Q3 2022

The Deloitte CFO Survey

The credit squeeze is here

A 12-year period of easy credit conditions is drawing to an end, according to the Chief Financial Officers of the UK's largest corporates. The third quarter CFO survey shows corporates facing a major reset, with CFOs rating credit as being more costly than at any time since 2010.

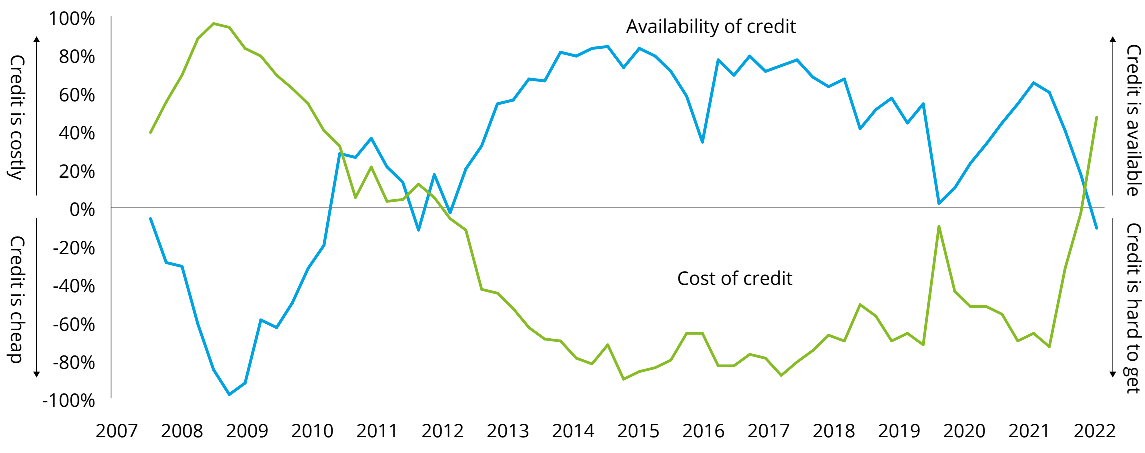
The financial market impact of the government's mini-Budget on 23 September, which took place roughly halfway through the survey period, has added to the pressures. Those CFOs who responded after the mini-Budget foresaw materially higher interest rates and were more likely to report elevated credit costs than those who responded before. Not since the depth of the credit crunch that unfolded in 2009 have CFOs rated debt, whether bank borrowing or corporate bonds, as a less attractive source of finance for their businesses than they do today.

The dampening effect of tight credit conditions is reinforced by wider concerns. CFOs rate external uncertainties as being at the highest level since the pandemic and see energy supply as the top business risk, followed by geopolitics. On average, CFOs attach a 78% probability to the UK falling into recession in the next 12 months.

Expectations for hiring have fallen sharply, with far more CFOs expecting to reduce hiring in the next 12 months than to increase it. Despite anticipating a reduction in hiring, persistent recruitment difficulties and high inflation seem to be driving CFO expectations for wage costs. They expect the pace of wage rises in their businesses to accelerate over the next 12 months.

Given rising credit costs and expectations of thinner profit margins, corporates are tilting towards more defensive balance sheet strategies, with cost control by far the top CFO priority. Monetary policy seems to play a role here – in survey responses since the Bank of England started raising rates in December 2021, CFOs expecting rises in financing costs have been much more likely to expect lower capital expenditure or strongly prioritise cost reduction than those expecting no change or a decrease in financing costs. In its latest World Economic Outlook, released on 11 October, the IMF warned that the "worst is yet to come" for the global economy. On the basis of this survey, CFOs expect, and are braced for, just such an outcome.

