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An instinct for growth™

UK Business Confidence Monitor

Q1 2014



Welcome



This quarter's *ICAEW/Grant Thornton Business Confidence Monitor* (BCM) predicts that the UK economy will grow 1.5% in the first quarter of this year. While this figure shows that the recovery continues to gather pace, I am worried about its long-term sustainability. Little has been done to address fundamental imbalances in the economy – particularly our weak exports, but also regional disparities in growth. These could potentially stall growth as future spending cuts and interest rate rises kick in.

We need a Budget for exports as part of a fundamental reassessment of what government is doing to support and drive overseas trade. We also want the Governor of the Bank of England (BoE) to look not just at employment, but at broader measures such as growth in productivity or investment when considering any future interest rate rise.

A handwritten signature in black ink, reading "Michael Izza".

Michael D M Izza
Chief Executive
ICAEW



We have seen an improvement in a broad range of key financial indicators in this quarter's BCM. What is important is the reported and expected growth in capital investment. This is crucial to a recovering economy, especially as businesses have been sitting on large cash reserves.

Confidence is strong across all sectors but the Construction and Banking, Finance and Insurance sectors are leading by example. It should not be forgotten that these were two of the most badly hit sectors during the downturn and there is still a long way to go to get back to pre-crisis levels of output.

A handwritten signature in black ink, reading "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 has increased again in Q1 2014 to +37.2, up from +31.7 in Q4 2013. Confidence has now increased for six consecutive quarters, suggesting that the economic recovery is gaining momentum.

The Confidence Index is a leading indicator for growth, and this quarter's reading suggests that the economic recovery will accelerate in the first quarter of 2014, building on the 0.7% expansion seen in Q4 2013. In 2013, the economy grew at its fastest pace since the financial crisis and it looks very likely that growth will quicken further this year.

KEY ISSUES EMERGING THIS QUARTER

- Business confidence has risen again in Q1 2014, to a new record high.
- Business performance is strengthening, as annual turnover and profit growth have continued to pick up.
- Alongside higher confidence, businesses are also reporting faster capital investment growth.
- However, export growth remains on hold – a concern given the UK's trade position.
- Confidence has risen sharply in the Construction sector, pointing to a strong performance in 2014 – encouraging given that output in the sector remains well below its pre-financial crisis peak.

The increase in business confidence in the first quarter of 2014 points to robust economic growth at the start of the year. However, there are some concerns about the sustainability of the economic recovery, particularly with respect to exports. Export growth has failed to pick up in this quarter's BCM, despite improving economic prospects in key UK export markets. A trade-led recovery has yet to emerge and this could start to weigh on growth prospects as exports fail to keep pace with imports.

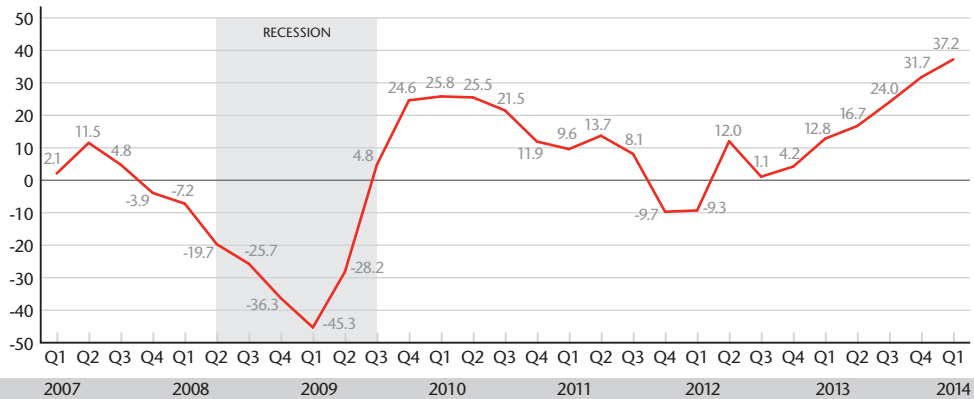
The unemployment rate is set to continue to fall, and looks likely to drop below the 7% threshold at which the BoE will consider raising interest rates within the next few months. However, with more than half of businesses still operating below capacity – indicating significant slack remaining in the economy – the Bank may decide that an immediate tightening of monetary policy remains unwarranted.



