The manufacturers' organisation

In partnership with:

MANUFACTURING OUTLOOK

2018 QUARTER 2

2.6 million employees

10% of UK output

70% of business R&D

Average wages higher than the rest of the economy

Carefully does it, taken by Chris Bishop at port of Blyth in Blyth, shortlisted in the Professional category of the EEF Photography Competition 2017.

FOREWORD

Lee Hopley
Chief Economist
EEF

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BDO LLP

Welcome to the 2018q2 *Manufacturing Outlook* report, in partnership with BDO LLP.

It would be fair to describe the economic news, for both the UK and internationally, as mixed over the past quarter. We've seen official statistics confirming sluggish UK GDP growth in the first three months of the year. This included more subdued growth in consumer spending and declines in exports and business investment.

But we also saw pressure finally easing on household incomes, with inflation falling back and wages moving in a more positive direction. In Europe, growth continued at the start of 2018, but at a slower pace than that seen at the end of last year and survey indicators are also suggesting that the best of the 2017 boom is behind us.

UK manufacturing continued to eek out some growth in the first few months of the year. But sectors exposed to weather-disrupted construction activity have had a particularly bumpy start to the year. Our latest survey suggests that some of these trends facing manufacturers look set to linger.

The overall headlines continue to be positive – with a net balance of companies expanding output levels and expecting recent orders growth, particularly from export customers, to continue into the next three months. But all of these indicators have edged down from last quarter's levels and there is, also, more divergence across sectors and regions – which we are reflecting in our forecasts for manufacturing output growth this year and next.

Some of the shifts in responses we note over the quarter include a slight drop in the proportion of companies seeing supportive demand conditions in European markets and a downward drift in output balances in some capital equipment industries from the lofty heights earlier in the year. Sectors in the construction supply chain are also looking a bit weaker. It isn't all downside developments, however, with the metals sectors riding on good global demand and rising prices.

Nevertheless, these factors together, play to a more subdued outlook for investment plans across the sector, where we see capex balances fall to the lowest level in a year and a modest drop in recruitment.

Our forward looking indicators are still very much in positive territory and in 'normal' circumstances we might be confident that further expansion in the global economy, a pick-up in the oil price and an easing of pressure on household budgets equated to a supportive environment for UK manufacturers, at least in the short term. But there is every chance politics might get in the way.

In the coming months Brexit debate will continue to heat up – if it's possible to inject even more heat into the negotiations! And there will be some key votes in Parliament that industry will be watching closely. Additionally, international relations look close to fracturing point on a number of fronts that could have implications for the expansion of trade flows and commodity prices. While we are currently expecting manufacturing to make a positive growth contribution this year and next, there is the potential for numerous hurdles that industry and policy makers could yet have to navigate.

2018Q2 HEADLINES

Our latest survey brings further evidence that growth, while continuing across manufacturing in the first half of 2018, is now past the peak of last year. All of our main indicators are still firmly in positive territory and above long-run averages, but they are also lower than those reported in the first three months of this year.

INDICATOR	BALANCE	CHANGE	
Confidence	6.1	↑	Sentiment about the UK economy over the next year improves further
Output	26 %	↓	Output balance continues downward drift from 2017H2 peak
UK orders	9 %	↓	New order intake from domestic customers stumbled in the past three months
Export orders	20 %	↓	UK – export orders gap reopens even as EU demand softens
Employment	17 %	↓	Further recruitment across firms of all sizes in the past quarter
Investment	10 %	↓	Investment intentions fall to lowest level in a year

Source: EEF Manufacturing Outlook Survey

While our 2018q1 *Manufacturing Outlook* report indicated a continuation of the buoyant demand conditions seen through last year, official statistics painted a more subdued picture. ONS point to growth of 0.2 % in the first quarter, down from 1.3 % at the end of last year.

Our latest data signal further expansion this quarter, but the strength of the output and orders balances would suggest that the rates of growth seen in the latter part of 2017 are unlikely to be repeated in the short-term. While sector balances remain largely positive we can expect to see some persistent weakness in the construction supply chain, and the recent boom in capital equipment industries also appears to be starting to fade. The latter trend is largely driven by softer domestic demand, but the pace of demand growth in overseas markets also drifting down.

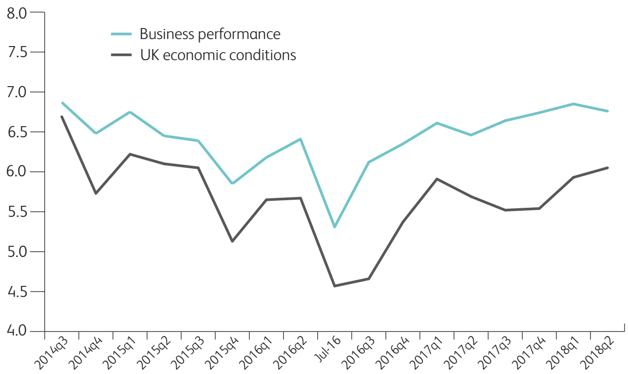
Nevertheless, UK manufacturers remain busy and also reasonably optimistic about the prospects over the next 12 months. This upbeat assessment is also driving on-going recruitment across manufacturers of all sizes. Although, again, the balance of companies expanding workforce numbers has edged lower compared with both the previous quarter and with firms' plans three months ago.

We see a more notable drop in investment plans this quarter, with the balance of companies planning to up their investment spending dropping back to a one year low of 10 %, from last quarter's 18 %. While we might expect there to be some Brexit-induced caution, weaker balances were not reported across the board. Indeed, it was again the construction-facing sectors that were the most cautious in the investment outlook over the past three months.

The overall picture for the sector continues to be a positive one, and even accounting for some weakness in the official statistics at the start of the year our forecasts for manufacturing growth, this year and next, are little changed coming in at 1.9 % and 0.5 % respectively.

OPTIMISM ABOUT UK OUTLOOK INCHES HIGHER

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



Source: EEF Manufacturing Outlook Survey

OUTPUT

Activity in the manufacturing sector continued to be positive in the second quarter of 2018, with a net balance of 26% of manufacturers reporting an increase in output. While the balance remains strong and above its long run average, the result is lower than last quarter which was already down from the historic high (34%) registered in the second half of 2017.

We need to record that this has been the seventh consecutive positive result. In the next quarter, manufacturers expect to continue expanding at the same pace registered this period hinting that the peak has now probably passed and expansion will continue but at a slower pace.

