



UK Business Confidence Monitor

Q2 2014

Welcome



The *ICAEW/Grant Thornton Business Confidence Monitor* (BCM) for this quarter confirms the increasing strength of the UK economic recovery. In the 12 months leading up to the next General Election, businesses expect to create almost half a million new jobs. Business expectations continue to improve across all regions and the economy is expected to grow by 1.2% next quarter, finally reaching its pre-recession peak.

In among the good news, there are two issues which could hold back the recovery – the skills gap is widening and exports are still not rising fast enough. The government needs to address both of these quickly otherwise growth could be stifled, creating challenges for whichever party comes into power in May 2015.



Michael D M Izza
Chief Executive
ICAEW



Business leaders are telling us they're currently more enthusiastic about their prospects than they have been in recent years. This optimism is certainly reflected in this quarter's BCM and is translating into tangible actions, as turnover and profit growth continue to accelerate. Moreover, capital investment growth, so crucial to a recovering economy, is holding steady and inflation looks likely to remain modest, which all bode well for the UK economy. There is, however, spare capacity in a number of sectors which shows how much further the recovery can go.

The skills shortage identified in this quarter's BCM is set to pose a unique challenge. If left unaddressed, this could severely hamper growth in the mid- to longer-term. Despite the significant estimate on job creation over the next year, the trick will really be to ensure that those now entering the workforce are adequately equipped to take on these new opportunities.



Scott Barnes
Chief Executive Officer
Grant Thornton

Economist's view



The latest *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) shows that business confidence remains at a record-high level in Q2 2014, standing at +37.3, broadly unchanged from the reading for Q1 2014. Confidence is stabilising at a high level after rising for six consecutive quarters, pointing to continued solid economic prospects this year.

The Confidence Index is a leading indicator for growth, and this quarter's reading suggests that the UK economy will show robust expansion in Q2 2014, with GDP rising by 1.2% over the quarter, up from the 0.8% quarter on quarter growth seen in Q1.

KEY ISSUES EMERGING THIS QUARTER

- Business Confidence remains at its highest ever recorded level in Q2 2014.
- Turnover and profit growth continue to accelerate, with faster growth expected ahead.
- Businesses expect domestic sales to be the key driver of growth over the next 12 months, rather than exports.
- Expected employment growth has accelerated, with jobs for a further 450,000 private sector employees expected to be created over the next 12 months.
- Alongside improving labour market conditions, salary growth is now keeping pace with inflation, supporting living standards.

The latest BCM suggests that the Chancellor will hold a good hand of cards ahead of the next election. Weaknesses in the economy lie more in the details than in the headline numbers, and the Chancellor will be hoping that these don't become a problem until after the next election. Exporting businesses are less confident in economic prospects than other businesses, suggesting that, despite Budget measures to encourage exports, more needs to be done to secure a trade-led recovery. Skills shortages also appear to be a growing issue in some sectors such as Construction, which could hold back their ability to expand in the future.

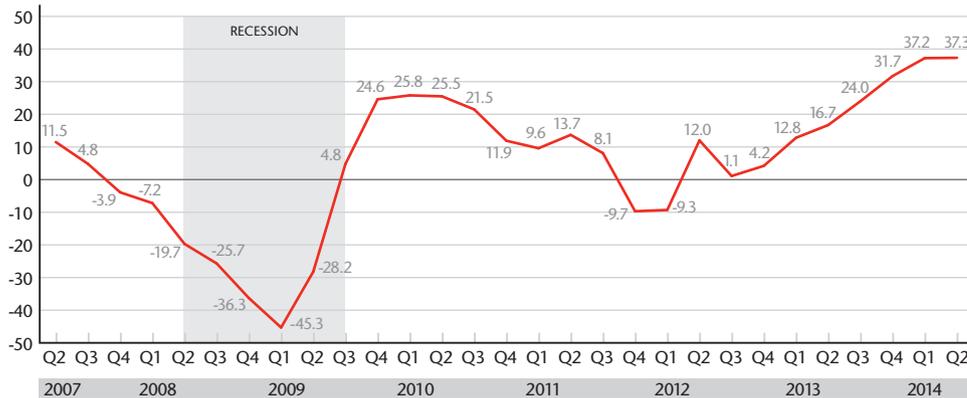
Slack in the economy remains high for now – over half of businesses are operating below capacity – which suggests that the Bank of England has little reason to raise interest rates this year. By 2015, however, solid growth could eliminate this slack, paving the way for a first rate rise in six years.



