ICAEW

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UK Business Confidence Monitor

Q4 2014

BUSINESS WITH CONFIDENCE

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Welcome

This quarter's *ICAEW/Grant Thornton Business Confidence Monitor* sees business confidence cooling for the second consecutive quarter. Although this is still high by historical standards, it demonstrates that concerns persist in our economic recovery – investment growth is expected to slow down next year, and skills shortages and levels of staff turnover are a bigger issue. With less than six months until the general election, questions will be asked about the long-term sustainability of the economic recovery and whether the underlying problems have been addressed.

In this BCM we have also compared the issues affecting business today with those at the same time five years ago, before the coalition government came into office. Labour market factors are a greater issue to businesses now than in the run up to the last general election when the predominant challenges for businesses were access to finance, and late payment. The problems in the eurozone mean exports continue to slow, so the government needs to work harder to ensure our recovery is placed on a broader footing.

Michael D M Izza
Chief Executive
ICAEW

While confidence has fallen again in this quarter's *ICAEW/Grant Thornton Business Confidence Monitor*, it is important to bear in mind that this is still at a relatively strong level. Crucially, the labour market remains buoyant, with further significant employment increases expected over the next 12 months. Business does, however, continue to express deep concern as to whether we have the right workforce available to fulfil these roles.

Our increased reliance on domestic demand is worrying. The problems in the eurozone are ongoing and this means that we are losing business with our single biggest trading partner. The government needs to do more to engender an export-led recovery in the medium term, and introducing tax credits for those looking to export and break into new markets would be a good start.

Scott Barnes
Chief Executive Officer
Grant Thornton

Economist’s view

The latest *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) shows that business confidence cooled in Q4 2014 for the second consecutive quarter, reaching a level of +28.6. Although this level compares to +32.3 in the previous three months and an all-time high of +37.3 in Q2 2014, the Confidence Index remains elevated by historic standards.

The Confidence Index is a leading indicator for growth, and this quarter’s reading suggests that the economy will expand at a quarter-on-quarter rate of 1.0% in Q4 2014. This is similar to growth rates seen earlier in the year, but other BCM findings indicate that the pace of economic expansion may slow further ahead.

KEY ISSUES EMERGING THIS QUARTER

- Business confidence continued to decline in Q4 2014 but remains high by historic standards.
- Turnover and profit growth have broadly stabilised at levels higher than that seen in the past five years.
- Export increases have weakened markedly alongside a struggling eurozone economy, while domestic sales have remained stronger.
- Investment growth has picked up in the past two quarters but is expected to slow again.
- Private sector job creation remains buoyant, with further significant increases predicted over the next 12 months.
- Salaries have started to creep up in real terms, although this is largely down to falling inflation, as annual pay rises remained steady this quarter.
- Skills shortages and levels of staff turnover are a greater concern for more businesses this quarter, highlighting a rising potential barrier to growth.

The latest BCM results continue to illustrate a relatively positive picture of the UK in 2014, but there are also signs that weaker economic conditions are approaching. Of particular concern is the wide trade deficit, as trade growth slumps alongside anaemic economic results from the eurozone, the UK’s largest buyer of exports. In addition, although faster investment growth in the second half of this year has been good news, it’s less encouraging to see businesses planning to limit investment over the next 12 months. Both these factors, combined with the necessary government budget cuts in the next parliament, suggest that economic expansion in 2015 is likely to be less impressive than this year’s stellar performance.

Douglas McWilliams
Chief Executive, Cebr
ICAEW Economic Partner

Business Confidence in Q4 2014

FIG. 1 TREND OF UK BUSINESS CONFIDENCE

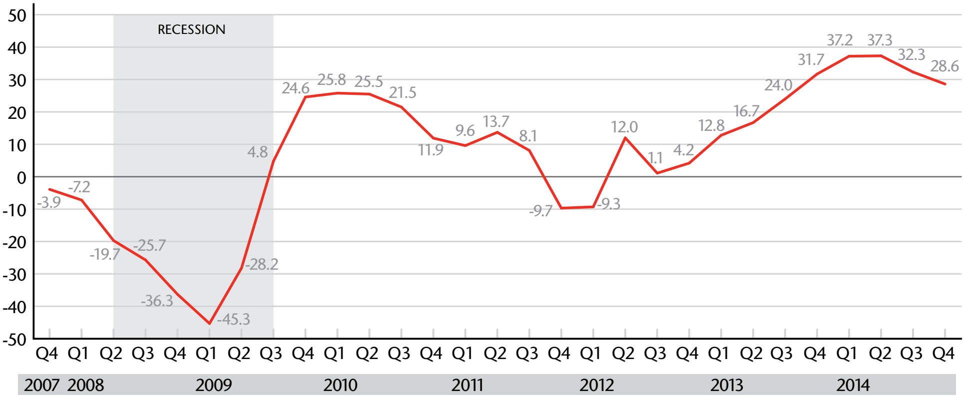
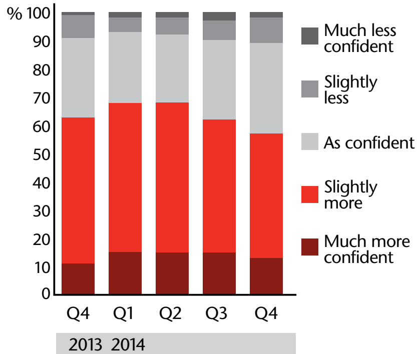