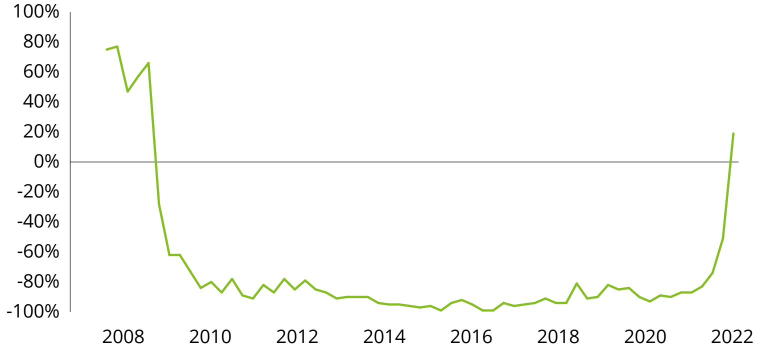
Chart 1. Cost and availability of credit
Net % of CFOs reporting credit is costly and credit is easily available



End of easy credit

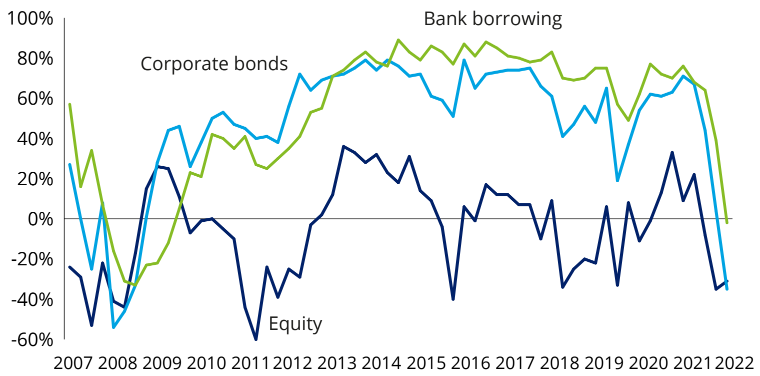
Rises in market expectations of interest rates, over the summer months, and the financial market impact of the government's mini-Budget seem to be reflected in CFOs' characterisation of the cost of short-term financing. For the first time in 14 years, CFOs describe, on balance, the level of short-term market interest rates in the UK as quite high or very high.

Chart 2. Short-term interest rates
Net % of CFOs who characterise short-term market interest rates in the UK as quite high or very high



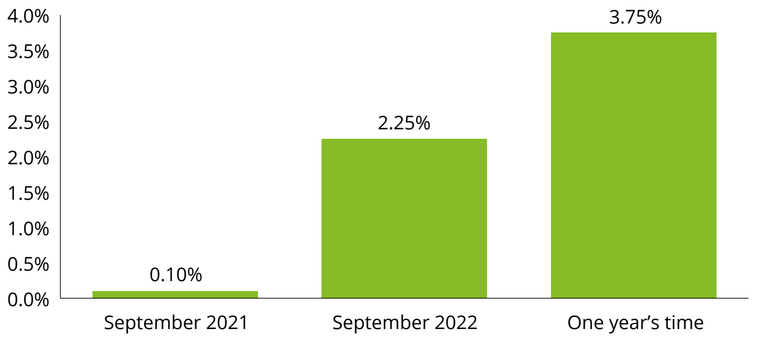
Tightening credit conditions have resulted in a sharp fall in the attractiveness of debt finance – whether bank borrowing or bond issuance – over this year. CFOs now see equity as a more attractive source of finance than corporate bonds, an assessment last seen during the depths of the credit crunch in 2009.

Chart 3. Corporate financing
Net % of CFOs who rate the following sources of funding for UK corporates as very or somewhat attractive



CFOs expect the Bank of England to continue tightening monetary policy but at a less aggressive pace than markets suggest. They see the Bank's base rate at 3.75% in a year's time, well below market expectations at the time of writing.

