ICAEW

Grant Thornton
An instinct for growth™

UK Business Confidence Monitor

Q2 2015

Welcome

This quarter's *ICAEW/Grant Thornton Business Confidence Monitor* shows that business confidence is flat for this quarter, following three consecutive quarters where it has fallen. The prolonged period of political and economic uncertainty around the general election campaign had a material impact on businesses, with investment, hiring, wage increases and exports all on pause. However, with a clear majority, the new government now has the opportunity to move quickly.

The gap between our exports and domestic demand is widening even more, and it is crucial that we look to boost our exports both inside and outside the EU. Businesses need to think globally from the start, and we need to make it easier for them to trade internationally. But the spectre of a referendum on our membership of the EU looms ever closer. The Prime Minister has a mandate to negotiate the UK's relationship with the EU, before holding a referendum in 2017. However, we risk being effectively closed to inward investment over the next two years, which would be of great concern for jobs and growth. We feel that the Prime Minister should put the referendum to the British people as soon as is practically possible.

Michael Izza

Michael D M Izza
Chief Executive
ICAEW

With business confidence levels stagnating, the new government has the opportunity to focus its efforts on making British business the powerhouse it can be. To do so, it needs to engage with business and ensure the voice of its critical mid-market companies is heard. This must include help in exporting and talent generation – areas we know British businesses want the government's support and which could unlock significant growth across the economy.

A priority for the government must be to negotiate a package of reforms to our relationship with the EU to bring to the country and this must be done in a manner which is measured, constructive and reflects the needs of business. A rush to referendum without informed debate would doubtless introduce greater volatility in the markets. While it's understandable that business confidence stagnated in the run up to the election, we would expect that with a clear roadmap on Europe, skills and reducing regulation that business confidence will again improve.

Sacha Romanovitch

Sacha Romanovitch
CEO-elect
Grant Thornton UK LLP

Economist's view

The latest *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) shows that business confidence remains broadly steady in Q2 2015, standing at +16.2. Although this is well down from the record highs in 2014, the reading continues to stand firmly in positive territory. As such, this quarter's result suggests that firms have been adopting a 'wait and see' approach to sources of uncertainty, including the new government's attitude to business and the possibility of an EU referendum.

The Confidence Index is a leading indicator for growth, and this quarter's reading points to steady economic expansion in Q2 2015, after the slowdown seen in Q1. Looking to the rest of the year, other indicators suggest a slight softening of conditions will occur over the next 12 months. In addition, BCM suggests economic growth is becoming more unbalanced and dependent on consumer spending.

KEY ISSUES EMERGING THIS QUARTER

- Business confidence remains broadly unchanged in Q2 2015, staying well into positive territory.
- This headline masks a mixed picture. The Service sector is holding steady and construction firms anticipate a strong year ahead, but manufacturers are becoming more pessimistic.
- Growth in turnover and profit is expected to slow marginally in the year ahead.
- Business performance is increasingly dependent on domestic consumers, as export growth falls back further.
- Uncertainty over the economic outlook can be seen in further deceleration of capital investment growth.
- Continued private sector job creation has helped to bring the unemployment rate back toward pre-crisis lows. However, this trend looks to be slowing, with businesses expecting slower employment growth over the year ahead.
- Average salary growth appears to have plateaued at just over the 2% mark. Although a tighter labour market should be pushing up wage growth, inflation dropping to zero appears to be exerting pressure in the opposite direction.

Overall, the latest BCM results suggest a slower-but-steady outlook for 2015, with businesses holding off investment plans until the political environment has settled down. Although consumer spending supported by zero inflation is positive for the short term, this reliance on domestic demand will become more of a concern in the coming years unless business investment and export growth pick up.

