MARKET UPDATE

Rising inflation – here to stay?

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G&T's Market Update Q2/2022 provides an overview of the UK construction market. With renewed global supply chain and inflationary pressures impacted by the conflict in Ukraine, our latest report highlights changes to key macro-economic indicators and the latest trade package and tender price inflation forecasts based on our quarterly surveys and regular discussions with the supply chain.

This quarter we consider the impact of rising inflation and whether the current market pressures are here to stay. In this report we'll:

- Analyse various datasets to provide a macro-overview of the UK construction sector against the current inflationary landscape
- Review the factors that are putting upward pressure on input costs and are causing market volatility and price fluctuations
- Summarise the latest forecasts from the World Bank for commodity price inflation and the broad trends that are likely to materialise
- Explore recent shipping, transport and energy cost movements and the underlying reasons for any changes

Please note – whilst our Market Update uses the most recently published data at the time of writing, release schedules between datasets differ. This inevitably means that not all datasets will cover identical periods.

Click **HERE** to view the TPI online

UK **Construction New Orders -2.6%**
(Q1 2022)

UK economy **expanded by 0.8%**
(Q1 2022)

UK **Construction PMI**
59.1 → **58.2**
Mar 2022 → Apr 2022

Cost of living to **slow overall economic growth**

'All Work' Material **Price Index 24.5%**
(Mar 2021 – Mar 2022)

Sustained price pressure on **energy-intensive** construction materials

War in Ukraine will result in **commodity prices remaining high**

UK **Construction Output 3.8%**
(Q1 2022)

Bank of England expects UK inflation to hit **10%** by end of 2022

Source: *ONS, Bank of England, ONS – International Trade*

Consumer Spending Growth Slowing

EY Item Club's consumer **spending growth forecast revised down** for 2022 amid cost-of-living increases.

Commodity Prices Climb Higher

Commodity prices continue their **upward trajectory** as Russia/Ukraine conflict adds to price pressures.

IMF: UK Growth Forecast Downgraded

2022 GDP forecast downgraded from **4.7%** to **3.7%** as inflation reduces real disposable income and financial conditions tighten.

UK Construction PMI 58.2 *(Apr 2022)*

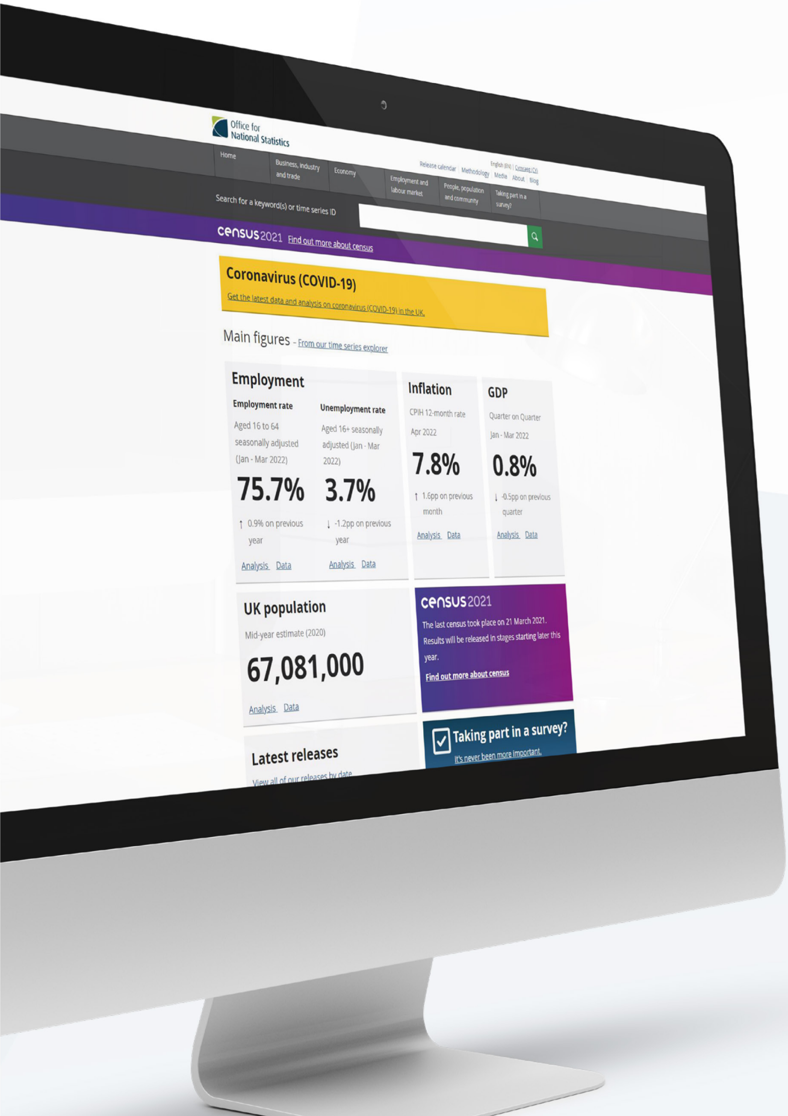
Another **strong rise in construction activity but challenges remain** amid weaker new order gains and higher costs.