Douglas McWilliams
Chief Executive, Cebr
ICAEW Economic Partner

Business confidence in Q1 2014

FIG. 1 TREND OF UK BUSINESS CONFIDENCE



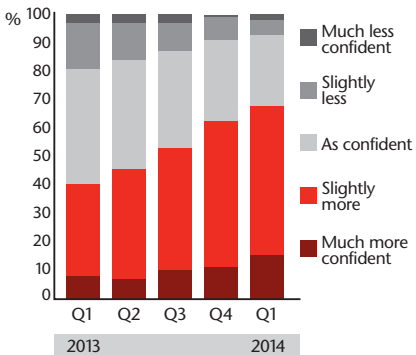
The latest ICAEW/Grant Thornton UK Business Confidence Monitor (BCM) shows business confidence continuing to improve. The Confidence Index for Q1 2014 has increased to +37.2, up from +31.7 in Q4 2013, and taking confidence to a new record high level.

CONFIDENCE CONTINUES TO RISE

This quarter's BCM findings show UK business confidence rising for the sixth consecutive quarter, increasing from +31.7 in Q4 2013 to +37.2. The Confidence Index stands at an all-time high now, surpassing the record level seen last quarter. This suggests that businesses are becoming increasingly optimistic about the economic outlook facing their organisations.

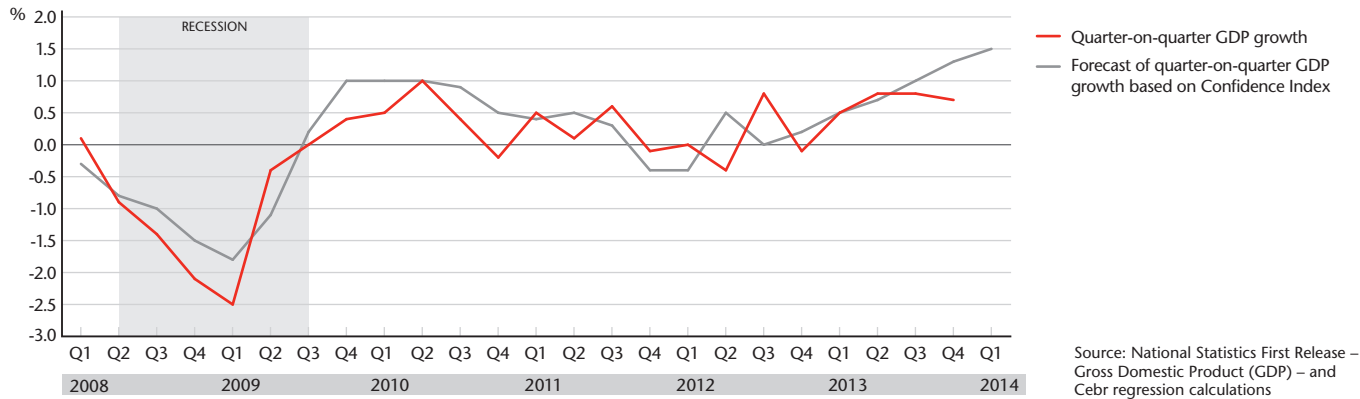
Over two thirds (68%) of businesses are more confident about their economic prospects over the coming 12 months than the previous year, up from 63% in Q4 2013 and 40% in the first quarter of 2013. BCM

FIG. 2 UK CONFIDENCE INDEX – DETAILED RESPONSES



suggests that the recovery is gaining momentum in Q1 2014, building on official data showing a generally solid economic performance at the end of 2013. In January, the International Monetary Fund (IMF) had to increase sharply its growth forecast for the UK economy in 2014 to 2.4%, up from a previous forecast of 1.9%. This quarter's Confidence Index suggests that even this revised forecast may be too pessimistic.

