eef The manufacturers' organisation

In partnership with:

BDO

# MANUFACTURING OUTLOOK

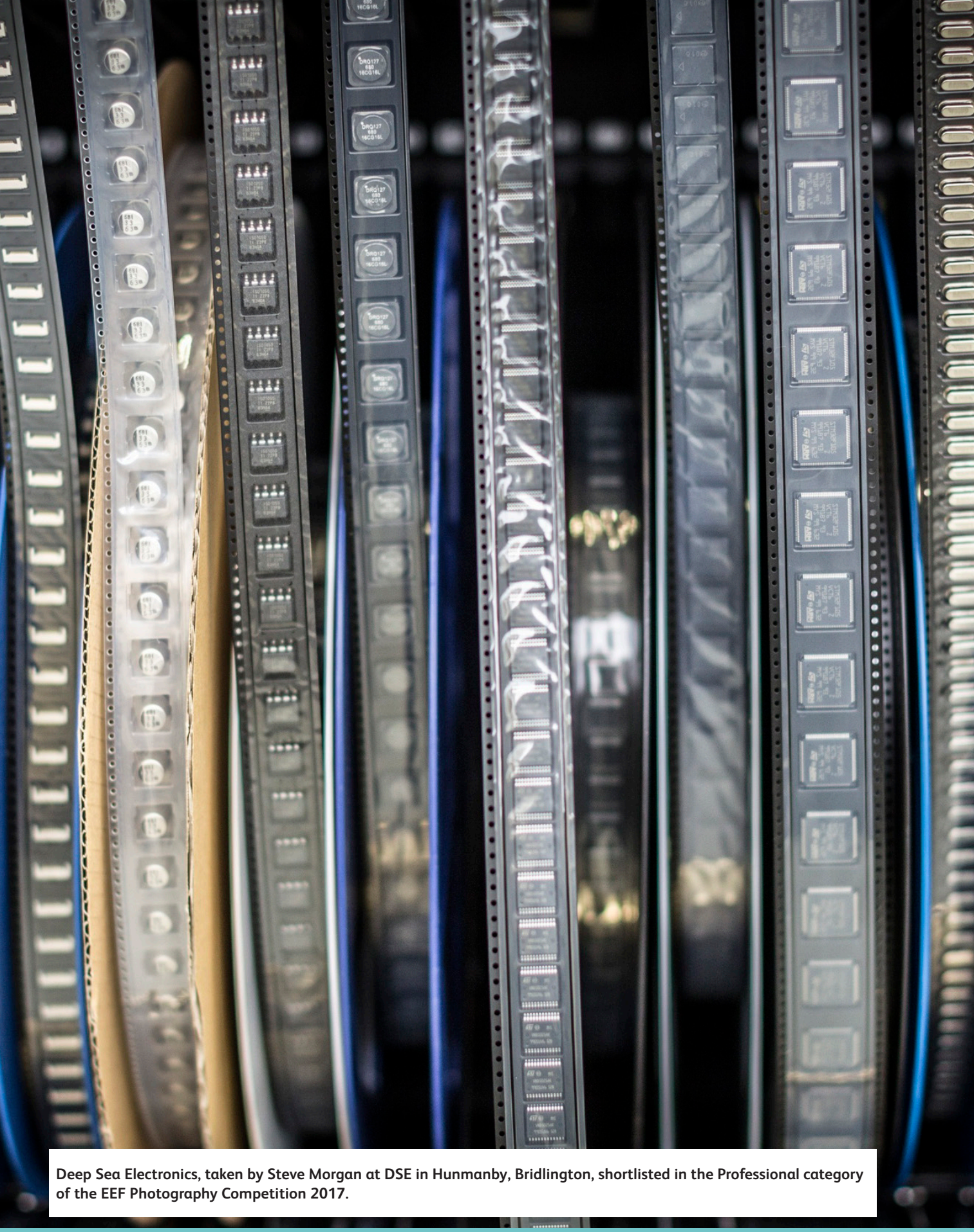
2018 QUARTER 1

**2.6** million employees

**10%** of UK output

**70%** of business R&D

Average wages higher than the rest of the economy



Deep Sea Electronics, taken by Steve Morgan at DSE in Hunmanby, Bridlington, shortlisted in the Professional category of the EEF Photography Competition 2017.

# FOREWORD

**Lee Hopley**
Chief Economist
EEF

**Tom Lawton**
Head, BDO Manufacturing
BDO LLP

Welcome to the 2018q1 *Manufacturing Outlook* report, in partnership with BDO LLP.

In many ways 2018 has manufacturers grappling with many of the same issues as the end of last year. On-going negotiations to hammer out some of the Brexit details dominate political headlines and boardroom discussions about future plans. Positively, the themes of improving global demand and order books filling up also remain consistent with the end of last year.

Indeed, our latest survey confirms that the first quarter of this year can still be characterised by buoyant demand, rising production levels and an increased need for skills. Inevitably some of the response balances reported over the past three months have eased off the multi-year highs seen in the second half of last year, but output, orders, investment and recruitment responses are all much more positive than the long-run average.

Moreover, the underpinning drivers of this positive picture remain linked to the strength of the global economic outlook. Recent data – from the eurozone to the US, from emerging markets to commodity producers – hasn't disappointed since the start of the year. Manufacturing activity indicators have marched higher, unemployment is heading lower and forecasts for growth this year have been revised up.

This has contributed, once again, to a broad spread of sectors reporting higher production levels and buoyant demand from overseas customers and their domestic supply chain. All of this makes us upbeat about the sector's prospects this year, with our new forecasts pointing to stronger growth than previously thought in 2018 and continued expansion in output into next year. Any worries we might have for UK industry are related to those sectors with a higher degree of exposure to household spending and construction activity.

While the global news had been pretty good, seemingly, there is no such thing as a problem-free upswing. Financial markets have become twitchy about the risk of inflation taking off and the possibility that the shift from ultra-loose monetary policy to something more normal could spur some adjustment risks. While this won't be a frontline concern for many manufacturers it does put the spotlight back on the actions of central banks.

The Bank of England has been preparing the ground for more rate rises this year, with markets now expecting the next quarter point hike to come in May. Unusually, for this time of year, we can be certain of stability on the fiscal side as the Chancellor presses ahead with just one Budget statement in the Autumn. March's Spring forecast update may, nevertheless, give us a steer on what future priorities might be. We would be hoping to see a focus on investment and some thought given to addressing the problems of the apprenticeship levy in the mix.

# 2018Q1 HEADLINES

Our first survey of 2018 picks up much where 2017 finished – on a largely positive note. None of the main output and orders indicators in this latest report have strayed far from the multi-year highs registered in the latter part of last year. And the story of UK manufacturers benefiting from a resurgent global economy is still in place. Political uncertainty aside, there are enough signs of this improvement continuing to spur more recruitment and a bit more investment.

| INDICATOR | BALANCE | CHANGE | |
|---|---|---|---|
| Confidence | 5.9 | ↑ | Confidence about UK outlook picks up with highest reading since 2015q3 |
| Output | 30% | ↓ | Output balance remains firm, though eases from multi-year highs |
| UK orders | 21% | ↑ | UK demand improves from more subdued end to 2017 |
| Export orders | 29% | ↓ | Global growth continues to support demand for UK exporters |
| Employment | 21% | ↓ | Employment balance holds well above long-run average at the start of 2018 |
| Investment | 18% | ↓ | Firms of all sizes report positive investment plans for the year ahead |

*Source: EEF Manufacturing Outlook Survey*

Manufacturing output increased by a barnstorming 2.8% in 2017 and at the end of the year the sector's production volumes were finally within touching distance of their pre-recession peak. From the official data released so far, last year also saw jobs increase and an uptick in investment spending. All of which are consistent with the solid run of responses to our survey in the past year.

