eef The manufacturers' organisation

EXECUTIVE SURVEY

MANUFACTURERS' EXPECTATIONS FOR THE YEAR AHEAD

CONTENTS

INTRODUCTION

This is EEF's annual look at manufacturing executives' views on the year ahead. This year we see that manufacturers continue to be positive and ambitious with their business plans – they have set out a broad range of areas to focus on in the year ahead and on balance, this results in positive views for firm level indicators on productivity, employment, investment and sales.

But the clouds that loomed overhead in 2016 have not dissipated and manufacturers continue to have them firmly front of mind. Companies see more risks than opportunities in the year ahead, with some persistent risks particularly exacerbated by Brexit.

2016 in review – how did it pan out?

Our 2016 survey showed that risks had become more prominent for manufacturers. Featuring high up on the list were significant movements in exchange rates, economic volatility in major markets, and uncertainty around the UK's place in the EU. The subdued outlook had led to something of a reduction in expectations for growth in 2016 compared with 2015.

Amidst these concerns, our 2016 report showed that manufacturers were planning on taking a diverse set of actions to create their own opportunities for growth, on the back of several years of volatile economic conditions.

As another risk-filled year started for the UK manufacturing sector, companies prepared themselves with broad-based efforts to capture opportunities and mitigate exposure to risks.

We were not to know twelve months ago what a truly historic year 2016 was to be. As the new year begins, will 2017 be as memorable?

What to expect in the year ahead

The theme that emerges from this year's survey is that long-term goals are still front and centre of manufacturers' minds; despite unpredictable economic conditions, manufacturers remain focused on actions to achieve growth – and their business plans – in 2017. The UK manufacturing sector is ambitious, resilient and is setting out strategies to achieve business growth.

In order to realise business plans in 2017 there is focus from UK manufacturers on productivity through process innovation, investment in technology and innovation and continued work to ensure flexible supply chains. The effort is broad based, with many actions going hand-in-hand with each other, in order to ensure successful business outcomes.

However, a smooth journey is not guaranteed and many actions remain challenging. With continued weakness in global demand looking set to persist this year, diversifying into new export markets remains at the top of the list as the most challenging area to deliver in 2017.

Despite this, firms are ready and ambitious for the year ahead, we see that they are positive about the prospects for the industry and there are overall encouraging views for firm level indicators on productivity, investment and employment, as well as domestic and overseas sales.

Expectations on profits remain the weakest indicator with significant exchange rate movements proving a potential boon for some but hitting import costs – and taking their toll on margins.

There are grey clouds looming on the horizon and companies still have risks firmly in their sights, whether related to Brexit or not. The balance of companies seeing more risks than opportunities has been growing over the years and it is expected to take a step further in 2017.

The UK's decision to leave the EU has clearly exacerbated risks to manufacturers' growth prospects, especially those associated with exchange rate movements, intensifying upward pressure on business costs, hitting inflation and ultimately also applying pressure on pay settlements.

Amidst mounting concerns about the UK economy, fears of a slowdown in major export markets are still alive. Manufacturers' concerns about weak global growth are unlikely to subside in 2017, echoing the disappointing growth in world trade in the past couple of years.

And putting aside the Brexit decision, cash flow risks continue to be seen in 2017 – reported as a growing concern in recent years. All in all, risks abound in the year ahead, heightened by mounting political uncertainties and subdued activity in the global economy.

HOW WILL BUSINESS PLANS BE DELIVERED IN 2017?

- Despite unpredictable economic conditions, manufacturers remain focused on actions to achieve growth and their business plans in 2017
- There is focus on process innovation, investment and ensuring flexible supply chains but it won't all be plain sailing – many actions remain challenging to deliver
- Long term goals are still front and centre of manufacturers' minds – they are not laying low in the face of uncertainty

Manufacturers have had to deal with challenging and volatile business conditions since the financial crisis but through all of this there is a constant: the UK manufacturing sector is ambitious, resilient and manufacturers set out strategies to achieve business growth. Our *Manufacturing Ambitions* report showed that three-quarters of manufacturers are going for growth – ranging from the substantial to those laying the necessary foundations for future growth[1].

This year is no different. Our survey shows that firms in the UK are focused on areas to deliver long-term growth and sustainable business.

The building blocks of success

Innovation, investment, exporting – three foundations of a successful and productive manufacturing sector, and importantly, a thriving and balanced economy. Manufacturing is more than just products, it is about the knowledge that goes into making the best alongside offering services that bring added value. It is a globally connected sector as part of interdependent, intricate supply chains and through selling products and solutions worldwide.

In order to realise business plans in 2017 there is focus from UK manufacturers on productivity through process innovation, investment in technology and innovation and continued work to ensure flexible supply chains. The effort is broad based with two in five firms focusing on four or more actions – with many going hand-in-hand with each other – in order to ensure successful business outcomes.

An innovative sector

Manufacturing plays a key role in the UK innovation landscape. Manufacturing performs 69% of total business R&D expenditure, employs 59% of innovation personnel and has the largest share of innovative firms.

And innovation is not just about new products, it encompasses all research and development activities which have a commercial purpose including the development of new processes or services, or bringing about a significant improvement in existing products, processes or services.

Fifty-six percent of survey respondents report they will be undertaking process innovations to increase productivity in order to deliver their business plan in 2017. Medium sized firms (those with 101-250 employees) are the most likely to be doing this, with seven in ten citing it as an action they will undertake, compared with just under half of small and large companies.

When uncertainties abound, process innovation can be a priority as it is a less risky investment. Process innovation can quickly pay for itself by increasing efficiency and reducing costs, and the returns are quickly visible on the bottom line. Process innovation is not just about taking out costs and enhancing margins, it boosts competitiveness, for example, by reducing lead times and improving quality.

[1]EEF/NatWest Manufacturing Ambitions: an industrial strategy for economic growth, October 2016

Complementary to this, half of companies expect to increase investment in technology and innovation in the next 12 months. Fast-moving changes in technologies – as part of the 4th industrial revolution[2] (4IR) – mean that steps can be taken to optimise existing business processes with better use of capital, workers and resources through data driven insights. This investment in technology and innovation will enable manufacturers to maintain their competitive edge in a constantly and rapidly changing world, and respond flexibly and quickly to customers' requirements.

