The manufacturers' organisation

In partnership with:

MANUFACTURING OUTLOOK

2017 QUARTER 3

2.7 million employees

£240bn in exports

68% of business R&D

Average wages higher than the rest of the economy

Rotor Rows, taken by Andy Newman at National Oilwell Varco in Manchester, runner-up in the Amateur category of the EEF Photography Competition 2016.

FOREWORD

Lee Hopley
Chief Economist
EEF

Tom Lawton
Head, BDO Manufacturing
BDO LLP

Welcome to the 2017q3 *Manufacturing Outlook* report, in partnership with BDO LLP.

A lot has happened since our last *Manufacturing Outlook* report in June, and political shifts have continued to dominate the domestic agenda. In the past three months the UK has had a snap election which resulted in a minority government, and negotiations on the UK's exit from the European Union officially starting. And none of this appears to have phased the manufacturers in our survey.

In the past three months UK industry appears to have taken more political upheaval in its stride. Our survey shows a strong positive balance of companies reporting rising output over the quarter, with this positive trend consistent across the vast majority of sub-sectors. Indeed the outturn this quarter was a fair bit stronger than firms had been anticipating three months ago.

In what has now become a fairly familiar story since the start of the year, the economic performance of markets outside of the UK continues to be of more interest to manufacturers than political shifts at home. The balance of companies reporting increased export orders has mounted an impressive recovery over the course of 2017; rising from -2% in 2016q4 to +33% in the past three months. While most sectors are upbeat about their fortunes in export markets, basic metals, mechanical and electrical are riding high on the current export wave.

While the headline survey balances provide one positive perspective on manufactured exports, the impact on overall net trade in official statistics has been elusive as growth in imports continues at the same pace. Our survey also shows that manufacturers are rebuilding their margins, taking advantage of the lower value of sterling to support profits.

Nevertheless, improved cashflow, solid demand prospects and another pick up in firm-level confidence over the next year has spurred a strengthening in investment intentions. While companies' capital expenditure plans have been positive since the end of 2016, but perhaps not as positive as might be expected given the strength of output and orders responses. That said investment plans have gained a bit of momentum in the past three months with the response balance picking up to a ten quarter high.

Overall, our report confirms a buoyant picture for manufacturing activity in the latter part of this year. There is a fly in the ointment. While firms are confident about their own performance, the same cannot be said for their optimism about the outlook for the UK economy in 2018. Our UK economy confidence indicator has slipped for the second quarter running. Weak official growth statistics, subdued forecasts from the Bank of England – to name but one – and the inevitable Brexit uncertainty is leading manufacturers to become more cautious in their assessment of future economy prospects. A view we have shared in our own forecasts since the start of the year as we continue to expect growth this year and next, at a tepid 1.6% and 1.3% respectively.

2017Q3 HEADLINES

Our survey balances have been positive, if somewhat undulating in recent quarters. Headline output and orders indicators may have fallen slightly short of expectations last quarter – potentially dampened by a snap election – but they are back up with a bang this quarter. On every measure response balances are both more positive than those recorded in 2017q2 and better than forecast three months ago.

INDICATOR	BALANCE	CHANGE	
Confidence	5.5	↓	Confidence about UK economy over the next 12 months dwindles further
Output	34 %	↑	Output balance advances more than expected
UK orders	22 %	↑	Stronger UK orders balance points to resilience in domestic demand
Export orders	33 %	↑	Overseas demand continues to lead in line with brighter global economy
Employment	25 %	↑	Manufacturers continue to recruit to fulfil order books
Investment	15 %	↑	Investment intentions across the sector strongest since 2015q1

Source: EEF Manufacturing Outlook Survey

A host of private sector surveys have indicated that UK manufacturers had a good first half of the year in 2017. Official data tell a slightly different story, with output contracting by 0.6 % in the second quarter. A deeper dive into the numbers points to a particular weakness in the auto sector, rather than a broad-based deterioration in trading conditions.

And our latest survey corroborates this view. If anything, manufacturers have stepped up a gear going into the second half of the year, with any consequences of snap elections and surprise outcomes outweighed by continuing growth in sales to the rest of the world. A story that was more or less consistent across all manufacturing sub-sectors over the past quarter.

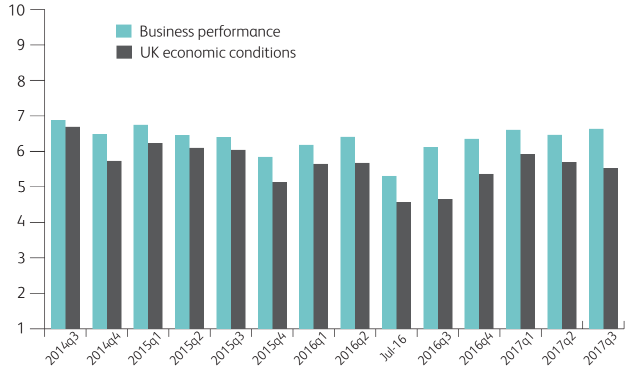
Indeed, in line with the results seen in q1, response balances for output, new orders and export sales are back at historically high levels and look set to maintain momentum into the final months of the year. The export surge has undoubtedly been supported by recent growth in the eurozone; the region has seen the best first half of the year since before the financial crisis. And three-fifths of manufacturers have noted good demand conditions in the region over the past three months.

Also on the up are recruitment plans. Manufacturers' seemingly insatiable demand for skills is continuing in the second half of the year. In addition to increased investment plans, recruitment balances for companies large and small are holding firmly in positive territory.

The outlier in our headline table above is confidence about the UK's economic outlook. In the face of solid demand at the firm level, the weakening in the pace of growth that is becoming more evident in official statistics has not gone unnoticed by the respondents to our survey, and our forecasts share their caution about the likely trajectory of GDP over the next 12 months.

FIRM LEVEL OPTIMISM BUT CONFIDENCE ABOUT UK OUTLOOK FALTERING?

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



Source: EEF Manufacturing Outlook Survey

OUTPUT

The loss of momentum in the output balance we noted last quarter was temporary as balances resumed their climb further into positive territory over the past three months. The softening in intermediate goods last quarter, driven by some election-related uncertainty in the construction sector has reversed. In addition output balances in the hard-pressed basic metals industry have rebounded strongly.

These emerging bright spots come on top of the benefits seen in other sectors from the increased activity in overseas markets.

