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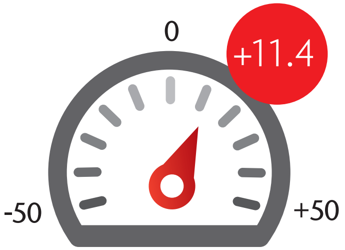
UK Business Confidence Monitor

Q1 2016

BUSINESS WITH CONFIDENCE

icaew.com/bcm

Overall confidence



falls

Profit growth

softens

Export growth

slows

▸ Key points

Confidence falls further, to its lowest level in three years, though it stays positive.

Turnover, sales and profit growth continue to soften, as do expectations for growth ahead.

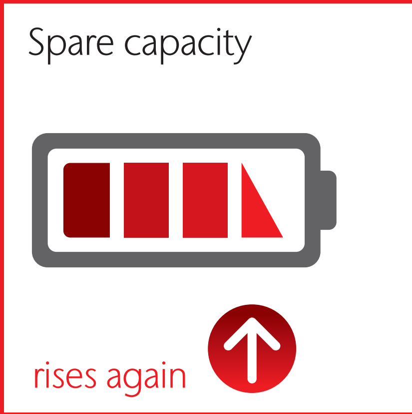
Some recovery in export sales is expected after two quarters of weak growth, though challenges remain.

▸ Implications

The downward trend in business confidence continues for another quarter and the cautious outlook is further highlighted as companies reduce investment and forecast further cutbacks. While still problematic, there seem to be early signs that the skills shortage, a handicap for so many businesses, may be peaking.

However, although the Chancellor was right to warn of a 'cocktail of threats', it is not all doom and gloom. Businesses expect sales and profits to continue to grow, consumer spending is underpinned by salary increases and fuel costs are lower – this all means that business confidence is still positive. There is also a prediction that export sales will start to grow in line with domestic sales as sterling weakens against the USD and euro, our largest trade partners. This has been flagged before but it hasn't materialised.

To better understand the situation you need to dig below the topline figures. Productive industries are the



▸ Key points

Reflecting slower growth and lack of confidence in the longer term, capital investment growth continues to fall, while R&D growth remains subdued.

The number of firms operating below capacity rises again, particularly in the Manufacturing and IT & Communication sectors.

Employment growth has eased off since 2015 while salary growth stays on hold. Concerns about a skills shortage, though still high, seem to have plateaued.

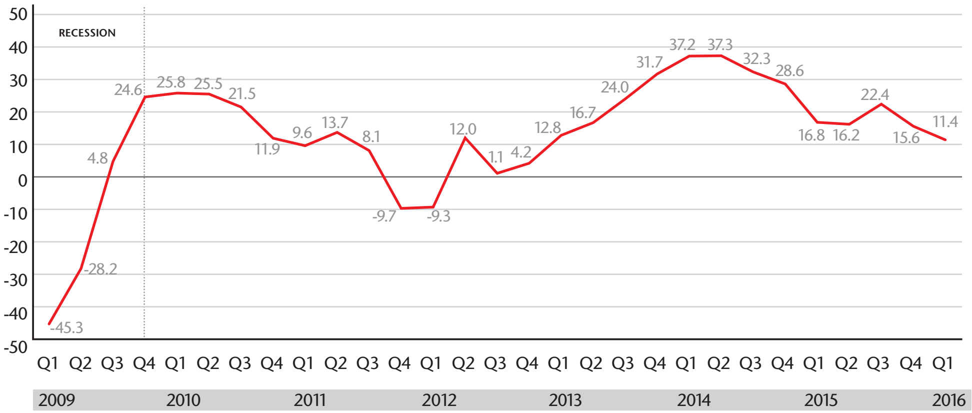
▸ Implications

least confident; the energy sector is into negative territory although not surprising with oil at less than $30 a barrel. Perhaps more worrying is that manufacturing also turned negative this quarter. This does not bode well for either a balanced economy or improved productivity. The North and London continue to experience the most marked decline.

At the individual business level, current trading conditions and the future outlook seem to be very dependent on individual circumstances. Perhaps the biggest implications of this quarter's monitor are at the national level and, therefore, could impact the forthcoming Budget. If growth is lower then tax receipts will be worse than the Autumn Statement projections. These were very finely balanced and the public finances could be at risk, leading to higher taxes from the Chancellor.

