eef The manufacturers' organisation

In partnership with: BDO

MANUFACTURING OUTLOOK

2017 QUARTER 1

2.7 million employees

£240bn in exports

68% of business R&D

Average wages higher than the rest of the economy

Hemispheres, taken by Rob Watkins at Croft Filters in Warrington, winner of the Amateur category in the EEF Photography Competition 2016.

FOREWORD

Lee Hopley
Chief Economist
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Welcome to the 2017q1 *Manufacturing Outlook* report, in partnership with BDO LLP.

We know that 2016 turned out to be a better year than expected for UK manufacturers. The sector's output expanded by 0.7% last year. It was not, however, smooth sailing with an erratic performance from quarter to quarter and an uneven growth picture across different sub-sectors. In the final months of last year official statistics showed expansion in more than half of manufacturing sectors, which seemed to confirm that the EU referendum has not done irreparable damage to UK industry.

Indeed, the same could be said for the UK economy as a whole. If anything, growth accelerated slightly in the final months of 2016, demonstrating the resilience of UK consumer confidence and, of course, spending. Virtually all the indicators for 2017 so far show that these positive trends have carried into 2017. And this is particularly the case for UK manufacturing. Recent engagement with our members and clients confirm the buoyant picture in our latest *Manufacturing Outlook survey*.

While some companies have been surprised by the sector's defiance of gloomier post-referendum expectations, the improving economic performance across many of the UK's major international markets and the benefits for the UK supply chain go some way towards explaining the gradual strengthening in activity over the past six months.

Recent surveys and data releases from the Eurozone are a case in point. Surveys of business activity and sentiment, such as the PMIs and the German Ifo index were solidly positive and followed a decent showing for GDP growth across the bloc at the end of 2016. Add to this that emerging market growth is on the up as commodity prices are recovering and fears of a hard landing in China have waned, and UK manufacturers essentially have a more supportive global economic environment than has been the case for some time. Clearly the weaker sterling exchange rate is putting a bit of extra wind in the sails of UK exporters.

Our latest survey shows that the positive external demand environment is an important source of growth for all manufacturing sectors. But with elections in at least three European countries on the cards this year and a number of big unknowns about what's coming next in US politics, we should be as focused on emerging risks in the rest of the world as we are to any Brexit-related challenges that might emerge over the course of this year.

The positive confidence indicators in our latest survey and increased plans to invest and recruit in the UK are a sign of UK manufacturers responding to fuller order books and ensuring they have the capacity and capability in place to respond to customer requirements. A continuation of the solid performance in key markets, as well as domestic policy in the forthcoming Budget that drives ahead with the priorities outlined by government in its industrial strategy Green Paper, are critical to keep these trends on track in 2017.

2017Q1 HEADLINES

Last quarter most of our survey indicators were back in positive territory with expectations that the improving trend would carry into the start of 2017. Our latest results show that this has indeed been the case, and then some.

All of the output and orders components far exceeded the positive expectations from three months ago. The accompanying pick up in confidence is helping to underpin more investment and recruitment.

INDICATOR	BALANCE	CHANGE	
Confidence	5.9	↑	Confidence about the UK market in the coming year gains ground
Output	31 %	↑	Output revival continues with balance of companies reporting growth beating forecast
UK orders	22 %	↑	Domestic market remains supportive for most manufacturing sectors
Export orders	25 %	↑	Export balance at highest level since 2011q2 with further gains expected
Employment	17 %	↑	Balance of companies of all sizes increased headcount in the past quarter
Investment	12 %	↑	Investment intentions head higher, hitting a 2-year high in 2017q1

Source: EEF Manufacturing Outlook Survey

2017 has started positively for a large proportion of manufacturers. The net balance of companies reporting growth in output surged to the highest level since 2013q3, with the total orders balance, at 29 %, posting the strongest response since 2011q2.

There are three notable trends underneath these headlines. First off, both the home and overseas markets are contributing to growth. Activity in the domestic market got back on track after the referendum and UK order balances have posted two consecutive quarters of double-digit balances. In contrast, predictions of a rise in export orders have been reported since the middle of last year, but have only now materialised with the balance of companies seeing an increase in export sales rebounding to 25 % from -2 % previously.

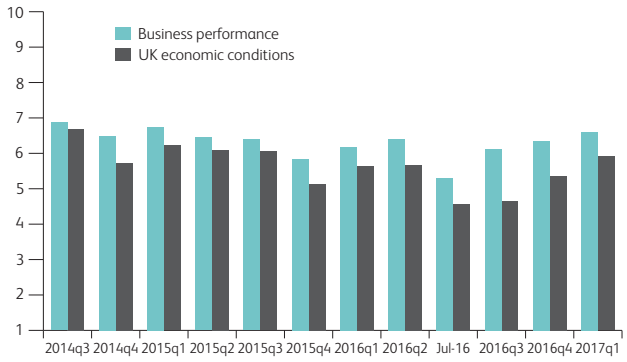
While the weak sterling exchange rate is doubtless a boon for many exporters, manufacturers have also become gradually more optimistic about demand in the rest of the world. In the past three months only a fifth of companies reported no improvement in any of their markets, significantly down on the 30 % making the same judgement a year ago.

Thirdly, all sectors are contributing to stronger output. If 2016 was characterised by a highly variable sector performance, the first quarter of 2017 is all about broad-based improvements. The strongest output balances were found in industries with a wide demand base – rubber and plastics and metal products. But following an extremely tough couple of years, there is a welcome return of positive balances in the basic metals and machinery sectors.

All of these trends are expected to persist into next quarter, spurring more confidence about the future and also leading more companies to make adjustments to their investment plans and their employment requirements. Whether this can completely withstand the uncertainty of Brexit negotiations is another matter.

MANUFACTURING FEELING INCREASINGLY UPBEAT ABOUT THE YEAR AHEAD

CONFIDENCE IN THE NEXT 12 MONTHS 1 = SUBSTANTIALLY WORSE, 10 = SUBSTANTIALLY BETTER



Source: EEF Manufacturing Outlook Survey

OUTPUT

The manufacturing sector built on the momentum seen towards the back end of 2016, to begin 2017 in rude health. This is illustrated by a hefty pick up in output, with the balance of companies reporting growth more than doubling from 13% to 31% in 2017q1. This is the largest output balance recorded since 2013q3. Perhaps most encouragingly, output growth is expected to rise further in the second quarter of the year, as macroeconomic conditions continue to foster a supportive environment for UK manufacturing.