FIG. 2 UK CONFIDENCE INDEX – DETAILED RESPONSES



The latest *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) shows business confidence continuing to moderate.
The Confidence Index for Q4 2014 dipped for the second consecutive quarter to +28.6, down from +32.3 in the previous quarter and from a record high of +37.3 in Q2 2014.

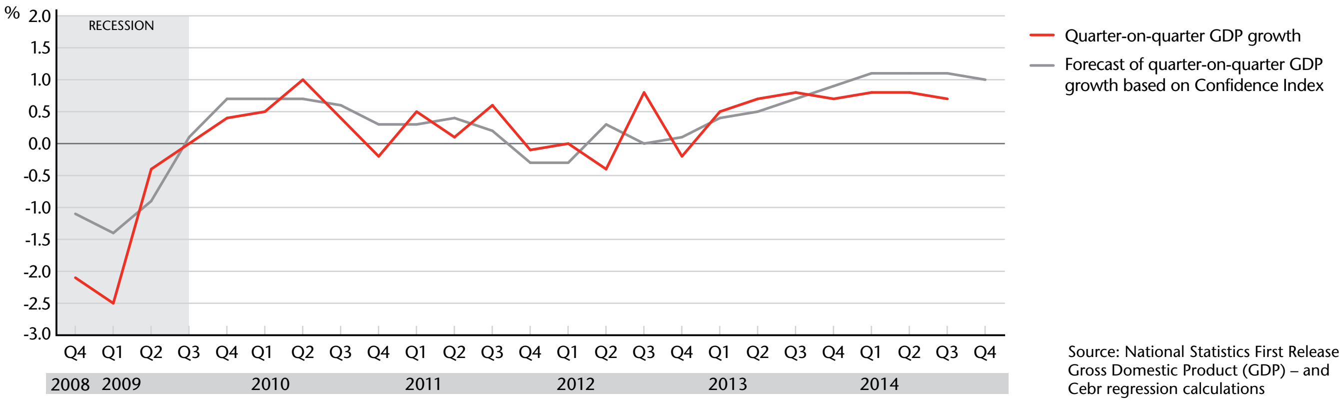
CONFIDENCE DIPS AGAIN BUT OVERALL REMAINS BUOYANT

Although confidence has now declined for two quarters in a row, it remains higher than it has been over most of the past 10 years, including before the financial crisis. This suggests that business conditions still remain relatively buoyant, however, the uncertainties surrounding the outcomes of the upcoming general election as well as the EU elections and a slowing global economy and weak eurozone, are starting to creep in.

Looking at the headline result in detail, still over a half (57%) of UK businesses remain more optimistic about the year ahead than the previous 12 months. Just 11% of companies expect the economic climate to deteriorate.

Overall, 2014 has seen the highest average business confidence readings since the BCM began 10 years ago. This points to a very strong year of economic expansion, with consensus forecasts projecting the fastest year of growth since 2007. In 2014 as a whole, the UK is likely to have the most rapidly expanding economy among the G7 nations.

FIG. 3 FORECAST OF QUARTERLY GDP GROWTH BASED ON ICAEW CONFIDENCE INDEX



Source: National Statistics First Release – Gross Domestic Product (GDP) – and Cebr regression calculations

The latest revised estimates of UK GDP show that the size of the economy is now 3.4% larger than its Q1 2008 peak, highlighting the strength of expansion in recent quarters. However, GDP per person is still lower than it was before the financial crisis. This indicates that further economic expansion will be needed before household spending power regains its previous highs.

