March 2017

NO SIGN OF IMMINENT SLOWDOWN FROM CBI SURVEYS

Three quarters after the referendum result, our surveys reinforce the wealth of other economic data which indicate that the UK economy is performing well. Business sentiment has improved and activity has continued to grow, buoyed by domestic demand and increasing appetite from overseas. However, the picture is mixed across sectors, and sterling-induced cost pressures are building across the economy, driving up inflation. At the very least, this is likely to push down on consumer spending as the year progresses, barring a notable pick-up in earnings growth.

Sentiment has improved across our surveys…

Following the UK's vote to leave the EU, there was a widespread deterioration in business sentiment at rates last seen during the Eurozone crisis of 2011 and, in some instances, since the 2008/09 global financial crisis. With the initial shock and accompanying uncertainty having receded since then, we have subsequently seen a broad recovery in sentiment across our surveys.

In particular, we have seen a marked improvement among manufacturers, whose assessment of the current business environment climbed at the fastest pace in two years in the quarter to January. Underpinning this appears to be a confluence of factors, with higher growth in orders, output and competitiveness providing manufacturers with more favourable operating conditions.

…but Brexit concerns persist

On the other hand, sentiment in the distribution sector (which includes retailers, wholesalers and motor traders) has grown at a more subdued pace following the referendum result. In addition, retailers have turned pessimistic in their near-term expectations for the overall business environment, anticipating that it will deteriorate for the first time in four-and-a-half years. In a special question aimed at gauging the motivations for their gloomier outlook, three-quarters of retailers cited rising cost pressures as having influenced the deterioration in sentiment, whereas Brexit-related uncertainty was also a prominent concern. Sentiment is also subdued in financial services, but has stabilised after falling persistently over 2016.

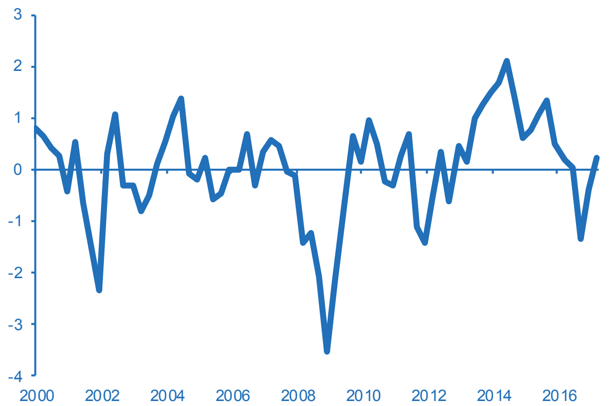
What does this mean for Finance Directors?

- Currently, the economy is on a decent footing and our surveys suggest it will remain so over the near-term.
- While consumer facing sectors are showing some tentative signs that volumes are beginning to soften, those servicing and supplying businesses appear to be faring better. But with consumer fundamentals likely to soften, businesses exposed to household spending may face some challenges.
- Firms are facing significant cost pressures, largely stemming from the weak exchange rate. With the pound still sensitive to political rhetoric and economic dataflow, hedging against exchange rate movements is advisable.
- Further out, the outlook is more uncertain, which much dependent on the evolution and outcome of EU negotiations. Businesses should bear this in mind in their forward planning, particularly in scenario planning.

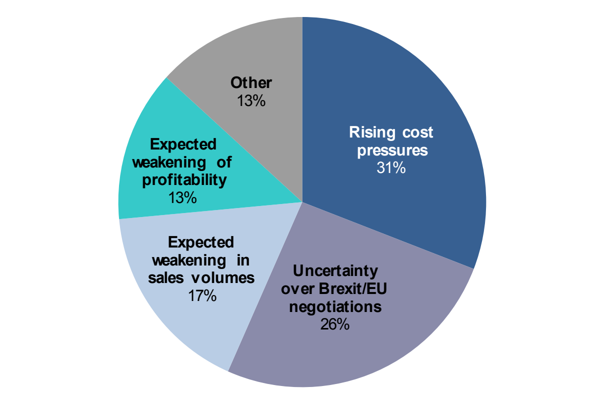
Activity continues to grow

Growth shows little sign of slowing for now. Early "nowcasts" for the first quarter from the Bank of England and the Office for Budget Responsibility (OBR) point to growth coming in at