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



Over 2013, the UK economy grew at its fastest rate since the financial crisis. Initial estimates from the ONS showed the economy growing at a quarter-on-quarter rate of 0.7% in the last quarter of 2013, with growth of 1.9% for the year as a whole.

BCM POINTS TO ACCELERATING GROWTH IN 2014

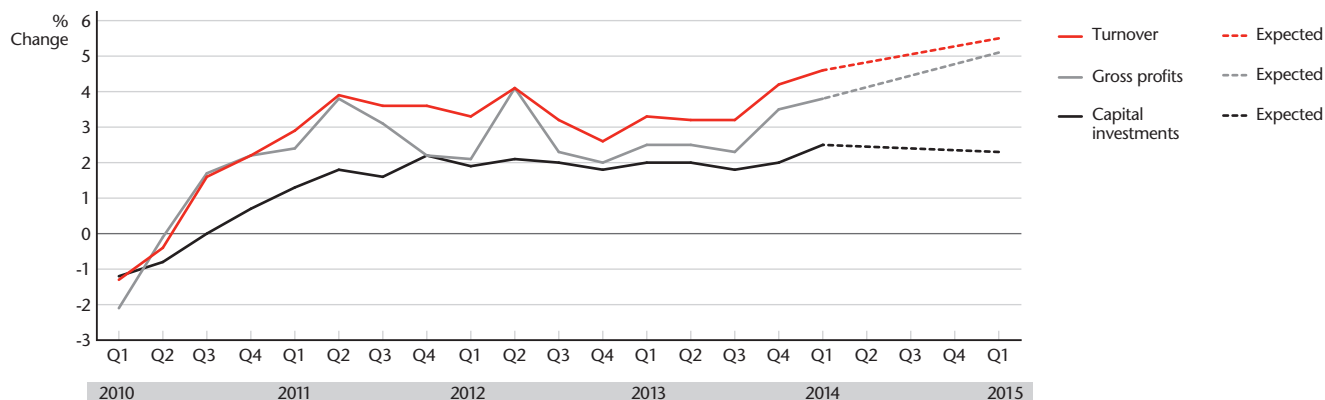
The latest Confidence Index results suggest that economic growth will accelerate in Q1 2014. Indeed, this quarter's record Confidence Index score is consistent with growth of 1.5% in Q1 2014 alone, which suggests that economic growth this year should easily exceed that seen in 2013. Economic growth of over 2% and probably close to 3% looks likely for 2014 as a whole.

While official data on the UK economy have been overwhelmingly positive in recent months, there are still concerns about the drivers of the

recovery. In particular, consumer spending accounted for the majority of the growth seen last year – 86% of growth according to the Office for Budget Responsibility's (OBR's) December publication – while other factors such as net trade weighed on economic prospects. The key challenge for the UK economy this year will be to achieve balanced and sustainable growth, where raising investment and overseas trade – as well as consumer spending – drive expansion.

Business Financial Performance

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



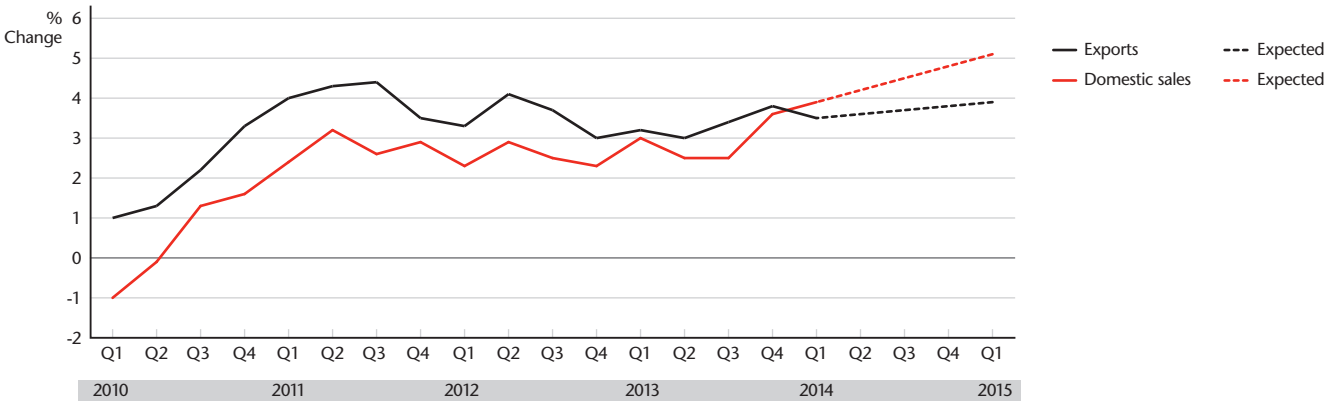
In line with rising confidence, business financial performance indicators continue to improve this quarter. Turnover and gross profit growth have increased, and businesses expect an acceleration in growth over the next 12 months – turnover is projected to rise by 5.5%, while gross profits are estimated to grow by 5.1%.

