Deloitte.

The Deloitte CFO Survey Q2 2016

Brexit hits confidence

Sentiment among the Chief Financial Officers of the UK's largest corporates has fallen sharply in the wake of the EU referendum. The second quarter survey took place between 28th June and 11th July, and provides a detailed picture of thinking among large UK-based businesses in the light of the vote.

Perceptions of uncertainty have soared in the wake of the vote to levels associated with the euro crisis five years ago. The spike in uncertainty has had a toxic effect on business sentiment with optimism dropping to the lowest level since the survey started in 2007, lower than in the wake of the failure of Lehman Brothers in late 2008. Corporate willingness to take risk has seen its largest ever decline. Just 8% of CFOs say now is a good time to take risk onto their balance sheet.

This quarter we asked CFOs what effect they expected an exit from the EU to have on their own spending plans over the next three years. 58% expected capital spending to be somewhat or significantly lower and 66% expected hiring to be lower over this period.

CFOs do not seem to be waiting for growth to slow before adjusting direction. There has been a marked shift to more defensive balance sheet strategies in the wake of the referendum. For the first time in more than a year the top two balance sheet priorities for major UK corporates are defensive - reducing costs and increasing cash flow.

Expectations for growth in capital spending, hiring and discretionary spending are at levels that were last seen just before the so-called "double dip" slowdown of 2012. Our long-running series on expected M&A activity has registered its largest ever fall.

More than two-thirds of our CFO panel believe that leaving the EU will lead to a deterioration in the UK business environment in the long term. About 20% expect little change and 12% expect an improvement.

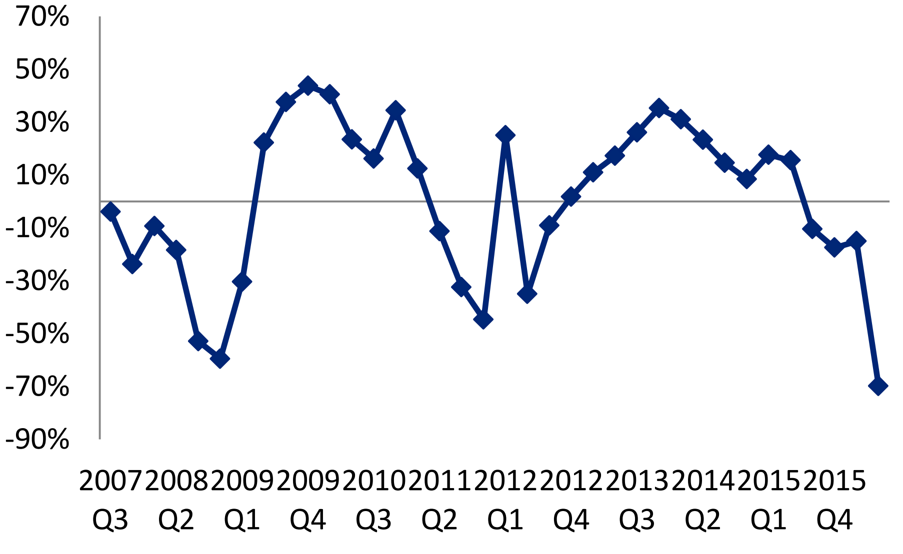
When asked what the authorities can do to support economic activity in the wake of Brexit an overwhelming majority - 91% of CFOs - said that giving a strong signal about the government's aims in the negotiations with the EU should be a strong priority. Maintaining the solvency and liquidity of the banking system was ranked second, with 88% rating it as a strong priority. In third place came pursing the government's budget deficit reduction plan, with 25% saying it should be a strong priority. Enthusiasm for cutting interest rates, restarting Quantitative Easing or cutting taxes was muted – in each case fewer than 10% of CFOs rated these strategies as strong priorities.

The referendum vote has triggered a strong, negative reaction from the UK corporate sector. CFOs are focusing on reducing costs and build up cash flow and have become more cautious about all forms of spending.

Yet the survey took place against a background of exceptional uncertainty and, as the chart below attests, corporate sentiment is changeable. CFOs believe that the best thing the government can do to bolster economic prospects is to provide a vision of the UK's post-EU future. Progress on this front could yet see corporate sentiment head higher.

Chart 1. Business optimism

Net % of CFOs who are more optimistic about the financial prospects of their company than three months ago



Authors

Ian Stewart
Chief Economist
020 7007 9386
istewart@deloitte.co.uk

Debapratim De
Senior Economic Analyst
020 7303 0888
dde@deloitte.co.uk

Alex Cole
Economic Analyst
020 7007 2947
alecole@deloitte.co.uk

Key contacts

Ian Stewart
Chief Economist
020 7007 9386
istewart@deloitte.co.uk

Richard Muschamp
CFO Programme Leader
20 7007 0724
rmuschamp@deloitte.co.uk

For current and past copies of the survey, historical data and coverage of the survey in the media and elsewhere, please visit:

www.deloitte.co.uk/cfosurvey

Policy uncertainty hits risk appetite

Corporate risk appetite has now fallen for the fourth consecutive quarter.