PAST THREE MONTHS	↑	34 %
NEXT THREE MONTHS	↑	29 %

The balance of companies reporting an increase in output over the past three months has shot up to 34 % from 26 %, beating last quarter's expectations of output balances remaining steady in the third quarter.

While there is still some variation, sub-sector differences over the course of this year have been less apparent than in recent years. For the third quarter running positive output balances have been reported across all of the main sectors covered in our survey – though the drivers of these buoyant trends vary.

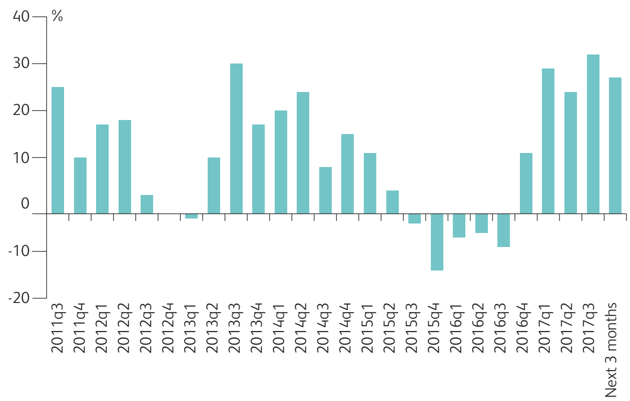
The biggest jump in performance is seen in basic metals, with a massive 68 % balance of companies in the sector recording output growth in the past three months, with a similar balance expecting the same again in the final months of 2017. The recovery in metals prices, competitive pound and an improved outlook for construction are creating considerably better conditions for growth than the sector has seen for some time.

Other construction facing sectors such as metal products and rubber and plastics have seen output balances hold firm in the past three month, though the former expects output to shift down a gear in the next quarter. This is possibly a result of some question marks about the strength of automotive demand.

While the official statistics created a more downbeat view of activity in the second quarter of this year, hefty contractions were limited to the motor vehicles sector. We should therefore expect to see some recovery in the official output numbers in the coming months.

OUTPUT BALANCE GAINS MOMENTUM IN 2017Q3

% BALANCE OF CHANGE IN OUTPUT



Source: EEF Manufacturing Outlook Survey

OUTPUT SUMMARY

% BALANCE OF CHANGE

SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS
Basic metals	68	60
Metal products	34	6
Mechanical	21	39
Electrical	54	40
Electronics	37	27
Rubber & Plastics	45	45
Other transport	17	33
TURNOVER		
£0-9m	27	21
£10-24m	33	33
£25m and over	44	47

Source: EEF Manufacturing Outlook Survey

ORDERS

Manufacturers' order books continue to look healthy in 2017q3. In the past three months export sales balances have seen further gains, pushing the total orders balance to historic highs. The domestic orders picture, while also positive, does look more modest in comparison but remains significantly above its long run average.

This quarter could, however, mark a peak with forward looking expectations indicating that manufacturers are expecting more of the same rather than another growth spurt in the final quarter of 2017.

UK ORDERS	PAST 3 MONTHS	↑	22%	NEXT 3 MONTHS	↑	18%
EXPORT ORDERS	PAST 3 MONTHS	↑	33%	NEXT 3 MONTHS	↓	21%
TOTAL ORDERS	PAST 3 MONTHS	↑	37%	NEXT 3 MONTHS	↑	30%

UK ORDERS

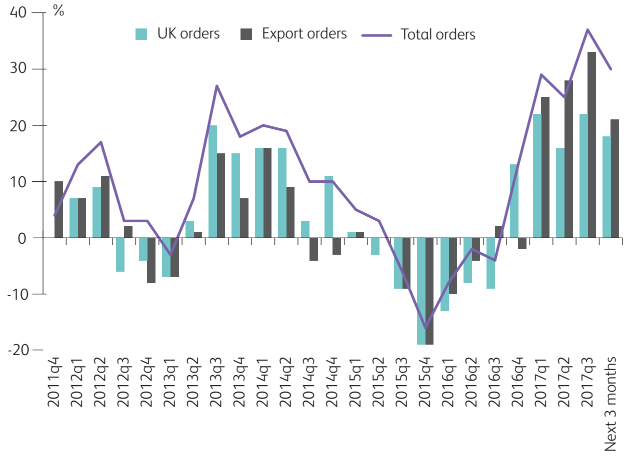
The domestic demand environment in the first half of this year has been characterised by concerns about a softening in consumer demand as rising inflation bears down on real incomes. There are limited signs of this significantly hampering new order intake for manufacturers. UK orders balances continued to be positive across the sub-sector spectrum over the past three months.

Underpinning the surge in the basic metals output balance, reported in the previous section, is a similarly large rebound in the proportion of companies in the sector experiencing an increase in domestic orders over the quarter. The resulting net balance of 63% is a far cry from the flat UK orders balance reported this time a year ago and should contribute to on-going output growth over the remainder of 2017. The uptick in construction activity which will be part of the positive basic metals story will also be supporting solid UK sales in the metal products sector, which has seen the domestic orders balance pick up from last quarter.

Of the sectors showing a below average UK orders picture, the investment goods sectors dominate. While the UK sales balances for electronics and mechanical equipment have shown some improvement from the previous quarter, the relatively subdued investment trends in the home market will currently be keeping a lid on growth in new domestic orders. Though there are some signs this could change in the latter part of this year with mechanical equipment firms noting a more positive outlook for UK demand in the next quarter and the pick-up in investment plans seen in our own survey (see page 6 for more detail).

EXPORTS CONTINUE TO THRIVE, WHILE DOMESTIC ORDERS ALSO REMAIN HEALTHY

% BALANCE OF CHANGE IN ORDERS



Source: EEF Manufacturing Outlook Survey

EXPORT ORDERS

In contrast to the slightly softer domestic picture for investment goods sectors, export demand is faring much better. Electronics and mechanical equipment have both recorded a stronger sales picture from overseas markets. For both the recovery in manufacturing activity and corresponding pick-up in Europe is noted as being positive for demand. Additionally, mechanical equipment manufacturers are particularly upbeat about US demand, while electronics firms are clearly seeing demand benefits from an improved outlook in Asia.

Our latest results show continued improvements in demand across Asian markets for the sector as a whole. The proportion of manufacturers identifying positive demand conditions in the region increased for the second quarter running and stood at 29% in the past three months.