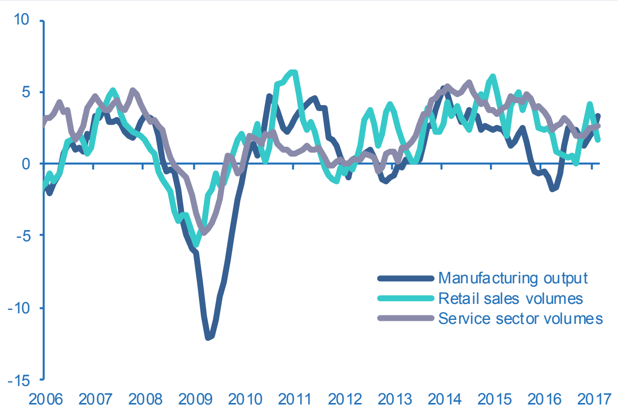
CBI sentiment composite (standardised % balance)



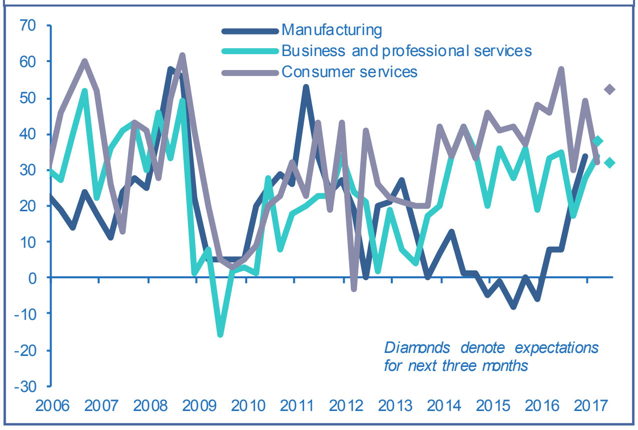
Drivers of deterioration in retailers' near-term sentiment



Activity across CBI surveys (standardised % balance, 3mma)



Average costs over the past/next three months (% balance)



around 0.5-0.6%; a similarly solid rate of growth to that seen in the second half of 2016.

Manufacturing in particular is performing strongly. Our Monthly Trends Enquiry for March shows that total order books remain comfortably above normal levels, while export order books have improved at one of the fastest paces in the survey's history. The quarterly survey in January highlighted strong rises in overseas competitiveness and our members are optimistic about the prospects for exports further ahead.

In contrast, there were some tentative signs of a softening in the consumer-facing side of the economy around the turn of the year. Retailers reported that annual sales volumes had contracted in January, driven by grocers whose sales fell at the fastest pace since August 2004. While there was a return to growth in February, it was tepid in comparison to the expansions seen in November and December as well as historically. Our retailing members indicate that this may partly be driven by price rises implemented at the beginning of the year, whereas the increased trading days in December due to the timing of Christmas may also have had a bearing on volumes. Similarly, the consumer services sector saw business volumes deteriorate in January at the fastest pace in nearly four years before subsequently experiencing a rebound.

The performance of the business and professional services has also been weaker: the sector saw no change in business volumes for the third consecutive quarter in the three months to February. However, their expectations for the coming quarter have turned positive for the first time since the referendum.

Building cost pressures prompt plans for price hikes

While activity seems to be holding up, this is against the backdrop of growing cost pressures. Higher costs are being felt most acutely among manufacturing firms, where the prices of imported raw materials are being pushed up by both the depreciation of sterling as well as by recovering commodity prices.

Meanwhile, a one-off question posed to retailers found that 85% of them were facing higher costs compared with a year earlier, making it easy to appreciate why it was the most commonly cited driver of the deterioration in their sentiment. Higher import costs were a key driver, with some members reporting that currency hedges made before the referendum have now largely unwound, causing costs to climb in a very immediate way due to the pound's weakness. However, a number of other issues are also in play: the introduction of the National Living Wage, revaluation of business rates and the apprenticeship levy among them.

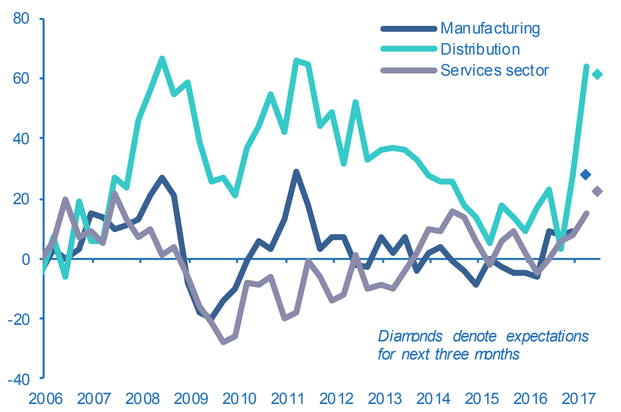
Amid these growing cost pressures, firms have raised their domestic prices at a faster pace, led by the distribution sector, and further hikes are in the pipeline. Expectations for selling price inflation climbed to the highest in a decade among business and professional services, whilst among consumer services they hit a nine-year high. Manufacturers are also increasing domestic prices, albeit at a more moderate rate than they have historically.