Following the EU referendum, just 8% of CFOs say that now is a good time to take greater risk onto their balance sheets; the lowest level in more than six years.

The UK's vote to leave the EU came as a surprise to financial markets.

However, the shock seen in the immediate aftermath of the result has not been as large as that which followed the collapse of Lehman Brothers in September 2008. While sterling has fallen faster, UK equities have proved more resilient. Consumer confidence recorded its sharpest monthly fall in almost 22 years in July but remains much stronger than in the aftermath of Lehman Brothers' collapse.

Markets have not interpreted Brexit as a financial crisis, but the vote has had a profound effect on perceptions of uncertainty.

CFO perceptions of uncertainty are now at levels last seen during the euro crisis in 2012, while measures of European economic policy uncertainty are at their highest levels on record.

Chart 2. Corporate risk appetite

% of CFOs who think this is a good time to take greater risk onto their balance sheets

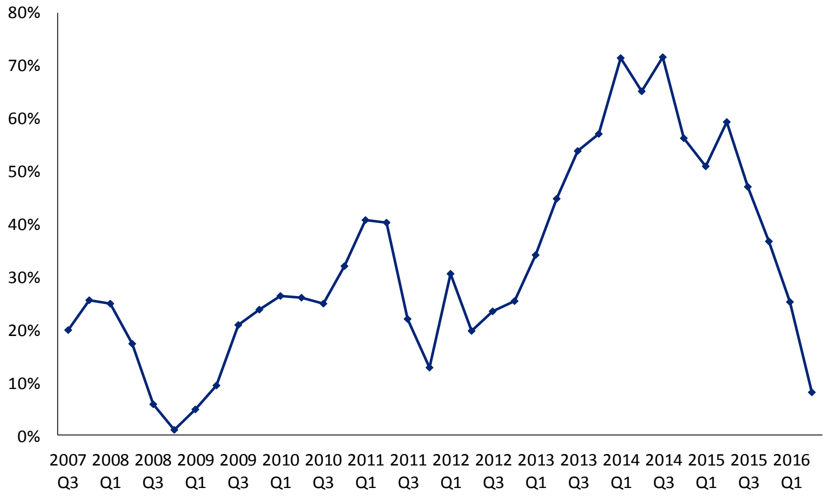


Chart 3. Brexit compared to Lehman Brothers' bankruptcy

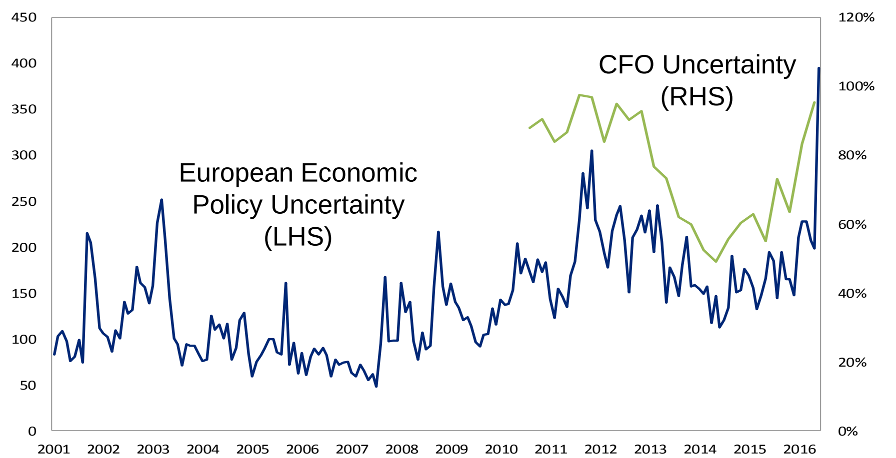
Immediate post-Brexit market reaction compared to that following Lehman Brothers' bankruptcy

	15 days after EU referendum	15 days after Lehman collapse	Now vs post-Lehman trough	
FTSE100 (change)	+4.8%	-13.4%	+47%	Better than previous
FTSE250 (change)	+3.2%	-16.5%	+67%	
Consumer confidence (level)	-9	-36	+27 points	
CFO risk appetite (level)	-84	-98	+14 points	
£/$ exchange rate (change)	-11.1%	-3.4%	-3.8%	Worse than previous
CFO optimism (level)	-70	-60	-10 points	
European Economic Policy Uncertainty Index (level)	394	217	+177*	
GDP growth %YoY (forecast for next full year*)	0.4%	-4.3%	+4.7%	
2009 vs 2017			**peak reached during euro crisis*	

Sources: Thomson Reuters Datastream, Deloitte CFO Survey, GfK Consumer Confidence Index, www.PolicyUncertainty.com and Consensus Economics

Chart 4. Uncertainty

% CFOs who rate the level of external financial and economic uncertainty facing their business as above normal, high or very high and European Economic Policy Uncertainty Index*



*The Economic Policy Uncertainty Index measures policy-related economic uncertainty based on newspaper coverage of policy uncertainty, and covers France, Germany, Italy, the Netherlands, Spain and the UK.
Source: "Measuring Economic Policy Uncertainty" by Scott R. Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com.

