UK Business Confidence Monitor

Q3 2014

BUSINESS WITH CONFIDENCE

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Welcome

This quarter's *ICAEW/Grant Thornton Business Confidence Monitor* sees the first fall in confidence in two years, which demonstrates that there is more to be done to get the recovery on a sustainable footing. The imbalances in our economic recovery that were masked by rising confidence continue to persist – our exports remain weak, and investment isn't maintaining momentum. If these aren't rectified, our burgeoning recovery could peter out.

That said, we are still operating from a high level, and we expect the economy to grow by around 0.9% in the third quarter. The private sector is also set to create 500,000 jobs in the next 12 months, and domestic sales are still driving the recovery. We look to the Bank of England and the Government to work harder to ensure that the recovery is placed on a broader footing.

Michael Izza

Michael D M Izza
Chief Executive
ICAEW

While confidence has dipped in this quarter's *ICAEW/Grant Thornton Business Confidence Monitor*, it is important to bear in mind that it is still relatively strong. The private sector is looking to create thousands of jobs, and most sectors are still very much in positive territory.

Various factors remain disappointing though. Investment isn't maintaining momentum, which is crucial to a recovering economy, exports remain well behind domestic sales, and the skills shortage is becoming more of a concern, particularly in construction. As the labour market continues to improve, and staff turnover increases, it is important that we ensure that those entering the workforce are adequately equipped with the skills needed to drive the economy forward.

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 weakened in Q3 2014, standing at +32.3 compared with +37.3 in Q2 2014. However, the Confidence Index remains at a high level by historic standards.

The Confidence Index is a leading indicator for growth, and this quarter's reading suggests that the economy will expand at a quarter-on-quarter rate of 0.9% in Q3 2014, broadly unchanged from the rates of growth seen in the first half of this year. Nonetheless, BCM also indicates that growth may slow further ahead.

KEY ISSUES EMERGING THIS QUARTER

- Business Confidence dips in Q3 2014 but remains high.
- Projections of future turnover and profit growth have levelled off, though business performance stays strong.
- Improved investment growth has been reported for the past year, however, this is expected to slow over the next 12 months.
- Domestic sales rather than exports remain the main driver of growth, reflecting the fact that the UK economy is growing more strongly than its key export markets. The strength of sterling, which has made exports less price competitive, may also be a factor.
- Growth in employee numbers shows no sign of slowing, which could pave the way for over half a million extra private sector jobs over the next 12 months.
- Despite strong job creation, salary growth expectations remain modest.

While economic growth is forecast to hold steady in Q3, BCM provides reasons to anticipate some modest slowdown thereafter. The relative weakness of exports means that the UK's trade position is likely to weigh on growth prospects. Skills shortages also remain an issue for many businesses and a lack of appropriately trained staff could hold back future expansion.

The share of businesses operating below capacity continues to fall back this quarter and, if current trends continue, this should pave the way for the Bank of England to raise interest rates in early 2015. However, with significant fiscal austerity set to take place in the next parliament – deficit reduction is far from over – the pace of rate rises is likely to be very gradual.

Douglas McWilliams
Chief Executive, Cebr
ICAEW Economic Partner

Business confidence in Q3 2014

FIG. 1 TREND OF UK BUSINESS CONFIDENCE

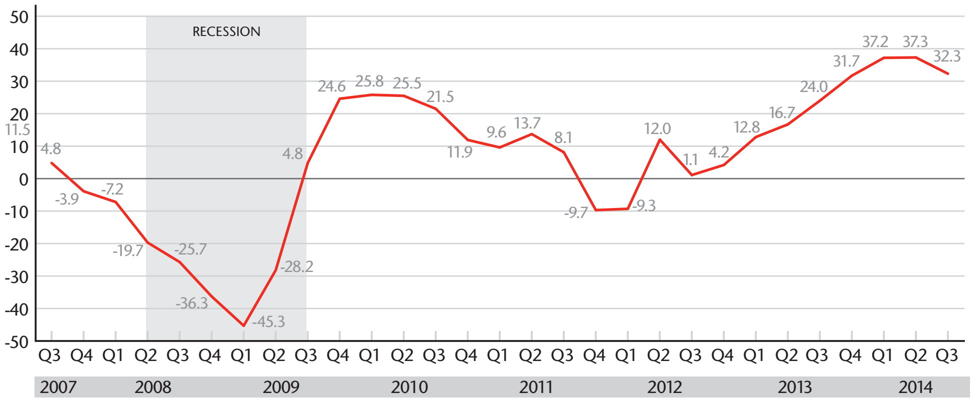
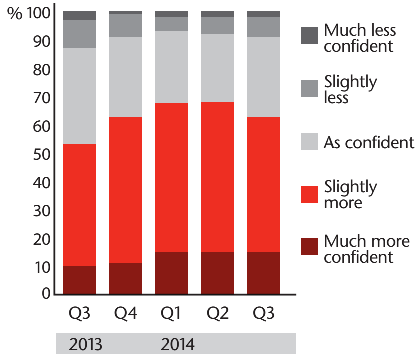