Douglas McWilliams
Chief Executive, Cebr
ICAEW Economic Partner

Business confidence in Q2 2014

FIG. 1 TREND OF UK BUSINESS CONFIDENCE

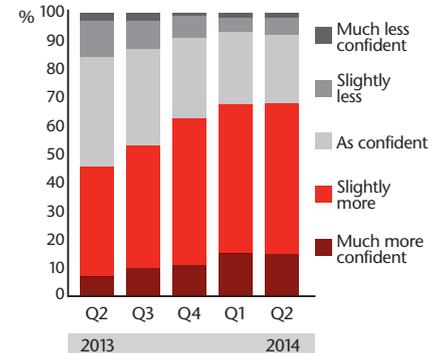


The latest ICAEW/Grant Thornton UK Business Confidence Monitor (BCM) shows business confidence holding steady at a record high level. The Confidence Index for Q2 2014 stayed stable, rising marginally to +37.3 from +37.2 the previous quarter and standing well above the reading of +16.7 at the same point a year ago.

CONFIDENCE REMAINS AT RECORD HIGH

The steadiness of this quarter's UK business confidence follows six consecutive quarterly increases, up from the +1.1 seen in Q3 2012, highlighting the extent to which business conditions have strengthened over the past two years. With optimism continuing at the highest level recorded since BCM began, this suggests that the private sector is expecting the economic environment to keep on improving over the next year. Almost seven out of ten businesses (69%) are more confident about their economic prospects for the year ahead than the previous

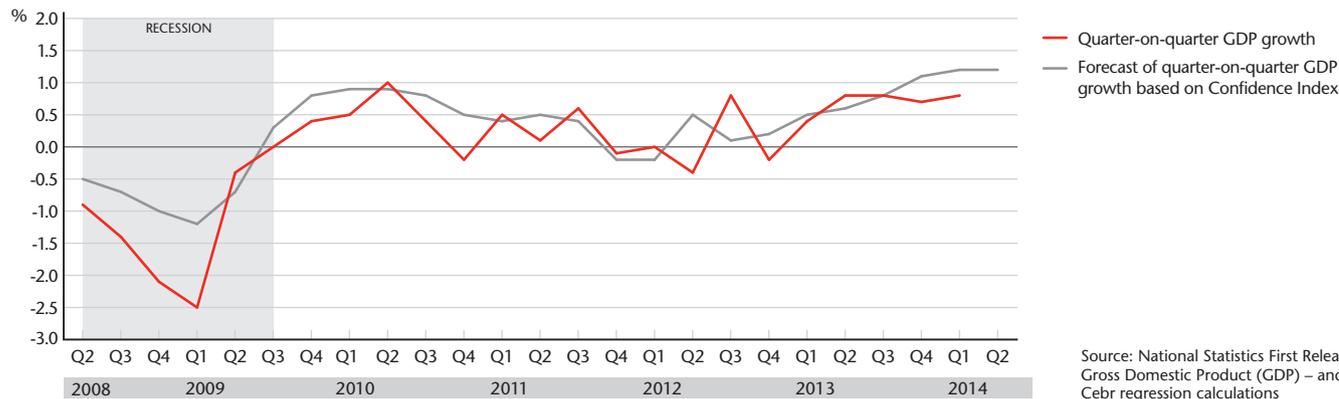
FIG. 2 UK CONFIDENCE INDEX – DETAILED RESPONSES



12 months. This is a minor increase from the 68% reporting the same in Q1 2014 but well up from the 46% in Q2 2013.

In April, the International Monetary Fund (IMF) upwardly revised its forecast for UK output growth in 2014 to 2.9%, from a previous estimate of 2.4%. If realised, this expansion would mark the UK as the fastest-growing economy in the G7, and these latest BCM results suggest that such a buoyant increase is looking increasingly likely.

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 UK economy is now expanding year on year at its fastest rate since the end of 2007. The first estimate from the Office for National Statistics (ONS) showed that GDP was 3.1% higher in Q1 2014 than at the same point a year before. This is the fastest annual growth since the 3.7% seen in Q4 2007, just before the economy starting tipping sharply into recession.