However, it is EU prospects that continue to stand out. Three-fifths of companies reported positive demand conditions across the UK's largest market in 2017q3, virtually unchanged from the previous quarter and up from 47% a year ago.

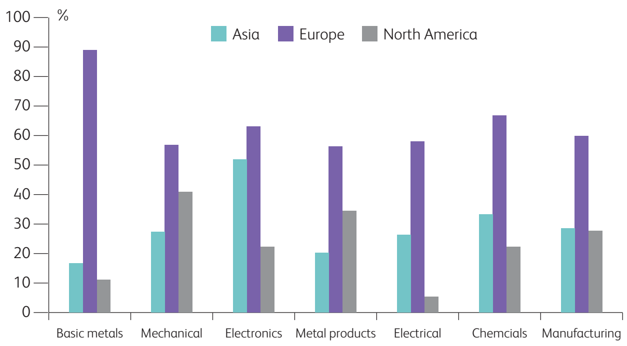
This sentiment stacks up with a growing body of evidence pointing to on-going recovery in Europe. For example manufacturing PMIs are firmly in expansionary territory and eurozone GDP increased at twice the rate of that in the UK in the second quarter of the year.

The chart below shows that most sectors are capitalising on this and the weaker exchange rate. In particular companies in the basic metals sector – 89% of which have seen solid demand there over the quarter – are seeing European markets play a major role in supporting export sales.

Will these trends persist? We should expect to see more growth in overseas sales as the forward-looking balances remain firmly positive, but almost all sectors' export balances for the next three months are down compared with the current quarter. This judgement aligns with our forecast assumptions that the global economy is in better health in 2017, but the pace of acceleration looks set to ease over the next year. Furthermore, the risks emanating from US politics and Chinese debt, to name but two, will also be on the radar of UK exporters.

POSITIVE EU DEMAND DOMINATES

% OF COMPANIES REPORTING POSITIVE DEMAND CONDITIONS BY MARKET



Source: EEF Manufacturing Outlook Survey

ORDERS SUMMARY

% BALANCE OF CHANGE

	UK ORDERS		EXPORT ORDERS		TOTAL ORDERS	
SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS
Basic metals	63	58	61	57	72	60
Metal products	23	6	18	9	30	16
Mechanical	14	24	27	13	31	34
Electrical	28	25	46	36	62	40
Electronics	16	3	23	29	28	31
Other transport	-33	50	50	50	17	50
TURNOVER						
£0-9m	17	15	21	14	35	26
£10-24m	19	20	32	25	30	33
£25m and over	23	29	33	34	29	35

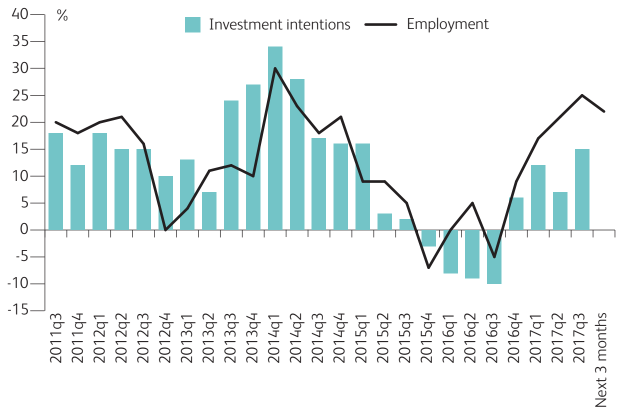
Source: EEF Manufacturing Outlook Survey

EMPLOYMENT & INVESTMENT

The balance of companies taking on more employees rose for the fourth consecutive quarter in 2017q3, reaching a three year high in the process, confirming that the recovery in manufacturing employment is firmly on track. This rise in recruitment activity is not that surprising, given the multi-year high output and order balances recorded in our survey, and encouragingly the positive news is extended to investment, where capital expenditure plans also rose, and have now been rooted in positive territory for the past twelve months.

EMPLOYMENT BALANCE AT A THREE-YEAR HIGH, INVESTMENT INTENTIONS GAIN MOMENTUM

% BALANCE OF CHANGE



Source: EEF Manufacturing Outlook Survey

EMPLOYMENT	PAST 3 MONTHS	↑	25%	NEXT 3 MONTHS	↑	22%
INVESTMENT	NEXT 12 MONTHS	↑	15%			

A balance of 25% of manufacturers reported an increase in headcount over the last three months, up from 21% in the previous quarter, as manufacturers increasingly took on more workers to help meet their growing demand requirements. The employment gains were also reassuringly broad based across sectors, with all but two sectors posting double digit employment balances.

Special mention must however go the basic metals sector, where the headcount balance has almost trebled over the last three months, as the sector continues its recovery following a calamitous 2015 and 2016.

Capital goods manufacturers are also benefiting from the upturn in global demand and resulting boost to global investment, and this is reflected in them taking on more workers to fulfil their busy order books. Looking ahead, employment gains are expected to lose some momentum, both at the UK level and across sectors. Nevertheless the balances are set to remain healthy and at sustained levels not seen since 2014.

Investment prospects have also had a strong quarter, with capital expenditure plans more than doubling from a balance of 7% to 15%. The improvement was once again widespread across sectors, with some of the biggest gains coming in the capital goods sectors, in line with buoyant demand prospects, as well as in construction related sectors as major projects were given the go ahead. Whether these balances will be sustained over the coming year, given the uncertainty surrounding the terms of the UK's exit from the EU, remains to be seen.

