The manufacturers' organisation

In partnership with:

MANUFACTURING OUTLOOK

2016 QUARTER 3

2.6 million employees

1/2 of UK exports

72% of business R&D

Average wages higher than the rest of the economy

Corgi Socks, taken by Sophia Campion, winner of the Young photographer category of the EEF Photography Awards 2013

FOREWORD

Lee Hopley
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Welcome to the 2016q3 *Manufacturing Outloo*k report, in partnership with BDO LLP.

In our last report, three months ago, we were reporting signs of gradual improvement in activity across UK manufacturing businesses. We had not noted significant signs of caution about the upcoming referendum and concluded that companies' responses were based on the assumption that the vote would result in the UK remaining a member of the European Union.

The positive pre-referendum sentiment in our survey was supported by a surge in manufacturing output growth in official statistics covering the second quarter of this year. But clearly, the vote to leave the EU in June has had a bearing on the outlook for the sector. In the immediate aftermath of the vote EEF's EU Referendum survey noted a sharp contraction in confidence about prospects for the UK economy and manufacturers' own firm-level performance, underpinned by an expectation that demand from domestic and European customers would falter in the second half of the year. Other surveys covering industry, non-manufacturing businesses and consumers pointed to similar declines in sentiment.

Our latest survey, however, suggests that the short-term hit to output could be more muted. Worries about the UK economic outlook prevail, but manufacturers appear less downbeat about activity levels in their own businesses over the remainder of this year. Indeed, response balances across our main output and orders indicators covering the past three months appear little changed from the previous quarter's survey. In addition, expectations about future export orders continue to climb higher, spurred by a weaker exchange rate and stronger demand signals coming from the US and emerging markets.

While the referendum outcome appears not to have pushed the sector back into recession, the results do not provide confidence that a return to stronger growth is on the cards this year either. While we see some, inevitable, sector variations in recent performance and future expectations, in aggregate the sector looks like it will move sideways, rather than up, in the coming quarters. These expectations are reinforced by the further downward drift in investment intentions, which remain at their lowest level since the end of the financial crisis.

Overall, it does seem that there has been some correction in the confidence readings from businesses compared with the immediate referendum reaction at the beginning of July. While that is clearly positive in terms of the short-term outlook for industry, questions marks will continue to remain about longer term prospects once the negotiations on a UK exit from the EU begin. And policy makers will, therefore, need to proceed quickly with the development of an ambitious industrial strategy and the policies that will make the UK a competitive proposition for future manufacturing investment.

2016Q3 HEADLINES

Growth prospects have weakened in the third quarter, as manufacturers report a decline in output and employment on the back of subdued domestic demand. Besides, the Sterling depreciation is likely to put pressure on manufacturers' profit margins. There is a silver lining from weak Sterling, however, as export orders spiked to a two-year high.

INDICATOR	BALANCE	CHANGE	
Confidence	4.7	↓	Confidence about UK economy suffers post-referendum
Output	-7 %	↓	Output balance remains negative for fifth quarter running
UK orders	-9 %	↓	UK demand falls against last quarter's expectation of a return to positive territory
Export orders	2 %	↑	Export balance posts first positive reading since 2015q1
Employment	-5 %	↓	Recruitment activity falls, but should pick up again next quarter
Investment	-10 %	↓	Investment plans continue their decline deeper into the red

Source: EEF Manufacturing Outlook Survey

As highlighted in our 2016q3 *Manufacturing Outlook survey*, manufacturers' confidence about the UK economy has taken a step back after the UK voted to leave the EU. Against last quarter's expectations, output and orders balances remained negative in 2016q3 while investment prospects dropped deeper into red. However, export orders provided some relief, turning positive for the first time in two years.

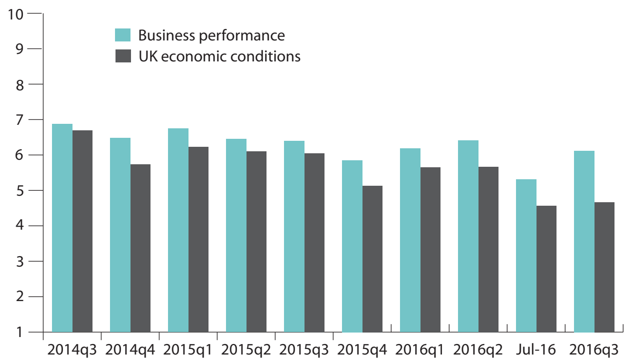
The trend is uneven across sectors. Construction-related industries – such as rubber and plastics and non-metallic minerals – expect a deeper downturn as slowing households' investment will drag on construction activity. Similarly, subdued demand from weak investment plans weighs on capital goods – such as mechanical equipment, although headwinds from the oil and gas industry are waning. In contrast, the food and drink industry benefited from sustained consumer spending, while electronics recorded high growth in exports.

