CBI Q2 SURVEY SUMMARY

SKILLS SHORTAGE CONCERNS PUSH FIRMS TO TAKE ACTION

Weak growth in Q1 raised concerns that the economy could be entering a more sustained slowdown. However, our Q1 surveys didn't show a deterioration in momentum across the sectors which we survey, and the Bank of England expressed scepticism about the extent of the Q1 slowdown. Our surveys for the second quarter suggest growth at a pace similar to that seen during 2017, with disparate trends persisting across sectors: consumer-facing firms continue to be squeezed by weak consumer incomes, while manufacturing continues to benefit from robust demand from abroad.

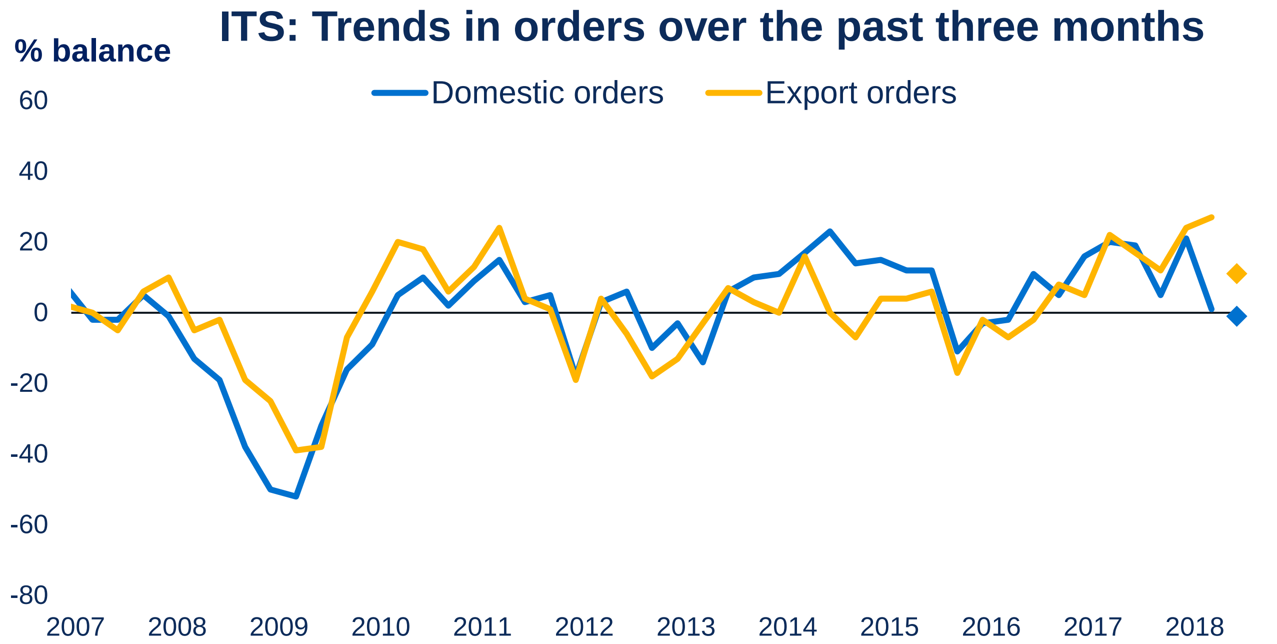
Exports lift manufacturers

Manufacturing output growth rebounded in the quarter to June after three months of progressively weaker growth. Our respondents suggested a few factors behind the slowdown, including uncertainty around leaving the EU, the bad weather in Q1 and lower disposable incomes. Capacity pressures remain intense in the sector, following a year-long run of strong growth, driven be external demand.

Manufacturing exports have benefitted from an improvement in competitiveness following sterling's depreciation in 2016 and the strength of global growth. In May, export orders growth was the strongest in 23 years, while June saw the level of export order books remaining far above the long run average. But domestic conditions remain weaker: domestic orders were unchanged in the three months to April, the weakest result in two years.

What does this mean for your business?