EMPLOYMENT AND INVESTMENT SUMMARY

% BALANCE OF CHANGE

	EMPLOYMENT		INVESTMENT
SECTOR	**PAST 3 MONTHS**	**NEXT 3 MONTHS**	**NEXT 12 MONTHS**
Basic metals	64	64	32
Metal products	18	9	4
Mechanical	25	20	23
Electrical	31	8	4
Electronics	30	36	14
Other transport	33	17	20
TURNOVER			
£0-9m	18	20	20
£10-24m	23	21	21
£25m and over	33	27	16

Source: EEF Manufacturing Outlook Survey

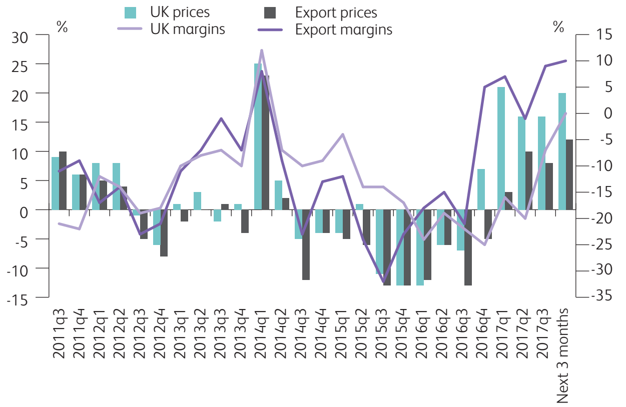
PRICES & MARGINS

Following some rapid increases in the price balances, which started towards the end of last year, it seemed balances were starting to ease in our 2017q2 survey. While we've seen some further moderation in export price balances over the past three months, further depreciation of sterling in recent months is expected to prompt more price increases in the final quarter of the year.

Past increases are now having their desired effect on profits with a notable improvement in margins on sales both at home and abroad over the past three months.

ANOTHER WAVE OF PRICE INCREASES TO COME?

% BALANCE OF CHANGE



Source: EEF Manufacturing Outlook Survey

UK PRICE	PAST 3 MONTHS	↔	16%	NEXT 3 MONTHS	↑	20%
EXPORT PRICE	PAST 3 MONTHS	↓	8%	NEXT 3 MONTHS	↑	12%
UK MARGINS	PAST 3 MONTHS	↑	-7%	NEXT 3 MONTHS	↑	0%
EXPORT MARGINS	PAST 3 MONTHS	↑	9%	NEXT 3 MONTHS	↑	10%

The pace of pass through of exchange rate-related cost increases and some higher commodity prices remained stable in the UK and eased further on export sales over the past three months. Still firmly in the black, the UK price balances indicate that there remains some price pressure in the supply chain.

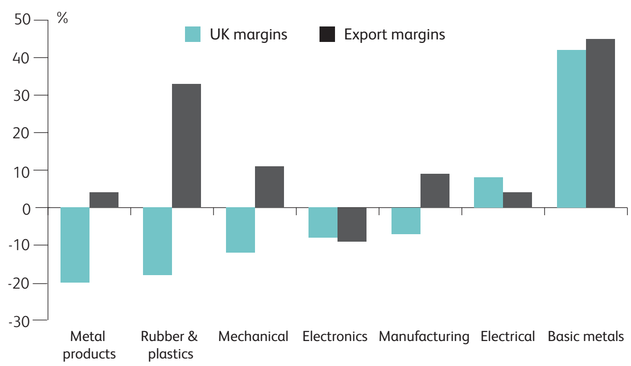
Once again the basic metals industry stands out, with a massive 67% of companies increasing prices on UK sales in the past three months on the back of increases in global metals prices. Other sectors noting elevated UK price balances in the past quarter were chemicals and rubber and plastics. Both having likely seen some impact from past commodity price increases.

While there has been some moderation in UK price balances in other parts of manufacturing, the outlook for the next three months is the return of some pricing pressure. Over the past quarter we have seen further falls in sterling, especially against the euro, which will create another wave of increased input costs.

Importantly there have been gains in margins at home and on export sales. Indeed export margins have been in positive territory for three out of the past four quarters. While companies are banking some of the gains from exchange rate movements and stronger growth in overseas markets, the challenge of building market share remains.

SOME SECTORS REBUILD MARGINS

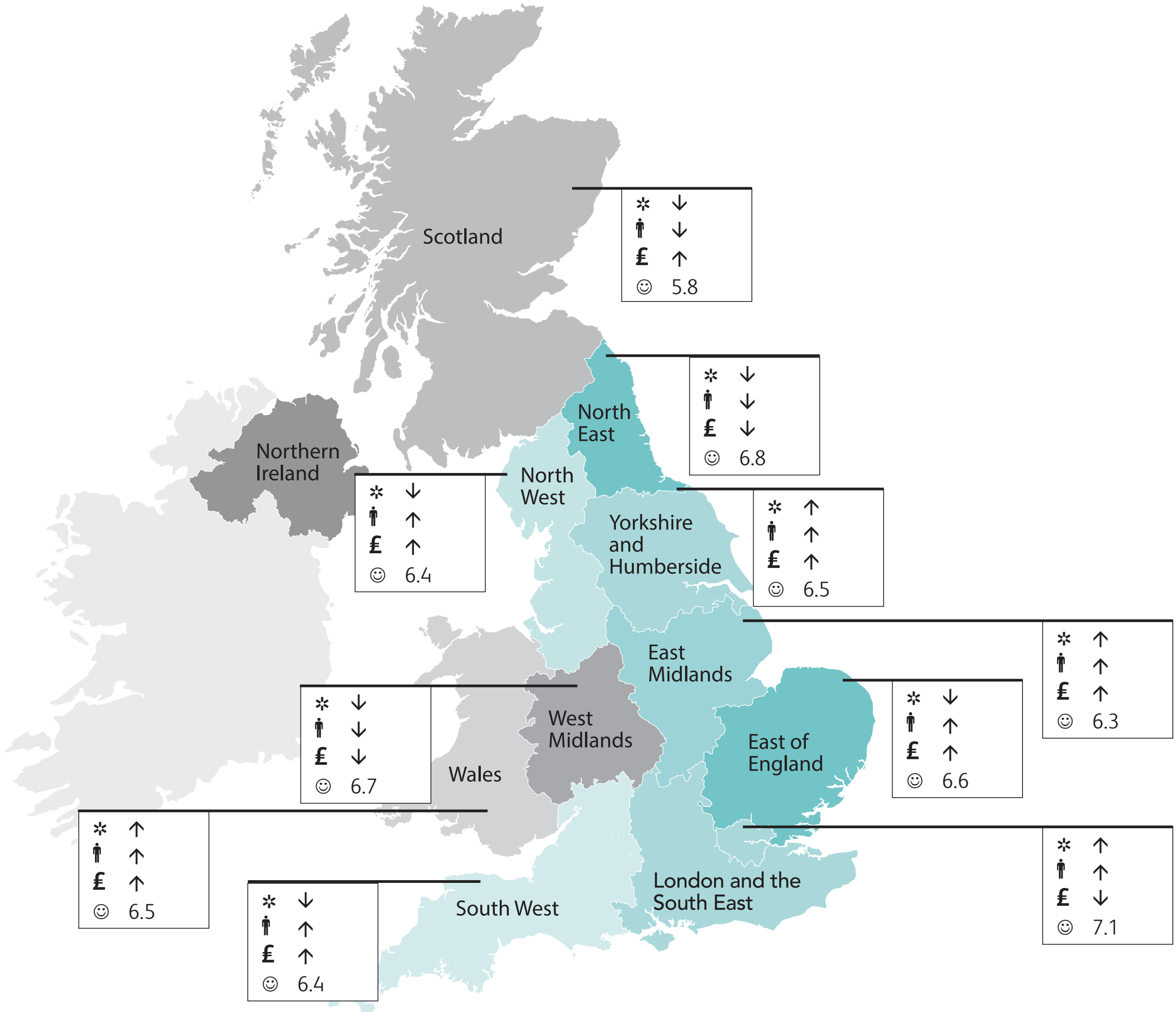
% BALANCE OF CHANGE IN MARGINS IN THE PAST THREE MONTHS



