The manufacturers' organisation

In partnership with:

MANUFACTURING OUTLOOK

2017 QUARTER 4

2.7 million employees

£240bn in exports

68% of business R&D

Average wages higher than the rest of the economy

Corkscrew Turbine, taken by Mike Brookes Roper at Kirkwall in Orkney, winner of the Professional category in the EEF Photography Competition 2016.

FOREWORD


Lee Hopley
Chief Economist
EEF


Tom Lawton
Head, BDO Manufacturing
BDO LLP

Welcome to the 2017q4 *Manufacturing Outlook* report, in partnership with BDO LLP.

Over the course of this year we have seen response balances across almost all of our survey indicators strengthen. Manufacturers have been more focused on capitalising on the improving global economic demand picture than the domestic political challenges that continue to dominate the headlines.

Our latest set of results show that these trends were very much at play in the final months of this year. Responses on output levels over the past three months were once again robust, with balances remaining at multi-year highs. This was a slightly better outturn that last quarter's predictions.

Strength in production levels have proved to be remarkably broad-based in the past four quarters. Output balances across 2017 have been consistently in positive territory for the main manufacturing sectors covered in our report – with the combined benefits of a pick-up in global growth and increases in commodity prices feeding growth throughout the manufacturing supply chain.

And it is the positive global economic conditions that are dominant again this quarter. The balance of companies reporting increased sales to overseas customers in the past three months matches last quarter's highs. This marks a substantial turnaround in the sector's export performance in 2017 compared with the challenges of last year.

However, moving in the opposite direction has been the balance of manufacturers reporting a rise in domestic orders. Forward looking indicators for UK demand have been someone weaker than other survey components this year, linked to concerns about the resilience of demand in the face of rising inflation, slowing consumption growth and inevitable Brexit jitters. While some more diversified sub-sectors are showing greater resilience, the divergence in confidence in the UK market versus the rest of the world is likely to linger.

Nevertheless, longer-term optimism amongst manufacturers about their own firm-level fortunes continued to edge higher this quarter. And together with growing pressure on capacity, manufacturers' need to increase investment has risen for the second quarter running, with the capital expenditure plans balance hitting its highest level since 2014q2. This is being accompanied by robust recruitment plans across the sector. While more investment by manufacturers in the UK is positive, other EEF research (see EEF's 2017/18 Investment Monitor) suggests that much of this will be short-term demand driven, with Brexit uncertainty still acting as something of a hindrance to larger-scale expansion plans.

Our survey period closed just as the Chancellor was getting ready to deliver his Budget. While many commentators were pointing to the tricky balance Mr Hammond needed to strike with his policy announcements, he largely navigated hurdles with a Budget that offered some giveaways for public services, households and businesses.

While there were some positives for industry, there was little that would have significantly altered the view of companies on the outlook for their businesses or the UK economy. And in line with the Office for Budget Responsibility's forecast updates, we continue to expect subdued GDP growth of 1.3% in 2018, but a stronger performance for manufacturing of 1.4%.

2017Q4 HEADLINES

2017 has seen a clean sweep of positive balances across our main output and orders indicators – the first time this has happened since the financial crisis. The year ended on a strong note, with output and exports response balances holding firm at the multi-year highs reported in the previous quarter. While manufacturers expect this momentum to carry into the start of next year, some softening in domestic sales means buoyancy in the rest of the world will be critical in sustaining growth.

INDICATOR	BALANCE	CHANGE	
Confidence	5.5	↔	Confidence about UK outlook unmoved as manufacturers remain cautious
Output	34%	↔	Output balance holds steady at the multi-year high seen last quarter
UK orders	12%	↓	Domestic demand while positive is the weak point in 2017q4
Export orders	33%	↔	Overseas sales maintain strength as good demand from EU markets continues to stand out
Employment	22%	↓	Buoyant production expecations driving yet more recruitment
Investment	20%	↑	Positive investment balances posted across all sectors

Source: EEF Manufacturing Outlook Survey

Our *Manufacturing Outlook* surveys have signalled positive trading conditions across industry since the turn of the year. Official data are showing a similarly robust picture, with manufacturing output expanding by 1.1% in 2017q3, putting the sector on track for the strongest annual rate of expansion since 2014.

Also consistent throughout this year has been the contribution of export demand to increased sales and production balances – a story which is evident across all sub-sectors. The global economy has mounted a strong performance this year, with emerging market growth accelerating, the US powering through some significant disruptions and – perhaps most importantly – a long-awaited recovery in Europe.

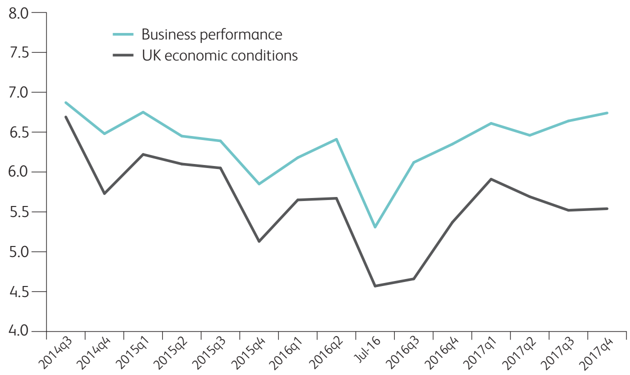
Business and consumer confidence indicators in our main trading partners have outperformed expectations at the beginning of the year and forecasters have been progressively raising their growth projections for the bloc this year and next. As such, around three-fifths of our survey respondents have noted improved demand conditions in EU markets over the past four quarters.

There are emerging signs, however, that the domestic market may be starting to move in the opposite direction, with UK sales balances falling short of last quarter's expectations. This looks to be impacting on some sectors harder than others, with diversified sectors such as metals products and chemicals doing better in the home market than export intensive industries, such as mechanical. However, with an uncertain outlook for sectors, such as construction and automotive in the year ahead, the former could provide some early warning of a sharper deterioration in the UK market.

Despite the rising fortunes of manufacturers and the continued confidence in their own growth prospects over the next 12 months, our survey continues to indicate caution about the broader UK outlook. A sentiment reflected in our own UK GDP forecasts for the year ahead.

BUSINESS CONFIDENCE IN 2017 SHOWS MARKED IMPROVEMENT ON LAST YEAR

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



Source: EEF Manufacturing Outlook Survey

OUTPUT

The recent momentum in manufacturing activity was sustained into the final quarter of the year, with the balance of companies reporting an increase in output remaining steady, at the historic high of 34%. This represents the fifth successive quarter the output balance has been positive, following a period of weakness across 2015-16, and is indicative of an industry in fairly rude health.

