BANK OF ENGLAND

Agents' summary of business conditions

and results from the Decision Maker Panel survey

2018 Q3

- Consumer spending growth ticked up, boosted by the warmer weather, but remained modest.
- Rising uncertainty, mostly related to concerns around Brexit, contributed to a slight softening in investment intentions.
- Export and domestic manufacturing output growth slowed modestly, but remained above average.
- Recruitment difficulties remained elevated; average pay settlements were a little higher than a year ago.

Annual **consumer spending** growth rose slightly, supported by the warmer weather, which boosted demand for seasonal food and outdoor leisure goods and activities. The underlying picture remained one of modest growth, however. Contacts reported weak demand growth for new cars, white goods and homewares, due to weak real income growth and housing market activity.

Growth in **business services** activity eased somewhat, and contacts indicated that there was tighter cost control on discretionary spending due to heightened uncertainty ahead of Brexit. Corporate financing and mergers and acquisition activity softened, following a period of elevated demand. IT and recruitment firms continued to report strong growth in demand.

Growth in **services export** values was broadly steady, supported by inbound tourism and demand for IT and recruitment services, as well for advisory services from overseas investors.

Growth in **domestic manufacturing output** eased slightly but remained above its long-run average. Companies in consumer goods-related supply chains faced headwinds from weaker demand growth, especially for cars and other big-ticket items. Some contacts reported weaker demand in construction supply chains, but demand from the oil and gas sector continued to improve. Growth in **manufacturing export volumes** also moderated, as global demand softened and the boost from sterling's past depreciation began to wane, but growth remained above average.

Construction output growth edged up, but remained sluggish. Growth in housebuilding slowed in some regions and some large commercial and infrastructure projects were delayed or put on hold. Conditions were more resilient in the private rental sector and student accommodation. Contacts cited skills shortages as a constraint on growth.

Investment intentions for the next 12 months softened slightly, depressed by economic and political uncertainty. Concern focused on the possibility of increased trade frictions with the EU after withdrawal, which some firms cited as a reason to put investment on hold or divert it to other countries or subsidiaries.

Corporate **credit demand** remained subdued, partly reflecting strong corporate cash balances and scarring from the financial crisis. Some larger contacts reported refinancing early in case of pre-Brexit volatility but such activity was expected to wane as Brexit approaches. Bank credit remained readily available for larger companies and those with strong balance sheets.

There was modest excess demand among investors for **commercial real estate**, but the underlying picture was mixed. Contacts reported increasing vacancies in secondary retail premises, albeit from a low base. Growth in demand for London office space weakened, while demand for logistics and warehouse premises remained buoyant.

The **housing market** softened a little in some areas, with some contacts reporting that properties were taking longer to sell. Activity was stronger at lower price levels. Demand for new-build houses continued to be supported by the Help-to-Buy scheme.

Capacity utilisation remained higher than normal in both manufacturing and services, with contacts citing availability of labour as the main constraint on output.

Employment intentions remained positive in most sectors except for consumer services, which weakened slightly. **Recruitment difficulties** remained elevated. Average pay settlements were a little higher than a year ago, in a range of 2½%–3½%. Growth in total labour costs picked up due to the increase in employers' pension auto-enrolment contributions, the Apprenticeship Levy, and ad hoc payments to retain staff with key skills.

Materials cost inflation remained elevated, reflecting higher global demand for commodities, and increased prices for fuel, energy and food. Many contacts reported being able to implement small increases in output prices.

Consumer goods price inflation held steady but contacts in the grocery sector expected upward pressure on food prices to emerge due to the dry weather reducing yields of some vegetable and arable crops.