BCM INDICATES ROBUST GROWTH AHEAD

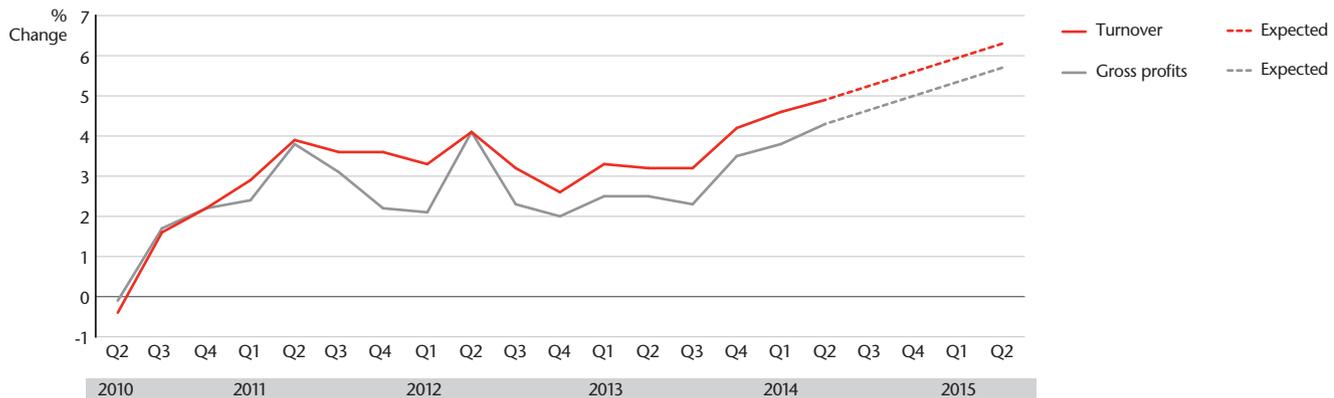
The latest Confidence Index results suggest that solid economic growth will continue into Q2 2014, with an Index of +37.3 consistent with a quarterly increase of 1.2%. This is up from the 0.8% quarter-on-quarter growth recorded in Q1 2014 and leaves the level of UK economic output at 3.6%, above its level a year before and back to its pre-financial crisis peak.

Furthermore, recent data from the ONS point to an encouragingly

broad-based recovery emerging. While the Services sector continues to steadily expand, the first estimates for Q1 GDP show rapid year-on-year growth of 5.1% in the Construction sector. Furthermore, output in the Production industries grew year on year at its fastest rate since the end of 2010. This represents a sharp turnaround from the contractions seen in those two sectors during 2013, and suggests that they are now contributing to growth, rather than being a hindrance to recovery.

Business Financial Performance

FIG. 4 AVERAGE % CHANGE OVER 12 MONTHS TO ...



Alongside buoyant confidence levels, business financial performance indicators continue to strengthen. This quarter, turnover rose year on year by 4.9% on average, while gross profits increased by 4.3%. These are both the fastest growth rates reported since 2008.

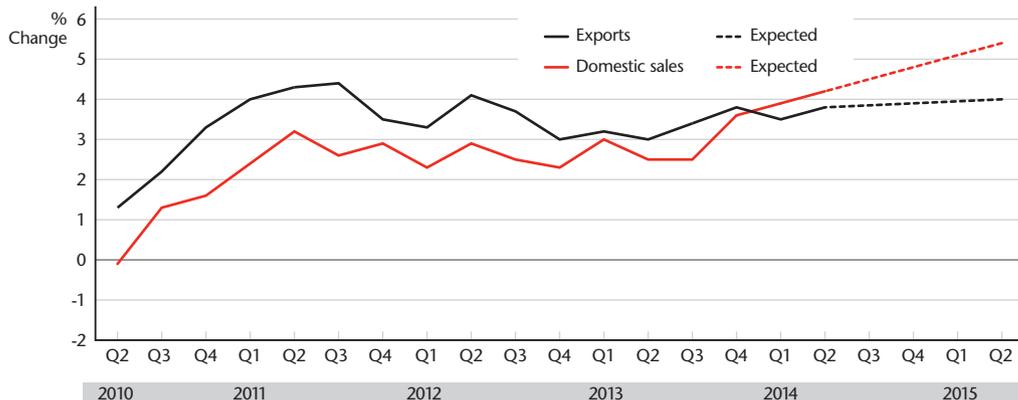
BUSINESS GROWTH TO ACCELERATE FURTHER

In addition to the improving performance over the past year, companies this quarter expect faster business growth ahead, in line with their optimism for the next 12 months. Turnover is projected to rise over the next 12 months by 6.3%, while increases in gross profits are expected to pick up to 5.7% annual growth. Profitability over the next year is expected to be supported by a continued benign outlook for inflation in business input costs, as the IMF predicts that the price of global commodities such as crude oil will fall

back through 2014. Businesses have been reporting input costs rising gently in recent quarters (1.7% over the past year), a trend that is expected to continue for the coming 12 months.