Source: EEF Manufacturing Outlook Survey

REGIONAL

The positive trends we are seeing across manufacturing in production, orders, employment and investment, are encouragingly reflected at the regional level. Indeed, the last three months has seen positive response balances for all of our key indicators, across every region, building on the momentum seen last quarter and confirming that the upturn in manufacturing activity is broad based across the UK.



KEY:

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

Source: EEF Manufacturing Outlook Survey

The balance of companies reporting rising production levels, while not improving in every region, remain strong and robust across the board, illustrating the relative health of the sector. In a number of cases where the balances have dropped, notably in the West Midlands and South West, these have been from multi year highs in the previous quarter, and are at least partially due to an unwinding effect. Looking ahead, the output balances are set to remain positive and stable, and point to a strong second half of the year overall.

This is backed up by strong order balances, which should sustain output growth across the regions. The only exception to this being the North East, whose order balance of +6% was considerably weaker than all other regions, and reflected weaker domestic demand, albeit offset to a certain extent by a strong export performance. While a lot less prominent, this trend is seen across most regions, with domestic order balances considerably lower than export balances, as manufacturers take advantage of strong global demand and the weak exchange rate.

Positive output and order balances, and the general strong activity in the sector, are unsurprisingly encouraging manufacturers to take on more workers. Employment balances are positive in all regions, and up compared with last quarter in all bar three – Scotland, the West Midlands and the North East. There is a considerably more mixed picture across investment however – with regions such as the East Midlands and South West recording historically high balances (+48% and +47%), while the East of England struggles to move into double digit balances. That said this is the first time since 2015q2, that no region has recorded a negative investment balance, and is indicative of the upturn in the sector.

BUSINESS CONFIDENCE INDICATORS

Manufacturers' confidence around their business have picked up considerably since the latter stages of 2016, and in the latest three months, responses have happily held up. In fact confidence was up in six of the ten regions, and broadly back up to their pre Brexit levels. The same level of optimism is not being felt with regards to the UK economic outlook however, with the overall UK indicator dropping across every region, and well below the business confidence indicators. While business and activity is good, the wider risks to the future economy, especially with regards to the ongoing Brexit negotiations, have not escaped manufacturers' minds.

UK ECONOMIC OUTLOOK WEAKER 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	
SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS
Scotland	20	18	28	18	19	9
North East	18	44	6	33	19	38
North West	17	29	41	32	29	44
Yorks & Humber	39	31	31	20	26	26
East Mids	33	38	30	42	30	20
Eastern	32	27	33	27	9	10
South East & London	52	37	38	38	26	32
South West	31	21	32	32	24	21
West Mids	32	40	30	33	22	14
Wales	40	13	36	36	20	7

Source: EEF Manufacturing Outlook Survey

ECONOMIC ENVIRONMENT

The UK economy, in line with expectations, slowed over the first half of the year. GDP grew by a modest 0.3 % in 2017q2, only slightly up from the lacklustre 0.2 % expansion seen in q1. This represents a notable slowdown from the 0.7 % growth seen across the latter stages of 2016, and is reflective of a subdued economic environment, one year on from the referendum. As a result of the economy's poor start to the year – the weakest opening half in five years – we have revised down our forecasts for 2017 from 1.8 % to 1.6 %. We expect the weakness to persist in 2018, pencilling in an expansion of 1.3 %.

UK HEADLINES

- UK GDP grows modestly in 2017H1, but contributing factors have shifted
- Inflation remains above target and is expected to peak at 3 % in autumn
- Investment, despite growing, is subdued given current global conditions
- Wage growth continues to disappoint

While we have revised down our forecasts marginally for 2017, the narrative behind them remains broadly the same as in our last *Manufacturing Outlook* report. Rising inflation and anaemic wage growth will continue to be the driving force behind the slowdown, despite the effects not appearing to be quite as prominent in recent figures.

Meanwhile, the outlook for investment continues to provoke debate, while net trade, despite favourable export conditions, has not made the positive contribution to growth many were expecting. Which path the economy follows over the course of the next 12 months, and in particular inflation's trajectory, will determine the Bank of England's interest rate setting, which currently remains at a record low of 0.25 %.

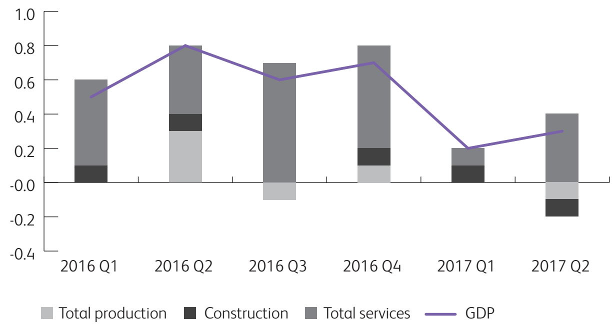
CONTRIBUTING FACTORS TO GDP GROWTH HAVE SHIFTED

In q2 the service sector picked-up to expand by 0.5 % from a weak 0.1 % in the previous quarter. This expansion was behind the economy's growth, and reflected a pick-up in consumer spending, on the back of an enduring strong labour market, as well as supportive credit conditions. That said, this was still a sub-par performance compared to that of recent times, and with inflation expected to rise further, peaking at around 3 % in the autumn, and wage growth to remain stubbornly weak, we expect household consumption and real incomes to remain subdued this year and next, dampening growth in the process.