PAST THREE MONTHS	↑	31%
NEXT THREE MONTHS	↑	33%

The increase in the output balance was ubiquitous across sectors, a rare feat and a clear indication of the current health of manufacturing. Some of the big improvements came in construction related sectors, with rubber and plastics and non-metallic mineral sectors posting notable growth. These sectors are likely to have benefited from the construction industry's bounce back at the last quarter of the year allowing companies in its supply chain to enjoy the security of a strong pipeline of work.

Metal products, another key input into the construction supply chain, also recorded healthy growth. Its output balance was however down on other construction related sectors, perhaps as a result of its more diverse customer base, notably motor vehicles which is set to come off the boil somewhat after a record breaking 2016. The export-intensive basic metals surprised to the upside, building on the growth seen in 2016q4, largely on the back of the sterling depreciation.

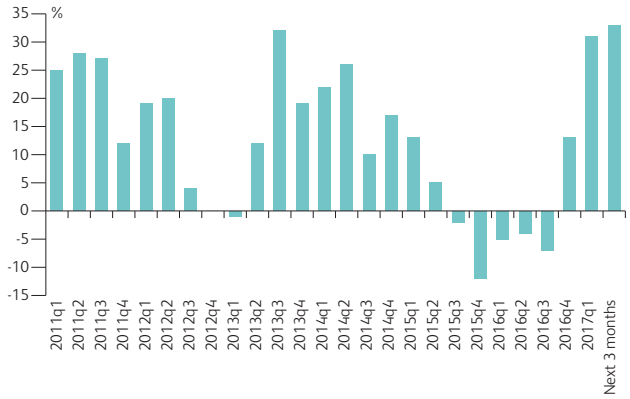
Capital goods sectors also experienced a strong start to the year. Mechanical equipment, the dominant investment good in UK manufacturing, reversed the trend of recent years to record a positive output balance. It appears that businesses, whilst remaining cautious about large scale new projects, recognise the need to invest in some extra capacity to meet improved demand conditions.

Electronics and electrical equipment, two of the strongest performing sectors last time round, have again done well. With a wide demand base, they are likely to be profiting from the overall strong economic environment, as well as being boosted by enduring healthy demand conditions in key export markets and better than anticipated investment conditions.

Finally, the food and drink and other transport sectors both had a strong quarter. Still resilient consumer spending and an aerospace industry which continues to benefit from a long order book are the likely sources behind impressive growth respectively.

OUTPUT BALANCE SURGES IN 2017Q1

% BALANCE OF CHANGE IN OUTPUT



Source: EEF Manufacturing Outlook Survey

OUTPUT SUMMARY

% BALANCE OF CHANGE

SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS
Basic metals	15	22
Metal products	33	35
Mechanical	22	28
Electrical	27	42
Electronics	26	40
Rubber & Plastics	43	50
Other transport	40	33
TURNOVER		
£0-9m	21	35
£10-24m	26	34
£25m and over	36	43

Source: EEF Manufacturing Outlook Survey

ORDERS

Last quarter, we noted a substantial improvement in demand conditions for UK manufacturers. Not only has this recovery been sustained in the first quarter of the year but all three order balances have accelerated to multi-year highs. The outturns for both UK and export order balances have significantly exceeded last quarter's forward looking expectations to post their highest balance since 2010q4 and 2011q3 respectively. Encouragingly, demand conditions are expected to remain supportive in the next three months too.

UK ORDERS	PAST 3 MONTHS	↑	22%	NEXT 3 MONTHS	↑	26%
EXPORT ORDERS	PAST 3 MONTHS	↑	25%	NEXT 3 MONTHS	↑	33%
TOTAL ORDERS	PAST 3 MONTHS	↑	29%	NEXT 3 MONTHS	↑	29%

UK ORDERS

The balance for UK orders over the past three months jumped to 22% from 13% in 2016q4, with the domestic economy proving to be more resilient than previously expected. The UK economy ended last year on a strong note and the positive conditions look to have carried over to the start of 2017. What's more, the strong pick up in export orders should have filtered through to the domestic supply chain.

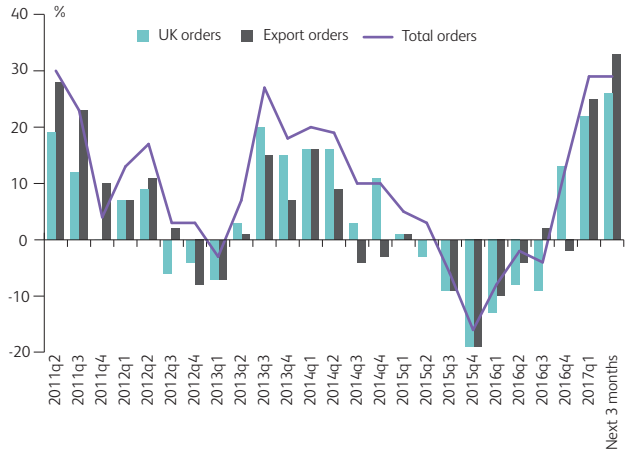
All manufacturing sectors reported positive balances on UK orders for the past three months but for basic metals. The weakness in the basic metals sector could be down to signs of volatility in the construction sector at the start of the year, although other manufacturing sectors in its supply chain – like non-metallic minerals and metal products – posted strong UK order balances for 2017q1. Still, demand is expected to flow back to the basic metals sector in the next three months.

Mechanical equipment posted a positive UK orders balance after eight consecutive quarters of deteriorating domestic demand conditions. With most companies now diversified away from the oil and gas supply chain and fuller order books supporting some additional investment across UK manufacturing, the mechanical equipment sector is looking to be on a more stable footing.

Food and drink also saw the UK orders balance move back into positive territory after a weak 2016q4 and manufacturers in the sector have pencilled in for a further improvement in the next three months. Elsewhere, the other transport sector continued to benefit from a steady supply of domestic orders, but expectations are for new orders to tail off in 2017q1, albeit that drop is likely to prove temporary.

ORDER BALANCES JUMP TO MULTI-YEAR HIGHS

% BALANCE OF CHANGE IN ORDERS



Source: EEF Manufacturing Outlook Survey

EXPORT ORDERS

Demand from the UK's key export markets has picked up considerably from the lows seen over the best part of the last three years. Manufacturing PMIs in nearly all of the UK's key export markets – the EU, US and China – have jumped at the start of 2017 to levels not seen since 2014. This is reflected in the balance of companies citing the lack of positive demand conditions from any export market continuing its decline from 25% in 2016q4 to 19% this quarter.

No doubt, the sterling depreciation has come at the right time to allow companies – especially in more commoditised sectors – to take full advantage of the improvement in overseas demand. Indeed, all manufacturing sectors have reported positive export order balances in 2017q1 and expect conditions to remain supportive for overseas sales in the next three months.