FIG. 2 UK CONFIDENCE INDEX – DETAILED RESPONSES



The latest *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) shows business confidence cooling slightly. The Confidence Index for Q3 2014 dipped to +32.3 from +37.3 the previous quarter, although remains well above the figure of +24.0 at the same point a year ago.

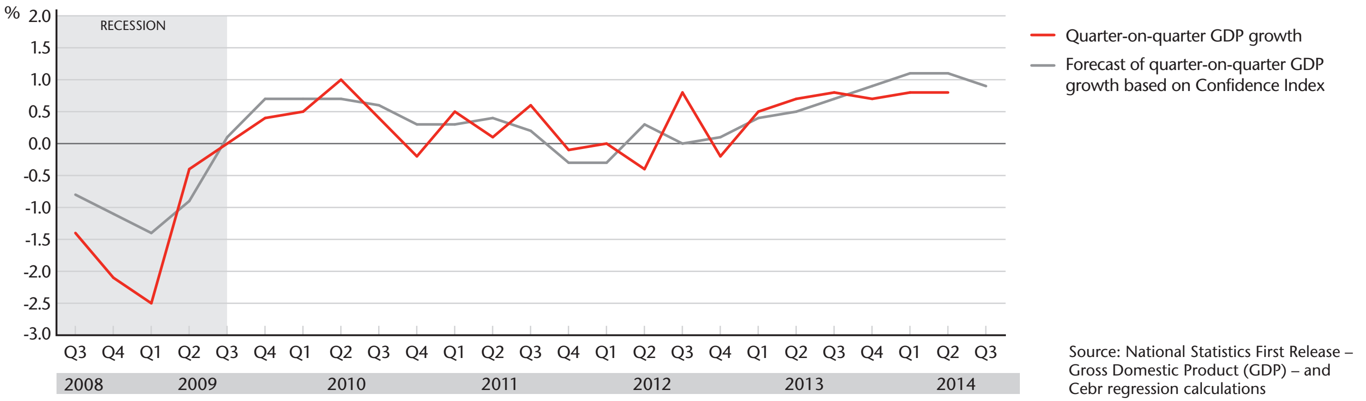
CONFIDENCE DIPS BACK IN Q3

This quarter's UK business confidence fell back for the first time in two years, indicating that economic growth may be starting to moderate. After a strong bounce back from the weak economic conditions seen in recent years, businesses appear to be settling now into the realism of a steadier growth environment ahead.

Overall, businesses remain optimistic about future trading conditions. More than three fifths (62%) of companies report this quarter that they are more confident about their prospects for the year ahead than the previous 12 months. At the other end of the scale, just 10% of businesses are less confident about the next year.

Business confidence levels still point to a strong year of growth for 2014 as a whole, with the UK seen as the fastest growing economy among the G7 developed nations, according to the International Monetary Fund (IMF). The IMF's latest views on the UK economy are a marked turnaround from their previous announcements that UK Government's policies may lead to only minimal growth at best.

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

UK GDP has now surpassed its pre-financial crisis peak in real terms – in Q2 2014 the size of the economy expanded 0.2% above the level last seen in Q1 2008. However, while this is positive news for the overall economy, continued solid growth is needed for average living standards and real disposable incomes to reach their previous peak.

ROBUST GROWTH FOR Q3 BUT SLOWDOWN FURTHER AHEAD

The latest Confidence Index figure remains strong, despite the latest dip, and as such suggests buoyant economic expansion continuing into Q3 2014. The result of +32.3 is consistent with a quarterly increase of +0.9%, broadly in line with growth seen in the first half of the year.

