BANK OF ENGLAND

Agents' summary of business conditions

2016 Q1

- Annual rates of activity growth had eased, in part reflecting slowing world growth and an associated increase in uncertainty. Consumer spending growth had, however, remained resilient.
- Bank credit availability had remained above normal for most contacts, although competition between lenders was reported to be stabilising after a period of intensification. Capital market financing conditions had become less favourable given recent market volatility.
- Growth in total labour costs had remained modest, with low inflation having a slightly moderating effect on pay awards. Companies often reported that competitive pressures were restraining price inflation.

Consumer spending growth had remained resilient, although some service providers and retailers had been affected by weaker tourist activity following terror attacks in Paris.

Business services turnover growth had eased since the start of the year, in part reflecting the effects of heightened global economic uncertainty.

Manufacturing output was lower than a year earlier, reflecting weak demand in export supply chains due to sluggish world demand growth, weakness in extraction, and sterling's earlier appreciation. The recent decline in sterling was expected to boost export volumes with the usual lags. Box 1 on page 3 presents results from a survey on exports.

Construction output growth had softened over the quarter, reflecting some easing in housebuilding growth and some deferrals of energy and commercial construction projects.

Investment intentions had eased, mostly reflecting increased caution in the face of heightened global uncertainty.

Credit had remained readily available, although capital issuance conditions had become less favourable, given recent market volatility.

Occupier demand had risen further in the **commercial real estate market**; investor demand for London property had eased, but had been resilient in other major centres.

Housing market activity had remained subdued relative to pre-crisis averages, although sales to buy-to-let investors had picked up ahead of the introduction of stamp duty changes in April.

Capacity utilisation had eased overall, and was below normal in the manufacturing sector and slightly above normal in services.

Employment growth intentions had fallen on the quarter alongside easing activity growth. **Recruitment difficulties** had eased, in part reflecting companies' past efforts to increase apprenticeships and training, which had started to feed through to the availability of skills.

Growth in **labour costs** had remained modest, with continuing reports that low inflation was moderating pay awards slightly. Some consumer services companies expected their labour costs to rise significantly as a result of the introduction of the National Living Wage (NLW) in April.

Materials costs had remained lower than a year ago, reflecting price declines across a wide range of inputs. **Imported finished goods prices** were slightly lower than a year earlier.

Manufacturing **output prices** were lower than a year ago as falls in input costs were passed through to customers. Business services price inflation had remained positive and was little changed over the quarter.

Consumer price inflation for goods had remained negative, but services price inflation had increased slightly, reflecting resilient underlying consumer demand growth. Some services contacts expected to pass on part of the costs of the NLW to retail prices.

This publication is a summary of monthly reports compiled by the Bank of England's Agents between late November 2015 and late February 2016. 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/publications/Pages/agentssummary/default.aspx.

Consumer services and retail sales

Annual growth of consumer spending had remained resilient overall. Retail sales growth had changed little over the quarter, with some contacts reporting that purchases had been held back from December into the January sales. New car sales had continued to grow solidly, stimulated by increased availability of finance and discounts offered by dealers. Consumer services turnover growth had slowed slightly, largely attributed to the effects of recent terrorist activity in Paris, for example on inbound tourism spending and on overseas travel. By contrast, demand for smaller-value leisure services, such as restaurants, bars and cinemas, had continued to grow steadily.

Business and financial services

Growth in business services turnover had eased (**Chart 1**). Increased global economic uncertainty was reported to have slowed the flow of mergers and acquisitions activity for some intermediaries and, combined with concerns about high commercial real estate valuations in London, had led to some easing in property investment related activity growth. Financial market volatility had delayed some work associated with capital market transactions. Demand from the oil and gas sector had continued to be weak and demand from manufacturing companies had eased. IT services growth had, however, remained strong. Demand for professional advice (eg tax planning and strategic hiring) was sustaining growth for a range of contacts, and buoyant occupier demand for commercial property was supporting property advisory and facilities management businesses. Wholesale suppliers to retail and construction were experiencing modest growth. Growth in exports of services had eased as clients adjusted to a weaker world outlook.