Disruption Causing Supply Chain Delays

There's an ongoing **challenge to keep up with demand** for construction products and materials, lengthening supplier lead times.

2022
GDP forecast downgraded from
4.7% to **3.7%**

WHERE ARE WE NOW: UK ECONOMIC OVERVIEW



UK unemployment rate reduced to
(Jan 22 – Mar 22)

3.7%

CPI 9% *(Apr 2022)*

Annual inflation hit a **40-year high** as businesses pass on "broad-based" rising costs

1% Base Interest Rate

Base rate raised to tackle inflation but expectations for further rises pared back amid stalling growth

Stagflation Looms for UK Economy

BoE forecasts **potential persistent high inflation as growth outlook worsens**

0.8% UK GDP *(Q1 2022)*

Economy at **risk of stalling or contracting** after slowdown in Q1

3.7% Unemployment Rate *(Jan 22 – Mar 22)*

UK unemployment falls below pre-pandemic levels in Q1 amid a **tightening labour market**

3.7% UK Construction Earnings

Average weekly earnings in construction (Y-on-Y three-month average) rose **6.9%** in March 2022

Source: ONS and Bank of England

Economic growth forecasts cut as inflation (expected to peak at over 10% towards the end of the year) impacts consumer spending and potentially stalls output growth.

The Bank of England's (**BoE**) economic growth trajectory shows that two non-consecutive quarters of falling output are forecast in Q3 2022 (when the energy price cap is lifted) and Q3 2023 (when the Government's temporary incentives for business investment end).

As UK inflation is impacted by global supply and demand forces that drive consumer price growth, many of the recent external inflationary drivers (ie the global supply chain problems caused by the pandemic and conflict in Ukraine) are beyond the control of the BoE or UK Government. These pressures have intensified following Russia's invasion of Ukraine, spurring a material deterioration in UK and global growth outlook.

Global supply/demand forces are driving

Consumer price growth

Source: Bank of England

According to the BoE's May 2022 Monetary Policy Report:

- UK GDP rose by **0.8%** in Q1 2022 but is expected to be broadly unchanged in Q2. This reflects the adverse impact of high inflation on real incomes and consumer spending
- Annual CPI inflation of **9%** in April was largely attributed to 'global factors' (eg higher prices of goods bought from abroad) and rising energy input prices
- The expectation is that inflation will begin to fall in 2023 and be close to the BoE's **2%** annual target in around two years
- This is because the underlying causes of high inflation are not expected to persist. Demand for goods will not rise as fast and some of the production difficulties businesses are facing will ease
- Recent strong earnings growth for the whole economy (**+5.4%** in the three months to February 2022 relative to a year ago) was above COVID levels and explains some of the recent rises in services inflation
- Despite the current tight labour market, unemployment is expected to rise from a 50-year low of **3.7%** to **5.5%** by 2025 which will help moderate wage increases and reduce inflation

Strong earnings growth

+5.4%

Source: ONS and Bank of England

The S&P Global/CIPS UK Construction Purchasing Managers' Index (PMI) fell to 58.2 in April. Despite a strong rise in construction business activity, the speed of recovery contracted amid weaker new construction orders.

Although tender opportunities reduced in April, the current project pipeline is strong. This supported another round of job creation in April and saw a steep rise in purchasing activity and input cost buying. Suppliers have been unable to keep up with strong demand for construction products and materials resulting in an extension of lead times and supplier delivery times. Supply chain delays were caused by labour, materials and transport shortages and have been exacerbated by delays at ports and the war in Ukraine.