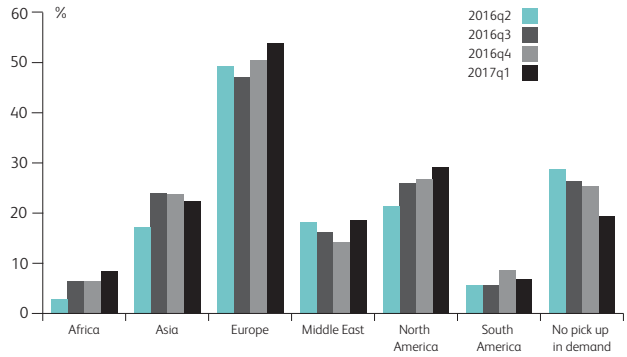
The mechanical equipment sector has seen one of the heftiest turnarounds in its export fortunes with the balance on export orders for the past three months climbing from -16% in 2016q4 to 23% in 2017q1. The sector is highly export-intensive and the recovery in global manufacturing activity has allowed it to benefit from the revival in demand for investment goods.

Commoditised industries that are more sensitive to movements in the exchange rate already saw some of the benefits of the low sterling filter through towards the second half of last year. Export order balances for the food and drink, metal products and rubber and plastics sectors, have remained strong in 2017q1 and are expected to stay robust in the next three months.

The benefits of the low sterling, although less significant than the pick up in export demand, are also starting to emerge for sectors on the high added value spectrum. The electronics and electrical equipment sectors reported two of the strongest balances for the past three months, building on last quarter's positive outturns.

DEMAND FROM THE US AND EUROPE CONTINUES TO IMPROVE

% OF COMPANIES REPORTING POSITIVE DEMAND CONDITIONS BY MARKET



Source: EEF Manufacturing Outlook Survey

ORDERS SUMMARY

% BALANCE OF CHANGE

	UK ORDERS		EXPORT ORDERS		TOTAL ORDERS	
SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS
Basic metals	-11	12	21	21	10	11
Metal products	28	37	26	38	30	34
Mechanical	15	21	23	30	23	26
Electrical	23	29	24	54	38	38
Electronics	13	24	37	27	32	30
Other transport	47	7	33	20	40	27
TURNOVER						
£0-9M	18	29	19	24	24	33
£10-24m	14	26	31	39	25	35
£25m and over	31	33	28	25	43	32

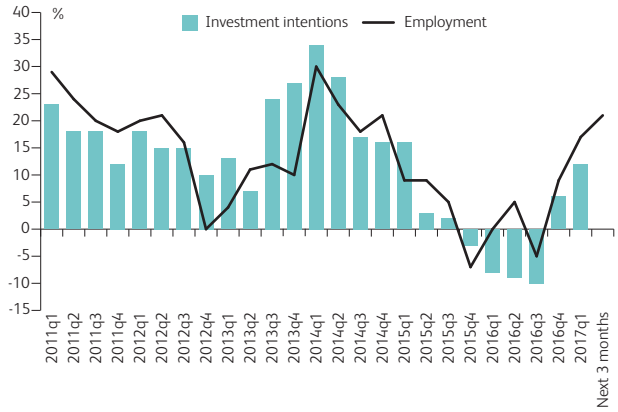
Source: EEF Manufacturing Outlook Survey

EMPLOYMENT & INVESTMENT

Employment and investment both continued to grow this quarter, after drifting back into positive territory in the final quarter of 2016. This trend is consistent with strong output balances and busy order books. The boost in demand – both from the UK and from major overseas markets – is prompting manufacturers to increase capacity and to take on more staff to fulfil customers' requirements. It additionally reflects manufacturers' improved confidence about the UK economy.

INVESTMENT CONTINUES TO GROW, EMPLOYMENT GAINS STRENGTHEN

% BALANCE OF CHANGE



Source: EEF Manufacturing Outlook Survey

EMPLOYMENT	PAST 3 MONTHS	↑	17%	NEXT 3 MONTHS	↑	21%
INVESTMENT	NEXT 12 MONTHS	↑	12%			

After turning positive in the final quarter of 2016, the employment balance continued to improve this quarter, up to 17% ahead of last quarter's expectations of 9%. The trend was rather broad-based across manufacturing sub-sectors, with the food and drink and the metals industries being the only exceptions.

Manufacturers' hiring intentions strengthened over the previous quarter particularly in the mechanical equipment, electrical equipment and non-metallic minerals industries, in line with healthy demand conditions reported by companies in those sectors. By contrast, the food and drink sector continued to report negative balances for employment. Yet this is softening slightly from larger drops in the last quarter of 2016, as the sector's output is recovering and manufacturers are finding ways to manage hefty rises in input costs. Hiring intentions also slid back in the basic metals industry after timid gains last quarter.

Investment continued on its gradual recovery path. Brighter demand conditions and stronger market sentiment about the UK economy have put balances for planned capital expenditure back into the black since 2016q4 after three consecutive negative prints. Investment is set to continue growing this quarter, as manufacturers need to invest to fulfil order books and boost productivity.

Improved profit margins from further price rises this quarter is also likely to have helped. Yet balances for capital expenditure are still lower than levels reported during earlier recoveries, suggesting that manufacturers remain cautious with their investment plans.

EMPLOYMENT AND INVESTMENT SUMMARY

% BALANCE OF CHANGE

	EMPLOYMENT		INVESTMENT
SECTOR	**PAST 3 MONTHS**	**NEXT 3 MONTHS**	**NEXT 12 MONTHS**
Basic metals	-5	5	5
Metal products	20	23	18
Mechanical	10	28	11
Electrical	12	12	-24
Electronics	23	20	7
Other transport	13	13	33
TURNOVER			
£0-9m	9	25	11
£10-24m	20	21	17
£25m and over	19	14	12

Source: EEF Manufacturing Outlook Survey

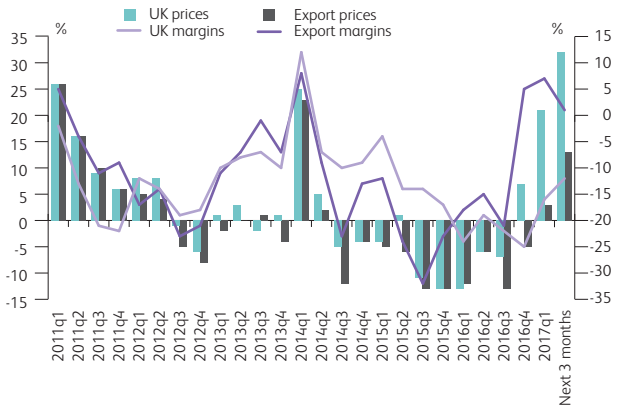
PRICES & MARGINS

Inflationary pressures continued to intensify across the manufacturing supply chain in the first quarter of 2017, with manufacturers putting up prices to respond to the surge in input costs caused by the earlier depreciation in sterling and the recovery in commodities and oil prices. As manufacturers' prices on domestic sales are rising, the squeeze on profit margins eased slightly this quarter, although balances were still stuck in the red.

