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Q4 2015

The Deloitte CFO Survey

The year ahead: A cautious start to 2016

Support among the Chief Financial Officers of the UK's largest corporates for staying in the EU has narrowed, mirroring a drift towards greater scepticism on the part of the UK public in the second half of 2015. A clear majority of CFOs continue to favour remaining in the EU, but those expressing unqualified support for membership fell from 74% in the second quarter to 62% in the fourth quarter. Just 6% of CFOs favour leaving. But 4% did not express an opinion, and a sizeable minority, 28%, say their decision will depend on the results of the Prime Minister's renegotiation of the UK's membership of the EU. The outcome of these discussions is likely to emerge following the European Council meeting in February. With almost a third, or 32%, of CFOs undecided or undeclared, an eventual deal could significantly affect business attitudes to EU membership.

UK CFOs are downbeat about the outlook for growth in the euro area in 2016 despite a stronger than expected acceleration in activity seen in the region in 2015. Indeed, CFOs are more pessimistic about prospects for the euro area this year than for emerging market economies. CFO sentiment is most positive on the US and the UK economies. Nonetheless, doubts about the pace and sustainability of the global recovery are weighing on business sentiment. CFO confidence fell through 2015 and ended the year at its lowest level since the second quarter of 2012, when the euro area was in recession.

Corporate risk appetite often reflects trends in financial markets. Thus the decline in the FTSE100 UK equity index since last summer has been accompanied by a softening in corporate risk appetite.

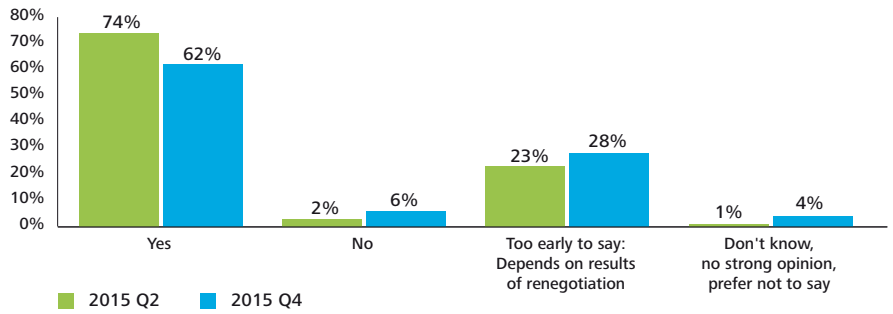
The proportion of CFOs who think now is a good time to take risk dropped to 37% in the fourth quarter, down from 47% in the third quarter and a peak of 72% in late 2014.

Such large moves in risk appetite feed through to the way in which companies run their finances. CFOs' balance sheet strategies have become more defensive, with a sharper focus on cost control which now tops CFOs' list of priorities. Meanwhile CFOs are placing less weight on growth through acquisitions and on capital spending.

In recent months uncertainties, especially in emerging markets, have prompted the Bank of England to push back the timing of UK interest rate rises. The consensus in financial markets in mid-December was that the Bank will start raising interest rates in the second half of 2016. The pace of tightening is expected to be gentle, with three-month interest rates rising by a total of about 100bp, from a current 0.6% to 1.6% at the end of 2018. The corporate sector seems well positioned to cope with this sort of trajectory with 64% of CFOs reporting that a 100bp rate rise would have no effect, or a positive effect, on their plans for investment or employment.

The surge in CFO confidence and risk appetite that started in late 2012 went into reverse in 2015. CFOs are upbeat about prospects for the US and UK economies, but see more risks elsewhere, especially in emerging markets and the euro area. CFOs have reacted by cutting back on risk-taking and sharpening their focus on cost control. This more defensive stance by the corporate sector points to slower growth in corporate hiring and capital expenditure in coming months.

Chart 1. CFO attitudes to EU membership
% of CFOs who gave the following responses when asked whether it is in the interests of UK businesses for the UK to remain a member of the EU



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

Contacts

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

Richard Muschamp
CFO Programme Leader
020 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

Europe

Public support for the UK's membership of the EU fell in the second half of 2015.

Between the end of May and the beginning of July four major opinion polls gave the 'In' camp an average lead of 18 percentage points. In the fourth quarter the same four polls showed the lead had been reduced to six percentage points.

