UK MARKET VIEW

Robust growth will be a long-term project for the next UK government

Q2 2024

Introduction

From a cost perspective, conditions are becoming slightly more favourable. The past quarter saw a continuation of easing labour cost pressures, a modest increase in material prices suggests these have stabilised. Despite these positive signs, the industry still faces significant hurdles. Pipelines remain weak and construction output fell again. Meanwhile, skills shortages and incumbent supply chain commitments will restrain capacity to respond to demand.

Given this, close collaboration between clients, consultants, contractors and subcontractors is essential. Pipeline visibility, early engagement and well considered procurement activities being fundamental to ensuring optimised outcomes. The second half of 2024 may revolve around what the next government can deliver, but quick fixes to increase output will be scarce, and current challenges won't disappear overnight.

Oliver North
UK & Europe Director of Cost and Commercial Management, Consultancy

Construction output declined...

0.9%

in the first quarter, the second quarter running where the sector has shrunk, with it also being 0.7% lower than it was a year ago.

The economy moved out of the recession it had fallen into in the second half of last year, with GDP growing...

0.6%

in Q1.

Regular construction earnings growth of...

2.6%

is much weaker than the average for the whole economy's 6%.

Material costs were...

0.2%

higher in Q1 2024 than Q4 2023, however in annual terms, prices are 2.3% down.

While total construction new orders were...

15.9%

higher than at the end of 2023, the rise comes from such a low base, that it is only a small start in rebuilding pipelines.

Tender prices

	2024	2025	2026	2027	2028
National	2.5%	3.0%	3.0%	3.5%	4.0%
London	2.0%	2.5%	3.0%	3.5%	4.0%

The table gives our current tender price inflation forecast. The figures should be treated as averages and there will always be variations due to procurement methods, project type and local factors.

Setting the scene

With a general election now due to take place on 4 July this report, produced during the pre-election period may, like much of the country, feel somewhat in limbo. Currently, polls predict a change in governing party, but it will take time for new policies to have an effect if this transpires. Furthermore, financial constraints are likely to limit what is possible, particularly in the short-term, and it would be unwise to expect anything too fundamental to change this year. Clarity on many government sectors will only become visible once a spending review has been conducted. Similarly, projects will take time before getting approval, but even if it takes time before construction starts, consultancies should benefit, as plans are worked up.

Even if money isn't instantly forthcoming, a new government can very quickly change impressions and policies. Labour has already announced they will merge the National Infrastructure Commission and Infrastructure and Projects Authority. Aimed at better defining plans, designs and costs from the start, the hope is that improved structuring of such projects from the outset will deliver improved outcomes. The National Infrastructure and Service Transformation Authority's remit will include looking at the bigger picture, in providing policy advice and supporting with strategy, as well as focusing on project specific issues through delivery assurance and contract negotiations. Boosting housing should also be high-up on a new government's agenda. While lower levels of building activity can be pinned on higher interest rates which are out of their control, planning reform and increased support for local authorities are both potential sources of support for the industry. Again, for construction, neither of these will change overnight, but consultancy work will pick-up earlier, and the hope is that as we move through 2025, progress starts becoming evident.

In our Q1 report, we highlighted the importance of interest rates and how they would need to start coming down before confidence in parts of construction returned. Fortunately, over the past three months, not a huge amount has changed. The expectation remains that the Bank of England will cut rates three times this year, and then another four in 2025. While May's publication of CPI inflation, at 2.3%, was slightly above forecasters' expectations, and may push back the first rate cut, the general direction of travel of economic data, has been consistent with predictions so far this year. Unfortunately, such moves are likely to be too late to support the industry in 2024, and again, little has changed for us to adjust this view.

Construction output fell again in the first quarter. Although the UK economy did move out of the recession it had slipped into in the second half of last year, the construction sector shrunk again. GDP's rise of 0.6% in the first quarter may sound impressive, but growth for 2024 is still set to be incredibly modest as underlined by the 0% growth figure for April. While rising real incomes should support the wider economy, construction output fell 0.9% for the second consecutive quarter. Additionally, all sectors within all new work are facing their challenges and, despite a rebound in new orders in Q1, it came from a very low base.