PAST THREE MONTHS	↓	26%
NEXT THREE MONTHS	↓	26%

Capital equipment manufacturers, such as mechanical and electronics, had been in the driving seat for a long time and their results are still positive but more subdued. After a long period of expansion this is normal, however some other factors may have played a role in this. A (small) effect may have been played by the bad weather at the start of the year which may have created more than a headache to logistics departments. A more important one is the slowdown that not only the UK economy, but also the EU and more in general world trade, faced in the first months of 2018. Once more, world expansion is still expected but it's unlikely to repeat what happened in 2017.

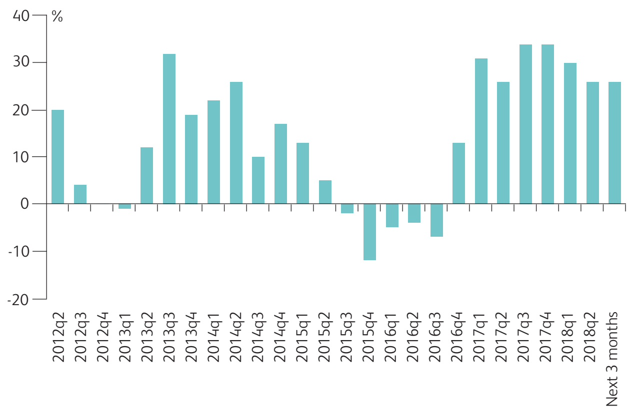
After a weak q1, also related to some seasonal factors, basic metals enjoyed a healthy expansion (37%). A similar situation is reported for metal products with a balance of 39%. These two sectors have been clearly helped by prices moving upwards but they may also be threatened by Trump's policies in the near future.

The positive moment is broadly shared but not by all subsectors. Indeed some of the sectors closely related to construction reported some weak results with electrical equipment showing a 12% balance and rubber & plastics at 13%. In the next quarter a bounce back for rubber & plastics is expected, but this won't be shared with the electrical sector.

Notably, q2 was characterized by small companies (between £0 and 9 million of turnover) doing better than medium and large companies. However, according to their own forecasts, this situation should be reverted in the next reading.

OUTPUT BALANCE TRENDING DOWN BUT REMAINING IN CLEAR POSITIVE TERRITORY

% BALANCE OF CHANGE IN OUTPUT



Source: EEF Manufacturing Outlook Survey

OUTPUT SUMMARY

% BALANCE OF CHANGE

SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS
Metal Products	39%	31%
Mechanical	27%	16%
Electrical	12%	6%
Electronics	19%	19%
Basic Metals	37%	65%
Rubber & Plastics	13%	33%
TURNOVER		
£0-9m	30%	16%
£10-24m	23%	36%
£25m and over	22%	44%

Source: EEF Manufacturing Outlook Survey

ORDERS

Manufacturers' order books continue to be in positive territory even if they are trending down since the peak registered in the third quarter of 2017. The net balance for total orders is at 23% which is down from 30% in 2018q1.

One of the main developments in our last *Manufacturing Outlook* was the reduction in the gap between export and domestic book orders. However, this trend has reverted in the second quarter of the year pointing to a still healthy, while lower than the last five quarters, expansion in the export market and a weak domestic performance. At 9%, the balance reporting rising UK sales is significantly lower than the 21% of the first quarter.

Comparing 2018q2 "past three months" results to the "next three months" results reported in 2018q1, businesses were expecting a better outcome, in particular in the domestic market.

UK ORDERS	PAST 3 MONTHS	↓	9%	NEXT 3 MONTHS	↓	15%
EXPORT ORDERS	PAST 3 MONTHS	↓	20%	NEXT 3 MONTHS	↓	19%
TOTAL ORDERS	PAST 3 MONTHS	↓	23%	NEXT 3 MONTHS	↓	20%

UK ORDERS

As said, UK results were weak but still positive. Domestic orders have been in positive territory for the last seven quarters with a net balance at 9% down from 21%.

UK consumers after a long period of sustained inflation and weak wage growth have started to see some real wage growth, however their confidence is still low and as a result this may have not been enough to offset other negative factors occurring this quarter.

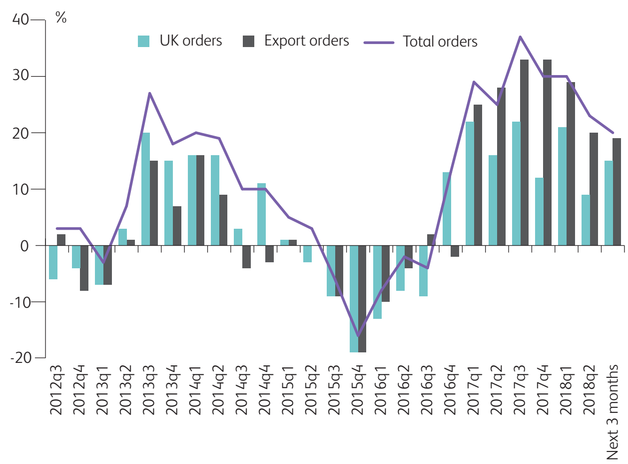
The first factor is again related to the well-known period of weakness experienced by the UK construction sector. In particular the electrical sector was affected reporting the only negative balance at -6% with no bounce back expected in the next three months. Non-metallic minerals and rubber & plastics, also suppliers for construction, reported weak results close to zero.

The second factor relates to what appears to be subdued growth in investment intentions. Mechanical equipment and electronics reported a positive but subdued order book balance much weaker than the one reported in the first quarter. The mechanical sector is expected to improve its position in the next quarter whereas electronics is forecasting a flat balance.

Positive news is again related to the basic metals sector which moved from a negative balance to a solid result at 28% which is expected to improve again next quarter.

POSITIVE ORDER BALANCE BUT BACK TO LEVELS REGISTERED A YEAR AGO

% BALANCE OF CHANGE IN ORDERS



Source: EEF Manufacturing Outlook Survey

EXPORT ORDERS

Export orders continue to lead the way as manufacturers benefit from the positive effects linked to the synchronized global expansion and Sterling's depreciation. However the effect of these two big positive factors is fading and this is reflected in an export balance at 20%, the weakest one since the last quarter of 2016.

The big hit Sterling received is almost 2 years old and so its positive effect is easing. More interesting is what happened to non-domestic markets. In line with recent *Manufacturing Outlooks*, Europe clearly remains the main customer, however the percentage of manufacturers noting a pick-up in demand from this market has retreated from 65% to 53%. This is related (again) to Sterling and a softer expansion seen in the EU q1 data.