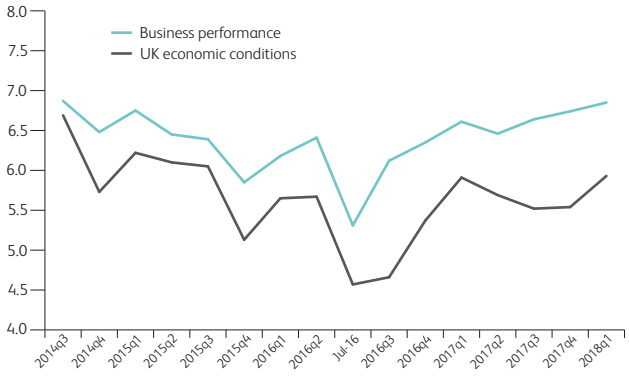
Our latest report signals the sixth consecutive quarter of positive (and double-digit) balances across output and orders indicators, with particular strength in the export picture reported once again. Nearly two-thirds of manufacturers gave special mention to improving demand conditions in the EU – which also had a solid start to the year according to the IHS Markit eurozone manufacturing PMI.

This is also reflected in the sector balances, where the export-intensive capital goods sectors – for example, electronics and electrical equipment – came out on top again this quarter. There was a bit of weakness in the metals sectors – both basic metals and metal products. We think there are some seasonal factors at play in the former and the latter's exposure to the construction sector may be weighing slightly as construction output has been flagging in recent quarters.

Nevertheless, there is a sense of optimism across UK manufacturing, with the forward-looking growth expectations edging a touch higher for the next quarter and longer-term confidence about firm-level performance recording an improvement for the third quarter running. Manufacturers' expectations about the outlook for the UK economy have also been dialled up a notch – likely to be helped along by a pick-up in UK orders, resilience in the official data at the end of last year and some modest upgrades in the Bank of England's recent forecasts.

### CONFIDENCE CONTINUES TO RALLY

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




*Source: EEF Manufacturing Outlook Survey*

# OUTPUT

Activity in the manufacturing sector continued to tick along at a healthy notch at the start of 2018, with a net balance of 30% of manufacturers reporting an increase in output. While this is slightly down on last quarter's historic high (34%), it remains strong, well above the survey's long-run average, and is indicative of a sector currently enjoying a sweet spot.

Looking ahead, manufacturers expect the positive conditions to be maintained, with a balance of 32% of manufacturers expecting output to increase over the next three months, up from 28%.

| | | |
|---|---|---|
| PAST THREE MONTHS | ↓ | 30% |
| NEXT THREE MONTHS | ↑ | 32% |

This quarter's impressive performance once again comes against the backdrop of a thriving global economy, which together with favourable trading conditions, continues to boost the sector. In fact the overall output balance has now been positive for six consecutive quarters, with healthy readings broadly seen across the main sectors covered in our survey.

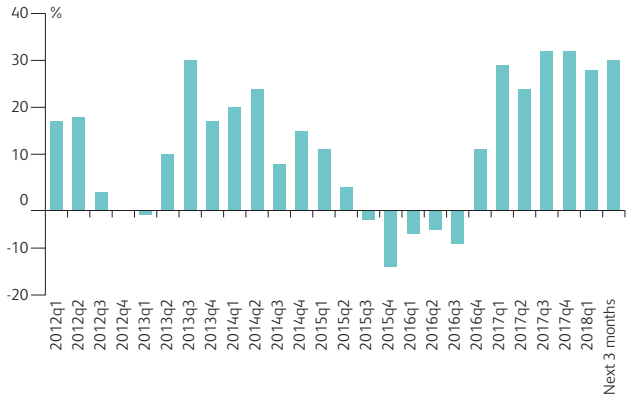
Capital equipment manufacturers were the main beneficiaries, as they were last quarter, as the global economy upswing, and accompanying revival in business investment, increases demand for their goods. The electrical equipment (35%), electronics (50%) and mechanical equipment sectors (28%) all posted strong balances, as manufacturers are increasingly encouraged to invest and expand activity to meet their growing demand requirements. This is despite the uncertain outlook in relation to the terms of the UK's exit from the EU. Elsewhere the transport sectors also had a strong quarter, with a combined balance of 33%. The outlook of automotive demand could however temper this performance in the coming quarters, given the concerns that the sector has reached saturation point.

There are also concerns regarding the outlook for a number of sectors in the construction supply chain. The basic metals sector and chemicals sector were the only two to record negative balances, while metal products and rubber and plastics both saw a fall in their output balances. How construction tackles its current problems – namely Brexit induced uncertainty and the liquidation of key contractor Carillion – is set to have a key bearing on these sectors' outlook.

Despite this uncertainty, this represents another strong quarter for manufacturing activity, confirming the momentum we saw in the official statistics towards the back end of 2017, and is set to be maintained over the next three months.

### OUTPUT BALANCE DIPS SLIGHTLY BUT REMAINS CLOSE TO HISTORIC HIGH

% BALANCE OF CHANGE IN OUTPUT




*Source: EEF Manufacturing Outlook Survey*

### OUTPUT SUMMARY

% BALANCE OF CHANGE

| SECTOR | PAST 3 MONTHS | NEXT 3 MONTHS |
|---|---|---|
| Metal Products | 12% | 31% |
| Mechanical | 28% | 37% |
| Electrical | 35% | 38% |
| Electronics | 50% | 26% |
| Basic Metals | -5% | 5% |
| Transport Equipment | 33% | 50% |
| **TURNOVER** | | |
| £0-9m | 21% | 33% |
| £10-24m | 33% | 35% |
| £25m and over | 42% | 51% |

*Source: EEF Manufacturing Outlook Survey*

# ORDERS

Manufacturers' order books continue to enjoy the positive momentum experienced for the entire of 2017. The net balance for total orders stood at 30% over the past three months – the same level registered in 2017q4 and only slightly lower than the 37% peak of 2017q3. Comparing the 2018q1 past three months outturn to expectations reported in 2017q4, businesses also saw a stronger improvement in orders than predicted.

One of the main developments of the quarter was the narrowing gap between domestic and foreign orders. Manufacturers focused on exports are still enjoying a stronger period compared to more domestic focused companies and sectors, however the gap between the two narrowed significantly and looking to the next quarter, the difference is expected to be minimal.

| | | | | | | |
|---|---|---|---|---|---|---|
| **UK ORDERS** | PAST 3 MONTHS | ↑ | 21% | NEXT 3 MONTHS | ↑ | 26% |
| **EXPORT ORDERS** | PAST 3 MONTHS | ↓ | 29% | NEXT 3 MONTHS | ↑ | 28% |
| **TOTAL ORDERS** | PAST 3 MONTHS | ↔ | 30% | NEXT 3 MONTHS | ↑ | 30% |

## UK ORDERS

For the sixth quarter in a row domestic orders were in positive territory and their performance is close to the recent peak of 2017q3. The net balance reporting growth was 21% up from 12% last time. Affected by UK consumers tightening their belts after a long period of sustained inflation and weak wage growth, domestic-focused sectors have now started to rise again and the prospects for the future are even rosier with a 26% balance expecting growth in the next three months.

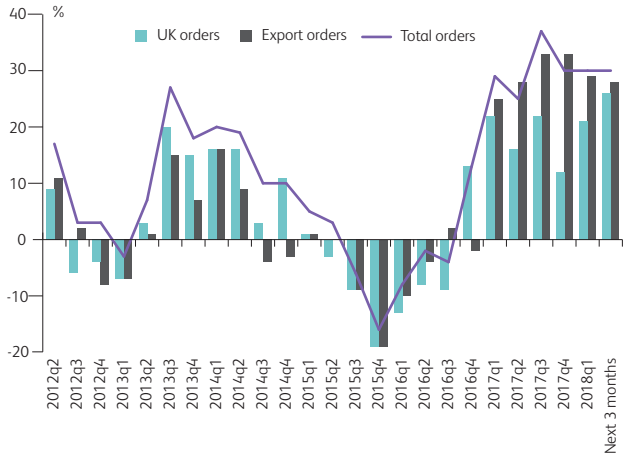
The manufacturing breakdown shows a positive picture for most of the sectors but not quite a clean sweep, with some manufacturers expecting ups and downs ahead.

