and managers of property must consider how this will affect construction projects, the on-going maintenance of buildings and the insurance rebuild valuations - are these valuable assets insured sufficiently?

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