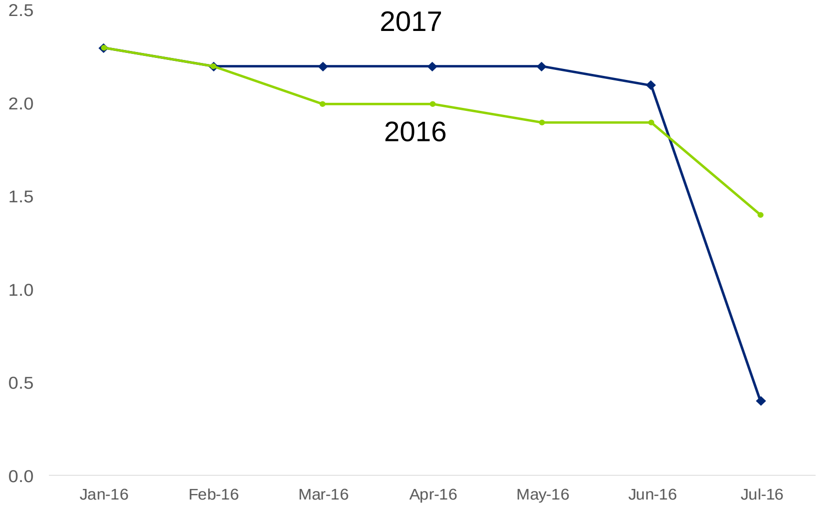
Weaker growth outlook

Growth expectations for the UK economy, for both 2016 and 2017, have fallen throughout the year.

Following the Brexit vote, economists now expect growth of 0.4% in 2017, down from 2.1% forecast on the eve of the referendum in June.

Chart 5. Evolution of 2016 and 2017 GDP growth forecasts

Evolution of Consensus GDP growth forecasts for the UK economy in 2016 and 2017 (% YoY)

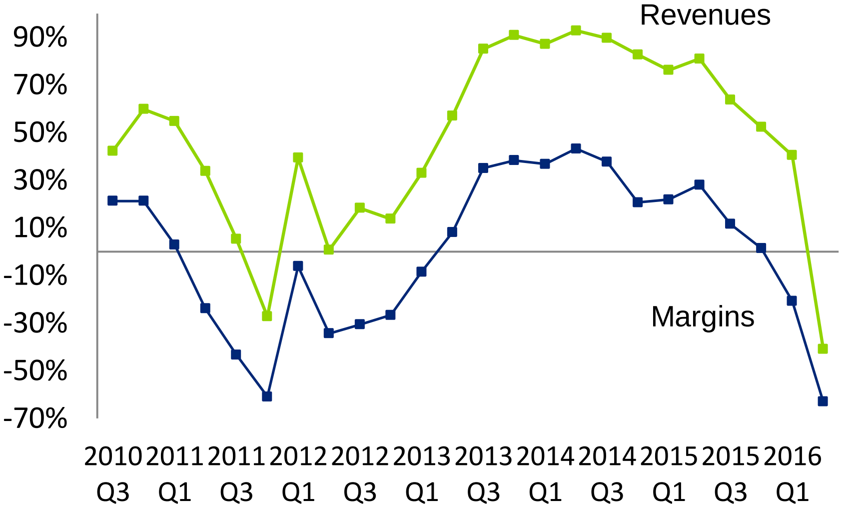


Expectations for revenue and margin growth have been cooling since late 2015 and fell sharply in the second quarter.

CFO expectations for both revenue and margin growth are now at their lowest levels since this question was first asked in 2010.

Chart 6. Outlook for corporate revenues and margins

Net % of CFOs who expect UK corporates' revenues and margins to increase over the next 12 months

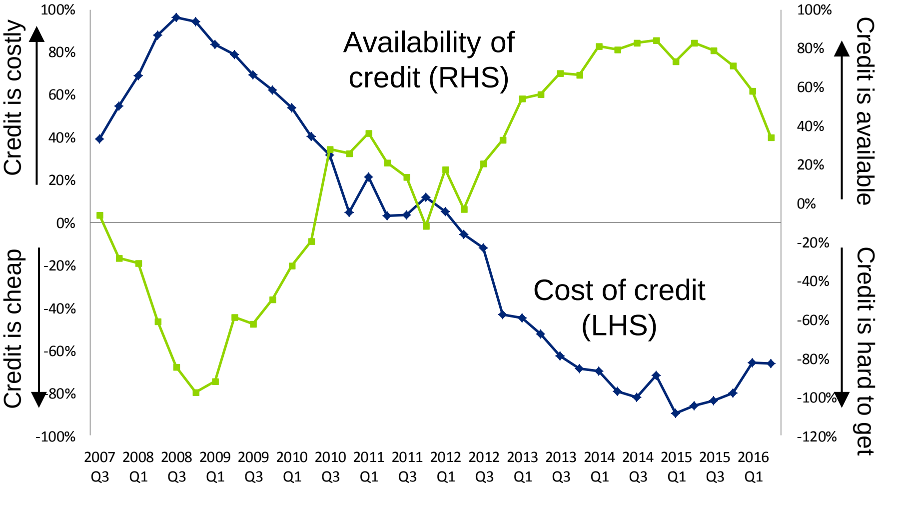


On balance, our panel of large corporates continues to view credit as being available and cheap.