While a 0.5 % expansion is a poor showing for the dominant service sector, it is still growth. The same could not be said elsewhere. The production sectors – manufacturing and construction – both disappointed in q2, falling by 0.6 % and 1.3 % respectively. Nevertheless, both sectors are set to see improvement in the near term, with manufacturing in particular benefiting from strong global demand and a supportive export picture, illustrated further by healthy PMI readings.

GDP GROWTH HAS SLOWED IN 2017

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



Source: ONS

INVESTMENT REMAINS SUBDUED

Little has changed in our forecasts for the future direction of business investment. While the strength of global demand, combined with the low cost of capital has encouraged firms to invest to expand capacity, this is being offset, to a certain extent, by Brexit induced uncertainty. As a result, taken as a whole, investment has been considerably weaker than one would expect given the favourable global climate, and we believe this is unlikely to improve over the coming year. We see investment growing slightly this year, before dragging on GDP growth in 2018, the closer we get to the deadline for leaving the EU. Conversely net trade, despite not contributing to growth this year, should reverse this trend and contribute positively in 2018.

THE "WAGE PUZZLE"

Despite the economic narrative changing little in the last three months, there is one aspect of the UK economy that continues to be a source of confusion for economists and policy makers alike – the weak performance in wage growth. With the unemployment rate dropping to 4.4%, its lowest level for 42 years, and the employment rate at a record high, conventional economic theory says wages should rise, as the labour market tightens and workers' bargaining powers increase. This has not materialised yet, with wage growth remaining weak and below inflation, resulting in negative real wage growth in four of the last five months. This will continue to dampen household spending and drag on the economy in the near-term, with no universally accepted explanation apparent for the cause.

UK ECONOMIC FORECASTS

% CHANGE EXCEPT WHERE STATED

	2016	2017	2018
Trading environment			
Exchange rate (€/£)	1.22	1.18	1.20
Exchange rate ($/£)	1.35	1.27	1.28
Exports	1.8	3.1	3.0
Imports	2.8	2.9	1.7
Current account (% GDP)	-4.4	-3.1	-2.4
Output			
Manufacturing	0.7	1.0	0.5
GDP	1.8	1.6	1.3
Costs and prices			
Average earnings	2.5	2.2	2.4
Oil price (Brent Oil $/bl)	43.5	48.3	45.5
Employment			
Manufacturing (000s)	2635	2634	2602
Rest of economy (000s)	31,726	32,017	31,994
Unemployment rate (%)	4.9	4.5	4.7

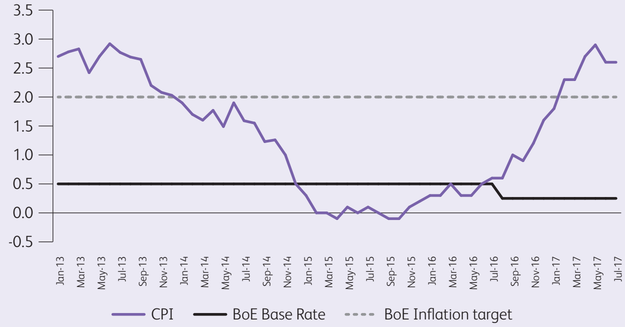
Source: Oxford Economics and EEF

MPC SPOTLIGHT

In its August meeting, the MPC voted by 6-2 to keep interest rates on hold at their record low level of 0.25%. Given the sluggish growth data, and weak domestic generated inflation, this did not come as too much of a surprise. Yet the question still remains, when will the Bank start normalising interest rates? It is now over 10 years since the Bank raised rates, and over a year since the latest emergency measures were implemented.

With inflation set to peak and then recede towards the end of 2017 and labour conditions expected to remain supportive, the future wage picture is likely to be a decisive factor in which way MPC members vote. The Bank does expect wages to rise next year, and there were some very tentative signs of this in the most recent data. As a result, a rate hike in the early part of 2018 is not out of the question, but this is not currently our central view.

MPC CONTINUE TO KEEP INTEREST RATES ON HOLD



Source: ONS and BoE

GLOBAL ECONOMY

- Global demand picks-up as business investment comes back online
- Eurozone on course for strongest annual growth since financial crisis
- US economy continues to gather momentum
- China's growth picks up in H1, but signs of slowing ahead

Healthy global demand conditions, and the notable recovery in business investment, means global growth remains on track to pick-up in 2017, following last year's relative trough. Indeed, we expect the global economy to expand by 3.6% this year and 3.7% in 2018, up from the 3.1% recorded in 2016.

The positive global picture is reflected in the eurozone, where quarterly growth figures have been healthy and robust across countries, and are set to contribute to an overall growth of 2.1% in 2017. This would be the strongest year on year growth since the financial crisis and is accounted for by stronger domestic demand, in particular the revival in business investment on the back of a more stable political environment.

The ECB's ultra-loose monetary policy – it has kept interest rates on hold at 0% - as well as its asset purchasing scheme, have also helped to boost household consumption, while a strong labour market has seen unemployment for the bloc drop to 9.1%, its lowest level for 8 years. Positive sentiment across the bloc is further highlighted by healthy survey data, which has been buoyant throughout the year, and we expect the improved outlook to continue throughout H2.

Meanwhile, growth in the US continues to gain momentum. GDP grew by 3% in the three months to June and is expected to average out at 2.1% for the year as a whole, a noticeable uptick from 1.5% growth seen in 2016. Firm business investment, together with a strong labour market, has seen confidence in the economy improve, and hence further interest rate hikes in the coming 12 months are expected by the Fed.

China, after a number of years of slowing growth, has had a strong first half of the year, and is one of the main contributors behind the improved global outlook. The economy expanded by 6.9%, in both q1 and q2, an improvement on last year's overall expansion of 6.7%. This performance, which if it continues will mark the first year growth has accelerated on the previous year since 2010, comes on the back of strong industrial production, reflecting the strength of global demand, as well as a thriving property market.

However, there are concerns whether this growth is sustainable, notably from the IMF, who have issued a warning that China's credit fuelled economic strategy, and the resulting build up in public and private debt, represents a risk to its financial stability. Furthermore, recent months have also seen a loss of momentum in Asian trade flows. All of which points to a less optimistic second half of the year for China, and as a result could dampen the current positive global outlook.

