



UK Business Confidence Monitor

Q1 2015



Welcome



This quarter's *ICAEW/Grant Thornton Business Confidence Monitor* sees business confidence fall for the third consecutive quarter, with companies increasingly more cautious in an uncertain year. We are less than 100 days from the general election, and a possible change in government and problems in the eurozone, have all meant that businesses are hunkering down, and waiting to see what happens before investing in and growing their business.

All this means that we have to continue to rely on domestic demand to keep our economic recovery growing in the short and medium term. Figures show that consumers are reacting to the unusual period of low interest rates and low inflation by spending their money. Wages are now outstripping inflation, which is falling due to low oil and commodity prices, and employees are feeling empowered to seek new pastures in order to maximise their earnings. While it is better to have growth based on domestic demand than no growth at all, with a general election campaign in sight it is imperative that business receives long-term assurances and not short-term campaign promises.

A handwritten signature in black ink that reads "Michael Izza".

Michael D M Izza
Chief Executive
ICAEW



Certainty is the bedrock of business planning and the number of 'known unknowns' on the horizon are starting to rattle UK business confidence. The UK business community entered 2015 in one of the strongest positions amongst global economies. Yet, in the context of a highly unpredictable UK general election just months away, coupled with significant uncertainties across the eurozone and the UK's relationship with the EU, some jitters amongst UK business leaders becomes understandable. Moreover, a continued domestic skills shortage is leaving employers short-handed and potentially unable to meet what demand exists.

To ensure a long-term, sustainable and diversified business environment in the UK, a step change in mind-set is needed from whichever party(ies) take residence in Downing Street. This must include considerations for supporting our businesses in new markets abroad, particularly where demand for 'Brand Britain' carries a premium. It also needs to address the skills imbalance and develop a world-class talent pool at home.

A handwritten signature in black ink that reads "Scott Barnes".

Scott Barnes
Chief Executive Officer
Grant Thornton

Economist's view



The latest *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) shows that business confidence continued to fall back in Q1 2015 for a third consecutive quarter, reaching a level of +16.8. Although this remains well into positive territory and the recent declines come from record highs in 2014, the latest cooling partly reflects growing political uncertainty for the years ahead. The UK general election and fragility in the eurozone, among other economic risks around the world, are now weighing on optimism.

The Confidence Index is a leading indicator for growth, and this quarter's reading suggests that the economic expansion will slow marginally in Q1 2015. However, looking further ahead, other indicators suggest that overall steady growth will continue in the UK for 2015, though at a slightly slower pace than in 2014.

KEY ISSUES EMERGING THIS QUARTER

- Turnover and profit growth are expected to remain steady over the coming year.
- The falling price of global commodities such as oil is being felt, as businesses expect input price growth to slow. This trend will support business bottom lines and provide a boost to consumer spending power.
- Investment growth has picked up in the past three quarters, but with uncertainties rising about the business environment over the medium term, this is expected to slow in the next 12 months.
- Employment growth also looks to have peaked, with slower increases in headcount over the next year than the past 12 months.
- Salary growth remains on hold, but with inflation reaching ever lower, employees are now seeing stronger growth in spending power.
- The effects of a tightening labour market are being felt, as skills shortages and levels of staff turnover are a concern for a rising share of businesses.

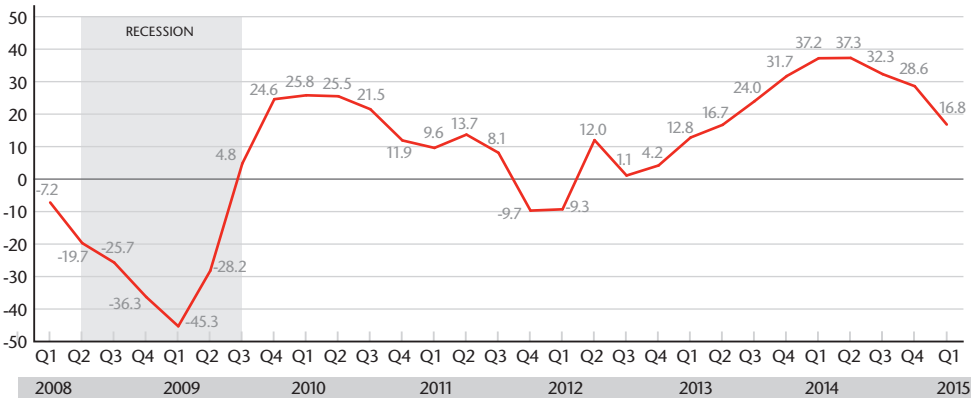
The latest BCM results point to a year of relatively stable growth conditions for 2015, with sales supported by domestic spending and rising consumer incomes in real terms, rather than by foreign demand. This trend of continued growth, alongside further reductions in spare capacity, would ordinarily provide strong evidence for the Bank of England to start raising interest rates. However, with the risk that consumer price inflation dips into negative territory this year on the back of falling oil prices, it now looks likely that monetary policy will remain on hold until late 2015 or early 2016.