The recent period of weakness in the UK construction sector is probably contributing to the subdued performance of sectors such as basic metals. However, the negative result may also be related to some seasonality surrounding its activity. The situation for the next three months appears to be slightly better, but the shift is mainly towards companies expecting more of the same rather than a material improvement in the next quarter.

Most sectors are seeing a continuation of the positive trends of the past year with clear signs that this won't be over in the months ahead. The mechanical equipment sector has boosted its domestic order books after months of orders coming mainly from abroad. A very similar picture can also be found in electronics, electrical and, to a lesser extent, in the metal products sector. This confirms something of a revival in capital and intermediate goods markets at home, where momentum should also continue in the next three months.

**ORDERS CONTINUE TO LOOK GOOD AND ALSO MORE BALANCED BETWEEN EXPORT AND DOMESTIC**

% BALANCE OF CHANGE IN ORDERS




*Source: EEF Manufacturing Outlook Survey*

## EXPORT ORDERS

The positive demand effects of the synchronized global expansion are still visible in export orders balances reported this quarter. While UK orders balances are catching up, export orders are still in the driving seat for this quarter and are also expected to be in the next one. Export performance in 2018q1 was also better than expected with a balance of 29% seeing a rise in export orders compared with a balance of 18% expecting growth in the next three months in 2017q4.

Broadly in line with the most recent results, manufacturing continues to see Europe as their main source of growth with two-thirds of companies indicating positive demand conditions from the continent. Results are also positive regarding Asian and North American markets, with positive market conditions seen by 27% and 26% of manufacturers respectively.

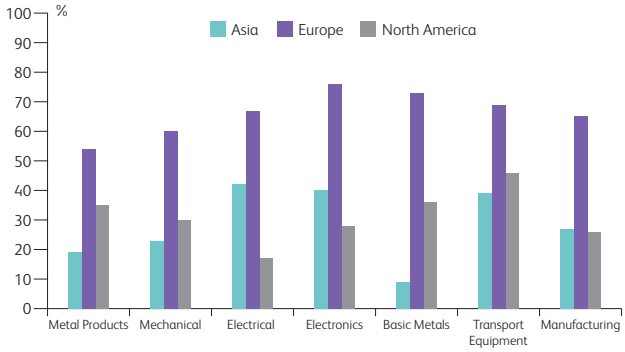
Looking at export performance by sector, electronics is the bright spot of the quarter confirming that the sector is finally on the rise after several years of decline following the dot-com bubble. Electronics manufacturers are currently seeing demand conditions better than the average for every single market with a very positive demand outlook coming from the Middle East (32%). Similarly upbeat about markets outside of Europe are the electrical equipment and transport sectors, with the former noting particularly strong demand in the Middle East (38%) and the latter in North America (46%).

Considering the broad-based positive news, the question is 'what can go wrong?' Looking ahead it appears that European PMIs have already peaked during the last months of 2017, however the rate of activity expansion is well above the long-run average. Eurozone GDP expanded by 2.5% in 2017 and it is expected to grow by 2.3% in the current year. Consumer confidence is way above its long-term trend as well as the economic sentiment and business climate indicators.

On the supply side, manufacturers have not invested heavily in the recent period compared to what the market and their order books would have suggested. This may create some capacity issues in the months ahead. Looking at demand, the main concerns remain those reported in the last few *Manufacturing Outlook* publications. On the US side, the Trump administration has more than once threatened the current status of free-trade, proposing tariffs and barriers for imports. On the EU side, as always, the focus is on Brexit and the so far lack of clarity about the future agreement with the biggest UK market.

### DEMAND FROM EU CONTINUES TO DOMINATE

% OF COMPANIES REPORTING POSITIVE DEMAND CONDITIONS BY MARKET




*Source: EEF Manufacturing Outlook Survey*

### ORDERS SUMMARY

% BALANCE OF CHANGE

| | UK ORDERS | | EXPORT ORDERS | | TOTAL ORDERS | |
|---|---|---|---|---|---|---|
| SECTOR | PAST 3 MONTHS | NEXT 3 MONTHS | PAST 3 MONTHS | NEXT 3 MONTHS | PAST 3 MONTHS | NEXT 3 MONTHS |
| Metal Products | 12 | 23 | 27 | 13 | 18 | 23 |
| Mechanical | 19 | 27 | 22 | 33 | 35 | 38 |
| Electrical | 21 | 31 | 32 | 44 | 24 | 31 |
| Electronics | 41 | 26 | 65 | 20 | 50 | 15 |
| Basic Metals | -5 | 11 | 18 | 18 | 0 | 30 |
| Transport Equipment | 29 | 35 | 22 | 41 | 44 | 50 |
| TURNOVER | | | | | | |
| £0-9M | 19 | 28 | 20 | 22 | 26 | 34 |
| £10-24m | 27 | 39 | 27 | 42 | 36 | 39 |
| £25m and over | 24 | 33 | 48 | 46 | 40 | 35 |

*Source: EEF Manufacturing Outlook Survey*

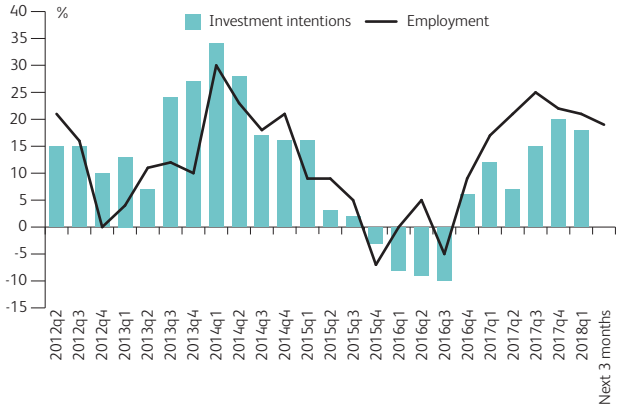
# EMPLOYMENT & INVESTMENT

For the second quarter in a row, the balance of companies taking on more employees moderated slightly with a result equal to 21% in 2018q1 which nevertheless is still close to the three year peak seen in 2017q3.

Investment intentions are also slightly down with the balance of companies planning an increase in capital expenditure slipping from 20% to 18%. The result is broadly positive, but it is still less than expected considering the extremely high demand for products and the good credit conditions the market is offering.

INVESTMENT INTENTIONS BROADLY UNCHANGED

% BALANCE OF CHANGE




*Source: EEF Manufacturing Outlook Survey*

| | | | | | | |
|---|---|---|---|---|---|---|
| **EMPLOYMENT** | PAST 3 MONTHS | ↓ | 21% | NEXT 3 MONTHS | ↓ | 19% |
| **INVESTMENT** | NEXT 12 MONTHS | ↓ | 18% | | | |

Looking at the sector picture, once again electronics is on top with a balance of 35% of respondents reporting a headcount increase in the past three months. Broadly the same expansion is expected for the next three months.

On the other side of the spectrum, both the basic metals and metal products sectors saw a tailing off in recruitment. In particular, basic metals had a small contraction in the balance of companies adding to their workforce in the last three months. However a small balance of respondents is expecting this to bounce back slightly in the next quarter.

In the next three months, hiring activities will remain healthy not only in the electronics sector, but also for a few others such as electrical equipment, transport, and mechanical equipment. However, the overall balance is expected to slow to 19%.

