UK Business Confidence Monitor

Q4 2015

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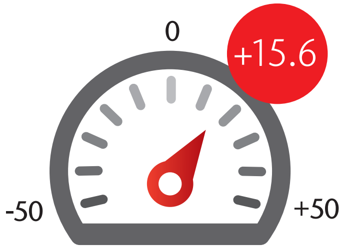
Overall confidence



falls

Export growth

slides back

Capital investment growth

slows

▶ Key points

Confidence falls again after post-election bounce, but remains in positive territory.

Exports slides further below domestic sales, although expectations for growth ahead are stronger.

Firms lack confidence in the longer term, planning to limit budget growth for capital investment and R&D.

▶ Implications

After the post-election bounce seen last quarter it is disappointing, but perhaps not surprising, to see confidence fall again. This survey period includes the Summer Budget which, on reflection, was not profit and loss friendly. A number of policies were introduced that will increase costs for businesses. These include the insurance premium tax rise, the living wage and apprenticeship levy – these additional costs are unlikely to be offset by the further reduction in corporation tax also announced.

This decline in confidence, coupled with anecdotal feedback we hear from members, reflects continued uncertainty in the UK and the EU, the impact of the Summer Budget and the forthcoming Autumn Statement and Comprehensive Spending Review. Internationally the economic slowdown in China is also causing concern. Investment is forecast to decline resulting from so much uncertainty and possibly impacted by a lower (than in recent years) Annual

Staff development growth

unchanged

Average salary growth

holds steady

Production sector

confidence declines

▸ Key points

More companies concerned about staff turnover as unemployment falls, but are not increasing investment in staff development.

With rising skills shortages, wage growth holds steady, well above current inflation levels.

Confidence in the Production sector continues to decline, but remains positive in the Service sector.

▸ Implications

Investment Allowance going forward. Exports are also projected to grow more slowly than domestic sales as the pound remains strong against the euro and the global economy stutters.

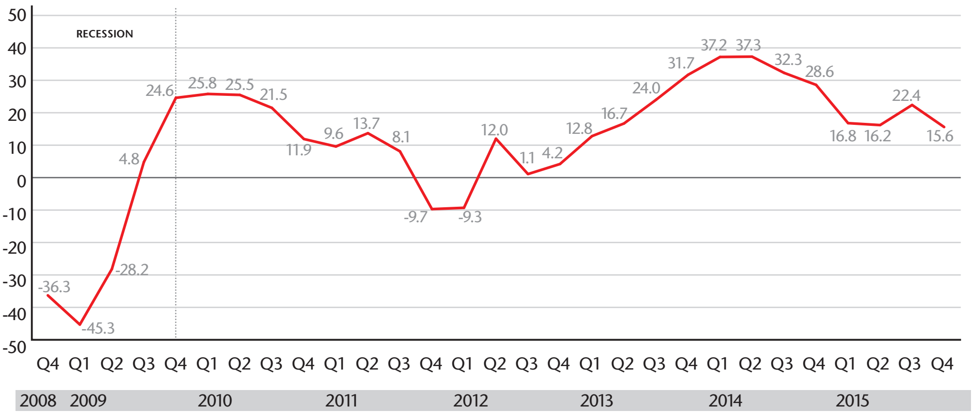
On the positive side, consumer spending continues to drive domestic demand as wage increases exceed inflation and the uncertain outlook has reduced the likelihood of increases in interest rates in the short term.

Unemployment continues to fall despite increasing skills shortages which are becoming severe in some sectors such as Construction and Transport & Storage.

Looking forward, the declining trend in confidence would seem likely to continue. With the UK's poor productivity versus global competitors, the Chancellor will have to play a deft hand this autumn.