Chart 4. Interest rate expectations
Historical and current levels of the Bank of England's base rate and the median of CFOs' expectations for its level in a year's time



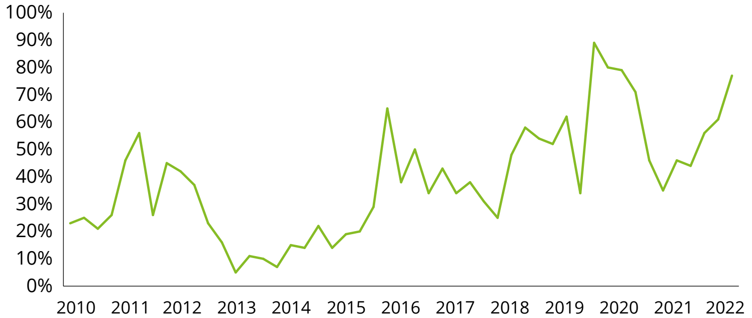
Risk appetite at recessionary levels

77% of CFOs rate the level of external financial and economic uncertainty as high or very high, the highest reading since the beginning of the COVID-19 pandemic and well above its long-term average.

One CFO told us that *"the crisis in Ukraine is increasing uncertainty on the supply side of the business. It's not just energy prices rising, but other important commodities too."*

Chart 5. Uncertainty

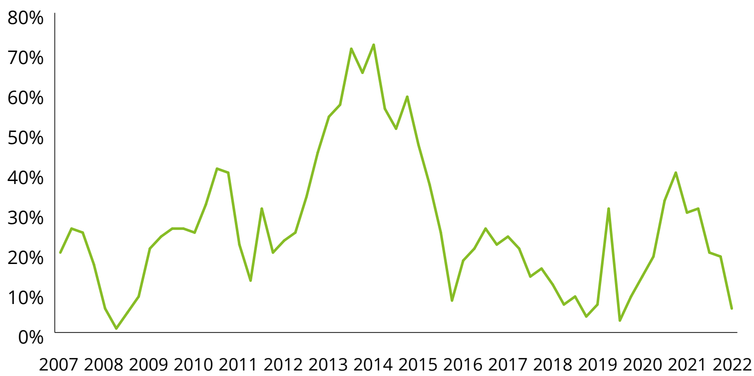
% of CFOs who rate the level of external financial and economic uncertainty facing their business as high or very high



Corporate risk appetite has fallen further and is now close to its lowest level on record. Only 6% of CFOs think this is a good time to take greater risk onto their balance sheets.

Chart 6. Corporate risk appetite

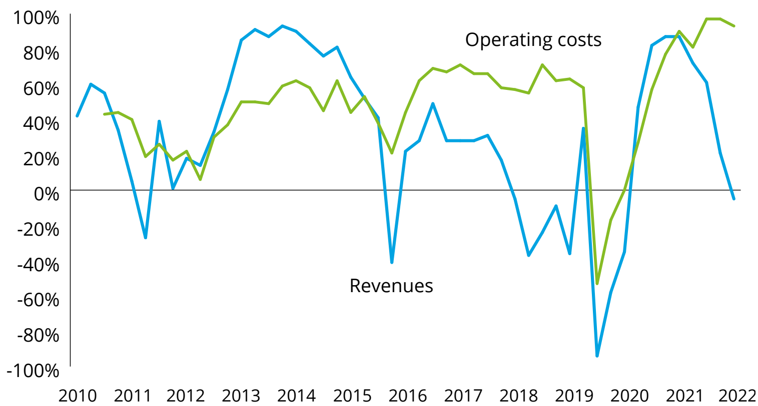
% of CFOs who think this is a good time to take greater risk onto their balance sheets



CFOs expect rising operating costs and a decline in revenues to drive a substantial squeeze on corporate margins. An overwhelming majority – 91% – of CFOs expect operating margins for UK corporates to decline over the next 12 months – the highest reading on record except in the depths of the pandemic.