This decline in public support for the EU has coincided with a narrowing in support among CFOs.

Chart 2. UK public opinion polls on EU membership

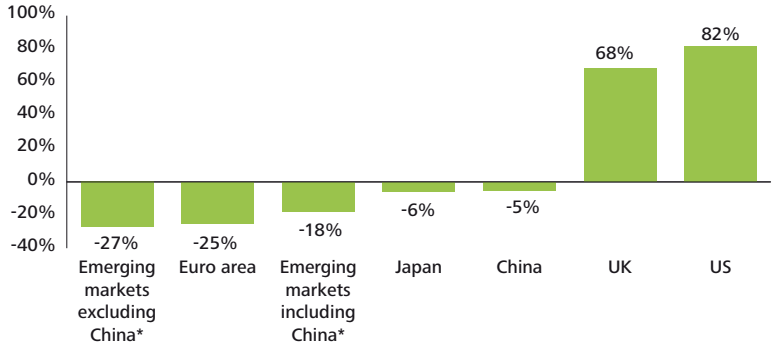
Mid-year polling (May to July)		In	Out	Don't Know	Lead (In)
ICM	31 May	47%	33%	20%	+14
Ipsos Mori	14-16 Jun	66%	22%	12%	+44
YouGov	19-24 Jun	44%	38%	18%	+6
Survation	29 Jun-6 Jul	45%	37%	18%	+8
Average		**51%**	**33%**	**17%**	**+18**

End-year polling (October to December)					
Ipsos Mori	17-19 Oct	52%	36%	12%	+16
Survation	16-17 Nov	43%	40%	18%	+3
YouGov	19-24 Nov	40%	38%	22%	+2
ICM	6 Dec	43%	39%	17%	+4
Average		**45%**	**38%**	**17%**	**+6**

CFOs are positive about prospects for growth in the US and the UK in 2016.

But CFOs are strikingly downbeat about the euro area. Levels of pessimism about euro area growth in 2016 are greater than for emerging markets' growth.

Chart 3. Growth prospects
Net % of CFOs who are optimistic about prospects for growth in the following regions in 2016

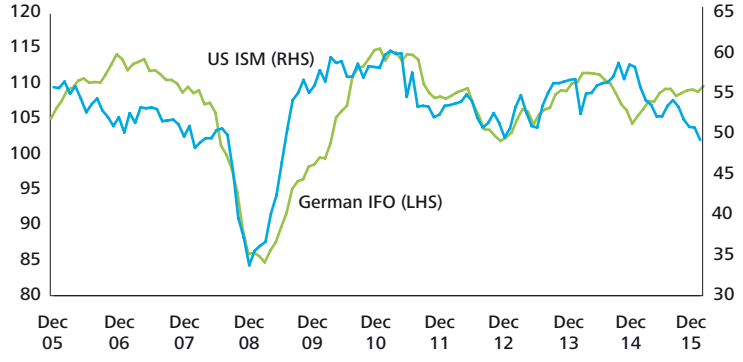


*GDP-weighted estimate based on CFO readings for emerging markets excluding China, and for China

Although CFOs are negative about prospects for the euro area, activity in the region picked up through 2015, and at a rather faster rate than expected.

German business confidence ended 2015 at higher levels than at the beginning of the year. Meanwhile US manufacturing activity dropped to a six-and-a-half year low in November.

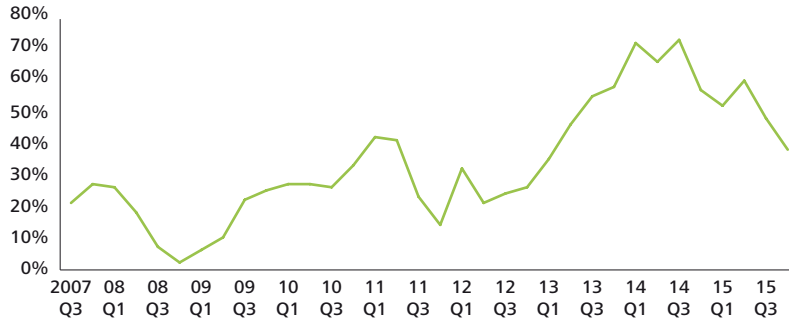
Chart 4. German and US business confidence
German Ifo Business Climate Index and US ISM Purchasing Managers Index (Manufacturing)



Risk appetite wanes

Other than a brief, post-election bounce, corporate risk appetite has been trending down for over a year. Just 37% of CFOs say that now is a good time to take greater risk onto their balance sheets, down from a peak of 72% in Q3 2014.