Business confidence in Q4 2015

Fig. 1 Trend of UK business confidence



43%
more confident

40%
as confident

16%
less confident
compared to the last 12 months

Confidence cooling but still pointing to growth

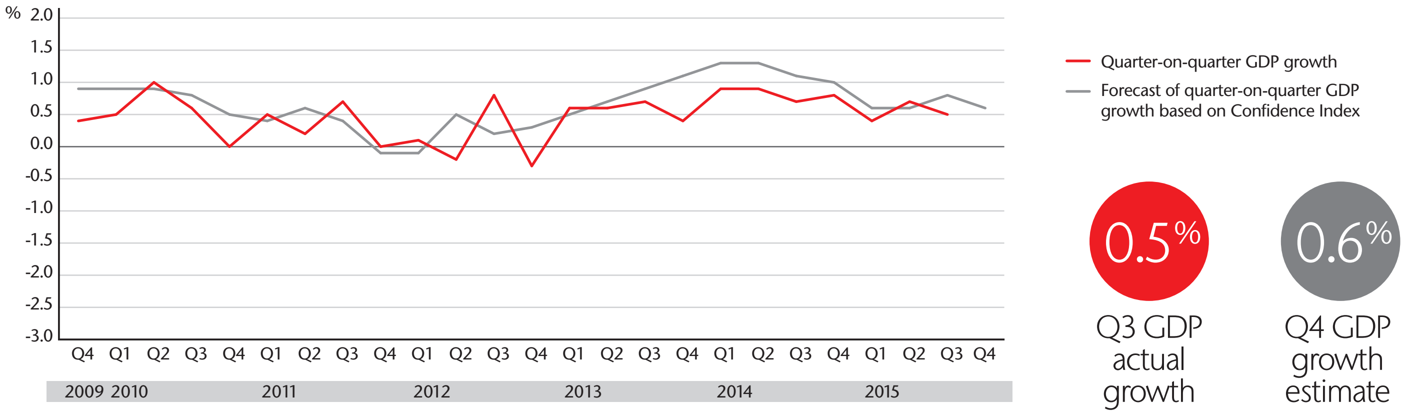
Key highlights

The latest *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) shows optimism falling back again in Q4 2015. The Confidence Index now stands at +15.6, down from +22.4 the previous quarter and from +28.6 at the same point in 2014. However, despite these declines, confidence still stands firmly in positive territory.

This quarter's decline in confidence highlights the current outlook for the UK economy: continued growth, but at a slower rate and underpinned by comparably fragile foundations. Optimism is still very much in positive territory, reflecting a relatively buoyant growth performance: economic output rose by 0.5% in Q3 2015, helping to boost employment levels and household spending power. However, darker clouds are on the horizon, with inflation rising to less-supportive levels next year, and global growth prospects appearing weaker than previously thought.

Within the headline results, the share of firms expecting the business environment to improve over the next 12 months has fallen to 43%. This is the lowest proportion since the first quarter of 2013, before the economy really took off. Meanwhile, the share of those expecting conditions to remain about the same stands at 40%: the highest figure since Q1 2013.

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



Service sector keeping economy on growth path

Key highlights

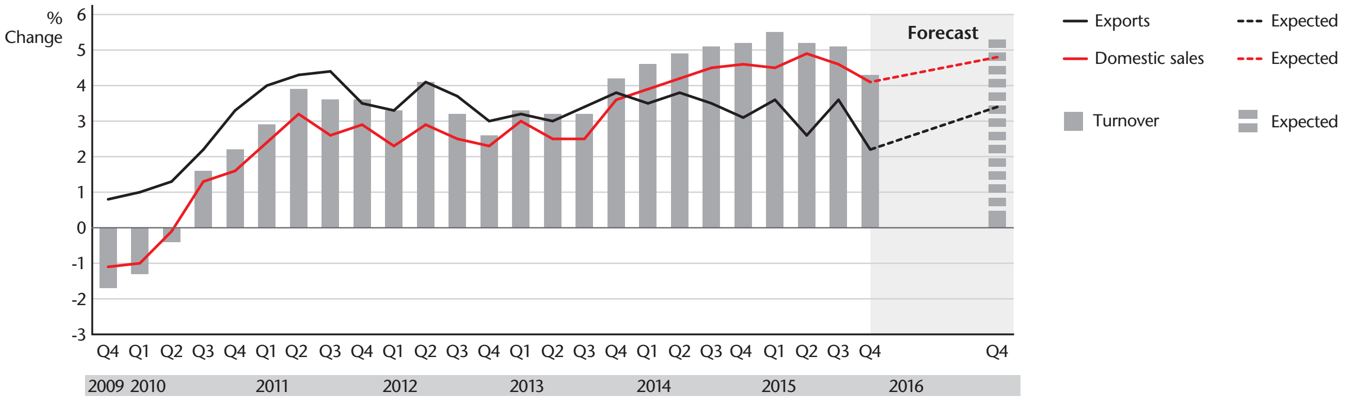
The first estimate of UK GDP growth for Q3 2015 showed a slowdown from the previous quarter. The economy expanded by 0.5%, down from the growth of 0.7% in Q2. This result should leave growth for the year as a whole comfortably above the 2.0% mark, but it is a sharp slowdown from the stellar performance seen in 2014.