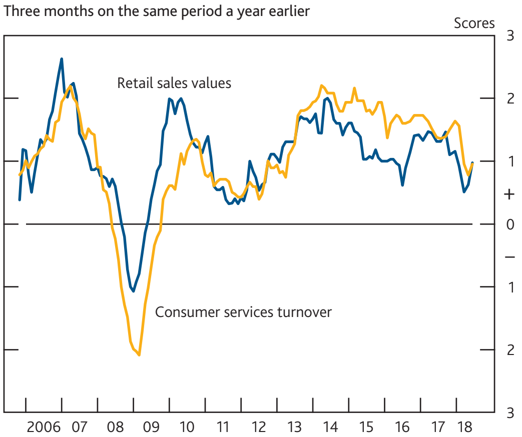
This publication includes a summary of economic reports compiled by the Bank of England's Agents between early June and late August 2018. It generally makes comparisons with activity and prices a year earlier. The report does not represent the Bank's own views, nor does it represent the views of any particular company or region. More information on the Bank's Agencies can be found at www.bankofengland.co.uk/about/people/agents. This publication also includes a summary of information gathered by the Bank's *Decision Maker Panel survey*. Further background is provided in Box 1 on pages 6–7.

Consumer services and retail sales

Agents' scores for consumption continued to rise following weakness earlier this year. Growth in retail sales values (**Chart 1**) was supported by the warm weather: sales growth in the grocery sector was driven by sales of fresh food, meat and alcoholic beverages. Growth in demand for new cars, white goods and homewares remained weak, however, suggesting little change to the underlying picture of modest consumption growth. Growth in demand for consumer services was also modest. The pickup in spending at pubs and on tourism (both inbound and domestic), which had been related to the warm weather, was partially offset by weaker growth in casual dining, cinemas and public transport.

Chart 1 Retail sales values and consumer services turnover

Three months on the same period a year earlier



Business and financial services

Growth in business services activity was slightly weaker but remained healthy. Softer corporate financing and mergers and acquisition activity followed a period of elevated demand as some companies sought to complete deals before Brexit. Marketing companies reported weaker demand as some consumer goods retailers cut advertising budgets. While asset managers reported solid growth and demand for accountancy services held up, contacts indicated there was tighter cost control on some business-to-business spending, such as travel and hospitality, partly due to heightened uncertainty ahead of Brexit. IT companies continued to report strong growth, and demand for recruiters remained supported by the tight labour market. Banks reported reasonable growth in revenues, reflecting financial market activity, and insurers reported that pensions annuity business supported growth.

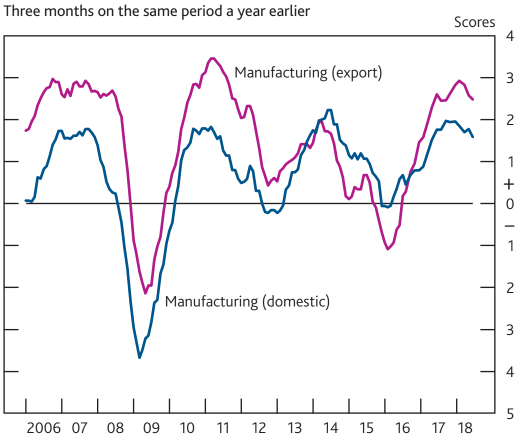
Growth in services export values was broadly steady, supported by inbound tourism and demand for IT, recruitment and architectural services, as well as for advisory services from overseas investors. Demand for services from the oil and gas sector continued to pick up, albeit from a relatively low level.

Production

Growth in domestic manufacturing output eased slightly but remained above average (**Chart 2**). Some contacts reported weaker demand in parts of the construction supply chain, linked to delays on some large infrastructure projects and a softening in some commercial property developments. Companies in supply chains for consumer goods and automotive faced headwinds from weaker demand growth. Engineering companies continued to report strong demand from the oil and gas sector. Domestic manufacturers continued to benefit from suppliers looking to source more goods from the UK.

Chart 2 Manufacturing output

Three months on the same period a year earlier



Growth in manufacturing export volumes also slowed a little, but remained above average, and global demand was firm for aerospace, pharmaceuticals, consumer goods and food. Contacts attributed slower exports growth to the waning effect of the past depreciation of sterling. Nonetheless, demand from non-EU countries, particularly the United States, had held up or strengthened. Contacts reported only limited direct effects from US tariffs. Demand from Asia-Pacific, South America and Africa was also strong. Contacts said that, to date, there had been little impact on export volumes from Brexit. However, some contacts were examining supply chains and considering stock building to mitigate any impact from potential trade frictions.