On the other hand, balances for export prices drifted back into positive territory, consistent with manufacturers' expectations three months ago. Consequently, profit margins on overseas sales continued to improve.

SQUEEZE ON UK MARGINS EASES AS PRICES DRIFT UP

% BALANCE OF CHANGE



Source: EEF Manufacturing Outlook Survey

UK PRICE	PAST 3 MONTHS	↑	21 %	NEXT 3 MONTHS	↑	32 %
EXPORT PRICE	PAST 3 MONTHS	↑	3 %	NEXT 3 MONTHS	↑	13 %
UK MARGINS	PAST 3 MONTHS	↑	-16 %	NEXT 3 MONTHS	↑	-12 %
EXPORT MARGINS	PAST 3 MONTHS	↑	7 %	NEXT 3 MONTHS	↑	1 %

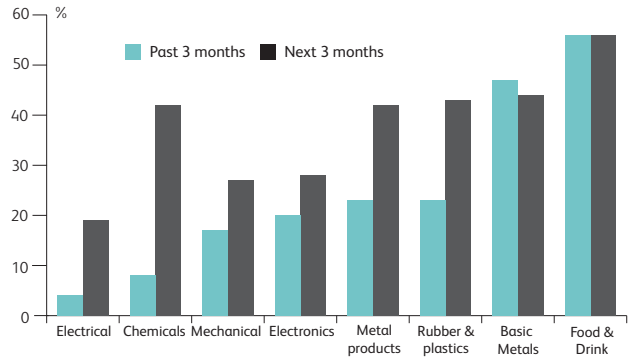
Inflationary pressures have become a regular feature of EEF's Manufacturing Outlook since the final quarters of 2016, as manufacturers were faced with the surge in input costs to multi-year highs following the sharp depreciation in the pound and, more recently, the recovery in oil and commodity prices.

This quarter, a large balance of manufacturers continued to report increases in domestic prices, with balances climbing to their highest level since 2014q2. This indicates that some of the past increases in input costs are now being passed through into higher prices across the manufacturing supply chain. While this is common across all sectors, price increases were particularly hefty in more commoditised industries like food and drink and metals. As a result, the squeeze on profit margins eased slightly this quarter, with balances recovering from their seven-year lows. The recovery is expected to continue into the next quarter, with further price increases providing more relief to manufacturers' profit margins on domestic sales.

Manufacturers have also reported improved margins on export sales in the first quarter of 2017, against last quarter's expectations of further tightening. The trend reflected rising export prices, and should continue in the next quarter despite the persistent weakness in the sterling exchange rate.

SECTOR VARIATION IN PRICE RISES

% BALANCE OF CHANGE IN UK PRICES

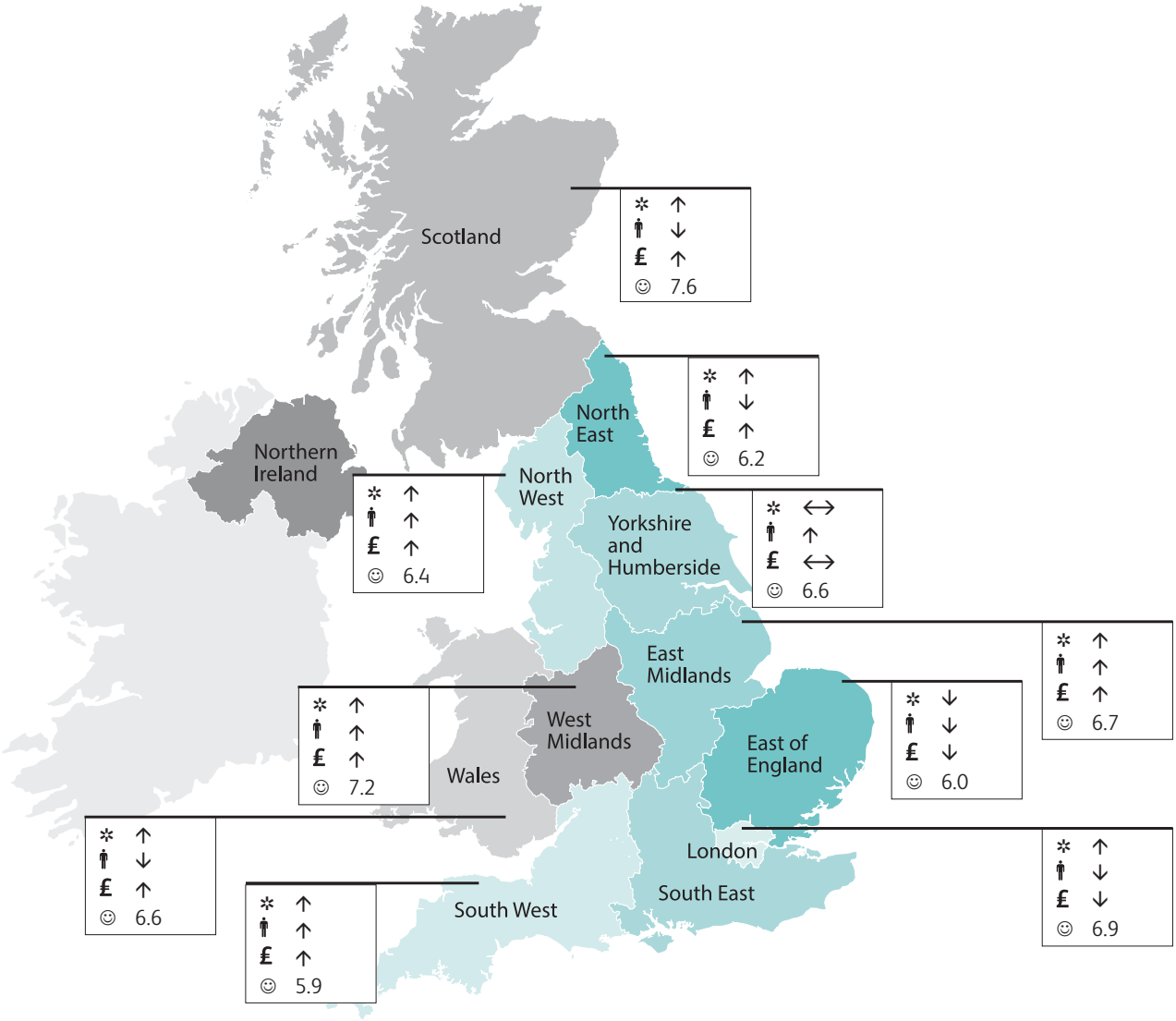


Source: EEF Manufacturing Outlook Survey

REGIONAL TRENDS

Encouragingly, all UK regions have reported growth in manufacturing output in the first quarter of 2017. Output gains also appeared to be stronger than in the past quarter across most UK regions, with the East of England being the only exception.