This continued improvement in key financial indicators comes alongside other signs that business conditions are easing in the UK. This quarter, fewer than one in three companies are reporting that customer demand is a greater challenge than a year ago, down on Q2 2013 when this figure was 41%.

FIG. 5 AVERAGE % CHANGE OVER 12 MONTHS TO ...

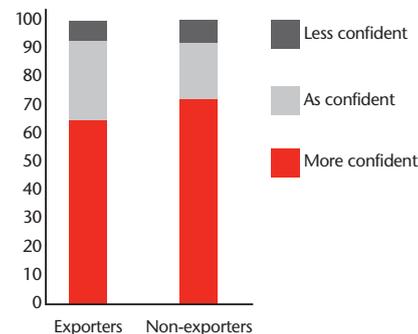


UK sales performance is strengthening, but this is being supported largely by domestic demand. This quarter, businesses are reporting year-on-year growth in domestic sales of 4.2%, up from 2.5% in Q2 2013. At the same time, export growth is accelerating less rapidly, with exports increasing year on year by 3.8%, compared to 3.0% growth at the same point a year ago.

GAP BETWEEN DOMESTIC AND EXPORT DEMAND WIDENS

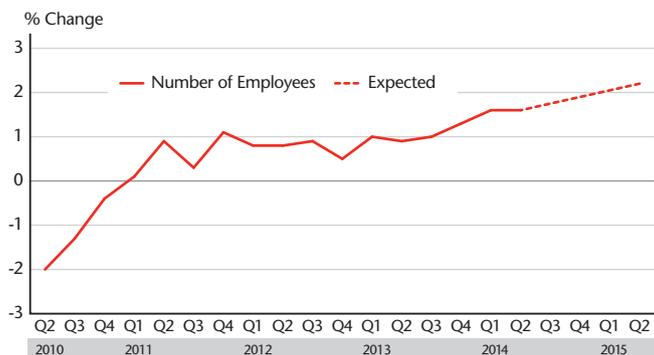
The latest performance figures indicate that the gap between export and domestic sales growth is widening. This trend is likely to continue over the next year, as export growth is expected to remain steady, while domestic sales growth is projected to accelerate to 5.4%. These projections reflect weaker confidence levels among exporters this quarter; just under two thirds of exporters are more confident about their prospects for the year ahead than the past year, compared to 73% of non-exporters.

FIG. 6 UK CONFIDENCE FOR EXPORTERS AND NON-EXPORTERS



The latest BCM results highlight one of the points of weakness facing the UK recovery: the trade deficit. Export prospects are lacklustre, as the UK's key trading partner, the eurozone, is only just emerging from recession. This, combined with rising import demand as consumers start to see real wage growth, suggests that the trade deficit is likely to widen over 2014 as a whole, weighing down on economic expansion.

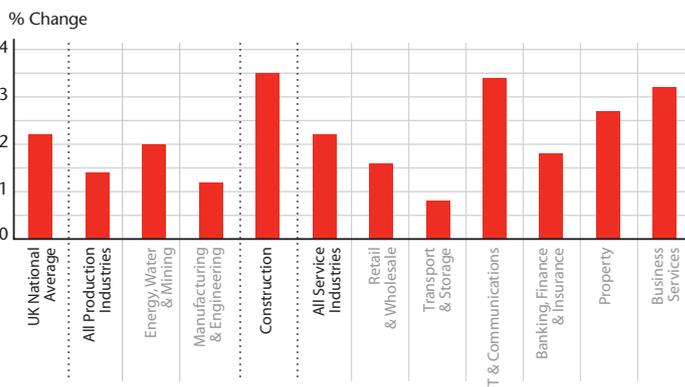
FIG. 7 AVERAGE % CHANGE OVER 12 MONTHS TO ...



Private sector hiring intentions are on the rise in the UK.

This quarter, businesses report increasing their number of employees by 1.6%, up from year-on-year workforce growth of 0.9% in the same quarter a year ago. This is projected to rise to 2.2% growth over the coming 12 months, an increase, if realised, that could provide jobs for a further 450,000 private sector employees.