Business confidence in Q1 2016

Fig. 1 Trend of UK business confidence



39%
more confident

43%
as confident

19%
less confident
compared to the last 12 months

Confidence slips to its lowest level in three years

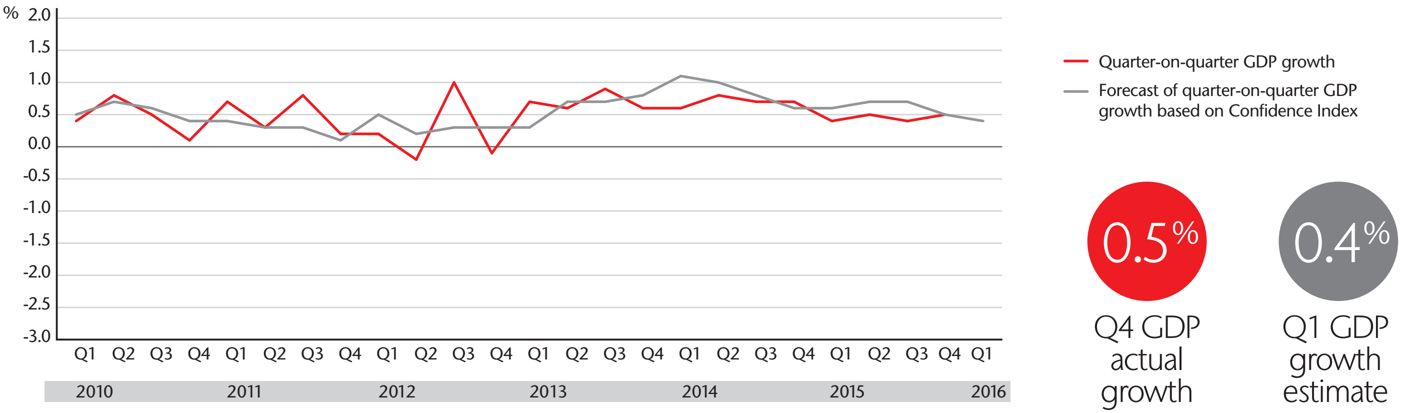
Key highlights

The latest *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) shows a further decline in business confidence. The index, while still positive, has fallen in all but one of the last seven quarters, and now stands at its lowest level in three years.

This quarter's reduction in business confidence continues a well-established downward trend, which developed against a difficult economic and political backdrop, particularly in the second half of 2015. The Office for National Statistics (ONS) reported repeated declines in manufacturing output, while growth in retail sales slowed in the second half of the year. 2015 also ended with a slight pick-up in inflation and reports of a large deterioration in the UK's trade balance, which widened from £4.7bn in Q3 2015 to £8.7bn in Q4 2015. Globally, as we move into 2016, concerns persist about China's slowing economy, and there are challenging political developments, including war in the Middle East and the consequent refugee crisis.

Nevertheless businesses are still positive in Q1 2016 and they expect economic conditions to improve over the next 12 months, even if at a slower pace than they had previously expected. Although the number of companies expecting economic conditions to improve over the next 12 months is now clearly below the number who expect conditions to remain unchanged (39% compared to 43%), these figures are comfortably above the 19% of firms who expect the business environment to worsen.

Fig. 2 Forecast of quarterly GDP growth based on ICAEW Confidence Index



Modest growth in GDP likely in Q1

Key highlights

The ONS has recently published its preliminary GDP estimate for Q4 2015, showing an increase of 0.5% quarter on quarter. However, the decline in business confidence in Q1 2016 suggests a likely slight slowdown in GDP quarterly growth in Q1 2016, to a figure of 0.4%.