According to the latest ONS data:

- Construction output reached a record high in Q1 2022, rising by **3.8%** on the previous quarter to £44.4bn
- Repair and maintenance work was the key driver of output growth, influenced by adverse weather in February and the return to the office increasing demand for refurbishments
- Headwinds of price inflation, rising interest rates, the growing cost of living and the fall in consumer and business confidence may present a challenge for construction activity growth
- Although new order growth contracted by **2.6%** in Q1 - order values for all sub-sectors were above their pre-pandemic levels
- New orders in Q1 were supported by pent-up demand from the pre-pandemic period
- Although rising inflation may impact the pipeline of new work, the evidence that new order levels remain well above the five-year average indicates that order books for the coming months are reassuringly full

Source: *S&P Global and ONS*

Construction input cost inflation is being largely driven by material price increases. Trades that are heavily fuel/energy-driven or materials-based are experiencing the worst of the inflationary pressure.

While there is a good supply of most products and materials across the UK, challenges remain for some items. Interrupted global supply chains and new bottlenecks in the wake of the Ukraine conflict are forcing some to seek alternative sources of supply (particularly for metal products) at greater cost.

Although the UK has limited direct exposure from Russian/Ukrainian-exported construction materials, both countries account for a significant proportion of global supply. These countries play an outsized role as suppliers of both energy and metals, accounting for large shares of global exports which will affect UK pricing.

Metal prices and the cost of energy-intensive construction materials have invariably risen in the wake of the conflict in Ukraine. The BEIS 'All Work' material price index increased by nearly **5%** in March. Material prices were, on average, nearly **25%** higher than they were one year ago.

This renewed pressure has pushed input costs and tender price inflation significantly higher. While prices are expected to peak in 2022, they will remain at historically elevated levels in 2023-2024.

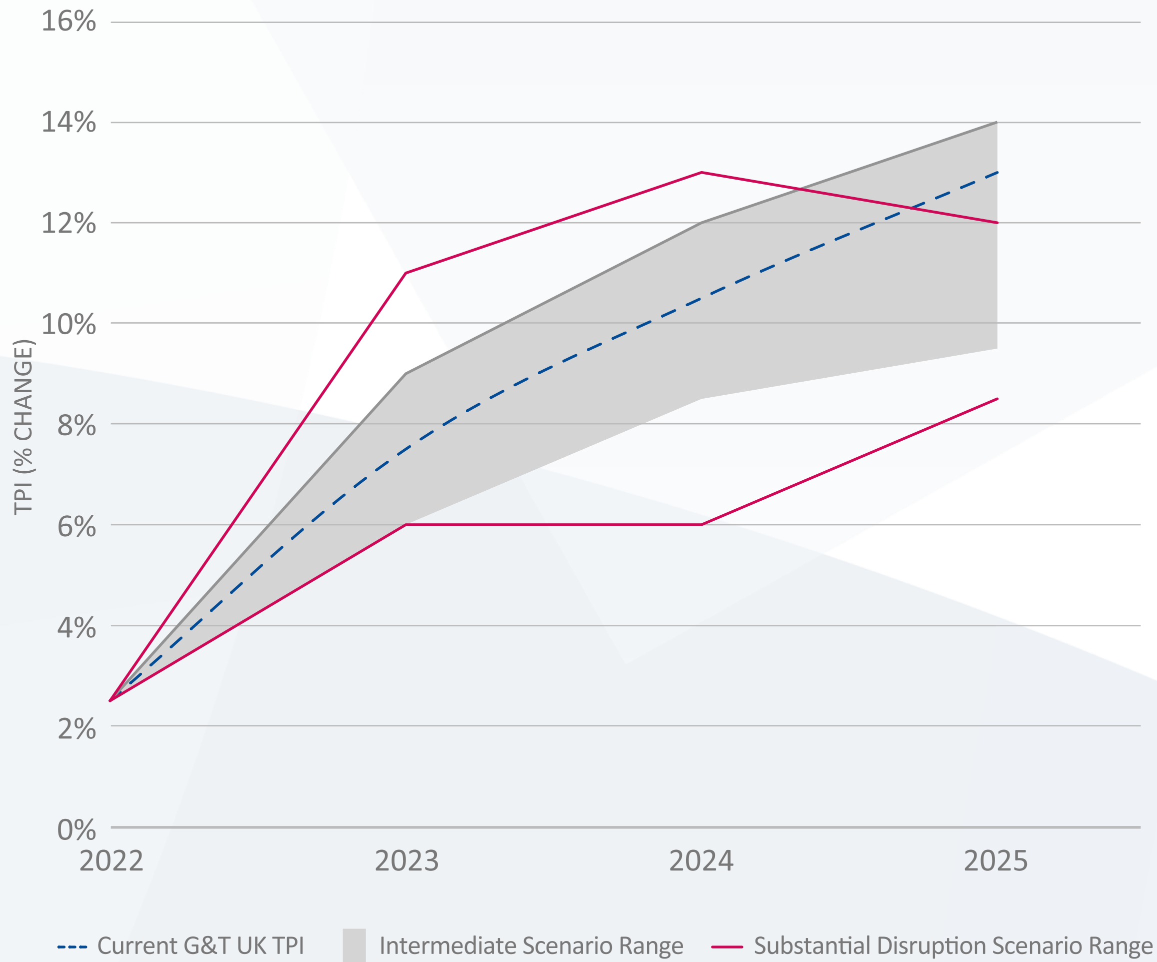
Material prices nearly
25% higher
than one year ago