FIG. 8 AVERAGE % CHANGE EXPECTED IN THE NEXT 12 MONTHS – BY SECTOR



LABOUR MARKET TO STRENGTHEN FURTHER

With private sector hiring on the up, the unemployment rate dropped to 6.9% in the three months to February 2014, and is likely to fall further in the coming months.

Particularly fast employment growth is expected to come over the next 12 months from the Construction industry at 3.5%, closely followed by IT & Communications and Business Services, at 3.4% and 3.2% respectively. However, an improving labour market is posing a problem for businesses, as 19% of companies report this quarter that staff turnover

is a greater challenge than a year ago, up from 13% in Q2 2013.

At the same time, with workers in greater demand, wage growth is being pushed up. This quarter, businesses have increased average total salaries by 1.9% year on year, and anticipate a 2.2% rise over the coming 12 months. The Office for Budget Responsibility forecasts consumer price inflation of 1.9% for 2014 and as such, the latest BCM results reinforce the view that real wage growth is returning as earnings start to grow faster than prices.

FIG. 9 SKILLS AS A GREATER CHALLENGE – BY SECTOR



In addition to staff turnover, the availability of workers with the appropriate skills is also becoming a challenge for more businesses. This quarter, 15% of companies report that finding the right management skills is a greater challenge than a year ago, and 16% report the same for non-management skills. These shares have been generally climbing, up from 11% and 10% at the same point in 2013.

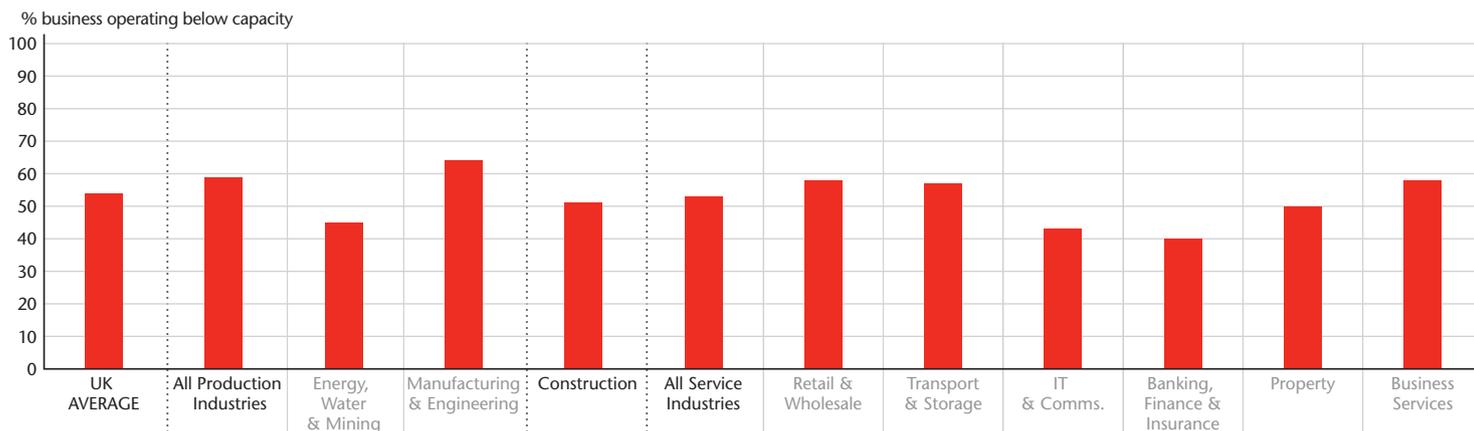
SKILLS SHORTAGE A RISK TO RECOVERY

As the labour market strengthens further, it is likely that more businesses will be reporting skills shortages. This is a factor that may hold back their ability to expand – a key risk to sustained economic recovery. This is a marked contrast from the lack of customer demand that held back UK expansion for much of the period since the 2008–09 downturn.

Although there are still more than 2.2m unemployed in the UK, a potentially large pool of labour from which to draw, more than 800,000 of

these have been out of work for more than a year and hence may have seen their skills deteriorate. A lack of workers with the right expertise is highlighted by the Production and Construction industries, where this quarter roughly 25% and 19% respectively find that the availability of workers with non-management skills is more of a challenge than a year before. Provision of the right skills that businesses demand is critical to long-term sustainable growth.