Although growth continues to tick along, it is not balanced across the UK's industries. In the latest reading, the Service sector expanded quarter on quarter by 0.7%, boosted by the Technology sector (such as computer programming and consultancy) and real estate businesses. This is a sharp contrast to the Manufacturing sector, where output declined by 0.3% on the quarter, and the Construction industry, which saw a very sharp contraction of 2.2% in Q3. Although the Service sector makes up the majority of the UK economy, the fact that growth is coming from a relatively narrow selection of sources makes the economy more exposed to negative shocks.

One factor that is likely to place more of a constraint on the economy in 2016 is the inflation rate heading back toward more typical levels, from the near-zero rate seen across all of 2015 to date. This unusual phenomenon is helping to significantly boost household real incomes and contributing to higher consumer confidence and spending. However, in the coming months, the rate is expected to rise, eating into household finances once again.

Business financial performance

Fig. 3 Domestic sales and exports – average % change



Turnover growth slowing, but expectations remain firm

Key highlights

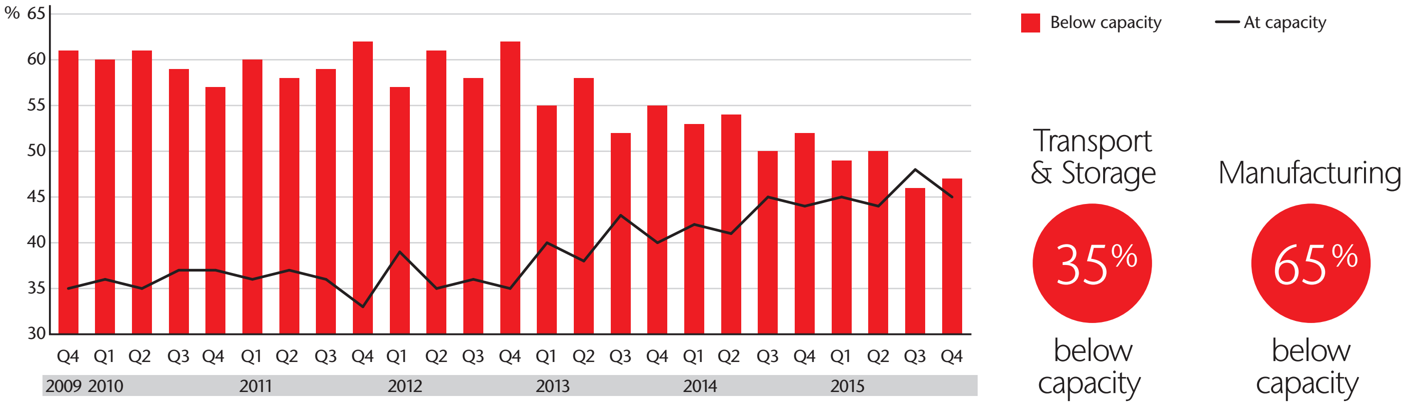
Annual turnover growth has been gradually slowing since the start of the year, reaching 4.3% this quarter. This is down from 5.5% at the start of the year, and is the weakest rate of increase seen since Q4 2013. A similar trend has been seen for profit growth, which now stands at its slowest since Q1 2014.