Looking forward, output balances for the next three months remain in positive territory across the UK, consistent with strong expectations for new orders. A broad-based improvement in business confidence has also translated into better investment and employment prospects.



KEY:

↑/↓ INCREASE/DECREASE ON PREVIOUS QUARTER
✲ OUTPUT
EMPLOYMENT
£ INVESTMENT
☺ BUSINESS CONFIDENCE

Source: EEF Manufacturing Outlook Survey

Output balances remained in positive territory across all parts of the UK in the first quarter of 2017. However, gains from the previous quarter were uneven across regions.

Manufacturing activity gathered steam in the West Midlands, the South West and the North West this quarter, with positive balances for output and new orders edging higher than in the final quarter of 2016. In all of these regions, the dominant automotive industry continued to report healthy conditions. The recovery in mechanical equipment has also helped sustain the expansion in manufacturing activity, particularly in the West Midlands.

Manufacturers in the East Midlands and Scotland have also reported solid gains in output from the previous quarter. This performance is likely to be driven by the recovery in the food and drink industry, after a trough in the previous quarter, in addition to strong growth in the rubber, plastics and non-metallic minerals industry. By contrast, growth in output has somewhat eased in the East of England. This is likely to reflect a slowdown in the dominant chemicals industry.

Looking forward, output balances remain positive in the next three months, and are expected to edge higher than this quarter's levels in eight out of ten regions. This is prompting manufacturers to increase the size of their workforce, with positive employment balances for the next quarter broadening to all UK regions.

BUSINESS CONFIDENCE INDICATORS

Regions' confidence about overall UK economic conditions continued to improve in the first quarter of 2017, reflecting brighter demand prospects and stronger-than-expected manufacturing activity since the EU referendum. In contrast to the universal improvement in sentiment about the UK economy, manufacturers' confidence about the performance of their business has varied across UK regions. While it improved in seven out of ten UK regions, it took a step back in the East of England, the South West, and the North East.

CONFIDENCE ABOUT UK OUTLOOK RECOVERS FROM POST-REFERENDUM LOWS

CONFIDENCE IN THE NEXT 12 MONTHS 1 = SUBSTANTIALLY WORSE, 10 = SUBSTANTIALLY BETTER

Source: EEF Manufacturing Outlook Survey

REGIONAL SUMMARY

% BALANCE OF CHANGE

SECTOR	OUTPUT		TOTAL ORDERS		EMPLOYMENT	
	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS
Scotland	15	30	27	20	3	22
North East	19	55	5	45	0	25
North West	30	30	41	30	19	33
Yorks & Humber	10	25	12	29	24	22
East Mids	48	43	38	48	24	33
Eastern	10	34	14	32	0	14
South East & London	40	36	38	34	12	20
South West	23	28	24	28	21	0
West Mids	44	54	43	60	30	34
Wales	25	50	38	43	13	-13

Source: EEF Manufacturing Outlook Survey

ECONOMIC ENVIRONMENT

The UK economy maintained its solid growth trajectory to end 2016 on a strong footing. The second estimate for GDP growth was revised up to a healthy 0.7% for the final quarter of the year, dispelling any lingering fears of a post Brexit collapse. In fact, steady growth throughout the second half of the year, driven by robust growth in the services sector, has resulted in the economy expanding by an estimated 1.8% in 2016, down from the 2.2% in 2015 but nevertheless a sound performance given the circumstances.

Despite growth holding up in 2016, the UK economy is still expected to slow this year and next. Rising inflation, as well as heightened uncertainty following the EU referendum is likely to lead to a gradual slowing – rather than a collapse – in GDP growth in the second half of this year.

HEADLINES

- GDP in 2017 to grow at a similar pace as 2016 but slow significantly in 2018
- Rising inflation and subdued wage growth to dampen consumer spending
- Global environment to remain broadly supportive, but uncertainty skews investment risks to the downside
- Sterling to remain at lower level, bringing with it associated boost to exports

ECONOMY APPEARS IN GOOD HEALTH

The UK economy looks to have begun 2017 in good shape. As well as the final quarter's positive GDP figures, other key indicators including industry PMIs and trade data have all pointed to activity levels being on the up, rebounding from the post referendum slump. Similarly, labour market conditions have also held up, with the unemployment rate remaining at an eleven-year low of 4.8% since September 2016.

INFLATION AT THE CENTRE STAGE

The most keenly watched indicator over the coming year will be the trend in consumer price inflation. Inflationary pressures were building towards the back end of last year and are set to continue in 2017. Rising oil prices, coupled with the large and sustained depreciation of sterling are pushing up input prices for imported goods, raising business' costs in the process.

With inflation set to rise to around 2.8% in 2017, wage growth will be at the forefront of consumers' minds. As has been the case in recent years however, wage growth is likely to disappoint and remain subdued. There remains limited scope to raise wages, with the Bank of England putting forward the case for a lower equilibrium unemployment rate as a potential reason behind the residual weakness in pay. Heightened uncertainty in the macroeconomic environment should also hold back pay settlement levels.

As a result, households' disposable incomes are likely to fall in real terms, weighing on consumer spending. With household consumption being the driving force behind the economy over the last two years, this will drag on GDP growth in 2017. 2018 however should see consumer spending picking up slightly, although remaining subdued, as inflation pulls back and unemployment remains relatively low.

A further drag on growth this year will come from business investment, which is set to remain weak. Uncertainty regarding any future UK/EU relationship as well as political uncertainty both in the UK and abroad will see investment remain broadly stable at its low level from 2016. Businesses will recognise the need to invest to fulfil current demand and capacity, but are likely to turn more cautious with regards to large scale new projects. Investment is expected to fall further in 2018, as uncertainty regarding the UK's exit from the EU ramps up.

There is however more positive news regarding trade. A combination of the weaker exchange rate providing a boost to export competitiveness as well as enduring healthy demand conditions in key overseas markets should see exports continue their upward trajectory in 2017. As a result, net trade should reverse the trend of recent years, and contribute positively to GDP growth this year and next.