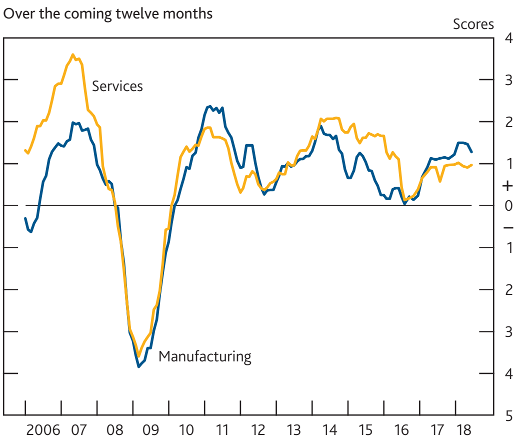
Construction

Construction output growth edged up further, but remained modest. Growth in housebuilding slowed in some regions, but growth in the private rental sector and student accommodation was firm. Some large and commercial infrastructure projects had been delayed or put on hold, but contacts said there was a large number of projects in the pipeline. Contacts also cited skills shortages as a constraint on growth. Although the hot weather had caused some challenges — for example through health and safety requirements or difficulties working with some materials — these were on a much smaller scale than in the winter, and contacts said that the dry weather had helped them to catch up on progress lost due to adverse weather-related disruption earlier in the year.

Investment

Investment intentions for the next 12 months softened modestly (**Chart 3**). Contacts' references to uncertainty had picked up, mostly related to concerns around Brexit. Concern focused on the possibility of trade frictions, which a few contacts cited as a reason to postpone investment or divert it to other countries or subsidiaries.

Chart 3 Investment intentions



Some companies with export markets or international supply chains said that they were reluctant to expand capacity until there was more clarity on future market access to the EU. Some companies are developing contingency plans — such as increasing stocks of components imported from the EU, seeking Authorised Economic Operator status, or reassessing their transport and logistics arrangements — although only a small minority of firms has started to implement them.

Contacts continued to invest in meeting regulatory or compliance standards as well as for security and maintenance, and the tightening labour market provided some impetus for firms to invest in automation to improve productivity.

Corporate financing conditions

Corporate credit demand remained subdued, reflecting strong corporate cash balances and scarring from the financial crisis. Some larger contacts reported refinancing early in case of pre-Brexit volatility but such activity was expected to wane as Brexit approaches. SMEs reported subdued, steady demand for working capital, asset finance and invoice financing.

Bank credit remained readily available for larger companies and those with strong balance sheets, with banks competing on price and non-price terms to win creditworthy borrowers. However, conditions were less favourable for small companies, and availability of all forms of credit, including trade credit insurance, has tightened for construction, consumer-facing and agricultural firms in recent months.

Contacts reported that a growing number of small firms were taking out non-bank finance — for example via crowdfunding or online business loan providers — when they have been unable to access bank funding, or when they need a quick decision. Larger borrowers reported strong availability of non-bank term finance from institutions and debt funds with an interest in the returns offered by longer-term projects.

Corporate distress and restructuring edged up on a year ago from a low base, mainly in the retail, casual dining and construction sectors.

Property markets

Commercial real estate

There was modest excess demand among investors for commercial real estate, but the picture was mixed at a sectoral level. Contacts reported increasing vacancies in secondary retail premises, albeit from a low base. Investors continued to reduce their exposure to retail property, especially in secondary locations and out-of-town premises. Retail valuations and rents have fallen moderately.

Growth in demand for London office space has weakened, and was only partially offset by increasing demand from the creative and digital industries. In other UK cities, rental growth for prime office space continued to be underpinned by a lack of new development and growing demand across the UK for more flexible space.

Investor demand for logistics and warehouse premises remained buoyant and exceeded supply. Contacts thought demand for warehousing could increase further as more businesses might seek to build inventory in the run-up to Brexit. However, there was reported to be limited spare warehousing capacity, especially in southern England.

There were signs that private equity funds were increasing investment in CRE, and contacts reported continued demand for UK commercial real estate from Asian investors, attracted by yields that were higher than in some other EU countries.