GDP GROWTH STARTS TO MODERATE, BUT STILL REMAINS STRONG

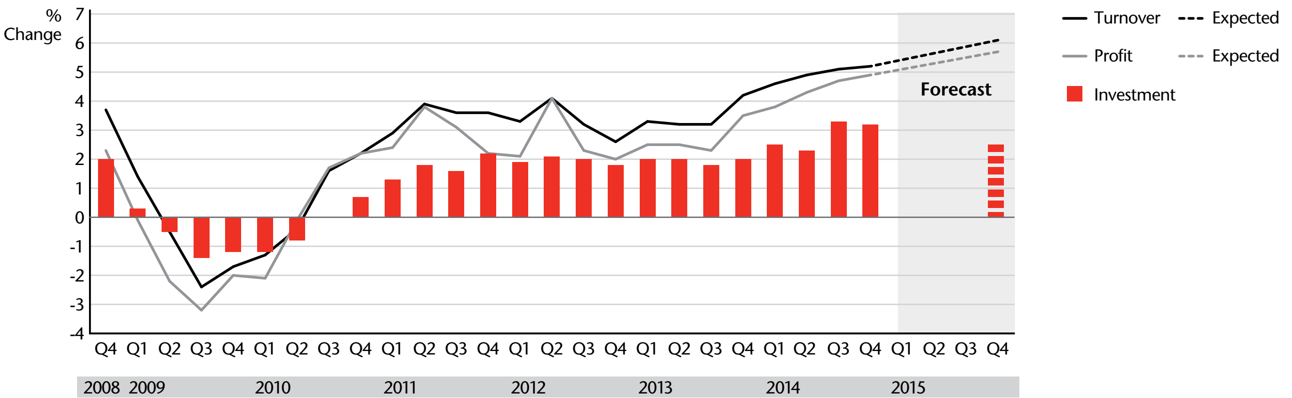
Even though the latest Confidence Index reading has dipped further, it still remains high, and as such continues to indicate robust growth for the final quarter of 2014.

Looking beyond Q4, economic expansion is likely to continue to moderate. Additional indicators from BCM on domestic sales and exports suggest that the trade deficit is widening, a factor that will weigh down on growth. In addition, business investment increases look set to slow.

These challenges from the private sector come alongside the need for government budget cuts in the next parliament, in order to successfully tackle the fiscal deficit. With both the private and public sectors placing downward pressure on growth, our own forecast suggests that the UK economy will expand at a slower rate next year, after the rapid growth we have seen during 2014.

Business Financial Performance

FIG. 4 TURNOVER, PROFIT AND INVESTMENT – AVERAGE % CHANGE



Business performance has stabilised this quarter following the strong expansion earlier in the year, though further upticks in growth are expected ahead. Turnover rose on average by 5.2% over the past 12 months, while gross profits increased by 4.9%, both broadly unchanged from results in the previous quarter. In line with still strong confidence, businesses expect growth in both measures to accelerate over the next year.

INVESTMENT GROWTH SET TO SLOW

Alongside these positive financial performance results, companies have boosted year-on-year growth in their capital spending to over 3.0% during the past two quarters. This is a rate of increase not seen since 2005, potentially a result of companies taking advantage of the upsurge of demand during 2014. The faster investment growth will help to rebalance economic expansion, supporting a boost in productivity and living standards over the longer term. The latest BCM findings corroborate those from the Office for National Statistics (ONS), which also show faster growth in total business investment in recent quarters.

However, less encouragingly, businesses expect slower capital expenditure growth over the year ahead, at just 2.5% on average. This is broadly in line with the increases seen during the first half of 2014, but generally below that seen before the financial crisis. The effects of uncertainties such as the upcoming general election, the possibility of a referendum on EU membership, and widespread economic malaise in the eurozone, are all likely to impact on business investment plans.

FIG. 5 AVERAGE % CHANGE OVER 12 MONTHS TO …

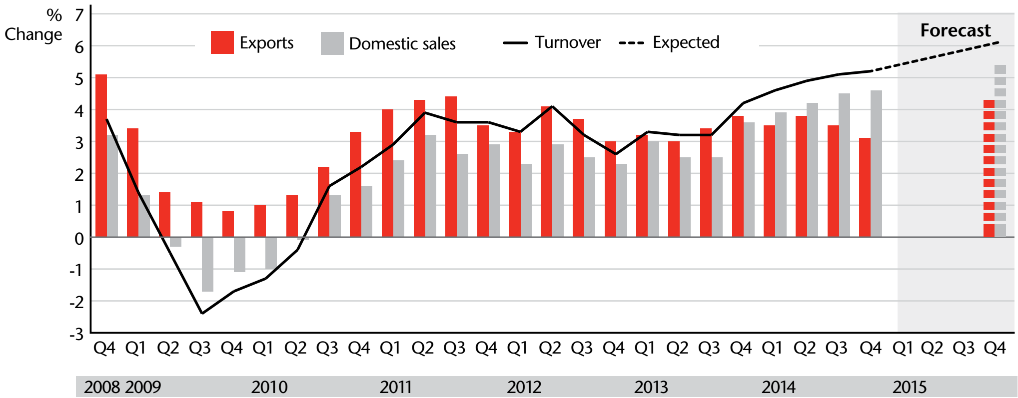
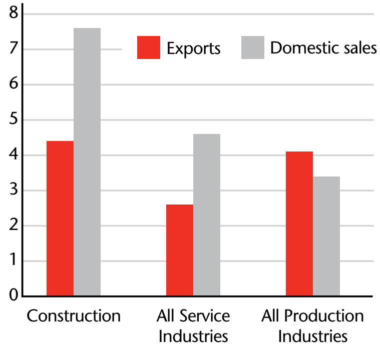