However, credit conditions are perceived as being tighter than they have been in recent years – with credit availability now at its lowest since Q4 2012.

Chart 7. Cost and availability of credit

Net % of CFOs reporting credit is costly and credit is easily available



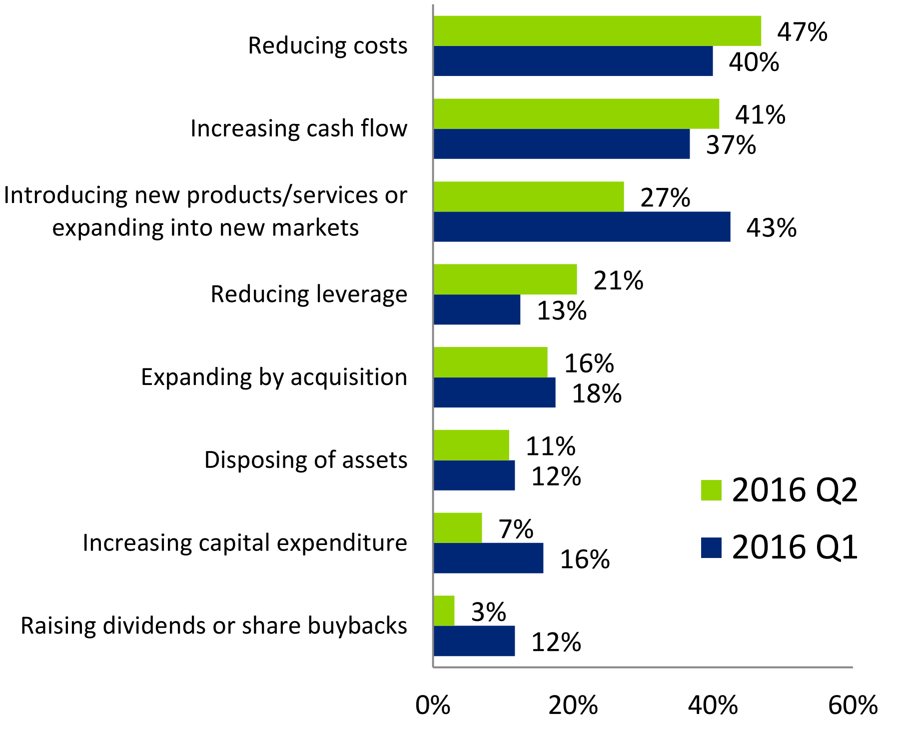
Sharper focus on defensive strategies

Defensive strategies – reducing costs and increasing cash flow – are the top two balance sheet priorities for major UK corporates. 47% of CFOs rate cost reduction as a strong priority, the highest reading in three and a half years.

Conversely, expansionary strategies, such as introducing new products or services or raising capital expenditure, have dropped sharply down the list of priorities.

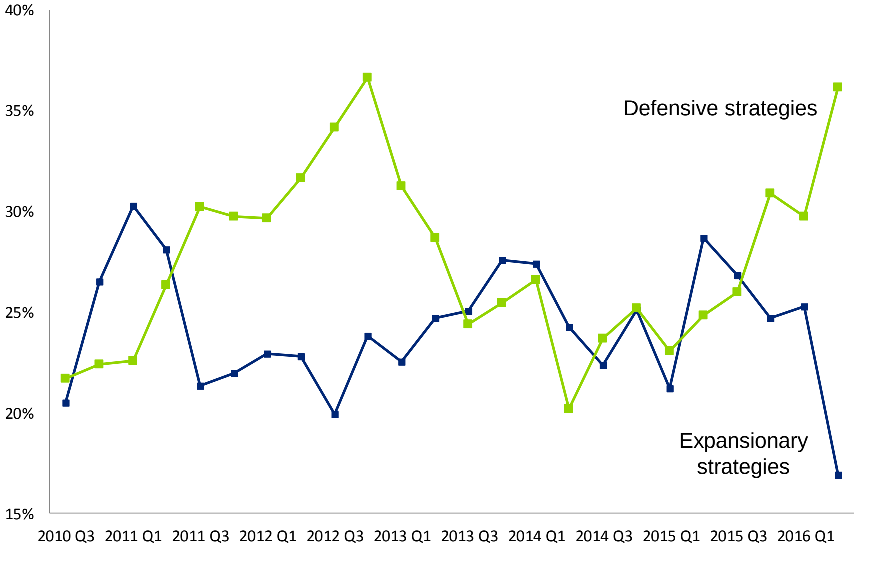
Chart 8. Corporate priorities in the next 12 months

% of CFOs who rated each of the following as a strong priority for their business in the next 12 months



CFO strategies have turned markedly more defensive. The mix of balance sheet strategies is at its most defensive in four years and least expansionary in six.