Manufacturing relies on its supply chains

Working with customers and suppliers to ensure supply chain flexibility will be undertaken by 44% of respondents in this year's survey. Modern manufacturing is built on complex supply networks and the relationships across these supply chains can be an important factor of success, with customer satisfaction, product quality and on-time delivery all key aspects in maintaining competitive advantage. Supply chain collaboration brings benefits such as improved inventory management, better customer responsiveness and lower costs.

Firms also look to maintain business resilience with increased marketing efforts and brand promotion to drive sales, diversification into new supply chains to target new sources of revenue, and also increasing revenue from services – in the latter case especially by companies in the electrical and machinery sectors.

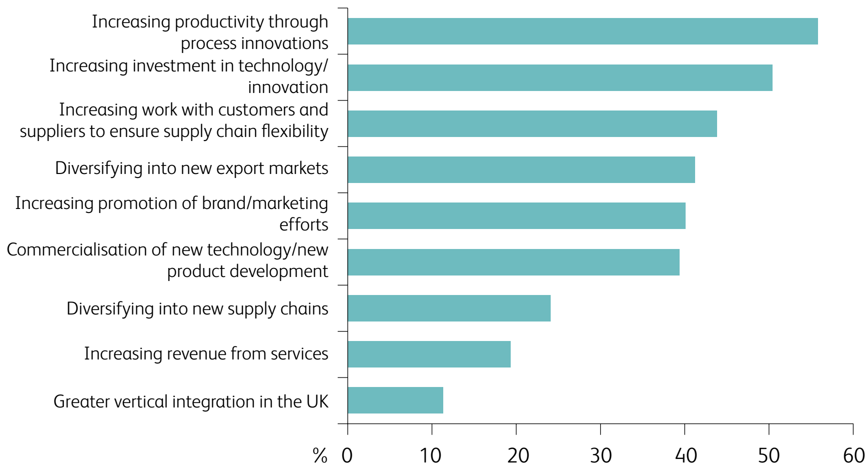
It won't all be plain sailing

It is clear that manufacturing executives

[2]See www.eef.org.uk/fourthindustrial for more information

Chart 1: The building blocks of success

% of companies undertaking each action in 2017 to deliver strategic business plan

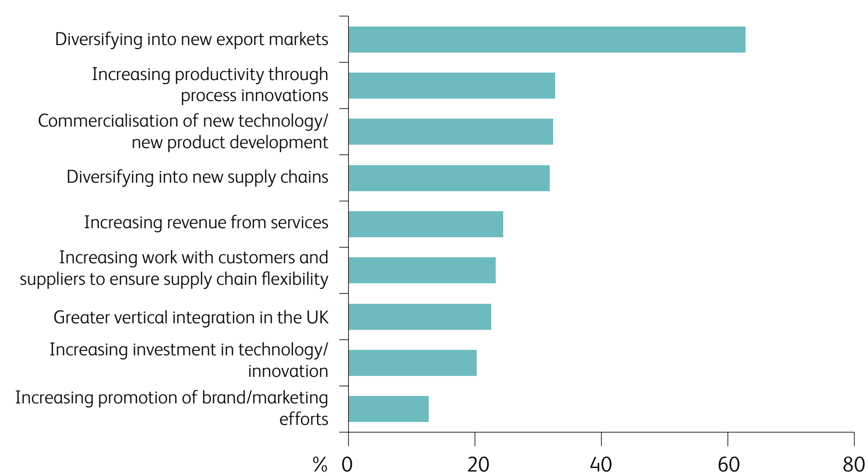


Source: EEF Executive Survey 2017

expect to increase investment in technology and innovation in the next 12 months

Chart 2: Many actions in 2017 remain challenging to deliver

% of companies who are undertaking action citing it as their biggest challenge to deliver in 2017



Source: EEF Executive Survey 2017

have their 2017 course plotted but a smooth journey is not guaranteed. Many actions remain challenging to deliver (chart 2).

Echoing last year's results, diversifying into new export markets tops the list with 63 % of companies looking to do this saying they thought it would be the biggest challenge to deliver. Continued weakness in global demand persisted throughout 2016 and looks set to remain this year too, exacerbating perennial exporting challenges such as navigating different business practices, non-tariff barriers and keeping on top of potential opportunities.

The UK as a place to manufacture

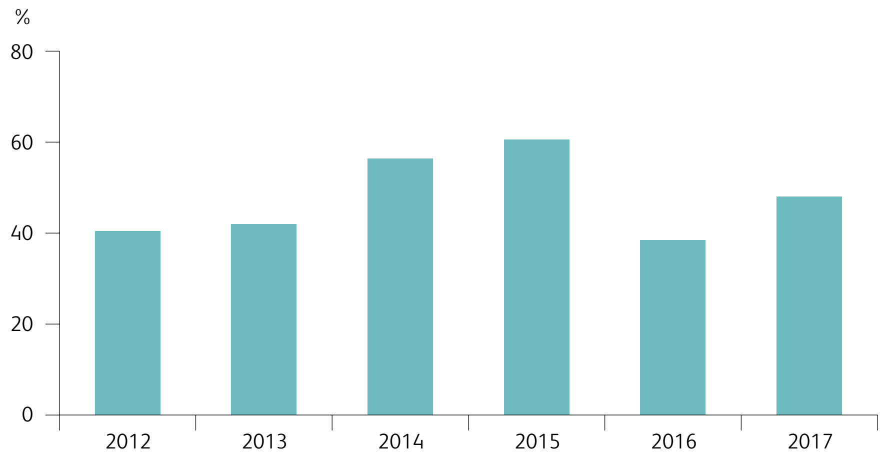
For the next 12 months at least, respondents are positive, on balance, about the UK as a place to manufacture (chart 3). Whilst this is encouraging, it could reflect perceptions about the current attractiveness of other locations, with unpredictability not just a UK phenomenon.