Encouragingly, the outlook also remains positive, with a net balance of 28% of manufacturers expecting the expansion in manufacturing activity to continue into 2018. While this is slightly down on this quarter's reading – and is likely to reflect some softening in the domestic market – it remains well above the survey's long run average.

PAST THREE MONTHS	↔	34%
NEXT THREE MONTHS	↓	28%

Manufacturers continue to thrive on the back of the global economy upswing, with the upturn in activity fairly broad based across sub-sectors. Indeed this is the fourth quarter in a row that positive output balances have been recorded across all the main sectors covered in our survey.

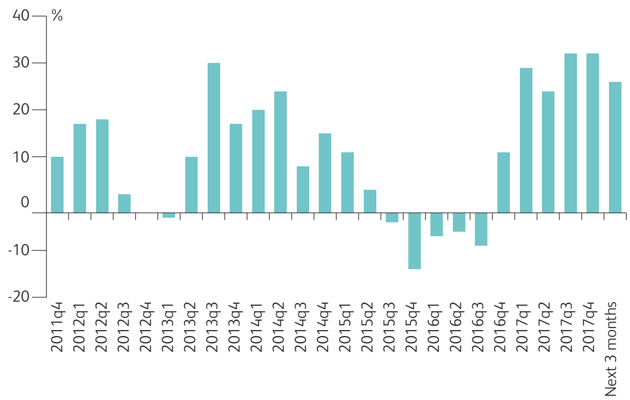
The biggest gains this quarter came from the capital equipment sectors. The upturn in the global economy, which has led to a revival in business investment, has encouraged manufacturers to expand capacity and take advantage of their improved demand requirements. The mechanical equipment and electronics sectors in particular have profited on the back of this, the former recording its highest output balance since 2010q3, and is being further supported by the positive export picture.

Meanwhile the weakness in the domestic market, and in particular the construction sector, though dragging on some sectors such as non-metallic minerals, has not had a defining impact on others in the supply chain where there is a wider demand base. Metal products, rubber and plastics, and chemicals have all recorded healthy output balances, benefiting from their greater diversification. The outlook with regards to the strength of automotive demand could however temper this in the coming year, given that this is a key market for all three.

Overall, despite the weakness at home, this represents another healthy quarter for manufacturing activity, backing up the recent official statistics, and points to the sector having its strongest year since 2014.

OUTPUT BALANCE REMAINS STEADY AT HISTORIC HIGH

% BALANCE OF CHANGE IN OUTPUT



Source: EEF Manufacturing Outlook Survey

OUTPUT SUMMARY

% BALANCE OF CHANGE

SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS
Metal products	27	21
Mechanical	40	34
Electrical	27	27
Electronics	50	36
Rubber & Plastics	40	43
Chemicals	53	40
TURNOVER		
£0-9m	25	24
£10-24m	48	26
£25m and over	43	46

Source: EEF Manufacturing Outlook Survey

ORDERS

After the great performance registered in the last quarter, manufacturers' order books continue to look healthy. Performance was slightly weaker than q3 but response balances remain much higher than the long-run average. The net balance for total orders was 30% in the past three months compared with the 37% peak reported in 2017q3.

Notably, the gap between domestic and foreign orders is widening with manufacturers able to differentiate between markets enjoying a boon from expanding global demand and a weak sterling. Businesses expect orders to keep expanding in the first quarter of 2018, but at a slower pace in both domestic and non-domestic markets.

UK ORDERS	PAST 3 MONTHS	↓	12%	NEXT 3 MONTHS	↓	16%
EXPORT ORDERS	PAST 3 MONTHS	↔	33%	NEXT 3 MONTHS	↓	18%
TOTAL ORDERS	PAST 3 MONTHS	↓	30%	NEXT 3 MONTHS	↓	24%

UK ORDERS

Domestic orders continue to be rooted in positive territory even if the balance of responses has dropped back compared to 2017q3. The latest figures show a net balance of 12% down from 22%. Concerns about squeezed real wages affecting consumer demand look to be having some impact on domestic order books, even if not presenting too much damage to demand at present. Encouragingly, the next three months are actually showing positive signs that the expansion may not be over yet.

Looking at the sub-sector details, manufacturers' performance is not homogenous across the industry. Indeed, clear differences are evident between them, with some sectors experiencing expansions or large rebounds while others registering only modest positive responses.

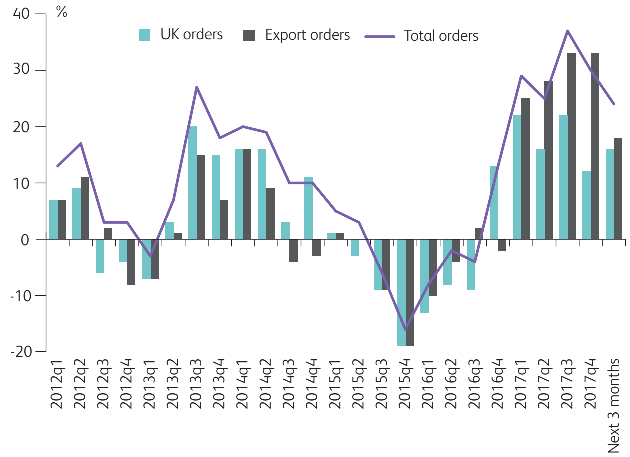
For example, the difficulties affecting the UK construction sector are part of the reason of the weaker order in-take of businesses linked to it, such as rubber and plastics. However some respondents see some possibility of an uptick in the next three months on the back of measures to support housing activity.

On the positive side, the chemical sector has bounced back showing a net balance of 53% in q4 and a similarly positive one of 33% for the next three months. The expansion is likely to be related to improvements in its diverse customer base so far this year.

Manufacturers linked to capital goods such as those in the mechanical, electronics, and electrical sector expect the domestic market to slowly pick-up in the next quarter and to see an increase in their order books, thanks to a somewhat improved appetite to invest and the increase in infrastructure activity in the UK.

ORDERS LOOK HEALTHY THANKS TO THRIVING EXPORTS

% BALANCE OF CHANGE IN ORDERS



Source: EEF Manufacturing Outlook Survey

EXPORT ORDERS

Compared to the domestic market, the rest of the world is pushing export order books to levels well above their long-term trend. The export orders balance expanded for the fourth quarter in a row and the negative balances registered in five of the six quarters between 2015q3 and 2016q4 now look like a fading memory. Interestingly, none of the sectors foresee a reduction in export new orders next quarter, even if the net balance for export orders is predicted to be 18%, lower than the 33% recorded in q3 and q4 of 2017.