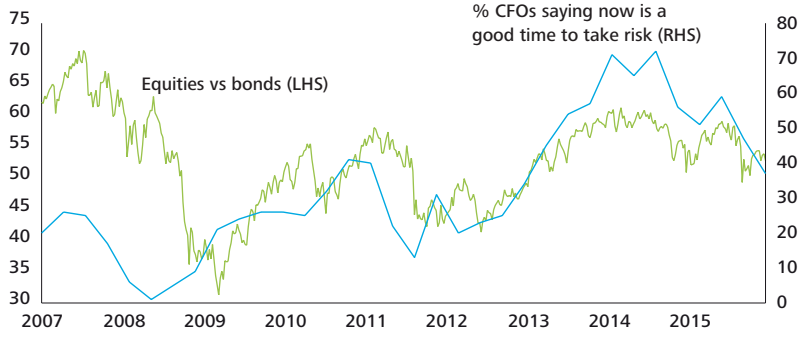
Chart 5. Risk appetite
% of CFOs who think this is a good time to take greater risk onto their balance sheets



The fall in corporate risk appetite has been mirrored by a decline in investor risk appetite.

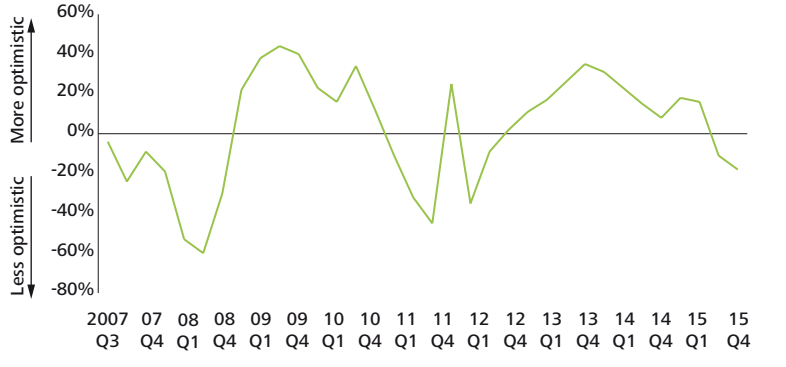
The second half of 2015 saw a rise in risk aversion among investors, as they moved from riskier assets including equities into safer government bonds.

Chart 6. CFO and investor risk appetites
% of CFOs who think this is a good time to take greater risk onto their balance sheets (LHS) and change in UK equities over bonds (RHS)



Sentiment among large corporates has declined for the third consecutive quarter. CFO optimism is at its lowest level since the second quarter of 2012, when the euro area was in recession and gripped by concerns that the single currency might break up.

Chart 7. Business confidence
Net % of CFOs who are more optimistic about financial prospects for their company now than three months ago