However, beyond Q3, other key indicators from BCM suggest that growth could start to ease later in the year – in line with similar economic data. Consumer confidence results from YouGov indicate that optimism among households may have peaked, while the June retail sales data from the ONS also showed a continued slowdown in spending growth. A decrease in consumer expenditure would weigh down on overall UK growth in 2015, coming at a time of relatively weak export performance and low business investment growth. In addition, sharp government spending cuts will be needed in the next parliament to address the budget deficit. This slower economic expansion in the medium term may weigh down on the ability of average living standards to regain their pre-crisis levels.

Business Financial Performance

FIG. 4 TURNOVER, EXPORTS AND DOMESTIC SALES – AVERAGE CHANGE …

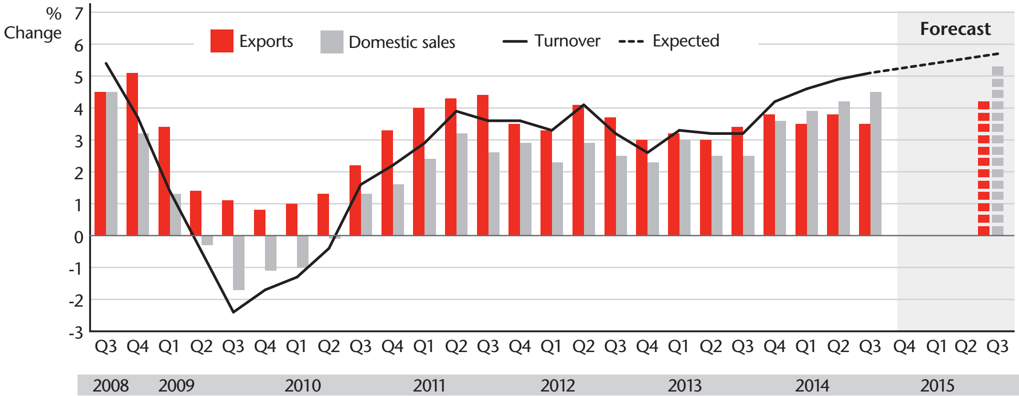
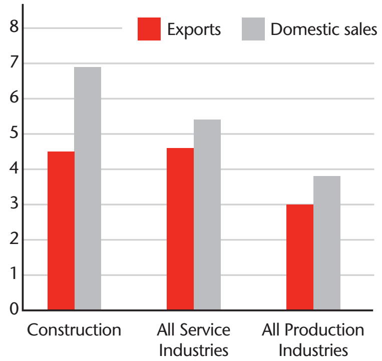


FIG. 5 EXPECTED % CHANGE OVER NEXT 12 MONTHS



Business performance continues to improve this quarter. Turnover rose on average by 5.1% over the past 12 months, maintaining an upward trend to reach the strongest result in six years. However, expectations for the year ahead have been levelling off, reflecting this quarter's dip in confidence.

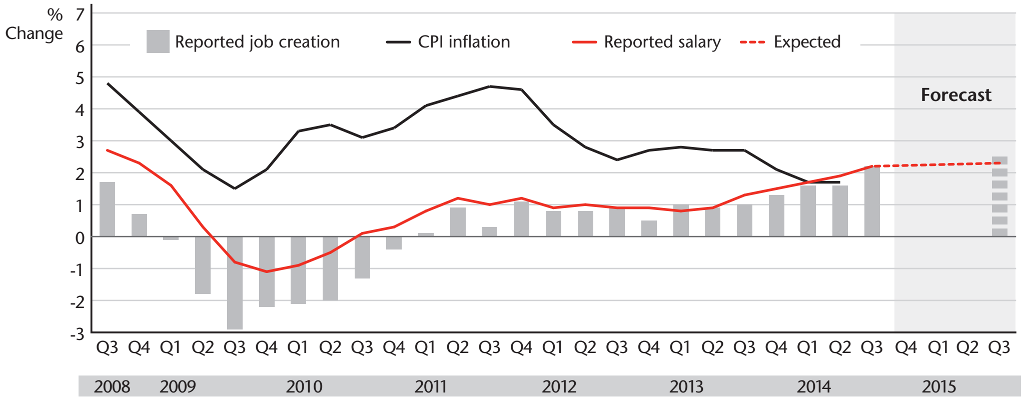
DOMESTIC SALES DRIVES TURNOVER GROWTH

This further uptick in turnover growth has been supported mostly by faster rises in domestic sales. Companies report these increasing by 4.5% over the past year, the largest increase seen since Q3 2008. Declines in unemployment and growth in consumer confidence over the past year have boosted domestic demand.