Our results, in line with the recent past, continue to show improvements in demand conditions across Asian and North American markets. The proportion of manufacturers identifying positive demand conditions in those markets stood at 29% and 32% respectively.

Consistent with the last few surveys, EU orders keep showing positive signs with 59% of respondents seeing a notable pick-up in demand coming from this market with peaks registered at 80% or more for electronics, chemicals, and rubber and plastics.

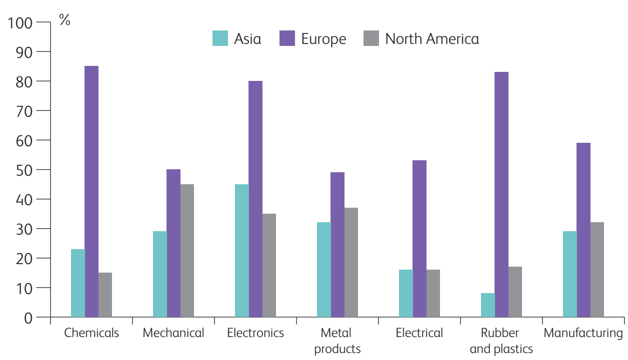
The UK's largest export market looks set to grow at a faster pace than seen in much of the post-crisis period. Manufacturing PMIs are firmly in expansionary territory and eurozone GDP is expected to end 2017 2.3% higher than the previous year. EU and eurozone consumers are optimistic as well, with consumer confidence reported by the European Commission at levels not seen since the pre-crisis period.

Is the bright picture going to continue? From a manufacturing perspective, order book expansion may put pressure on capacity and may force them to invest more in capital equipment to satisfy the growing demand. The healthy trend in global demand more broadly is expected to continue but at a slower pace – in line with forecasts that see the global economy expanding at a reduced speed in 2018.

Furthermore, the risks associated with US inward-looking politics, the Brexit process and future trade deal with the EU, and the EU uncertainties linked to political elections and regional troubles, will also be on the radar of UK exporters.

ALL SECTORS BENEFIT FROM POSITIVE EU DEMAND

% 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	17	17	29	16	23	18
Mechanical	7	19	26	18	33	26
Electrical	0	5	18	17	18	17
Electronics	3	30	57	31	43	54
Chemicals	53	33	31	23	60	7
Rubber and Plastics	33	0	29	17	33	46
TURNOVER						
£0-9m	20	15	22	16	28	23
£10-24m	12	30	42	17	40	31
£25m and over	19	24	38	25	42	36

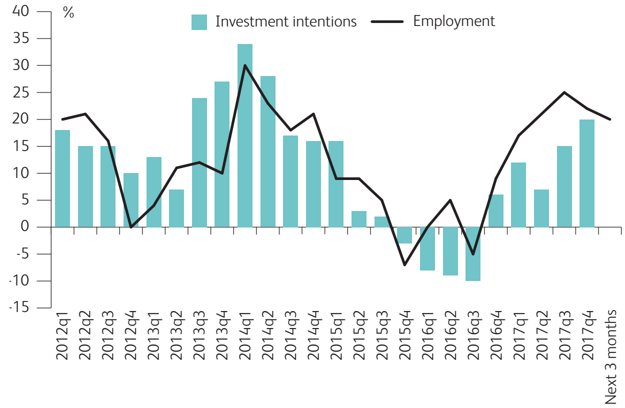
Source: EEF Manufacturing Outlook Survey

EMPLOYMENT & INVESTMENT

The balance of companies taking on more employees eased slightly in the final quarter of the year, but remained close to last quarter's three-year high. Encouragingly, investment intentions also picked up significantly this quarter, reaching their highest levels in three years. As demand continued to outperform expectations in the past quarter, manufacturers are expanding capacity by increasing both headcount and capital expenditures to meet increased demand.

INVESTMENT INTENTIONS AT A THREE-YEAR HIGH

% BALANCE OF CHANGE



Source: EEF Manufacturing Outlook Survey

EMPLOYMENT	PAST 3 MONTHS	↓	22 %	NEXT 3 MONTHS ↓	20 %
INVESTMENT	NEXT 12 MONTHS	↑	20 %		

Recruitment intentions continued to be firmly rooted in positive territory in the final quarter of 2017. A balance of 22 % of manufacturers reported an increase in headcount in the past three months, a touch lower than last quarter's three year high of 25 %. Employment gains were fairly broad-based across the manufacturing supply chain, with double-digit balances reported in most subsectors. Food and drink was the only exception, with negative employment balances reflecting the weaker outlook for the sector from squeezed consumer spending.

As manufacturing is expected to continue its solid performance into next year, hiring activity remains anchored in positive territory, with a balance of 20 % of companies expecting an increase in headcount in the next quarter.

Happily, investment intentions continued to go from strength to strength this year. This quarter, investment balances climbed to a three-year high of 20 %, and increased for the third quarter in a row. Investment balances were positive across all sectors, but some of the biggest gains were reported in the capital goods sectors, in line with a solid global picture and so far resilient investment activity in the UK. Whether this trend will be sustained into next year is under question, however.

EMPLOYMENT AND INVESTMENT SUMMARY

% BALANCE OF CHANGE

	EMPLOYMENT		INVESTMENT
SECTOR	**PAST 3 MONTHS**	**NEXT 3 MONTHS**	**NEXT 12 MONTHS**
Metal products	19	14	9
Mechanical	24	17	19
Electrical	41	35	18
Electronics	20	32	38
Rubber and Plastics	13	-21	15
Chemicals	40	0	13
TURNOVER			
£0-9m	19	19	22
£10-24m	34	11	-1
£25m and over	27	13	23

Source: EEF Manufacturing Outlook Survey

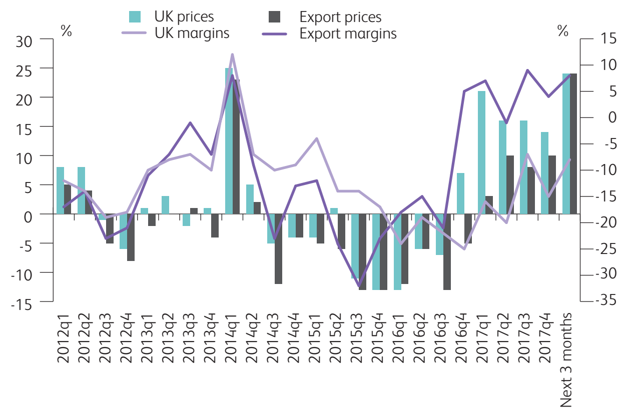
PRICES & MARGINS

Inflationary pressures eased slightly in the final quarter of 2017, as balances for UK prices drifted lower from peaks reported in our survey at the start of the year. However, further price increases are still in the pipeline for next year, as companies react to the recent rises in oil and other commodity prices. This should translate into improved margins on domestic sales.