Chart 9. CFO priorities: Expansionary vs defensive strategies



Arithmetic average of the % of CFOs who rated expansionary and defensive strategies as a strong priority for their business in the next 12 months.

Expansionary strategies are introducing new products/services or expanding into new markets, expanding by acquisition and increasing capital expenditure.

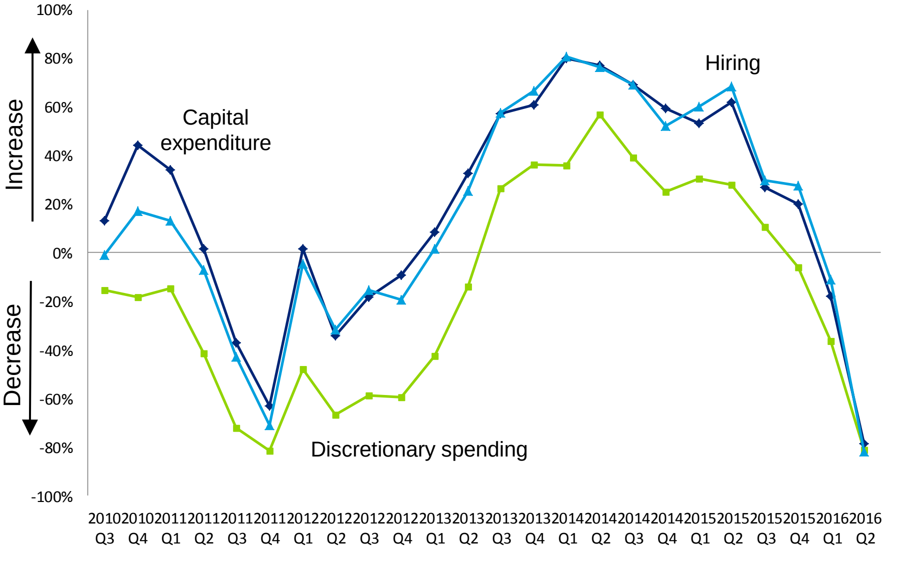
Defensive strategies are reducing costs, reducing leverage and increasing cash flow.

Factors affecting investment

In keeping with the move towards defensive strategies, CFO expectations for growth in capital spending, hiring and discretionary spending by UK corporates have fallen sharply in the second quarter. They are now at levels last seen just before the so-called "double dip" slowdown of 2012.

Chart 10. Outlook for capital expenditure, hiring and discretionary spending

Net % of CFOs who expect UK corporates' capital expenditure, hiring and discretionary spending to increase over the next 12 months

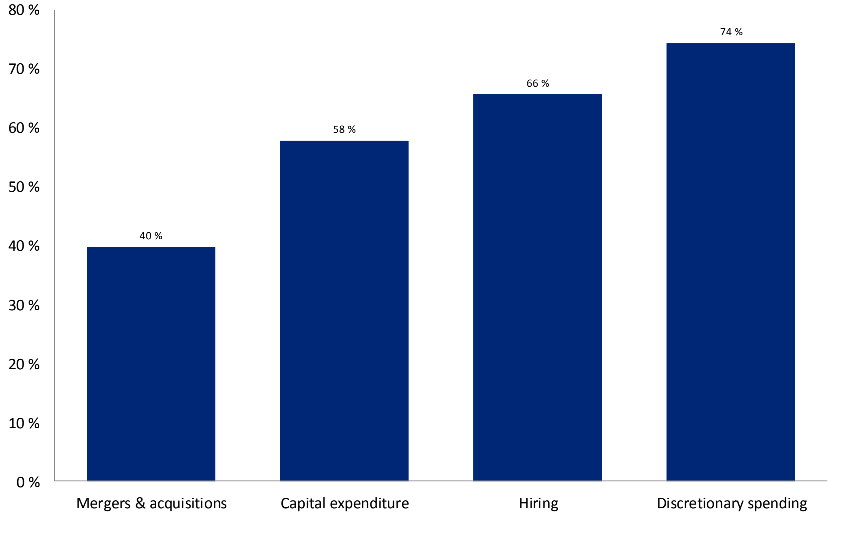


This quarter we asked CFOs what effect they expected an exit from the EU to have on their own spending plans over the next three years. 58% expect capital spending to be lower and 66% expect hiring to be lower over this period.

In addition, more than two-thirds of our CFO panel believe that leaving the EU will lead to a deterioration in the UK business environment in the long term. About 20% expect little change and 12% expect an improvement.

Chart 11. Effect of Brexit on own spending and hiring decisions

% of CFOs who expect M&A activity, capital expenditure, hiring and discretionary spending by their business to decrease over the next three years as a consequence of Brexit



Policy response to Brexit

On what the authorities could do to support economic activity, an overwhelming majority - 91% of CFOs - say that setting a clear direction for the government's aims in the negotiations with the EU should be a strong priority.