Scott Corfe
Associate Director, Cebr
ICAEW Economic Partner

Business confidence in Q2 2015

FIG. 1 TREND OF UK BUSINESS CONFIDENCE

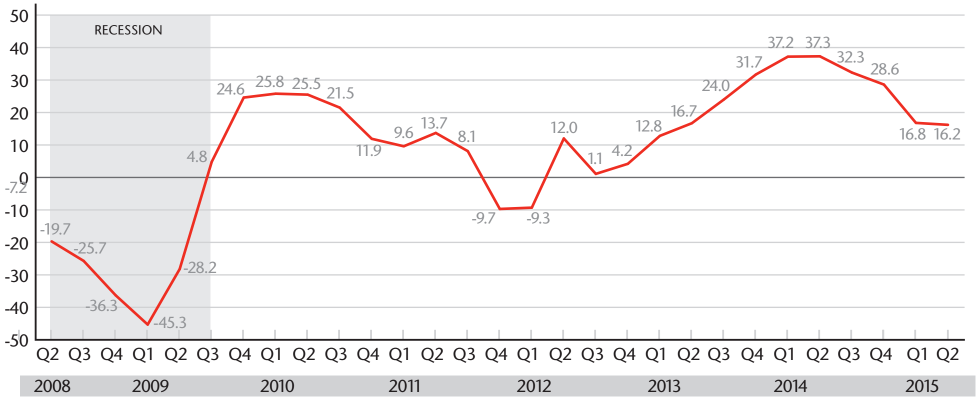
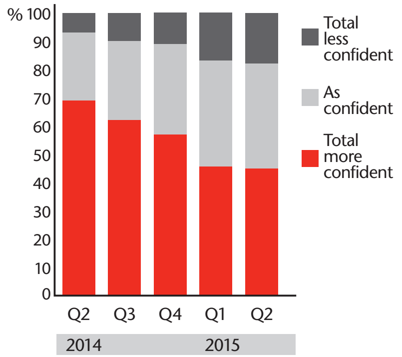


FIG. 2 UK CONFIDENCE INDEX – DETAILED RESPONSES



The latest *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) showed optimism broadly stabilising in Q2 2015, after falling sharply for the previous three quarters. The Confidence Index now stands at +16.2, down from the record high of +37.3 at the same time a year ago, but remaining firmly in positive territory.

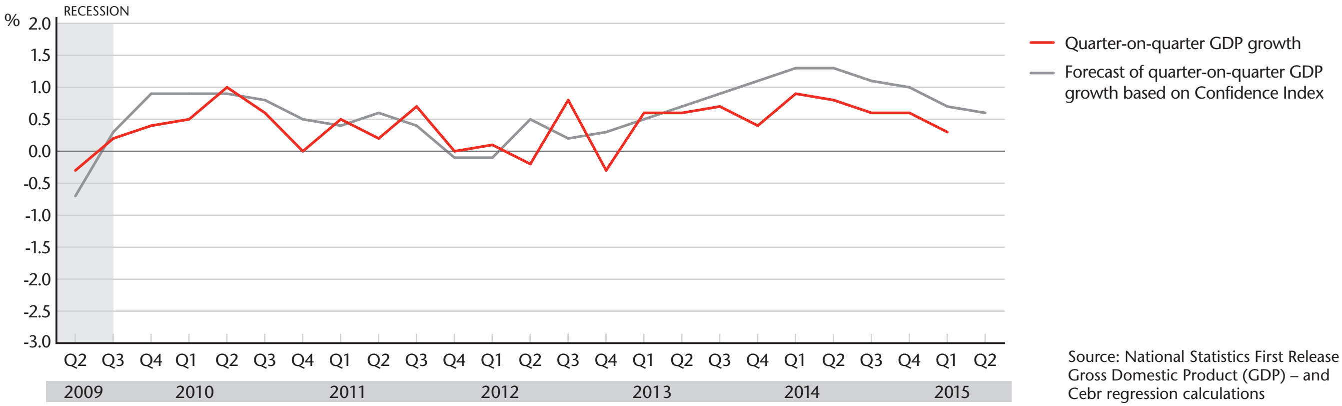
CONFIDENCE STABILISES AS BUSINESSES ADOPT 'HOLDING PATTERN'

After falling back for three consecutive quarters, business optimism levels stabilised in Q2. Looking within the headline result, the proportions of businesses expecting conditions to improve, worsen or remain the same all stood largely on hold compared to the previous quarter. This highlights the across-the-board 'holding pattern' which firms appear to have adopted ahead of several political uncertainties.

The UK general election is likely to be one factor that weighed on business leaders' minds this quarter, with much uncertainty prevailing over the stance towards private sector enterprise that the different potential governments could have taken. In addition, concerns over a British exit from the EU or a Greek exit from the eurozone create further uncertainty. Recent research from Grant Thornton suggests that nearly three quarters of UK businesses (72%) believe that a 'Brexit' would have a negative economic impact on the EU.

However, despite these uncertainties creeping into the outlook, confidence is relatively solid and suggests that the business environment in 2015 will remain buoyant.