This strong picture contrasts with the performance of exports. They have risen by a more modest 3.5% over the past 12 months, following a broadly flat trend since 2011. The UK's key export markets such as the eurozone and the US continue to post disappointing growth figures, with expansion remaining well below that of the UK.

Businesses expect export sales growth to pick up over the coming year, though this may prove difficult given recent developments. The value of sterling has appreciated significantly in recent months against the dollar and the euro. If this trend is sustained, UK exporters will become less competitive in the global marketplace. This may make it difficult for the UK economy to achieve sustainable, trade-driven growth and reduce its dependence on domestic consumption.

FIG. 6 AVERAGE % CHANGE OVER 12 MONTHS TO …



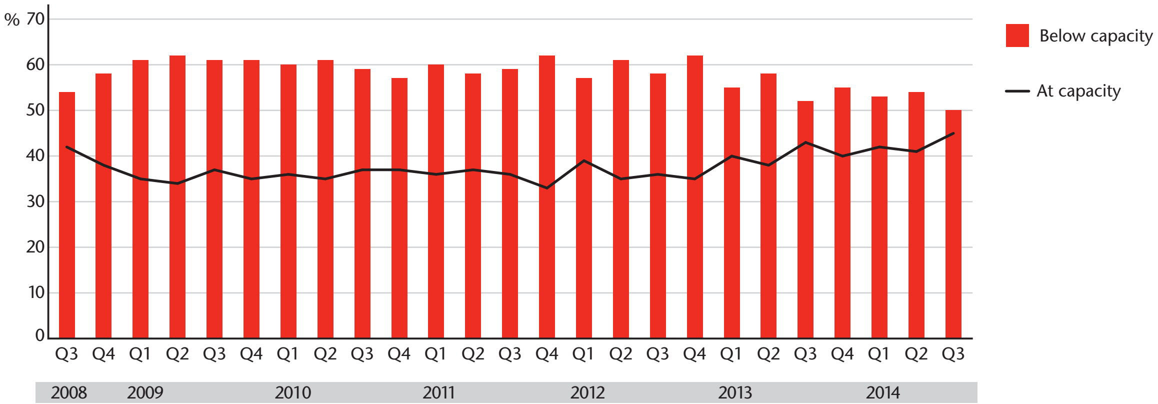
The UK's private sector continues to signal strong hiring intentions, with average employee numbers increasing year on year by 2.2% this quarter. This is the fastest growth rate since Q2 2008 and follows a recent strong performance in the labour market. The unemployment rate fell to just 6.6% in the three months to May 2014, down by 1.2 percentage points from the same point a year before.

PRIVATE SECTOR JOB CREATION SHOWS NO SIGN OF SLOWING

Strong headcount growth is expected to continue, with employee numbers increasing by 2.5% over the coming 12 months. This would translate into over half a million private sector jobs over the next year. This is important at a time when the public sector continues to cut back on headcount, and it also helps to bring unemployment back towards pre-financial crisis norms.

A further sign of the strengthening labour market is pay growth, which picked up to 2.2% over the past 12 months. Annual consumer price inflation was 1.7% in the three months to June 2014. This suggests that wages are now rising in real terms again – something not seen for a sustained period since before the financial crisis. As businesses expect to keep pay growth at roughly this level for the coming year and the Office for Budget Responsibility forecasts inflation of 1.9% for the year as a whole, this trend of cautious real pay growth could continue.

FIG. 7 SHARE OF BUSINESSES OPERATING AT AND BELOW CAPACITY



This quarter, the proportion of businesses reporting that they are operating below capacity falls further, to 50% of companies. This is the lowest figure since Q2 2008, reflecting the extent to which the economy has recovered in recent quarters. At the same time, the share of companies operating at capacity has reached 45% this quarter, up from just 43% at the same time the previous year.