This slowdown is coming from both domestic and overseas sources. Export growth this quarter fell to just 2.2% over the past 12 months, which is the weakest reading since Q3 2010. This latest movement takes the rate well below that of domestic sales, which stood this quarter at 4.1%, down from 4.5% at the start of the year.

Export performance is likely being affected by factors such as weaker demand in China and other emerging economies, as well as sterling being near its strongest point against the euro since 2007, hampering the UK's competitiveness. Domestic growth is being held up more robustly by relatively favourable conditions at home, with wage rises far outpacing the current 'no-flation' rate of price increases.

However, despite the latest weaker performance, businesses expect faster growth ahead, picking up to 3.4% and 4.8% respectively for exports and domestic sales. This reflects the fact that business confidence is still firmly positive, although given the economic headwinds both at home and abroad expected in 2016, may prove challenging to achieve.

Fig. 4 Spare capacity – average % change



Spare capacity diminishing rapidly in UK economy

Key highlights

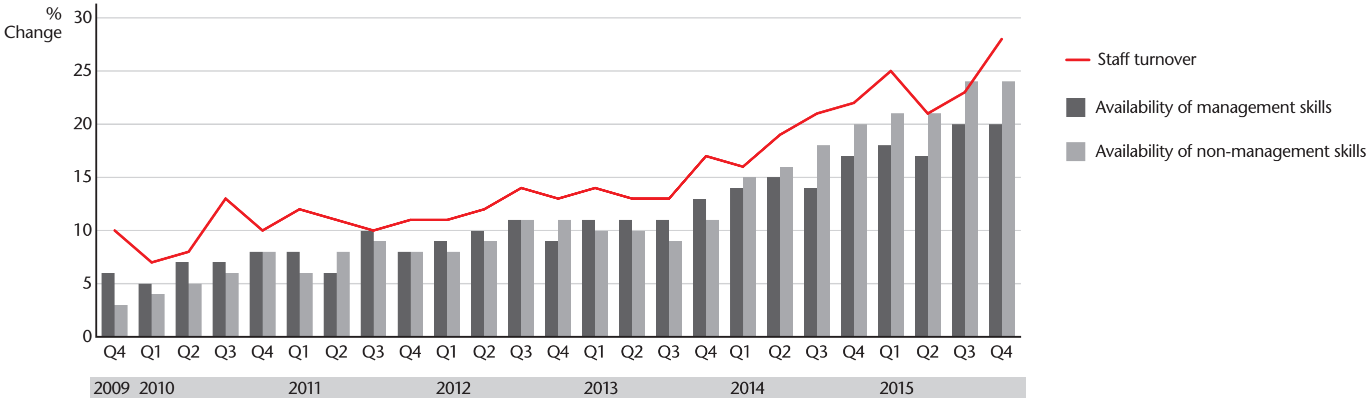
This quarter, fewer than half of firms (47%) are operating below full capacity. This is well down on the 52% of businesses reporting the same in Q4 2014 and from the highs of 62% seen in 2009 and 2011. This quarter's result is the largest year-on-year decline in two full years in the share of companies with spare capacity.

This rapid utilisation of spare capacity is not being felt equally around the economy however. As mentioned earlier, the Service sector is still seeing buoyant growth. This is reflected in the share of firms with spare capacity, which has dropped to 45% this quarter from 52% a year ago. Within the service sector, the Transport & Storage industry has seen a particularly sharp drop in this metric, which has halved over the past year.

However, the difficulties facing the Manufacturing and Construction industries can also be seen in these spare capacity figures. Almost two-thirds of manufacturers (63%) are operating below capacity this quarter, unchanged from the same point a year ago. However, the share of construction companies reporting the same has even increased over the past 12 months.

With this spare capacity in some sectors in mind, the Bank of England has stated that they aim to keep monetary policy loose in the immediate term so that growth is sufficient to absorb the remaining under-utilised resources. By mid-2016 though, conditions are expected to be suitable for the first interest rate rise.