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 first estimate of UK GDP growth for Q1 2015 showed a notable slowdown for the start of the year. Output was just 0.3% higher than in Q4 2014, well below the 0.6% rate of expansion in the previous two quarters, and the slowest rate since the contraction seen at the end of 2012. The service sector continues to provide the largest contribution to growth, while output in the Manufacturing sector is struggling to rise.

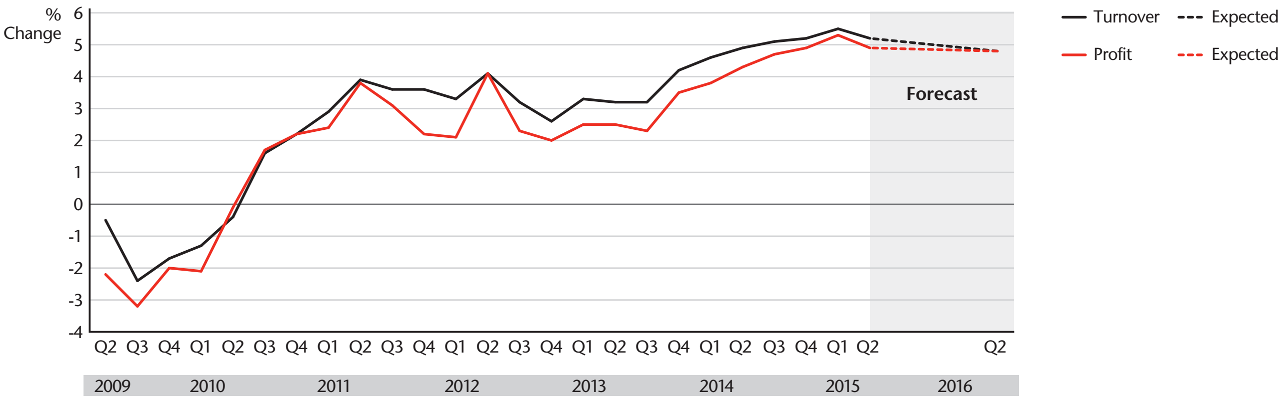
CONSUMER SPENDING TO SUPPORT UK ECONOMY IN 2015

Despite this weakness in the first quarter, economic expansion across the year as a whole is likely to remain relatively buoyant, if slower than the rapid 2.8% output increase seen in 2014. Consumers and households are expected to provide the greatest contribution to growth this year, as the falling cost of many essential items including food, home gas and petrol provides a significant boost to spending power. Although nominal wage rises remain well below pre-financial crisis averages, the fact that inflation stands at zero means that all of this increase is passed through into higher real incomes.

While the consumer sector is projected to give a strong performance this year, constraints on growth are expected to come from public sector spending cuts and from the trade balance, as exports to the eurozone remain sluggish. Private sector investment is also likely to hold back overall expansion, as businesses hold off capital spending plans for now.

Business financial performance

FIG. 4 TURNOVER AND PROFIT – AVERAGE % CHANGE



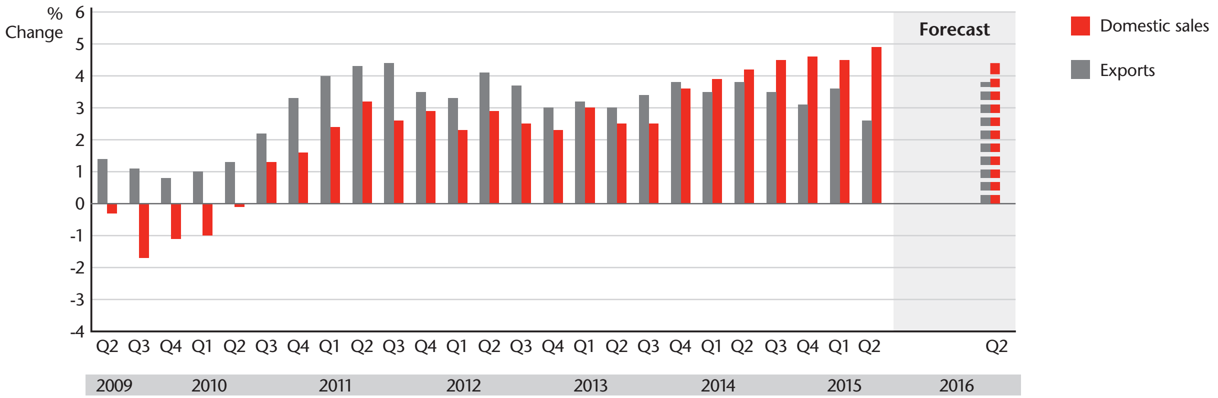
Business profit and turnover growth both fell back this quarter from Q1 2015, when the fastest rates since the financial crisis were achieved. In addition, businesses expect both of these metrics to grow more slowly over the next 12 months than they did over the past year – the first time that this has been the case since the economy was in recession in 2009.