None of this is surprising and, as a result, we maintain our forecasts from our last report. As well as the rise in new orders, one other glimmer of optimism is that construction insolvencies in Q1 were at their lowest level since the end of 2021. Admittedly this indicator can be volatile, but it might point to the start of conditions getting better. Even so, project teams must stay vigilant about the risks of insolvency, which despite the small drop, remain as a significant risk. Ensuring the correct mitigation strategies, such as taking care with the procurement route and performing robust due diligence on the proposed supply chain continue to be important.

With output falling, and pipelines weak, it is possibly unsurprising that employers are trying to control labour costs, and earnings in construction are rising much slower than in other sectors. However, as well as vacancies being high, two recent reports also highlight the challenges with skills shortages. For the time being, pay is not a major issue with regards to tender prices, but one topic we discuss is why, later in the forecast period, it may well become one again. This, and steadily rising construction output, are why we think tender prices will slowly accelerate through the forecast period and reach 4% by 2028.

A second risk that may also have a big effect in the coming years is what happens if Donald Trump is re-elected as President of the United States. The U.S. Presidential election is not until November, and neither who the winner will be, nor any policies are particularly clear at the moment, but this is an important topic to explore in an attempt to understand some of the potential scenarios for UK construction.

The latest construction numbers

Output

It was another disappointing quarter for construction output with the industry shrinking 0.9%. For all new work, following a 4.5% drop in the final quarter of 2023, output fell a further 1.8%. This was the fifth quarter in a row where output has declined and new work is now 10.1% lower than it was in Q4 2022, when it hit its post-pandemic peak. What is also concerning is just how broad-based the hit to the industry is. Excluding repair and maintenance, the only sector where output rose in Q1 2024 was private housing. Yet private housing output is down over 12% compared to a year ago, and the pick-up in the first quarter was just 1.4%. While there may be some cautious optimism that output will continue to grow as interest rates come down, at least initially, the recovery is likely to be slow, and from a very low base.

A fall of 5.3% meant private commercial was the worst performing sector in the first quarter, but there were also sizeable drops in infrastructure, public non-housing and private industrial. The difficult economic environment is likely to continue to make things tough, and last year's lack of new orders will also hinder output.