A handwritten signature in dark ink, appearing to read 'Charles Davis', written in a cursive style.

Charles Davis
Director, Cebr
ICAEW Economic Partner

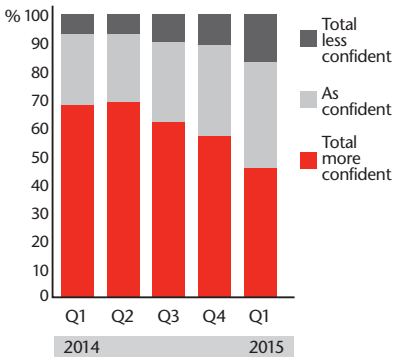
Business confidence in Q1 2015

FIG. 1 TREND OF UK BUSINESS CONFIDENCE



The latest ICAEW/Grant Thornton UK Business Confidence Monitor (BCM) shows a further cooling of business optimism this quarter. The Confidence Index dipped for the third consecutive quarter, reaching +16.8 in Q1 2015, down from a record high of +37.3 in Q2 2014.

FIG. 2 UK CONFIDENCE INDEX – DETAILED RESPONSES

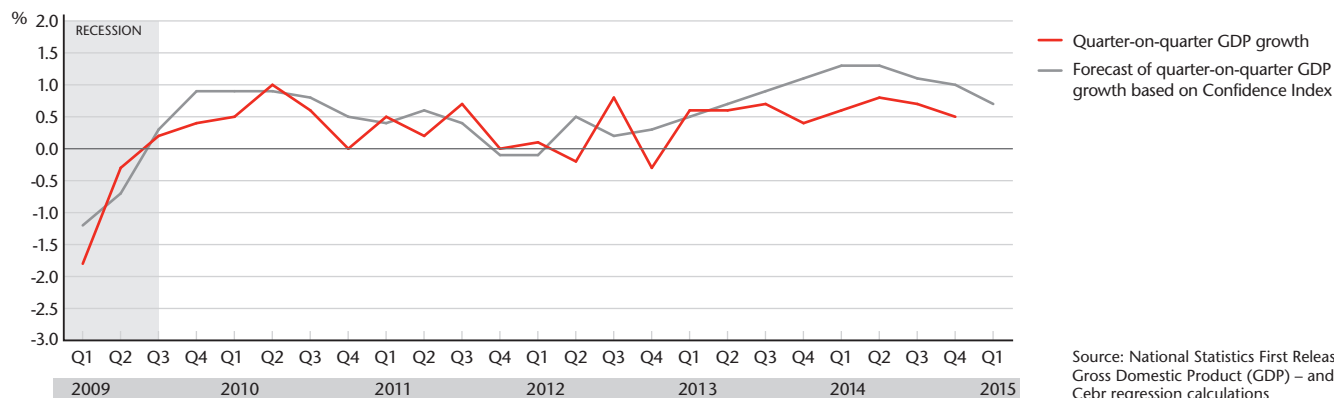


CONFIDENCE DECLINES AS UNCERTAINTIES START TO TAKE HOLD

Optimism readings have been falling since the middle of 2014, partly due to stabilisation of business conditions. This quarter, the share of companies reporting that they are as confident in their prospects for the year ahead as they were in the previous 12 months, has jumped to its highest since early 2013. It is now nearly 4 in 10 (38%), which is up from just 25% a year before. This trend is to be expected, given that 2014 saw buoyant growth, with the economy expanding at its fastest rate since before the financial crisis and businesses adjusting to a more stable economic environment.

However, the sustained drop in the Confidence Index also reflects some unease creeping into the business outlook. The share of firms reporting that they're less confident in the year ahead rose to 17% this quarter, up from 7% a year before. Political and economic uncertainties on the domestic and global stage at the moment are likely to be affecting business perceptions. The UK general election in May has no clear leader at this stage; furthermore the eurozone is going through a period of very weak growth, and tensions in Russia and Ukraine rumble on, affecting international trade.