Housing market

The housing market appeared to have softened a little, with fewer transactions and weaker price inflation in many areas. The market was stronger in the north, especially in Scotland, but there was a shortage of properties being put up for sale on the secondary market. The new-build market remained stronger than the secondary market, though some large housebuilders reported slightly weaker demand and the need for greater use of incentives, especially for higher-priced properties. Sales of lower-priced new-build houses continued to be supported by the Help-to-Buy scheme.

Mortgage availability continued to be favourable and most contacts believed that strong competition in the sector would keep lending rates low, despite the rise in Bank Rate.

Capacity utilisation

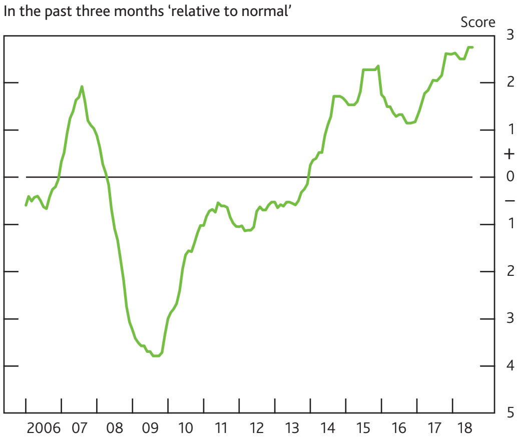
Capacity utilisation remained higher than normal in both manufacturing and services, mainly due to labour shortages. Capacity constraints were particularly elevated in electronics manufacturing due to global supply issues for components, while constraints eased in the automotive sector. Business services firms reported capacity constraints in labour and fixed assets. By contrast, many consumer-facing businesses reported excess capacity in labour — albeit with some flexibility to reduce hours — and fixed assets.

Employment and pay

Employment intentions were modestly positive, though intentions in consumer services weakened slightly, as contracting headcount in retail offset growth in tourism and hospitality. Recruitment difficulties remained elevated (**Chart 4**), and labour market tightness was cited by some construction, haulage and IT contacts as a binding constraint. A continued slowing in the inward flow of EU migrants was reported to have exacerbated skills shortages in agriculture, manufacturing and hospitality. Firms were addressing recruitment difficulties by hiring and training lower-skilled workers, upskilling existing staff, taking on more apprentices and graduates, and investing in automation to improve productivity. An increasing number of contacts reported expanding non-salary benefits such as flexible working and changes to working conditions to attract and retain staff.

Chart 4 Recruitment difficulties

In the past three months 'relative to normal'

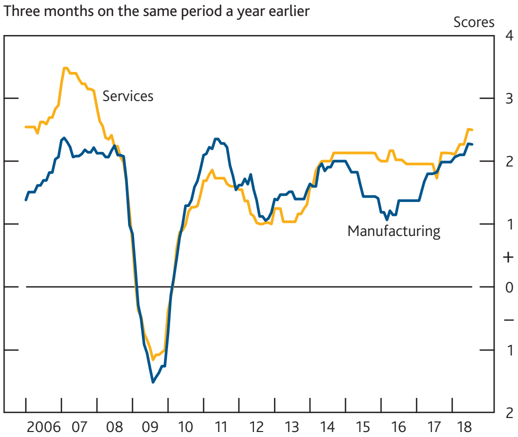


Some contacts reported reducing the number of hours worked by staff. Reasons for reducing hours included: containing overall labour costs; realising efficiency gains from automation; and improving work/life balance.

Average pay settlements were a little higher than a year ago, in a range of 2½%–3½%. Growth in total labour costs picked up due to the increase in employers' pension auto-enrolment contributions; the rise in the National Living Wage — and pressure to maintain pay differentials in line with it; the Apprenticeship Levy, and *ad hoc* payments to retain staff with key skills (**Chart 5**).