FIG. 6 AVERAGE PERCENTAGE CHANGE OVER 12 MONTHS – BY SECTOR



UK domestic demand continues to bolster business performance, with domestic sales rising over the past year by 4.6%. This is broadly unchanged from the previous quarter, but well up from the 3.6% growth seen in Q4 2013. In addition, a further uptick to 5.4% increase is expected for the year ahead.

DOMESTIC SALES ROBUST BUT EXPORTS CONTINUE TO SLOW

The buoyant performance of domestic sales remains offset to some extent by a deterioration of export growth, which has slowed notably to just 3.1% over the past 12 months. This is the smallest increase seen since Q2 2013 and comes alongside a weakening of the eurozone economy: Germany contracted in Q2 2014 while France showed zero growth.

With UK exports slowing, the trade deficit is expected to widen in 2014 as a whole – a factor that will weigh on overall economic expansion in the short term.

Although a further pickup in domestic sales growth is expected over the coming 12 months, this would likely be supported by marginal real wage increases due to weak inflation, rather than by rising consumer confidence. The latest household data from YouGov show a decline in optimism, as expected house price growth has slowed and workers are seeing less business activity at their workplace. Weaker household confidence suggests that the extent to which consumer spending can hold up economic expansion will be more limited.

FIG. 7 AVERAGE % CHANGE OVER 12 MONTHS TO …

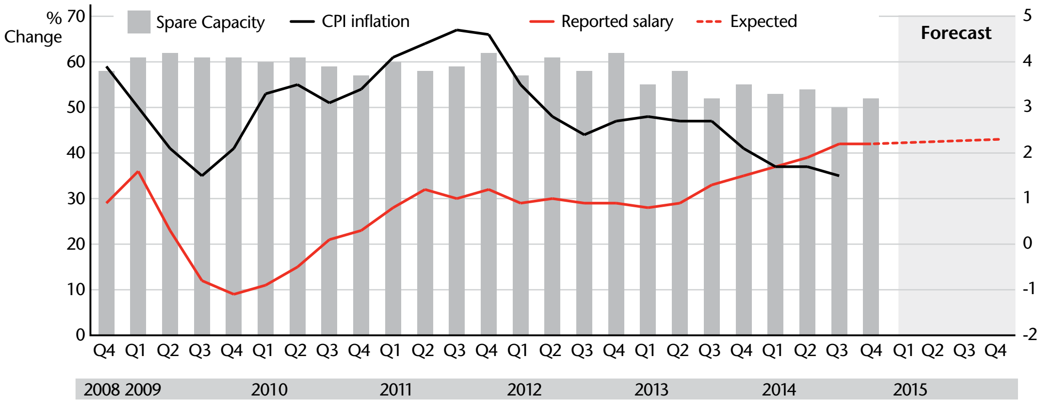
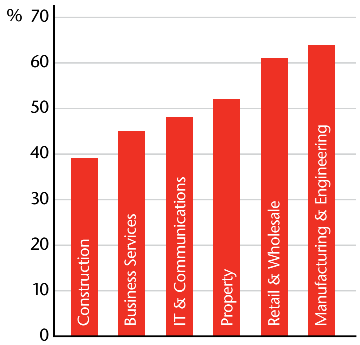


FIG. 8 BUSINESSES OPERATING BELOW CAPACITY



More than half of businesses (52%) still report that they are operating below capacity this quarter, with firms in the manufacturing sector most likely to have additional capacity. The share continues to slowly fall year on year, but remains above the series low of 45% seen in Q2 2008. Spare capacity has also fallen back in the labour market, with the unemployment rate reaching 6.0% in the three months to August 2014.