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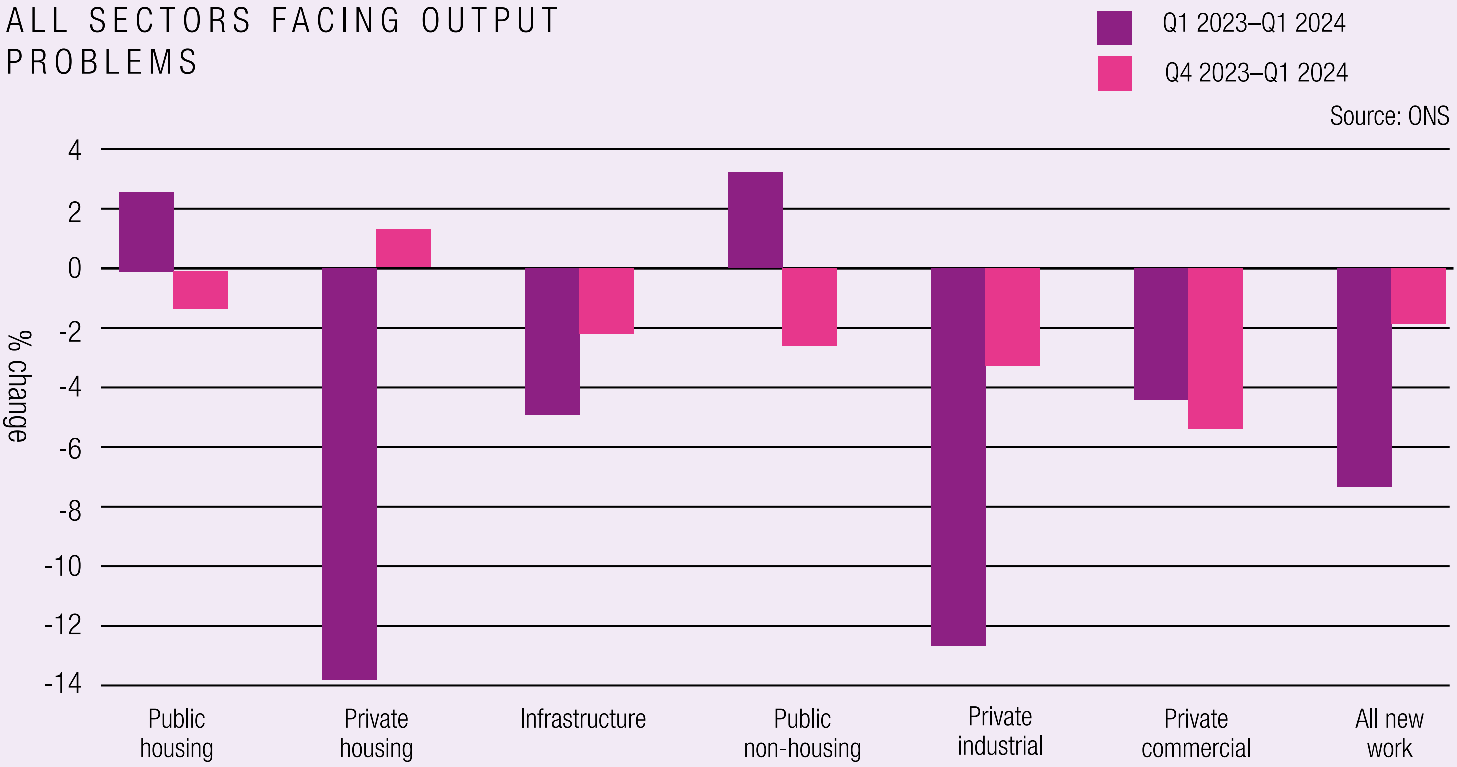
ALL SECTORS FACING OUTPUT PROBLEMS