Maintaining the solvency and liquidity of the banking system was ranked second, with 88% rating it as a strong priority. In third place came pursing the government's budget deficit reduction plan, with 25% saying it should be a strong priority.

Enthusiasm for cutting interest rates, restarting Quantitative Easing or cutting taxes was muted – in each case fewer than 10% of CFOs rated these strategies as strong priorities.

CFOs have reduced their expectations for interest rates. A majority – 54% – now expect the Bank of England's base rate to be below its current all-time low of 0.5% in a year's time.

The substantial post-referendum depreciation in the sterling probably lies behind a sharp rise in CFOs' expectations for inflation.

30% of CFOs expect inflation to be above 2.5% in two years' time, up from just 2% in the first quarter.

Chart 12. Policy response to Brexit

% of CFOs who think the following strategies should be a strong priority for policymakers as they respond to the outcome of the EU membership referendum

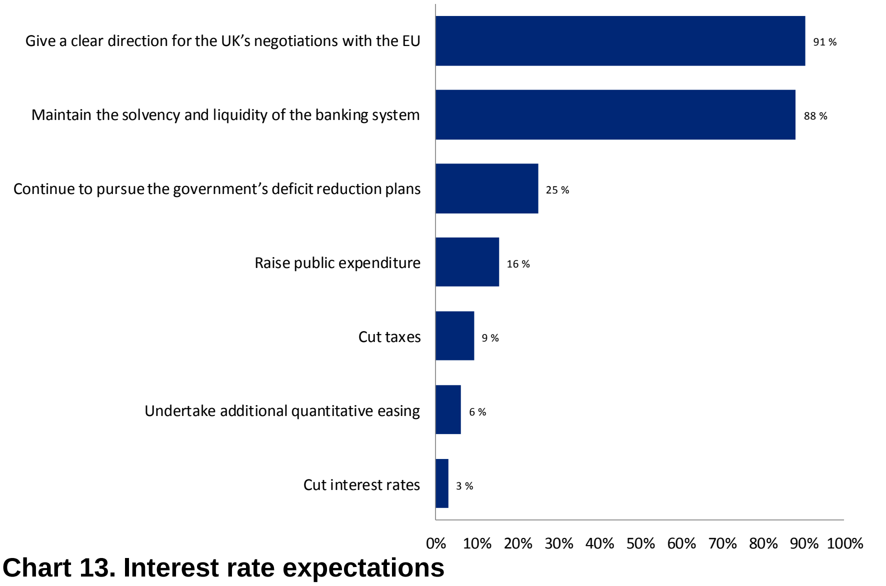


Chart 13. Interest rate expectations

% of CFOs who expect the Bank of England's base rate to be at the following levels in a year's time

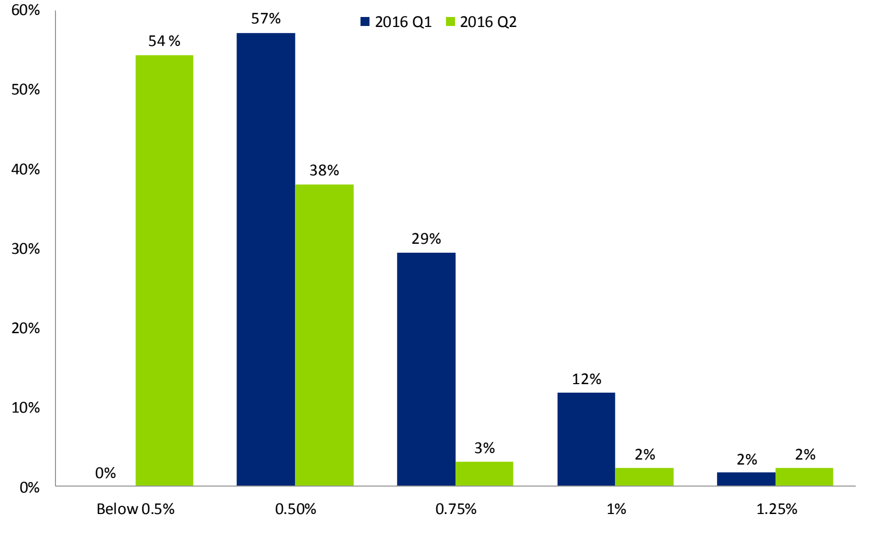
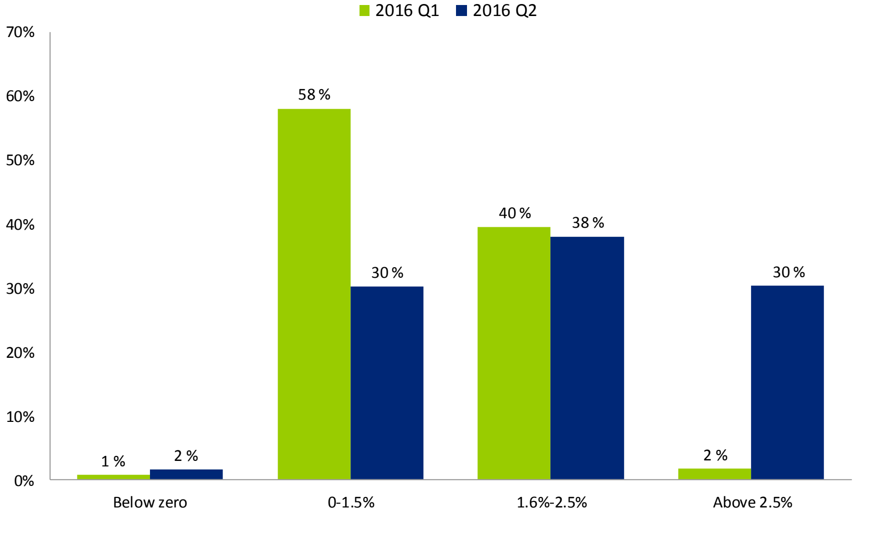