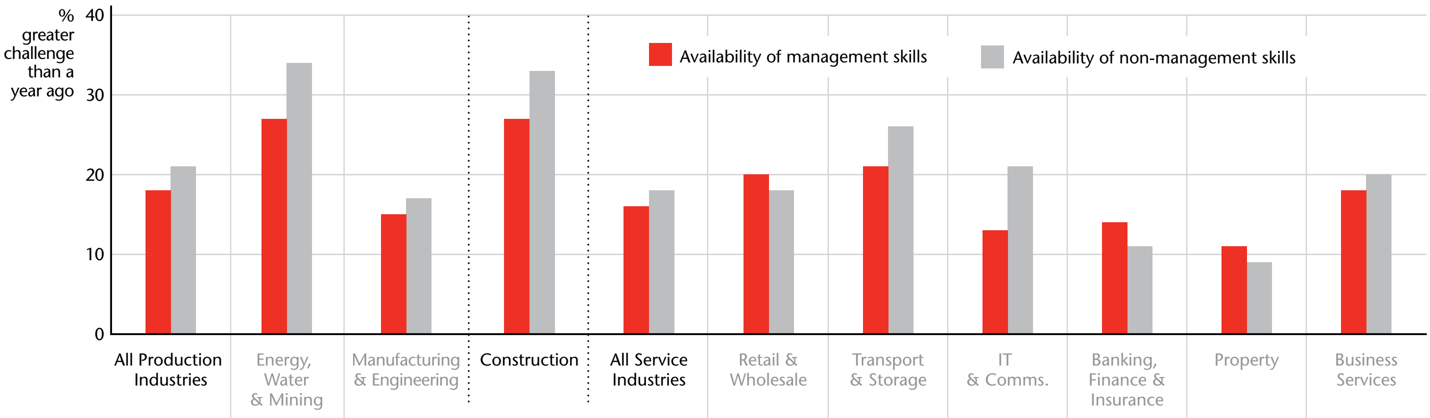
SALARIES SEEING REAL GROWTH DUE TO FALLING INFLATION

Although unemployment has been falling back during 2014, there are still signs of fragility in the labour market. The share of people working part time, only because they cannot find a full-time job, remains highly elevated. As a result, businesses still have the scope to keep wage growth relatively low. During the past 12 months, average total salaries have grown by 2.2%, which is faster than the increases seen over the past five years, but still remains below rates of over 3% reported before the financial crisis.

On the positive side, salaries have now returned to growth in real terms, as consumer price inflation dropped to just 1.5% in Q3 2014. Consensus forecasts suggest that inflation will stand at around this level in Q4 and during 2015, so real wage increases can be expected to continue in the short term.

Pay growth is the key indicator monitored by the Bank of England for interest rate decisions. With salary growth remaining historically weak, it is increasingly likely that the Bank will wait until the second half of 2015 before raising its rates.

FIG. 9 AVAILABILITY OF SKILLS AS A GREATER CHALLENGE – BY SECTOR



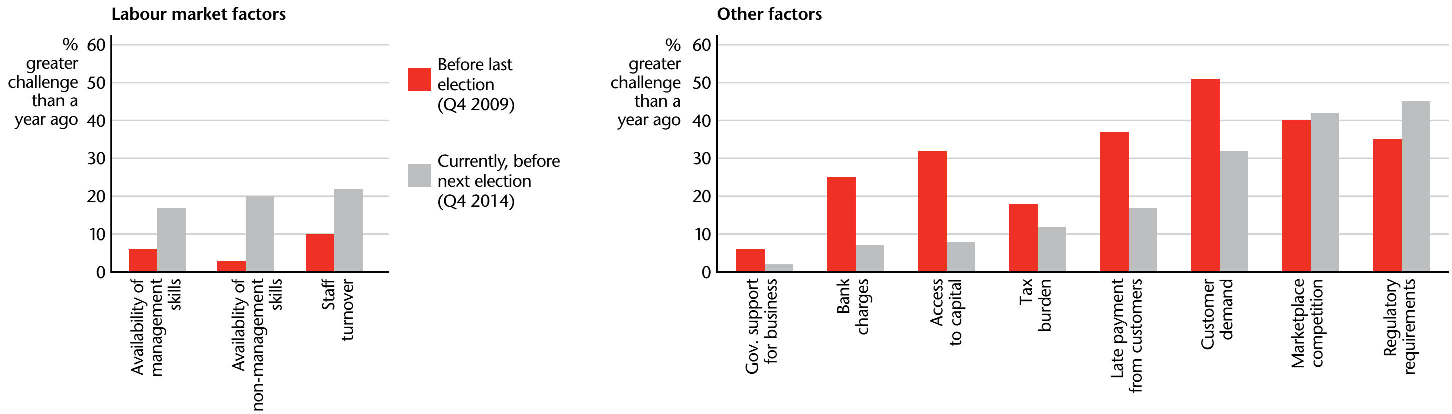
As unemployment continues to fall, more businesses are experiencing challenges from the tightening labour market. This quarter, one in five companies (20%) report that the availability of non-management skills is a greater challenge than a year ago, up from just 11% in Q4 2013. Similarly, 22% of firms feel that levels of staff turnover are more of an issue, up from 17%.