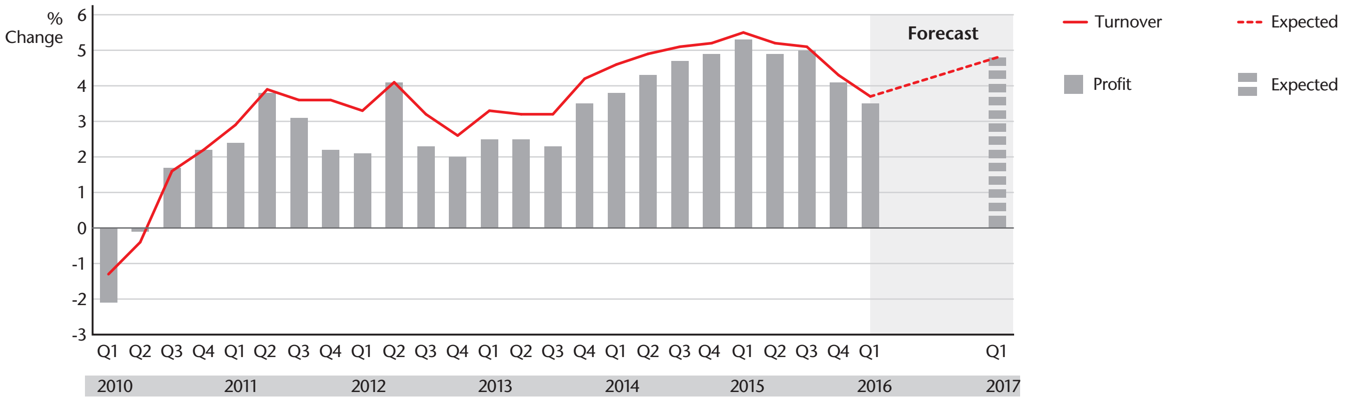
The ONS official data confirm that growth in 2015 was weaker than in 2014. At 1.9% the year-on-year increase in GDP in Q4 2015 was below 2% for the first time since Q1 2013 and the growth rate for 2015 as a whole was well down on the previous year's (just 2.2% compared with 2.9%).

The official data reveal that there were marked variations between sectors. Services did particularly well in Q4 2015, with financial and business services leading the way, whereas both construction and the utilities sectors recorded small falls in output in the quarter. The manufacturing component flattened off, after three quarterly declines in a row.

The further softening that has occurred in business confidence implies that GDP growth in Q1 2016 may well be slower than in Q4 2015. Accordingly, our forecast is for an increase of just 0.4% quarter on quarter. That is well below the historical trend (going back to the 1950s) of 0.6% a quarter. Since the Governor of the Bank of England has said that growth needs to move above its long-run trend before there is a clear case for raising interest rates, an imminent rise in rates remains unlikely.

Business financial performance

Fig. 3 Turnover and profit – average % change



Growth in turnover and sales continues to ease

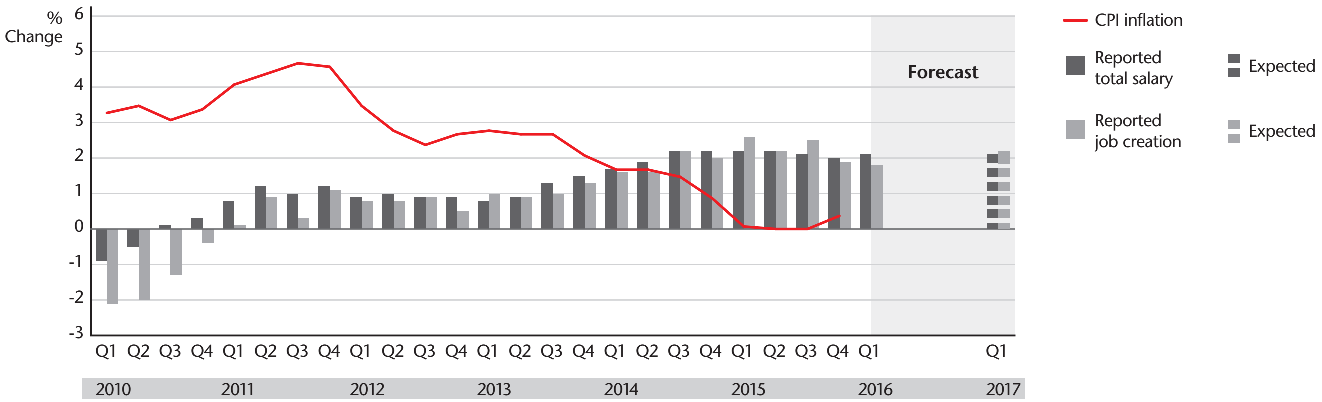
Key highlights

Consistent with softening confidence, growth in turnover and sales continues to ease, with the weakest outturn growth since Q3 2013. Nevertheless, businesses still predict turnover and sales to continue growing over the next 12 months, even if not as rapidly as they previously thought, and they anticipate some recovery in export sales, after two quarters of weak growth.

Turnover growth softened through 2015 and sales growth declined from the middle of the year. An important reason, particularly for manufacturing firms, was the strength of sterling, which made it harder for UK companies to compete at home and abroad. In addition, weakness in global markets dampened export performance. The ONS reported a 4% decline in UK exports of manufactures between Q2 2015 and Q3 2015 – the latest quarter for which data is available.