Source: BEIS

Our scenario-based fan chart has been updated to reflect G&T's latest UK average TPI inflation forecasts.

- The 'Limited Disruption' scenario has been removed in response to recent developments and evolutions in the Russia/Ukraine conflict
- Many of the conditions outlined in our 'Intermediate' scenario have been met and our updated UK TPI forecast sits roughly in between the upper and lower ranges of this scenario
- Our upwardly revised forecasts reflect the broad-based supply shock of the conflict and ensuing roll-out of sanctions and retaliatory measures
- While UK construction has returned to normal levels of activity and output growth, the conflict has sparked a renewed wave of input cost inflation
- Higher energy prices have increased manufacturing costs for many construction materials, while interrupted trade flows have created supply chain disruption which has amplified global inflationary forces
- Material price inflation may have peaked for 2022 and labour costs might be the real driver of further inflation from Q2 2022 onwards, but material prices are expected to remain elevated throughout the rest of the year

DISRUPTION SCENARIO RANGES COMPARED TO G&T TPI (CUMULATIVE INFLATION) FORECAST



Source: *Descriptions of each scenario, and the relevant qualifying conditions for each, are provided in G&T's* ***Russia-Ukraine Conflict Report***

Project pipelines **remain strong** but tendering opportunities have reduced

Additional risk pricing is being applied to tenders due to uncertainty putting pressure on project budgets

Significant **cost hikes** will be followed by a **gradual cooling off**/normalisation period

Suppliers are learning to mitigate against **supply chain disruption**, establishing new trade partners

Tariffs and **sanctions on Russia** have affected global supply and pricing

Compounding inflationary pressures/**market volatility** has seen some new schemes stall

The supply chain will want to **capitalise on abnormal conditions** for as long as possible

Project viability concerns may cause a drop in demand and encourage more **competitive tendering**

Project pipelines

remain strong

According to the World Bank's Commodity Markets Outlook (April 2022) the war in Ukraine has had a significant impact on commodity markets, aggravated by a surge in restrictions in trade. Some commodity prices have reached all-time highs in nominal terms due to sharp rises in input costs.

Key updates include:

- While prices are expected to peak in 2022, they are to remain higher than previously forecast in the medium term
- Most commodity prices will also remain elevated in 2023-24 compared to five-year average levels
- Energy and non-energy prices are forecast to rise by ***c.50%*** and ***20%*** in 2022, respectively, before reducing somewhat in 2023 and settling at a higher level than seen previously
- Metal prices are projected to increase by ***16%*** in 2022 relative to 2021 and ease in 2023, while remaining at historically elevated levels

The analysis found that the war's impact could be longer-lasting than previous impacts due to the following reasons:

1. Broad-based price increases result in less scope to substitute the most affected energy commodities for other fossil fuels
2. Increase in price for some commodities driving up the production costs of others
3. Policy responses focused more on tax cuts and subsidies than on long-term measures to reduce demand and encourage alternative sources of supply
4. The war is leading to more costly patterns of trade that could result in longer-lasting inflation

While the outlook for commodity markets depends heavily on the duration of the war in Ukraine and the extent of sanctions, it is assumed that the channels through which commodity markets have been affected are likely to persist.