Chart 5 Total labour costs per employee

Three months on the same period a year earlier



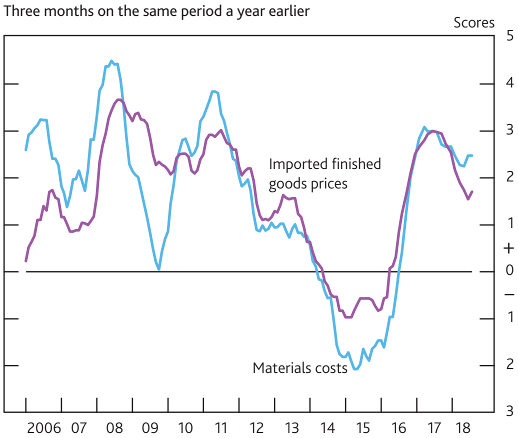
Pricing

Supply chain pricing

Materials cost inflation remained elevated (**Chart 6**), driven by rising prices for fuel, food ingredients, metals, packaging materials, construction products, and energy, where contacts reported increases of up to 20% on renewal of contracts. Many contacts reported being able to implement small increases in output prices, though competitive pressures limited the ability of some manufacturers and suppliers of commoditised services to increase prices.

Chart 6 Raw materials and imported finished goods

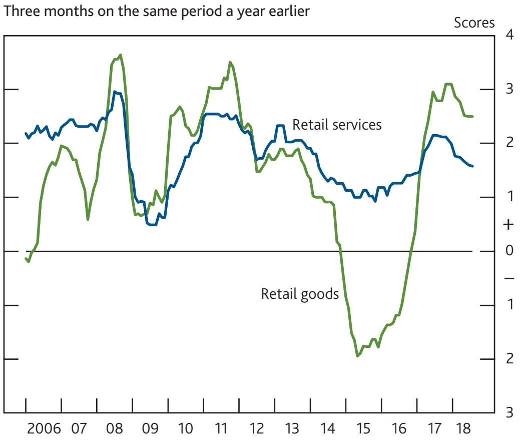
Three months on the same period a year earlier



Consumer prices

Consumer goods price inflation held steady at an elevated level, reflecting past exchange rate effects and higher fuel prices. Price growth was limited in the retail sector, and was modest in the services sector more broadly (**Chart 7**). Looking ahead, contacts in the grocery sector expected upward pressure on food prices due to the dry weather reducing yields of some vegetable and arable crops.

Chart 7 Retail goods and services prices



Box 1
Results from the Decision Maker Panel survey

Overview

Together with academics from Stanford University and the University of Nottingham, the Bank has developed the Decision Maker Panel (DMP) survey to help monitor recent developments in the UK economy and to track businesses' expectations and the uncertainty surrounding them.(1) The DMP is particularly valuable in helping to assess the implications for UK businesses ahead of the UK's withdrawal from the EU. The more quantitative responses from the DMP survey complement the more qualitative intelligence gathered from Bank Agents' contacts.

The panel comprises Chief Financial Officers from small, medium and large UK companies operating in a broad range of industries and it is designed to be representative of the population of UK businesses.(2) Around 4,400 businesses had agreed to be part of the panel at the time of the July survey. The response rate has averaged around 45% in recent months. Aggregate-level data from the DMP survey are available on the Bank's website.(3)(4) This box summarises the latest findings.

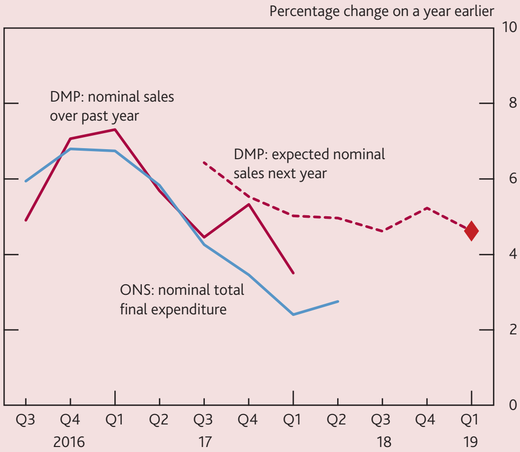
Sales expectations

DMP members reported that nominal sales rose, on average, by 3.5% over the year to 2018 Q1 and they expected sales to increase by 4.6% over the next year (**Chart A**). In line with recent macroeconomic data, businesses experienced a slowdown in sales growth in Q1 compared to previous quarters. But businesses anticipate this slowdown will be temporary as expected year-ahead sales growth did not fall substantially. **Chart A** also shows that the DMP sales growth data have followed a similar pattern to the nearest equivalent measure in the National Accounts, total final expenditure.(5) This indicates that the DMP data are providing a representative view.