Whilst in 2016 we saw large companies remain upbeat and SMEs views drop, this year all sizes of firms have similar positive balances. So whereas SME views have lifted from last year, large companies (with over 250 employees) are less positive about the UK as a place to manufacture than they had been 12 months previously.

will increase marketing efforts and brand promotion in 2017

Chart 3: The UK as a competitive place to manufacture

% balance of companies agreeing that the UK will be a competitive location for manufacturing activities



Source: EEF Executive Surveys

A balance of

agree that the UK will be a competitive location for their manufacturing activities in 2017

IN SUMMARY:

We have seen in this section that post-EU referendum, manufacturers have evolved their long-term ambitions and their priorities remain focused on innovative new technologies and processes associated with the 4th industrial revolution, improving the offer to customers and ensuring flexible and collaborative supply chains. Long term goals are still front and centre of manufacturers' minds – they are not hunkering down in the face of uncertainty, rather they are pursuing their growth ambitions and laying the foundations for success.

MANUFACTURERS' BUSINESS EXPECTATIONS

- Whilst there is a mixed picture on industry overall, at the firm level companies expect positive outcomes on productivity
- Actions undertaken to achieve growth in the year ahead will pay off with sales growth both at home and abroad and increases in employment to help boost capacity
- Expectations on profits remain the weakest indicator, with looming risks affecting this and the outlook on the UK and global economy

The manufacturing sector reports being ready and ambitious for the year ahead, but what will these aims amount to? On balance, we see that firms are positive about the prospects for the industry in 2017 – although by a slim margin – and there are overall encouraging views for firm level indicators on productivity and investment and employment as well as domestic and overseas sales.

The picture on profit margins looks less rosy however, and companies are also less sure about the UK and global economic environment overall – as we shall discuss in depth later on, firms still have a range of risks firmly on their radar.

Expectations about industry prospects somewhat mixed

The largest proportion of firms – 42% – expect conditions in industry in 2017 to remain the same as 2016, where manufacturing output growth looks set to end up at 0.2%. With a third expecting improvements and a third deterioration, there is a small positive balance overall on industry prospects.

There are some minor fluctuations between sectors, but these are certainly far less marked than we have seen in previous surveys where sector variances have been pronounced.

Productivity improvements continue to be part and parcel of expectations across sectors for the forthcoming year – and as we have seen in the previous section, actions to ensure success in this area top the list for companies.

Sales expectations in the black

Our *Manufacturing Outlook* survey results in the latter part of 2016 showed domestic demand has been positive and firms looking at the year ahead expect this to remain the case, with half expecting UK sales to increase in the next 12 months, and 17% expecting a decrease – a picture reflected across all company sizes. This balance, at 33%, has ticked up from the 19% posted 12 months ago (chart 4).

The actions discussed in the previous section – such as increased marketing efforts and diversifying into new export markets – look set to pay off with

On balance,

1/2

firms expect productivity improvements in 2017

On balance,

1/3

firms expect UK sales to increase in 2017 export sales, on balance, expected to be positive, both to EU and non-EU markets.

Employment and investment set to hold up

Employment looks set to hold up with 36% of firms planning for increases in permanent employee numbers in the next 12 months – for nearly all the expectation is for moderate growth. SMEs responding to our survey are more likely than large companies to be predicting an increase.

Encouragingly, seven in ten companies expecting increases in employment say this is due to the need to increase capacity – especially within small (77%) and medium (85%) sized businesses. Between four in ten and three in ten say they will be increasing their number of apprentices (linked to the introduction of the Apprentice Levy in April), bringing in new skills for new areas, continuing to fill long-term skills gaps and replacing retirees.

Temporary employees remain an important part of a flexible manufacturing workforce, and use is expected to remain broadly flat in 2017. Where firms do expect increases, this is mainly to help manage volatile order books but also as a means to deal with capacity growth and a route to bring in new skills.

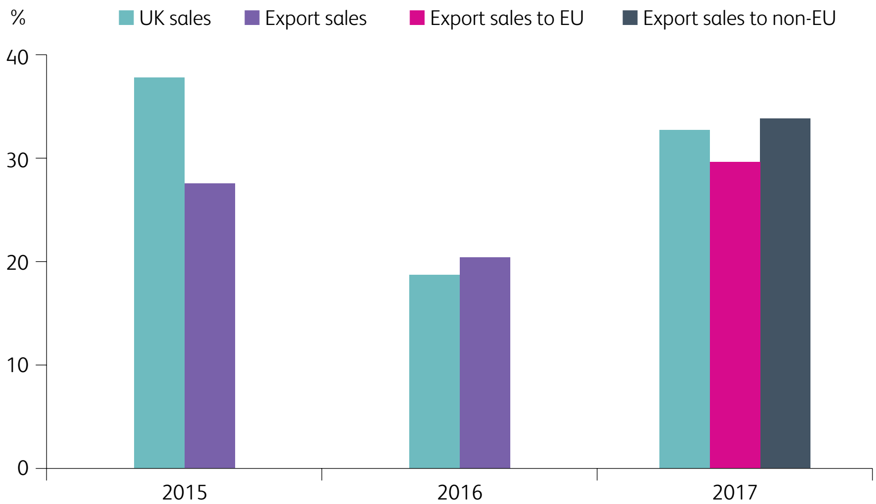
The investment picture is a little more mixed, but still in positive territory, with just over a third expecting investment to pick up this year, and a fifth expecting a deterioration. This echoes a pick-up in investment intentions in our quarterly *Manufacturing Outlook* report in 2016 Q4, and EEF's 2016 Investment Monitor which showed that despite the uncertainty in the economy, manufacturers recognise the need to invest to satisfy current customer demand and to support productivity improvements as discussed earlier.

Expectations on profits remain weakest indicator

With significant exchange rate movements proving a potential boon for some but placing upward pressure on import costs, there is an impact on margins. The survey shows expectations for profits growth in 2017 mirror this squeezed picture, at a balance of 7% it remains at the level seen throughout the history of the survey, with exception to an extremely positive outlook in 2014.