Export prices edged up as the sterling exchange rate recovered from its trough following the snap election results. As a result, manufacturers' margins on export sales remain firmly in the black for this quarter and next.

PRICE INCREASES ARE STILL IN THE PIPELINE FOR NEXT YEAR

% BALANCE OF CHANGE



Source: EEF Manufacturing Outlook Survey

UK PRICE	PAST 3 MONTHS	↓	14%	NEXT 3 MONTHS	↑	24%
EXPORT PRICE	PAST 3 MONTHS	↑	10%	NEXT 3 MONTHS	↑	24%
UK MARGINS	PAST 3 MONTHS	↓	-15%	NEXT 3 MONTHS	↓	-8%
EXPORT MARGINS	PAST 3 MONTHS	↓	4%	NEXT 3 MONTHS	↓	8%

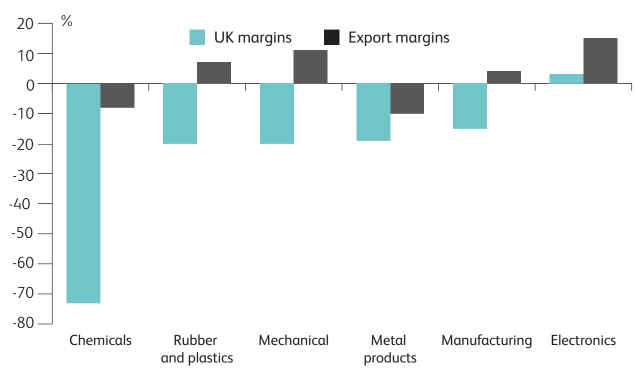
The steady rise in inflation lost some ground in the final quarter of 2017. The balance of companies reporting a rise in UK prices fell to 14% in 2017q4 – its lowest level so far this year. This trend was also apparent in official statistics, which showed the annual rate of inflation for goods leaving the factory gate falling to a 12-month low of 2.8% in October.

Further price increases are still in the pipeline for next year, however. This comes as a response to the recent surge in the price of oil and other commodities, both up by around 10% on their levels a year ago. This had the largest impact on the non-metallic minerals, chemicals, and basic metals industries, which showed the highest balances for expected price increases in the next three months. This should provide some relief to manufacturers' margins on UK sales in those sectors.

Export prices edged up in the past three months, reflecting the slight appreciation in the sterling exchange rate on the back of the Bank of England's decision to increase interest rates for the first time in a decade. Further increases are expected at the start of next year as a response to the rise in input costs.

ENERGY PRICE INCREASES EXACERBATE MARGIN PRESSURES ON UK SALES

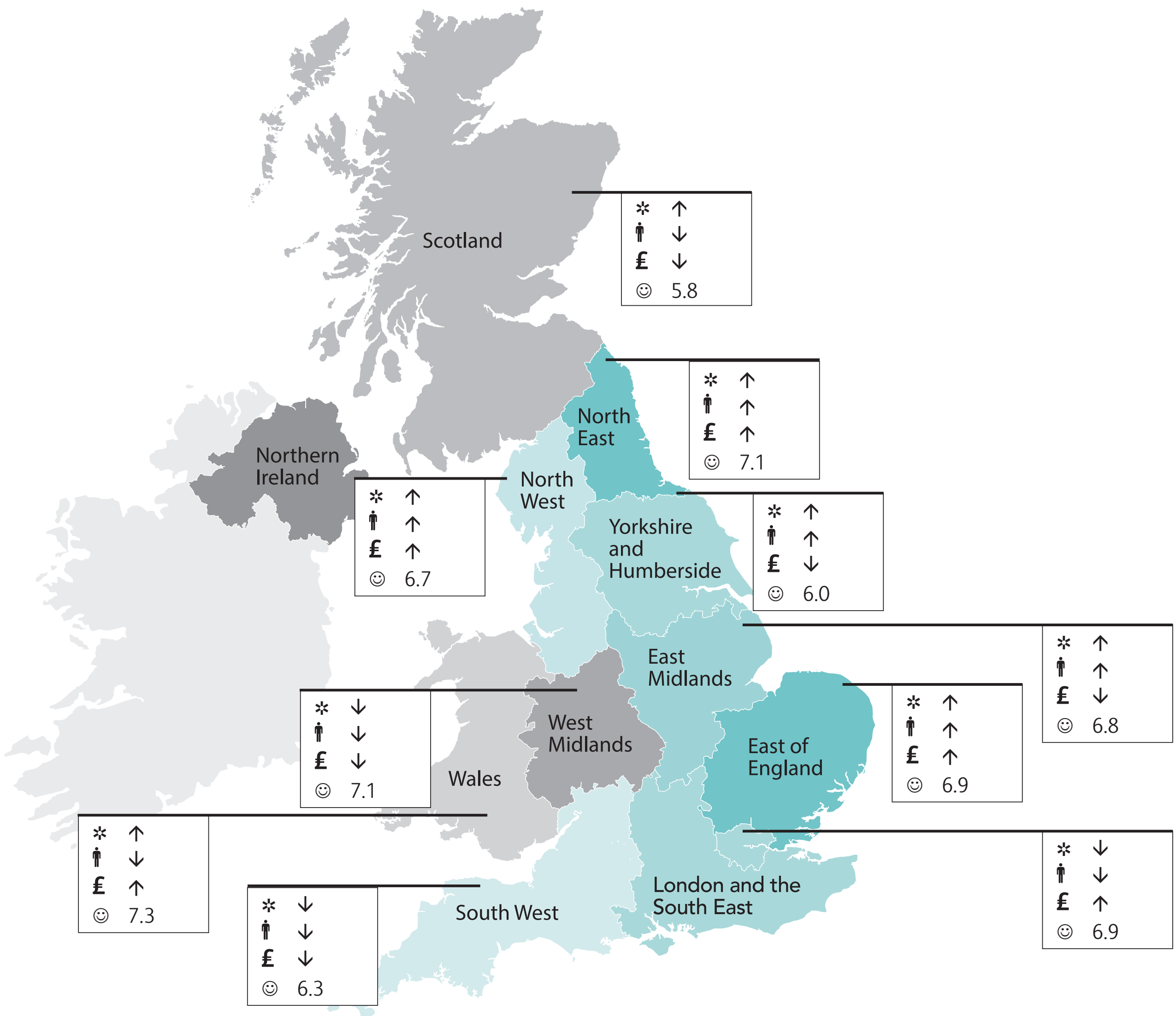
% BALANCE OF CHANGE IN MARGINS IN THE PAST THREE MONTHS