- The slowdown at the start of the year appears temporary, and we expect growth to have been stronger in Q2, but underlying conditions remain tepid.
- For **manufacturers**, global growth seems past its peak, but the lower level of sterling should continue to support competitiveness in global markets.
- **Consumer-facing firms and retailers** can expect UK demand to remain weak but stable: household income growth will continue to be held back by relatively weak wage growth; there is limited scope for employment or credit growth to provide additional support; but household net debt levels remain below pre-crisis peaks, and interest rates are only expected to rise to a limited degree, implying low default risk overall.
- **Skill shortages** remain elevated across sectors and firms tell us that they are increasingly looking at changes in their business models to help manage this, e.g. through investing in automation and AI. IT spending plans remain above average.
- We expect **interest rates** to rise by 25bp in August due to limited capacity in the UK economy, with further rises in February and November 2019.
- **Oil prices** are expected to stabilise as further capacity comes on-stream.
- Do our survey findings resonate with your company's experience? Let us know: **charlotte.dendy@cbi.org.uk**
- Are you getting your voice heard through the CBI's regular surveys? Participate here: **www.cbi.org.uk/business-issues/the-economy/business-surveys/**

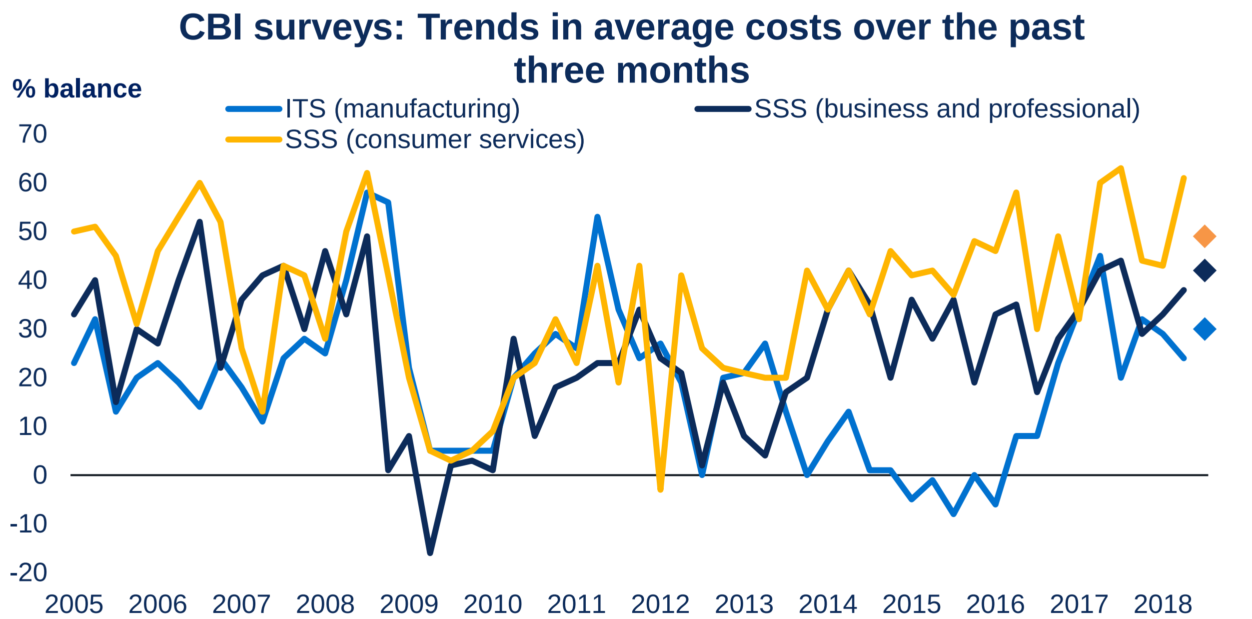


*CBI quarterly surveys: Industrial Trends Survey was conducted between 26th March and 12th April 2018, Service Sector Survey was conducted between 27th April and 11th May 2018, Distributive Trades Survey was conducted between 26th April and 11th May 2018.