Several factors may help to explain why companies are predicting they will make gains in 2016. The Chancellor has abandoned his plans to cut tax credits in 2016, which is good news for consumer spending growth. So too is the improved outlook for inflation, reflecting further falls in oil prices, which reached $40 a barrel in December 2015, compared with $60 a barrel a year earlier (and $110 a barrel in June 2014). Partly as a result, interest rates are now not expected to rise before late 2016 at the earliest, which has in turn contributed to a fall in sterling. Finally, the eurozone economy seems to be strengthening which, combined with a weaker exchange rate with the euro, could help UK businesses rebound their exports over the next 12 months.

Fig. 4 Employment, salary and consumer price growth (CPI) – average % change



Labour and input costs are rising slowly but profits growth is still weak

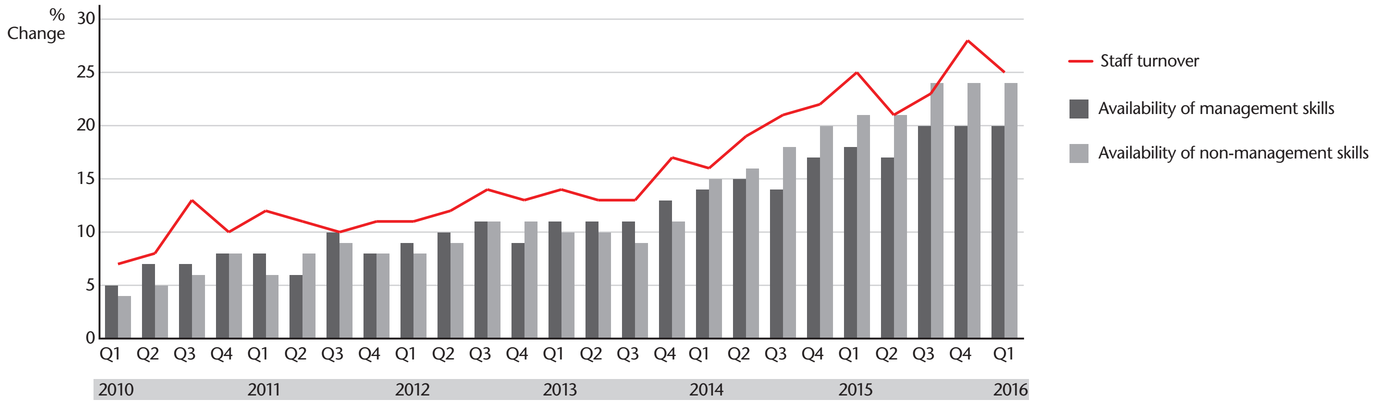
Key highlights

Reflecting companies' predictions of softening growth in turnover and sales, businesses expect a continuation of modest growth in both employment and average salaries. These factors, together with modest rises in input prices, explain subdued growth in company profits.

Labour costs continue to grow, although not as rapidly as in the recent past, reflecting the broader economic slowdown. Both employment and average salary growth is reported to have increased by around 2% over the last 12 months, with similar rises expected for the coming year. Business Services, and to a lesser extent Property and Construction, are setting the pace on both employment and salary growth, while IT & Communications is also seeing notable expansion.

Taken together, the predicted rises in employment and salaries imply increases in direct labour costs that are broadly in line with companies' expectations on turnover growth over the next 12 months. This combined effect will also impact on the rate at which businesses are able to grow their profits, and consequently generate funds for investment. Fortunately, due to lower global commodity prices (not least oil), input costs are increasing rather more slowly than labour costs which will support overall profit growth. Q1 2016 is the fourth quarter in a row in which the rise in input costs is just 1% or thereabouts, and no acceleration is expected. However, the 3.5% increase in profits to Q1 2016 is the weakest since Q4 2013 and the outlook is for a similarly subdued trend in 2016.