MODEST INVESTMENT GROWTH EXPECTED

The latest figures in BCM show growth in capital spending picking up as companies become more confident in the economic outlook. In recent quarters reported investment growth has generally surpassed projections from a year earlier, pointing to an improving investment environment. We may see businesses deliver more than the 2.3% growth that they forecast over the next 12 months. Companies could start to use some of their cash reserves – which stand close to £500bn according to ONS data – to expand capital investment over the coming year.

Although the latest figures show that business investment is starting to turn a corner, they also suggest that future investment growth will be relatively modest and that official forecasts are too optimistic. The OBR expects real business investment to grow by 7.8% per year on average between 2014 and 2018, which would require company investment intentions to accelerate significantly from where they currently stand.

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



Domestic sales growth continues to accelerate, this quarter overtaking export growth. Over the last 12 months domestic sales have grown by 3.9% while exports have grown by 3.5%. Domestic sales growth is expected to shoot even further ahead of export growth over the coming year, raising questions over whether the UK economy will be successful in rebalancing to more trade-oriented expansion.

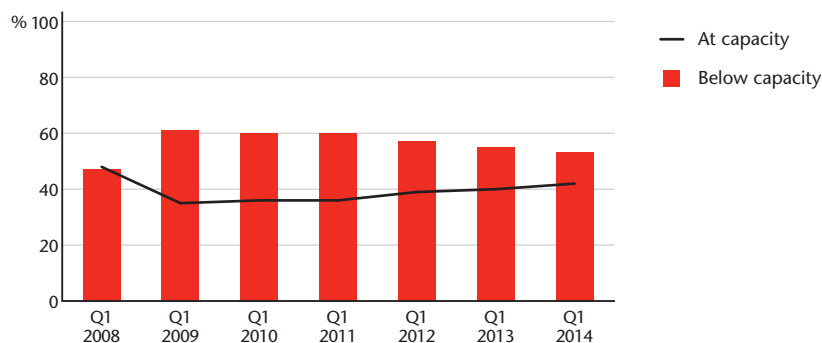
EXPORT GROWTH REMAINS SUBDUED

Despite the rise in business confidence this quarter, export growth has failed to pick up. Further, businesses expect exports to grow by 3.9% over the next 12 months, down from predicted growth of 4.4% in Q4 2013. The latest figures come despite a general improvement in the economic outlook of key UK export markets, suggesting that government departments such as UK Trade & Investment (UKTI) need to do more to secure a trade-led recovery.

The lacklustre performance of UK exports could start to weigh on growth prospects. The UK has been

running an annual trade deficit – importing more than exporting – since 1997, illustrating the relative weakness of the UK’s trade position. For small and medium-sized enterprises, data in BCM show a clear downward trend in reported export growth over the past year, while domestic sales growth has been on a general upward trend. This suggests that with the domestic economy improving, fuelled by consumer demand, smaller businesses may be choosing to focus on the UK market rather than overseas expansion.