While cost pressures head up in services…

Service sector cost growth has strengthened across both services sectors recently. Consumer services growth picked up to similar rates seen in Q2 and Q3 2017 in the latest quarter.

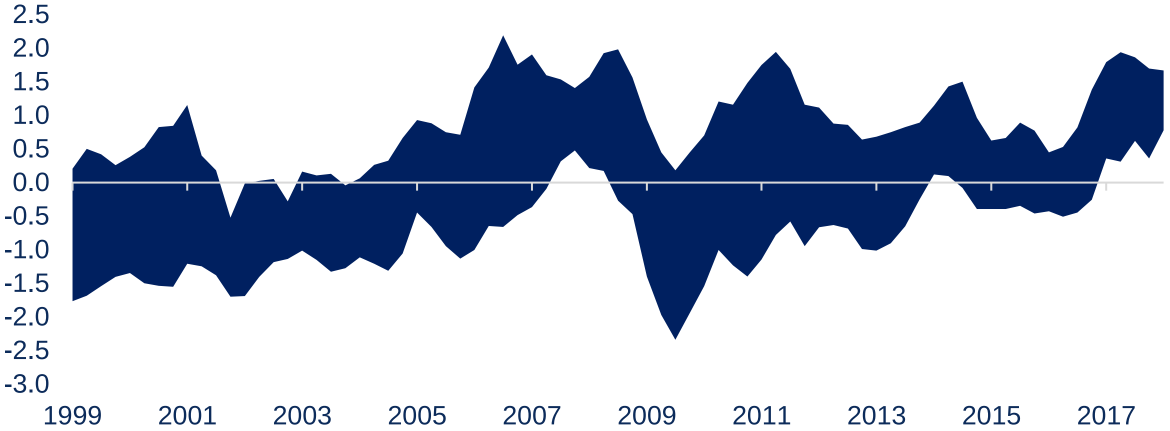
In manufacturing, costs edged lower, but growth remained elevated historically and looks set to remain so, particularly with oil prices now higher. Energy costs appear to be a big factor pushing up costs currently according to anecdote from business, although oil prices look likely to stabilise in the coming months (please see our recent note: “Are oil prices heading to $100 per barrel?”). Other firms, mainly in the manufacturing sector continue to cite the impact of the fall in the value of the pound as a key reason behind rising costs - specifically buying inputs in dollars which have become more expensive. In the service sector, the recent increase in the pensions auto-enrolment contribution is feeding to cost growth.



…which is feeding into inflation

Official data indicates that inflation has eased in recent months, from its previously elevated level – in May CPI was 2.4%, down from its peak of 3.1% in November. But pressures from strengthening oil prices and employee non-wage costs continue to feed into prices across sectors. Inflationary trends appear to closely mirror the trends in costs with the strongest price increases reported in the service sector. Prices growth in manufacturing and distribution remains far above long-run averages. Across all sectors, inflationary pressures are set to remain elevated over the next three months.

Swathe of prices over the past three months across surveys* (standardised, 3MMA, %)