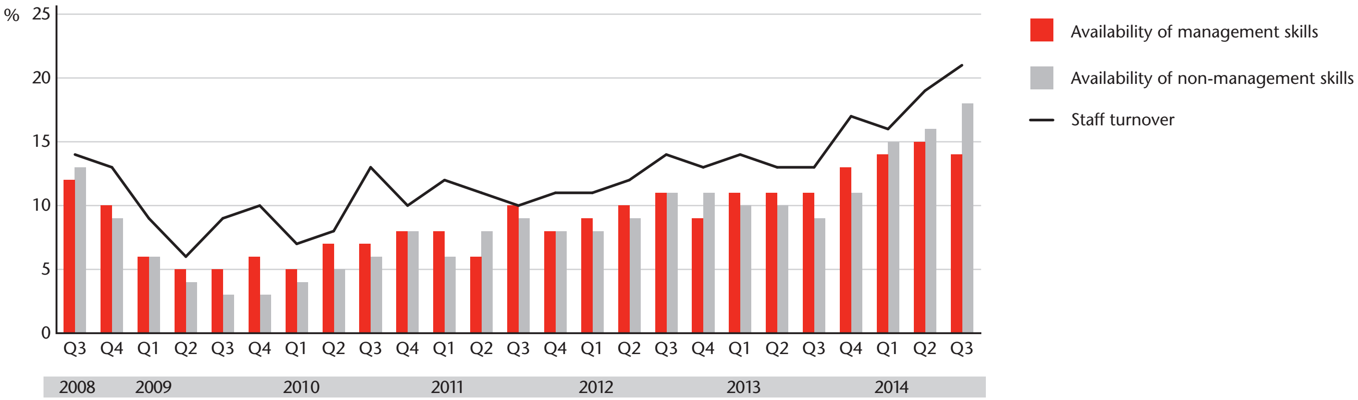
GROWTH BRINGING DOWN SPARE CAPACITY LEVELS

The manufacturing sector continues to have the highest share of companies with spare capacity, at 69% reported this quarter. Although the sector has been growing at a fairly solid year-on-year rate in 2014 so far, the level of its output still remains 7.4% below its pre-crisis peak according to the ONS.

Falling levels of spare capacity suggest that businesses may be using their resources more effectively. As wage growth has been traditionally linked to increases in productivity, this is likely to be a factor contributing to reported salary rises. However, with the share of businesses operating below capacity still above the level seen before the financial crisis, salary expectations remain modest for now.

Both productivity growth and the amount of slack in the economy have been cited by the Bank of England as measures they are considering when setting monetary policy. With both of these indicators improving, the need for an increase in the Bank's base rate is drawing closer.

FIG. 8 STAFF TURNOVER AND AVAILABILITY OF SKILLS AS A GREATER CHALLENGE



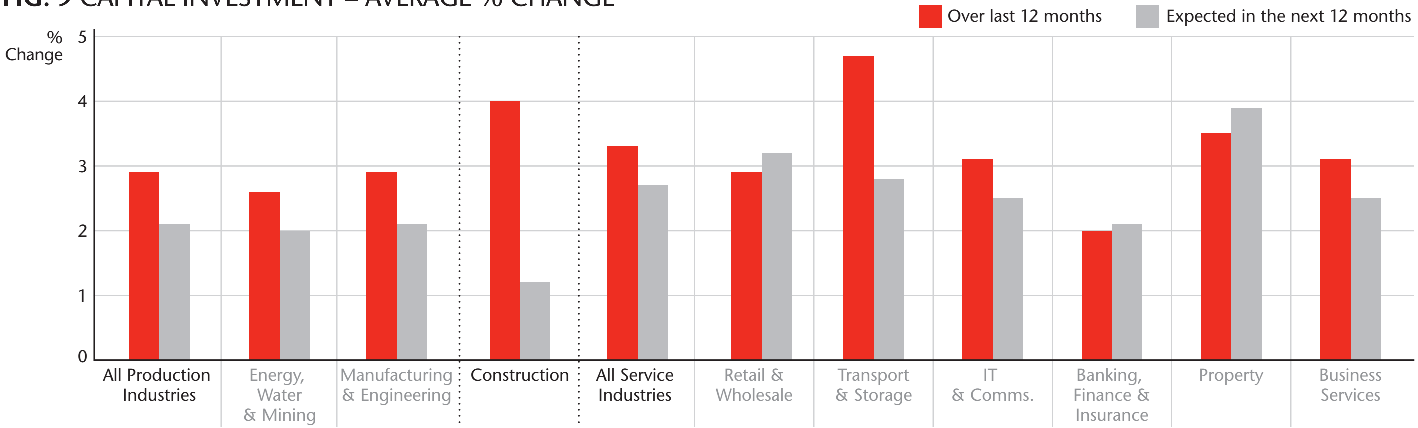
While significant additions to headcounts are a sign of a strengthening economy, skills shortages are increasingly becoming a challenge for businesses. A lack of available staff with the right skills to fulfil new orders is likely to become one factor that could cool economic expansion in the coming quarters.