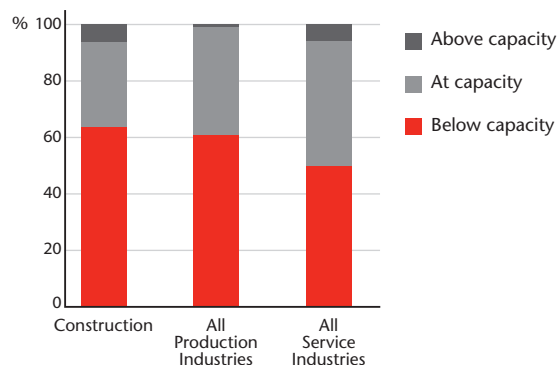
FIG. 6 SHARE OF BUSINESSES OPERATING AT AND BELOW CAPACITY



More than half of businesses are operating below capacity.

While there are signs that the proportion of companies operating below capacity has fallen steadily since 2009, with output still running below potential in many industries the BoE may be justified in keeping interest rates on hold for the time being, even as unemployment falls.

FIG. 7 SHARE OF BUSINESSES OPERATING AT, ABOVE AND BELOW CAPACITY



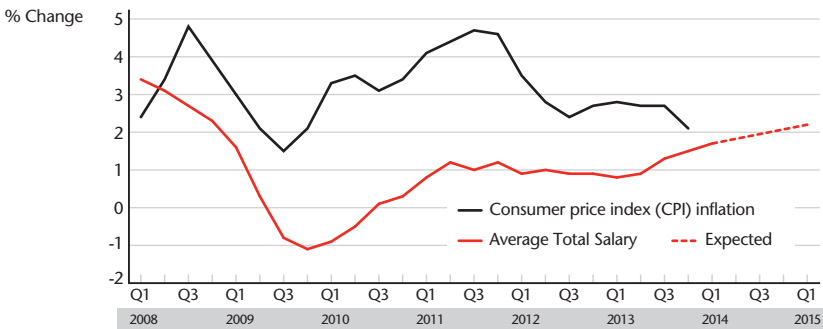
MOST BUSINESSES OPERATING BELOW CAPACITY

Businesses in the Construction and Production sectors are more likely to be operating below capacity than their counterparts in the Services sector. The variations in spare capacity are likely to reflect differences in how sectors have fared since the financial crisis: the Services sector has rebounded, with output in Q4 2013 standing 1.4% higher than in the same quarter of 2007, while output of the Production sector was 12.3% lower and in the Construction sector output was 10.3% lower.

Under the BoE's policy of forward guidance, it will consider raising

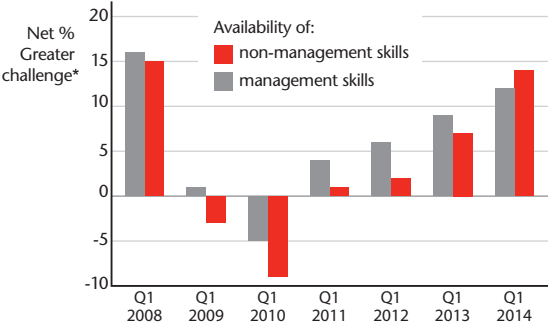
interest rates once the unemployment rate falls below 7%, something which looks set to occur over the next few months as the private sector continues to create jobs. However, with output in Production and Construction still well down on pre-crisis levels, the Bank may want to wait until spare capacity diminishes in these sectors before raising rates. At present, with over half of UK businesses operating below capacity, an immediate tightening in monetary policy seems unwarranted.

FIG. 8 AVERAGE % CHANGE OVER 12 MONTHS TO ...



The availability of skills has become more of an issue as the labour market improves. This quarter, a net 14% of businesses report non-management skills to be a greater challenge than a year ago, the highest share since Q1 2008. With many parts of the economy expanding or turning a corner, skills shortages are becoming more of a problem as businesses look to take on more staff.

FIG. 9 SKILLS AS A GREATER CHALLENGE



* calculated as the proportion of companies saying 'greater challenge' minus the proportion of companies saying 'less of a challenge'

PAY GROWTH LOOKS SET TO OVERTAKE INFLATION

Businesses expect total salaries to rise by 2.2% over the next 12 months. While this is still weaker than the typical pay growth seen before the financial crisis, it is an improvement on recently-reported figures. This could pave the way for earnings growth to overtake inflation in 2014, supporting a return to real (inflation-adjusted) household income growth. This in turn should support consumer spending over the coming year and reduce the need for individuals to dip into savings or borrow to finance spending – putting household budgets on a more sustainable footing.