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



Staff turnover a rising challenge as unemployment falls

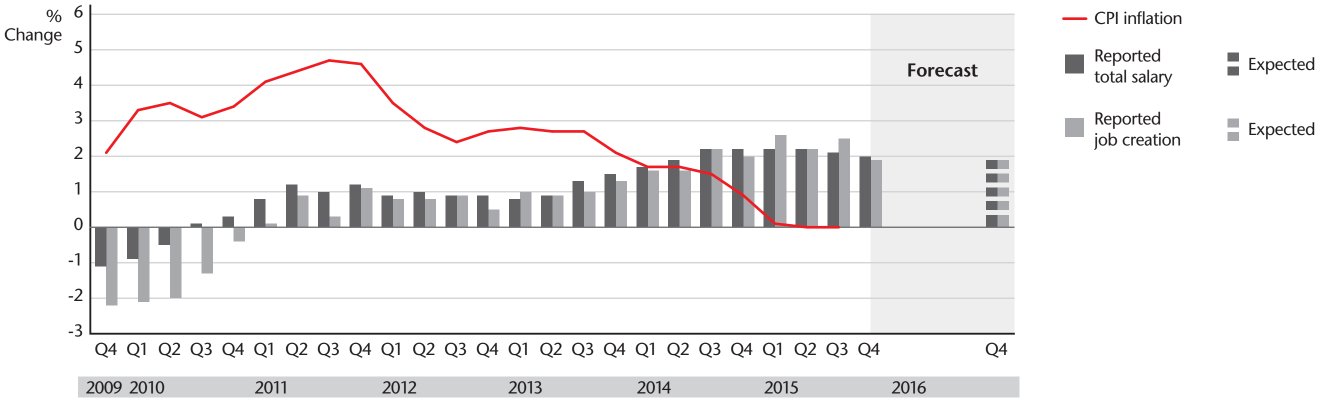
Key highlights

This quarter, more than one in four businesses (28%) report that staff turnover is a greater challenge than a year before. This is well above the share of 22% stating the same in Q4 2014, and the lows of near 5% in the depth of the 2008-09 recession, highlighting the extent of the labour market recovery in recent quarters.

A further sign of the tightening labour market is that 24% of firms report that the availability of non-management skills is more of a challenge now than a year ago. With unemployment falling almost back to pre-recession levels, at 5.4% in the three months to August 2015, hiring conditions have much improved for UK workers. However for businesses, this means it's harder to hold on to staff and to find people with the right experience.

One thing that companies have done recently to counteract the negative effect of these market forces was to invest in their staff, to try to boost productivity and to retain them for longer: staff development budgets have risen 2.3% over the past year. This is the fastest growth seen since Q1 2008, before the financial crisis really took hold. However, in a sign that business confidence isn't quite as strong as it has been, staff development budgets are expected to grow at the slower rate of 1.6% over the year ahead.

Fig. 6 Employment, salary and consumer price growth (CPI) – average % change



Real wages continue to be boosted by zero inflation

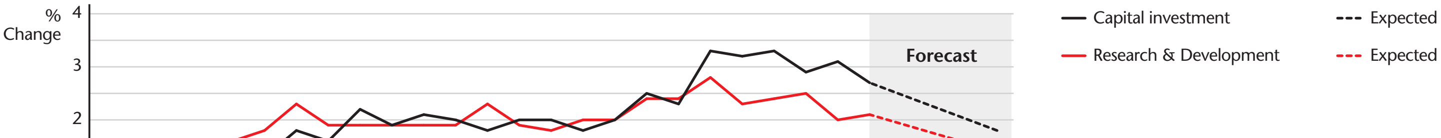
Key highlights

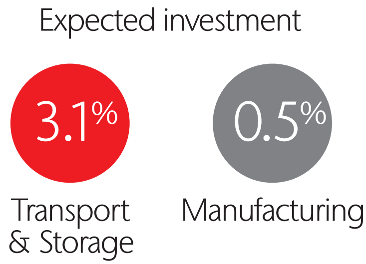
Wage growth is holding up, despite nearly a full year of effectively zero inflation. Average total pay rose over the past year by 2.0%, broadly in line with results from previous quarters, and further growth of 1.9% is projected for the 12 months ahead. Consumer price inflation, meanwhile, has stood at zero on average since January, meaning wages are rising robustly in real terms.