Chart 4: UK and export sales balances show bounce from 2016

% balance of change expected in 2017



Source: EEF Executive Surveys

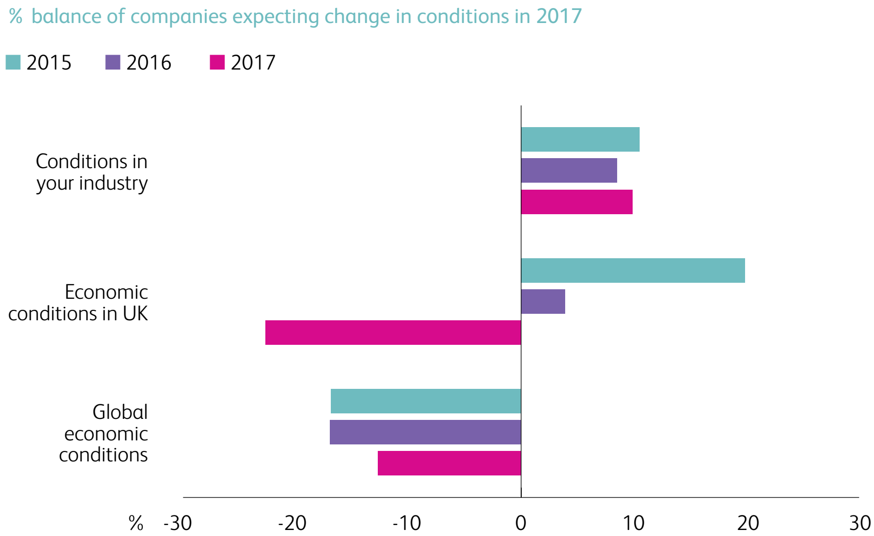
say increases in employment would be in order to increase capacity

Views on the economy

Whilst there are positive balances for sales, and companies on balance appearing fairly upbeat for their own business prospects, manufacturers are less positive about economic prospects in 2017. This is a trend often seen in EEF surveys where firms are surer about their own business, and what is in their control, than domestic or global economic prospects.

Whilst views on global economic conditions remain negative on balance, but slightly improved from last year (chart 5), what stands out is the change in balance for UK economic conditions. This level was last seen in expectations for 2012, the inaugural year of this report. Small and medium sized companies are more negative than large ones – with the former posting balances at -23% and -31% respectively and large firms at -7%. Medium sized companies balance is most negative as they have the smallest proportion of firms expecting any improvements in prospects in the next 12 months.

Chart 5: UK economic conditions turn negative



Source: EEF Executive Surveys

But this outlook is unsurprising given the uncertainty around the journey to the UK leaving the EU which will unfold over 2017 and the raft of risks companies see on the horizon – more of which is discussed in depth in the following section.

IN SUMMARY:

Despite the outlook for 2017 industry conditions as a whole not much changed from last year, actions undertaken to achieve growth in the year ahead look set pay off. Firms anticipate sales growth whether in domestic or export markets and increases in employment are expected to help boost capacity.

The investment picture is mixed, but still positive, with manufacturers recognising the need to invest to satisfy current customer demand and to support productivity improvements. Expectations on profits remain the weakest indicator, with some firms hit by increased import costs following movements in exchange rates.

Whilst firms are fairly upbeat for their own company prospects, they are less positive about economic prospects in 2017. With a range of ambitious actions on the cards for 2017, manufacturers believe this will translate to positive results at the firm level, but they are not disregarding the risks for the year ahead.

UK FORECASTS

The UK economy performed relatively well in 2016, shrugging off EU referendum-related uncertainty in the first half of the year and showing strong resilience in the aftermath of the referendum outcome. Yet this momentum is unlikely to continue this year, and risks are largely skewed to the downside.

First off, inflation is expected to edge up in 2017, reversing the trend of the past couple of years. Downward pressures from the dive in oil prices had started to unwind by the end of 2016; they are set to reverse in 2017 as oil and commodities prices are recovering from their low levels a year ago. Furthermore, the sterling exchange rate depreciated sharply against major currencies as an early reaction to the UK's decision to leave the EU. As a result, companies have experienced a surge in input costs, which soared to multi-year highs. As the weak pound is expected to prevail, cost pressures will be gradually feeding through into higher consumer prices in the year ahead. Finally, the pickup in inflation could put upward pressures on wages, itself resulting in a second-round upward pull on consumer prices, something which the Bank of England will be looking out for.

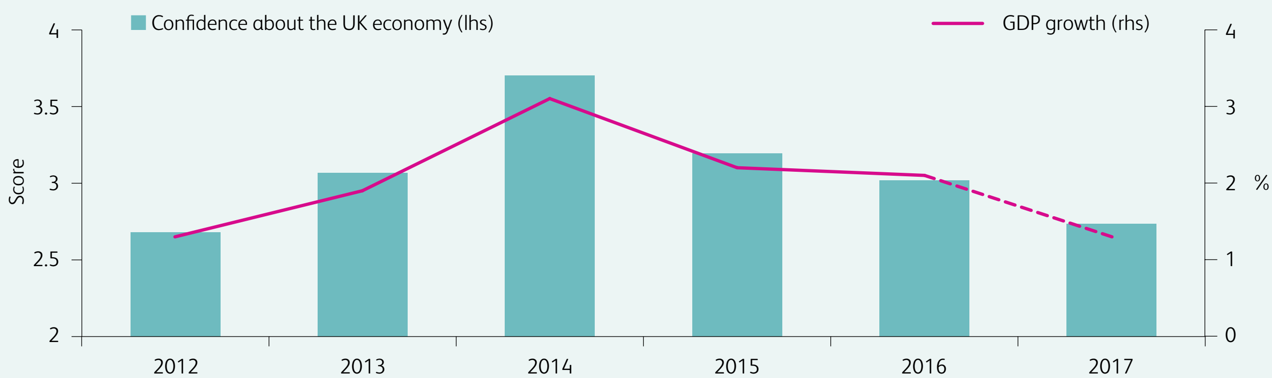
There are however some downside risks to wage growth. Indeed, the rise in consumer price inflation will still be unfolding by the time pay settlement levels are agreed at the major bargaining round in January. Moreover, persistently weak productivity, which dragged on pay rises since the financial crisis, is unlikely to reverse this year. Heightened uncertainty will further weigh on employers' intention to offer higher pay levels, as the upward trend in pay freezes in EEF pay survey data has so far suggested. The trend in inflation and earnings will take its toll on households' disposable income, resulting in a slowdown in private consumption.