Fig. 5 Staff turnover and availability of skills as a greater challenge



Concerns over skill shortages remain high, but are no longer rising

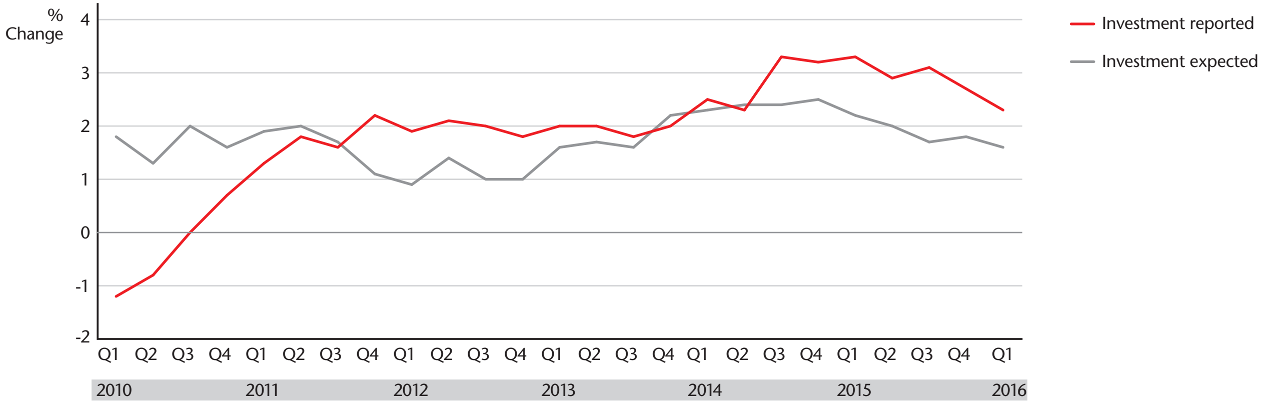
Key highlights

Although concerns over the impact of skill shortages remain high they are no longer rising – a development which is consistent with the evidence of a slowdown in turnover and sales growth, and consequently employment rises. That is mirrored in a similar levelling-off in companies reporting that staff turnover is a growing concern to their business.

The slower growth in turnover and sales in 2015 also appears to have had an impact on businesses' concerns about skill shortages. For most of the period since 2009 the economy's recovery from recession has been accompanied by a rising proportion of companies reporting that availability of skills is a greater challenge to their business than a year earlier. However, in the last three quarters, though still high this figure has remained stable, for both management skills at 20% as well as non-management skills at 24%.

The situation is similar for companies reporting that staff turnover is a greater challenge to their business than a year earlier. The proportion of firms noting this also began an upward trend back in 2009, but that trend appears to be reaching its peak. There is also a similar pattern apparent in the ONS data on vacancies. These rose a substantial 23% in the year to Q4 2014, but only 7% in the year to Q4 2015. Taken together, these factors reflect the evidence that although salaries growth and employment growth will continue in 2016, the pace is likely to be moderate in both cases.

Fig. 6 Capital investment – average % change



Growth in capital spending, including R&D, remains weak

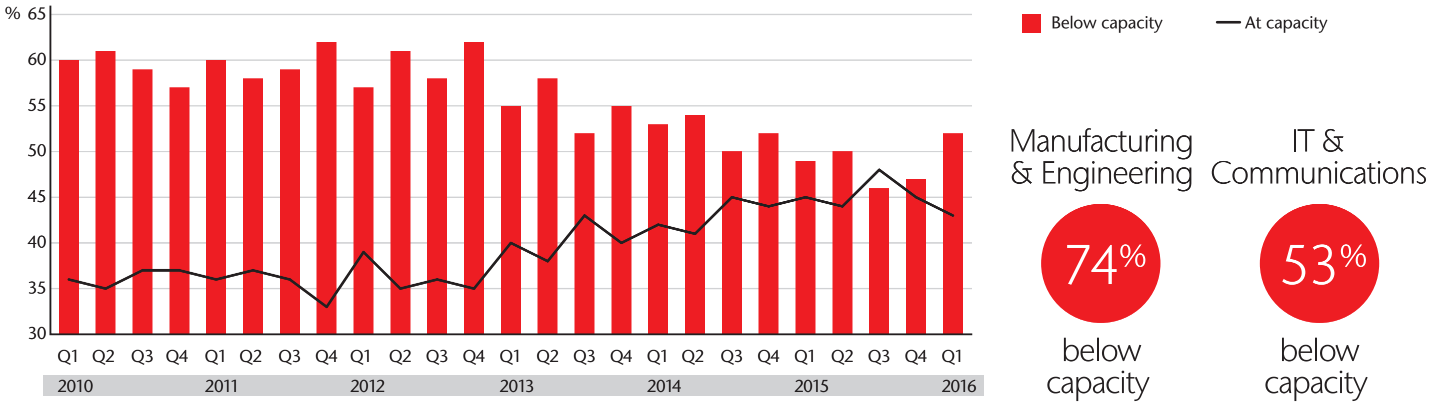
Key highlights

Weaker business confidence and expectations of muted growth in both sales and profits are clearly all feeding through to weaker investment plans. Growth in capital spending has already moderated after a brief surge and is expected to remain low, while Research & Development (R&D) spending is rising only slowly.