Production

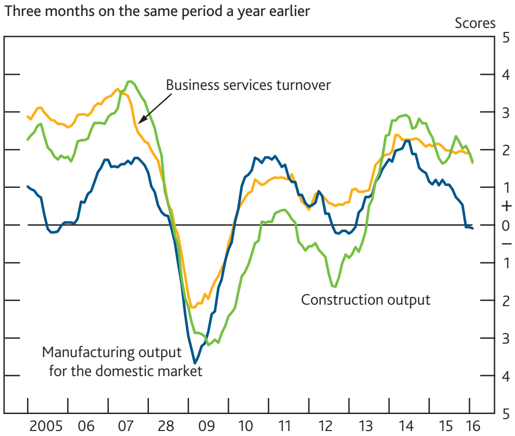
Manufacturing output for the domestic market had been unchanged on a year earlier (**Chart 1**), with export volumes contracting further. Low oil and steel prices had depressed demand for capital goods from related supply chains. There were further reports in a number of subsectors of increased import penetration by European companies, although sterling's recent depreciation was expected to provide some relief. Suppliers into aerospace and automotive sectors had continued to see modest growth, however. Manufactured export volumes had been adversely affected by a weaker world economy and a marked decline in demand from extraction sectors globally. Sterling's earlier appreciation had weighed on the competitiveness of UK exports, but the recent depreciation was thought likely to boost volumes with the usual lags. Box 1 on page 3 reports the results of an export survey.

Construction

Growth in construction had eased overall (**Chart 1**), although reports from contacts were mixed. Growth in private new house building activity continued, although it had eased in some regions. Social housebuilding had remained weak. A

Chart 1 Activity

Three months on the same period a year earlier



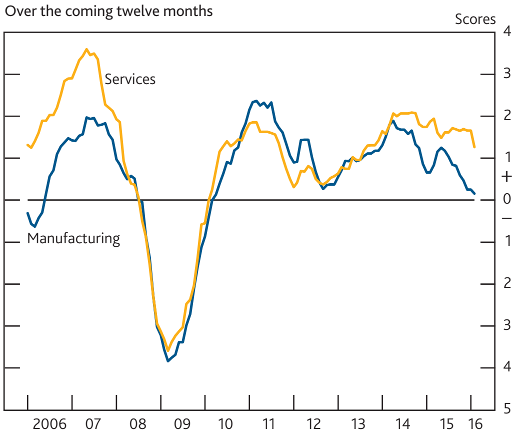
deferral or cancellation of energy-related projects had weighed on activity among some construction contacts. Commercial development continued to increase overall, particularly for industrial and office accommodation, although there were reports of rising costs leading to some projects being postponed. Infrastructure activity was growing, albeit with significant variation across regions.

Investment

Investment intentions had eased, reflecting a slowing in global growth and an associated increase in uncertainty. In manufacturing, intentions were marginally positive. For some companies, capital spending was being supported by R&D expenditure, the introduction of higher-margin products, and efforts to improve productivity. Service sector investment intentions remained modestly positive, but had softened, in part reflecting some increased caution about spending. High construction costs were reported to be deterring some investment in new buildings, but there was strong growth in refurbishment of premises and spending on infrastructure for regional air travel was expanding.

Chart 2 Investment intentions

Over the coming twelve months

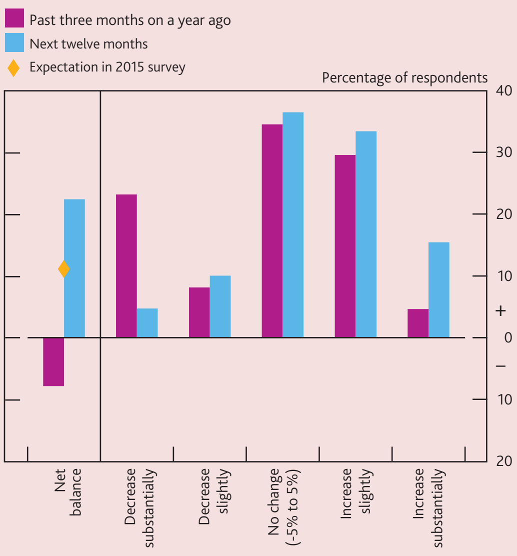


Box 1
Agents' survey on exports

The Agents surveyed business contacts to ask: how the sterling value of their UK exports had changed over the past three months on a year earlier; expectations for the next year; and which factors had affected and were likely to affect the sterling value of exports. Some 280 companies responded. Results were weighted by export turnover and, for the aggregate results, reweighted by sectoral shares of UK exports.

On balance, respondents reported a decline in the sterling value of exports over the past three months compared to the same period a year ago, but expected a modest increase in export values over the coming year (**Chart A**). That expectations balance was more positive than in the Agents' exports survey in June 2015. Survey responses differed markedly between sectors: while a net balance of goods exporters had seen a fall in exports in the past year, services exporters had, in contrast, generally seen growth. Respondents in both sectors expected exports to increase in the coming year.