Chart 7. Outlook for corporate revenues and operating costs

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

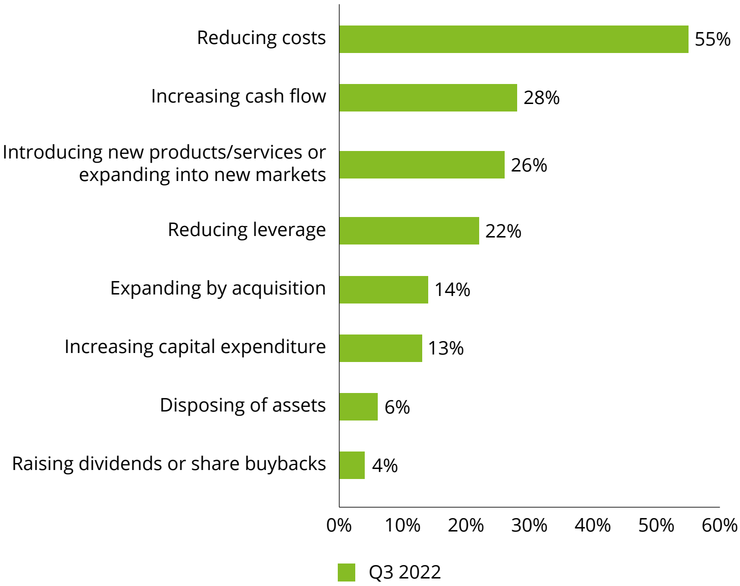


Cost reduction is top strategy

With rising credit costs and expectations of a margin squeeze, corporates are tilting towards more defensive strategies. Cost reduction and increasing cash flow – both defensive strategies – are the top two priorities for CFOs for the next 12 months.

They are placing less emphasis on expansionary strategies such as introducing new products or services, increasing capital expenditure and expanding by acquisition.

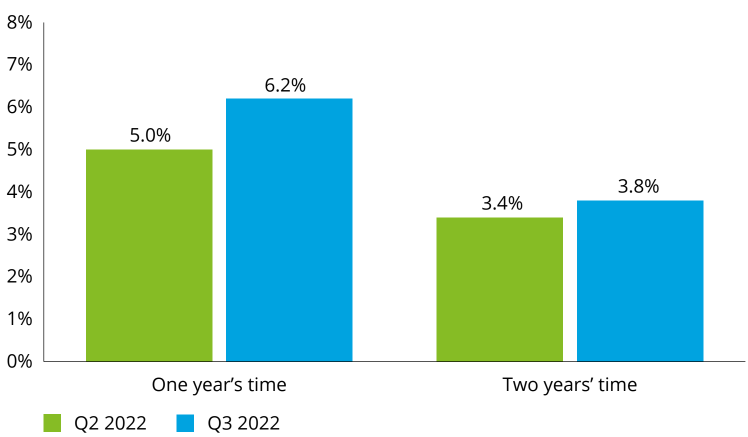
Chart 8. Corporate priorities in the next 12 months
% of CFOs who rate each of the following as a strong priority for their business in the next 12 months



CFOs expect inflation to fall to 6.2% next autumn, indicating greater and more persistent price pressures than reflected in the second quarter survey. According to one CFO, *"consumer prices do not yet fully reflect the price pressures we are seeing."*

In two-years' time, CFOs expect inflation to be running at at 3.8%, almost double the Bank of England's 2% target.

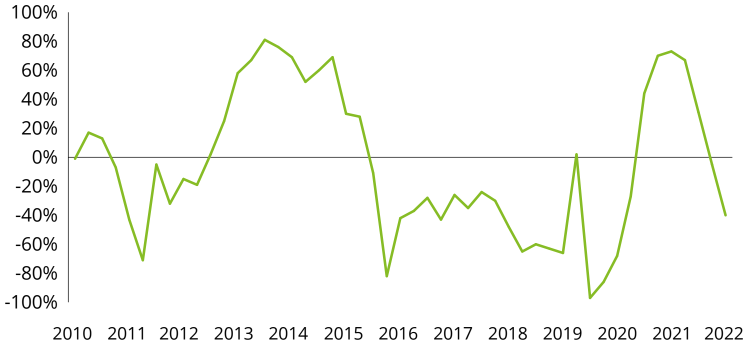
Chart 9. Inflation expectations
CFOs median expectations for inflation in one year's time and two years' time



Labour demand to cool

On balance, CFOs expect UK corporates to reduce hiring over the next 12 months.