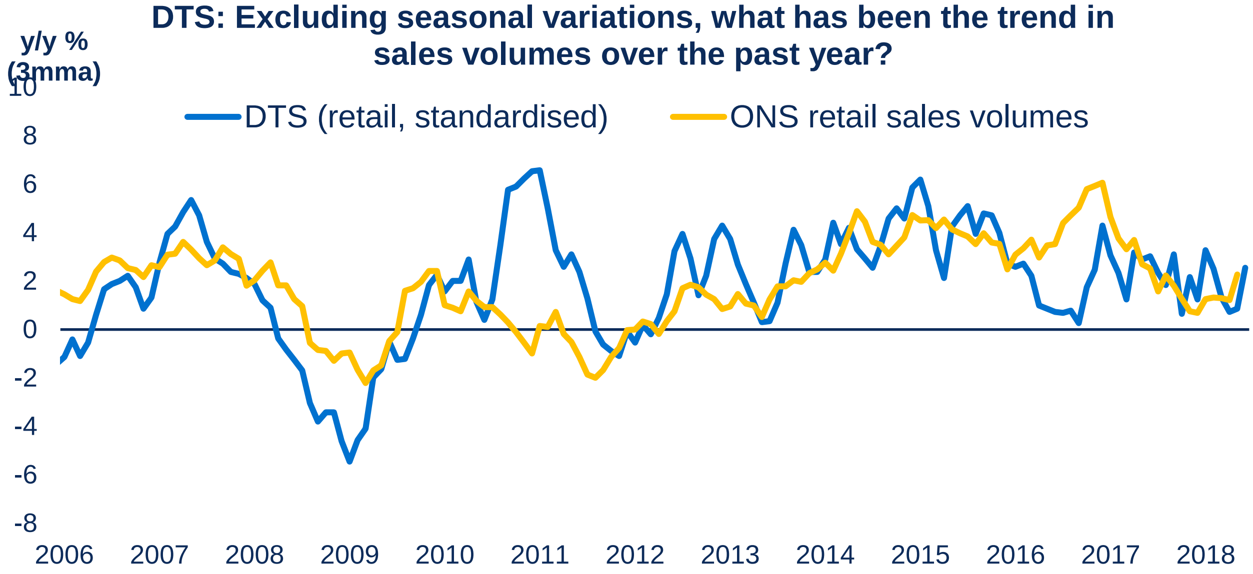


*This chart shows a standardised range of pricing pressures across the ITS, SSS and DTS. If the swathe is in positive territory, it implies that price pressures have strengthened.

Consumer-facing firms continue to face a challenging environment…

After the poor weather in Q1, volumes growth in retail has recovered somewhat. Yet, some smaller retail firms have said that the bad weather in Q1 is continuing to affect demand in Q2, due to the seasonal nature of their businesses. Meanwhile, concerns remain around debt levels and deeper ongoing structural issues such as digital disruption. In addition, elevated inflation paired with weak wage growth means that growth in consumer spending power is still subdued historically and unlikely to provide much support for consumer-facing firms in the near future. Consequently, sentiment and investment spending plans remain gloomy for retailers and consumer-facing firms.

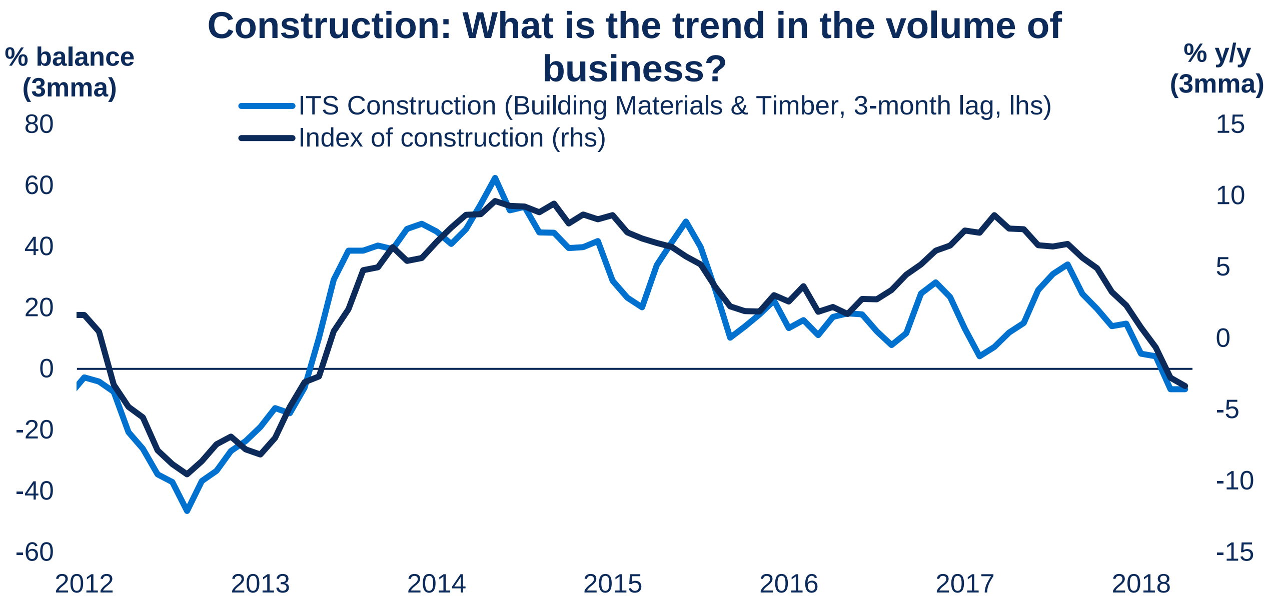
DTS: Excluding seasonal variations, what has been the trend in sales volumes over the past year?