Business investment grew strongly in the second half of 2014 and early 2015. Companies reported greater expenditure increases than at any time since the recession. The ONS presented a similar picture, particularly for Q1 2015. On their measure, business investment in that quarter was no less than 9.3% up on a year earlier. However, as 2015 progressed and economic conditions became more worrying, the growth in companies' capital spending slowed – and again the ONS data support that. This deceleration has continued into Q1 2016, with businesses reporting that their capital spending is just 2.3% higher than it was a year earlier, and with only modest rises expected in the 12 months ahead.

The sector with the lowest expectations for capital spending is Manufacturing & Engineering – not surprising given that close to three quarters of manufacturers say that they are operating below capacity. The sector's expectation is for a rise in investment of just 0.5%. The sector is also particularly important in terms of its contribution to R&D spending and although that is growing, it is doing so at rates that are lower than in 2014 and the first half of 2015. Indeed, for the third quarter in a row, companies in Q1 2016 in this sector report an increase in their R&D budgets of only 2%, compared with a year earlier.

Fig. 7 Spare capacity – average % change



More firms are operating below capacity

Key highlights

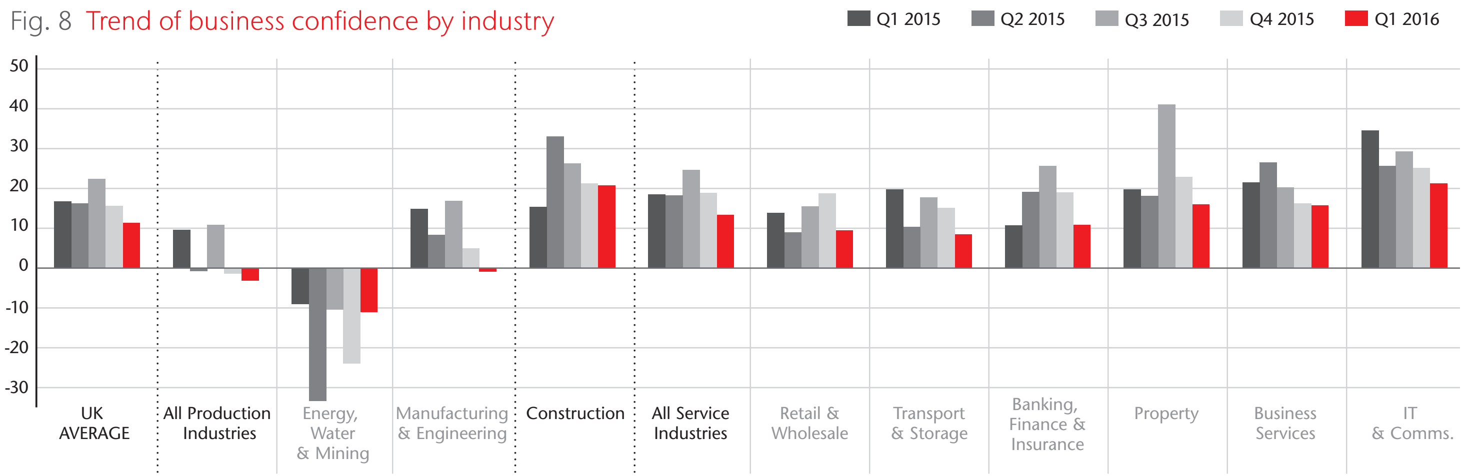
A combination of relatively strong rates of investment in late 2014 and early 2015, and slowdowns in growth in sales and turnover – and consequently investment – in the period since then, has resulted in an increase in the number of firms who say that they are operating below capacity. The Q1 2016 increase is the second in a row – something not seen since 2011.

The degree of spare capacity in the economy is one of the factors that the Bank of England considers in setting interest rates. For the last two years and more, evidence of declining spare capacity has been taken by many commentators as a reason to expect rate rises sooner rather than later. The apparent upturn in the trend in this indicator therefore adds to the reasons for expecting rate increases to be delayed until the closing months of 2016, if not later.

Within the overall total, the 74% of Manufacturing & Engineering companies who report that they are operating with spare capacity is the highest proportion of any sector. This is likely to reflect the sector's poor sales performance during 2015. Retail & Wholesale has the second highest level of spare capacity, which is likely to be the result, at least in part, of the long-term trend away from 'bricks and mortar' retailing and towards online shopping, and the consequent weakening in demand for floorspace. Linked to that, Retail & Wholesale delivered only a marginal 0.6% increase in investment in the year to Q1 2016.