Source: EEF Manufacturing Outlook Survey

REGIONAL

The national picture continues to be healthy, with the positive trends seen across production, output, investment and employment last quarter, sustained this time round. Indeed for the second consecutive quarter, positive balances were recorded for all our key indicators, across every region, confirming that the upturn in activity is not just sectoral based, but regionally based too.



KEY:

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

Source: EEF Manufacturing Outlook Survey

The output balances across regions remain strong and robust, building on the momentum seen last quarter. Seven out of the ten regions saw improvements in the last three months, while those regions where output balances did fall, these were from historic highs in q3, and reflect at least a partial paring back effect. Special mention must go to the North West however, whose output balance has almost trebled, from 17% to 50%, with capital equipment manufacturers in the region in particular benefiting from the revival in business investment.

The healthy output balances are backed up by strong order books. In line with the wider manufacturing trend, domestic orders are trailing export orders, as manufacturers take advantage of the healthy global environment and weak exchange rate. There are some exemptions however, notably in the North West and South West, where the UK market is playing a more important role in new orders. The latter a likely result of the dominant electronics and aerospace sectors in the region.

The positive news across output and orders, is leading manufacturers to increase their headcount. While there is some disparity between regions, with the East Midlands and Yorkshire and Humber recording historic highs (48% and 40%), and outperforming other regions such as the West Midlands (15%), the fact that all regions have recorded positive, double-digit employment balances is illustrative of the upturn in the sector. Likewise, investment plans, have also remained steady, with the East of England enjoying noticeable gains. Whether this investment picture will be sustained next year is up for debate, given that uncertainty is set to be ramped up the longer we go with no clarity on the UK's terms of exit from the EU.

BUSINESS CONFIDENCE INDICATORS

Given the positive balances we are seeing across our survey, it is unsurprising that manufacturers' confidence regarding their business have remained healthy in the last three months, rising in six out of the ten regions. This is a far cry from the latter stages of 2016, when Brexit uncertainty and what it may mean for the manufacturing outlook saw confidence dip down. Like last quarter, however, the same level of optimism is not being felt with regards to the overall UK economic outlook, which significantly trails business confidence in the vast majority of regions. Therefore although business and activity is good, the wider risks to the future economy are still at the forefront of manufacturers minds.

UK ECONOMIC OUTLOOK CONTINUES TO TRAIL BUSINESS CONFIDENCE ACROSS REGIONS

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

Source: EEF Manufacturing Outlook Survey

REGIONAL SUMMARY

% BALANCE OF CHANGE

	OUTPUT		TOTAL ORDERS		EMPLOYMENT	
REGION	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS
Scotland	22	32	23	21	15	24
North East	35	35	29	35	29	29
North West	50	25	47	25	39	28
Yorks & Humber	40	13	40	21	40	16
East Mids	38	34	41	30	48	18
Eastern	48	36	52	35	35	18
South East & London	45	34	47	38	13	0
South West	29	37	19	30	19	10
West Mids	24	33	21	22	15	16
Wales	50	38	38	50	13	-13

Source: EEF Manufacturing Outlook Survey

ECONOMIC ENVIRONMENT

The UK economy picked up slightly in the third quarter of the year, with the first estimate showing GDP expanding by 0.4 %. Despite this, following some downward revisions to the back run data, we now expect the economy to grow by 1.5 % in 2017, down from 1.6 % previously.

While this is welcome growth, given the uncertainty shrouding the economic outlook, it is still a relatively subdued performance, especially when considering our international counterparts who are thriving on the back of a global economy upswing. Looking ahead, we expect the economy to slow further in 2018, pencilling in an expansion of 1.3 %.

HEADLINES

- Economy expected to slow further next year
- Inflation to peak, before receding in 2018
- Tentative signs of emerging wage pressures, but dependent on a number of factors
- Investment to contribute slightly to growth, but remains subdued

The narrative behind our forecasts for the coming year remain broadly unchanged from three months ago, with the only notable adjustment coming from business investment, which we now expect to contribute slightly to growth. The story of hard pressed households on the back of rising prices remain, but is expected to be less prominent next year, while net trade is expected to contribute positively to growth in 2018. Clearly the greatest development since our last *Manufacturing Outlook* came last month when the Bank of England raised interest rates for the first time in a decade. What this might mean for the future path of monetary policy over the next few years is of significance for households and business alike.

SQUEEZE ON HOUSEHOLDS LESS PROMINENT IN 2018

The squeeze on households, on the back of rising inflation and weak wage growth, should moderate in 2018. Inflation is set to peak in the closing months of 2017, as the pass through of the sterling depreciation becomes exhausted, before receding in 2018. Higher energy costs, particularly from rising oil prices, should keep inflation above the Bank's target however, and as a result the trend of weaker household spending will still be relevant next year. The extent of this is naturally dependent on wage growth, which continues to puzzle and provoke debate.

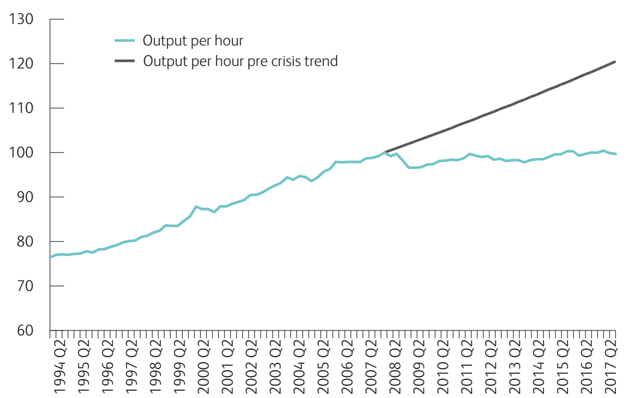
EMERGING WAGE PRESSURES ON THE HORIZON?

