

MAJOR DRIVERS OF THE ECONOMY AND CONSTRUCTION IN 2010



As we face another year of economical and political uncertainty our Construction Economics team provides an insight into ten key factors which will determine progress in the economy and demand for construction over the next 12 months.

1. Quality of recovery. Despite signs of improvement recorded at the turn of the year, most observers anticipate that any recovery in the US, UK and Eurozone will be slow and drawn-out. Temporary factors such as time-bound fiscal stimulus and the effect of the inventory cycle are big contributors to the current upswing. Strong headwinds affecting future growth have not been eliminated, and factors including high unemployment, cautious consumers, low investment and public-sector retrenchment could usher in a sustained period of relatively low growth in developed economies. There remains the risk that a double dip recession could still take place, and there is talk of a ‘www’ recession – a roller-coaster of economic stimulus and retrenchment. The quality of any recovery will be hugely important, not only to ensure that budget deficits are narrowed, and confidence is restored, but also to ensure that the foundations are in place for the next cycle.

2. Mixed fortunes in the construction industry. Overall, UK construction is expected to continue to shrink in 2010, although the infrastructure and housing sectors should have a better year. Outside of the UK, limited private investment and public sector deficits will hold back growth in Europe. Infrastructure investment in resource-rich emerging economies could however grow rapidly, creating the potential for pressure on the availability of some raw materials.

3. Faster growth in Asia and other emerging economies.

Apart from Russia, the BRIC countries, Brazil, India and China, and other Asian economies have emerged relatively unscathed from the downturn. They do not have the huge burden of debt built-up in the West, and are expected to continue to grow at a much faster rate. These countries depend on exports for growth, a continuing trend which will contribute further to persistent global imbalances in borrowing and saving. The UK is unfortunately unlikely to benefit from growth in the emerging economies, as most of our exports are to the US, Germany and other EU markets.

4. Uncertainty. After the extraordinary events of 2008 and 2009, 2010 may offer fewer seismic shocks, but will be a year of many ‘known unknowns’: the election in the UK, changes to credit-ratings, currency fluctuation, the effect of removal of stimulus and the commencement of fiscal tightening, together with an increased terrorist threat. The environment for decision-making in government and business will continue to be highly complex, with most of the risks on the downside. With the outside possibility of a hung parliament in the UK, sovereign debt default or further political unrest in the Gulf, the term ‘exogenous growth shock’ may become as overused as ‘Green Shoots’ or ‘Too big to fail’ were in 2009.

5. Addressing the budget deficit. One ‘known known’ is that ballooning budget deficits such as the UK’s must be addressed. The timing, speed and scale of the switch from stimulus to retrenchment could be the most important and difficult policy decision taken in the UK in 2010, made even more difficult by the timing of the election. Many commentators think that cuts should be delayed until 2011, even though plans for retrenchment need to be published as soon as possible to bring confidence to the markets. Achieving a balance between protecting economic recovery, serving the people and retaining the confidence of bond markets will be the key issue, which could well define the election. A spending hiatus after the election has the potential to be very damaging for UK construction at a point when revival may just be about to commence in the private sector.

6. Construction suffers a double whammy of withdrawal of stimulus and start of spending cuts. It might not feel like it in the hard-pressed construction sector, but aggressive fiscal stimulus in countries including the UK, US and China has included substantial additional capital investment in construction. In the UK, in addition to extra investment, funding has been brought forward from the 2010/2011 tax year. Furthermore, a 20% reduction in future capital investment programmes is on the cards. Construction has often been the ‘safety valve’ of the economy, and with many public sector programmes dependent on scarce PPP funding, public sector projects could become even harder to get off the ground after 2010.

7. Industry consolidation. Merger and acquisition is back on the agenda, which will increase activity in the banking, financial services and consulting sectors as strong organisations position themselves for the upturn. Whilst M&A will not directly benefit construction, it will contribute to wider business confidence and may create downstream opportunities for future investment. The dark side of consolidation is unfortunately also likely to be a major theme for 2010 as a combination of low margin work, poor cashflow, scarce capital and the consolidation of banks' loan books result in a continuing stream of business failure. Loss of capacity, and possibly increased raw material prices driven by a wider global recovery will be the main drivers of upward pressure on construction costs during 2010, even though prices are unlikely to increase before 2011.

8. Inflation.....and deflation. Deflation was one of the greatest concerns of many economists during 2009, threatening to introduce a vicious circle of falling prices, lower wages and reduced demand. Whilst the overall economy has escaped this fate, construction in many markets including the Gulf, Ireland, US and UK has suffered rapid and sustained cuts in prices. In the UK, construction prices are already down by 18% from the peak and still have some way to go, before supply and demand return to balance. Elsewhere in the UK economy, inflation has been very persistent, and with VAT back at 17.5% and the effect of 2009's energy price cuts falling out of the system, UK CPI is likely to hit 3.5% in the 1st quarter. For 2010, there are inflation risks related to currency devaluation, and possibly increasing demand for oil and raw materials, although increases during 2009 were largely unjustified by economic fundamentals. Given other downside risks such as deficit reduction or stalling recovery, short-term inflation should not be an immediate concern. However, management by the Bank of England of QE policy and interest rates during 2010 could have long term implications for both inflation and the creation of future asset bubbles.

9. A bad year for the Pound....and the Euro? Sterling is likely to be dogged by sovereign debt concerns during 2010, with some commentators speculating about Pound:Euro parity. Devaluation could be great for the UK's net trade but bad for construction, with most of construction's imports being denominated in Euro. However, with basket case economies such as Greece locked into the Eurozone, the continuing attraction of the Euro as the reserve currency of choice could also take a battering. Given the importance of the devalued Pound to the UK's current competitive position, a bad year for the Euro is unlikely to offer much benefit to the UK other than opportunities for anti-European points scoring.

10. Global agreement or discord? Stalled World Trade Talks will resume in 2010, as will efforts to get a binding carbon reduction deal following the disappointments of Copenhagen. With the need for urgent but sensible multi-lateral action required on Banking Regulation and other aspects of fall-out from the credit crunch, the success and failure of the world's diplomats and negotiators needs to be a keynote of 2010, if global recovery and our sustained prosperity are to be built on firm foundations.

Construction is unlikely to have a positive year during 2010, but **foundations are now being set for improved prospects for the future**. Actions taken during 2009 and 2010 to improve credit conditions, continuing need to invest in social and physical infrastructure and the limited supply of most private sector property assets promise the return of demand in the foreseeable future.

Property and construction's future will however be characterised by **much less money**, so investment will need to be focused on maximising efficiency, by for example, unlocking value from existing assets, or by achieving better outcomes with less resource.

The quality of our recovery will be determined in part by the condition and readiness of our industry. Amongst the gloom, organisations that are **comfortable with uncertainty, ready for recovery** and are **able to deal with opportunity** will thrive in the 'new normal'.

Simon Rawlinson
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