Faced by a fall in domestic demand, companies are expecting weaker investment. This will be exacerbated by heightened uncertainty around the UK's relationship with the EU. There are upside risks to business investment, however. As companies need to fulfil order books while coping with a highly uncertain environment, the contraction might turn out to be not as bad as most forecasters predict.

Net trade is projected to provide some relief. Exports will pick up in the year ahead driven by a better outlook in major trading partners and underpinned by the weak pound. On the other hand, imports are expected to stall, reflecting the weakness in domestic demand.

Chart 6: Weak expectations about UK economic prospects

GDP growth and average outlook score for the UK economy (1 = significant deterioration and 5 = significant improvement)



Note: dashed lines are forecasts for 2017.

Source: EEF Executive Survey, ONS and EEF analysis

RISKS IN THE YEAR AHEAD

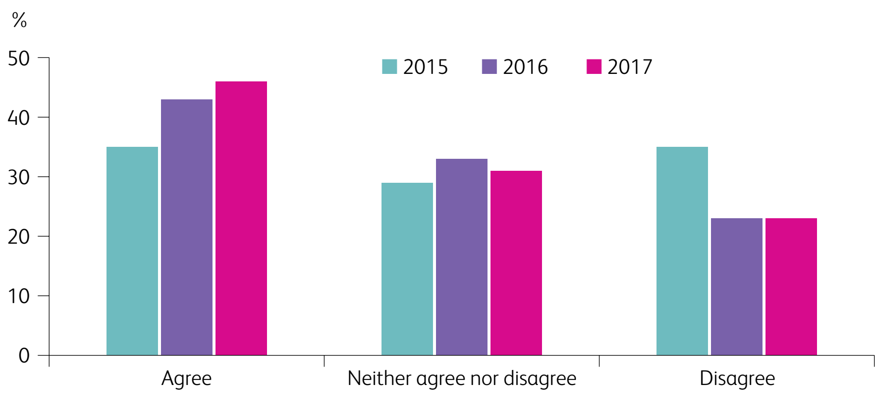
- Almost half of companies see more risks than opportunities in the year ahead
- The UK's vote to leave the EU has exacerbated manufacturers' concerns, with exchange rate movements overshadowing other Brexit-related risks
- Concerns about weakness of global trade growth remain on the radar

As we have seen so far, manufacturers are focused on delivering long-term growth strategies. Notwithstanding their overall positive expectations for 2017 in terms of sales, profits and employment, they still have risks firmly on their radar. The balance of companies seeing more risks than opportunities has been growing over the years; it is expected to take a step further in 2017 (chart 7).

Whilst some of the risks that loomed over in 2016 are still unfolding, the UK's decision to leave the EU has clearly exacerbated risks to manufacturers' growth prospects, especially those associated with exchange rate movements. And amidst mounting concerns about the UK economy, fears of a slowdown in major export markets are still alive (chart 8). Indeed, manufacturers' concerns about weak global growth are unlikely to abate in 2017, echoing the systematically disappointing growth in world trade in the past couple of years.

Chart 7: Risks are still looming large in 2017

% of companies agreeing with the statement: "There are more risks than opportunities for my company in 2017"



Source: EEF Executive Survey

Chart 8: Manufacturers' confidence about the UK economy deteriorates further

Average outlook score for industry, UK economy and World economy, where 1= significant deterioration and 5= significant improvement

Source: EEF Executive Survey

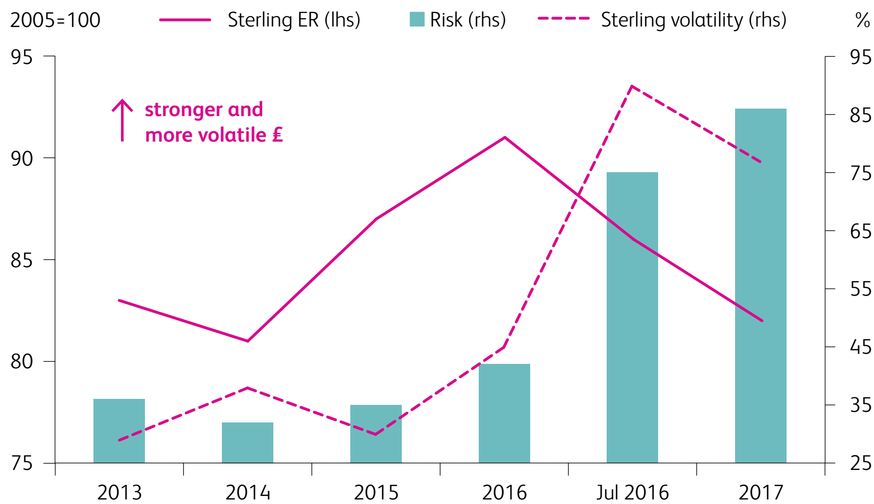
Exchange rate movements dominate Brexit-related concerns for the year ahead

Significant movements in sterling are on top of manufacturers' concerns for the year ahead. While this was seen as an important source of worry in previous years, the plunge in sterling in the wake of the UK's vote to leave the EU, along with a heightened day-to-day volatility since the referendum outcome, have clearly exacerbated risks stemming from exchange rate fluctuations. As a result, the share of companies seeing sterling movements as a source of risk in 2017 reached an all-time high in the survey's five-year history, leaping to 86% up from 42% in 2016, with four in five manufacturers linking this risk to Brexit (chart 9).

While exchange rate movements are a source of risk for companies of all sizes, small enterprises are the most exposed. They are also more likely to be affected by significant volatility in sterling: a balance of 26% of small firms agree that a low but volatile exchange rate provides their business with more risks than opportunities, compared to 23% and 22% respectively for mid-sized and large companies. This gap reflects the higher cost for small manufacturers from hedging against exchange rate risk, as they may lack the required resources and supply chain flexibility to protect themselves from large currency fluctuations.