Now that the DMP has been running for around two years, there are sufficient data to be able to compare the reported sales growth out turns for panel members to their expectations a year earlier. In aggregate, reported annual sales growth between 2017 Q3 and 2018 Q1 has been slightly lower than was expected by DMP members a year earlier (as shown by the solid red line on **Chart A** being below the dotted red line). But the prediction that sales growth would slow during this period has been accurate.

At the individual firm level, predictions made by DMP members for the sales growth of the business that they represent have proved to be well correlated with subsequent out turns. That is evident in **Chart B**, which splits firms into twenty-five quantiles according to their previous sales expectations and compares realised sales growth with earlier expectations for the same period. Businesses who previously expected higher sales growth have had significantly higher sales growth than those who had lower expectations. As well as collecting information on the central expectations of businesses, the DMP also collects information about the uncertainty surrounding those expectations. Errors in

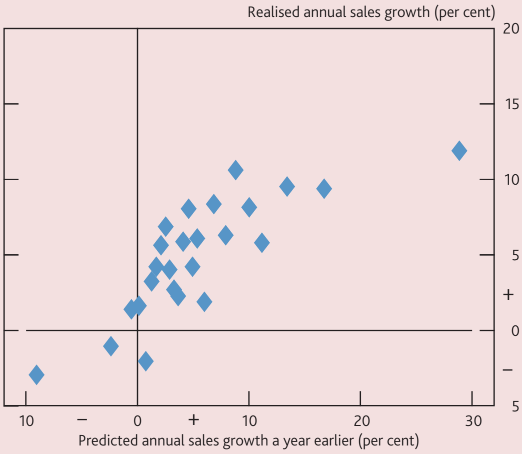
Chart A Average realised and expected growth in nominal sales



Sources: DMP, ONS and Bank calculations.

(a) Questions about sales refer to the last complete quarter. Latest DMP data are for year to 2018 Q1 and expectations for year to 2019 Q1, which are shown by the diamond.

Chart B Realised and expected growth in nominal sales at firm level



Sources: DMP and Bank calculations.

(a) Comparison of average realised firm-level sales growth for 2017 Q3 to 2018 Q1 with predictions for the same business made a year earlier. Individual responses are divided into 25 quantiles according to previous sales expectations. Average responses are shown for those 25 groups.

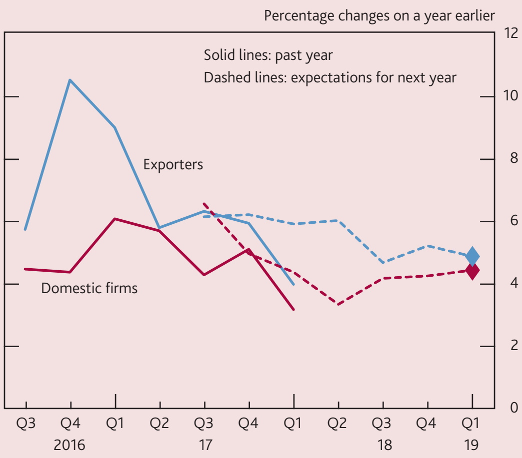
(1) This project is supported by the Economic and Social Research Council (grant number ES/P010385/1).
(2) When it was launched, the DMP initially excluded a small number of sectors, such as agriculture, mining and finance. Those sectors are excluded from the results reported in this box, but the survey is now being expanded to include these industries and they will be included in future reports as soon as sufficiently large samples have been built up.
(3) For details on the methodology, please see www.bankofengland.co.uk/publications/Pages/quarterlybulletin/2017/q2/a3.aspx. All results are weighted.
(4) For aggregate data and details on questions, please see www.bankofengland.co.uk/-/media/boe/files/statistics/research-datasets/dmp-results-september-2018.xlsx.
(5) Total final expenditure is defined as GDP before imports are deducted.

predicting year-ahead sales growth appear to be correlated with the uncertainty around those predictions.