Rising salary growth may, in some sectors, reflect a growing skills shortage. In the Construction sector a net balance of 17% of businesses report that non-management skills are a greater challenge than a year ago, up from a net balance of -1% in Q2 2013, and salary growth in the sector has increased in line with this. Last year, house builders in the UK reported a sharp increase in bricklayers' pay due to a shortage of skilled workers.

Trends in business confidence – industry

FIG. 10 TREND OF UK BUSINESS CONFIDENCE



Confidence in the Construction sector continues to rise this quarter, with the Confidence Index for the sector standing at an all-time high at +52.2, much higher than the +37.2 seen for all UK businesses. The sector has started to turn a corner and should make a significant contribution to GDP growth in 2014, though output remains much lower than before the economic downturn.

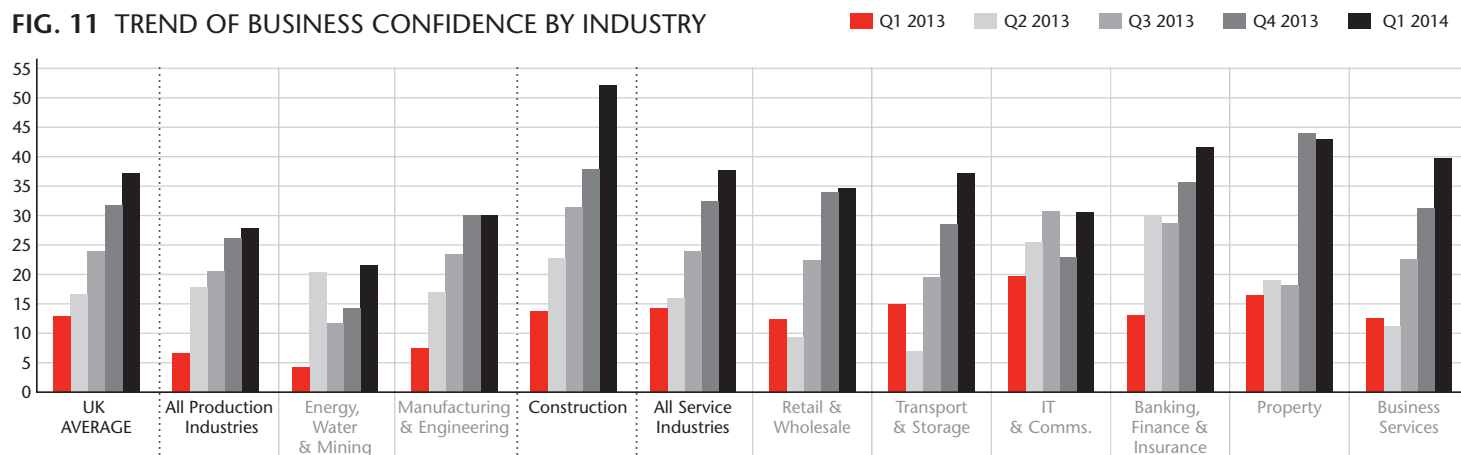
FINANCIAL SECTOR RETURNING TO HEALTH

This quarter, confidence in the Banking, Finance and Insurance sector increased to +41.6, sharply up from +13.0 in Q1 2013. Confidence stands above the previous peak seen at the end of 2009, when the worst of the financial crisis was drawing to a close and the UK economy started to exit recession. The improving health of the financial services industry has clear implications for the rest of the economy, given the reliance of consumers and businesses on bank finance.

The success of the Construction and Banking, Finance and Insurance sectors will be important in

determining the strength of the UK economy in 2014. The Construction sector has a high economic multiplier due to its large value chain, meaning that its success feeds through into many other parts of the economy. It is estimated that every £1 spent on construction output generates £2.84 of total economic activity. The Banking, Finance and Insurance sector accounted for 9.0% of GDP last year – a significant share – so stronger growth in the sector is good for the overall economic picture.