The pick-up in the Middle East, recorded three months ago, also slightly contracted in this quarter from 21% to 18%. The Iran uncertainties and the possibility of US "secondary sanctions" may have discouraged new orders in this market despite higher oil prices which usually go hand in hand with high demand.

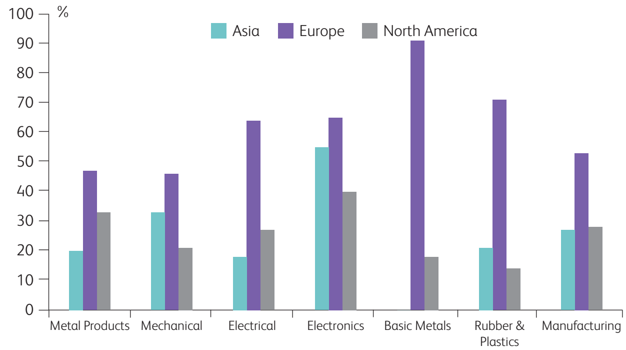
Looking at the sectors, metal products and non-metallic minerals, which have showed signs of weakness in the domestic market, enjoyed a healthy expansion in the non-domestic one. Mechanical equipment and electronics continued to perform better in the export market compared to the domestic one, however some signs of slowdown are also present here.

In our last *Manufacturing Outlook* we asked ourselves what could go wrong and some of the factors appear to have materialised. It seems clearer that the Eurozone expansion peaked in 2017 and appetite for UK exports is now fading. More worryingly, the Trump administration have implemented some important decisions in terms of tariffs and sanctions against Iran. While the impact of tariffs have not effected the EU yet, this could change, while US "secondary sanctions" will hit those manufacturers who trade with both the US and Iran.

On the EU side, as always, the focus is on Brexit. It appears clear that the "cliff-edge" has been moved to the end of 2020 (even if it's not yet official), however the lack of clarity is clearly not ideal.

EU DEMAND STILL ON TOP BUT SOFTENING

% 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
Metal Products	13%	17%	31%	24%	29%	28%
Mechanical	7%	20%	20%	8%	22%	7%
Electrical	-6%	-6%	13%	27%	0%	6%
Electronics	17%	0%	15%	27%	32%	13%
Basic Metals	28%	44%	18%	20%	47%	50%
Rubber & Plastics	6%	40%	7%	21%	6%	47%
TURNOVER						
£0-9m	13%	14%	13%	10%	23%	14%
£10-24m	20%	24%	30%	29%	26%	29%
£25m and over	11%	22%	28%	34%	28%	39%

Source: EEF Manufacturing Outlook Survey

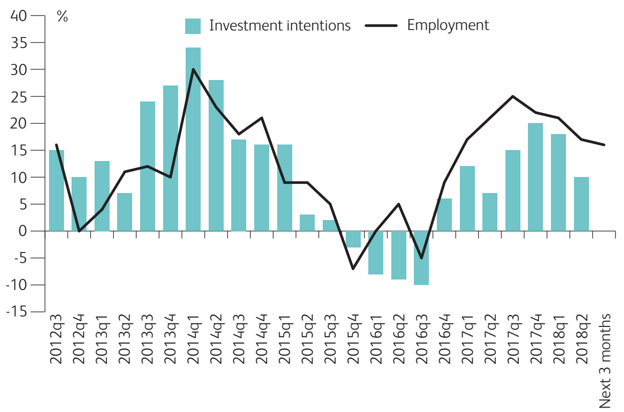
EMPLOYMENT & INVESTMENT

In line with the results seen in the previous sections, balances for employment and investment remain broadly positive but trending downwards. Notably, the positive employment result is the seventh in a row and the streak is expected to continue in the next three months.

The slowdown in investment is consistent with weaker results seen in the sectors supplying capital equipment such as mechanical equipment and electronics.

THE GAP BETWEEN EMPLOYMENT AND INVESTMENT INTENTION HAS WIDENED

% BALANCE OF CHANGE



Source: EEF Manufacturing Outlook Survey

EMPLOYMENT	PAST 3 MONTHS	↓	17%	NEXT 3 MONTHS	↓	16%
INVESTMENT	NEXT 12 MONTHS	↓	10%			

Looking at the sector picture, basic metals and metal products appear to be the most positive with a high level of employment activity and, in the case of basic metals, a high level of investment intentions.

Mechanical equipment shows a solid balance for investments in the next three months which may help the sector to improve its capacity utilization which has increased thanks to the boom the sector has had in the recent period. On the other side, the positive results registered by electronics in the last quarter has not been replicated and the balance for investment is currently at zero.

On the other side, construction suppliers, such as those in the electrical and rubber & plastics sectors, show no signs of confidence with negative investment balances and weak (or negative for rubber & plastics) employment balances.

Overall the impression is that the investment cycle has peaked in the second half of 2017 and the uncertainties over Brexit and US policies have pushed manufacturers to use more flexible resources (labour) over long-term investments despite the buoyant expansion of 2017 and the still positive prospects for 2018.

EMPLOYMENT AND INVESTMENT SUMMARY

% BALANCE OF CHANGE

	EMPLOYMENT		INVESTMENT
SECTOR	**PAST 3 MONTHS**	**NEXT 3 MONTHS**	**NEXT 12 MONTHS**
Metal Products	23	13	6
Mechanical	15	10	19
Electrical	6	12	-7
Electronics	13	34	0
Basic Metals	21	17	39
Rubber & Plastics	-6	-7	-7
TURNOVER			
£0-9m	18	7	6
£10-24m	17	29	23
£25m and over	15	21	18

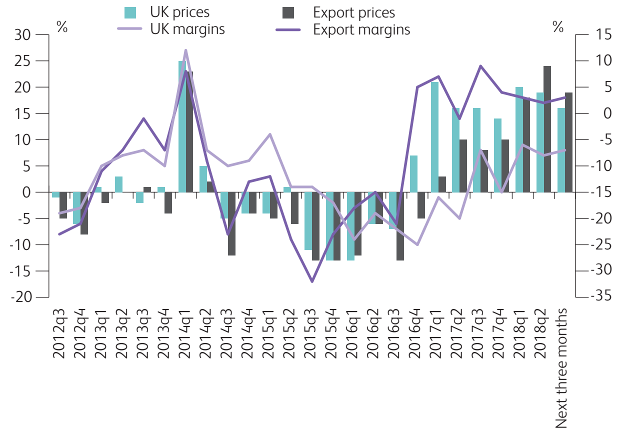
Source: EEF Manufacturing Outlook Survey

PRICES & MARGINS

Manufacturers' expectations that price increases would start to fade over the course of this year, are largely confirmed this quarter. Tracking the fall in official producer price inflation, the balance of manufacturing raising prices on UK orders has trended down from the peak last year and that looks set to continue in the coming quarter. However, it seems the sector continues to have some pricing power overseas.