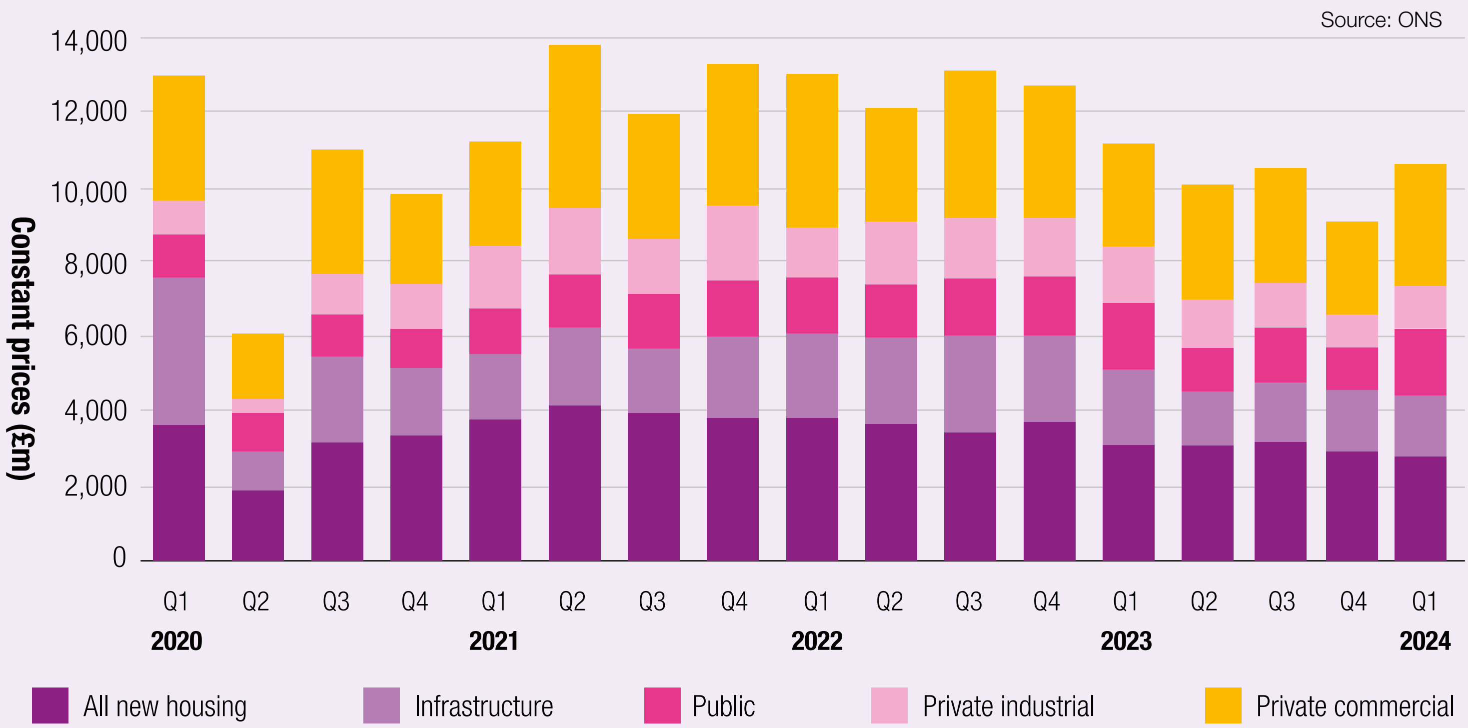
New orders

There are two ways to interpret the Q1 2024 new orders numbers. Those with a positive outlook, may view it as a strong quarter, with total new orders rising 15.9% making it the industry's best quarter for a year. Nonetheless, new orders remain much lower than they were, and the recent improvement will only start to fill up pipelines. On a four-quarter rolling basis, new orders are still incredibly low, almost 20% lower than they were a year ago. One slightly better quarter has not fixed this issue. In addition, and as with construction output, the lack of pipeline is a widespread challenge.

While most sectors did recover in Q1, and in some cases by a considerable amount, on a medium term rolling four-quarter basis, relative to 12 months ago, conditions are poor. Infrastructure, which only managed growth of 1.8% in Q1, is almost a third lower based on the last four quarters than it was in the four quarters leading up to Q1 2023. Having previously been faring very well, the last year has seen a substantial reduction in spending on roads. Whereas some larger infrastructure projects, such as Hinkley Point C and HS2 take years to build, and so provide some support to output, the size of the drop-off in new projects will create a drag factor.

Private industrial has seen a similar trend of strength a couple of years ago, followed by more recent weakness. In this instance, between Q4 2023 and Q1 2024, the sector was up 35.3%. Nonetheless, the comparison on the rolling four-quarter basis has it down 31.7%, with warehouses noticeably lower as the logistics sector has gone off the boil. Public non-housing (43.8%) and private commercial (27.9%) also had very strong first quarters, but both remain around 10% down on the medium-term basis. It will take several more very healthy quarters before we can even start to consider pipelines as recovering.

NEW ORDERS START TO RECOVER



Labour costs

Regular annual construction pay growth eased from 3.8% at the end of 2023, to 2.6% in the first quarter of 2024. Construction pay has been slowing at a much faster rate than average pay across the whole economy, where the lack of movement is giving the Bank of England a headache. Whereas average growth for the whole economy remains at 6% and is limiting the rate at which the services component within CPI inflation eases, the slowdown in construction pay will be a main contributor to modest tender price growth this year. After dropping in quarter-on-quarter terms in Q4 2023, earnings did rebound in the first quarter. However, the 0.8% quarter-on-quarter rise would only lead to an annualised rate of 3.1%, and with the challenges caused by insolvencies and falling output, firms look set to continue to try to take a tough line on pay.