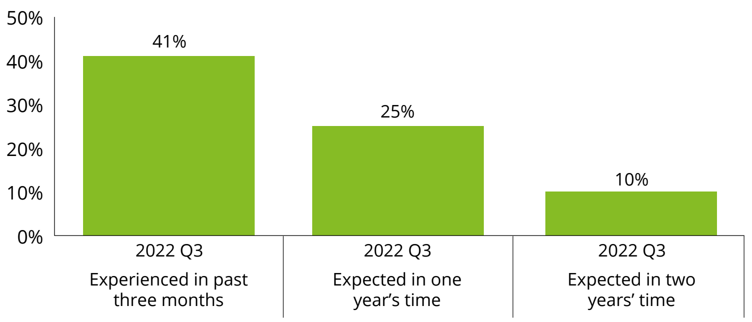
Chart 10. Outlook for corporate hiring
Net % of CFOs who expect UK corporates' hiring to increase over the next 12 months



CFOs continue to report high levels of recruitment difficulties and labour shortages faced by their businesses. They see some improvement in a year's time but a significant proportion – one in four – expect to continue experiencing significant or severe recruitment difficulties after a year.

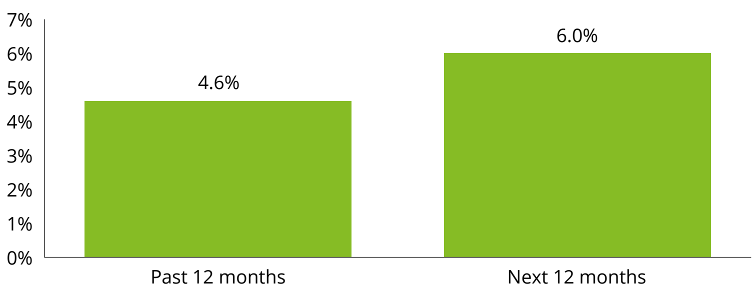
The move to hybrid and remote working seems to have introduced a further complicating factor for some hiring managers. One CFO told us: *"we're seeing more of a national market for jobs. We're now worrying about an employee in Birmingham getting poached by a London-based firm."*

Chart 11. Recruitment difficulties and labour shortages
% of CFOs who report significant or severe levels of recruitment difficulties or labour shortages experienced by their business over the last three months and those expecting similar levels of disruption in one year's and two years' time



Despite anticipating a reduction in hiring, persistent recruitment difficulties and high inflation seem to be driving CFO expectations for average wage rises at their businesses. They expect a significant acceleration in average wage costs over the next 12 months.

Chart 12. Average wage costs
Change in average wage costs experienced by CFOs' businesses over the last 12 months and the average expected change over the next 12 months