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



The latest estimates for UK GDP show an expansion of 2.6% across 2014 as a whole, a growth rate that hasn't been exceeded since 2006. This suggests that the UK was one of the fastest growing advanced economies last year.

BUOYANT BUT SLIGHTLY COOLER GROWTH LIKELY FOR 2015

Following on from this strong result for 2014, the latest confidence readings suggest that growth is likely to cool slightly in the year ahead. This trend was already evident in the GDP readings for the final quarter of 2014, which showed the slowest growth since Q4 2013.

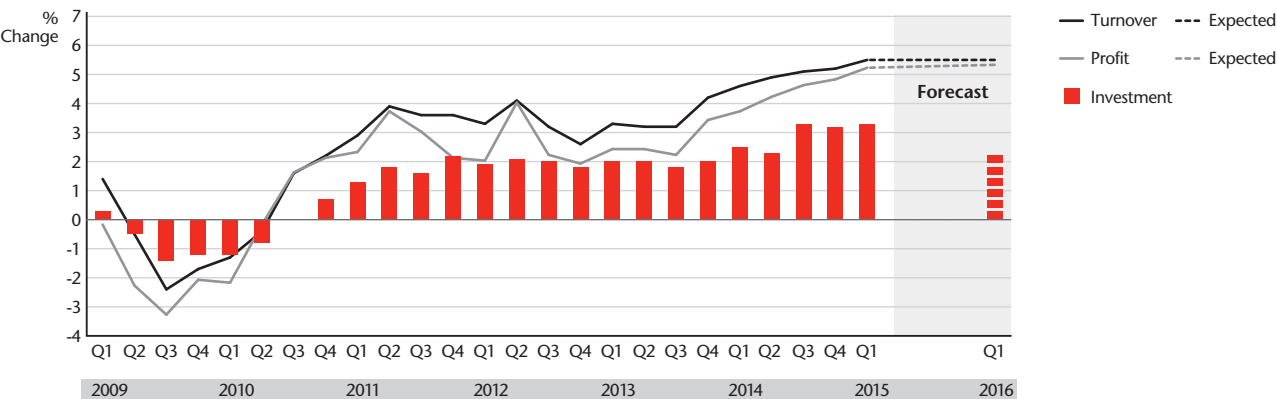
Trade is likely to be one factor weighing down on economic expansion this year. The eurozone is going through a sustained period of economic fragility, leading to the European Central Bank recently announcing an injection of more than €1 trillion of quantitative easing cash

into the economy. The UK still sends roughly half of its goods exports to the bloc, and as such, the extent to which trade-led growth will emerge this year is limited.

The coming year is likely to be relatively favourable for households and consumers, suggesting that growth will continue to rely on domestic demand. The inflation rate is projected to reach near the zero mark this year and may dip into negative territory for a short period, providing a significant boost to household spending power.

Business financial performance

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



Business profit and turnover have reached their fastest growth rates since 2008, in line with the buoyant economic performance in 2014. However, reflecting the cooling of the Confidence Index, this upward momentum appears to have come to a halt. Turnovers and profits are expected to rise over the next year by around 5.5%, an unchanged rate from growth over the past 12 months.

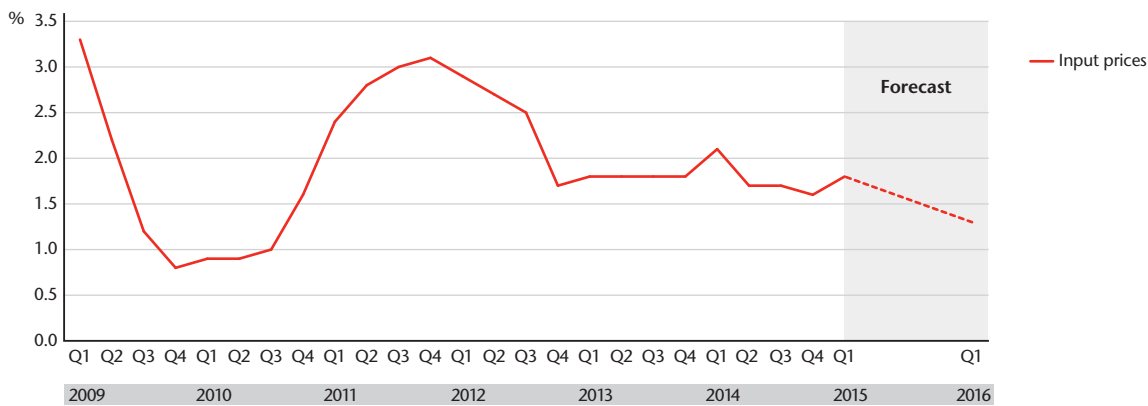
CONFIDENCE DIP AFFECTING INVESTMENT INTENTIONS