FIG. 10 INDUSTRIES OPERATING BELOW CAPACITY



The level of spare capacity in the UK economy continues to generally go down as, this quarter, over half (54%) of businesses report operating below full capacity. This latest reading follows a general downward path from 58% at the same point a year before, although remains above levels seen before the economic downturn. Only 5% of businesses report operating above full capacity.

MUCH SPARE CAPACITY REMAINS IN MANUFACTURING

Almost two thirds of businesses (64%) in the Manufacturing & Engineering sector are operating below capacity. This reflects the latest figures from the ONS that show manufacturing output in Q1 2014 remaining 8.3% below its pre-financial crisis peak. However, growth in the sector is picking up – a trend that may be expected to continue, unless hampered by the lack of technical skills.

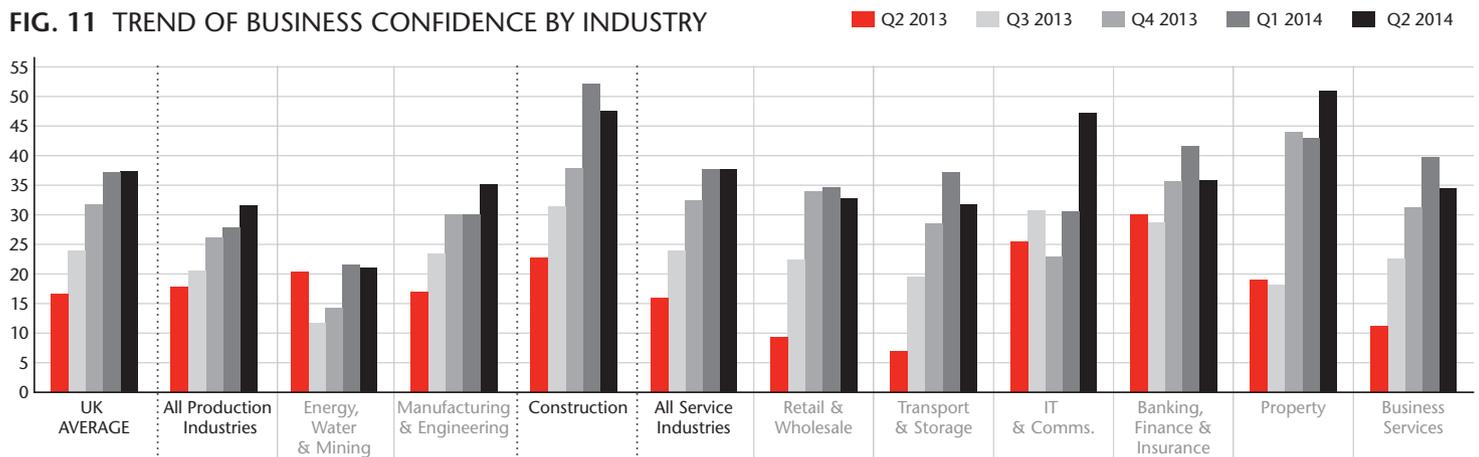
However, at the other end of the scale, just 43% of businesses in the IT & Communications sector report being under capacity, down from

54% in Q2 2013. These findings are in line with continued expansion seen in the sector – according to the ONS, output in computer consultancy activities in early 2014 stood at its highest level ever.

The BoE's latest forward guidance policy states that monetary policy will only start to be tightened once spare capacity is reduced. The latest BCM results highlight the amount of slack remaining in the economy, but the strong growth predicted this year could pave the way for a Bank rate rise in early 2015.

Trends in business confidence – industry

FIG. 11 TREND OF BUSINESS CONFIDENCE BY INDUSTRY



Confidence remains well up on a year before across all industries. Optimism continues to stand near record highs in the Construction sector and maintains an upward trajectory in the Production industries, starting to reach the level of confidence among firms in the Services sector.