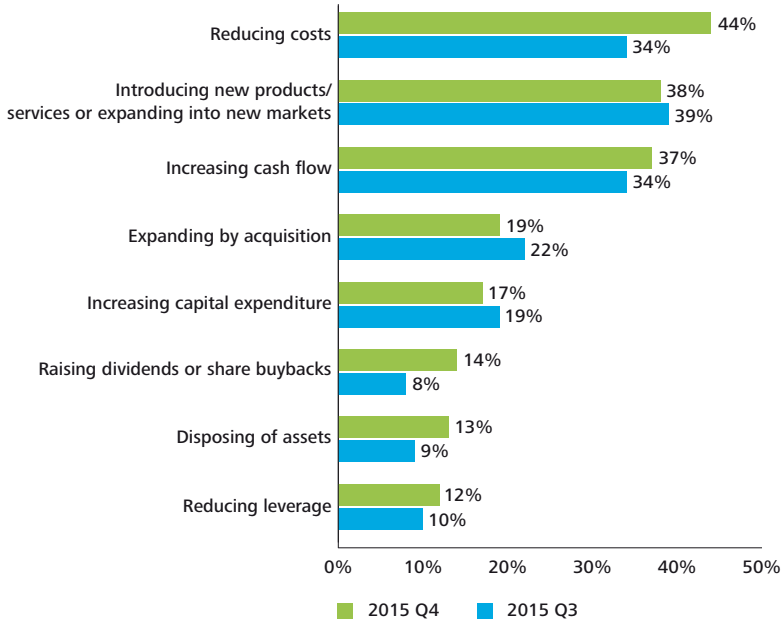
Focus on cost control

For the first time in a year CFOs rate cost reduction as their number one priority for the next 12 months.

CFOs are also placing greater emphasis on other defensive strategies such as increasing cash flow, disposing of assets and reducing leverage.

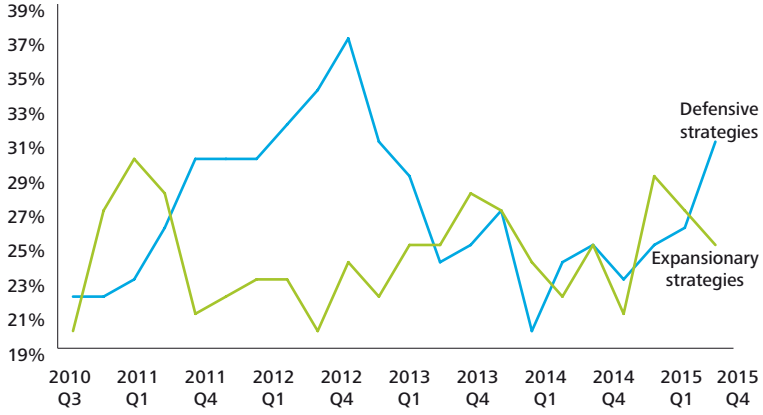
In contrast, CFOs are placing rather less emphasis on growth strategies such as introducing new products and services, expanding by acquisition and increasing capital expenditure.

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



The increased focus on defensive strategies means that CFOs are more defensive than at any time in the last three years.

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.

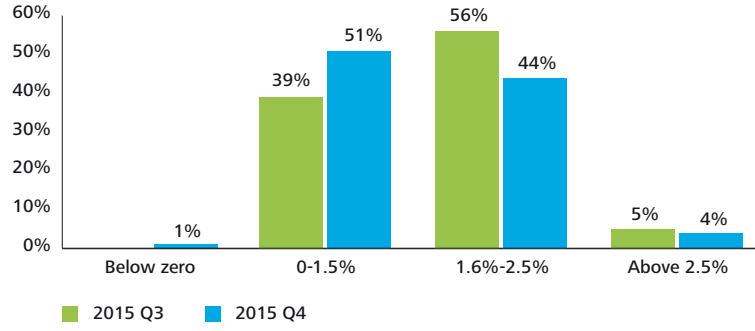
Inflation and interest rates

CFOs' expectations for inflation fell between the third and fourth quarters of 2015.

A narrow majority (51%) now expect inflation to remain below 1.5% in two-years' time.

The fall in CFOs' expectations for inflation coincided with downgrades to both market and Bank of England forecasts for inflation in 2016.

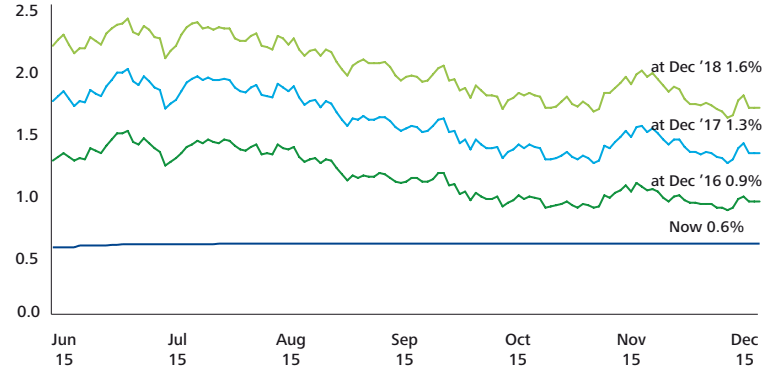
Chart 10. CFO inflation expectations
% of CFOs who expect consumer price inflation in the UK to lie between the following ranges in two-years' time



As inflation forecasts have fallen so, too, have financial market expectations for future interest rates.