TURNOVER AND PROFIT EXPECTATIONS SOFTEN

Although business confidence remains relatively buoyant, turnover and profit growth are now projected to slow during the next 12 months. These latest findings are in line with other forecasts which suggest that the growth seen in 2014 is unlikely to be surpassed in the medium term. The Office of Budget Responsibility (OBR), for instance, expects GDP to rise by 2.5% in 2015 and projects slower increases for the following years.

These results also highlight how the sharp decline in the cost of inputs, such as crude oil, have not supported growth in profitability. This is likely due to the fact that roughly four fifths of the UK economy is comprised of service sector firms. For many of these, labour and property will make up a significant share of their costs and will be unaffected by the cheaper cost of fuel. However, one sector where the falling oil price may be boosting bottom lines is in manufacturing, where profit growth is higher this quarter than in Q2 2014, while turnover growth has remained broadly similar.

FIG. 5 DOMESTIC SALES AND EXPORTS – AVERAGE % CHANGE



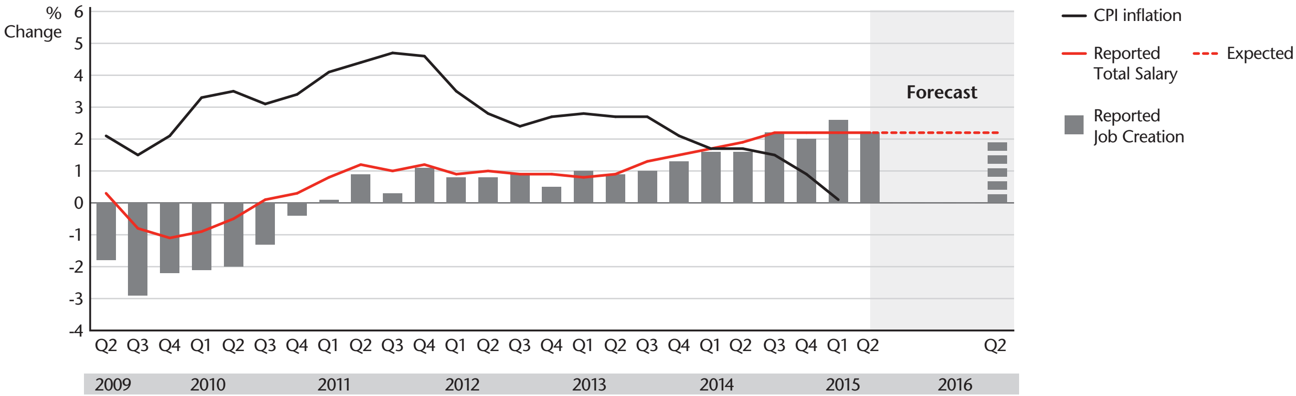
Export sales growth continued to slide back this quarter to just 2.6% over the past year. This is well down from the growth rates seen during 2014 and is now at the slowest pace since Q3 2010. The UK continues to send roughly half of its goods exports to the eurozone, and as such sluggish expansion in the single currency bloc is likely weighing on the growth of overseas sales.

UK INCREASINGLY RELIANT ON DOMESTIC DEMAND

At the same time as this softening of overseas sales conditions, domestic demand has held up robustly, with sales rising by 4.9% over the past year. This is the fastest rate of growth since Q2 2008, and reflects the boosts to UK household spending power achieved from the rapid unemployment declines in recent months and from inflation dropping to zero.

This strong domestic consumer performance is encouraging for the short term, providing the shot in the arm required at a time when other sources of demand are more fragile. However, an over-reliance on household spending over the medium to longer term would risk bringing volatility into the growth outlook, as the lack of diversity in the sources of growth leaves the economy exposed to domestic shocks. Nevertheless, business expectations suggest that export performance will pick up again over the next 12 months, a trend that, if realised, would help to spread the risk.