Chart 14. Inflation expectations

% of CFOs who expect consumer price inflation in the UK to lie between the following ranges in two years' time

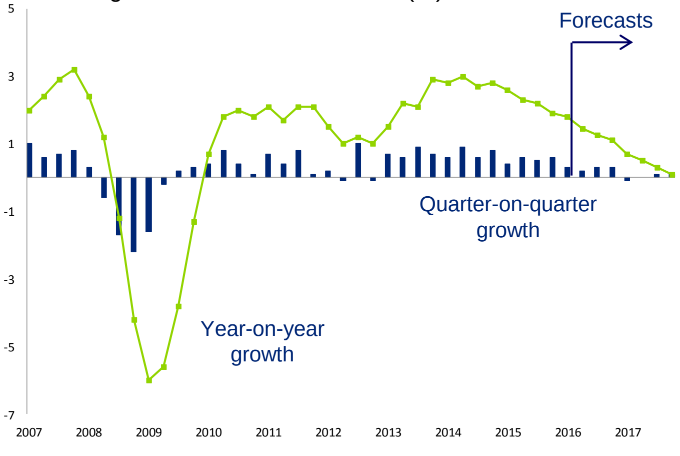


CFO Survey: Economic and financial context

The macroeconomic backdrop to the Deloitte CFO Survey Q2 2016

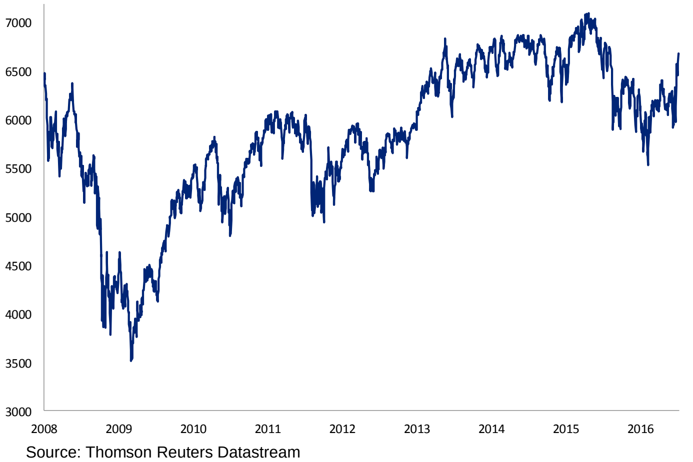
The outlook for global growth softened in the second quarter with the International Monetary Fund making its fourth consecutive reduction in its global growth forecasts. China's slowdown and weak commodity prices are taking a deeper toll on emerging markets than expected and advanced economies are still struggling to escape the legacies of the financial crisis. The UK's vote to leave the EU triggered sharp reductions in average UK growth forecasts and euro area growth forecasts edged lower. Early indicators suggest the vote has had a dampening effect on UK activity; construction activity fell at its fastest pace in seven years in June and consumer confidence saw its sharpest fall in almost 22 years following the referendum. The Bank of England surprised markets by keep UK rates on hold in July but hinted that it will ease policy in August. S&P and Fitch downgraded the UK's credit rating. Concerns about the health of the Italian banking system re-surfaced. Yields on government bonds declined across the world with markets assuming that slower global growth and the Brexit vote would keep interest rates lower for longer. Sterling fell almost 15% against the dollar in the weeks after the vote. After sharp immediate losses, the UK FTSE 100 and FTSE 250 rallied strongly as part of a global rise in risk appetite driven by expectations of easier monetary policy and better US economic data.