Material costs

Material costs fell in each of the last seven months in 2023, but the start of 2024 has seen a shift. The 'all work construction material price index' has started to rise again, and in the first quarter was 0.2% higher than in Q4 2023. Despite this, the large falls in the second half of last year mean that the index is 2.3% lower than it was 12 months ago. Yet, after a lengthy period of significant movements, that materials are seeing some predictability and stability will help contractors with tendering.

Further keeping material prices under control are recent falls in the price of oil. Brent crude did rise above US$90 per barrel over the past quarter, but that it has settled back to nearer US$80/bbl is helpful, albeit the risks haven't disappeared entirely. Nonetheless, as always, there are some products causing concern and the latest commodity doing so is copper. At one point, prices had jumped 30% since the start of March and, although they have cooled from their peak, prices are still over 20% up. Whether these prices prove sustainable, and the strength of demand continues to outstrip supply to such an extent, will be particularly important for MEP packages.

INFLATIONARY PRESSURES CONTINUE TO MODERATE

Sources: ONS, DBT

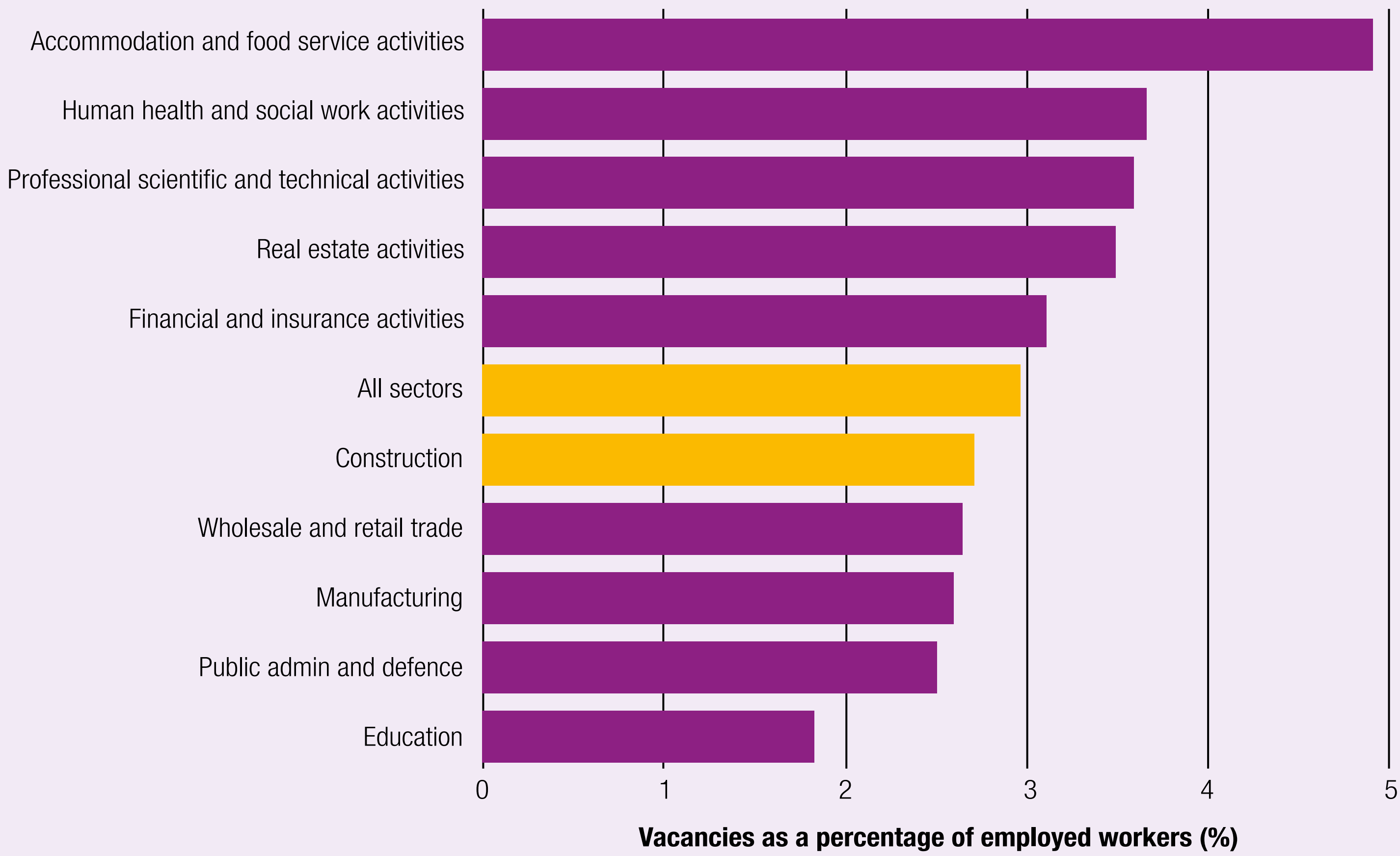
Slowing pay growth unlikely to last

While construction pay growth is easing and, therefore, shouldn't be a major concern when tendering, problems with skills shortages suggest this won't be the case once construction recovers from its current slump. As well as surveys regularly reporting labour shortages as a challenge, there are several other lights flashing red. Over the past six months, the number of vacancies has barely changed, despite output in the industry shrinking. Similarly, that payrolled headcount is falling, but firms are still keen on hiring, means there may be a dearth of good candidates. Alongside little recent movement in construction vacancies, they remain incredibly high compared to their pre-pandemic levels. Whereas the situation is not as bad as it was, there remain around 40% more vacancies than there were in 2019. This is far worse than in the wider economy, and the shortfall in workers is likely to eventually lead to renewed wage pressures. Looking at granular construction labour force data, one explanation for the increase in vacancies is a noticeable reduction in those aged between 45 and 59 working in the sector since 2019. Vacancies being high suggests firms would like to replace them but are unable to.

Nonetheless, despite these concerns around vacancies, by some metrics, they appear far worse in other sectors. As a share of total payrolled employees, vacancies in construction are much lower than elsewhere. The proportion of vacancies to payrolled employees is 2.7% in construction, lower than the almost 3% all sector average, as well as the 3.6% found in professional, scientific and technical activities. This lack of professional service workers, which includes quantity surveyors, architects and engineers may not create the same problems in terms of cost but could be just as much a risk to delivering future projects, as a recent government report noted.