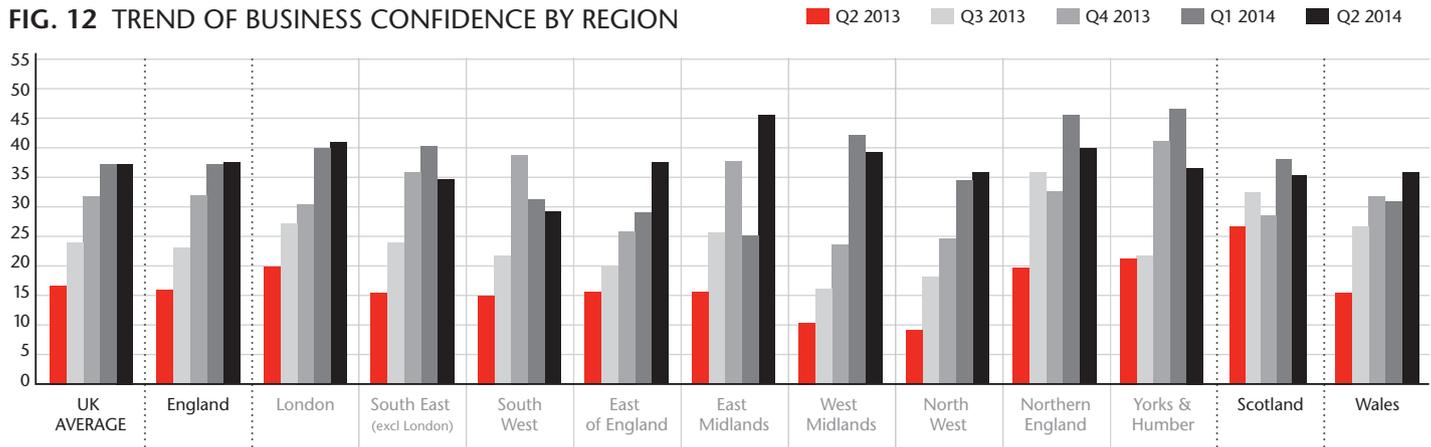
ALL INDUSTRIES LOOK SET TO EXPAND

Confidence in the Manufacturing & Engineering sector has been steadily climbing in recent quarters, with an Index reading of +35.1 in Q2 2014, up from +17.0 at the same point a year before. This latest movement helps to close the gap with confidence reported by businesses in the Services sector, and is reflected in investment intentions for the sector. Manufacturers expect to increase capital investment over the coming 12 months by 3.0%, up from 2.0% over the past 12 months. This compares to the Construction and the Services sectors, which expect to hold investment growth steady.

Although confidence in the Construction sector slipped marginally in Q2 2014 compared to the last quarter – potentially due to high rainfall earlier in the year hampering activity – the Index reading for the sector remains well ahead of the same period a year before, suggesting a strong year ahead. Housebuilding activity has shown strong year-on-year growth in recent months, as the housing market has recovered strongly – this trend is likely to continue through 2014.

Trends in business confidence – region

FIG. 12 TREND OF BUSINESS CONFIDENCE BY REGION



Confidence has been generally going up among many of the UK's regions over the past year. Year-on-year confidence has strengthened the most in the Midlands and the North West, while the South West and Yorkshire & Humberside have seen a weaker increase.

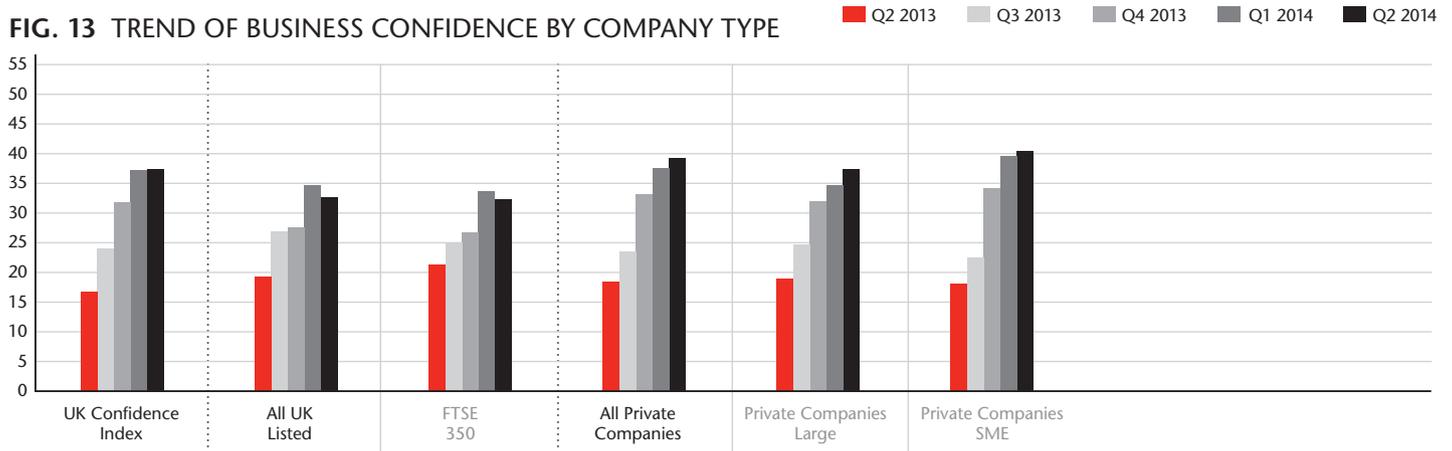
CONFIDENCE HIGHER THAN A YEAR AGO ACROSS UK