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	0.9
Germany	1.9	2.1	2.0	0.5	1.7	1.8
Japan	1.0	1.4	1.3	-0.1	0.4	0.7
US	1.5	2.1	2.4	1.3	1.9	1.7
Eurozone	1.7	2.1	1.9	0.2	1.5	1.3
China	6.7	6.8	6.2	2.0	1.5	2.0
India	7.9	6.9	7.4	4.9	3.5	5.5
World (2010 PPPs)	3.1	3.6	3.7	2.9	2.6	2.6

Source: Oxford Economics

SECTOR FORECASTS

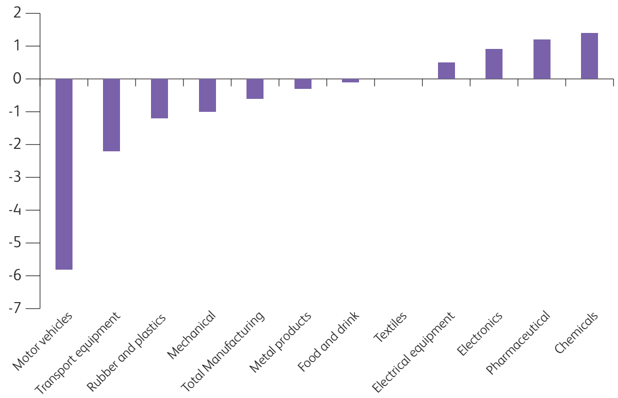
The manufacturing sector, following a robust start to this year, slowed considerably in 2017q2. Output contracted by 0.6 %, its weakest performance for three quarters and a far cry from the 1.2 % expansion enjoyed over the back end of 2016. However, it should be noted that the fall in output was almost entirely down to weak production in the motor vehicle sector, and as such, the official figures do not match with the rather more buoyant private survey data, including our own, which points to the sector being in better shape.

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 continue to flourish, the pick-up in global demand, and the expected boost to business investment globally, should also support capital goods manufacturers.

Despite this, risks do remain. Whilst the weak exchange rate has supported exports, the flipside of rising input costs and the associated rise in inflation, combined with weak wage growth, is affecting some consumer facing sectors. Elsewhere, intermediate goods manufacturers, particularly those in the construction supply chain have had a rocky start to the year, but we expect these sectors' fortunes to improve. Overall, given these factors, and to reflect the weaker than anticipated second quarter, we have revised down our forecasts for manufacturing growth from 1.3 % to 1 % this year. We still expect manufacturing to slow further in 2018, expanding by 0.5 %, on the back of rising Brexit uncertainty, the closer we get to the 2019 leave deadline.

OUTPUT BY MANUFACTURING SUB SECTOR 2017Q2

OUTPUT, % QUARTERLY CHANGE



Source: ONS (2017)

A MIXED PICTURE FOR CONSUMER FACING GOODS

The **food and drink** sector is perhaps the most heavily exposed sector to household spending patterns, given that almost two thirds of final demand is derived from consumers. As such, rising inflation, combined with weak wage growth has seen growth in the sector stall in recent quarters. Despite this, the demand inelastic nature of food and drink protects the sector from any substantial falls in output, and we expect the sector to recover in the second half of this year and next, as inflation begins to recede. We have pencilled in growth of 0.4 % for 2017 and 0.9 % in 2018.

Textiles also derives the vast majority of its final demand from consumers, but unlike food and drink, the sector also has a significant export presence. Sterling's depreciation, together with strong global demand has seen exports surge over the first half of the year, offsetting weaker consumer spending at home. However, with signs that momentum is beginning to slow, especially amongst trade flows to the EU, we do not expect the recent pace of expansion to continue. We are forecasting growth to slow in the remainder of the year to post 4.6 %, before contracting by 4.5 % in 2018.

After a number of years of healthy expansion, the **motor vehicle** sector has come off the boil considerably in 2017, and was almost single-handedly responsible for manufacturing's weak performance in 2017q2, contracting by 5.8%. While part of this contraction is likely to be a temporary phenomenon, a result of consumers bringing forward their car purchases ahead of changes to vehicle excise duty, there appears to be more concerning underlying issues effecting the sector. Indeed, exports to both the EU and US are down considerably, and there are general signs that demand for cars globally is waning. As a result, we expect the current weakness in the sector to be sustained, contracting by 1.2% and 1.4% over 2017 and 2018.

REVIVAL IN INVESTMENT IS SUPPORTING CAPITAL GOODS

Capital investment, after a number of years of subdued activity, has picked-up over the last year. Strong global demand, combined with some recovery in activity in the oil and gas industry, is encouraging manufacturers to invest and expand capacity in order to meet growing demand. This is turning around the fortunes of capital goods manufacturers.

The **mechanical equipment** sector has taken full advantage of this turn around. Despite contracting slightly in q2, the sector had seen four consecutive quarters of expansion leading up to this, including a particularly strong q1 in which it grew by 3.5%. The sector is being further supported by the strong export picture, given that 44% of the sector's final demand is derived from exports. As such we expect the sector to continue to perform well this year, expanding by 5.1%. Growth should temper in 2018 as business turns more cautious the closer we get to the EU exit deadline, and this is reflected in our 0.9% growth forecast for 2018.

The **electronics** sector is also largely a capital good, but holds a significantly more diverse demand base. As a proxy investment good, the upturn in global demand is boosting the sector, while exports continue to gain momentum after a strong start to the year. As a result we see the sector growing by 2.7% this year, before slowing to 0.2% in 2018.