FIG. 11 TREND OF BUSINESS CONFIDENCE BY INDUSTRY



Confidence has increased across most industry sectors. Confidence has improved in the Construction and Services sectors this quarter, while confidence for Production Industries is well up on the same quarter in 2013, pointing to improved confidence across the private sector.

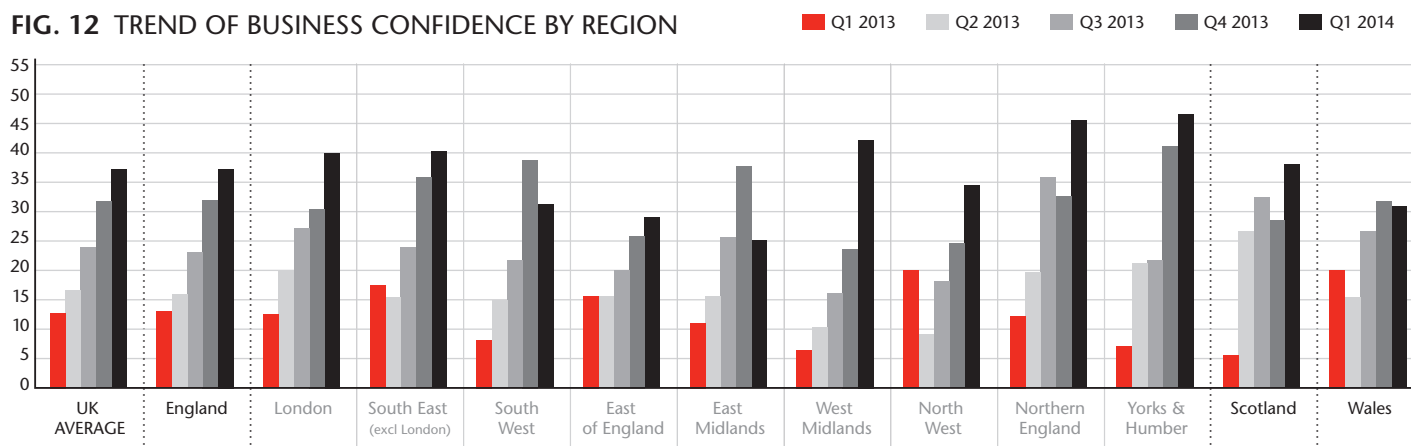
MIXED PICTURE FOR INVESTMENT ACROSS INDUSTRIES

Outside of Construction, where confidence soared to +52.2 this quarter, key parts of the UK's Services sector also look set for a solid start to 2014. Following three consecutive quarters of rising confidence, the Business Services sector is expected to create a significant number of jobs over the coming year, with businesses anticipating an increase in staff headcount of 2.4% on average over the next 12 months – notably higher than the 1.6% average across all UK businesses.

There is a mixed picture for capital investment at an industry sector level. Capital investment intentions for the coming 12 months are broadly unchanged for the Production Industries compared with Q1 2013, while they have increased in the Construction and Services sectors. The Retail & Wholesale sector, within Services, has seen a particularly strong acceleration in capital investment growth intentions, from 1.2% in Q1 2013 to 3.2% in Q1 2014, suggesting that the strengthening consumer outlook is leading to more investment.

Trends in business confidence – region

FIG. 12 TREND OF BUSINESS CONFIDENCE BY REGION



Confidence remains much higher than a year ago across all UK regions. Over the past year, confidence has increased the most in Yorkshire & Humber, the West Midlands and Northern England. Wales has seen the smallest increase in confidence over this period.