This real wage growth is contributing significantly to household spending power, which in turn is allowing consumers to drive economic growth. This is helped further by continued buoyant job creation in the private sector – this quarter, firms are reporting an increase in staffing levels by 1.9%. Although this is down from even faster growth earlier in the year, it compares favourably with average employment growth between the start of the financial crisis in 2008 and the start of the BCM series in 2004. Businesses expect this job creation to continue at the same rate over the year ahead – tallying up with figures from the Office for National Statistics (ONS) which show job vacancy numbers holding steady at elevated levels in recent months.

While stable growth in the labour market will help to bolster consumer confidence, one factor that will probably weigh down on economic growth over the year ahead is the expected acceleration in consumer price inflation in the first half of 2016. This is likely to come alongside wage growth remaining on hold – a trend that will eat into real spending power gains.

Fig. 7 Investment – average % change





R&D and capital investment growth to slow ahead

Key highlights

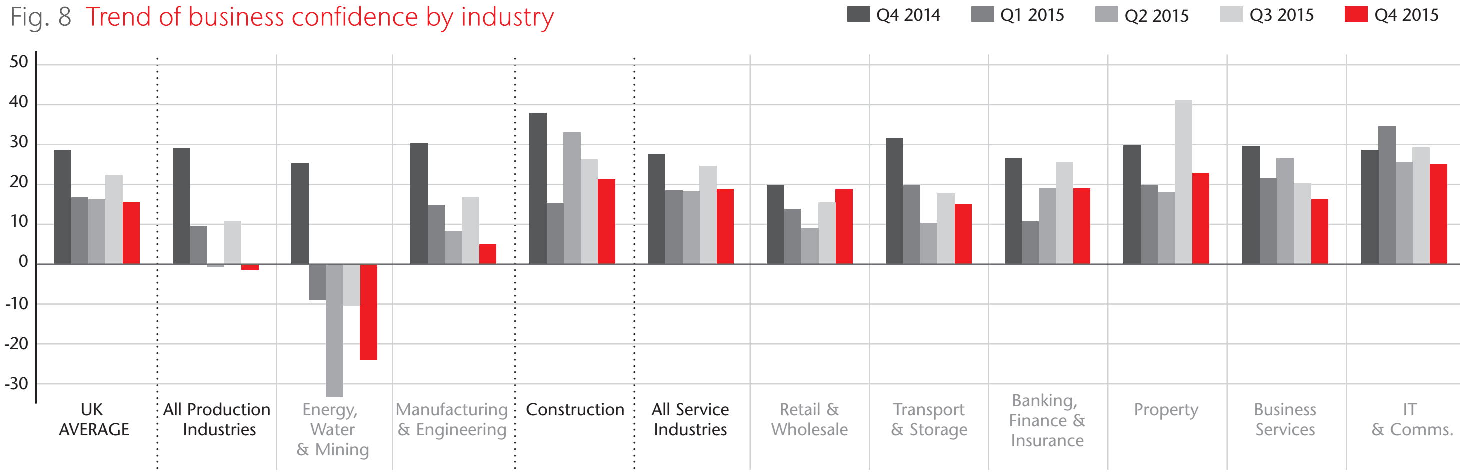
Although annual growth in capital investment remains higher than much of the post-recession period, at 2.7% this quarter, it has been generally slowing from highs of 3.3% at the start of the year. In addition, businesses expect growth in investment budgets to slow to 1.8% over the year ahead, which if realised would be the slowest growth since Q3 2013.

Research & Development (R&D) is another area of investment where spending growth is slowing, in a further sign that businesses lack confidence in the longer-term outlook. R&D budgets rose over the past year by 2.1%, down from 2.8% in the second half of 2014, and are expected to rise by just 1.4% over the coming 12 months.

Although investment plans are generally falling back across the economy, one sector where intentions for capital expenditure are holding firm is the Transport & Storage industry. Increased investment in this part of the economy is a sign of continued overall economic growth, as it signifies rising demand for the shipment of goods – either bought by consumers, or needed as extra inputs by other businesses.