The sharp year-on-year uptick in business confidence across the Midlands and in the North West comes alongside a steady rise in optimism among manufacturing firms, which make up a large share of the local economies. With UK manufacturing companies expecting to see strong growth in the year ahead, these regions look set to benefit from recovery in this sector. Confidence meanwhile remained strong in London this quarter, with an Index reading of 40.9, only marginally up on the 40.0 seen in Q1 2014.

Confidence in the South West has declined now for two consecutive quarters. This may be due in part to the difficult weather conditions and flooding faced in the region early in 2014, as well as the resulting closure of the main rail link with the rest of the country. Reported sales and profit growth has also gone down in the region since the end of 2013. However, an uptick in these financial performance indicators is expected for the year ahead, suggesting that problems may have now been overcome.

Trends in business confidence – type

FIG. 13 TREND OF BUSINESS CONFIDENCE BY COMPANY TYPE



Confidence has increased across all firm types over the past 12 months. However, the strengthening of optimism has been sharper at private companies than at listed firms. At FTSE 350 listed UK firms, the Confidence Index increased by 11.1 points year on year to reach +32.3 this quarter, compared to a rise of 22.3 points to +40.4 among small and medium-sized privately-held companies.

SMEs TO FUEL JOB CREATION OVER NEXT YEAR

In line with a sharp uptick in confidence for prospects over the next 12 months, private firms are looking to increase staffing levels. Over the next year, small- and medium-sized private companies plan to increase their headcounts by 3.0%, while FTSE 350 listed firms are projecting an increase of just 1.1%.

However, listed firms are rapidly increasing their investment in the UK. Over the past year, FTSE 350 firms report growing capital investment by 3.7%, compared to just 2.0% for private companies. Likewise, research

and development budgets increased year on year by 3.1% for FTSE 350 companies, compared to 2.4% among private companies. While these findings may illustrate a greater desire to invest among listed corporations, they might also indicate difficulties in financing for private firms. This reflects the latest BoE *Credit Conditions Survey*, which showed in Q1 2014 that credit availability improved markedly for large corporates, but only improved slightly for small firms, and remained unchanged for medium-sized 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

Cebr

Centre for economics and business research Ltd is an independent consultancy with a reputation for sound business advice based on thorough and insightful research. Since 1992, Cebr has been at the forefront of business and public interest research. They provide analysis, forecasts and strategic advice to major UK and multinational companies, financial institutions, government departments and agencies and trade bodies. For further information about Cebr please visit www.cebr.com

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.

Grant Thornton UK LLP

Dynamic organisations know they need to apply both reason and instinct to decision-making. At Grant Thornton, this is how we advise our clients every day. We combine award-winning technical expertise with the intuition, insight and confidence gained from our extensive sector experience and a deeper understanding of our clients.

In the UK, we are led by more than 200 partners and employ nearly 4,500 of the profession's brightest minds, operating from 27 offices. We provide assurance, tax and specialist advisory services to over 40,000 privately-held businesses, public interest entities and individuals nationwide.

We are the UK member firm of Grant Thornton International Ltd, one of the world's leading organisations of independent assurance, tax and advisory firms. With over 35,000 Grant Thornton people, across 120 countries, all focused on making a difference to clients, colleagues and the communities in which we live and work.

ICAEW is a world leading professional membership organisation that promotes, develops and supports over 142,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

As leaders in accountancy, finance and business our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. Together we contribute to the success of individuals, organisations, communities and economies around the world.

Because of us, people can do business with confidence.

ICAEW is a founder member of Chartered Accountants Worldwide and the Global Accounting Alliance.

www.charteredaccountantsworldwide.com

www.globalaccountingalliance.com

ICAEW

Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK

T +44 (0)20 7920 3508

E bcm@icaew.com

icaew.com/bcm

 [linkedin.com](https://www.linkedin.com/company/icaew) – find ICAEW

 twitter.com/icaew

 [facebook.com/icaew](https://www.facebook.com/icaew)