CONFIDENCE RISES OR HOLDS STEADY IN MOST REGIONS

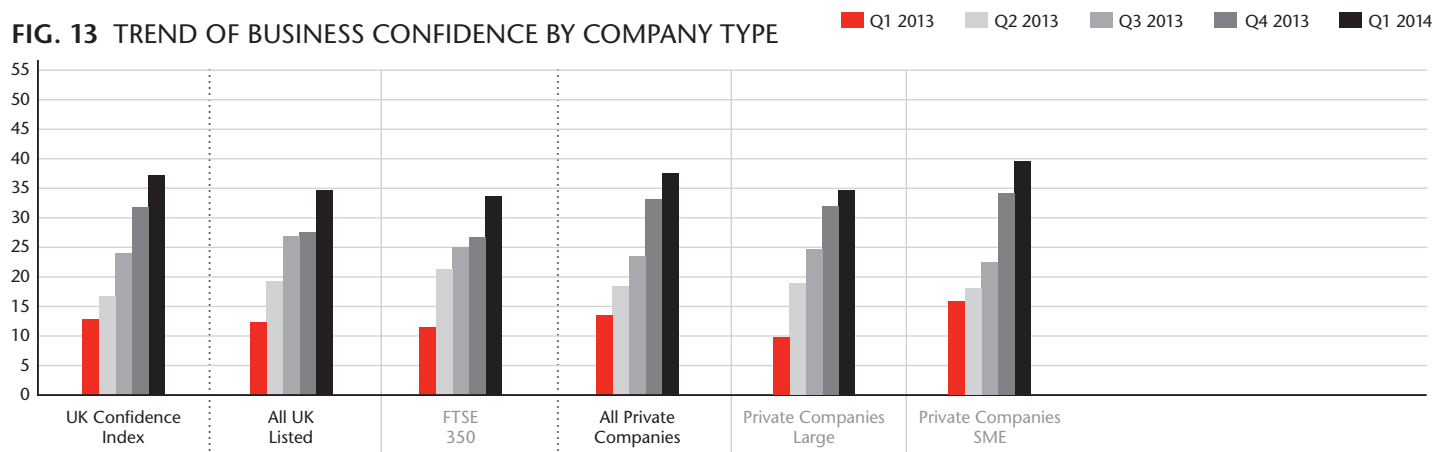
In England, businesses in the West Midlands report a significant increase in confidence this quarter, with the Confidence Index standing at +42.2, up from +23.7 in Q4 2013. Although the unemployment rate in the region remains relatively high, at 8.1% over the three months to November, this is 1.3 percentage points lower than the three months to August, suggesting a significant improvement in the regional labour market. The West Midlands has also benefitted from a strengthening UK car industry: data from the Society of Motor Manufacturers and Traders

showed the greatest number of new car registrations since 2007 last year.

The picture in Wales is more muted, with the Confidence Index standing at +30.9 – broadly unchanged from Q4 2013. Public sector job shedding could particularly hurt Welsh economic performance; nearly a quarter (24.6%) of jobs in the country were in the public sector in Q3 2013, much higher than England's 17.9%. That said, confidence in Wales is still firmly in positive territory and Welsh businesses expect improved performance over the coming year.

Trends in business confidence – type

FIG. 13 TREND OF BUSINESS CONFIDENCE BY COMPANY TYPE



Confidence has increased this quarter and it now stands at a similar level across all types of organisation. Confidence continued to increase across all types of organisation in Q1 2014, with private SMEs slightly more confident than other types of organisation.

FTSE 350 COMPANIES RETURN TO JOB CREATION

This quarter, FTSE 350 companies report that staff headcount is 1.1% higher than a year ago and they expect employee numbers to grow by 0.8% over the next 12 months – an encouraging sign that some of the largest companies in the UK are recruiting again. Between Q3 2012 and Q4 2013, FTSE 350 companies reported no growth or year-on-year declines in employee numbers, and the return to headcount growth may reflect an improving economic outlook in the Western economies.

Over the coming year, all types of business expect stronger growth

for domestic sales than for exports, suggesting that the current economic and policy environment is geared more towards domestic consumption than trade. This is particularly the case for private SMEs, which expect sales to grow by 6.3% over the coming year, higher than the 4.3% they expect for export growth. Export competitiveness may be hampered by the recent strengthening of sterling against other major currencies: between January 2013 and January 2014, sterling appreciated by 3.2% against the US dollar.

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.

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

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