Exporters versus domestic businesses

In the year following the June 2016 EU referendum, businesses who export experienced significantly higher annual sales growth than domestically focussed firms (**Chart C**). That is likely to have reflected the depreciation of the exchange rate boosting the growth of nominal exports. More recently, the gap in sales growth between exporters and non-exporters has narrowed. But sales growth is still reported to have been slightly higher among exporters and is expected to remain so over the year to 2019 Q1.

Chart C Average realised and expected growth in sales of exporters and non-exporters



Sources: DMP and Bank calculations.

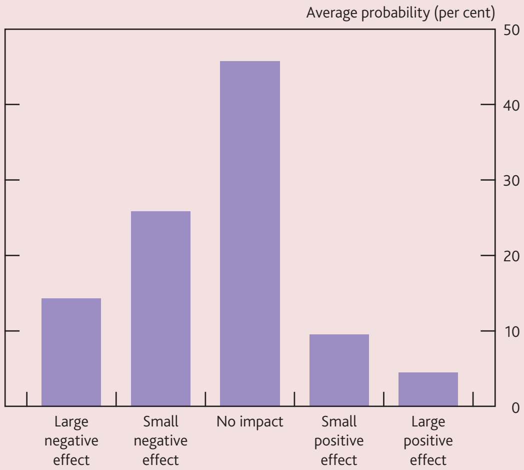
(a) Questions about sales refer to the last complete quarter. Latest data are for year to 2018 Q1 and expectations for year to 2019 Q1, which are shown by the diamonds.

Although the exchange rate depreciation appears to have helped boost the sales of exporters since the referendum, firms thought that Brexit was more likely to lead to lower than higher exports over the longer term. The average probability of Brexit eventually decreasing foreign sales was put at 40%, while the average probability of a positive impact was 14%, with a 46% chance of no impact (**Chart D**).

The depreciation of sterling may also have boosted the profit margins of exporters if it allowed them to receive high sterling prices for their exports without raising foreign currency prices. To investigate this, DMP panel members were asked about their profit margins for the first time between May 2018 and July 2018.

Exporters reported higher profit margins than more domestically focussed businesses in 2018 Q1. But the results also highlight the important effects that higher imported costs have had on profit margins too, given that the exchange rate depreciation will have increased these costs. Profit margins

Chart D Expected eventual impact of Brexit on exports

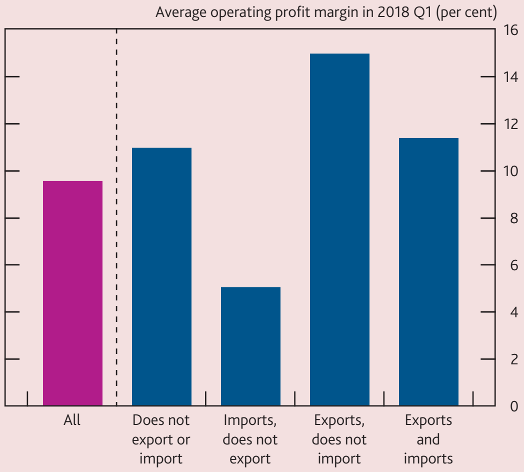


Sources: DMP and Bank calculations.

(a) Question: 'How do you think the eventual Brexit agreement will affect the revenue your business generates by selling UK-sourced goods and services in international markets, compared to what would have been the case had the UK remained a member of the EU?'. A large effect corresponds to changing exports by 10% or more, a small effect is defined as less than 10%. Question asked to exporters only between May and July 2018.

were reported to be highest for exporters who did not also import any goods or services (**Chart E**). Firms who both export and import had similar margins to those who did neither, indicating that the positive export and negative import effects on margins are likely to have largely offset each other for these firms. Margins were reported to be lowest for domestically focussed firms who import.

Chart E Operating profit margins



Sources: DMP and Bank calculations.

(a) Profit margin data were collected between May 2018 and July 2018 and refer to 2018 Q1. Breakdown by use of exports and imports is for a subsample who has responded to questions about their exports and imports in previous surveys.