CONSTRUCTION AFFECTED THE MOST BY SKILLS SHORTAGE

The construction sector has seen rapid growth in recent quarters, with the latest ONS estimates showing a year-on-year rise in output of 3.0% in Q3 2014, alongside sustained increases in employment. With this buoyancy, however, skills scarcities are becoming a potential barrier to further expansion of the sector. A third of companies (33%) report that the availability of non-management skills is a greater challenge now than a year ago, up from 15% in Q4 2013.

At the other end of the scale, businesses in both the banking, finance and insurance, and property sectors report some of the lowest levels of concern about skills shortages. Just 11% of banking firms feel that the availability of non-management skills was a greater challenge now than a year ago, broadly unchanged from Q4 2013. The fact that large companies in this sector continue to make significant headcount reductions suggests that workers with these skills are relatively easy to recruit at present.

FIG. 10 CHALLENGES FACED BY BUSINESSES – COMPARISION WITH THE RUN UP TO LAST GENERAL ELECTION



Labour market factors seem to be of a greater challenge to businesses now than they were at the same point ahead of the 2010 general election. This is in contrast to other economic issues that have fallen back as a concern over the last five years.

SHIFT IN BUSINESS CHALLENGES OVER LAST FIVE YEARS

Looking back at the time before the last election, Q4 2009, which came on the heels of the global financial crisis, more than 50% of firms saw customer demand as posing a greater challenge compared with a year earlier. Late payment from customers, marketplace competition and access to finance were also seen as more of a concern then by over 30% of businesses.

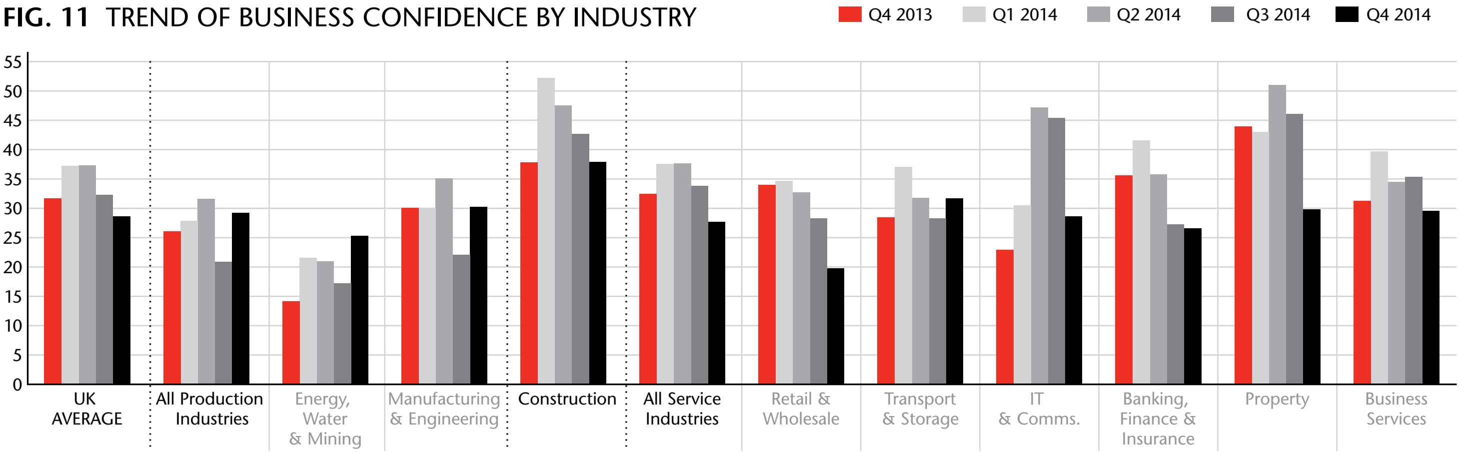
With the UK economy having largely recovered from the 2008/09 downturn, most of these problems seem to have declined as a greater issue over the past five years.

Access to capital and late payment from customers are now seen as a rising challenge to a relatively small proportion of firms compared to last year. Customer demand is also a growing problem for fewer businesses than five years ago (32% vs 50% in Q4 2009).

However, the current economic climate poses new challenges to businesses related to the labour market. Staff turnover and skills shortage are perceived as one of the top growing barriers to further business expansion.