Chart 9: Brexit exacerbates risks related to exchange rate movements

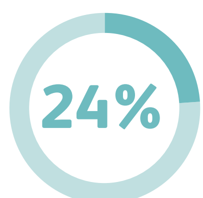
% of companies citing exchange rate movements as a risk to their business plan in 2017 (rhs), sterling volatility (rhs) and sterling effective exchange rate (lhs)



Note: Sterling ER is the average effective exchange rate (2005=100) over the previous year. Sterling volatility is measured as the standard deviation of daily changes in the sterling effective exchange rate over the previous year.

Source: EEF Executive Survey, EEF Referendum Survey for July and Bank of England

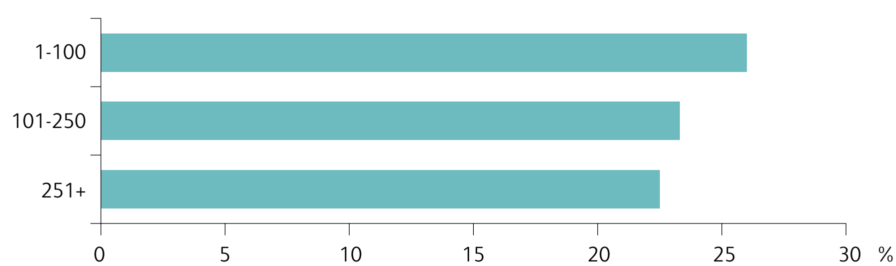
On balance,



of manufacturers agree that a low but volatile exchange rate provides their companies with more risks than opportunities

Chart 10: Small companies are the most exposed to exchange rate movements

% balance of companies agreeing with the statement: "A weak but volatile exchange rate provides my business with more risks than opportunities in the year ahead"



Source: EEF Executive Survey 2017

A FOCUS ON EXCHANGE RATES

The sterling exchange rate fell sharply against major currencies in the wake of the referendum to leave the EU. Since its peak in November 2015, it lost around 20 % of its value against both the US dollar and the euro by early December 2016. But what does this mean for UK manufacturers?

To start with, a sterling depreciation pushes up import prices, thus leading to higher input costs. While firms will respond by charging higher output prices to their clients, previous episodes of depreciation have suggested that the pass-through is not immediate nor complete. This will pose a threat to manufacturers' margins on domestic sales, which may take some time to recover. A long-term look at *EEF Manufacturing Outlook* shows that balances for profit margins on domestic sales were trapped in negative territory for seven quarters in a row following the dive in sterling in the aftermath of the financial crisis (chart 11). Moreover, upward movements in prices might be constrained by weaker demand prospects, as the trend following the 2008-9 downturn suggests.

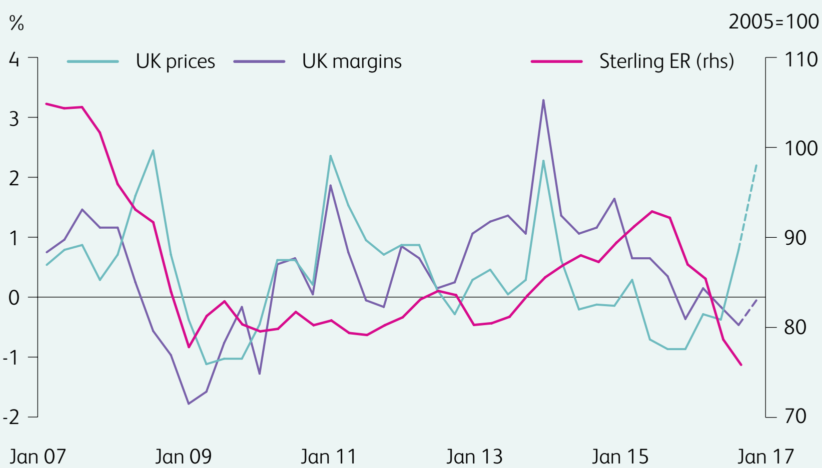
The exchange rate depreciation is also expected to have an impact on exports. Economic theory suggests that the weak pound should boost competitiveness of UK manufactures, leading to higher export sales. Again, a look at long term relationships shows that the link is not straightforward.

First off, exchange rate movements also affect firms' pricing strategies abroad[3]. Research by the ONS[4] provided evidence that following earlier episodes of depreciation, export prices have actually increased, moving alongside with import prices.

This surge reflected manufacturers' reaction to rising input costs, with companies passing it through to their overseas clients. Besides, around half of UK exports are denominated in foreign currency, which reduces the responsiveness of export prices to movements in sterling. Moreover, exchange rate volatility adds some complexity to manufacturers' pricing strategy in overseas markets.

Chart 11: Sterling depreciation will take its toll on manufacturers' profit margins on domestic sales

Sterling effective exchange rate (rhs) and balances for UK prices and margins (lhs)



Note: standardised balances of prices and margins on domestic sales.
Dashed points are expectations for prices and margins in 2017q1.

Source: EEF Manufacturing Outlook and Bank of England

[3] See for example Paul Krugman (1986): "Pricing to Market when the Exchange Rate Changes", NBER Working Paper No. 1926, May 1986
[4] Hardie, Jowett, Marshall, Wales (2013): "Explanation beyond exchange rates: trends in UK trade since 2007", Office for National Statistics, August 2013

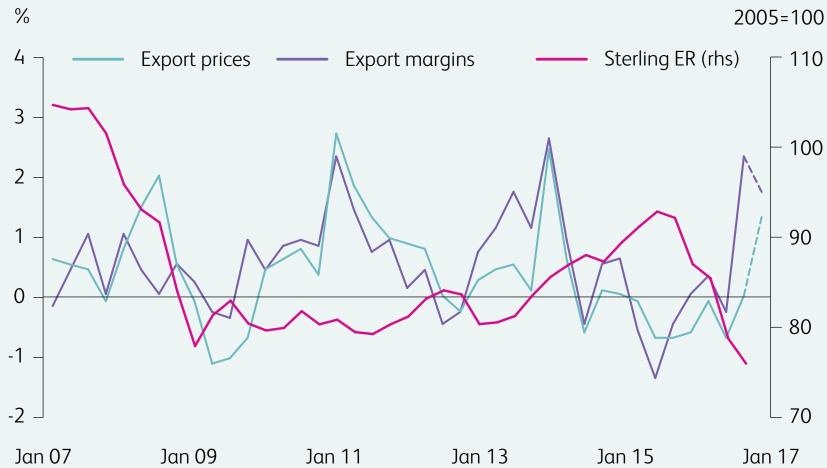
These results are consistent with long term series from our *Manufacturing Outlook* survey (chart 12). As highlighted in our 2016q4 *Manufacturing Outlook*, balances of export prices are expected to improve in the first quarter of this year reflecting firms' readiness to preserve profit margins on overseas sales following the dive in sterling.