Trends in business confidence INDUSTRY

Fig. 8 Trend of business confidence by industry



Confidence weakens across most sectors, including all service sub-sectors

Key highlights

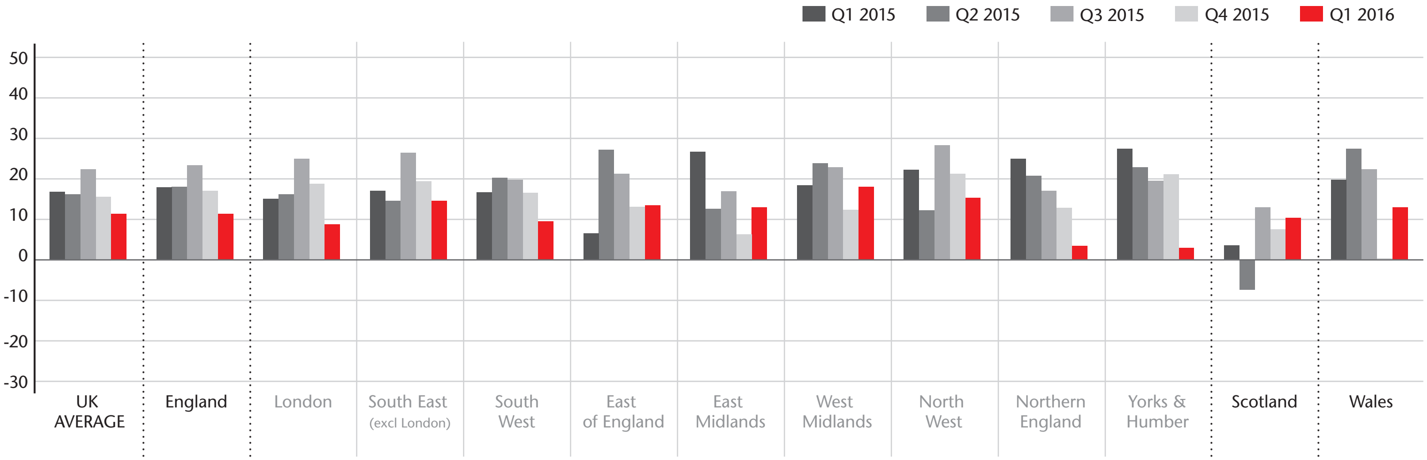
In the Energy, Water & Mining sector confidence has been improving, though still remains firmly negative, reflecting severe problems in the oil sector. Confidence has also weakened in Manufacturing & Engineering (indeed it is very marginally negative) and across all sub-sectors within services.

The problems faced by the oil industry are probably the main reason why the Energy, Water & Mining sector has had negative expectations about business conditions for five quarters in a row. The sector as a whole experienced a rise of just 0.2% in its sales in the year to Q1 2016 and a 2.1% fall in its exports. As a result it cut investment by 1% and employment by 2.6%, with a number of North Sea operators announcing large redundancies.

The sector as a whole predicts further reductions in investment, although employment levels are expected to stabilise. The government recently announced a £250m rescue package for North Sea businesses – rather less than the industry was asking for.

The IT & Communications sector continues to show the strongest confidence, although it has eased off for the second quarter in a row; over the last 12 months IT & Communications has led all other sectors in terms of growth in sales, exports, employment and salaries. It has not, however, been the lead sector in terms of capital investment, trailing behind Banking, Finance & Insurance, Property and Transport & Storage, probably reflecting a marked rise in spare capacity.