Expectations for UK interest rates at the end of 2016, 2017 and 2018 are now lower than they were in the summer of 2015.

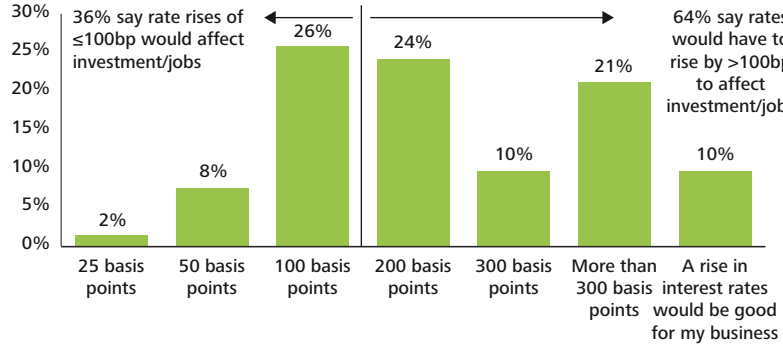
Chart 11. Financial market expectations for UK interest rates
UK market rate expectations for end-year three-month interest rates



The corporate sector seems fairly well positioned to cope with the cumulative 100bp rate rise priced in by financial markets in the next three years.

Almost two-thirds of CFOs say that interest rates would have to rise by more than 100 basis points before their businesses cut planned investment or employment.

Chart 12. Effect of rate rises on corporate spending
% of CFOs reporting that the Bank of England's base rate could rise by the following amounts before their business responds by cutting planned investment or employment

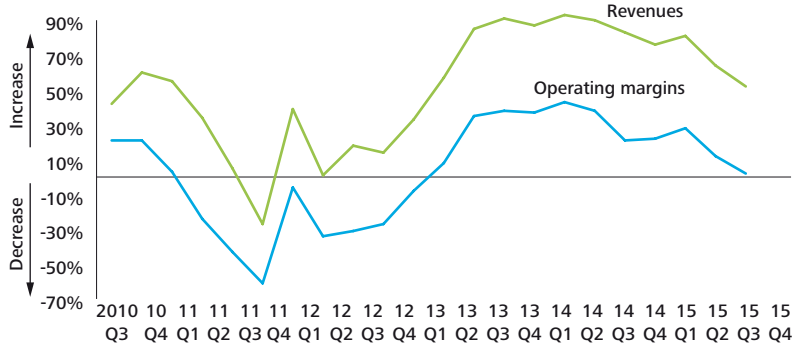


Weaker margins

Expectations for revenue and margin growth dipped in the second half of 2015.

While a majority of CFOs still expect UK corporate revenues to increase over the next 12 months, the outlook for revenues and margins is at its weakest for two-and-a-half years.

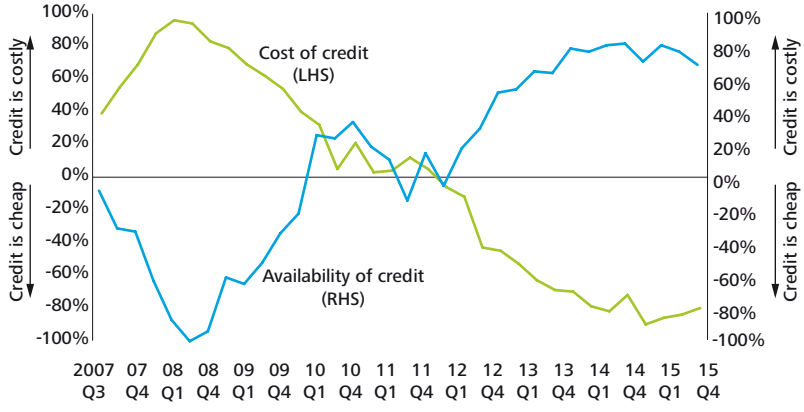
Chart 13. Outlook for corporate revenues and margins
Net % of CFOs who expect UK corporates' revenues and margins to increase over the next 12 months



Our panel of large corporates continues to enjoy good access to credit.