Despite the expectations for steady growth for the coming year, companies appear to be less confident in longer-term prospects – an important determinant of investment plans. Capital spending growth picked up during the past three quarters to rates of over 3% for the first time since the financial crisis, but is expected to fall back to just 2.2% over the next 12 months. This reduction in investment intentions is likely to be affected by political uncertainties, which affect a longer timescale than the next 12 months. Depending on the outcome of the general election

in May, a referendum on the UK's EU membership may occur in the next few years. The possibility of exiting the EU makes it harder for companies to plan effectively.

These BCM findings also suggest that the Office for Budget Responsibility's forecast of government spending moving into surplus by 2018/19 will prove hard to fulfil. This projection is based on rapid business investment growth over the next five years, of 8.8% in 2015 alone. Without this growth, a surplus may not be achieved until the next decade.

FIG. 5 INPUT PRICES, YEAR-ON-YEAR GROWTH



Input price inflation is projected to slow to just 1.3% over the next 12 months, which would be the lowest cost growth rate since the UK was coming out of the 2008-09 recession. This trend comes on the back of sharp declines in world oil prices, with the cost of Brent crude oil falling to under \$50 a barrel in January from over \$110 in September 2014.

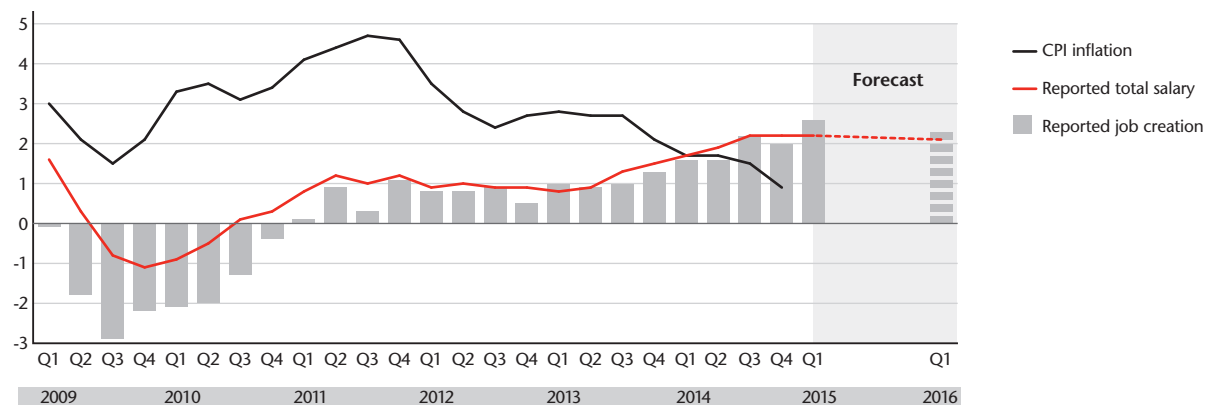
COST INFLATION TO REACH LOWEST LEVEL SINCE 2010

The falling cost of key commodities such as oil has important implications for the UK economy, with the price of vehicle fuel and utilities going down. As a result, consumer price inflation is projected to fall into negative territory for a brief period in 2015 and remain generally low across the whole year.

This is a marked turnaround from the rapid consumer price inflation

seen most of the time since the 2008-09 recession, and will help to provide a boost to household spending power, as well as easing pressure on business bottom lines. This uplift to domestic demand will help economic growth to cool only marginally rather than more significantly, at a time of weak investment intentions and poor trade prospects.

FIG. 6 YEAR-ON-YEAR EMPLOYMENT, SALARY AND CONSUMER PRICE GROWTH



This quarter, firms have reported increasing their staff headcounts by **2.6% over the past year – the fastest annual increase since comparable data began in 2004**. This buoyant job creation has helped to bring down the UK unemployment rate to just 5.8% in the three months to November 2014, reaching close to the levels seen before the financial crisis.