PRICES ON EXPORT SALES HEAD HIGHER

% BALANCE OF CHANGE



Source: EEF Manufacturing Outlook Survey

UK PRICE	PAST 3 MONTHS	↓	19 %	NEXT 3 MONTHS	↓	16 %
EXPORT PRICE	PAST 3 MONTHS	↑	24 %	NEXT 3 MONTHS	↓	19 %
UK MARGINS	PAST 3 MONTHS	↓	-8 %	NEXT 3 MONTHS	↓	-7 %
EXPORT MARGINS	PAST 3 MONTHS	↓	2 %	NEXT 3 MONTHS	↓	3 %

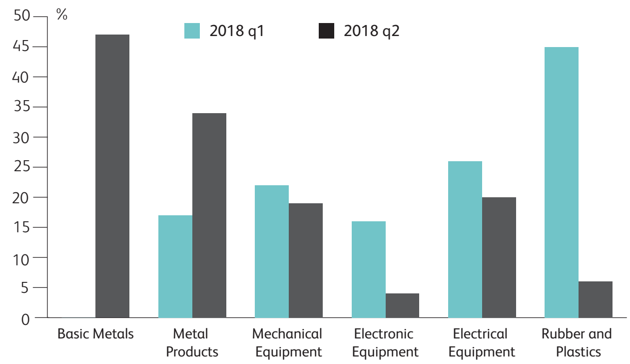
The balance of companies increasing prices on domestic orders has been in positive territory for the past seven quarters. It is becoming increasingly clear that the effects of Sterling's past depreciation is now fading and this is feeding through to firms' pricing intentions, which have continued to head lower this quarter.

But over the past three months more export customers are likely to have experienced price increases from their UK suppliers, as the balance of companies raising prices on export orders hit its highest level since the beginning of 2011. A closer look at the sector make up of these increases shows elevated export price balances in basic metals and metal products. This is a consequence of strong demand across the industry and rising world metal prices.

Indeed, in all other sectors price balances on UK and export sales have come in lower this quarter than in the previous three month period. To that end, there remains some pressure on margins, particularly in the home market, with only basic metals looking like it will buck this trend. The issue to watch, however, will be developments in the oil price. Further increases could add to margins pressure and make output price inflation somewhat stickier this year.

RISING METALS PRICES CONTRIBUTING TO OVERALL INCREASE

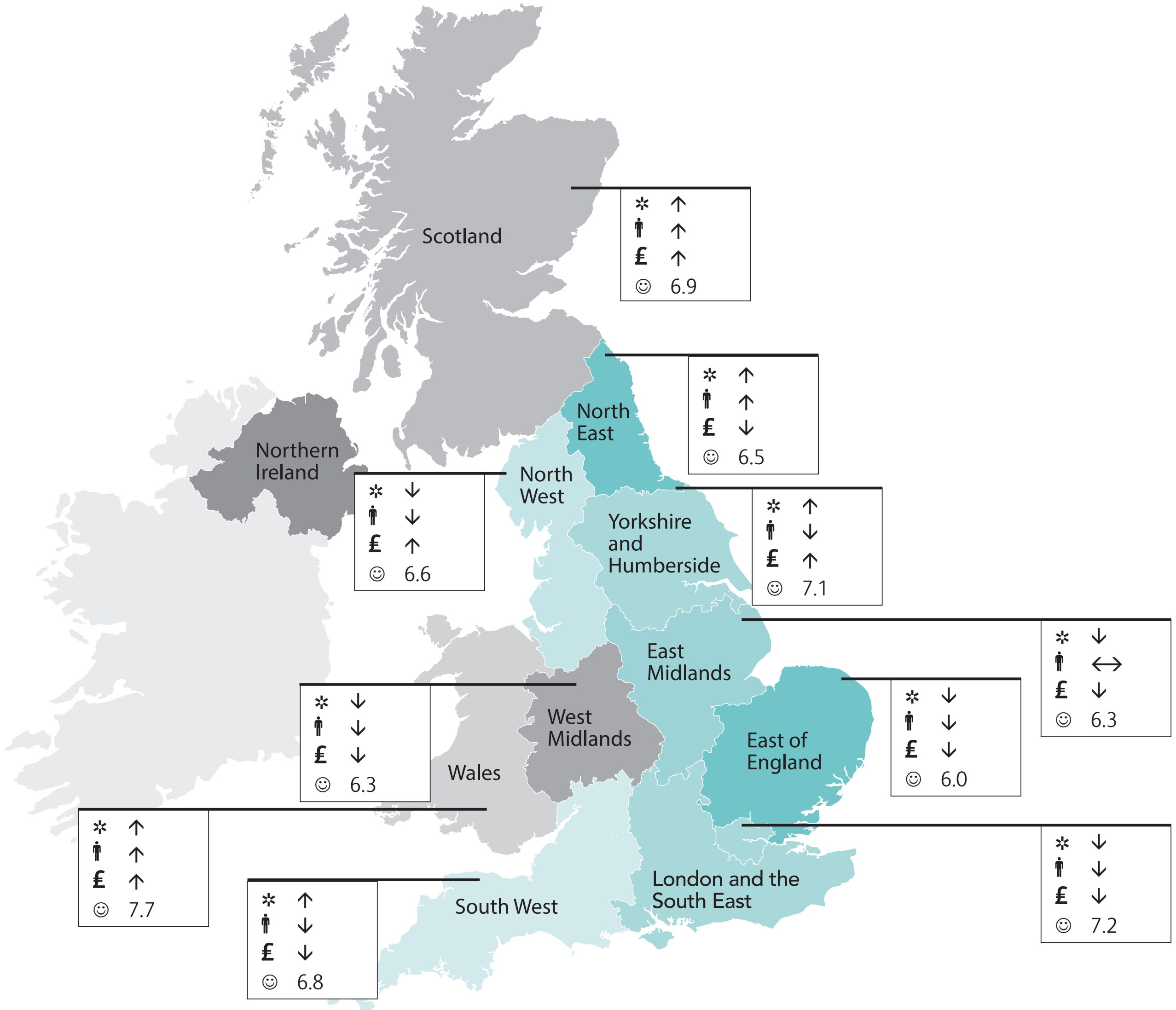
% BALANCE OF CHANGE IN EXPORT PRICES IN THE PAST THREE MONTHS



Source: EEF Manufacturing Outlook Survey

REGIONAL

All regions continued to see a positive net balance of manufacturers increasing output in the past three months and companies predict this pattern will continue into the second half of the year. But the number of regions seeing increases and decreases in output balances over the past three months compared with the previous quarter was evenly matched. The sector composition of output growth in 2018q2 appears to sit behind this divergence.