Export price dynamics may help explain the relatively weak sensitiveness of UK export volumes to changes in the sterling exchange rate. Instead, overseas demand prospects appear to play a greater role in driving export sales. And EEF's *Manufacturing Outlook* has reported fairly gradual improvements in major markets over the course of last year.

Yet all sectors are not alike. The surge in input costs depends on firms' import intensity, which varies largely across manufacturing sub-sectors. On the other hand, the scope of the pass-through into higher output prices is influenced by firms' pricing power in both the domestic and export markets, as well as the elasticity of demand to changes in prices. These differences might explain why some sectors still see some opportunities from the weak but volatile pound (chart 13).

Chart 12: Exchange rate movements are likely to affect firms' pricing strategies abroad

Sterling exchange rate (rhs) and balances for export prices and margins (lhs)

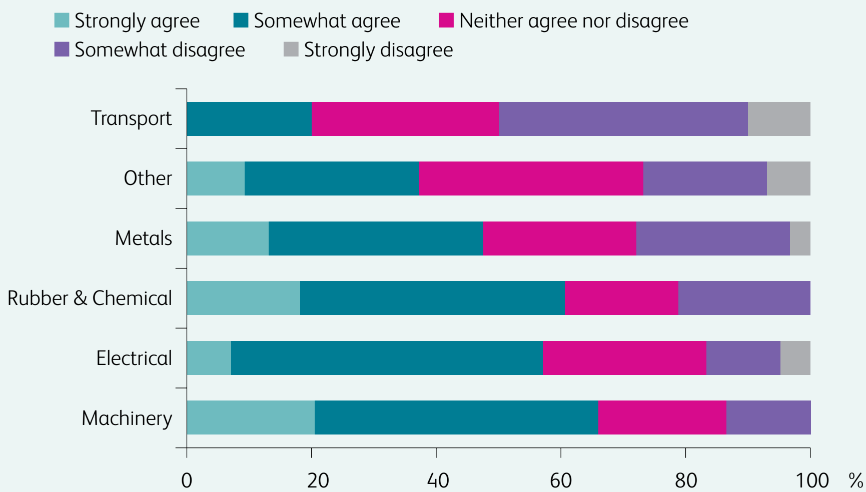


Note: standardised balances of prices and margins on export sales. Dashed points are expectations for prices and margins in 2017q1.

Source: EEF Manufacturing Outlook and Bank of England

Chart 13: Sterling risks and opportunities are uneven across sectors

% of companies agreeing with the statement: "A weak but volatile exchange rate provides my business with more risks than opportunities in the year ahead"



Source: EEF Executive Survey 2017

The weak sterling intensifies upward pressures on business costs

Reflecting the impact of exchange rate movements, cost pressures are a significant source of risk for manufacturers in the year ahead. Digging into this area, cost pressures are twofold.

Firstly, the dive in sterling caused import prices to surge to multi-year highs, resulting in significant upward pull on input costs. As the weak sterling is expected to prevail over the course of 2017, the rise in input costs will continue to drag on manufacturers' growth prospects, with four in five companies in our survey seeing it as a source of risk in the year ahead. Indeed, previous episodes of depreciation suggested that companies are reluctant to fully pass through the increase in production costs into higher consumer prices. This means that the surge in input costs will take its toll on manufacturers' profit margins.

Moreover, the Organisation of Petroleum Exporting Countries (OPEC) agreed in December 2016 to cut crude oil production for the first time since 2008, accelerating the ongoing recovery in oil prices after a protracted two-year slump. This trend should heighten the surge in input costs, resulting in a further squeeze of profit margins.

Secondly, manufacturers expect pay pressures to be building up in the year ahead. While inflation has been flat over the past couple of years, pay settlements across manufacturing have been running at around the 2 % mark last year. But as manufacturers anticipate input costs to be feeding through into higher inflation, they expect pay pressures to intensify, with the trend being further heightened by the skills shortage in the industry. It is worth noting however, that concerns about pay settlements have eased a touch compared to last year, when pay settlements were considered as the most important source of rising business costs.

Brexit has cast a shadow over manufacturers' ties in the UK and abroad

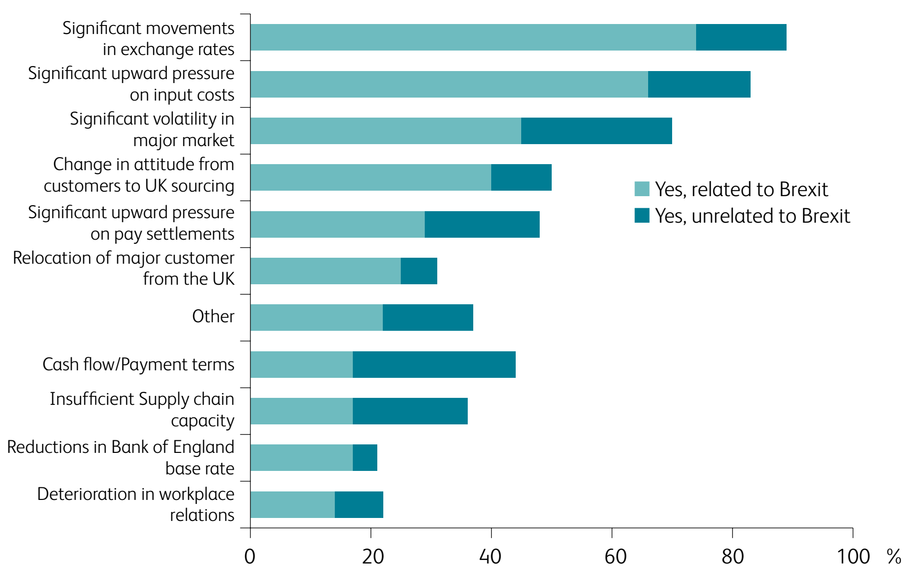
Half of manufacturers in our survey fear a potential change in attitude from customers to UK sourcing. This reflects concerns about the potential impact of uncertainty surrounding the future relationship of the UK with the EU on the renewal of long term contracts. However, only 13 % of companies expect this risk to pose the most significant threat to their business plan in 2017. Indeed, any changes to the current trade deal with the European bloc will not come into force in 2017, and manufacturers expect ongoing relationships to continue into the year ahead.