SKILL SHORTAGE MORE OF AN ISSUE AS LABOUR MARKET TIGHTENS

This quarter, 18% of businesses report that finding workers with non-management skills is harder than a year ago, well above the 9% seen at the same point in 2013. This follows a general upward trend since mid-2013, and highlights the extent to which finding suitable staff has become an issue as unemployment has fallen back. In a similar vein, staff turnover is more of a challenge now than a year ago for more than a fifth of businesses (21%). This is up from 13% in Q3 2013, as buoyant hiring intentions make it easier for valuable workers to find a new job.

Further reductions in the unemployment rate are likely to make skills shortages more of an issue, bringing growth down to more stable levels in 2015. Unless policymakers take appropriate steps to address these shortages, this factor is likely to remain a constraint on growth in the medium term.

FIG. 9 CAPITAL INVESTMENT – AVERAGE % CHANGE



This quarter, businesses report capital investment increasing by 3.3% over the past year, up from 2.3% last quarter. Although this is the fastest annual growth in capital investment seen since Q2 2005, the latest BCM results indicate that this increase is not likely to be sustained over the coming year.

NO ACCELERATION IN INVESTMENT GROWTH EXPECTED AHEAD

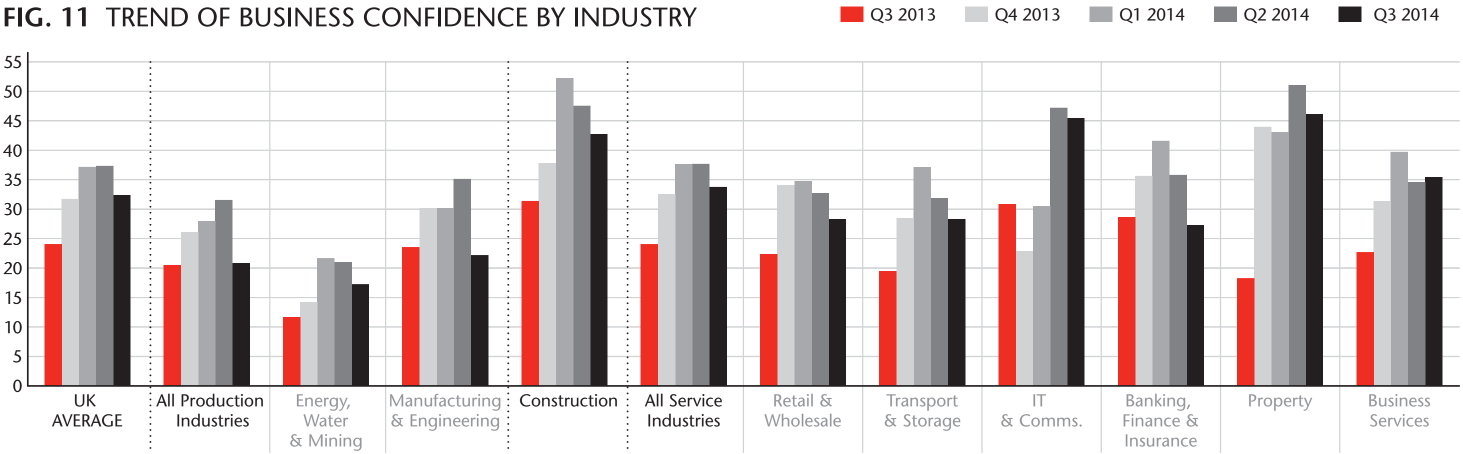
Investment growth of 2.4% is predicted for the next 12 months, broadly in line with annual growth seen over most of 2013 and 2014. The lack of an uptick in capital expenditure suggests that companies' expectations for growth prospects over the medium term are not quite as strong as for the short term. This raises concerns that the UK will struggle to achieve sustainable expansion unless business investment reaches higher levels, as this is needed to drive productivity growth.