BANK OF ENGLAND KEEP RATES UNCHANGED

Following its February Inflation Report, the Bank of England left the base rate unchanged at 0.25%, whilst upgrading its forecast for growth to 2% in 2017 and 1.6% in 2018. Overall we are slightly more pessimistic than the Bank of England and expect quarterly GDP growth to slow to a slightly greater extent over the course of the year. However, arithmetic effects should mean GDP grows at a similar pace to 2017 in annual terms at 1.8%, with most of the impact of the slowdown in consumer and business spending felt in 2018. We therefore expect GDP growth to slow to 1.3% in 2018.

UK ECONOMIC FORECASTS

% CHANGE EXCEPT WHERE STATED

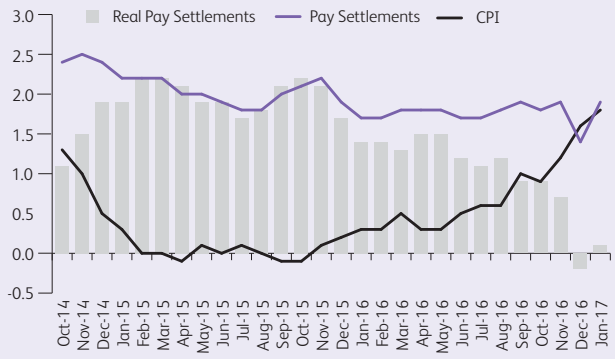
	2016	2017	2018
Trading environment			
Exchange rate (€/£)	1.22	1.20	1.21
Exchange rate ($/£)	1.35	1.25	1.23
Exports	1.4	2.8	3.3
Imports	2.5	2.6	1.8
Current account (% GDP)	-4.5	-3.2	-2.5
Output			
Manufacturing	0.7	1.0	0.1
GDP	1.8	1.8	1.3
Costs and prices			
Average earnings	2.5	2.9	2.9
Oil price (Brent Oil $/bl)	43.5	50.1	52.9
Employment			
Manufacturing (000s)	2641	2618	2579
Rest of economy (000s)	31,872	31,942	32,024
Unemployment rate (%)	4.9	5.0	5.0

Source: Oxford Economics and EEF

SPOTLIGHT: EARNINGS

HIGHER INFLATION IS EATING INTO REAL PAY

% INCREASE IN PAY SETTLEMENTS (3 MONTH AVERAGE) AND CPI INFLATION



Source: EEF Pay Bulletin and ONS

With consumer price inflation rising to 1.8% in the year to January, and set to go above the Bank of England's 2% threshold, wage growth is inevitably going to come under scrutiny in the coming year.

Whilst the labour market has remained resilient in recent months, wage growth has disappointed. In the final three months of the year, growth in average weekly earnings fell 0.2pp to 2.6%. Taking into account inflation dynamics over the same period, the fall in nominal wage growth resulted in real core wage growth decelerating by 0.3pp to 1.4%, its lowest level since January 2015. With the upward trend in CPI set to continue throughout 2017, weak growth in nominal wages is set to put the squeeze on consumer spending.

Our own Pay Bulletin survey paints a similar picture. Average pay settlements across manufacturing drifted up in January, though the acceleration remained modest compared to that of consumer price inflation.

GLOBAL HEADLINES

– Faster growth in the US to drive global growth
– President Trump's trade policy a concern
– Eurozone growth to temper with political uncertainty abound
– China's economy continues to slow but other emerging economies improve

Following a subdued 2016, we expect 2017 to bring with it a pick up in global growth. Global composite PMIs all point to activity levels being on the up, with manufacturing PMIs particularly impressing. We therefore expect growth in the world economy to accelerate to 3.3% in 2017, after 2016's trough.

Much of this growth is set to be driven by the US economy and in particular the newly elected Trump administration's focus on expansionary fiscal policies. A steady labour market as well as stronger business investment should provide further support for the world's largest economy. The level of confidence in the US economy was illustrated in the Fed's decision to increase interest rates in December for only the second time in a decade, with further hikes in 2017 also signalled from some members this month. As a result, after lacklustre growth of 1.6% in 2016, US GDP growth is expected to rise to 2.3% this year.

2017 however will bring much uncertainty, in particular regarding the direction of President Trump's trade policies. How the economy responds to such policies is still uncertain, and represents a significant risk to the global outlook.

In the Eurozone, activity expanded by 1.7% in 2016, shrugging off any Brexit related effects. Looking ahead, we expect growth to temper slightly in 2017, as rising inflation from the recovery in oil prices dampens consumer spending. 2017 will also see general elections across the continent, with the Netherlands, France and Germany all set to go to the polls. Heightened political uncertainty as well as the continued fragility of the European Banking system could also hinder investment. As a result, we see growth falling to 1.5% in 2017. These projections are however based on the assumption that non Eurosceptic parties win elections in France and Germany, not a given at the moment.

EMERGING MARKETS' ACTIVITY ON THE MEND

In 2017, emerging market growth should improve overall, but performance will differ across countries. GDP growth in China is set to slow further, as the continuing rebalancing of the economy takes shape. Elsewhere the recovery in global commodity prices should provide a boost to emerging regions. In particular rising oil prices should help to boost growth in oil exporting countries in the Middle East and Africa, as well as Russia. In Latin America, growth in Brazil and Argentina is likely to stabilise as both countries slowly emerge from recession. The outlook for a number of countries is however uncertain, with those heavily reliant on free trade particularly at risk from possible US protectionist measures.

INTERNATIONAL ECONOMIC FORECASTS

% CHANGE EXCEPT WHERE STATED

	GDP			INFLATION		
	2016	2017	2018	2016	2017	2018
France	1.1	1.4	1.6	0.2	1.3	1.3
Germany	1.8	1.5	1.4	0.5	2.1	1.9
Japan	1.0	1.2	1.3	-0.1	0.6	0.8
US	1.6	2.3	2.5	1.3	2.5	2.2
Eurozone	1.7	1.5	1.5	0.2	1.7	1.5
China	6.7	6.3	5.9	2.0	2.4	2.6
India	7.1	6.7	7.2	5.1	5.4	5.4
World (2010 PPPs)	3.0	3.3	3.6	2.7	3.3	3.1

Source: Oxford Economics

SECTOR FORECASTS

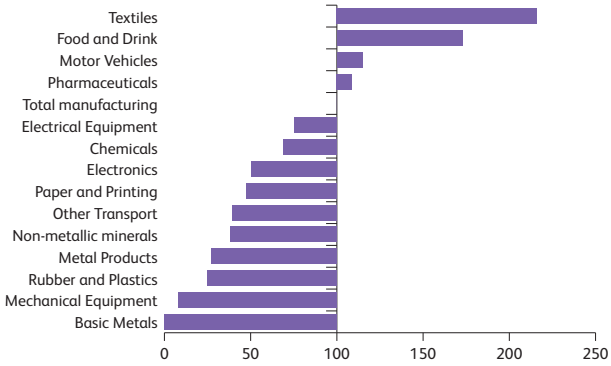
The improvement seen in the manufacturing sector during 2016q4 continued to gather pace at the start of 2017. Better global economic conditions and a still supportive domestic market have helped sustain higher levels of activity across the manufacturing industry. The common trend likely to affect the performance of different manufacturing sectors over the course of the next two years is the depreciation in the value of sterling via its impact on domestic inflation and export competitiveness.