Investment intentions in the next 12 months remain positive with each sector expecting to invest more in the coming year. However, once again, the balance is subdued when the broader picture is considered. Manufacturers appear not keen to invest heavily considering the high level of uncertainty surrounding the UK and its future relation with the EU.

EMPLOYMENT AND INVESTMENT SUMMARY

% BALANCE OF CHANGE

| | EMPLOYMENT | | INVESTMENT |
|---|---|---|---|
| SECTOR | PAST 3 MONTHS | NEXT 3 MONTHS | NEXT 12 MONTHS |
| Metal Products | 8 | 10 | 12 |
| Mechanical | 22 | 16 | 18 |
| Electrical | 24 | 31 | 15 |
| Electronics | 35 | 32 | 19 |
| Basic Metals | -5 | 5 | 5 |
| Transport Equipment | 18 | 39 | 31 |
| TURNOVER | | | |
| £0-9m | 13 | 21 | 19 |
| £10-24m | 27 | 22 | 22 |
| £25m and over | 37 | 26 | 15 |

*Source: EEF Manufacturing Outlook Survey*

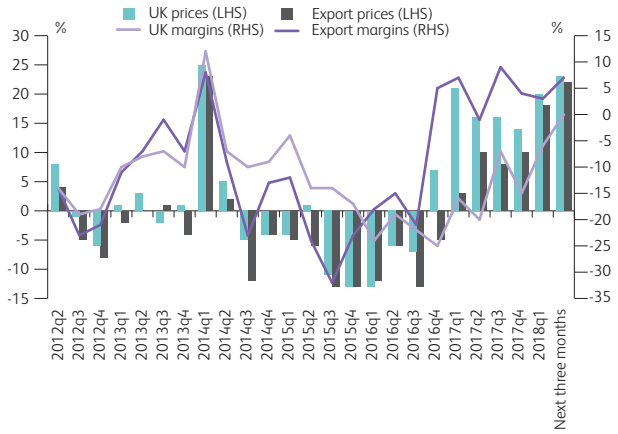
# PRICES & MARGINS

Inflationary pressures appeared to be easing through the latter part of 2017, with UK price balances drifting down and export price balances stable. However, in line with last quarter's expectations, the balance of companies increasing prices has picked up again – a trend that is evident across a number of sub-sectors.

Moreover, our survey suggests that this is more than just a price adjustment at the start of the year as a similar proportion are pencilling in increases in the next three months.

## PRICE RISES INTENSIFY AT THE START OF THE YEAR

% BALANCE OF CHANGE




*Source: EEF Manufacturing Outlook Survey*

| | | | | | | |
|---|---|---|---|---|---|---|
| **UK PRICE** | PAST 3 MONTHS | ↑ | 20% | NEXT 3 MONTHS | ↓ | 23% |
| **EXPORT PRICE** | PAST 3 MONTHS | ↑ | 18% | NEXT 3 MONTHS | ↓ | 22% |
| **UK MARGINS** | PAST 3 MONTHS | ↑ | -6% | NEXT 3 MONTHS | ↑ | 0% |
| **EXPORT MARGINS** | PAST 3 MONTHS | ↓ | 3% | NEXT 3 MONTHS | ↓ | 7% |

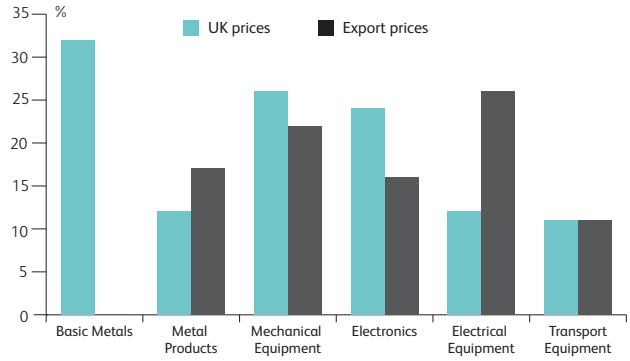
Our survey and, indeed, official producer price data had indicated an easing in inflationary pressures at the factory gate, but our survey points to a pick-up once again at the turn of the year – a move signalled in last quarter's report. This move, in response to the recent rises in some commodity prices, is expected to provide some relief on profit margins over the coming quarters.

As chart 7 illustrates, the increases in prices is broad-based across manufacturing sub-sectors. In the domestic market, the heftiest balance of companies raising prices over the past three months was in basic metals, mechanical equipment and electronics – all of which would have been exposed to increases in metals prices and (although to a lesser degree) are still passing through some higher costs of imported components and materials.

The strength of world demand, especially for investment goods, such as mechanical and electrical equipment, is also aiding manufacturers pushing through price increases. This is again accompanied by expectations that this will lead to further improvements in margins on overseas sales, which it is hoped will persist at least until mid-2018.

## INPUT COST INCREASES DRIVE PRICE HIKE IN MOST SECTORS

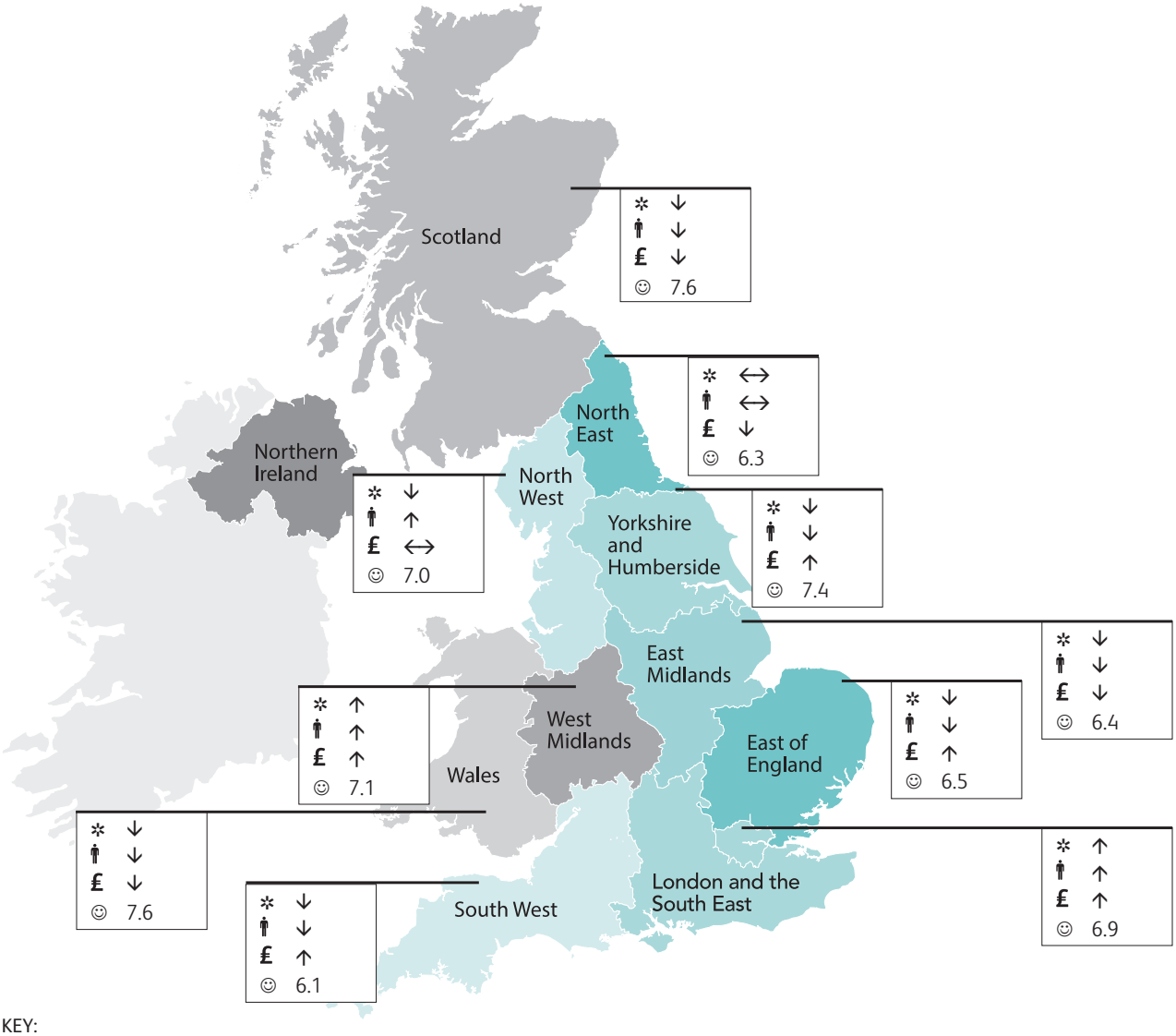
% BALANCE OF CHANGE IN PRICES IN THE PAST THREE MONTHS