KEY:

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

Source: EEF Manufacturing Outlook Survey

In line with the positive headline balances at the national level, our survey continued to record solid levels of activity across all regions. However, we note some variation in performance relative to the start of the year. The decent pick-up in output balances across the metals industry is apparent in the North East, Yorkshire and Humberside and Wales – all of which count metals production in the top three dominant manufacturing industries.

These regions are also amongst the most upbeat about new order in-take, both in the past three months and expectations for the coming quarter. Similarly positive about the recent output performance and upcoming new orders are manufacturers in London and the South East. While balances have softened somewhat compared with last quarter, net response balances were, nevertheless, still more positive than the national average. The concentration of the buoyant electronics sector in this region is playing a role in increased output and orders.

In contrast, the Midlands regions – both East and West – have seen output and orders balances slide in the past three months. Challenges facing the dominant automotive sector in this part of the country are likely to be holding down overall output balances. And with that, plans to invest and recruit. Additionally, the softer outlook for investment amongst domestic companies more broadly is likely to be weighing on new orders for some West Midlands manufacturers in the major capital goods sector.

Responses on output and orders across the North West have also dipped this quarter, but remain elevated. Positive demand conditions in aerospace, together with a solid outlook for the chemicals sector will be propping up output and expectations on future orders growth.

BUSINESS CONFIDENCE INDICATORS

Confidence about firm-level prospects outpaces sentiment about the UK economic outlook over the next 12 months in all UK regions. In line with more positive levels of optimism in the metals and electronic industries, Yorkshire and Humberside, the North East and London and the South East are most confident about business prospects in the coming year. Some of these sector trends may also be playing into how manufacturers view prospects of the wider economy, with the biggest gains in confidence seen in the North East and South East. In contrast, companies in the Midlands, South West and East of England have downgraded their outlook for UK growth in the year ahead.

CONFIDENCE ABOUT UK OUTLOOK DIVERGES ACROSS REGIONS

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

Source: EEF Manufacturing Outlook Survey

REGIONAL SUMMARY

% BALANCE OF CHANGE

REGION	OUTPUT PAST 3 MONTHS	OUTPUT NEXT 3 MONTHS	TOTAL ORDERS PAST 3 MONTHS	TOTAL ORDERS NEXT 3 MONTHS	EMPLOYMENT PAST 3 MONTHS	EMPLOYMENT NEXT 3 MONTHS
Scotland	18	23	20	18	15	13
North East	46	31	31	31	38	8
North West	29	11	43	10	14	10
Yorks & Humber	39	27	25	37	28	36
East Mids	9	18	0	0	9	22
Eastern	6	38	41	29	6	0
South East & London	42	40	45	38	23	31
South West	20	0	7	-7	7	-14
West Mids	24	28	5	23	13	0
Wales	33	67	33	67	33	33

Source: EEF Manufacturing Outlook Survey

ECONOMIC ENVIRONMENT

The UK economy slowed sharply in the first quarter of the year, with the second estimate of GDP pointing to a modest 0.1 % expansion. If confirmed this will represent the economy's weakest performance since the end of 2012, and well below our expectations last quarter.

While a significant proportion of the slowing is likely to reflect the poor weather that hit the country in February and March – affecting the construction, manufacturing and some service sectors such as retail – the modest overall performance suggests the story of hard pressed consumers on the back of elevated prices remained relevant in the opening months of the year.

There are also concerns that the global economy upswing, which has been evident over the last year, could be coming to an end with a run of weaker data points over the last few months. That said, with a small rebound in industrial activity and consumption expected next quarter, we are forecasting GDP growth of 1.2 % in 2018, down from last quarter, and 1.3 % in 2019.

HEADLINES

– Economy slows considerably in first quarter of year

– Inflation falls back to lowest level in a year

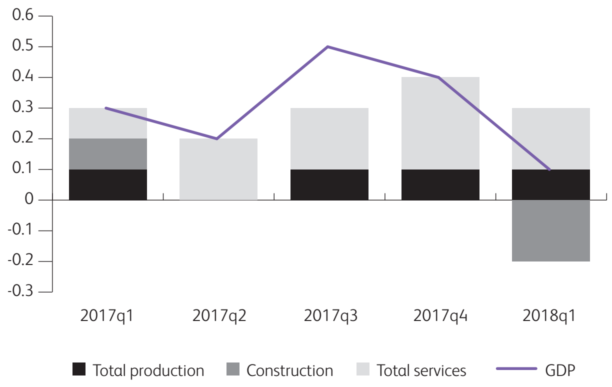
– Wage pressures emerging

– MPC keep interest rates on hold at their May meeting

The narrative behind our forecasts, despite the weak start to the year, remains broadly unchanged from our last *Manufacturing Outlook*. We still expect investment growth to be subdued and for net trade to contribute positively to growth. We will be keeping a close eye on developments in the global economy however, given its upturn over the last year was a defining factor behind our positive investment and trade outlook. The only other small change in our outlook is on private consumption, where Brexit uncertainty and falling confidence, is set to hold back spending despite modest improvements in prospects for consumers.

UK ECONOMY SLOWED SHARPLY IN Q1

% QUARTER-ON-QUARTER CHANGE IN GDP AND SECTORS' CONTRIBUTION TO GROWTH



Source: ONS (2018)

PRIVATE CONSUMPTION SET TO REMAIN SUBDUED DESPITE IMPROVED PROSPECTS

The economic narrative over the last year has been dominated by the story of rising inflation and weak wage growth hitting consumer pockets. While the rise in inflation can be explained by Sterling's post Referendum slump, wage growth has remained stubbornly weak despite a thriving labour market. This has been puzzling economists and policy makers alike. However there are signs that the dynamic is changing. Inflation fell to 2.4 % in April, its lowest level for over a year as the effect of Sterling's depreciation fades. Meanwhile wages, on the back of a labour market which continues to perform well, increased by 2.9 % in the year to March, meaning real wages turned positive for the first time in a year. The prospects for consumers therefore appear to be improving.

However despite this, Brexit uncertainty still looms large. This is reflected in Gfk's consumer confidence indicator which has fallen back and remains rooted in negative territory. Uncertainty, the fact that any wage increases for the time being are still modest, and that the UK savings ratio remains exceptionally low, means consumers are refraining from "splashing the cash" despite the squeeze on households moderating.