In addition, there are areas where spending on R&D is more buoyant. The Business Services sector expects budgets to increase by 2.5% over the next year, accelerating from 1.9% during the past 12 months, while the IT & Communications industry projects an increase of 2.1% ahead. These are both strong growth industries for the UK economy, and further investment is encouraging for future expansion.

Fig. 8 Trend of business confidence by industry



Production confidence down, but optimism rising in Technology sector

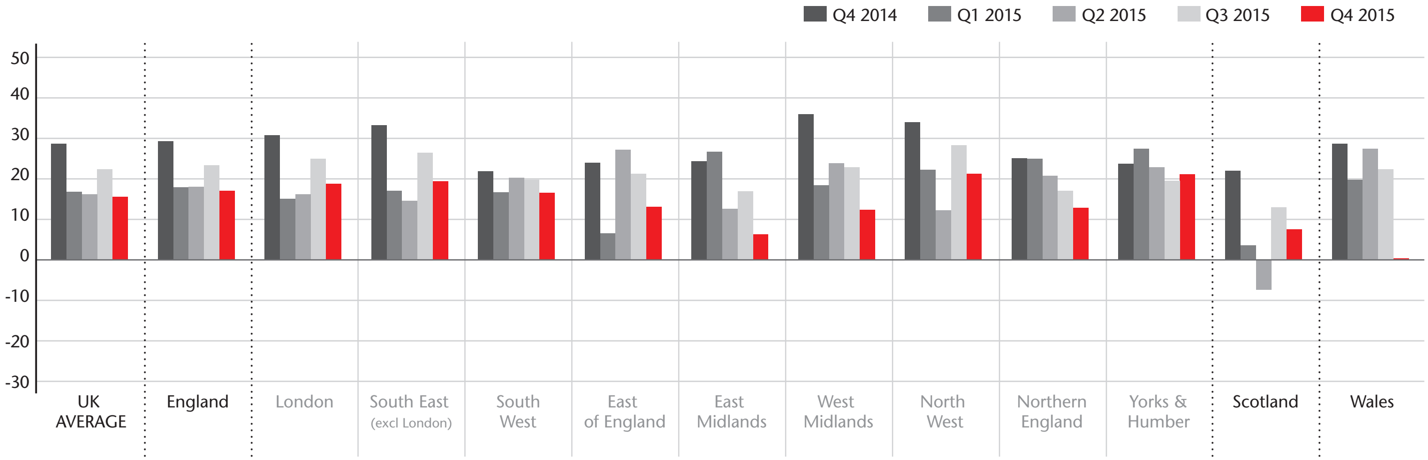
Key highlights

The manufacturing sector has seen its confidence levels steadily declining to just +4.9 this quarter, down from +30.3 at the same point a year ago and a high of +35.1 earlier in 2014. In conjunction with another sharp negative turn in optimism from the Energy, Water & Mining sector, this takes overall production industry confidence just into negative territory this quarter.

These disappointing results from the manufacturing sector come following a weak revenue performance. Manufacturers this quarter report sales volumes rising over the past year by 2.1%, lower than any sector in Services or Construction, and less than half of the economy-wide average. The sector may be constrained by weak export activity, as the value of sterling remains strong against the euro, and demand from some emerging economies is cooling.

The Service sector, meanwhile, has maintained a more optimistic outlook, reflecting the economy's current overall reliance on services for growth. This is particularly the case in the IT & Communications sector. Firms in this industry recorded a Confidence Index reading of +25.2 this quarter, broadly unchanged from +28.6 at the same point a year ago. These technology firms project the strongest sales growth of any other sector, at 7.9%, and have seen buoyant expansion over the past year. On the back of strong expectations, these businesses are investing for the future: IT & Communications firms have the second-fastest planned rate of R&D growth in the UK.