FIG. 6 AVERAGE % CHANGE OVER 12 MONTHS TO …



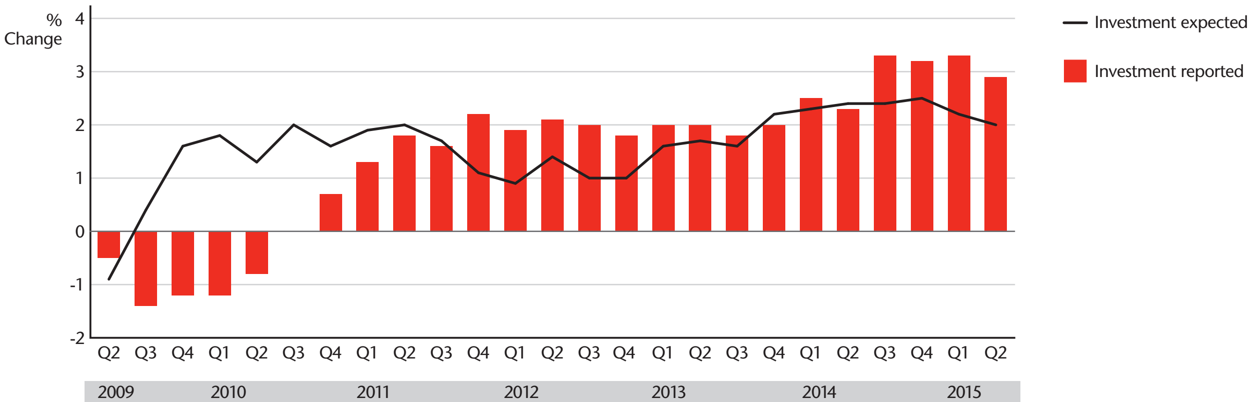
Private sector job creation is now falling back from the peak rate of annual growth reached last quarter. Sustained employment growth has helped to bring the UK unemployment rate down to just 5.6% in the three months to February 2015, a rate close to those seen before the financial crisis. With the tightening labour market and ongoing skills shortages, businesses expect to slow headcount growth over the year ahead.

LARGEST REAL WAGE GAINS IN A DECADE THANKS TO 'NO-FLATION'

Businesses have reported keeping year-on-year wage growth steady at 2.2% for four consecutive quarters. Despite this plateau, workers are seeing the fastest growth in 10 years in their real earnings. Consumer price inflation became 'no-flation' after dropping to zero in February and March, meaning that the full gain in cash terms is passed through into higher spending power. This boost is likely to continue over the next 12 months, as businesses project further average wage gains of 2.2% ahead, while inflation is likely to remain weak, at 0.2% across 2015 as a whole according to the latest OBR forecasts.

Falling unemployment and rising real wages are both factors currently supporting domestic demand. However, some fragility remains in the labour market despite the positive headline numbers, as many people working part time continue to do so only because they can't find a full-time placement. More rapid declines in this measure of underemployment are likely during 2015 as the headline unemployment rate reaches its pre-crisis average.

FIG. 7 INVESTMENT – AVERAGE % CHANGE



Companies have been reporting a slowdown in capital investment growth over the past three quarters. Although investment is still relatively strong, this trend reflects some nervousness about the current political uncertainty, with firms holding off their capital spending plans until the outlook clears. As such, investment intentions for the year ahead have also been falling back in recent quarters.

UNCERTAINTY SHOWS THROUGH IN INVESTMENT INTENTIONS

Businesses are expecting to increase their capital investment by 2% over the next year, down from previous predictions and the growth of 2.9% seen for the past 12 months. This finding highlights one risk to the growth outlook for 2015: the OBR's GDP growth forecast of 2.5% for the year is dependent on business investment growth of 5.1%, which may be difficult to achieve.

Within the overall figures, the Manufacturing sector stands out as having particularly weak investment intentions, projecting just 0.4% growth compared to 2.4% across the service sector. As output in the sector is still some 5% below its pre-crisis peak at the start of 2008 and is currently struggling to grow, no additional investment is required to meet the present demand. In fact, almost one in two manufacturing companies (48%) believes that customer demand is more of a challenge now than last year, a figure that has been rising in recent quarters and is now well above the economy-wide level of 34%.