The cost of credit is not far off its lowest reported levels, while credit availability is near to all-time highs.

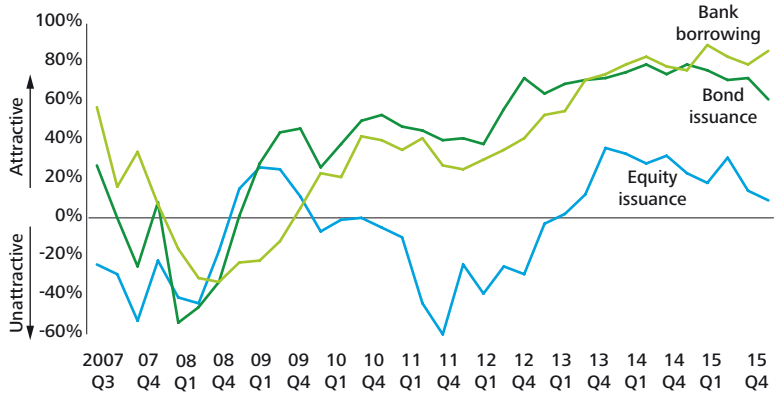
Chart 14. Cost and availability of credit
Net % of CFOs reporting credit is costly and credit is easily available



Bank borrowing remains the most attractive source of funding for CFOs, with a significant majority (86%) viewing it as an attractive source of external funding.

As has been the case for the last five years, CFOs view equity issuance as a less attractive source of funding than bond issuance or bank borrowing.

Chart 15. Favoured source of corporate funding
Net % of CFOs reporting the following sources of funding as attractive

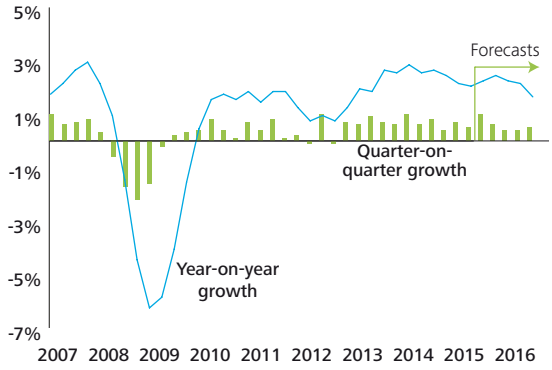


CFO Survey: Economic and financial context

The macroeconomic backdrop to the Deloitte CFO Survey Q4 2015

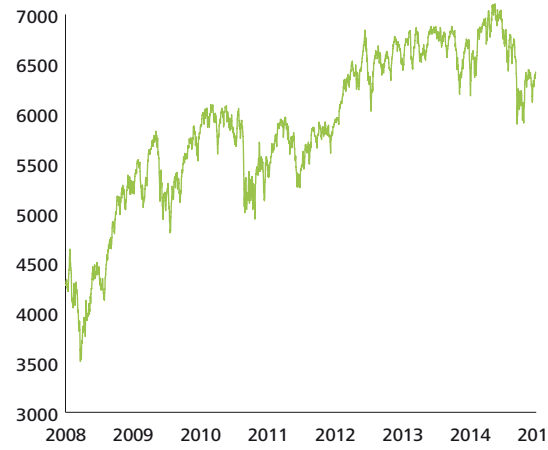
The International Monetary Fund cut its forecast for global growth in 2015 and 2016. Activity in emerging markets continued to disappoint, with economists nudging down their forecasts for growth in most emerging economies. Growth in the advanced economies continued and broadened, though indicators of industrial activity have generally softened, partly as a result of weaker export market demand. After a short-lived market rally in October, equities, especially those in emerging markets, lost value towards the end of the year. In early December the oil price fell below $40, to the lowest level in seven years; metals prices also softened. Inflation remained close to zero in the US, the euro area and the UK and inflation forecasts for 2016 continued to decline. The European Central Bank's announcement of a further round of Quantitative Easing fell short of market expectations, though the ECB's President subsequently reassured markets that there were "no limits" to the tools the ECB could use to fight deflation. As widely anticipated the US Federal Reserve raised interest rates on 16th December, the first time US interest rates have been increased in almost ten years.