Investment intentions have perked up

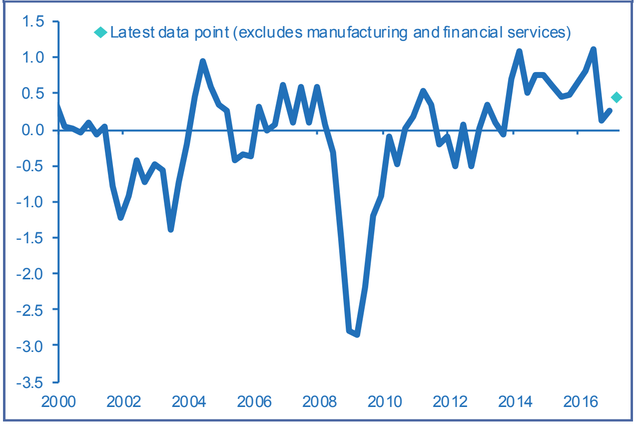
The softening in planned capital expenditure seen straight after the referendum result has seen a broad-based reversal across our surveys. As manufacturing output growth has gained pace, capacity pressures have emerged, leading the proportion of firms working below capacity to drop to the lowest level since July 2015. This has spurred manufacturers to invest in expanding their capacity, with the highest proportion of survey respondents on record reporting this as a motivator for investment. Planned spending on buildings and plant for the year ahead have both risen further above their respective long-run averages, whereas so-called intangible investments in product & process innovation and training & retraining have firmed to the highest in a year.

Investment intentions have also recovered in the services sector as well, with an improvement in planned capital expenditure on IT contrasting with more subdued intentions across other areas. While the services sector hasn't experienced the same rebound in investment intentions as the

Selling prices over past/next three months (% balance)



CBI investment intentions composite (standardised % balance)



manufacturing sector, planned capital authorisations are holding above their respective long-run averages. But in contrast, retailers' year-ahead investment intentions turned negative in February following a modest improvement over the previous two quarters. Anecdotal evidence suggests that the negative outlook for investment may stem from a necessity to make savings in order to offset a greater cost burden as described earlier.

Mixed picture on hiring

Firms across all sectors expect to expand their headcount over the near-term. Manufacturers took on more staff in the three months to February after having previously cut back on staffing levels for the first time in over six years, though the proportion of firms stating that they thought skilled labour would likely limit output over the quarter ahead hit the highest level since the late 1980s. The sector has historically faced relatively pronounced skill shortages, which tend to intensify when there is an acceleration in output growth.

Employment growth has also held up among consumer services, in contrast to more moderate rises among business and professional firms (chiming with the trends in activity in both sectors). However, near-term hiring intentions have softened for consumer services, whereas business & professional services anticipate that recruitment will accelerate. Hiring has weakened most markedly in the retail sector, where firms have cut staff at the fastest pace for two years and a broadly similar reduction in staffing levels is expected in March. This may be driven by an expectation that volumes will soften amid a weakening in household spending, as well as a reflection of a broader need to make savings in order to counter the elevated cost pressures outlined previously.

In terms of medium to long-term hiring intentions, anecdotal evidence across all sectors suggests that there is a considerable amount of uncertainty among firms who are generally waiting for greater clarity on the outcome from Brexit negotiations before committing to any changes to the size and composition of their workforce.

Wage outlook stable

All sectors are anticipating similar levels of wage growth over the next year, at an average of around 2.0-2.5%, suggesting that planned pay awards haven't been upwardly adjusted for the higher inflation that is expected in 2017. Indeed, many of the businesses we speak to still judge salary increases of between 2.0-3.0% as being the norm given the heavier cost burden that they are facing as well as the highly uncertain outlook for business. However, the upward pressure on pay from higher inflation is very much an issue on our members' minds and could well have a bearing on pay awards further ahead, with the majority of respondents expecting to match or exceed RPI in 2017 according to the CBI/Pertemps Employment Trends Survey in December.

Slower growth in the pipeline

Despite the good news on growth since the referendum vote, the outlook remains clouded. Costs are rising strongly, which is starting to push through to factory-gate prices and consumer prices generally. Given that there is little sign that wages are rising to offset, consumer spending is likely to slow.

The improvement in investment intentions since the immediate aftermath of the referendum result is welcome, but these are likely to be highly sensitive to the negotiations with the EU following the triggering of Article 50. And while some partial offset may come from a boost to net exports owing to the weaker pound, experience from the weakness of sterling over 2007-09 suggests that that any overall benefit to trade may be rather mild. Taken together, this suggests that we're still likely to see slower growth further ahead.

George Brown, Economist
(george.brown@cbi.org.uk)