FIG. 8 SHARE OF BUSINESSES OPERATING AT AND BELOW CAPACITY

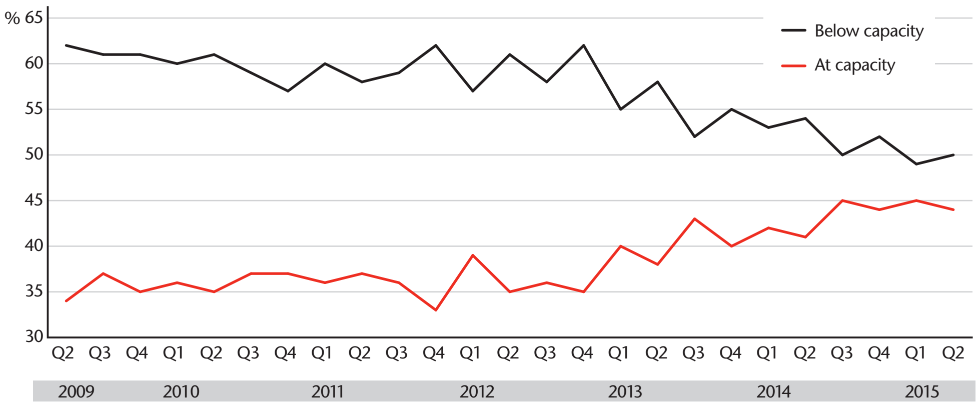
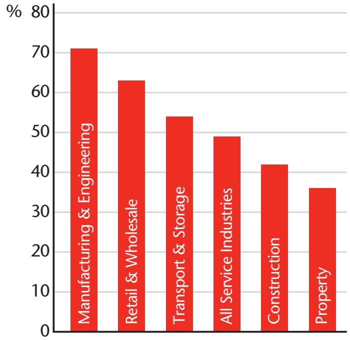


FIG. 9 BUSINESSES OPERATING BELOW CAPACITY



This quarter, half of businesses report operating below capacity. While this has broadly stayed the same since last quarter, the share continues to fall steadily year on year, highlighting how far the UK's recovery from the great recession has come. The last time that spare capacity was lower for a sustained period of time was in Q2 2008, when the downturn had just begun.

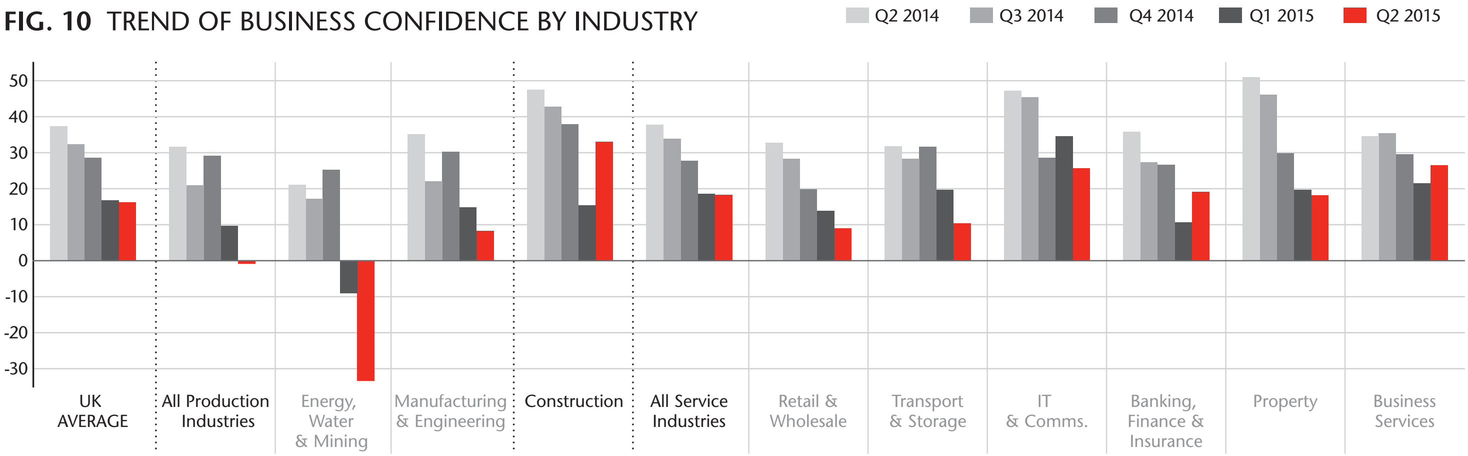
SPARE CAPACITY CONTINUES DOWNWARD JOURNEY

Slack in the economy is still a key concern for the Bank of England's Monetary Policy Committee in their interest rate decision, because a tighter economy will generate greater inflationary pressures. As such, falling spare capacity is likely to become an issue for inflation targeting in 2016 and beyond. However, domestic inflation is currently being highly influenced by external factors such as the price of crude oil. The base rate is likely to remain on hold until inflation starts to rise towards the target rate of 2.0% again.