Source: ONS, Macrobond.

…while construction has faced other trials

Our proxy for construction[1] has shown growth weakened since the middle of 2017, in line with official data, both of which point to declining output in the sector in early 2018. This isn't surprising given the setbacks the sector has experienced from "the Beast from the East" and the impact from the failure of Carillion feeding through. More recently, anecdote from the sector suggests that most Carillion contracts have been picked up by other companies. However, there have been some delays as customers take the opportunity to renegotiate prices. Some companies continue to experience delays in decisions being made by clients to go ahead with projects as well as more subdued demand due to Brexit and weaker economic sentiment. But companies have also spoken positively about public sector demand, particularly linked with HS2 and Crossrail.



Persistent concerns about skills shortages push firms to take action…

Reports of skill shortages across our surveys in aggregate have been elevated since 2015, albeit fairly stable. However, the trends by sector are rather different. Among manufacturers, concerns that skill shortages are likely to limit the level of business have largely trended upwards since 2015 and have strengthened further over the past nine months, while concerns that labour shortages could hold back investment were at a record high (highest since 1974) at the end of 2017. These trends in manufacturing are hardly surprising given the degree to which output has increased in the past year. In financial services, skill shortage reports increased between 2016 and mid-2017, but have eased since. Although concerns are high in both the consumer and business & professional services, they appear to have eased compared with mid-2015.

Firms have highlighted a number of reasons for these shortages covering both domestic and external issues. Some have mentioned that new technologies entering the workplace quickly create problems as often workers do not readily have the skills needed without additional training, for example AI, virtual reality and 5G. We hear a lot from firms that coders are hard to come by and there appear to be labour shortages in these new technology areas. Other businesses point to regional challenges e.g. struggling to recruit the workers they need in certain parts of the UK. Meanwhile, a number of firms have observed that lower migration to the UK has made it harder to recruit for certain roles.

Firms tell us that they are increasingly changing their approach to workforce management in order to reduce the impact that skill and labour shortages have on their business, through both changing their recruitment focus and looking at ways to improve staff retention. For example, a number are looking into different types