UK GDP growth: Actual and forecast (%)



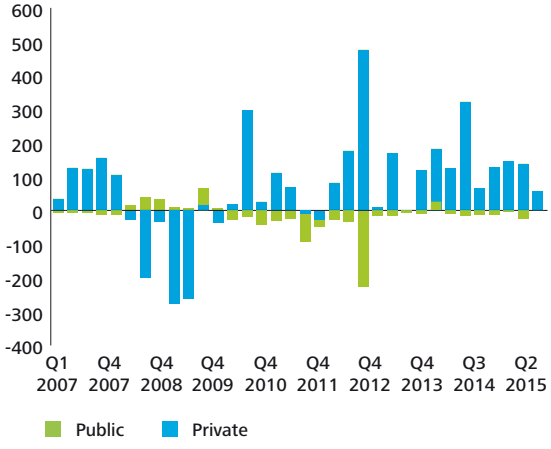
Source: ONS, consensus forecasts from *The Economist* and Deloitte calculations

FTSE 100 price index



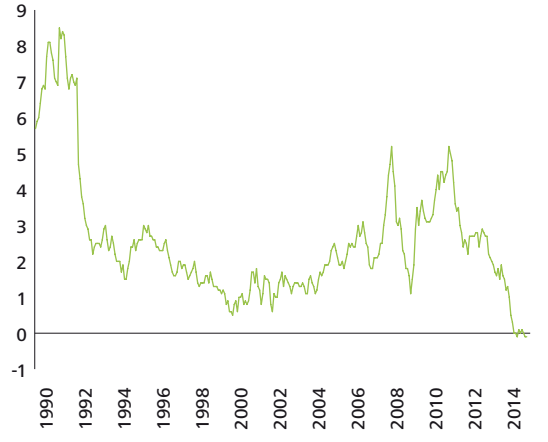
Source: Thomson Reuters Datastream

UK private and public sector job growth (thousands)



Source: Thomson Reuters Datastream

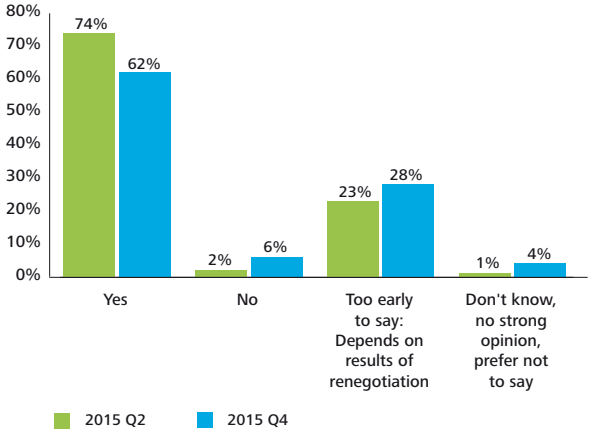
UK annual CPI inflation (%)



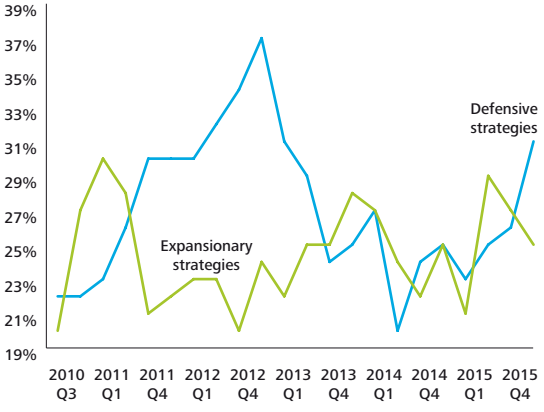
Source: Thomson Reuters Datastream

Two-chart summary of key survey messages

CFO attitudes to EU membership
% of CFOs who gave the following responses when asked whether it is in the interests of UK businesses for the UK to remain a member of the EU



CFO priorities: Expansionary vs. defensive strategies



About the survey
This is the 34th quarterly survey of Chief Financial Officers and Group Finance Directors of major companies in the UK. The 2015 fourth quarter survey took place between 11th November and 2nd December. 137 CFOs participated, including the CFOs of 24 FTSE 100 and 62 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 99 UK-listed companies surveyed is £374 billion, or approximately 18% 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.

Designed and produced by The Creative Studio at Deloitte, London. J3512