Trends in business confidence – industry

FIG. 11 TREND OF BUSINESS CONFIDENCE BY INDUSTRY



The services sector has significantly contributed to the dip in confidence across the UK this quarter. This is the second consecutive quarterly decline in optimism for the sector. Similarly, confidence among construction firms has been cooling since Q1 2014, albeit from very high levels. Meanwhile, optimism levels in the production sector have fluctuated over the past two quarters, but remain well above those seen a year ago.

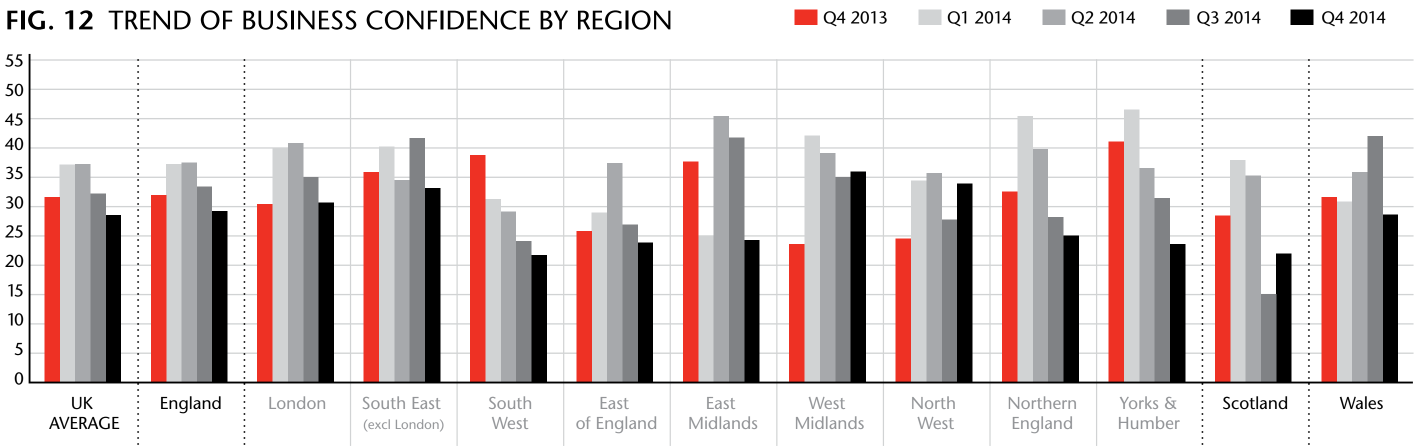
CONFIDENCE STANDS LOWEST IN THE RETAIL SECTOR

Confidence levels in the retail & wholesale sector have been generally falling back over the past few quarters, and now stand lower than in any other part of the economy, at just +19.8 in Q4 2014. These findings come alongside intense price competition in the sector. The latest retail sales figures from the ONS show that shop prices have been falling year on year for six out of the seven months up to and including September 2014. Particularly sharp and sustained discounting has been seen among department stores and supermarkets.

Optimism has generally fallen back around most other sectors; one exception is the manufacturing & engineering sector, where the Confidence Index has remained broadly unchanged for much of the past year. Manufacturers have been benefitting from very low cost inflation this year as the global price of hard commodities and energy falls back. However, this positive is offset by slowing growth of global demand, as expansion in emerging economies cools and the eurozone continues to struggle.

Trends in business confidence – region

FIG. 12 TREND OF BUSINESS CONFIDENCE BY REGION



The decline in the headline UK Confidence Index is seen across many of the regions this quarter, with only some areas seeing an increase of any magnitude. With this latest decline, confidence levels are generally lower around the country than they were a year ago, reflecting the political and economic uncertainties that lie ahead.