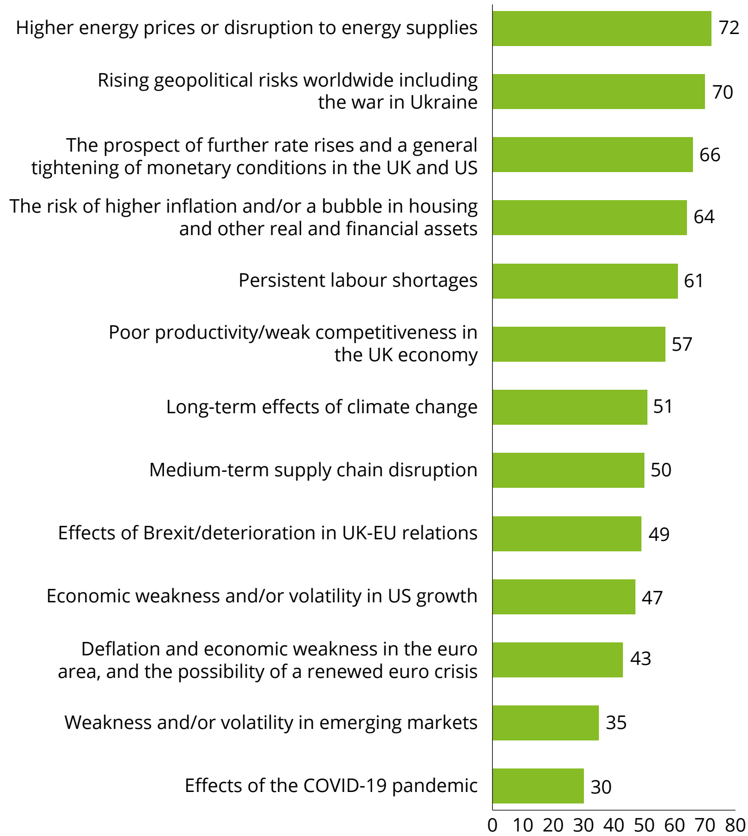


Energy supply and geopolitics top the risk list

Higher energy prices or disruption to supply and rising geopolitical risks are the top two concerns for CFOs as the war in Ukraine threatens Europe's energy supply. One of our CFO panellists worries that European governments might be *"unable to provide the energy required to operate homes and economies"* this winter.

The prospect of further rate rises and higher inflation embedding itself in the economy follow closely as the next biggest concerns for business.

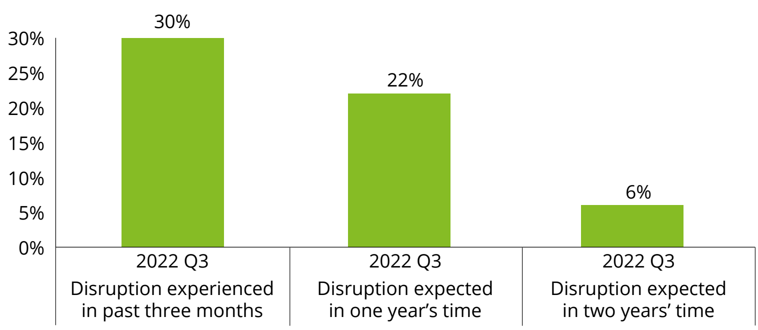
Chart 13. Risk to business posed by the following factors
Weighted average ratings on a scale of 0-100 where 0 stands for no risk and 100 stands for the highest possible risk



Almost a third of CFOs reported significant or severe supply chain disruption in the third quarter. They expect minimal improvement in the situation in a year's time, with almost a quarter expecting significant or severe disruption to persist over that period.

Some are also concerned about the health of their suppliers, with one CFO considering whether "they are strong enough to pull through" this challenging period.

Chart 14. Supply chain disruption
% of CFOs who report significant or severe levels of supply chain disruption experienced by their business over the last three months and those expecting similar levels of disruption in one-year's and two years' time