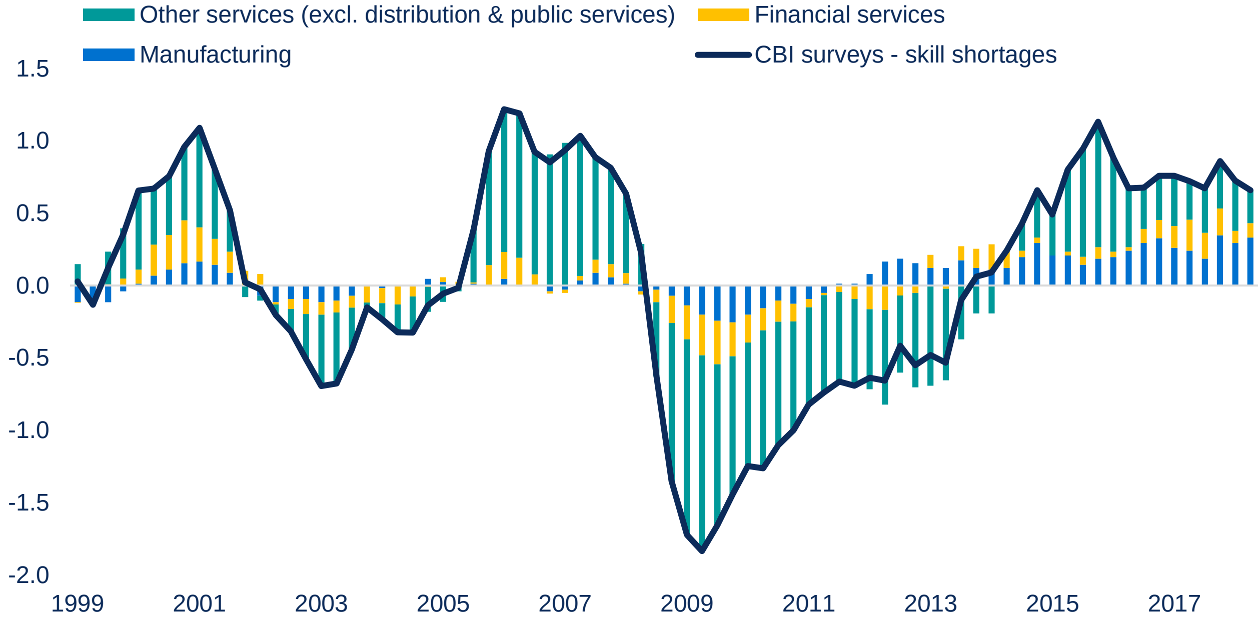
[1] Our proxy is a composite of manufacturers of building materials and timber manufacturing in the ITS.

of benefit packages including performance related pay and flexible working environments. CBI surveys have shown a switch away from tangible investments towards intangible investments such as IT, retraining and investing in efficiency, which would seem to fit in with the overall story. Many firms are investing in taking people out of the production process and in automated lines. Investment in training & retraining and improving productivity also appear to have grown in popularity.

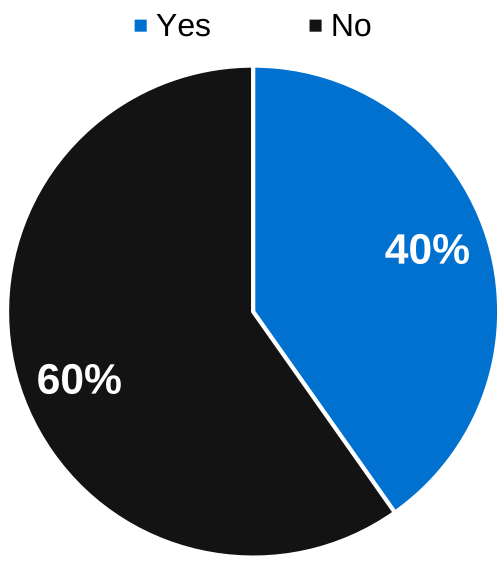
However, a recent CBI survey revealed mixed views on access to skills and labour: 60% of firms surveyed said that they have not found it more difficult to recruit or retain workers over the past year relative to the previous year, while 40% said that it has become harder. Nevertheless, labour shortages were more notable in certain sub-sectors, particularly in distribution where the yes/no split was 52% vs 48%. Meanwhile, in manufacturing the majority (55%) cited that they were not finding it harder to retain or recruit workers. The services sector were even less concerned with 64% stating that it has not become more difficult.

In terms of the total sample, of those that said that retaining/recruiting staff has become more difficult, 21% of respondents said that they were planning to change how and where they advertise jobs and to undertake more in-house training in response; 20% were planning to increase wages to address this issue; and 13% of respondents said that they are planning to increase non-wage benefits and choosing to invest in automation to reduce skills shortages.