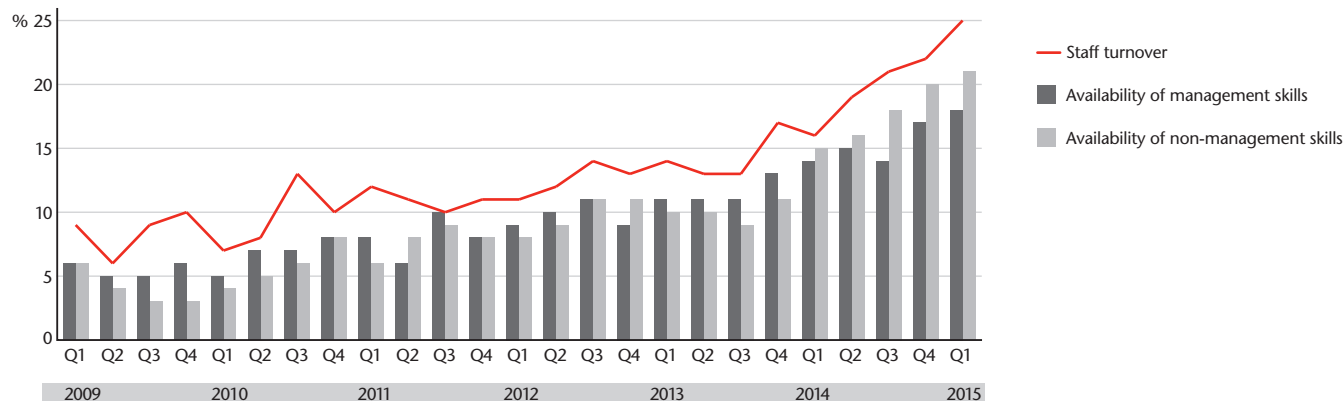
EMPLOYMENT GROWTH MAY HAVE PEAKED

In line with the expectation of slightly cooler growth conditions ahead, BCM results indicate that a peak has been reached in employment growth. Over the next 12 months, firms anticipate increasing staff levels at the slower rate of 2.3%.

Despite buoyant employment increases, businesses have kept salary growth on hold this quarter at 2.2%, unchanged from the previous two quarters and expected to remain broadly at this level for the coming year. While this is only up marginally

in nominal terms from the 1.7% year-on-year salary growth reported in Q1 2014, it represents a much more significant uptick in real, inflation-adjusted salary growth. During Q1 2014, annual consumer price inflation stood equal with pay growth. Now, pay is rising by more than a percentage point faster than prices, meaning that employees are seeing a notable rise in their spending power and as such, are likely to contribute strongly to economic growth during 2015.

FIG. 7 STAFF TURNOVER AND AVAILABILITY OF SKILLS AS A GREATER CHALLENGE



This quarter, the proportion of firms reporting that staff turnover is a greater challenge now than a year ago rose to its highest since before the financial crisis, to 1 in 4 companies (25%). This factor is a particular problem in the Construction sector, where 36% report it as more of an issue, sharply up from just 15% of companies at the same point in 2014.

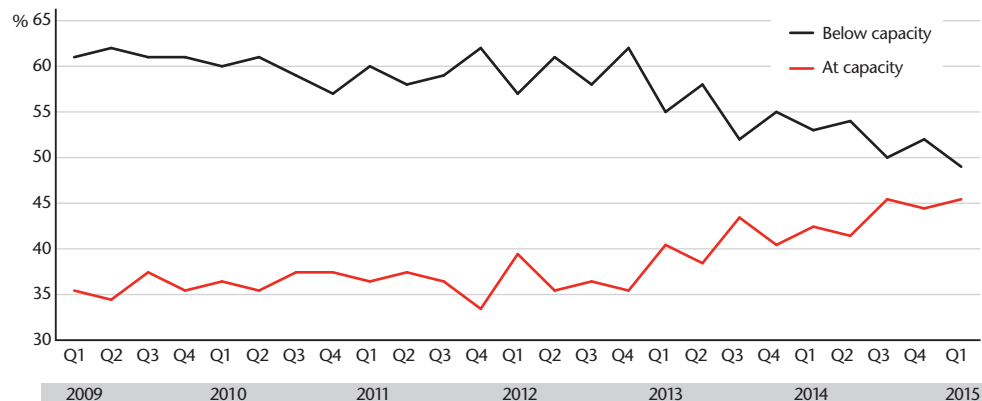
STAFF TURNOVER MORE OF A CHALLENGE THAN PRE CRISIS

A further sign of the tightening labour market comes from the share of firms reporting skills shortages. This quarter, 21% are finding that the availability of non-management skills is a greater challenge than a year ago, up from 15% in Q1 2014, with a similar upward trend for management skills.