On the other hand, there are concerns about major customers relocating outside the UK, and one in three firms believe this would pose a risk to their

of companies say that upward pressure on input costs will be a risk to their business plan in 2017

Chart 14: Brexit exacerbates risks for the year ahead

% of companies citing risks to business plan in 2017



Source: EEF Executive Survey 2017

company in 2017. This seems a worry across all sizes of firms, although large companies are the most cautious about the prospect of this.

Brexit apart, cash flow risks continue to be alive in 2017

Cash flow problems and changes in payment terms (normally extensions) were reported as a growing concern in recent years; and 2017 is no exception. Nearly half of firms in our survey (44%) mention it as a risk in the year ahead, with only a small proportion linking it to Brexit. This risk is more prevalent in the metals industry, with a fifth of companies in the sector citing it as the main source of worry in the year ahead.

Volatility in major markets remains a source of concern

Concerns about demand from overseas markets are not abating in the year ahead. Economic volatility in major markets continue to be a source of risk for two in three manufacturers going into 2017, and for a fifth of companies, this will pose the most significant risk to growth. This chimes with the weakness in world trade growth in recent years, which weakened further in 2016 to its lowest pace of change since the

INTERNATIONAL FORECASTS

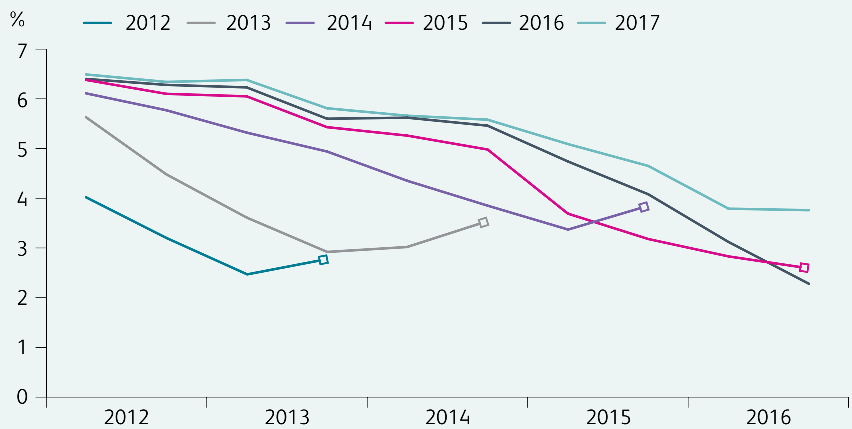
This time last year our forecasts painted a gloomy picture of the world economy for 2016, with the balance of risks clearly skewed to the downside. The reality was weaker still, and global trade growth reached a new low in 2016, consistently falling behind our expectations.

The upturn is still on the horizon, however. Global activity, and manufacturing in particular, turned a corner by the end of 2016. Market fears about China's economic rebalancing calmed somewhat, and the economy showed positive signs of stabilisation at the end of 2016. Moreover, the momentum in oil and commodities prices is helping sustain economic activity in major emerging markets, with Russia and Brazil likely to be recovering from prolonged recessions.

Economic activity appears to be heading in the right direction in developed countries as well. Growth in the US is expected to accelerate this year, after a trough in 2016, underpinned by a strong labour market. The eurozone economy will expand at a fairly modest growth rate,

Chart 15: Global trade growth systematically disappointing over recent years

Forecast vs actual global trade growth



Note: each line shows how forecasts for a particular calendar year have evolved over time.
The diamond shows actual growth rates.

Source: IMF *World Economic Outlook* 2012-2016

although slightly weaker than in 2016 reflecting fading tailwinds from the low oil prices and supportive monetary stance.

While some risks that loomed over 2016 are still unfolding, new, challenging threats have emerged, exacerbating uncertainty around global growth in the year ahead. Firstly, political uncertainty in Europe is mounting as a consequence of the UK's decision to leave the EU, along with major elections in France and Germany to be held in 2017. Secondly, the election of Donald Trump as the 45th president of the United States will take the case for protectionism one step further, threatening growth prospects in emerging markets. As a result, burdens that weighed on global trade in the previous years are unlikely to abate in 2017.

financial crisis. The trend is unlikely to reverse and companies expect this risk to continue dragging on export sales into 2017.

A slowdown in the eurozone tops manufacturers' concerns, with 70% of companies fearing a negative impact on their sales from a banking crisis in Europe. Next on the list is China, where a downgraded economic outlook would negatively affect 45% of manufacturers selling into this market. A better outlook in emerging markets would provide some relief to manufacturers' exports, with three-fifths of companies anticipating a positive impact on their business.

IN SUMMARY:

All in all, risks abound in the year ahead, heightened by mounting political uncertainties – not only in the UK but also in major partners.

Domestically, Brexit has worsened the balance of risks to manufacturers' business plans. On top of concerns is the plunge in sterling, which will pose the most significant threat to companies going into 2017. This reflects its potential impact on business costs, pricing strategies at home and abroad and, ultimately, profit margins. Moreover, the rise in input costs is heightened by the ongoing recovery in oil and commodities prices from a protracted two-year fall. Putting the EU referendum to one side, risks stemming from changes to cashflow and payment terms remain a source of worry particularly for firms in the upstream sectors, continuing the trend seen in recent years.

The world economy provides little relief. Concerns about volatility in major markets are still alive in 2017, echoing the serially disappointing growth in world trade since the global downturn. These fears are unlikely to fade in the year ahead.

The manufacturers' organisation

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

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

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

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