alinea knowledge

The EU referendum
After the result

28 June 2016

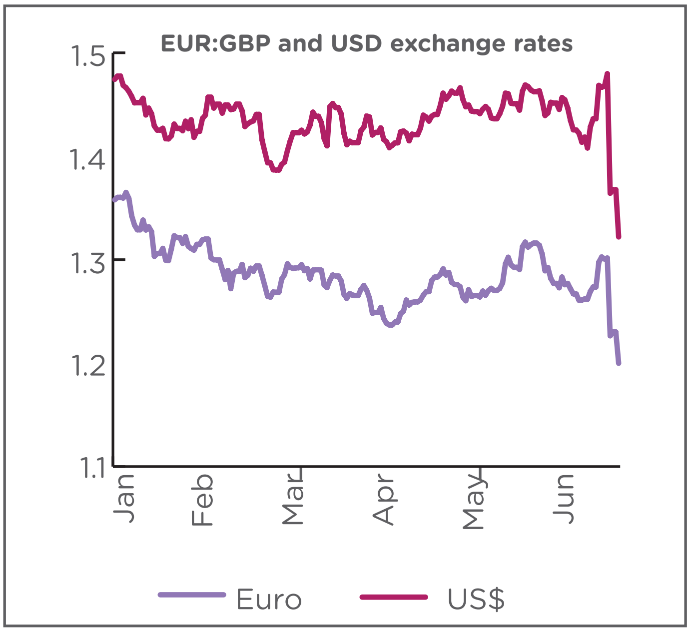
Market mentality - React first, think later?

Uncertainty ahead

Investors value certainty above all else. Since the middle of 2015 and the Great Fall of China, global markets have been turbulent, but London has been in somewhat of a bubble.

'Brexit' has added to this uncertainty. With a turnout of 72%, the Leave campaign won with a majority of 52%. In a briefing following the announcement, the Governor of the Bank of England, Mark Carney, sought to reassure the markets that the UK economy is "well prepared" and that the UK economic powers had been engaged in extensive contingency planning to ensure the safety of the UK market. His opening comments were that "inevitably, there will be a period of uncertainty and adjustment."

The market's instant reaction was one of panic, with risk averse investors shedding shares in early trading, but it didn't last long and markets did bounce back later on Friday. News reports remarked that Sterling was at its lowest value against the dollar since 1985 and losing the gains it had made against the Euro. Global stock markets were hit in this initial panic with banks and construction firms particularly badly hit.



It is likely that the key drivers of this panic are that in the final days before the polls closed, many expected Remain to win, strengthening the pound and reinforcing the stock markets. Few expected to find the UK wanting to split from the single market.

The other cause of uncertainty is that there is no clear blueprint which the UK can follow. When Greenland left the EU after gaining independence from Norway, it took 3 years to negotiate an exit for just a population of 56,000 and concerns over fishing. The UK exit will be quite different as the official exit process will only start once Article 50 of the Lisbon treaty is triggered which is not expected to happen until later this year under the new Conservative leadership.

It could be two and a half years until the UK is formally out of the EU.

As the market adjusted to the news on Friday, shares and the pound began to slowly rebound, perhaps as opportunists sought to take advantage of undervalued stocks.

As cost consultants, we must remain unemotional - particularly as clients will be looking at the risks, costs and potential benefits for their schemes that might present themselves. We must react and think at the same time.

The events this week have added to the volatility and there is no clear outcome for construction prices, with pressures in both directions. In weeks and months to come, we expect the tale to unravel and the picture to become clearer.

What does it mean for construction?

Sterling is a key concern. The pound has suffered throughout 2016, falling to a low of 1.25 against the Euro in April then recovering, only to be pushed lower by the referendum verdict (only to bounce once again to 1.25). This volatility weakens Britain's purchasing power abroad. In the lead up to the referendum, we identified packages which could be affected by a volatile euro rate. These were: bar reinforcement, MEP plant elements, stone, drylining, masonry, fittings, façades and lifts. These elements could make up between 10% and 30% of a project cost. Over the coming weeks, we will be working to understand the sensitivities around these packages and developing a risk profile.

Yet, as the British currency becomes more attractive to international investors, assuming that demand stays high, this could encourage inward investment - particularly as asset values are discounted due to market adjustments

Demand may be in a more difficult position. Several high profile financial occupiers have suggested that they may look at moving their main offices elsewhere and investors are becoming increasingly risk averse, as shown by the number of projects in London in particular, which were 'waiting to see' the result of the referendum.

This may cause developers to shy away from the UK market, particularly those funds which need a secure return. We believe the market could move away from speculative developments as funders require certainty before committing. The effect on the housing market is not clear and as such we are currently watching the house-builders closely. The future of infrastructure investment also remains unclear, as once an exit is negotiated, the UK may not have access to the European Investment Bank. Over the last three years, the EIB has committed £16bn in funding to the UK.

It could be suggested that free movement of trade and people is inevitable as a fact of modern day globalisation. Any attempt to stem the flow of migrant **labour** into the UK would have a detrimental upwards effect on the cost of construction. The RICS recently remarked that even with EU labour, there is still an acute skills crisis which has helped push industry wages up 6%, much above the average. Barratt Development's Chief Executive commented that on a typical site, 30-40% of the labour force were from Europe. However, we believe that this could be closer to 80% across London, but much less in the regions. In time, with the support of industry/government and a re-examination of the higher education system, this skills crisis may be less dependent on migrant labour, but until then, we will continue to rely on transient labour.

On the other hand, if demand loosens slightly or the industry calms for a short period, this extra capacity could help to remedy the skills crisis and release some capacity back into the market, limiting any further rises.

If a **period of reflection** follows the verdict, and client organisations take some time to understand what the vote means, we could see uncertainty in the pipeline. This, in turn, fosters uncertainty in the contracting market.

In the short-term, we do not believe that there will be a dramatic impact on project costs beyond a fluctuating currency, which has been a feature of 2016. Until the Brexit negotiations take place, little will change. We may see a shift to smaller, easier projects that will span the "still in the EU" period whilst some of the uncertainty is taken out of the system.

Until the supply / demand imbalance is addressed structurally in the market, we will continue to see inflation in the market unless there is a severe abatement in the demand for tendering. However, we do not see this coming to the fore at the moment as we are still seeing contractors refusing to tender because they already have full order books.

In summary, see the three key issues being:

- Labour - short to medium term, no impact on prices
- Sterling - ongoing volatility pending political stability
- Margin - medium term, possibly a more competitive approach to margins/preliminaries.

Our forecasts for construction costs will be updated at the end of July (a month following the referendum) as part of our next planned publication of our Market Review.

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