Fig. 9 Trend of business confidence by region



Confidence weakens across most regions

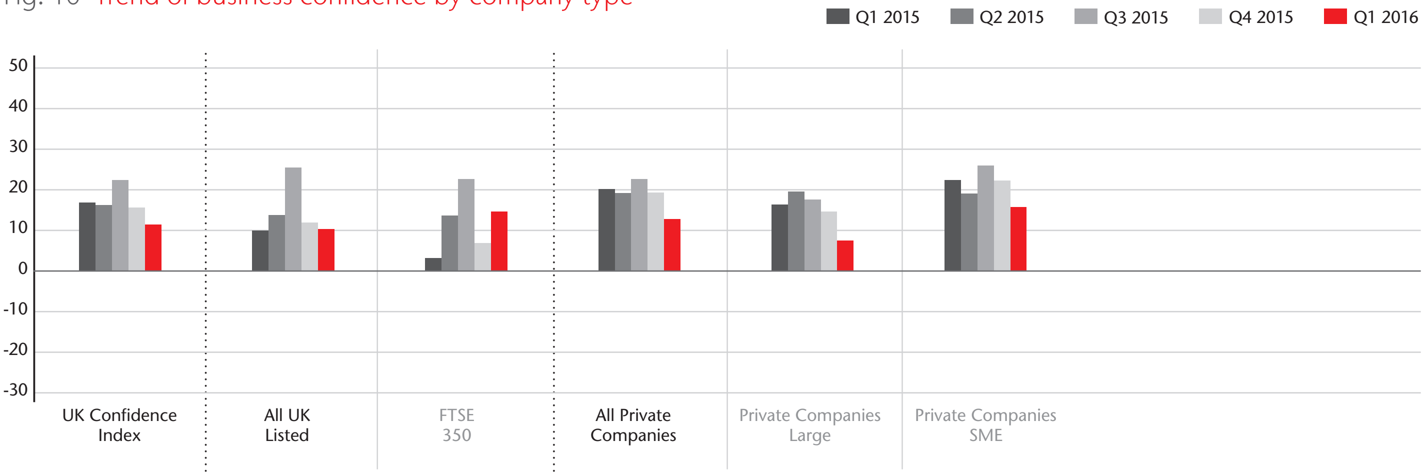
Key highlights

Just as the decline in confidence is widely spread across sectors, so the same is true across regions. London has seen a larger than average fall in confidence since Q1 2015, but so too have England's three northern regions, implying little evidence of any immediate rebalancing of the economy.

In Northern England confidence has fallen particularly sharply and the index for the region is now only marginally positive at 3.5. Data from HM Revenue & Customs indicate that the region is highly reliant on exports, and after two quarters in a row in which export performance was very weak but predictions were for a pick up, companies' expectations have now been revised down in line with experience. In Yorkshire & Humber confidence is even weaker: the index stands at just 3. The region was, of course, one of the worst hit by the very bad weather at the end of 2015 and the beginning of 2016.

In Scotland, confidence has not been displaying the same downward trend as at the UK level, but optimism among businesses remains relatively low. Clearly there are large negative impacts on Scotland's economy from the problems of the North Sea sector, including difficulties for the engineering sector and for suppliers more generally. Partly as a result of these 'knock-on' effects, the Scottish Government's measure of onshore GDP rose by just 0.1% in Q3 2015.

Fig. 10 Trend of business confidence by company type



Confidence rises within FTSE 350 companies, falls in privately-owned firms

Key highlights

FTSE 350 companies report an increase in confidence in Q1 2016 after a rather worrying Q4 2015, and up from the same point a year before. Optimism for privately-owned companies is down on Q1 2015, particularly for larger unquoted businesses.

FTSE 350 companies report a rebound in confidence in Q1 2016 after a particularly troubled Q4 2015. These companies tend to have greater exposure than average to the global economy – this may have been a factor explaining the particularly poor Q4 2015. Increasing awareness that the UK isn't highly vulnerable to problems in China, and to emerging markets generally, alongside the lower pound and the Governor of the Bank of England's dovish remarks on interest rates, may all be factors that help to explain the more recent strengthening in confidence among FTSE 350 companies.

Compared to FTSE 350 businesses, privately-owned companies have seen a more progressive easing of confidence in recent quarters, with the exception that Q1 2016 looks particularly weak for larger firms with 250+ employees. However, their assessments of both their business performance and the challenges that they face remain clearly positive. In particular, their export expectations are stronger than those of either privately-owned SMEs or FTSE 350 companies.

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

Oxford Economics

Oxford Economics is one of the world's foremost advisory firms, providing analysis on 200 countries, 100 industries and 3,000 cities. Their analytical tools provide an unparalleled ability to forecast economic trends and their economic, social and business impact. Headquartered in Oxford, England, with regional centres in London, New York, and Singapore and offices around the world, they employ one of the world's largest teams of macroeconomists and thought leadership specialists.

Kudos Research

Interviewing and data analysis was undertaken by Kudos Research.

Kudos Research specialises in premium quality, custom-tailored UK and international data collection, as well as data analysis and research advisory services. Kudos Research interviews customers, stakeholders, business leaders and opinion formers across the globe, online and by telephone, as well as recruiting them for focus groups and depth interviews.

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UK Economic Forecast

Produced with Oxford Economics, ICAEW's economic partner, this quarterly newsletter provides a forward-looking perspective on how the UK economy is going to develop over the next 12 months.

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