CONSTRUCTION HAS VACANCY PROBLEMS, BUT IT COULD BE WORSE

Sources: ONS, HMRC



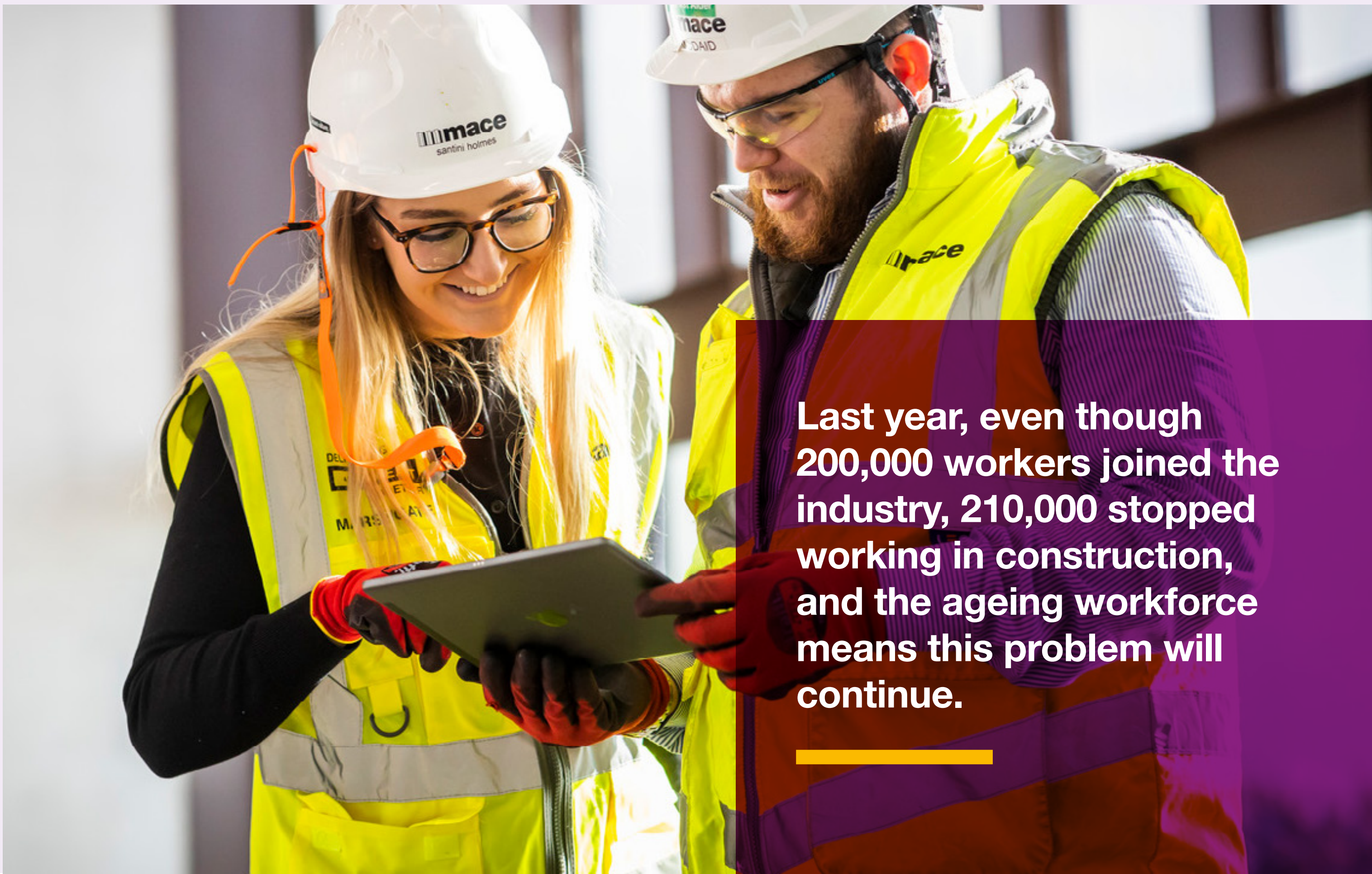
Given there is a target for 16,000 professionals to gain accreditation but only 1,000 have done so to-date, with another 1,000 set to achieve it by March 2025, this problem looks set to persist. One sentence that may mean we don't see the sort of growth we desire, is the suggestion that the speed of "government investment matches the development of the market to minimise inflationary pressures". This is certainly sensible advice - but may risk hindering infrastructure spending.

A second report, which also shows considerable difficulties stemming from the labour market comes from the CITB. In its latest outlook, it suggests there will need to be an extra 251,500 workers entering the industry over the next five years. Despite the size of the workforce only having to go up by around 80,000, with people also leaving the industry in huge numbers, the sector must find an additional 50,000 workers a year. Last year, even though 200,000 workers joined the industry, 210,000 stopped working in construction, and the ageing workforce means this problem will continue.

The report also forecasts how output in the various sectors will perform over the next five years, albeit this must be viewed in relation to recent growth. While infrastructure and private industrial are set to see relatively weak growth, averaging 1.5% and 0.4% respectively, in previous years they have grown rapidly. By contrast, the fastest growing sector will be public non-housing, averaging 3.1%, and while building on a strong 2023, it follows on from several much weaker years. Furthermore, with a likely new government and a lack of available detail around a much-needed government Spending Review, significant risks, both upside and downside, exist to this forecast. Going into considerable amounts of detail, the report also showed how carpenters and joiners is the trade which will see the fastest growth, while South West England will need to create the most jobs.