These latest findings show that as unemployment continues to head down, it is more difficult to find and retain workers. As such, the tighter labour market is likely to contribute to slightly cooler growth in 2015 than

the previous year. In addition, it is likely that 2015 will be characterised by businesses making more of their existing workers, by increasing their average hours. This will help to reduce underemployment in the economy, something which rose sharply during the 2008/09 recession. While firms reduced staff numbers by 2.4% from peak-to-trough during the downturn, available hours were cut even more – by 4.5%, according to figures from the Office for National Statistics (ONS), bringing down the pay to workers and the cost for business.

FIG. 8 SHARE OF BUSINESSES OPERATING AT AND BELOW CAPACITY

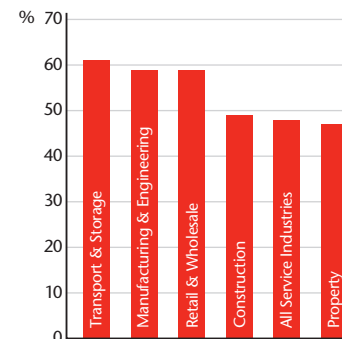


This quarter, just 49% of businesses report operating below capacity, under the half mark for the first time since **Q2 2008**. This latest reading is down from 53% at the same point a year ago and is part of a general downward trend from the highs seen following the 2008-09 recession.

SPARE CAPACITY FALLS TO LOWEST IN ALMOST SIX YEARS

These latest findings from the BCM highlight the extent of the UK recovery over the past five years, with spare capacity returning to near 2007 levels. Ordinarily, this would be firm evidence that the Bank of England should start to raise the base rate of interest from the 0.5% at which it has stood for nearly six years. However, the substantial disinflationary pressures coming from international factors suggest that the base rate will be kept on hold at least until late 2015.

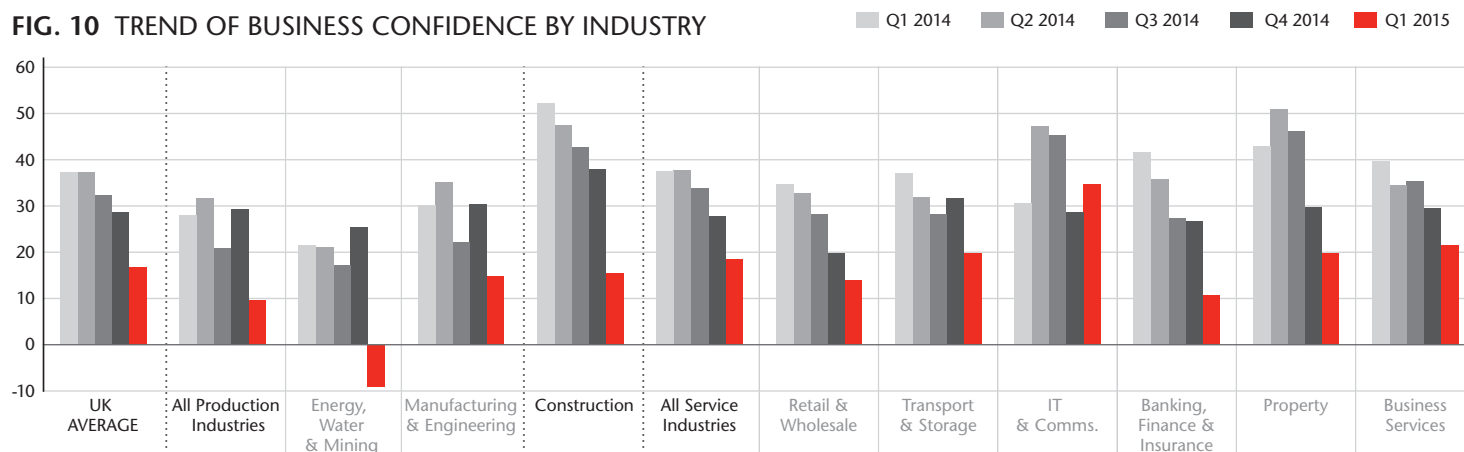
FIG. 9 BUSINESSES OPERATING BELOW CAPACITY



Despite the overall reduction in spare capacity, there are significant differences between sectors. Spare capacity is highest in the transport and storage sector, as well as the manufacturing industry, both with around 60% of firms operating below capacity. This share for manufacturing firms has fallen 10 percentage points from 69% at the same point a year ago, suggesting some recovery recently. However, the latest figures from the ONS indicate that output in the sector remains at 5.6%, below its 2006 pre-crisis peak, suggesting there is still some way to go.