*Source: EEF Manufacturing Outlook Survey*

# REGIONAL

The regional picture, despite softening a little, remains positive, reflecting the buoyant trends seen across manufacturing as a whole. Indeed, while the balances of our key indicators – output, orders, employment and investment – fell across many regions, these were from multi-year highs in the previous quarter, and so their levels continue to be broadly healthy.




KEY:

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

*Source: EEF Manufacturing Outlook Survey*

Activity across the regions continues to be robust, with a clean sweep of positive output balances in 2018q1. In fact nine out of the ten regions recorded double digit balances, with only manufacturers in the South West bucking the trend with a balance of 6%. Special mention must go to the South East and London, and North West, whose output balances of 49% and 42% were particularly strong. The latter continues to benefit from the revival in business investment, which is boosting demand for capital equipment manufacturers in the region.

The healthy output balances are underpinned by strong order books. Export orders continue to largely outperform domestic orders across regions, as manufacturers take advantage of strong demand emanating from across the world. There has however been some noticeable improvements in domestic demand, particularly in the South East and London, where the dominant food and drink sector is likely to be benefiting as inflation recedes and wages start to pick up. There is one exception to the positive news – the East Midlands. The region's total orders balance turned negative for the first time in two years and perhaps reflects some weakening in the automotive industry. This was echoed in its relatively weak output balance which fell from 38% to 14%.

Manufacturers' employment decisions were again generally positive, with particularly strong balances recorded in the South East and London (43%), North West (51%) and Yorkshire and Humber (30%). That said, there was some weakness across other regions. The East Midlands saw its employment balance fall from 48% to 9%, while a negative balance of -14% in Wales was also disappointing. Investment intentions meanwhile happily remain positive for all regions, a rare feat in our survey, illustrating the strength of the global economy.

## BUSINESS CONFIDENCE INDICATORS

Continuing the recent trend, manufacturers' confidence in their own businesses was healthy over the last three months, rising in five out of the ten regions, and remaining well above the levels seen in the immediate aftermath of the EU referendum. This is not all that surprising given the strong balances being recorded across our survey, as manufacturers take advantage of the global upturn and supportive trading conditions. The same level of optimism is not being felt towards the whole economy outlook however, which continues to trail behind, and is not likely to improve until clarity on the terms of the UK's exit from the EU are gained.

### UK ECONOMIC OUTLOOK CONTINUES TO TRAIL BUSINESS CONFIDENCE ACROSS REGIONS

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


*Source: EEF Manufacturing Outlook Survey*

### REGIONAL SUMMARY

% BALANCE OF CHANGE

| REGION | OUTPUT | | TOTAL ORDERS | | EMPLOYMENT | |
|---|---|---|---|---|---|---|
| | PAST 3 MONTHS | NEXT 3 MONTHS | PAST 3 MONTHS | NEXT 3 MONTHS | PAST 3 MONTHS | NEXT 3 MONTHS |
| Scotland | 11 | 18 | 17 | 22 | 2 | 16 |
| North East | 35 | 53 | 47 | 29 | 29 | 35 |
| North West | 42 | 50 | 47 | 41 | 51 | 38 |
| Yorks & Humber | 29 | 51 | 32 | 53 | 30 | 31 |
| East Mids | 14 | 40 | -9 | 41 | 9 | 0 |
| Eastern | 32 | 39 | 41 | 44 | 11 | 11 |
| South East & London | 49 | 42 | 53 | 37 | 43 | 40 |
| South West | 6 | 41 | 22 | 31 | 13 | 19 |
| West Mids | 41 | 33 | 32 | 32 | 25 | 15 |
| Wales | 14 | 29 | 29 | 57 | -14 | 14 |

*Source: EEF Manufacturing Outlook Survey*

# ECONOMIC ENVIRONMENT

After a slow start to the year, the UK economy expanded by 0.5 % and 0.4 % in the last two quarters of 2017. The annual growth was 1.7 %, a performance slightly lower than the 1.9 % registered in 2016. The 2017 result was better than expected also thanks to an important upward revision to 2016 data.

Looking ahead, we expect the economy to slow further in 2018 and 2019, pencilling in an expansion of 1.5 % and 1.3 % respectively.

## HEADLINES

- Modest growth in the next two years with a notable shift in the demand contribution structure
- Inflation gradually slowing down but not reaching the 2 % target until the end of 2018
- Signs of emerging wage pressure which may accelerate the monetary policy tightening cycle
- Investment to remain subdued in 2018, slightly rebounding in 2019 as we get more clarity on the Brexit process

The narrative behind our forecasts for 2018 remains similar to the one included in the last *Manufacturing Outlook*, but the buoyant year for global trade has had an effect on our 2018 forecast and net trade is now expected to contribute more to growth than previously forecast.

Overall, the major change compared to our latest release is the new 2019 forecast. This will be the year of the UK departing from the EU and some important assumptions are clearly needed. In our scenario, the March 2019 cliff edge will be avoided and a transition period will last at least until the end of 2020 – in line with recent government statements. Clarity on the Brexit process will arise by the end of 2018 and this will allow businesses to restart their investment plans after a long 'wait-and-see' period.

Households will be cautious in 2018 after a long period of belt-tightening due to negative real wage growth. By the end of 2018 private consumption should start to pick up again and expand further next year. Despite this, household consumption contribution to total GDP will be low compared with historical standards.

The path the economy and inflation will follow in the next months will also be crucial for the Monetary Policy Committee decisions. The current Bank of England assumptions are for three rate hikes by the end of 2019, up from the two predicted in November 2017.

## HOUSEHOLD WILL CONTRIBUTE LESS THAN USUAL TO TOTAL GDP

Historically, consumer spending has been by far the largest contributor to UK GDP growth, but after a long period of contracting real wages and a savings ratio close to its lowest point ever, the situation has changed. In 2017, consumption grew only by 1.8 % – a low performance by historical standards. Inflation probably peaked in November 2017 and the recent Sterling appreciation should calm down prices. However, higher commodity prices are pushing in the opposite direction and we think that the 2 % BoE target will be met only in the last quarter of 2018. Consumer confidence is currently in negative territory, but it should start ascending in the next months also thanks to real earnings starting to pick up.