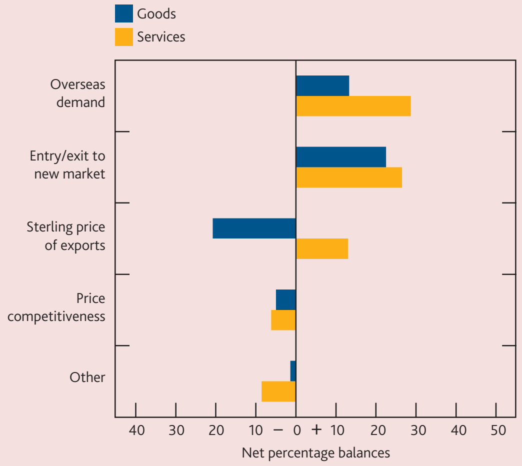
Chart A Export values growth



In terms of the factors affecting export growth, overseas demand growth had been a negative influence on goods exports over the past year. But in the coming year, both goods and services exporters expected overseas demand to grow (**Chart B**). A sharp turnaround in expectations for goods exporters partly reflected responses from car manufacturers.

The sterling price of exports had boosted growth in services export values over the past year, but had pushed down goods exports growth, and that pattern was expected to continue over the coming year (**Chart B**). Over the past year, that could

Chart B Factors affecting export values over the next twelve months



have reflected the pass through of lower input costs, which were likely to have weighed on goods prices relative to services prices. In addition, there may have been differential effects from bilateral exchange rate movements. The share of exports accounted for by the euro area is greater for goods than for services; and during the year to January 2016, sterling appreciated against the euro but fell against the US dollar, which might have pushed down sterling export prices for goods relative to services.

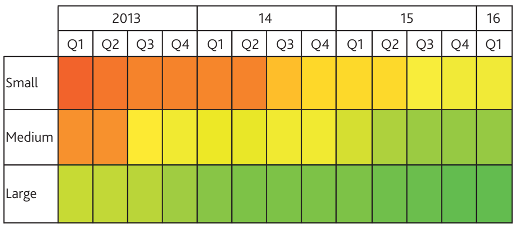
Examining survey responses by the principal type of export customer, respondents facing consumer and business and financial services customers were expecting an improvement in export sales in the coming year (**Chart C**). Those respondents selling into the manufacturing and, most notably, extraction sectors were the most downbeat about prospects.

Chart C Export performance by customer

Corporate financing conditions

Bank credit had generally been readily available to most businesses (**Chart 3**), with the exception of those with no recent track record of profitable trading and/or few tangible assets. Competition among banks for lending to stronger companies remained intense, although there were tentative signs that it was stabilising alongside reports of slowing growth among challenger banks. Correspondingly, there were fewer reports of easing covenants and loan rates appeared to have levelled off. That said, reports of reductions in arrangement fees and early repayment charges had become more frequent. Non-bank finance also appeared to be readily available, although capital markets were viewed as less favourable given recent market volatility. Companies' expectations of spreads on bond issues had increased and they were being more selective about timing when accessing the market. Elsewhere, non-bank lenders continued to compete to supply credit, particularly for commercial property investment, where pension funds had a strong appetite to lend. Peer to peer lending had continued to grow rapidly, helped by a growing number of referrals from banks where credit requests did not meet their loan criteria. In asset finance, loan rates were low, and underwriting standards were softening, as the entry of private equity funds into the market had increased competition.

Chart 3 Heatmap of credit availability relative to normal by size of business(a)



(a) This mapping is based on individual Agencies' national assessments of corporate credit availability, weighted by the gross value added of their regions or countries. 2016 Q1 uses Agents' latest assessment as of February. The greater the intensity of red, the tighter credit availability; the greater the intensity of green, the looser credit availability. Yellow indicates normal conditions. Includes bank and non-bank credit.

Property markets

Commercial real estate

Occupier demand for commercial real estate had continued to grow steadily and occupancy rates were increasing — particularly for industrial and warehousing space. Demand for prime office space had also continued to increase, with the resulting reduction in available supply leading to some refurbishment of existing property. But, outside London, speculative building remained limited, given that office rents were rising only gradually from low levels. For retail property, the picture was more mixed, with a significant overhang of vacant property still evident in secondary and tertiary markets. An increasing number of occupiers were reported to be purchasing property, rather than leasing. Investor demand had eased for London property, partly reflecting some concerns about high valuations, but had held up in major regional centres. Box 2 provides a summary of recent intelligence gathered on overseas investor demand in particular.