Across the industries, the property sector expects the fastest increase in capital investment over the next 12 months. This reflects the recovering state of both the housing market and commercial property, areas which are also likely to perform strongly in the coming months.

Businesses in construction are signalling the weakest investment intentions, in contrast to their strong predictions for turnover growth over the next year. Lack of skilled labour could be a possible factor holding back further investment, as companies in this sector report the skills shortage as a greater challenge this quarter compared to a year ago.

Trends in business confidence – industry

FIG. 11 TREND OF BUSINESS CONFIDENCE BY INDUSTRY



The dip in confidence, seen across the UK this quarter, comes from all three of the major industries – construction, production and the services sector. While confidence in the construction sector has been cooling for the past two quarters, this is the first quarter-on-quarter decline for optimism in production and services since mid 2013.

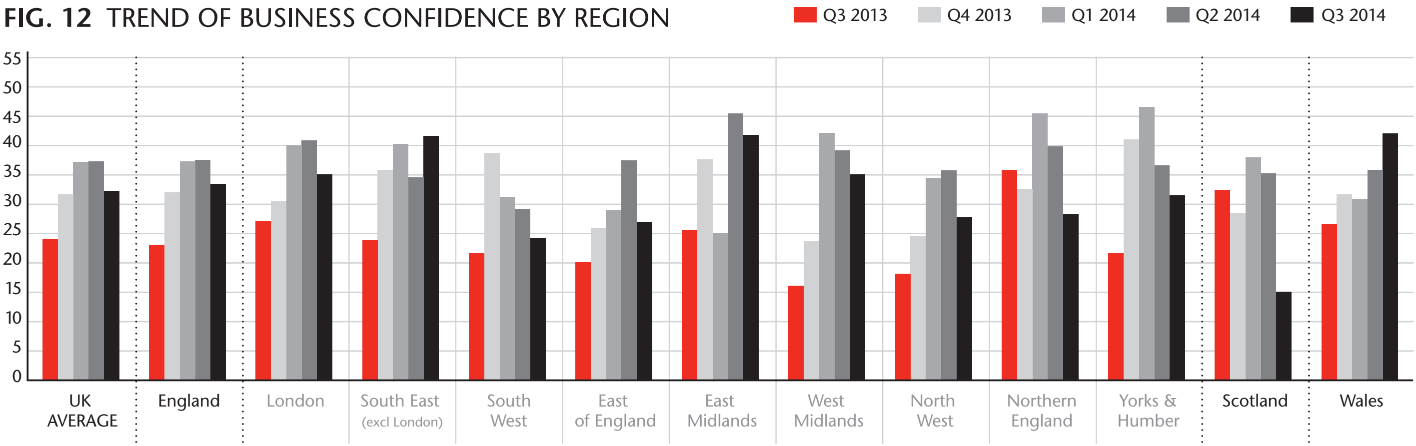
OPTIMISM REMAINS HIGH IN CONSTRUCTION AND IT SECTORS

Despite declines in recent quarters, confidence levels remain high among Construction and IT & Technology companies. This buoyant outlook for the year ahead is reflected in their expectations for further growth, as businesses in both these areas of the economy predict some of the fastest increases in sales and employment of any sector over the next year. However, these sectors also have the biggest share of companies reporting difficulties in finding workers with the right skills, which could constrain their growth in the quarters ahead.

Meanwhile, businesses in the production industry continue to have the lowest confidence reading this quarter. This is reflected in their weak expectations for sales growth and headcount increases. George Osborne mentioned in his first 'non-emergency' Budget of March 2011 that he wanted to encourage the UK to rebalance towards the manufacturing sector, helping to drive invention and innovation. The latest BCM results suggest that this rebalancing still remains elusive.

Trends in business confidence – region

FIG. 12 TREND OF BUSINESS CONFIDENCE BY REGION



The decline in the headline UK Confidence Index is reflected in many of the regions this quarter, with Wales and the South East being the only areas seeing an increase. However, despite this latest dip in confidence, optimism levels generally remain well up on a year before.