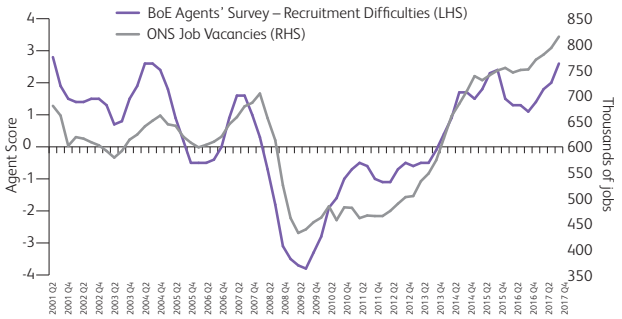
As a result of these factors, we forecast an expansion in household spending of 0.9 % in 2018 and 1.1 % in 2019

## IN 2018 WE MIGHT SEE REAL WAGES GROWING AGAIN

Wage growth has been disappointing in the last year. Despite an extremely solid labour market and consumer prices on the rise, real wage growth has been negative for most of 2017. There are several possible explanations for this phenomenon. In our opinion the key ones include: uncertainty over Brexit and the future, a residual slack in the labour market also involving part-time employees and formerly "discouraged" workers, and an extremely weak productivity performance.

### PLENTY OF VACANICES BUT IT'S NOT EASY TO FIND THE RIGHT SKILLS

RECRUITMENT DIFFICULTIES AND JOB VACANCIES




*Sources: Bank of England and ONS*

For the next two years several factors will have an impact on wage growth and they are not all going in the same

direction. On one side, all the key factors cited above may keep wages depressed. On the other side, high inflation, a significant slowdown in net migration figures, high company profits and busy order books, the National Living Wage, and chronic skill shortages, which companies are continuously reporting as a major problem, are all pushing wages upwards. As a result of the combination of these forces, we forecast wages growing by 2.7% in 2018 and 2.5% next year.

## INVESTMENT PICKING-UP, BUT JUST FROM 2019

The roaring global economy led to a revival in business investment in 2017 with the sector expanding by 2.2% after the 0.5% contraction experienced in 2016. Even if order books are healthy and capacity utilization is slightly over its long-term trend, we think that uncertainty surrounding the Brexit process will convince companies to hold on their investment plans. Our current expectations are for a very small expansion in 2018, pencilled in at 0.4%.

As said above, in our scenario we expect clarity over Brexit by the end of 2018 and to avoid the so-called "cliff edge" in March 2019. This situation should push businesses to invest more in order to be able to expand their production capacity. We expect business investment to grow by 1.3% in 2019.

However, as we said in our previous *Manufacturing Outlook*, given the status of the global economy, this is a weaker performance than one would expect, and it is way below the one other developed countries are expected to achieve.

Meanwhile, net trade is forecast to finally be a major contributor to growth with exports continuing to expand in particular in 2018 thanks to global demand and a currency, which has recently appreciated, but is still way below the level it was in the first half of 2016.

### UK ECONOMIC FORECASTS

% CHANGE EXCEPT WHERE STATED

| | 2017 | 2018 | 2019 |
|---|---|---|---|
| **Trading environment** | | | |
| Exchange rate (€/£) | 1.14 | 1.10 | 1.04 |
| Exchange rate ($/£) | 1.38 | 1.38 | 1.35 |
| Exports | 6.3 | 4.0 | 2.5 |
| Imports | 2.9 | 2.3 | 2.2 |
| Current account (% GDP) | -4.5 | -3.3 | -2.9 |
| **Output** | | | |
| Manufacturing | 2.8 | 2.0 | 0.6 |
| GDP | 1.7 | 1.5 | 1.3 |
| **Costs and prices** | | | |
| Average earnings | 2.6 | 2.7 | 2.5 |
| Oil price (Brent Oil $/bl) | 54.2 | 67.7 | 64.8 |
| **Employment** | | | |
| Manufacturing (000s) | 2673 | 2659 | 2607 |
| Rest of economy (000s) | 32,456 | 32,667 | 32,737 |
| Unemployment rate (%) | 4.4 | 4.3 | 4.4 |

*Source: Oxford Economics and EEF*

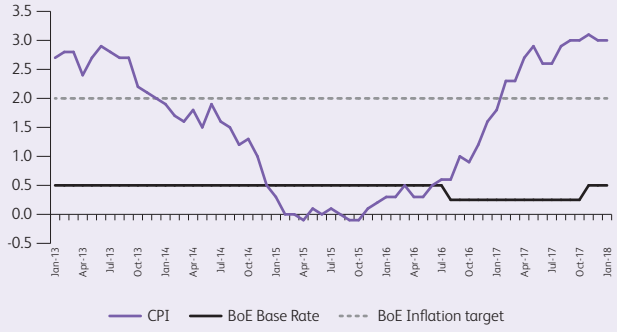
# SPOTLIGHT: THE START OF A TIGHTENING MONETARY POLICY CYCLE?

In February the MPC voted unanimously to keep interest rates at 0.5% after the 25 basis points hike decided in November 2017. While rates have not changed, there are several signs that another hike is coming sooner rather than later.

The latest *Inflation Report* is now predicting three more hikes by the end of 2019, up from the two reported in the November edition. Markets are currently betting on two hikes by the end of 2018 and the Bank of England has suggested that some domestic inflationary pressures are building, while the effect the sharp Sterling devaluation had on prices is fading. However, the BoE also made it extremely clear that the decision will be data driven, so the next GDP, CPI and earnings releases will be crucial to understand if May will be the date for the next rate rise.

### TWO RATE HIKES BY THE END OF THE YEAR?

BANK OF ENGLAND BASE RATE




*Source: Bank of England*

## GLOBAL ECONOMY

– Global expansion expected to peak in 2018
– Eurozone growth based on solid fundamentals
– Growth in the US to continue, but concerns of over-heating
– Turbulence on the equity markets but economic fundamentals remain solid

For the first time since 2011, world GDP is expected to have expanded by 3%. The very good performance is still below the long-term average, but it is welcomed considering that it was driven by the vast majority of countries. In 2017, only 12 countries out of 200 have reported a contraction – compared with 36 in 2012 and 94 in 2009 (IMF data). In the next two years expectations are for an even faster growth peaking at 3.2% in 2018 and a slightly slower expansion of 2.9% in 2019.

The eurozone, after several years of sluggish growth, is not seen any more as a drag to global growth, but actually as one of its engines. For a long period, eurozone growth was based for the most part on non-domestic demand and basing your fortunes on someone else's willingness to buy your products. The current expansion is instead based mostly on internal demand. Consumer spending and disposable income are running together in the same direction and this means that households are not basing their spending on consumer credit or their own savings. Investments are also on the rise with businesses busy and willing to hire new employees, indeed, in December unemployment was at 8.7%, down from 9.7% a year ago. Inflation is still lower than the ECB target while the central bank is continuing its progressive reduction in asset purchases. On the political side, Germany is still working on finding a majority for the next government, however the major concern comes from the Italian election with a likely absence of a majority in the parliament and a possible success of populist parties (first election results will be known while we publish our *Manufacturing Outlook*).

US growth continues to be strong even if the last quarter of 2017 registered a 2.6% annualised growth down from 3.2% in q3. According to the consensus forecast, the US has not reached its cycle peak yet which is predicted for 2018. As with the eurozone, a big contribution to growth is coming from business investment and an extremely solid job market. However, it appears that the extreme positivity registered by business surveys is not completely found in the data and there is a notable diversion between consumer spending and real disposable income, with the latter not running at the same pace of the former. Some concerns are also coming from the major fiscal reform that the Trump administration is putting in place. The radical reform is a major fiscal boost to an economy already healthily expanding and at an advanced stage of its business cycle. The tax plan may end with an over-heating economy and expanding the public deficit, which would lead the Fed to tighten its monetary policy to calm down inflationary pressures.

Linked to the last point, in the first months of the year equity markets have been suddenly woken up by worries of a bubble burst. Better than expected data for US earnings caused panic on the market with traders believing that inflation may start to run faster with the Fed forced to tighten monetary policy more than previously believed. This possibility caused a correction in asset prices and a rise in bond yields. However, the correction has brought valuations just back to those seen in the last quarter of 2017 and economic fundamentals are still solid. However, this does not mean that markets may not continue to correct inflated asset prices after so many years of loose monetary policy.