Trends in business confidence – industry

FIG. 10 TREND OF BUSINESS CONFIDENCE BY INDUSTRY



This quarter, the Confidence Index fell back across the main industry groupings of production, construction and services. In one sub-sector – Energy, Water and Mining – the reading even dropped into negative territory for the first time since 2009. This is likely to be a result of the significant price declines seen in the global crude oil markets.

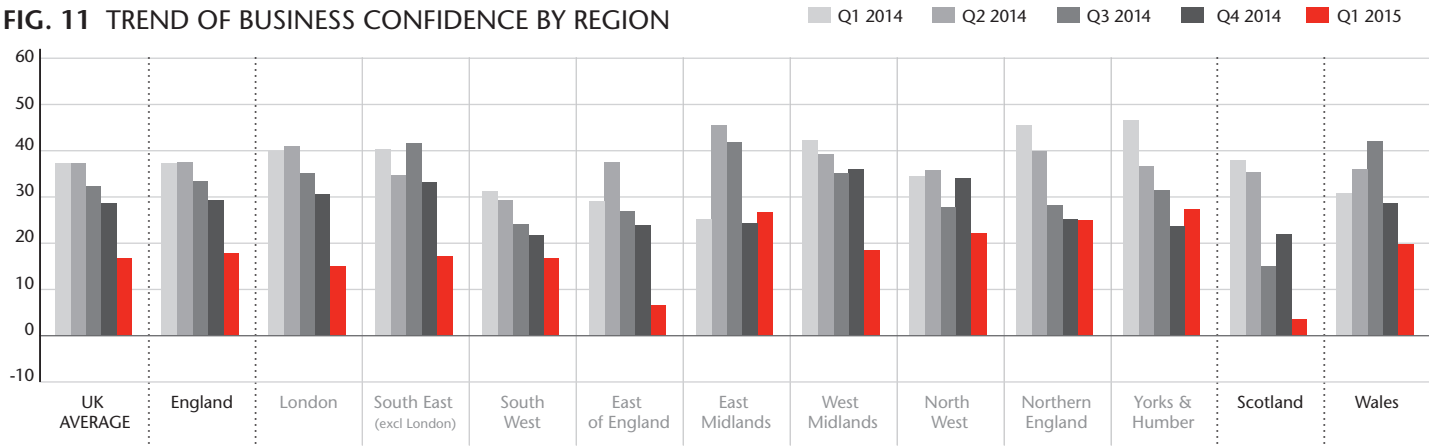
CONFIDENCE FALLING BACK AROUND THE ECONOMY

The Manufacturing sector has one of the highest proportions of firms that are less confident in the outlook for the next 12 months than the past year, with 22% expecting a worsening of prospects. This proportion has been rising in recent quarters, alongside the weakening of economic conditions in the eurozone, which is the UK's biggest goods trade partner. Such findings also serve to highlight how elusive a rebalancing of the economy towards manufacturing-led growth is.

One bright spot however is the IT & Communications sector, where the Confidence Index increased this quarter, in contrast to every other sub-sector. This buoyant optimism follows a year of rapid growth in the computer programming and consultancy industry, with ONS figures showing a 7% annual expansion in 2014, well above the UK-wide figure of 2.6%. With strong confidence readings, 2015 could see similar growth for the sector.

Trends in business confidence – region

FIG. 11 TREND OF BUSINESS CONFIDENCE BY REGION



Confidence is down on a year ago in virtually every UK region, with declines also seen quarter on quarter in many areas. Businesses in Scotland record the lowest Confidence Index readings, at just +3.6 this quarter, well down from the +38 seen at the same point the previous year, on the back of sharp confidence declines at firms in Scotland’s oil and gas industry.