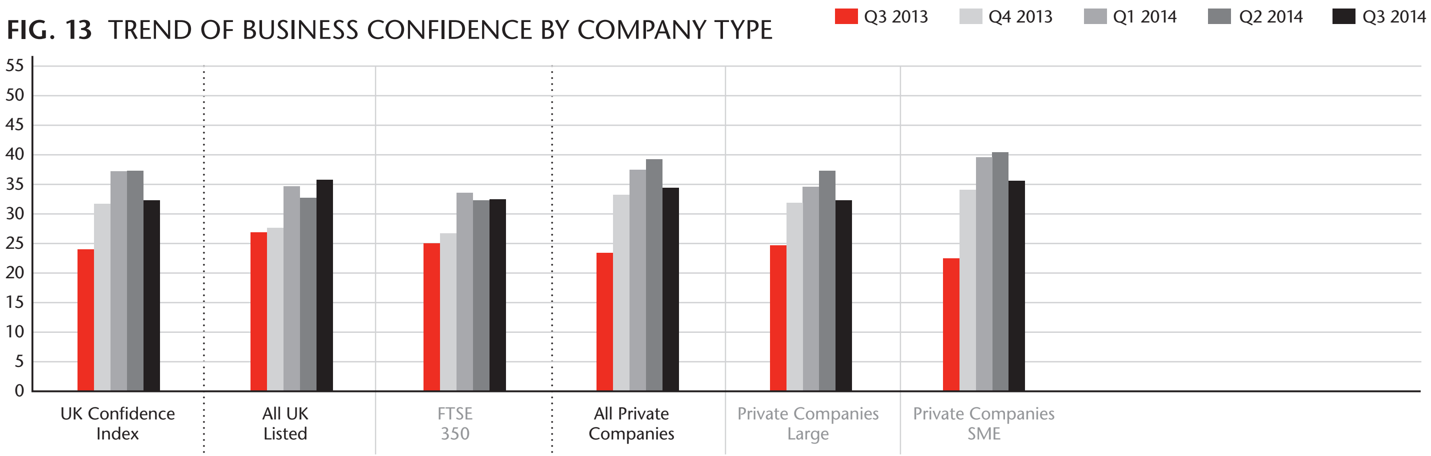
CONFIDENCE IN WALES CONTINUES ON UPWARDS PATH

The strongest confidence performance seen across the UK in recent quarters has been in Wales, with a Confidence Index reading of +42.1 this quarter, following a general upward trend over the past year. The labour market in Wales has showed marked improvements in recent months. The unemployment rate was standing, during the three months to May 2014, at 1.6 percentage points lower than the same point a year before. This is a stronger performance than for the UK as a whole, which saw the rate fall by 1.3 points over the same period.

At the same time, confidence among businesses in Northern England has been declining for the last two quarters, to reach +28.3. This reflects continuing difficult conditions in the region's labour market, as the unemployment rate of 9.6% in the three months to May 2014, is the highest in the UK.

Trends in business confidence – type

FIG. 13 TREND OF BUSINESS CONFIDENCE BY COMPANY TYPE



Confidence has been generally increasing among listed companies over the last 12 months – this quarter's decline is limited to those in private ownership. The Confidence Index for all UK listed businesses climbed to +35.8 this quarter from +26.9 at the same point a year ago. Optimism levels for all private companies also remains up on a year before, but has slipped this quarter to +34.4 from +39.2 in Q2 2014.

LARGER COMPANIES FINDING IT HARDER TO KEEP STAFF

Although employee retention is becoming more of a challenge for businesses across the UK economy, there are signs that this issue is not being felt equally. This quarter, 27% of FTSE 350 companies report that staff turnover is a greater challenge now than a year ago, comparing similarly to 24% of large private businesses, but well above 14% of small and medium-sized private enterprises. However, despite this concern, larger firms remain broadly as confident about prospects for the next 12 months as their smaller counterparts.

Although staff turnover has more of an effect on larger companies, the latest results indicate that all types of businesses are finding it difficult to recruit workers with the right skills. This quarter, 17% of listed UK companies report that the availability of non-management skills is more of a challenge now than a year ago. This is broadly similar for private companies, and private SMEs in particular.

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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Kudos Research

Interviewing and data analysis was undertaken by Kudos Research.

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