Fig. 9 Trend of business confidence by region



Confidence holding up across most of southern England

Key highlights

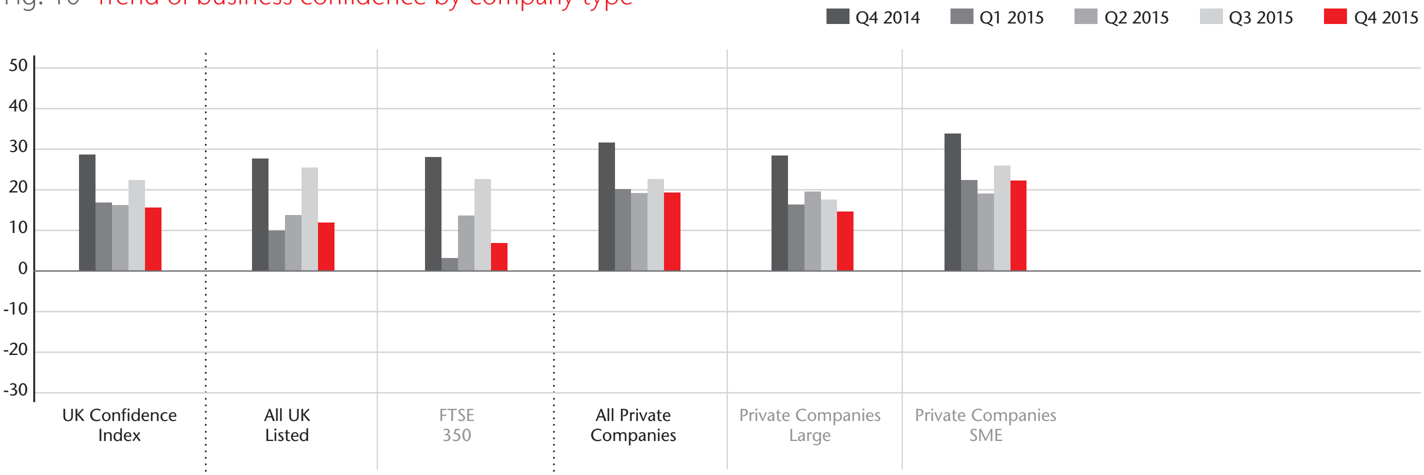
Confidence has held largely steady in recent quarters in London, the South East and the South West. Optimism is likely being boosted by the relatively high prevalence of firms in the IT & Communications, Property and Retail & Wholesale sectors, all of which currently have either high or rising optimism levels.

Parts of northern England are also seeing confidence levels hold up reasonably well, including the North West and Yorkshire & Humber. Optimism in these areas may be buoyed by continued announcements on the Northern Powerhouse, including Chinese President Xi's visit to Manchester, where he revealed the first non-London direct air link between China and the UK, starting in 2016.

However, in northern England, confidence has been falling without pause since the start of 2014. An optimism reading of +12.8 was recorded this quarter, down from +25.1 a year before and from a high of +45.5 at the beginning of 2014. Other signs of economic weakness from this part of the country can be seen in the housing market, where the average price of a home has been increasing slower than anywhere in England in recent months, and in the labour market, where employment fell quarter on quarter in the three months to August.

Trends in business confidence TYPE

Fig. 10 Trend of business confidence by company type



Investment rising fastest at private companies

Key highlights

Confidence has taken a hit at FTSE 350-listed firms this quarter, with an index reading declining to +6.9. This is down from +28.0 at the same point a year before, and stands well below the +19.3 for all private companies. The outlook at FTSE 350 companies may be clouded by worsening global prospects, with these firms generally more exposed to worldwide markets.

Confidence among privately-owned companies, meanwhile, has held up relatively firmly in recent quarters, with the current reading largely unchanged since the start of 2015. On the back of this buoyant optimism, private companies are investing in their future. Capital expenditure is up by 3.1% over the past year at these firms, compared to 1.5% among FTSE 350 companies. In addition, R&D budgets at private companies rose 2.7% in the last 12 months, compared to 1.4% at their listed counterparts. This investment is encouraging for the future of the UK's growth prospects.

One factor that may be holding back confidence at FTSE 350 firms is the level of competition they are facing. This quarter, more than half (55%) report that competition in the marketplace is more of a challenge than a year ago, compared to 36% of privately-owned companies. As mentioned above, these listed firms are often more globally-facing than privately-held firms, and as such face stiff opposition from potentially cheaper companies from emerging economies.

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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