On the one hand, rising inflation – partly down to the depreciation in sterling and partly down to higher energy prices – is likely to weigh on demand for consumer goods. On the other hand, the combination of a more competitive exchange rate and improving overseas demand is likely to support an improved export performance.

Import-intensive sectors that cater to domestic consumer markets are likely to find themselves on the wrong side of this trend, while those with a high export presence should be able to cushion the blow. Intermediate goods manufacturers should post decent growth by offsetting the increase in input costs through better than expected demand from end customers. Finally, manufacturers in capital goods sectors should see a pick up in activity as fuller order books prompt some investment in extra capacity but that growth is likely to be tempered by uncertainty around the progress of the Brexit negotiations.

SLOWDOWN IN CONSUMER SPENDING WILL WEIGH ON EXPOSED SECTORS

FINAL CONSUMPTION EXPENDITURE % OF TOTAL DEMAND FOR PRODUCTS, INDEX (TOTAL MANUFACTURING = 100)



Source: ONS (2014) and EEF analysis

SECTOR GROWTH RATES AND FORECASTS

% CHANGE

	OUTPUT			EMPLOYMENT		
	2016	2017	2018	2016	2017	2018
Basic metals	-12.3	1.2	-0.1	-2.4	-2.0	-1.6
Metal products	0.8	1.0	0.4	2.8	-0.1	0.6
Mechanical	-1.1	2.2	0.2	-2.7	-2.8	-3.5
Electronics	-0.9	0.6	-0.9	1.0	2.7	-1.3
Electrical	-5.5	-3.9	-0.7	-1.6	-3.9	-1.2
Motor vehicles	4.6	2.9	-1.8	0.0	1.8	0.1
Other transport	1.8	3.0	2.3	7.2	0.7	-1.3
Food and drink	0.7	0.3	0.9	1.6	0.8	-1.2
Chemicals	-2.6	1.0	0.7	0.3	-4.6	-5.0
Pharmaceuticals	3.8	1.9	-1.7	0.6	-2.6	-6.0
Rubber and plastics	-0.9	1.3	0.8	-7.5	3.1	2.7
Non-metallic minerals	8.3	-1.9	-1.9	6.0	-7.0	-4.9
Paper and printing	-1.1	-0.3	-0.1	-6.6	-1.2	-0.9
Textiles	-4.0	-3.3	-3.6	8.8	-2.5	-6.7
Manufacturing	0.7	1.0	0.1	0.4	-0.9	-1.5

Source: EEF and Oxford Economics

LOW STERLING A DOUBLE-EDGED SWORD FOR CONSUMER GOODS

While the proliferation of political risks over the next two years has generated significant variation in forecasts for the UK economy, most analysts agree that mounting inflationary pressures over the next two years are likely to weigh on consumers appetite to spend. Indeed, rising inflation and sluggish wages could mean negative real earnings growth for UK households.

The food and drink sector, where ballooning input costs due to the pound depreciation are expected to push up food and drink retail prices by 5%-10%, is particularly vulnerable to fluctuations in consumer sentiment. Households are likely to react to higher prices and a deterioration in their disposable income by reining in spending for food and drink products. Still, a low sterling is expected to provide a boost to tourism, providing some relief for manufacturers in the sector. As a result, we expect output in the sector to be broadly flat in 2017, before picking up in 2018 as inflation starts to drop back.

The textiles sector is likely to face similar conditions. However, as textiles are more elastic to demand fluctuations than food and drink, the sector is less well positioned to absorb the potential demand shock. As such, we expect the sector to continue on its long term decline and contract by around 3% in both 2017 and 2018.

The motor vehicles sector is in a stronger position to stem the tide from the slowdown in consumer spending. While demand for big ticket durable items is likely to slow, the sector is particularly export-intensive, with the majority of cars manufactured in the UK travelling to overseas markets. Nevertheless, we expect growth to come off the boil in 2017 and turn negative in 2018, as major automotive manufactures reconfigure their production lines to manufacture the new round of models.

GROWTH PROSPECTS FOR CAPITAL GOODS TO BE TEMPERED BY BREXIT UNCERTAINTY

Capital goods have suffered the most from sluggish activity in global manufacturing and the drying up of oil and gas investment over the past couple of years. But with momentum in major manufacturing nations improving considerably over the past few quarters, growth prospects have brightened somewhat.

The mechanical equipment sector, which has borne the brunt of weak investment, is also likely to see the most upside from the partial reversal of this trend. Indeed, the sector saw solid quarter on quarter growth over 2016 after a horrid 2015, which saw output falling by almost 13%. With orders flowing in the manufacturing sector, companies are likely to put some more capacity in place, pushing up output growth in the sector to 2.2% in 2017. However, as Brexit uncertainty is likely to reach its peak in 2018, we expect companies to turn more cautious with investment, drawing output growth in the mechanical equipment sector to a halt.

The electronics and electrical equipment sectors are also partly consumer goods but have intermediate and investment segments as well. The electronics industry is likely to return to growth in 2017, as the combination of better growth in the global electronic components industry and UK government plans for the extension of full fibre broadband to the whole country kick in. However, fierce competition from the increasingly saturated nature of the global electronic industry and the dependence of the sector on imported materials should temper growth to about 0.6% in 2017.

The electrical equipment sector saw output fall by 5.5% in 2016 as its key supply markets like construction, electronics and electricity generation underperformed. With no significant rebound expected in any of these markets and the sector also exposed to consumer demand, we forecast growth in the sector to continue to contract in both 2017 and 2018.