OPTIMISM DECLINES ACROSS SOUTH BUT STRONGER IN NORTH

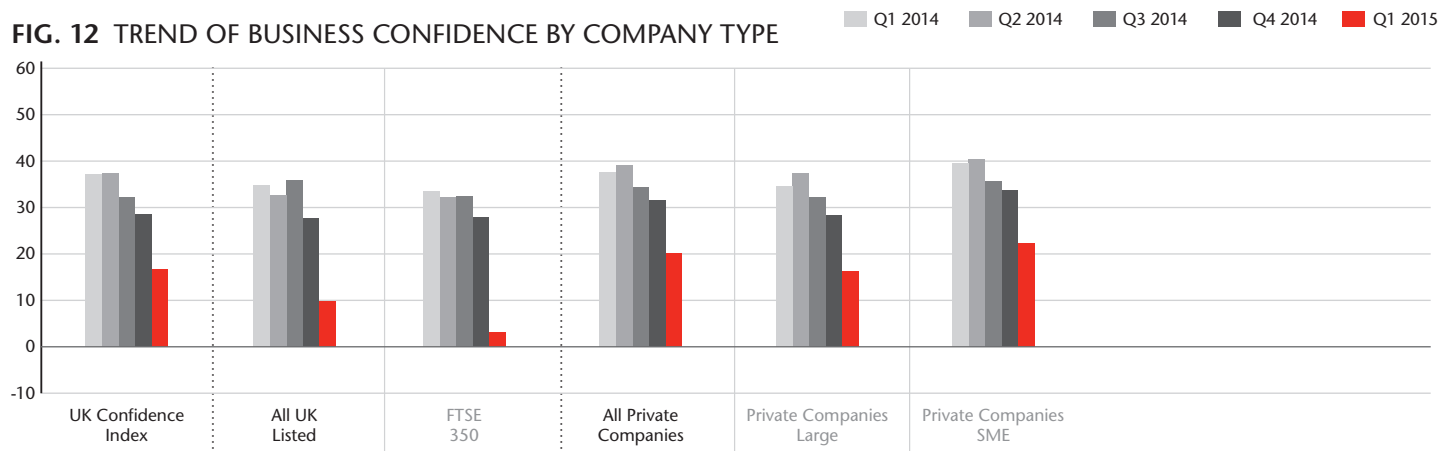
The regions of southern England, including the South East, South West, East of England and London, have seen confidence generally decline steadily over the past four quarters. Two factors that may weigh on growth for businesses in London in particular this year are levels of staff turnover and competition in the marketplace, with a greater proportion of firms in the capital citing these as a greater challenge compared with a year ago than anywhere else in the UK.

and Yorkshire & Humber have seen their Confidence Index readings hold steady this quarter, at a higher level than that seen in the south. One aspect that may be helping to keep confidence in the north more buoyant is recent trade performance. The latest figures from HMRC show that exports in Northern England rose year on year by 6.1% in Q3 2014, while Yorkshire & Humber saw their export level remain broadly on hold, compared to a UK-wide decline of 5.5% over the same period.

In contrast to these trends, the northern regions of Northern England

Trends in business confidence – type

FIG. 12 TREND OF BUSINESS CONFIDENCE BY COMPANY TYPE



Confidence is falling back across all firm sizes and types. However, the year-on-year decline has been sharpest among FTSE350 companies, to a reading of +3.1 this quarter, down from +33.6 in Q1 2014. This is the lowest reading of any firm type, with a quarter of these firms reporting that they are less confident in prospects for the year ahead than the year just gone.

LARGER FIRMS, LOWER CONFIDENCE

At the other end of the scale, small and medium-sized private companies have the highest Confidence Index reading, at +22.4 this quarter. Just 13% of these firms expect business prospects to worsen over the year ahead.

This split in optimism levels between smaller and larger companies is likely due to differing market focus. Larger firms are often more concerned with global markets, but with growth weak in the eurozone and slowing in key emerging markets such as China, their prospects for expansion will be constrained.

On the other hand, smaller firms are generally more domestically-focussed, where a boost to consumer spending power is expected this year. These different confidence readings are also reflected in hiring intentions. FTSE350 and larger private firms expect to increase their headcounts at a slower rate over the coming 12 months than the last year. As such, this means that 2015 is likely to be a year where small and medium-sized firms provide a strong contribution to UK economic growth, with larger companies holding back due to international pressures.

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](https://www.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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Kudos Research

Interviewing and data analysis was undertaken by Kudos Research.

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