### INTERNATIONAL ECONOMIC FORECASTS

% CHANGE EXCEPT WHERE STATED

| | GDP | | | INFLATION | | |
|---|---|---|---|---|---|---|
| | 2017 | 2018 | 2019 | 2017 | 2018 | 2019 |
| France | 1.9 | 2.1 | 1.9 | 1.0 | 1.3 | 1.3 |
| Germany | 2.5 | 2.4 | 1.8 | 1.7 | 1.8 | 2.3 |
| Japan | 1.8 | 1.7 | 0.9 | 0.5 | 0.7 | 1.2 |
| US | 2.3 | 2.8 | 2.0 | 2.1 | 2.3 | 1.8 |
| Eurozone | 2.5 | 2.3 | 1.8 | 1.5 | 1.4 | 1.7 |
| China | 6.9 | 6.4 | 6.0 | 1.5 | 2.3 | 2.6 |
| India | 6.2 | 7.5 | 7.0 | 3.3 | 5.3 | 5.5 |
| World (2010 PPPs) | 3.7 | 3.9 | 3.6 | 3.8 | 3.0 | 2.9 |

*Source: Oxford Economics*

# SECTOR FORECASTS

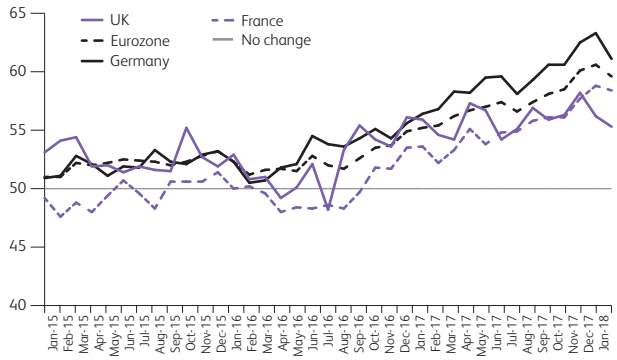
The manufacturing sector enjoyed an excellent year in 2017, expanding by 2.8%, its strongest growth since 2014, and well above the sector's average annual growth rate. Encouragingly the healthy performance was broad based across sub sectors, and points to significant momentum being carried over into 2018.

The sector continues to benefit from the global economy upturn, which combined with the weak Sterling is providing a supportive boost to exports, which were up over 10% in 2017. While exports continue to thrive, the strong global economy is also bringing investment back online, supporting capital equipment manufacturers, and those in their supply chain. While these factors mean the sector is in fairly rude health, risks do remain, notably from the weakness in the construction sector, as well as, of course, uncertainty at the terms of the UK's exit from the EU. These dynamics should see growth slow over the next two years, but given that the strength in the global economy is showing no signs of abating, as well as a better than expected end to 2017, we do not envisage this slowing to be as great as previously thought, and have revised up our forecasts for 2018 to 2.0%. In 2019 we expect the sector to slow further, pencilling in an expansion of 0.6%, as elevated levels of uncertainty take effect.

These forecasts, especially growth of 2.0% in 2018, are healthy. It should be noted however that this is predominantly a global economy story, with manufacturing across the world, and specifically Europe, currently enjoying a sweet spot. Therefore, while we have revised up our forecasts, and if they should be realised it will mean another good year for the sector, we still trail our European counterparts, who are set to have an even stronger year, free of the uncertainty generated by Brexit.

**MANUFACTURING ACTIVITY IS HEALTHY ACROSS EUROPE**

MANUFACTURING PMIs




*Source: Markit/CIPS (2018)*

## GLOBAL ECONOMY CONTINUES TO BOOST CAPITAL EQUIPMENT MANUFACTURERS

After a period of weakness across 2015-16, business investment has picked up over the last year. The recovery comes on the back of strong global demand, as well as the rise in oil prices back up to around the $60/barrel mark. The **mechanical equipment** sector, as the chief investment good in UK manufacturing, is perhaps the sector that has benefited most from this turnaround. Indeed the sector expanded by a substantial 7.7% in 2017, confirming the positive balances we saw in our own *Manufacturing Outlook* across the year. While we expect the sector to have another good year, boosted further by positive trading conditions, weakness in some of its key intermediate markets including construction and automotive, a general unwinding from a strong year in 2017, as well as Brexit uncertainty pulling back some domestic investments, means we believe growth in the sector will slow to 5.1% in 2018, and then 0.5% in 2019.

In a similar position is **electronics**, which is largely a capital goods sector, deriving most of its demand from other manufacturing markets. The sector has benefited from the upturn in global demand and investment, illustrated in the sector recording five consecutive quarters of expansion for the first time since the "dot-com" bubble. This momentum, combined with healthy export prospects to Asia and the Middle East, means the sector is set to expand by 3.5%

this year, before slowing to 1.0% the following year. **Electrical equipment** meanwhile is also set to grow this year and next, although at a reduced pace. We are forecasting growth of 0.6% and 0.4% over the coming years.

While capital goods manufacturers have benefited from the cyclical upturn in the global economy, and the associated boost to investment, manufacturing as a whole is profiting from the improved demand conditions. This is evident in the **metal product** sector's performance, a key barometer of the industry given that it feeds into so many other supply chains. The sector, following a weak start to 2017, saw momentum build throughout the year, culminating in growth of 5.8% in 2017q4, and 1.9% for the year as a whole. This momentum, combined with the strong global environment, should be enough to offset weakness in other parts of the economy – notably the construction sector – and we are forecasting growth of 3.4% in 2018. As manufacturing slows however, we expect the metal products sector to follow suit and are predicting growth of 0.5% in 2019.

**Basic metals**, the key input into the metal products sector also appears to have turned a corner, recording growth of 3.1% in 2017. The prospects for 2018 remain positive, with steel prices expected to remain elevated, global supply set to be reduced following Chinese anti-dumping measures and trading conditions to be supportive. That said, the industry still remains unbalanced, and while we expect growth to be good this year at 3.0%, in 2019 we are forecasting a contraction as the sector unwinds, notable weakness in the construction industry takes effect, as well as the prospect of US protectionist measures hitting demand.

## SECTORS IN THE CONSTRUCTION SUPPLY CHAIN TO BE EFFECTED BY ITS WEAK OUTLOOK

The outlook for construction this year, as we have mentioned, is not promising. The industry actually had quite a strong 2017, expanding by 5.1%. However this performance was heavily weighted towards the start of the year, with 2017q4 representing the third successive quarter of contraction, indicating that momentum in the sector has been stalling. The sector is being hit by Brexit

### SECTOR GROWTH RATES AND FORECASTS

% CHANGE

| | OUTPUT | | | EMPLOYMENT | | |
|---|---|---|---|---|---|---|
| | 2017 | 2018 | 2019 | 2017 | 2018 | 2019 |
| Basic metals | 3.1 | 3.0 | -0.3 | -2.1 | 4.2 | -1.1 |
| Metal products | 1.9 | 3.4 | 0.5 | 4.1 | 1.5 | -0.9 |
| Mechanical | 7.7 | 5.1 | 0.5 | 4.8 | 2.7 | 0.0 |
| Electronics | 6.5 | 3.5 | 1.0 | 4.6 | 2.6 | -2.4 |
| Electrical | 1.3 | 0.6 | 0.4 | 2.1 | 7.0 | -0.3 |
| Motor Vehicles | 0.2 | -0.4 | 0.7 | 5.1 | 0.0 | 0.0 |
| Other transport | 11.5 | 6.2 | 3.2 | -2.4 | -2.2 | -2.2 |
| Food and drink | 2.0 | 1.1 | 1.1 | -0.6 | -2.5 | -2.0 |
| Chemicals | 3.6 | 1.6 | 0.8 | 1.1 | -4.6 | -4.2 |
| Pharmaceuticals | -4.4 | 1.6 | -0.8 | 10.5 | -2.8 | -5.9 |
| Rubber and plastics | -1.0 | -1.0 | 0.4 | -0.6 | 1.9 | 2.5 |
| Non-metallic minerals | 0.7 | -0.1 | 1.2 | -5.3 | -5.6 | -2.6 |
| Paper and printing | 2.1 | -0.8 | -0.8 | -1.4 | -4.9 | -4.1 |
| Textiles | 2.2 | -4.1 | -2.9 | -10.8 | -5.4 | -6.3 |
| Manufacturing | 2.8 | 2.0 | 0.6 | 1.1 | -0.3 | -1.6 |

*Sources: EEF and Oxford Economics*

uncertainty, with commercial office building in particular expected to feel the full force as corporations hold off making investment decisions until they have clarity on the Brexit deal. This of course was all before the liquidation of the UK's second biggest contractor Carillion, and the knock on effects this is going to have across the supply chain.