UK GDP growth: Actual and forecast (%)



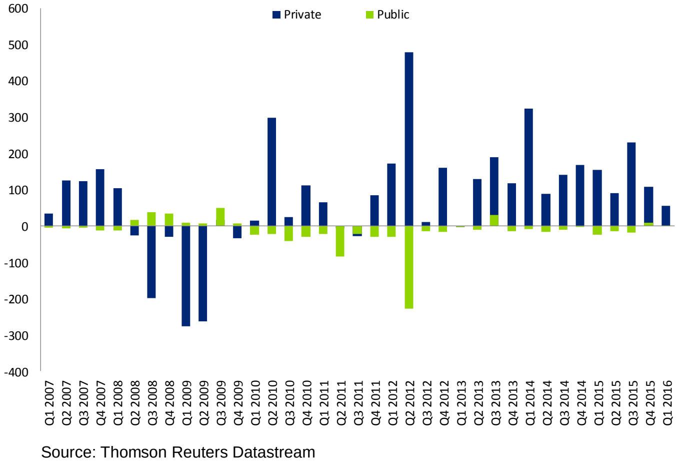
Source: ONS, Consensus Economics and Deloitte calculations

FTSE 100 price index



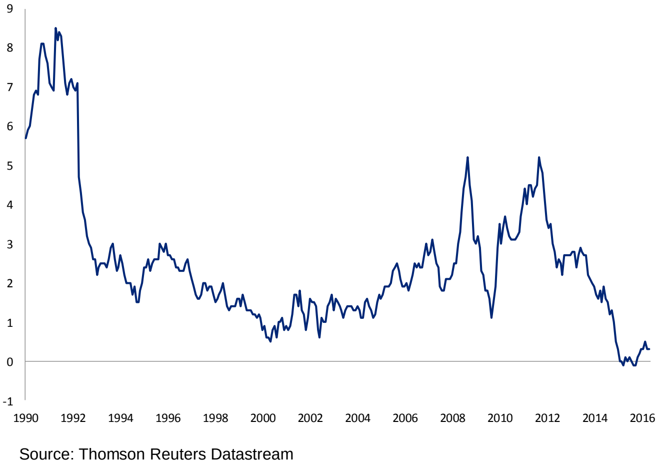
Source: Thomson Reuters Datastream

UK private and public sector job growth (thousands)



Source: Thomson Reuters Datastream

UK annual CPI inflation (%)

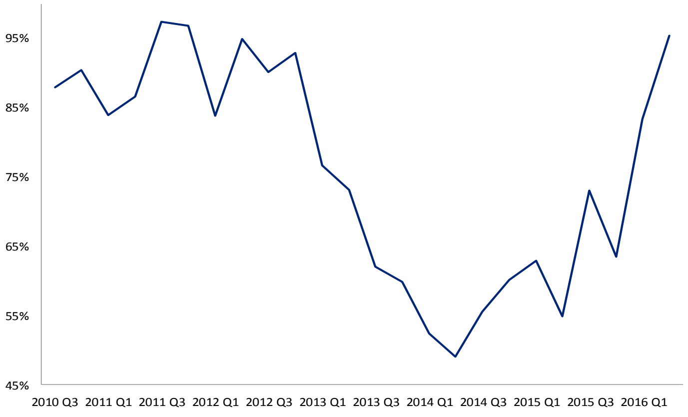


Source: Thomson Reuters Datastream

Two-chart summary of key survey messages

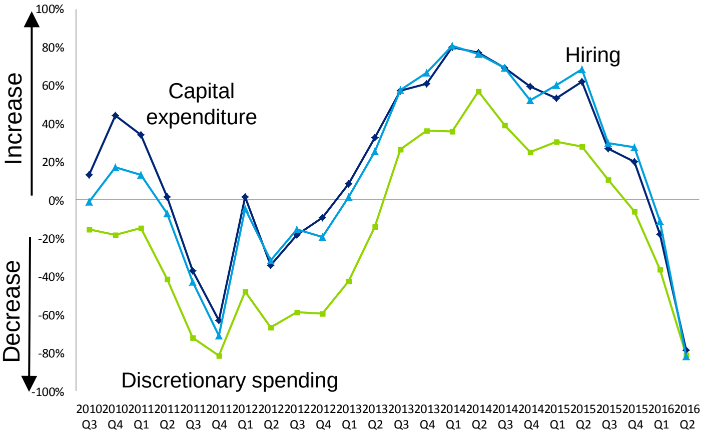
Uncertainty

% of CFOs who rate the level of external financial and economic uncertainty facing their business as above normal, high or very high



Outlook for capital expenditure, hiring and discretionary spending

Net % of CFOs who expect UK corporates' capital expenditure, hiring and discretionary spending to increase over the next 12 months



About the survey

This is the 36th quarterly survey of Chief Financial Officers and Group Finance Directors of major companies in the UK. The 2016 second quarter survey took place between 28th June and 11th July. 132 CFOs participated, including the CFOs of 25 FTSE 100 and 57 FTSE 250 companies. The rest were CFOs of other UK-listed companies, large private companies and UK subsidiaries of major companies listed overseas. The combined market value of the 94 UK-listed companies surveyed is £365 billion, or approximately 16% of the UK quoted equity market.

The Deloitte CFO Survey is the only survey of major corporate users of capital that gauges attitudes to valuations, risk and financing. To join our panel of CFO respondents and for additional copies of this report, please contact Anthea Neagle on 020 7303 0116 or email **aneagle@deloitte.co.uk**.