BUSINESS INVESTMENT OUTLOOK STILL SUBDUED

We continue to forecast some modest growth in business investment this year, but there is little in our latest survey to suggest an acceleration is in prospect. The recent strength of the global economy means that the level of capacity utilisation in the UK is also running above its long run average and this should precipitate some additional investment, but ongoing Brexit negotiations means there could still be a cliff edge for businesses in our forecast period. While our investment forecast is positive, it is not as positive as one would expect given the economic climate, with uncertainty still likely to impede some larger scale investment decisions.

NET TRADE CONTRIBUTES POSITIVELY TO GROWTH

Net trade is also expected to contribute positively to growth, with exports continuing to expand on the back of continued growth in global demand and Sterling remaining well below its level in the first half of 2016. There are risks to the downside however, especially given the recent developments in trade policy from the Trump presidency, and escalating tensions between the US and Iran. A tit for tat process could easily lead to escalation, with a cycle of retaliation having significant negative effects on trade prospects.

UK ECONOMIC FORECASTS

% CHANGE EXCEPT WHERE STATED

	2017	2018	2019
Trading environment			
Exchange rate (€/£)	1.14	1.13	1.14
Exchange rate ($/£)	1.29	1.38	1.35
Exports	5.7	2.5	2.6
Imports	3.2	1.5	2.1
Current account (% GDP)	-4.1	-3.2	-2.3
Output			
Manufacturing	2.5	1.9	0.5
GDP	1.8	1.2	1.3
Costs and prices			
Average earnings	2.4	2.8	2.5
Oil price (Brent Oil $/bl)	54.2	71.9	68.9
Employment			
Manufacturing (000s)	2673	2686	2646
Rest of economy (000s)	32,411	32,586	32,662
Unemployment rate (%)	4.4	4.3	4.4

Source: Oxford Economics and EEF

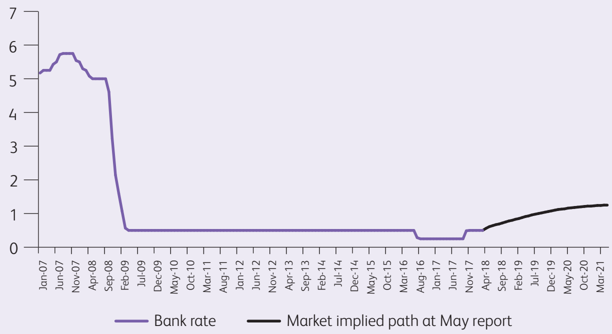
SPOTLIGHT: MPC KEEP RATES ON HOLD

Perhaps the most anticipated economic development – or lack of in this case – was the Bank of England's monetary policy decision in May. At one point, markets had priced in an 80% chance of a rate rise. However a string of weaker data points in the preceding month, including weak q1 GDP growth, made the case for a hike less and less compelling. In the end the committee voted by 7-2, as expected at the time, to keep rates on hold at 0.5%. A less hawkish Inflation Report means markets now expect only three rate rises over the coming three years.

While the decision was not unexpected, concerns remain over the Bank's communication strategy. Manufacturers are not unduly fazed by a prospect of a rate rise, but they do want to be made clearer about the Bank's monetary policy stance, so they can take necessary actions.

NO RATE HIKE THIS TIME ... BUT THEY ARE COMING

BANK OF ENGLAND BASE RATE AND MARKET IMPLIED PATH OF INTEREST RATES AT MAY MEETING



Source: Bank of England

GLOBAL ECONOMY

- Momentum in global economy eases, but remains robust
- Eurozone growth effected by adverse weather
- US and China growth both expected to pick-up in q2
- Downside risks remain, particularly with regards to geopolitical events and trade protectionism

The recent momentum seen in the global economy, which came on the back of the revival in business investment and world trade, eased in the first quarter of the year. Indeed growth was weaker than expected across the Eurozone, US and China. Despite downside risks to the global outlook, global financial conditions remain broadly supportive and we expect growth to pick-up in the remainder of the year. We are expecting healthy growth of 3.8% and 3.6% this year and next.

In the Eurozone after a booming 2017, GDP growth slowed to 0.4% in 2018q1. Like the UK, a portion of this slowing can be attributed to the poor weather seen across some northern European countries. However even taking that into account, it does appear that growth in the bloc peaked last year, with a widespread decline in survey data adding to weakness in hard data. Labour conditions remain supportive and monetary policy remains ultra-accommodative, which should mean the Eurozone will, overall, have another good year, expanding by 2.2%.

The US economy, despite also slowing in the opening months of the year, remains on a solid footing. Survey data and measures of business confidence remain above long run averages, and the outlook is boosted given the incoming personal and business tax cuts announced in December 2017, as well as continued government spending. The labour market also continues to perform well, with robust employment growth and firming wages set to boost consumer spending. We are expecting strong growth for the US of 2.8% this year.

While this is good news, it is US politics that could have a bigger bearing on the global outlook. The introduction of tariffs, by the US, as a means of reducing perceived imbalances with China has been a dominant risk to global trade flows for most of this year so far. A full scale trade war now seems to have been avoided (at the time of writing).

Elsewhere Trump's decision to withdraw from the Iran nuclear deal, is sparking not only geopolitical concerns, but is also one of a number of factors pushing up oil prices – together with low inventories, ongoing OPEC cuts and production disruptions in Venezuela. These events have seen Brent break the $80 mark and as such we expect a slightly higher profile for oil prices this year and next.

Meanwhile in China, despite slowing growth in q1, the outlook is little changed. Expansionary fiscal policy, robust credit growth and strong global demand should see the economy pick-up over the coming quarters. Maintaining current GDP growth rates, while reducing the risks to financial stability remains a key challenge for the government, but there is hope that the authorities will start to place less emphasis on arbitrary growth targets, and instead take stronger action to rein in risky lending.

INTERNATIONAL ECONOMIC FORECASTS

% CHANGE EXCEPT WHERE STATED

	GDP			INFLATION		
	2017	2018	2019	2017	2018	2019
France	2.0	1.8	1.7	1.0	1.6	1.4
Germany	2.5	2.2	1.7	1.7	1.8	1.8
Japan	1.7	1.4	0.9	0.5	1.0	1.1
US	2.3	2.8	2.2	2.1	2.5	2.0
Eurozone	2.5	2.2	1.7	1.5	1.5	1.6
China	6.9	6.3	6.0	1.5	2.4	2.6
India	6.4	7.3	7.0	3.3	5.2	5.6
World (2010 PPPs)	3.7	3.8	3.6	3.0	3.2	3.1

Source: Oxford Economics

SECTOR FORECASTS

The manufacturing sector, following an excellent year in 2017 in which it expanded by 2.5% – its strongest growth since 2014 – eased in the opening months of the year. Indeed the second estimate of q1 GDP has the sector expanding by a modest 0.2%. This comes on the back of two small contractions in February and March, following an extraordinary run of ten consecutive months without a fall in output.