While the metal products, basic metal and electrical equipment sectors will all be affected by this, **non-metallic minerals**, which generates 63% of intermediate demand from the construction industry, is most exposed to its performance. As a result we expect the sector to contract this year, before picking up again in 2019. Likewise **rubber and plastics**, where nearly a third of its intermediate demand comes from construction is also set to feel the effects, and we expect a contraction of 1.0% this year. In 2019, however, the sector should pick up as manufacturers take advantage of the opportunities on offer from the move to more environmentally friendly products. Meanwhile **chemicals** is also forecast to have a weaker year given that a fifth of its output goes into construction in the form of paints and coatings. This should drag on the sector, despite healthy private survey data, and we expect growth of 1.6% in 2018.

## MIXED BAG FOR CONSUMER FACING SECTORS

With inflation expected to recede, and wages to finally pick-up on the back of the strong labour market, the squeeze on consumers and some consumer facing sectors should ease this year. **Food and drink**, the sector most exposed to household spending, is expected to have a steady few years, although weaker than its 2017 performance. The slowing is partially down to the sugar levy coming into effect in April of this year. However the demand inelastic nature of food and drink products, as well as an improving export performance, should offset this drag and we expect growth of 1.1% in both 2018 and 2019.

On the other hand, **textiles**, after recording strong growth in 2017 relative to its recent performance, is set to struggle over the coming years. Cheap labour from Asia, a lack of available skills in the UK, and uncertainty around future trading arrangements with the EU – the sector's largest export market – are all expected to impact the sector adversely. We have pencilled in consecutive contractions of 4.1% and 2.9% in 2018 and 2019 respectively.

Meanwhile **motor vehicles**, after healthy year on year growth rates stretching back to 2010, is expected to see a continuation of the slowing trend we saw in 2017, in which the sector expanded by 0.2%, its weakest growth since the financial crisis. While Brexit related risks dominate the media narrative, there is an increasing concern that the sector has reached saturation point, with large falls in output in the domestic market, driving the overall decline. Demand for diesel cars is also likely to be impacted by fiscal policy announced in the Autumn Budget. We are expecting the sector to contract by 0.4% in 2018, before recovering to post modest growth of 0.7% in 2019.

## OTHER TRANSPORT TO COME OFF THE BOIL BUT PHARMACEUTICALS TO PICK-UP A LITTLE

The **other transport** sector, and in particular the aerospace sector, has been a source of good news for the manufacturing sector over the last decade, with healthy growth rates recorded on a yearly basis. Indeed, last year the sector expanded by a hugely impressive 11.5%. The sector however is set to come off the boil over the coming years, with a general unwinding combining with production difficulties for major OEM Airbus taking effect. That said, with order books backlogged at record levels, the sector should still post healthy growth of 6.2% in 2018 and 3.2% in 2019.

**Pharmaceuticals**, after a poor 2017 in which it contracted by over 4%, is expected to recover a little in 2018 and expand by 1.6%. However, with increased competition from generics likely to continue, and big players such as AstraZeneca and GSK recording subdued results, the days of strong annual growth could be behind the sector for a while. We expect the sector to contract again in 2019 by 0.8%.

## MID-MARKET MANUFACTURER'S JOURNEY TO 4IR

It is really promising to see the Q1 results highlight how ambitious UK manufacturers are defying Brexit uncertainties and continuing to invest in their businesses' futures. Hopefully, some of this uptick in investment also reflects a move towards more automation and increasing use of the concepts of 4IR.

There is a lot of buzz about what the 'next industrial revolution' looks like and the potential it holds, but the journey looks different for every organisation, and so may the end destination.

For mid-market firms - the heart and soul of the UK manufacturing industry - revolutionary digitisation can feel aspirational, not inspirational. Cutting-edge technologies like artificial intelligence, robotic process automation or in-line 3D printing might seem like distant dreams for manufacturers that are still focused on migrating to the cloud or just dipping their toes into shop-floor automation.

However, stagnation is a death knell in today's manufacturing environment. Technology, competition and shifting consumer expectations have changed the game, and mid-market manufacturers can't afford to sit back and watch how it's going to play out. Manufacturers in China and India are investing in automation and innovation to better compete on a global scale and cater to growing customer demand for speed, convenience and customisation. And Germany – where the term "Industrie 4.0" originated – has possibly leapfrogged the UK in manufacturing innovation.

Mid-market manufacturers are in a good position to take advantage of the changes that 4IR is introducing. As established businesses, with strong track records and plans for the future – this should mean more funding and resources for innovation (and more room for smart risk-taking); less bureaucracy and red tape than their larger, FTSE counterparts means more flexibility, collaboration and faster decision-making.

But the UK manufacturing mid-market is far from one big homogeneous group; it represents a wide spectrum of manufacturing capabilities deployed in different ways with different priorities and varying levels of technology and supply chain complexity.

The keys to success are: 1) establishing a clear, shared vision of the future 4IR value chain environment of your industry and your company in that industry; and 2) developing a tailored, prioritised action plan designed to boost momentum and continued progress. A plan that establishes the right starting point based on a realistic assessment of where you are right now will be critical.

While every organisation has a different implementation trajectory, real and meaningful progress is possible for them all. For some manufacturers, the 4IR journey might be evolutionary instead of revolutionary – and that's okay. Small, incremental innovations add up over time, and as long as these "incrovations" are aligned with the overarching 4IR vision, what is evolutionary today may be revolutionary when you look back five years from now.

However, manufacturers need stability and certainty in government policy if they are to commit to significant capital investments in 4IR technology and skills. Therefore, it is critical that the Government creates a long-term industrial strategy that avoids the disruptions of the political cycle.

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

**Tom Lawton**
Partner and Head,
BDO Manufacturing
0121 352 6372
tom.lawton@bdo.co.uk

eef The manufacturers' organisation

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

We work with the UK's manufacturers from the largest to the smallest. 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.

To find out more about this report, contact:

**Lee Hopley**
Chief Economist
lhopley@eef.org.uk

**Martyn Jenkins**
Economist
mjenkins@eef.org.uk

**Francesco Arcangeli**
Economist
farcangeli@eef.org.uk

**EEF Information Line**
0808 168 5874
research@eef.org.uk

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

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

BDO

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

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

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

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

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

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

To talk about any issues your manufacturing business may be facing please contact:

**Tom Lawton**
Head, BDO Manufacturing
0121 352 6372
tom.lawton@bdo.co.uk

**Baljit Bhamra**
Marketing and Business Development Manager – BDO Manufacturing
0121 352 6296
baljit.bhamra@bdo.co.uk

Published by EEF, Broadway House, Tothill Street, London SW1H 9NQ
Copyright ©EEF February 2018

Ref: 18.02.POL.LH.NB

eef The manufacturers' organisation

We foster enterprise and evolution to keep your business competitive, dynamic and future focused
www.eef.org.uk