Wage growth, despite the labour market performing well, has remained weak, trailing inflation and dampening consumption in the process.

While there are a number of possible explanations for this, from a "broken Phillips curve" to Brexit related uncertainty, it is the UK's poor productivity growth – which has flat lined since the financial crash – which is likely to be one of the main contributing factors. It is an underlying concern for the economy, with the OBR recently slashing its forecast for productivity growth in the Autumn Budget. There are, however, tentative signs that wage pressures could be building, with labour slack eroding, the prospect of losing access to EU migrant labour, as well as confidence holding up, all set to encourage employers to offer higher pay packages. We will have to wait until the new year for hard data on this, and while we are forecasting a pick-up in wage growth, we are not as optimistic about the resurgence as other forecasters, including the Bank of England, given Brexit uncertainty and the fact there is no quick fix to the UK's longstanding productivity problem.

PRODUCTIVITY GROWTH IN THE UK HAS FLAT-LINED SINCE THE RECESSION

WHOLE ECONOMY OUTPUT PER HOUR (2007Q4 = 100)



Source: ONS

INVESTMENT TO GROW, BUT REMAINS SUBDUED

The upturn in the global economy has led to a small revival in business investment, and we now believe investment will make a modest contribution to growth in 2018. The majority of this growth is likely to come from export intensive sectors such as manufacturing, given that global conditions are expected to remain supportive.

The shift from our last report, in which we had investment dragging on GDP growth next year, is the recognition that businesses – while not particularly optimistic – have a greater idea about the future path of the economy, illustrated though the convergence in GDP forecasts compared to last year. Businesses are therefore more inclined to make some investments on the back of this. However, given that the global economy is "close to firing on all cylinders", this is a weaker performance than one would expect, and we are not forecasting a strong showing from business investment, given that uncertainty is likely to be ramped up the closer we get to the deadline for leaving the EU.

Meanwhile, net trade is expected to reverse the recent trend and contribute positively to growth next year, as exports continue to benefit from healthy global conditions, outpacing import growth.

UK ECONOMIC FORECASTS

% CHANGE EXCEPT WHERE STATED

	2016	2017	2018
Trading environment			
Exchange rate (€/£)	1.20	1.14	1.14
Exchange rate ($/£)	1.35	1.29	1.33
Exports	1.1	4.4	2.5
Imports	4.3	2.7	1.7
Current account (% GDP)	-5.9	-4.4	-3.4
Output			
Manufacturing	0.7	2.1	1.4
GDP	1.8	1.5	1.3
Costs and prices			
Average earnings	2.2	2.3	2.4
Oil price (Brent Oil $/bl)	43.5	52.6	54.7
Employment			
Manufacturing (000s)	2635	2651	2618
Rest of economy (000s)	31,875	32,293	32,405
Unemployment rate (%)	4.9	4.4	4.3

Source: Oxford Economics and EEF

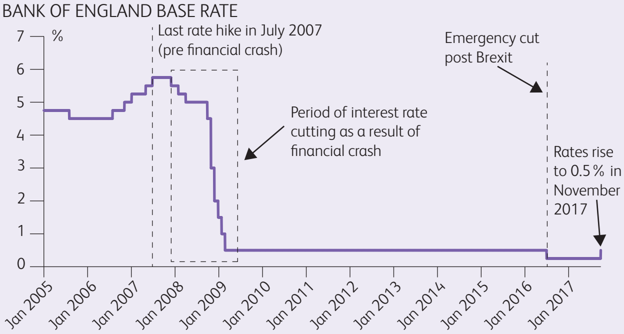
SPOTLIGHT: INTEREST RATES RISE FOR FIRST TIME IN A DECADE

Last month the MPC voted by 7-2 to raise interest rates by 25 basis points. This represented the first rate hike since July 2007. The hike, while being reported as momentous, is not likely to create huge waves in the economy, given that rates remain at the historically low level of 0.5%.

Of greater importance will be the future path of monetary policy. The indication from the *Inflation Report* that the hiking cycle will be gradual and limited should provide some reassurance to industry and households. This needs to be combined with clarity on how the evolution of data will determine the timing and pace of future changes, particularly with regards to wage growth. We do not expect another rate hike until late-2018.

MPC RAISE INTEREST RATES FOR FIRST TIME IN A DECADE

BANK OF ENGLAND BASE RATE



Source: Bank of England

GLOBAL ECONOMY

- Momentum in the global economy is expected to continue into 2018
- Eurozone in particular benefiting from healthy demand conditions
- Growth in the US consolidates
- China set for first acceleration in growth since 2010, but concerns regarding credit growth remain

The recent momentum seen in the global economy continued into the second half of the year, with the eurozone in particular benefiting from healthy global demand conditions. Encouragingly, the revival in global business investment, which is underpinning this pick-up, should raise the global capital stock and hence further strengthen the outlook in the near term. We expect the global economy to expand by 3.6% and 3.8% this year and next, a noticeable rise from the 3.2% recorded in 2016.

In the eurozone, quarterly growth rates have been healthy and robust across countries, and are expected to contribute to an overall growth rate of 2.3% in 2017. This would be the strongest year on year growth since the financial crisis, and is helped accounted for by stronger domestic demand, on the back of accommodative monetary policy and easing credit conditions. The recovery in demand has also led to some of the slack in the labour market being absorbed, with the unemployment rate dropping to 8.9% in September, its lowest level since 2008. Along with this, private survey data remains buoyant and has done all year, while strong business and consumer confidence indicators are further evidence of the positive sentiment felt across the continent. Despite some downside risks to the outlook, notably politically based with regards to elections in Italy and Catalonia, we expect this performance to be sustained into 2018.

Meanwhile growth in the US continues to be strong. GDP increased at an annualised rate of 3% in the three months to September, only slightly down on the 3.1% recorded in q2, the highest growth seen since 2015q1. This should help to contribute to an overall growth rate of 2.2% in 2017. As with the eurozone, strengthening business investment, together with a strong labour market has been the driving force behind this improved performance. As a result further interest rate hikes in the coming 12 months are expected by the Fed.