Some of the weakness seen at the start of the year can be attributed to the poor weather seen across the winter, with construction related sectors in particular experiencing a disruption. However, even taking the weather into account, there is a sense that momentum in the sector is beginning to slow, with manufacturing PMIs, while remaining healthy, falling back. This is not all that surprising given the exceptional year last year, and a slight unwinding was to be expected.

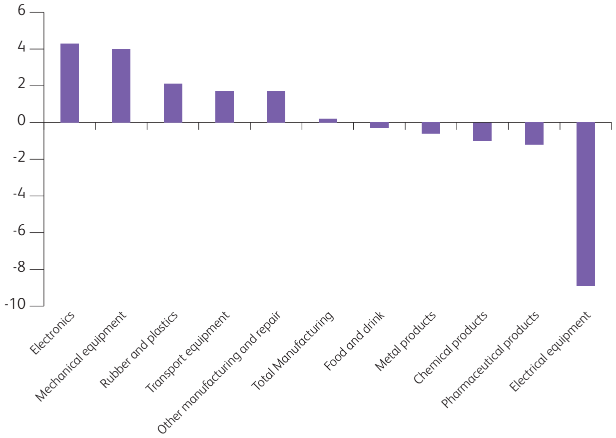
Nevertheless with global conditions set to remain firm, Sterling's depreciation still providing a bit of support for exporters, and capital equipment manufacturers still benefiting from the upturn in business investment, we still expect the sector to have a good year by historical standards. We are forecasting growth of 1.9% this year, only slightly down from our last report, to reflect the weaker first quarter. Looking ahead, we still expect the sector to slow further in 2019, pencilling in an expansion of 0.5%, as uncertainty ramps up and momentum in the global economy continues to ease.

CONSTRUCTION RELATED SECTORS IN FOR A TOUGH YEAR

The construction sector has had a torrid start to the year, contracting by 2.7% in the opening quarter. Slowing momentum over the last year and Brexit induced uncertainty (particularly in the commercial office building sector) has combined with poor weather and the liquidation of key contractor Carillion, to create a stormy backdrop for the industry. This has had a negative impact on a number of manufacturing sectors in its supply chain.

A MIXED START TO THE YEAR ACROSS MANUFACTURING SUB-SECTORS

% CHANGE IN OUTPUT THREE MONTHS ON PREVIOUS THREE MONTH, MARCH



Source: Markit/CIPS (2018)

With 63% of intermediate demand coming from the construction sector, **non-metallic minerals** (bricks, mortar, glass) is the sector most exposed to construction's outlook. Indeed a 4.0% contraction in q1 illustrates the extent of the correlation between the two. While there is likely to be some bounce back in construction, this tends to happen over the length of a contract and not necessarily in the subsequent quarter. As a result we expect the sector to have a weak year, contracting by 4.2%. Next year we expect an improvement, as the effect of Carillion diminishes, forecasting a small rebound of 0.9%.

Similarly the **chemicals sector** is set to feel the effects of weaker construction activity, given that a fifth of the sector's output goes into it in the form of paints and coatings. This is despite fairly positive private survey data. We are forecasting the sector to move from growth of 3.0% last year, to a small contraction of 0.2% this. **Rubber and plastics** where nearly a third of its intermediate demand comes from construction is also set to feel the effects. The move away from single plastics is likely to add to the headwinds facing the sector, although there should be some longer term opportunities on offer for those manufacturers who can grasp this changing landscape. We are forecasting growth of 0.6% for the sector this year.

Basic metals, after a couple of dreadful years over 2015 and 2016, has seen its prospects improve recently, with growth of 3.2% in 2017. Key forces behind the improved outlook include Sterling's depreciation which, after an initial lag, has filtered through into what is an export intensive sector, Chinese anti-dumping measures which look to limit global supply, and the rise in steel prices. Construction of course is set to drag on the sector this year, and there are significant downside risks from President Trump's steel and aluminium tariffs, but given where the sector has been, the outlook is fairly positive and we are forecasting another strong year, with growth of 3.1%, only slightly down on last year.

Linked to the basic metals sector is the **metal products sector**. Again construction is set to drag on the sector, given 20% of its intermediate demand is destined for the industry. A further drag is set to come from the struggling automotive sector (see below). However overall the sector follows the wider manufacturing trend, and although we expect some unwinding this year, strong fundamentals in important sectors such as mechanical equipment and other transport, as well as firm global demand should see the sector have another good year. We are forecasting growth of 3.1% this year. Next year we see the sector slowing considerably, in line with manufacturing, as uncertainty takes hold. We have pencilled in a small contraction.

CAPITAL EQUIPMENT MANUFACTURERS CONTINUE TO THRIVE

While some construction related sectors are having a hard time of it, the opposite is true of capital equipment manufacturers – namely mechanical equipment and electronics – which continue to enjoy a sweet spot. Their impressive performance comes on the back of the pick-up in business investment over the last year, with the weaker Sterling offering a boost given their export intensity, as well as the rise in oil prices back up to above the $70/barrel mark.

SECTOR GROWTH RATES AND FORECASTS

% CHANGE

	OUTPUT			EMPLOYMENT		
	2017	2018	2019	2017	2018	2019
Basic metals	3.2	3.1	-0.7	-1.0	4.9	-0.8
Metal products	2.3	3.1	-0.4	4.8	3.2	-0.8
Mechanical	8.1	9.7	-0.7	4.3	5.6	0.4
Electronics	4.5	5.8	0.3	3.5	2.9	-2.5
Electrical	4.2	-6.5	2.0	-0.5	0.4	-0.3
Motor Vehicles	0.5	-0.2	0.2	5.7	1.8	0.5
Other transport	8.5	8.9	3.2	-1.8	1.0	-1.4
Food and drink	2.0	0.3	0.6	-0.9	-2.9	-1.6
Chemicals	3.0	-0.2	0.4	1.2	-4.4	-3.7
Pharmaceuticals	-4.8	1.1	0.8	8.3	-10.9	-5.6
Rubber and plastics	-0.7	0.6	0.1	-0.3	2.1	0.4
Non-metallic minerals	0.7	-4.2	0.9	-5.6	-5.9	-1.4
Paper and printing	0.8	-2.0	-1.2	-0.8	-0.7	-3.8
Textiles	0.7	-6.7	-2.6	-11.3	-7.5	-5.9
Manufacturing	2.5	1.9	0.5	1.1	0.4	-1.4