SECTOR GROWTH RATES AND FORECASTS

% CHANGE

	OUTPUT			EMPLOYMENT		
	2016	2017	2018	2016	2017	2018
Basic metals	-12.4	3.3	2.2	-7.7	-4.5	-0.9
Metal products	0.8	-0.5	1.5	3.7	3.2	-0.6
Mechanical	-1.2	5.1	0.9	-2.7	4.2	0.9
Electronics	-1.0	2.7	0.2	0.4	-0.5	-1.3
Electrical	-5.7	1.4	0.2	-2.8	-1.1	-0.6
Motor Vehicles	4.3	-1.2	-1.4	-2.2	2.8	-0.7
Other transport	2.3	5.9	3.2	1.6	-0.4	-0.3
Food and drink	1.0	0.4	0.9	0.7	0.0	-1.3
Chemicals	-2.5	2.7	-0.2	2.3	2.1	-4.7
Pharmaceuticals	4.0	-3.6	0.8	-0.6	2.7	-5.0
Rubber and plastics	-1.0	0.1	2.6	-4.8	3.8	0.9
Non-metallic minerals	8.4	-1.2	-0.7	1.1	-4.9	-3.8
Paper and printing	-1.5	2.0	0.5	-6.1	-1.3	-1.5
Textiles	-4.0	4.6	-4.5	2.9	-7.2	-6.5
Manufacturing	0.7	1.0	0.5	0.3	0.9	-0.9

Source: EEF and Oxford Economics

In a similar position is the **electrical equipment** sector. While exports have been very impressive, up 54% to China, and 8% overall in q2, the sectors high import intensity, as well as its household goods segment, should drag on the sector given the inflation and wage growth dynamics in play. As a result we see an expansion of 1.4% this year, before growth tempering to 0.2% in 2018.

SECTORS IN CONSTRUCTION SUPPLY CHAIN SHOULD SEE A PICK-UP IN H2

The construction sector saw output fall by 1.3% in q2. To some extent this was expected, with the snap general election likely putting on hold a number of projects. However, with a healthy pipeline of work, including urgent maintenance in light of the Grenfell Tower fire, as well as major construction projects such as HS2 and Thames Tideway Tunnel getting underway, the industry should post growth this year, boosting a number of manufacturing sub sectors.

The outlook for the **non-metallic minerals** sector is particular dependent on construction activity, with 62% of its intermediate consumption supplied to the industry. However, after an outstanding 2016, in which the sector expanded by 8.4%, we expect to see a winding down this year and next, despite the construction sector's improved outlook. **Rubber and plastics** though, where almost a quarter of output goes into construction, should benefit from the industry's improved performance in H2. We expect the sector to post slight growth of 0.1% this year, after two consecutive years of contraction.

The **metal products** sector is also a key input in the construction supply chain, and should benefit from its pick-up in activity. The sector inputs to a wide range of other sectors, including mechanical equipment, where the revival in business investment should provide further support. Conversely, motor vehicles, another key destination for metal products is set to drag on the sector as it continues to grapple with its own difficulties. Overall, despite the improved outlook for H2, its poor start and the resulting arithmetic effects have us forecasting a small contraction of 0.5% for 2017. We expect the sector to continue to build on its momentum throughout the second half of the year however, and post growth of 1.5% in 2018.

Basic metals, after a horror past few years, looks to be showing signs of improvement. Sterling's depreciation appears to be finally filtering through to the sector, with exports up 4.5% in the opening half of the year, and this trend is expected to continue. Meanwhile steel prices are also on the up following 2015's collapse, and are being further helped by Chinese anti-dumping measures. We therefore expect the sector to post growth of 3.3% this year, and 2.2% next, as the recovery continues.

OTHER TRANSPORT CONTINUES TO THRIVE, WHILE RISKS REMAIN FOR PHARMACEUTICALS

Other transport, and in particular the aerospace sector, continues to be a source of good news for UK manufacturing. An insatiable demand for air travel, which has seen a record backlog of engine orders, as well as a surge in demand for single aisle aircraft, means the sector continues to thrive. We expect output to continue to expand at healthy rates over the next two years – forecasting expansions of 5.9% and 3.2% in 2017 and 2018.

Meanwhile the notoriously erratic **pharmaceuticals** sector, which saw a large contraction at the start of the year as major corporations were hit by a patent cliff, looks to be picking up, with exports and activity improving over the last three months. However, this will not be enough to offset the near 10% fall in q1, and so we are forecasting a 3.6% contraction in 2017. Looking ahead, while we expect the sector to recover to post growth of 0.8% in 2018, uncertainty regarding the NHS's pricing review of pharmaceuticals, given that the NHS's drug bill is over £16 billion, represents a downside risk to the sector.

IT IS VITAL THAT THE GOVERNMENT DELIVERS A SUSTAINABLE INDUSTRIAL STRATEGY WHICH FOCUSES ON SKILLS AND EDUCATION

Manufacturing has had an excellent 2017 to date and this latest survey shows continuing optimism for orders and sales both in the UK and overseas.

However, for UK manufacturers' to continue to thrive in a post-Brexit world, we need a trained, highly skilled and diverse workforce which can flex with the needs of the changing economy and the priorities of business. People and skills are at the heart of the 'new economy'. The ongoing skills shortages in the manufacturing sector are likely to be enhanced by the move towards Industry 4.0 ("4IR"). A new way of thinking is required centred around a long-term, sustainable industrial strategy and the Government and manufacturers' need to work together to design something that works now and for the future.

Encouragingly, one of the ten pillars of the Governments 'Modern Industrial Strategy' is 'developing skills'– but with the long running skills shortages in the sector, we need to start seeing more rapid implementation and results.

The progress to 4IR (in UK and the rest of the world) will be one of the most significant changes to impact UK industry and we need to consider how we respond to these challenges and opportunities. In particular the skills we need and how we develop these skills – including retraining throughout a working life and designing an education system that will support the needs of the employer now and in the future. As UK manufacturers automate and digitise, implementing 4IR processes, it is likely to mean in the longer term manufacturers will require fewer un-skilled/semi-skilled workers with new types of roles being introduced to deliver work in the 4IR manufacturing environment.

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

At the centre of our policies is harnessing the potential of high-quality apprenticeships to bridge the skills gap, particularly in the manufacturing sector. The Government has a very clear vision to deliver three million apprenticeships by 2020. With employers in charge, this target can be achieved as long as apprenticeships are synonymous with quality and deliver the skills that employers are calling for. In 2017, a new independent body – the Institute for Apprenticeships – will act as the 'guarantor' of quality and it will be an employer-led body that will also advise on the new Standards.

However, our policy identifies some additional steps we would like to see taken so that apprenticeships in the UK are improved, which include:

- Reforming the Ofsted assessment system for schools to give some weight to the number and quality of apprenticeship places secured by schools
- Focusing government targets on apprenticeship outcomes/qualifications rather than the numbers starting
- Clarity that the detail of the new apprenticeship standards are comparable nationwide.

If properly supported, Britain's historic strengths in manufacturing, engineering, innovation, design and service – as well as the potential that the move to more automated/digitised manufacturing offers – provides the fundamental foundations for a successful and well-balanced UK economy.

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

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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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