In Asia, China, after a very strong first half of the year, should see its economy expand by 6.8% in 2017, providing the greatest contribution to global growth. This would represent the first acceleration in annual growth since 2010, helping to dissipate some of the fears of a slowdown in our last report. While this is good news for the economy, there remain concerns around the nature of this growth and specifically how it is being accompanied by rapid private credit expansion. Maintaining current GDP growth rates, while reducing the risks to financial stability, is a challenge but it is hoped that following the Chinese 19th National Party Congress, authorities can now 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		
	2016	2017	2018	2016	2017	2018
France	1.1	1.8	1.8	0.2	1.0	0.8
Germany	1.9	2.5	2.4	0.5	1.8	1.7
Japan	1.0	1.6	1.7	-0.1	0.4	0.7
US	1.5	2.2	2.6	1.3	2.2	1.9
Eurozone	1.8	2.3	2.1	0.2	1.5	1.2
China	6.7	6.8	6.4	2.0	1.6	2.3
India	7.9	6.5	7.5	4.9	3.3	5.5
World (2010 PPPs)	3.2	3.6	3.8	3.0	3.0	2.8

Source: Oxford Economics

SECTOR FORECASTS

The manufacturing sector, following a poor q2, bounced back in the third quarter of the year, expanding by a healthy, and much better than expected, 1.1%. This was its strongest quarterly performance for a year and encouragingly, the pick-up was fairly broad based across sectors, indicative of an industry in good health.

Indeed, manufacturing continues to benefit from a healthy export environment, with strong global demand conditions combining with the weak exchange rate providing a supportive boost to exporters. While exports flourish, the synchronised upturn in global demand, and the resulting boost to business investment, is also supporting capital goods manufacturers, after a period of subdued activity. While we expect the supportive global environment to be maintained, and manufacturing to overall have its strongest year since 2014, expanding by 2.1%, risks do remain for the sector in the year ahead.

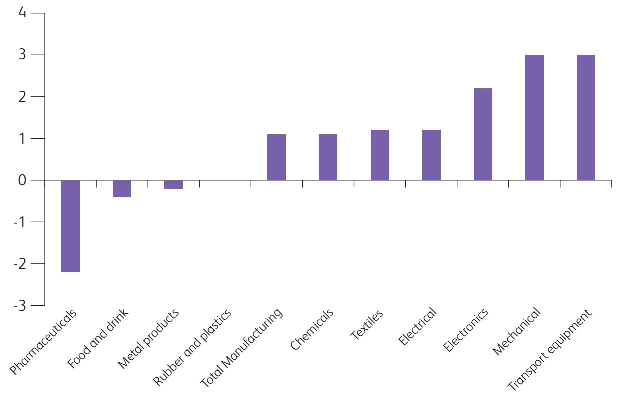
The much documented dynamic of rising inflation and weak wage growth continues to impact on consumer facing sectors, although is expected to be less prominent next year as inflation recedes. Meanwhile the construction sector is struggling amidst Brexit induced uncertainty and rising costs, dragging on a number of intermediate manufacturing sectors in its supply chain. Overall, the next 12 months should see manufacturing slow, along with the whole economy, as the risks highlighted offset some of the gains we are seeing on the back of a strong global economy. Uncertainty regarding the terms of the UK's exit from the EU is also likely to be a defining factor the closer we get to the 2019 leave deadline, and as a result we are forecasting growth of 1.4% in 2018.

INVESTMENT GROWTH AROUND THE WORLD DRIVING CAPITAL GOODS RECOVERY

An increased willingness to invest in response to strong global demand, competitive prices linked to the sterling depreciation, and the recovery in oil prices are all boosting capital equipment manufacturers, topmost among them those in the mechanical equipment sector.

MOST SECTORS SEE GROWTH IN Q3

OUTPUT, % QUARTERLY CHANGE



Source: ONS (2017)

As the chief investment good in UK manufacturing, the **mechanical equipment** sector is perhaps the best barometer of the turnaround in the global capital goods market. The sector had a strong third quarter, expanding by 3%, and is expected to end the year with an impressive annual growth of 6.5%. As well as the revival in capital investment, the sector is being further supported by the strong export picture, given that 43% of final demand is derived from overseas sales. Looking ahead, while we expect these trends to continue next year, heightened uncertainty regarding the Brexit deal is expected to pull back some domestic investments and, as a result, we expect growth in the sector to slow to 1.6% in 2018.

The **electronics** sector is also largely a capital goods sector, and derives the majority of its demand from other businesses, with only a very small portion coming direct from consumers. As a result it has been able to benefit from the upturn in global demand and investment, and has been shielded to a certain extent by the slowing in household spending. We expect growth of 4.2% this year. 2018 should see the sector slow, as the sector's high import intensity in relation to exports weighs on profit margins, and we have pencilled in an expansion of 2.5%.

Similarly the **electrical** equipment sector, following four successive quarters of growth, is set to expand by 4.3%

this year. A number of encouraging prospects emerging from the domestic market and abroad will not be enough to sustain this performance in 2018, however, and we see growth unwinding to 1.2% in 2018.

While the outlook remains broadly positive for capital goods manufacturers, there is one industry that all three feed into, along with a number of other manufacturing sub sectors, which could temper the current optimism – construction.

WEAKNESS IN CONSTRUCTION TO HIT MANUFACTURERS IN SUPPLY CHAIN

The construction sector, after a strong start to the year, has seen its fortunes take a turn for the worse with two successive quarters of contraction and is now, by definition, in a recession. The industry is struggling as the fall in new orders seen during the second half of 2016 is now starting to feed through to activity on the ground, with commercial office projects in particular suffering. While housing policies set out in the recent Autumn Budget should help to offset some of the risks, uncertainty remains regarding a number of high profile projects, while rising costs on the back of the sterling depreciation is also a concern for contractors. These factors are likely to effect a number of manufacturing sub sectors in its supply chain.

With 63% of intermediate demand coming from construction, **non-metallic minerals** is perhaps the most exposed sector to trends in construction activity. As a result, to reflect the weaker outlook as well as a winding down effect following an impressive 2016, we see the sector contracting by 2.4% and 1.2% in 2017 and 2018 respectively. Likewise the **chemical** 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. Combining this with rising oil prices, and we are forecasting growth to soften from 3.4% this year, to 1.4% next. Meanwhile **rubber and plastics**, which generates nearly a third of intermediate demand from construction is set to suffer this year, contracting by 2.1%, before picking up slightly next year as manufacturers take advantage of the drive to more environmentally friendly products.