Source: World Bank

Rising fuel prices have placed a strain on the road freight industry. The 5p per litre cut in UK fuel duty and the release of US oil reserves have helped drive down the price per barrel of crude oil in recent weeks, but it remains to be seen how significant an impact they will have on the price-per-mile index

According to the International Chamber of Shipping, Ukrainian and Russian seafarers account for **14.5%** of the global shipping workforce. A shortfall in shipping crew will see supply chain disruptions worsen.

Shipping experts are expecting further delays whilst experiencing some of the highest transportation prices on record, but the initial shockwaves to global trade appear to have now stabilised.

Energy Prices

Unprecedented rises in fuel and energy prices in 2022 have spurred a second wave of post-pandemic inflation. Increasing energy costs have become a key driver of building cost inflation, increasing production costs of energy-intensive construction materials.

Trades that are heavily fuel/energy-driven or materials-based are experiencing the worst of the inflationary pressure.

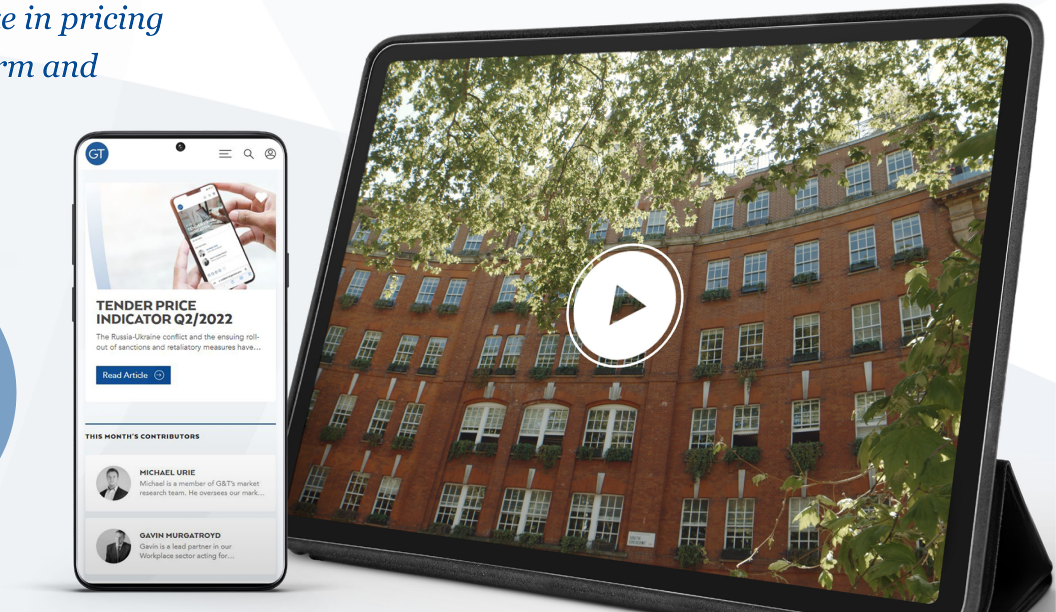
Rising global energy prices: A result of...

- Lower pipeline supplies of gas
- Gazprom halting supplies of gas to Poland and Bulgaria
- High demand for liquefied natural gas from Asia led to lower shipments to Europe
- Rebounding economies post-pandemic
- Low levels of wind and renewable energy generation/output
- A prolonged cold winter in Europe (2020/21) put pressure on stored gas supplies
- Nuclear power station outages

Source: International Chamber of Shipping and Transport Exchange Group

In summary – we see suppliers learning to mitigate against supply chain disruption by adapting to interrupted trade flows and establishing new trading partners. Although we've seen labour costs rising, coupled with sharp increases in material and component pricing, the impact to the overall cost of your project will vary. Higher input cost pressures and rising interest rates may impact demand and prompt a slowdown in new order growth in the coming months, but for now, the current project pipeline is strong. We see the industry responding to the spike in pricing with resilience - seeking alternative supply in the medium term and moderating some of the impact of these price increases.

Click **HERE** to view our Q2 Market Update Video



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