CONSTRUCTION SUPPLY CHAIN A MIXED BAG

The construction sector is expected to fare somewhat better than initial predictions following the EU referendum result. The slump in the construction of commercial buildings is expected to be offset by stronger housing investment, not least because of government measures announced at the Autumn Statement. Still, most forecasts for the construction sector as a whole

put growth at below 1%, which is exceptionally low by historical standards.

The non-metallic minerals sector supplies most of its output to the construction sector. After a stonking 2016, we expect output to contract in 2017 as the rise in input costs starts to bite and commercial investment stagnates. On the other hand, the pound depreciation and diminishing over-capacity in Chinese steel production has provided significant relief for the price-sensitive basic metals sector. We therefore expect the sector to rebound in 2017 and post growth for the first time since 2012.

The metal products sector is also part of the construction supply chain but benefits from a more diverse demand base. We expect the sector to take advantage of continued demand flowing through the automotive industry in 2017, as well as the recovery in the mechanical equipment sector. However, these benefits should start diminishing towards the second half of the year, as prospects for both automotive and mechanical equipment deteriorate. As a result we've pencilled in 1% growth in 2017 and 0.4% in 2018.

BUSINESS AS USUAL FOR OTHER TRANSPORT AND PHARMACEUTICALS

The other transport and pharmaceuticals sectors are largely shielded from demand fluctuations. Growth in the other transport sector is predominantly driven by the order book of aerospace manufacturers and their supply chain. With aircraft backlog now at the highest ever level and delivery levels in 2017 expected to increase for a seventh year in a row, we forecast the sector to grow by 3% this year and 2.3% in 2018.

Last year, the pharmaceuticals sector saw output grow at its fastest pace since 2009 and should have another good year in 2017 as drug companies continue to churn out new products. However a number of risks on the horizon are likely to weigh on the sector's performance in 2018. We expect the impact of major drugs coming off patent and the deteriorating financial position for some of the major drug manufacturers to push output growth down to -1.7% in 2018.

CAN WE CREATE A MANUFACTURING POWERHOUSE TO DRIVE THE NEW ECONOMY?

Rapid developments in technology and regulation, the growth of populist politics, an uncertain relationship with the EU and opportunities for a whole raft of new trade deals across the globe means that many of the boundaries that once shaped the way manufacturers do business are changing or disappearing altogether.

But despite these and other uncertainties, it is promising to see the q1 results highlighting the sector's resilience, with manufacturers pushing forward and generating a continued strong performance. However, it is likely that manufacturers will face significant challenges in the short and medium term. As the dynamics of our trading relationships change, they will need the support of government in dealing with these challenges.

BDO's New Economy research is our contribution to the debate on what Britain's post-Brexit economy should look like. We believe that a 'new economy' is needed which makes the most of the UK's talents, skills and entrepreneurial spirit. It is an economy which, despite Brexit, is outward-looking and helps its home-grown manufacturing businesses expand abroad. And it is an economy which puts the UK's entrepreneurially spirited, mid-sized manufacturers at the heart of its thinking; businesses which we feel are too often overlooked and undervalued by policymakers.

To create a truly sustainable and balanced 'new economy' we believe policymakers must focus on fuelling the growth of sector powerhouses like manufacturing, and our report suggests some detailed policies with a particular focus on helping the manufacturing sector grow.

At the centre of our policies for the building of a new economy is the requirement for a long-term industrial strategy. Whilst we welcome the Government's comments about developing an industrial strategy, we have not yet seen the rhetoric being turned into clear and decisive action. The UK manufacturing sector needs a strategy that is comprehensive, based on a genuine understanding of the needs of industry and is long-term.

Manufacturing is a long-term game and much of the sector relies on significant capital investments which pay off over years or even decades. The implications of the 4th Industrial Revolution on the manufacturing sector will be wide ranging but will almost certainly require significant investment in technology and skills and will almost certainly require constant evolution as a result of new technologies and processes.

Therefore it is critical that the Government builds a strategy over the long term (15 to 20 years), which avoids the disruptions of the political cycle. This should include setting a formal target for manufacturing growth over the next 5, 10 and 20 years to provide the background to a sustainable industrial strategy.

Despite its relative decline in the past few decades, in my view the manufacturing sector, including its connected service industries, is still the most critical part of the UK economy. If properly supported, Britain's historic strengths in manufacturing, engineering, innovation, design and service - as well as the significant potential that the move to more automated/digitised manufacturing offers - provides the fundamental foundations for a successful and well-balanced UK economy.

For more information on BDO's New Economy report go to www.neweconomy.bdo.co.uk.

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eef The manufacturers' organisation

EEF is dedicated to the future of manufacturing. Everything we do is designed to help manufacturing businesses evolve, innovate and compete in a fast-changing world. With our unique combination of business services, government representation and industry intelligence, no other organisation is better placed to provide the skills, knowledge and networks they need to thrive.

We work with the UK's manufacturers from the largest to the smallest, to help them work better, compete harder and innovate faster. Because we understand manufacturers so well, policy makers trust our advice and welcome our involvement in their deliberations. We work with them to create policies that are in the best interests of manufacturing, that encourage a high growth industry and boost its ability to make a positive contribution to the UK's real economy.

Our policy work delivers real business value for our members, giving us a unique insight into the way changing legislation will affect their business. This insight, complemented by intelligence gathered through our ongoing member research and networking programmes, informs our broad portfolio of services; services that unlock business potential by creating highly productive workplaces in which innovation, creativity and competitiveness can thrive.

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The data used in this survey has been provided by EEF members. Contributing to our surveys helps to accurately reflect trends and behaviours that shape the UK manufacturing sector.

If you would like to participate in future surveys, please contact Amanda Norris in our Information and Research team anorris@eef.org.uk

BDO

Accountancy and business advisory firm BDO LLP is the UK member firm of BDO International, which has more than 1,400 offices in 154 countries. We operate from 18 offices across the UK, employing 3,500 people offering tax, audit and assurance, and a range of advisory services.

Manufacturing is a priority sector for BDO and this focus enables us to tailor the wide range of services we offer and apply our skills and knowledge to help clients achieve their objectives.

We provide real solutions to industry issues, utilising our capabilities in everything from sector-specific tax, audit and business advice to patent box, research and development claims and acquisition opportunities to help our clients grow in the UK and overseas.

We have an excellent understanding of the issues affecting UK manufacturers as an industry sector, but we also focus on specific sub-sectors to improve our knowledge and our service to clients. These include: aerospace, automotive, building products, chemicals, food and drink, industrials, marine, test and measurement and technology.

Manufacturing remains one of the key industries of the UK economy. We are delighted to be able to play an active role in supporting the businesses that operate in this vibrant, changing and challenging sector.

For further information about our business and services, please visit our website: www.bdo.co.uk

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