The recommendation from the CPA report was for "HM Treasury and the Infrastructure Projects Authority to analyse risks to the government's portfolio of infrastructure projects caused by the lack of skills." While a good question to ask, the simple answer, and this also applies to what happens if the construction industry doesn't find the extra 250,000 workers seems fairly clear. In short, it won't be possible to deliver all of the projects and there will be delays and rising costs. This is one reason we expect tender prices to steadily accelerate over the forecast period, but even thinking about what might happen five years into the future, there are already worrying upside risks to tender prices.

More widely, given how infrastructure projects should help productivity, failure to achieve the goals will hurt GDP and make the UK a less attractive destination for investment.



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What will a second Trump presidency mean for UK construction

Unsurprisingly, most eyes in the UK will be on our own general election, and what policies a new government will implement. However, as we have seen with the disruption to markets caused by Covid 19 and the invasion of Ukraine, often the UK economy's most influential drivers come from abroad. Therefore, in order to understand some of the challenges that the UK construction sector may face next year, we need to look across the Atlantic to November's US election.

Joe Biden's Inflation Reduction Act created risks around rising demand for construction products and a shift in investment towards the US but there appears little evidence of these issues currently having a noticeable effect. The policy and the stimulus from this and the Infrastructure Investment and Jobs Act will continue, whoever wins the election, as will the strong demand for construction products in the US. Yet, if Mr Biden wins, his policies are likely to be fairly predictable and, instead, it is the potential of Donald Trump winning a second term, which holds the most interest, as well as the most risk, to UK construction. A recent Oxford Economics survey suggested around 40% of businesses from across the world, saw it as one the two main threats to the global economy.

Given a lack of manifesto, as well as how quickly policies seemed to change in Mr Trump's first term, uncertainty is one major risk. Businesses dislike uncertainty, and it is possible that investors would negatively react to a second term. At present, markets do not seem concerned, but this can change quickly, and an increase in the risk premium would mean a rise in borrowing costs. Uncertainty also complicates trying to model potential outcomes, and there seem to be as many conclusions as to what might happen as there are articles on it.

One common theme is that the policies will be inflationary in the US. Increasing tariffs and cutting taxes are both likely to push up prices. Assuming policies limiting the behaviour of the Federal Reserve don't happen, and the Central Bank can respond as one would expect, then this inflation would lead to higher interest rates. In this particular scenario, the expectation is that yields in other countries will also rise, likely exacerbated by changing attitudes to risk. The concern to UK construction is, therefore, that higher US interest rates will lead to the Bank of England having to follow suit, with corporates finding borrowing more expensive. As we have seen over the past two years, higher interest rates can hit construction output, most noticeably the housing market, meaning this is one spillover effect to be wary of.

Depending on just how far Mr Trump's policies would go if elected, there is also a chance of a trade war. If the US does raise tariffs, then other countries are likely to reply in-kind. The larger the increase in tariffs, the more retaliation that would occur, and the bigger the hit to global GDP there would be. Globally, the manufacturing sector would bear the brunt of such moves, but other sectors would also be hit. For UK construction's industrial sector, notably new factories, there would be a risk from a trade war - although this doesn't make up a huge part of output. The more worrying likely scenario will be that, if there is a general weakness in the economy, the housing sector may face problems.

Nonetheless, it may not all be bad news for construction, and one possible outcome is that commodity prices fall. With a potentially significant knock to global trade, demand for commodities would drop, leading to lower prices. Potentially pulling down material prices, lower commodity prices could lead to new projects becoming more viable. Such scenarios will not occur immediately, and it is likely to take several years before a jump in tariffs and weaker global growth truly take effect. Similarly, we do not consider any of the more serious risks from a second Donald Trump presidency, and its potential for huge increases in tariffs alongside retaliatory responses, as a baseline. Ultimately, and especially five months out from the US election, it is far too early to consider this as being the case. Nonetheless, there are clear risks and, if Mr Trump is re-elected, his policies will need analysing further.

Mace
155 Moorgate
London EC2M 6XB
+44 (0)20 3522 3000

Contacts
Oliver North oliver.north@macegroup.com
James Donald james.donald@macegroup.com

macegroup.com