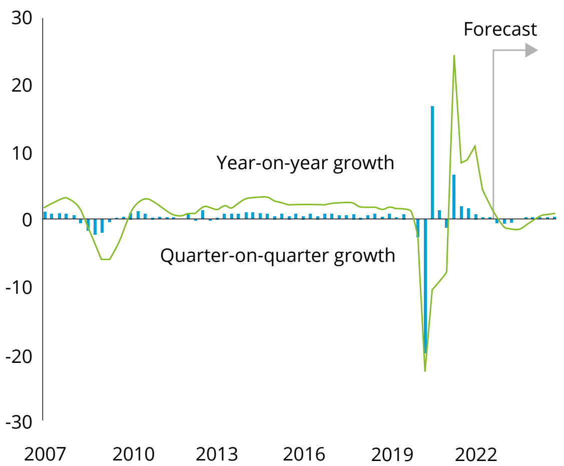


CFO Survey: Economic and financial context

The macroeconomic backdrop to the Deloitte CFO Survey Q3 2022

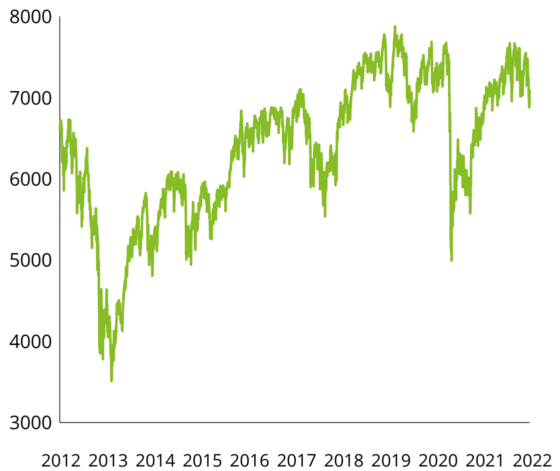
The global economy continued to slow in the third quarter of 2022 and recession risk increased in major western economies, particularly Europe. Continued geopolitical tension arising from Russia's invasion of Ukraine kept commodity prices at very high levels and sparked concerns about energy shortages in Europe over the winter. Inflation increased further across the globe and to multi-decade highs in the US, Europe and the UK, squeezing consumer incomes and corporate margins. Central banks raised interest rates aggressively despite slowing economic activity. The Bank of England raised rates from 1.25% to 2.25%, the highest level since 2008. Hopes of a soft landing faded with the Bank forecasting a recession in the UK starting at the end of the year. Governments have devoted significant efforts to shielding economies from the energy crisis by providing help to households and businesses. However, this fiscal stimulus contributed to an increase in expectations for future interest rates, further tightening financial conditions and increasing volatility in financial markets. The Bank of England stepped in to avoid "widespread financial instability" after the UK chancellor's fiscal announcement of unfunded tax cuts led to a surge in gilt yields. The US dollar strengthened considerably against a wide basket of currencies, including sterling and the euro, benefitting from the US Federal Reserve's tightening and safe haven flows.

UK GDP growth: Actual and forecast (%)



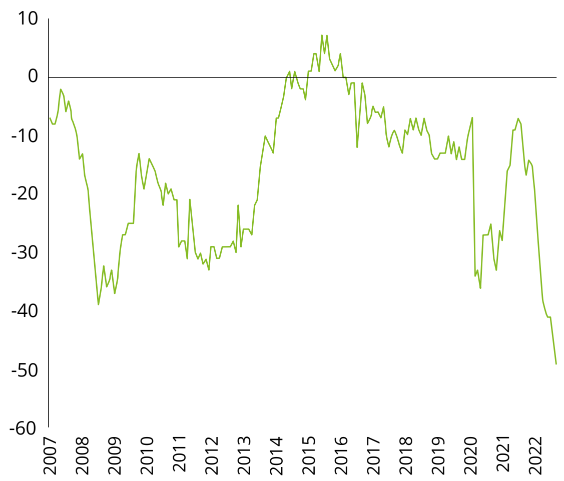
Source: Refinitiv Datastream, Deloitte calculations

FTSE 100 price index



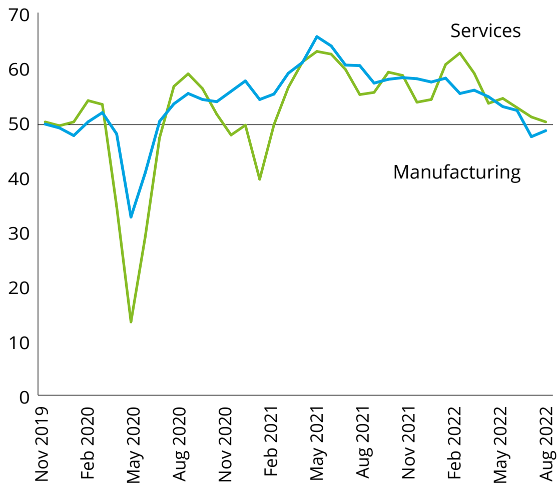
Source: Refinitiv Datastream

GfK Consumer Confidence Index (UK)



Source: Refinitiv Datastream

Markit Purchasing Manager Indices (UK)



Source: Refinitiv Datastream, readings above 50 indicate expansion

Two-chart summary of key survey messages

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

Outlook for corporate hiring
Net % of CFOs who expect UK corporates' hiring to increase over the next 12 months

About the survey

This is the 61st quarterly survey of Chief Financial Officers and Group Finance Directors of major companies in the UK. The 2022 third quarter survey took place between 20th September and 3rd October. 87 CFOs participated, including the CFOs of 23 FTSE 100 and 30 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 60 UK-listed companies surveyed is £463 billion, or approximately 20% 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 Elaine Hoang on 020 7007 4717 or email ehhoang@deloitte.co.uk.

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