Housing market

Housing activity had remained subdued relative to pre-crisis levels, although sales to buy-to-let investors had picked up, with evidence of some investment purchases brought forward ahead of the introduction of stamp duty changes in April. There had continued to be shortages of properties available for sale, although there were occasional reports of a moderate pickup in new listings. Demand for new-build housing remained robust, supported by take up of the government's Help to Buy scheme. Prices and rents were increasing steadily in most regions, with the exception of some areas dominated by high-value properties. Strong competition in the mortgage market had led to a further narrowing of lending spreads, including at higher loan to value ratios.

Capacity Utilisation

Capacity utilisation had eased, remaining below normal for manufacturing and slightly above normal for services. For manufacturing companies that easing had reflected weaker activity, particularly among exporters. Among services companies, utilisation had fallen slightly as trainee programmes established to deal with skills shortages were translating into increased productive capacity, while demand growth had softened.

Employment and pay

Employment growth intentions had eased over the quarter, (**Chart 4**) reflecting a continued focus on raising productivity, heightened uncertainty, and a softening of demand growth. Intentions remained weakest in manufacturing, where the workforce was expected to contract over the coming six months. A weakening of consumer services intentions partly reflected companies' response to an expected increase in labour costs associated with the National Living Wage, but planned employment growth remained slightly positive overall. In business services, modest headcount growth was expected, driven by increasing workloads in IT, accountancy and property related services, partially offset by consolidation in some other subsectors, such as banking and transportation.

Recruitment difficulties remained above normal, but had eased in recent months. That easing had partly reflected softening employment intentions, but also efforts over recent years to address skill shortages — such as enhanced graduate and

Box 2
International investment in UK commercial property

Against a backdrop of strong overseas investment in UK commercial property in recent years, the Agents asked contacts about the composition of that investment, and any associated risks.

Contacts reported that, notwithstanding the growth of Middle and Far Eastern investment over recent years, North America remained the largest source of investment flows, along with a sizeable contribution from continental Europe. While North American inflows tended to be driven by pension and private equity funds, Middle and Far Eastern flows were dominated by sovereign wealth funds and demand from high net worth individuals. Contacts noted, however, that it was difficult to see the full picture of investment flows, particularly as some of those were handled by asset managers and institutions based in the United Kingdom.

In terms of destination of investment, London accounted for the bulk of inflows, particularly for Middle and Far Eastern investors. As rental yields in London had become compressed, investor interest had spread to some other major cities, but not more widely. Contacts reported that UK property funds remained the dominant investors in commercial property outside London.

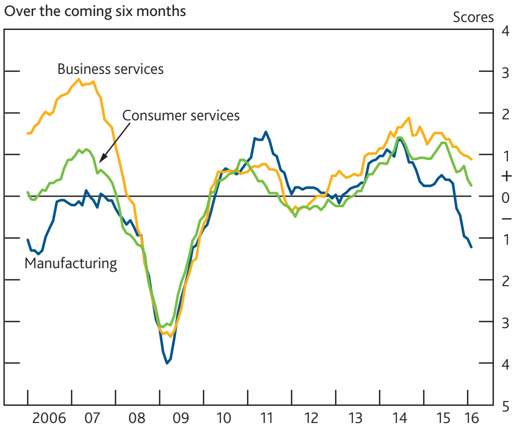
Most overseas investment was seen to be medium to long-term, including where made through open ended property funds. But some contacts viewed US private equity investments as potentially shorter-term in nature, with some investments made at the bottom of the downturn approaching the point at which they might be expected to be sold on. The risks of any major future reversal of investment flows were not, as yet, expected to be amplified materially by leverage on overseas investment, which was mostly reported to be low.

Most recently, financial market volatility and oil price declines had been associated with some slowing in investment from Asia and the Middle East. However, investor flows overall had continued to be supported by a 'safe haven' status for UK property.

apprenticeship programmes and the deskilling of some processes through automation — that were now bearing fruit. The availability of engineering skills had increased in some regions as a result of job cuts in the oil and gas supply chain. A lack of experienced individuals persisted in a range of specialist disciplines, however, especially in accountancy, IT, construction, haulage (drivers) and hospitality (chefs). Box 3 provides a stock-take of recent Agency intelligence gathered on labour supply developments more generally.