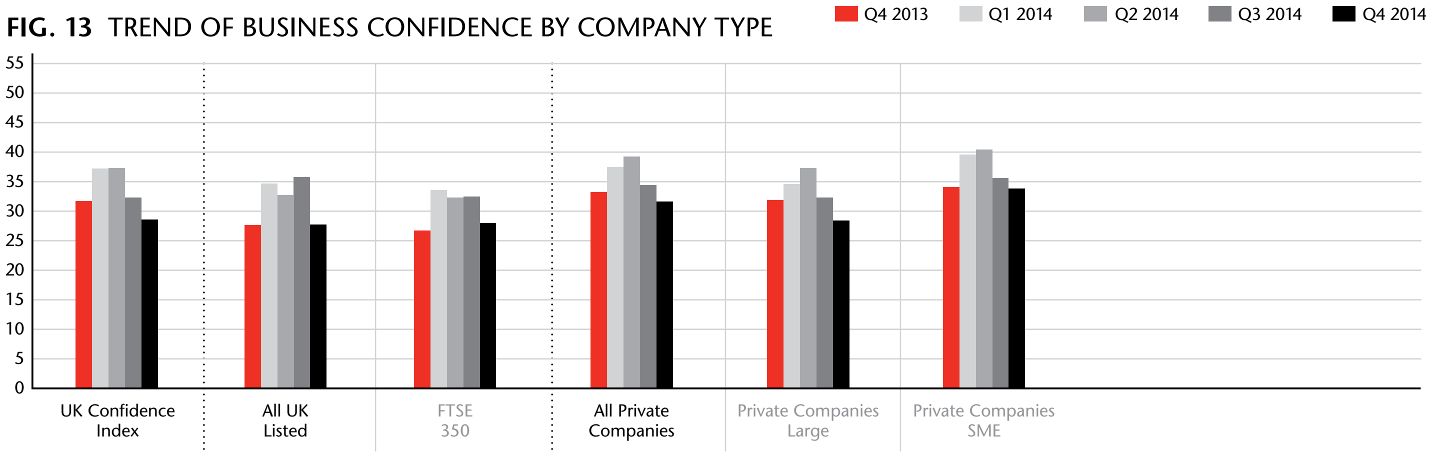
CONFIDENCE FALLING BACK AROUND MOST OF THE UK

Confidence levels have declined across much of the UK. Northern England is one region that has seen a particularly sustained drop in confidence, with optimism levels declining during the past three quarters. There are widespread signs of weakness in the labour market for the region, which may be one factor depressing confidence. Unemployment in Northern England stood at 9.3% in the three months to August 2014, well above the 6.0% level for the UK as a whole. At the same time, the availability of non-management skills is cited as a greater challenge now than a year ago by 30% of businesses in the region. This scarcity of skills at the same time as high joblessness is likely to hold back growth over the coming year.

Meanwhile confidence in Scotland increased this quarter, one of the only parts of the UK where this is the case. The Confidence Index there stood at +22.0, potentially buoyed by the reduced uncertainty that came with the results of the Scottish Referendum in September. However, even in Scotland, confidence levels still remain down on a year before.

Trends in business confidence – type

FIG. 13 TREND OF BUSINESS CONFIDENCE BY COMPANY TYPE



Confidence has generally declined across all different types of firm, including both listed businesses and privately-owned companies. Listed firms had a Confidence Index reading of +27.7 this quarter, while private businesses had a reading of +31.6.

SMALLER BUSINESSES MORE CONFIDENT THAN LARGER ONES

Small and medium-sized private companies recorded a Confidence Index score of +33.8 this quarter, compared to +28.4 for larger private firms and +28.0 for FTSE 350 listed corporations. This divergence may reflect differing exposures to the slowing world economy – larger firms tend to be more globally focussed than smaller businesses. The results illustrate this, as privately-owned SMEs are seeing stronger domestic sales growth than larger firms, but their export expansion is weaker.

Private SMEs have posted faster turnover growth and sales volume growth than their larger counterparts over the past 12 months. In line with their greater optimism, small businesses are also increasing their employees' salaries by a larger amount, 2.5% over the past year compared to just 1.6% for FTSE 350 firms.

With global economic conditions looking weaker for 2015, smaller firms may be in a better position to grow over the year ahead than larger private and listed businesses.

About BCM

BCM is one of the largest and most comprehensive quarterly reviews of UK business confidence and provides a regular snapshot of the economy, informed by senior business professionals running all types of businesses across the UK. It is shared with a range of national and regional policymakers, the business community, academics and researchers. It is a credible predictor of GDP and economic change and supports policy decision-making.

The report is based on a continuous research programme of approximately 4,000 telephone interviews each year with ICAEW members working in industry and commerce. This probes opinions on past performance and future prospects for members' businesses, and investigates perceived changes in the impact of factors such as availability of skills, government regulation and the tax regime. Data are weighted to represent the UK economy by value.

For further technical details please see: BCM Technical Appendix at icaew.com/bcm

Business Confidence Index methodology

The Business Confidence Index is calculated from the responses to the following:

'Overall, how would you describe your confidence in the economic prospects facing your business over the next 12 months, compared to the previous 12 months?'

A score was applied to each response as shown on the right, and an average score calculated.

Using this method, a Confidence Index of +100 would indicate that all survey respondents were much more confident about future prospects, while -100 would indicate that all survey respondents were much less confident about future prospects. Further technical details on the design of the survey are available upon request.

Variable	Score
Much more confident	**+100**
Slightly more confident	**+50**
As confident	**0**
Slightly less confident	**-50**
Much less confident	**-100**

ACKNOWLEDGMENTS

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Interviewing and data analysis was undertaken by Kudos Research.

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