CBI surveys - skill shortages and contributions by sector (standardised % balances)

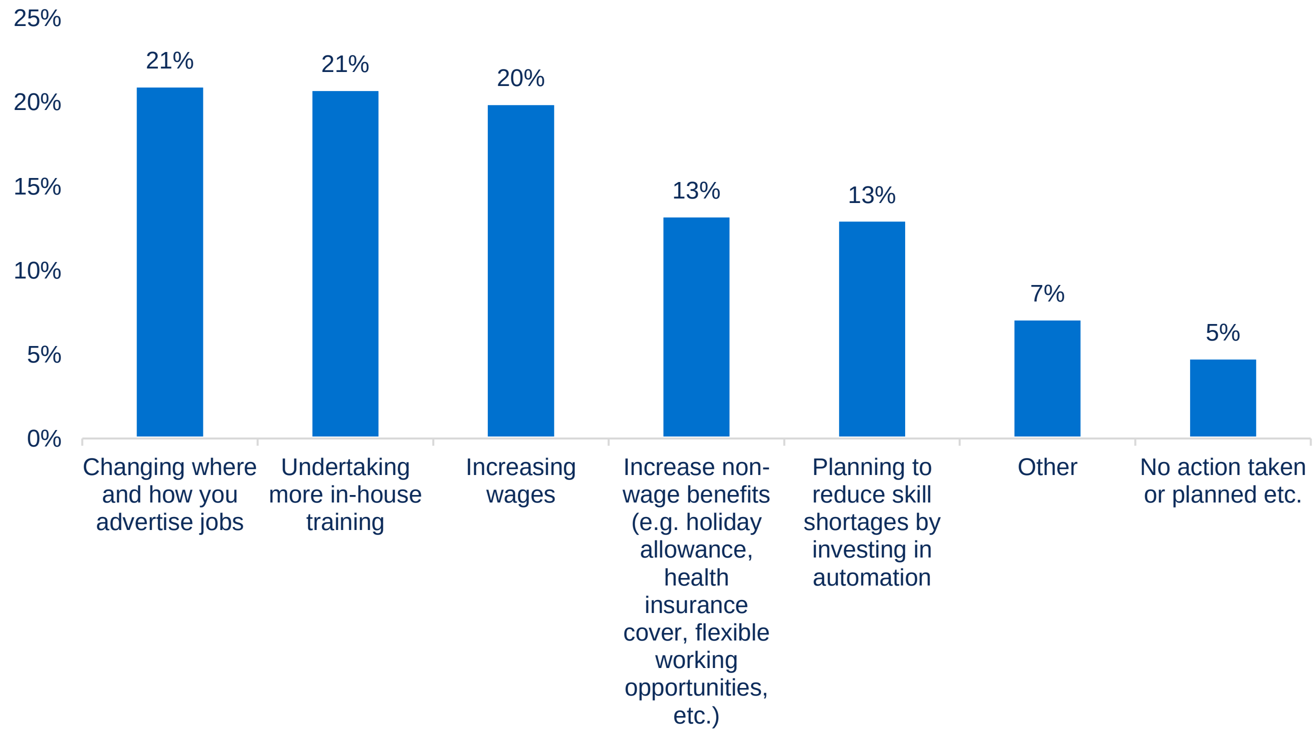


CBI survey: Have you been finding it more difficult to recruit/retain workers over the past year relative to the previous year?



*conducted between 14th and 29th May 2018, with the results based on the weighted responses from 428 companies across manufacturing, services and distribution.

CBI survey: Are you taking or planning to take any action in response? [tick all that apply]



...although wage growth is only expected to tick modestly higher

With stronger inflation and pressure from skills shortage, wage growth has edged higher in the services and manufacturing sectors. The mean rise in wages in the manufacturing sector has been on an upward trajectory for roughly a year and has now caught up with wage growth in other sectors. Meanwhile, the service sector has seen a sharp pick-up in wage growth over the last twelve months which links in with the stronger cost growth witnessed in the latest SSS survey. The pick-up was driven by both sub-sectors however wage growth in consumer services is expected to rise to the 3% mark while those in business and professional services are tipped to stay at 2.3%, above the average of 1.8% and 1.5% respectively. Wage growth has drifted down in distribution to broadly in line with growth in other sectors. On average, anecdote points to wage increases of 2-3%, which is supported by our survey data. A couple of firms have mentioned that the reported pay differentials between the UK and the rest of Europe are narrowing reflecting both the decline in sterling and the recovery in Eurozone growth, which is causing some EU workers to return home.