Within the headline spare capacity result, there is again a marked split between different parts of the economy. The service sector roughly matches the UK economy overall, although the retail sector stands out, with nearly two in three firms (63%) operating below capacity. Manufacturers, meanwhile, have an even higher degree of slack, with 71% of companies reporting excess capacity. This gives further reason why manufacturers may not be planning to carry out much investment over the next 12 months – businesses already have the capital capacity to spare.

Trends of business confidence – industry

FIG. 10 TREND OF BUSINESS CONFIDENCE BY INDUSTRY



With the overall stabilisation of the Confidence Index this quarter, business optimism held generally steady in many sectors. However, the Energy, Water & Mining sector stood out by the severity of the decline in confidence seen this quarter, with an index reading of -33.4, likely on the back of the sustained low prices of crude oil during 2015 so far.

PRODUCTION SECTORS SEE CONFIDENCE SLUMP

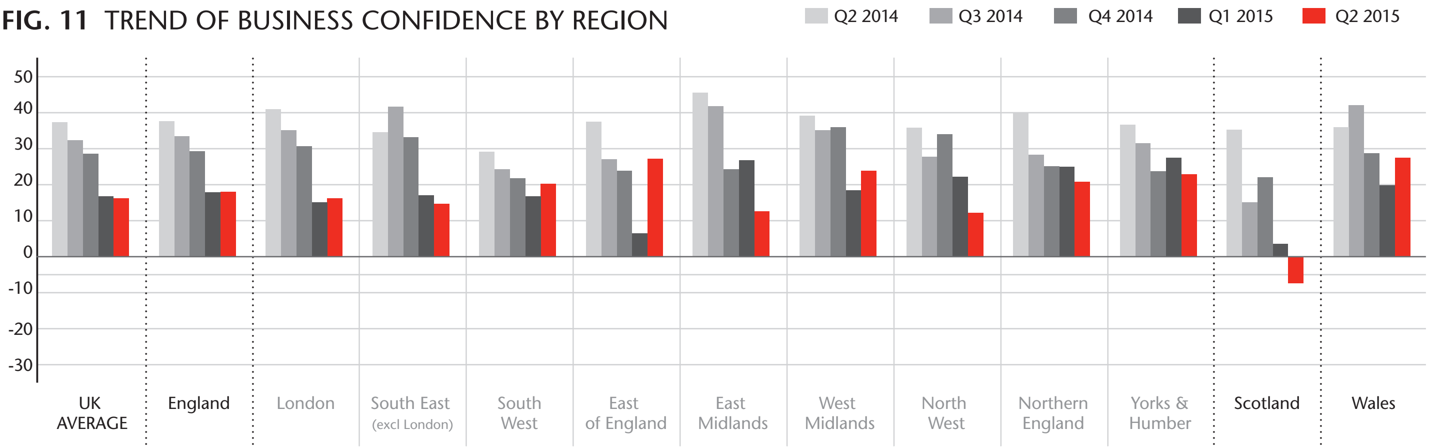
Some other production sectors also saw a continued downward path for their confidence levels, with the Manufacturing sector reporting one of the lowest optimism readings. This suggests that after growing only marginally in recent quarters, the next 12 months will also prove challenging for this sector, based on the Office for National Statistics (ONS) data.

The Retail & Wholesale sector also saw confidence continue to diminish. Although retail sales volumes are well up year on year in the latest ONS figures, shorter term indicators suggest a sluggish start to the year. In addition, intense price competition between major supermarkets is likely to be weighing down on business prospects for the year ahead.

Sectors where confidence is holding strong include Construction, Business Services and IT & Communication. These parts of the economy are likely to be the key driving forces of growth over the short to medium term, with construction firms expecting the fastest rise in sales volumes in the next 12 months of any other sector.

Trends of business confidence – region

FIG. 11 TREND OF BUSINESS CONFIDENCE BY REGION



Confidence levels have been generally holding up around much of the country this quarter compared to the previous three months. There are a few exceptions, notably Scotland's Confidence Index reading that has slumped to -7.4, sharply down on both the previous quarter and the same point a year before. This decline is likely on the back of collapsing confidence in the oil and gas industry, which makes up a much larger share of Scotland's economy than the UK as a whole.