Growth in total labour costs had remained modest, with the majority of pay increases in the 2%–3% range. Low inflation was moderating pay growth slightly. This was particularly the case in manufacturing, where a number of sub-2% settlements were reported; reduced overtime and shift payments due to weaker demand had also dampened labour cost growth in the sector. In services, awards above 3% continued to be largely targeted at addressing particular skills shortages, with limited impact on total labour cost growth. The National Living Wage was expected to have a significant impact on the wage bills in a number of sub-sectors, including retail, leisure and social care, both directly and through raising the pay of some other lower-paid staff over time to maintain pay differentials. The contacts most affected planned to limit the impact on costs through a range of strategies, including reducing other elements of remuneration and managing headcount and average hours more tightly.

Chart 4 Employment intentions



Pricing

Supply chain pricing

Materials costs had remained lower than a year earlier, with particularly sharp declines for oil and related commodities, and metals. Imported finished goods costs had remained marginally lower than a year earlier overall, although sterling's past weakening against the US dollar was feeding through to an increase in some goods costs, as hedges expired. Some contacts reported that Far Eastern suppliers had lowered prices because of excess capacity.

Manufacturers' output prices were modestly lower than a year ago (**Chart 5**), with contacts reporting strong price competition, particularly from competitors in the euro area,

Box 3
Recent intelligence on labour supply developments

This box summarises intelligence gathered by the Agents over recent months on developments in, and expectations for, labour supply, as part of a wider stock take of supply undertaken by Bank staff ahead of the February *Inflation Report*.

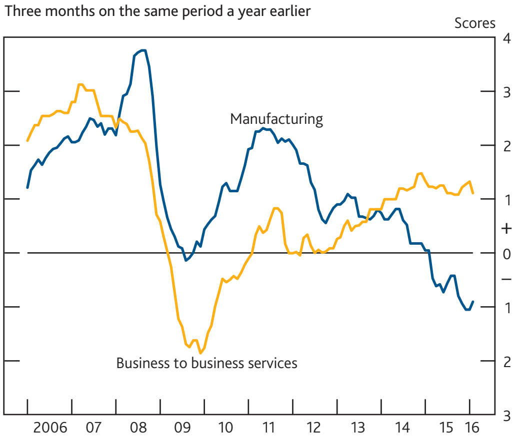
Agents' contacts expected that participation in the labour market would increase further over time. Reasons for that included the positive effects of apprenticeship schemes and, to a lesser extent, expectations of further increases in labour market activity among those over 65 years old or with caring commitments, often linked to increasing flexibility in working hours. But that increased flexibility — for example through the use of minimum hours contracts — was reported to have contributed to a decline in average hours over the past year or so. And Agents' contacts reported a continuing structural shift towards increased self-employment, partly reflecting a focus among younger cohorts on work/life balance and a tendency for those made redundant or taking early retirement to return to the workforce in consultancy roles. More generally, technological change was seen to be facilitating self-employment in a range of fields.

Unemployment had fallen sharply over the past two years, but contacts often expected that further declines would be more gradual. That partly reflected easing employment intentions alongside a softening in manufacturing demand growth; and some business services companies reported having reached their optimal staffing levels after a period of catch-up. Companies were also putting a greater emphasis on raising productivity rather than staff numbers, in some cases — especially among consumer services companies — reflecting expected increases in labour costs due to the National Living Wage. Skills shortages had remained elevated in a range of sectors, but had started to ease recently, in part as apprenticeship and trainee programmes were increasing the pool of skilled labour within companies.

and resistance to attempts to increase prices from customers. Business services price inflation had remained positive and little changed: professional services firms reported being able to raise fees on specialised services, but rates on a range of commoditised services remained restrained by competitive pressures. Profitability had remained flat in manufacturing and was growing only modestly among services companies.

Chart 5 Manufacturing and services prices

Three months on the same period a year earlier



Consumer prices

Retail goods price inflation had remained negative. Annual declines in grocery prices had been sustained by a continuing structural shift from time-limited promotions to 'every day' lower prices. More generally, retailers reported being reluctant to increase prices, given consumers' sensitivity to any such changes. That said, sterling's recent depreciation against the US dollar was expected to lead to higher clothing prices in the latter part of the year. Consumer services price inflation had risen on the quarter, reflecting resilient demand growth for a range of services. Accommodation services providers and owners of new rented housing expected continued low to mid single-digit rental growth as demand growth outpaced supply. Inflation for some regulated prices, such as in public transport and utilities, was being restrained by the indexation of prices to RPI. Some contacts in the consumer services sectors most affected by the National Living Wage expected that some of the additional labour costs would be passed on to consumers.