Sources: EEF and Oxford Economics

The **mechanical equipment sector**, as the chief investment good in UK manufacturing, is perhaps the sector that has benefited most over the last year. The sector has recorded three consecutive quarters of expansion with a particularly healthy start to 2018 which saw growth of 4.0% in 2018q1. We expect this momentum to continue this year, especially given that the sector's capacity utilisation is above its long run average, which should encourage manufacturers to invest further. We are forecasting growth of 9.7% this year. This is huge growth, and in all likelihood the peak for the sector. As the pass through of the Sterling depreciation fades, weakness in key markets such as automotive and construction take effect, and uncertainty ramps up, we expect the sector to unwind next year and are forecasting a small contraction of 0.7%.

The **electronics sector** also had a strong start to the year, expanding by 4.3% in q1. The sector continues to benefit from the upturn in global demand and investment, with semiconductor sales – a key proxy for the sector's performance – remaining robust, and exports performing well. We have pencilled in growth of 5.8% in 2019 and 0.3% in 2019.

Another bright spot in the capital goods segment is **other transport**. This sector, and in particular the aerospace segment, has been a source of good news over the last three years, with huge growth of 8.5% recorded in 2017. With momentum expected to continue on the back of an apparent insatiable demand for air travel, and a huge backlog of work in hand, we expect the sector to have an even stronger year, forecasting growth of 8.9%. Two hugely impressive years, will ultimately see some unwinding next, and we are expecting weaker, although strong growth, of 3.2%.

CONSUMER SECTORS FACE A SUBDUED YEAR

While consumers' prospects are expected to improve, with inflation receding and wages picking-up, Brexit uncertainty and low levels of savings means the outlook for consumer facing sectors remains subdued.

Food and drink had a weak start to the year, with the poor weather effecting production and the introduction of the sugar levy representing a further challenge for manufacturers to negotiate. That said, the demand inelastic nature of food and drink products protects the sector from sustained periods of contraction, and we are forecasting growth of 0.3% in 2018, before picking-up to post 0.6% growth in 2019.

The recent weakness in the **motor vehicles** sector, which expanded by 0.5% in 2017, its weakest growth since the financial crisis, is expected to continue this year. Indeed while Brexit induced uncertainty continues to dominate the media narrative there are a number of other factors at play. In particular demand for diesel cars has fallen back considerably on the back of government policy announced last year, while there is also an increasing concern that the sector has reached saturation point, with large falls in output in both domestic and export markets driving the decline. This has led us to forecast a small contraction this year of 0.2%. We expect the fortunes of the sector to level off in 2019 however and are pencilling in a 0.2% expansion.

Likewise the **textiles sector**, after recording growth in 2017, is set to struggle over the coming years. Low labour cost competition, and a lack of available skills and capacity in the UK is limiting the extent to which the UK can benefit from the rise of 'fast fashion'. This means we are forecasting a hefty contraction of 6.7% this year. The sector should bounce back a little next year, but we are still forecasting a contraction.

Official data shows that 2018 was a disappointing year for the **paper and printing** sector, but prospects seem to have turned a corner at the turn of this year and the fundamentals for the sector look better this year. While consumers are still under pressure, the rise of online retailing here and in major export markets means demand for packaging materials has a positive outlook. And while there had been some consolidation in the industry, this is also spurring additional investment into new technology and productivity improvements. Nevertheless, a positive quarterly growth profile this year still means a year on year fall in output of around 2% is in prospect.

VALUE CREATION SHOULD BE CORE TO 4IR STRATEGY

As manufacturers navigate their journey through 4IR, it's important to understand that you don't need to be a tech whiz to turn the 4IR phenomenon to your advantage. The opportunity boils down to three areas of potential value creation: bottom-line impact, top-line growth and risk mitigation.

While value is created in different ways, incremental value is available to every manufacturer – but it must be rooted in incremental improvements to your current capabilities. It can start with a single improvement initiative in a single functional area. Even small, functional change has ripple effects throughout the entire enterprise. These single, incremental improvements should ultimately be performed against the backdrop of your overarching 4IR vision and strategy to drive tangible ROI enterprise-wide.

The key is to flip your thinking. Instead of focusing on specific technology features or tools, let your goals for value creation lead the way. The real goal for your business isn't, for example, to have predictive maintenance capabilities; it's for that predictive maintenance investment to reduce your mean time between failures, optimise return on invested capital and ultimately preserve or enhance asset value. Start with your high-level objective – whether it's higher levels of performance agility, better inventory turnover or a reduction in production errors – and work backwards from there, asking the question, "How will information transparency, availability and automation unlock business value to this capability?"

Keep in mind that value creation opportunities will also evolve as you progress in 4IR maturity. Digitisation can fundamentally change the nature of your relationships with suppliers and customers, fostering collaboration and breaking down traditional barriers. The linear supply chain will morph into an integrated value chain of mutually beneficial relationships where suppliers and customers collaborate to achieve efficiencies and lower costs by exchanging information and securely integrating systems and processes.

The integrated value chain is based on a new level of transparency and information sharing, including constant, bidirectional communication and inter-company visibility into everything from inventory condition, supply status and shipping delays to future-focused factors predicting shifts in demand. This flow of information and aggregated business intelligence across the supply network is often referred to as the digital thread, the lifeblood of 4IR.

The real value of the digital thread comes from enabling faster speed to market and speed to decision, empowered by access to more relevant and timely information, enabling better business intelligence and greater intimacy with supplier performance and customer behaviour, resulting in "win/win/win" relationships.

However, a world-class digital infrastructure via superfast broadband is essential to enable UK manufacturing to continue to develop 4IR. Therefore, it is critical that the Government understands and invests in the right digital infrastructure in the short term.

Read more in our BDO US report 'The Middle Market Manufacturer's Roadmap to Industry 4.0' – https://www.bdo.com/insights/industries/manufacturing-distribution/the-middle-market-manufacturer-s-roadmap-to-in-(1)/the-middle-market-manufacturer-s-roadmap-to-indust

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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. As 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

Accountancy and business advisory firm BDO LLP is the UK member firm of BDO International, which has more than 1,500 offices in 162 countries. We operate from 18 offices across the UK, employing 3,600 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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