SECTOR GROWTH RATES AND FORECASTS

% CHANGE

	OUTPUT			EMPLOYMENT		
	2016	2017	2018	2016	2017	2018
Basic metals	-12.1	1.1	0.3	-1.8	-8.3	-1.9
Metal products	0.9	-1.6	1.3	3.1	3.4	-0.7
Mechanical	0.7	6.5	1.6	-1.9	3.4	-0.7
Electronics	0.0	4.2	2.5	-1.4	3.6	1.8
Electrical	-4.9	4.3	1.2	-1.3	1.2	0.9
Motor Vehicles	4.5	1.5	0.1	0.1	3.8	0.5
Other transport	2.5	10.0	4.7	2.6	0.9	0.8
Food and drink	1.5	0.2	0.5	0.8	-0.5	-2.5
Chemicals	-2.8	3.4	1.4	1.4	1.9	-3.1
Pharmaceuticals	3.4	-3.9	-0.8	-2.3	8.6	-7.0
Rubber and plastics	-1.2	-2.1	1.7	-7.3	2.1	3.0
Non-metallic minerals	8.1	-2.4	-1.2	5.4	-5.3	-2.0
Paper and printing	-1.7	1.7	0.9	-6.7	-0.8	-0.5
Textiles	-4.4	9.3	-2.6	10.6	-9.5	-2.2
Manufacturing	0.9	2.1	1.4	0.3	0.8	-1.3

Source: EEF and Oxford Economics

Basic metals, another key input into construction, after a couple of dreadful years, looks to be showing signs of recovery. Sterling's depreciation appears to be finally filtering through to the sector, boosting exports, while steel prices are also on the up following the 2015 collapse, and are being further helped by Chinese anti-dumping measures. We therefore expect the sector to expand by 1.1% this year. Next year we do not expect growth to the same extent, given that the sector is still fundamentally struggling from an over-capacity problem, as well as the weakened outlook for construction, with growth softening to 0.3%.

Basic metals are the main input into the **metal products** sector, which should also see construction drag on its performance next year. That said, the sector's greater demand base, including mechanical equipment, should see it post positive growth next year of 1.3%, as it broadly follows manufacturing's wider performance. There is however one other notable consumer facing sector which is set to drag on metal products, automotive.

THE CONSUMER PICTURE IS BLURRED

After a long period of healthy expansion, the **motor vehicle** sector is cooling down. An up and down year should see the sector post its weakest growth (1.5%) since the financial crisis, and we expect this weakness to be sustained into the new year. While Brexit related risks dominate the headlines, and in particular the uncertainties regarding future trading relations with the EU, there is the more concerning issue that the industry has reached saturation point. Healthy year-on-year growth figures, supported by waves of financial incentives, have lost momentum, with domestic demand for cars dwindling. News from around the globe does not provide much support either, with exports down to the US and China, and as a result we are forecasting flat growth (0.1%) next year.

The **food and drink** sector is the sector most exposed to household spending patterns however. As such, rising inflation combined with weak wage growth has put the squeeze on consumers, leading to successive contractions in the last two quarters. That said, given the demand inelastic nature of food and drink products, as well as its strong export performance to the EU, the sector should still post growth of 0.2% this year. Looking ahead, with inflation set to peak and then recede next year, the sector should get some respite and we expect it to expand by 0.5% in 2018.

Like food and drink and motor vehicles, **textiles** also derives the majority of its final demand from consumers. Sterling's depreciation, together with strong global demand, has supported exports while retail sales at home have also managed to hold up. We expect a healthy growth of 9.3% on the back of this two-pronged effect. Shadows are looming over 2018 however. Uncertainties over the future trading relations with the EU – its most important market – as well as a general unwinding effect should see the sector contract by 2.6% in 2018.

OTHER TRANSPORT PROSPERS, WHILE LESS CERTAIN OUTLOOK FOR PHARMACEUTICALS

The plight of the motor vehicle sector is in stark contrast to the **other transport** sector, and in particular aerospace which continues to thrive. An outstanding 10% growth rate is expected this year, and with orders backlogged at record levels, the sector remains in good health going into 2018.

Meanwhile the **pharmaceuticals** sector continues to live up to its reputation and perform erratically. After a terrible q1 and a small recovery in q2, the sector shrank again in the three months to September and we expect an annual contraction of 3.9% for 2017. The EU and United States are the sector's biggest export destinations, however demand also tends to be volatile in these markets. On the domestic front, demand from the NHS is not picking up as many had anticipated, with downward pressures on prices and increased competition from generics impacting the sector. These downside risks have lead us to forecast a small decline of 0.8% next year.

FOCUSED REGIONAL INFRASTRUCTURE INVESTMENT IS KEY TO DRIVING MANUFACTURING GROWTH

Given the rapidly evolving national and global supply chains it is essential that the UK government invests in the building and development of an infrastructure that is fit for the future in order to support manufacturing and general economic growth. World class infrastructure allows businesses to be run from anywhere in the country, linked physically within the UK and to our ports and airports by road and rail and linked digitally within the UK and the world via superfast broadband.

Encouragingly infrastructure is one of the key foundations outlined in the Government's new Industrial Strategy. However, historically the pace of change has been very slow and UK infrastructure appears to be falling behind other leading economies and the demands of the market.

At BDO we believe that to create a truly sustainable and balanced 'new economy' policymakers must focus on fuelling the growth of the geographic and sector powerhouses of the North, the Midlands and surrounding regions – and our New Economy report suggests 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 investment in smart infrastructure to create the right environment for businesses and local communities to flourish.

Better roads and rail links will give the best return if they connect the regions and the regional powerhouses – helping areas on the cusp of sustainable economic success to cement their position and help their businesses to thrive. In uncertain financial times, the Government needs to get the best possible value out of any investment, and some plans will deliver far more value than others.

Governments will inevitably be drawn to larger "legacy type" projects like HS2 but these may not always provide the best value – particularly for the regions. We believe that the Government should also focus on smaller 'shovel-ready' projects that can get off the ground quicker and have a more immediate economic impact. Working on smaller and more targeted infrastructure projects would ensure a greater short-term benefit.

It is critical that local government and businesses are included in a collaborative discussion about what infrastructure would benefit each location to help ensure that smaller, regionally focused infrastructure projects make a real difference to local citizens.

Finally, social infrastructure should not be overlooked – particularly schools and education. If schools are equipped with the right resources, they can deliver a labour force with the right skills and knowledge to drive local job and economic growth. This will not only assist with the on-going skills crisis in the sector but will also ensure talent is evenly spread across the UK.

Digitisation, automation, new materials and new processes are changing the world of manufacturing. These are areas where UK manufacturers have excelled for many years and given the right support and the right investment in infrastructure manufacturing will continue to be the leading sector in the UK economy. But the government needs to act quickly.

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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 1,400 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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