CONFIDENCE IN SCOTLAND TIPS INTO NEGATIVE TERRITORY

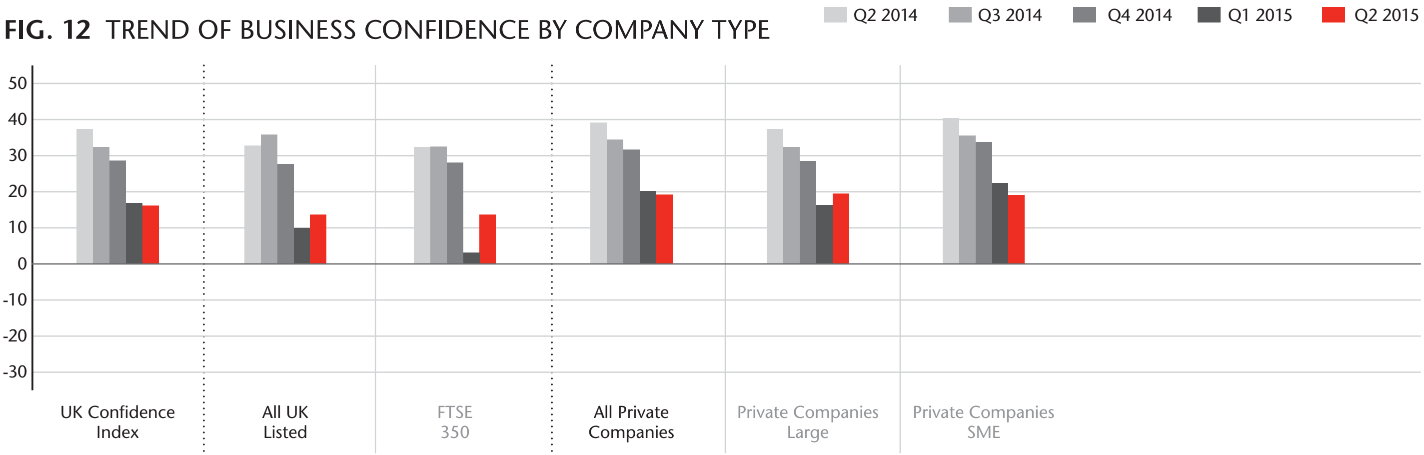
In most other parts of the UK however, confidence levels have halted on the downward path seen in recent quarters and have generally stabilised across the board. This is largely reflected in business projections for turnover and sales volume growth in the next year, with many expecting similar or slightly slower growth than that seen in the past 12 months.

Firms in London for instance have seen their key financial performance indicators stabilise in recent quarters, with similar growth expected ahead. However, one factor weighing on the minds of companies in the capital appears to be tax burdens. Measures such as the increased bank levy announced in the March 2015 Budget will impact the important Financial Services sector, while the structural reform to stamp duty will weigh on the top end of the property market.

Another region, however, where confidence continues to fall back notably is the North West, where more businesses are reporting skills shortages, which are likely to weigh on their outlook for the year ahead.

Trends of business confidence – type

FIG. 12 TREND OF BUSINESS CONFIDENCE BY COMPANY TYPE



Confidence stands steady at private sector businesses, halting the downward path followed during recent quarters. Meanwhile, at listed companies, optimism appears to have increased this quarter after reaching lows in Q1 2015. Firms in the FTSE350 saw confidence rise by the greatest amount, although are still less optimistic than all other business types.

SKILLS SHORTAGES HITTING PRIVATE COMPANIES

One factor that may be constraining confidence growth at private firms more than at publicly-listed corporations is the trend of skills shortages. In recent quarters, the proportion of privately-held companies reporting that the availability of non-management skills is more of a challenge now than a year ago has risen sharply. This share has risen to 23% this quarter, up from 15% at the same point a year ago and from just 8% in Q2 2013. At listed firms, however, the proportion has remained largely on hold over the past few years at around the current 15% level. These larger, often global businesses may have access to wider labour markets from which to draw their staff.

Despite these trends, listed corporations are increasing their average salaries at a faster rate than private businesses, at 2.5% compared to 2.2% over the past year. Moreover, salary growth has been continuing on an upward trend at listed firms, while the rate of pay increases appears to have stagnated at private companies in 2015 so far.

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.

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

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.

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 144,000 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

Chartered Accountants Worldwide

GAA Global Accounting Alliance

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 – find ICAEW
twitter.com/icaew
facebook.com/icaew