The Sterling depreciation provides little relief in the near term. As import prices soared, manufacturers' production costs picked up in the past quarter while output prices remained low. As a result, manufacturers' profit margins were squeezed on both domestic and overseas sales. Yet the bright side is that the weak Sterling is likely to have triggered a rise in export orders over the last quarter, which stood at a two-year record high. Margin pressures are expected to ease over the next quarter as the Sterling depreciation passes through into higher output prices.

Investment prospects deteriorated for the fourth quarter running. Although the decline was of a lower magnitude, we still see no sign of recovery in the short term. In a context of heightened uncertainty about future demand, manufacturers are likely to postpone capital expenditure decisions, with investment probably stabilising at low levels.

BUSINESS CONFIDENCE HOLDS UP IN FACE OF DECLINING SENTIMENT ABOUT UK GROWTH

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



Source: EEF Manufacturing Outlook Survey

OUTPUT

The previous two quarters had seen improvements in manufacturers' output levels with companies predicting that this would continue into the second half of the year. But in the past three months this has gone into reverse, with the balance of companies reporting output growth dropping back to -7% from -4% in 2016q2. However, improvements are expected to get back on track with a balance of manufacturers planning for output growth next quarter.

PAST THREE MONTHS	↓	-7%
NEXT THREE MONTHS	↔	4%

Manufacturers' output balances failed to climb back into positive territory – as was anticipated last quarter – over the past three months, rather remaining negative for the fifth quarter running. The decline in the overall output balance from -4% to -7% was driven by weakening activity across the majority of manufacturing sectors, with metal products, electronics and food and drink notably bucking the downward trend.

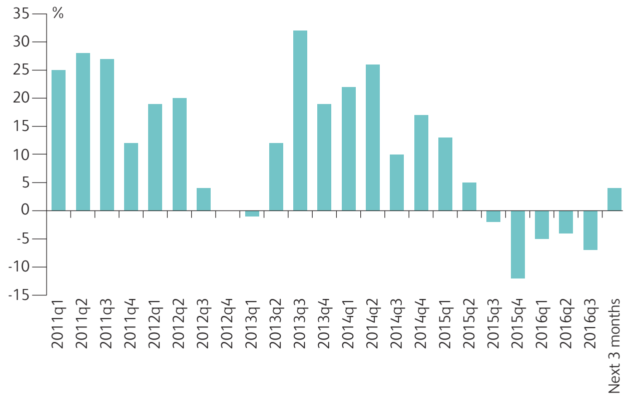
Some of the big declines in the past three months were in mechanical equipment. This sector hasn't been short of challenges in the past two years, but in recent reports we had noted signs that depressed demand conditions in oil and gas supply chains were waning and the drag from weak global manufacturing activity was also bottoming out. Any previous indications that conditions might be stabilising have been counteracted by renewed weakness – particularly in the domestic market, a consequence of declining investment plans. There is some optimism that this decline will be short-lived with positive output expectations for the coming quarter.

Similarly, construction–related sectors have had a difficult three months, with rubber and plastics seeing the most significant output balance fall. The resilience of metals products in the face of slower construction activity is a result of its much more diversified customer base, which has seen the sector's output balance pick up to +3% from -2% in the previous quarter. Companies in this sector expect to see further output gains in the coming quarter.

The most upbeat sectors in our survey are electronics and food and drink. The former is benefitting from favourable exchange rate movements and brightening demand prospects in the US and Asian markets. In contrast, the more domestically-focused food industry continues to be supported by robust household spending, a trend that manufacturers expect to be sustained in the next three months.

OUTPUT BALANCE EDGES DOWN AS RECOVERY IS POSTPONED

% BALANCE OF CHANGE IN OUTPUT



Source: EEF Manufacturing Outlook Survey

OUTPUT SUMMARY

% BALANCE OF CHANGE

SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS
Basic metals	-25	-27
Metal products	3	15
Mechanical	-22	3
Electrical	7	7
Electronics	22	11
Rubber & Plastics	-22	11
Other transport	9	0
TURNOVER		
£0-9m	-16	0
£10-24m	9	21
£25m and over	35	27

Source: EEF Manufacturing Outlook Survey

ORDERS

In line with the softening output balance, order in-take also disappointed in the past three months. Against expectations of growth in total orders last quarter the balance deteriorated slightly from -2% to -4% this quarter. Much of this fall was concentrated in declining sales to UK customers. In contrast, manufacturers had been more downbeat about export prospects, but on the upside, overseas sales surprised, posting their first positive balance since 2015q1.

UK ORDERS	PAST 3 MONTHS	↓	-9%	NEXT 3 MONTHS	↔	4%
EXPORT ORDERS	PAST 3 MONTHS	↑	2%	NEXT 3 MONTHS	↑	12%
TOTAL ORDERS	PAST 3 MONTHS	↓	-4%	NEXT 3 MONTHS	↓	8%

UK ORDERS

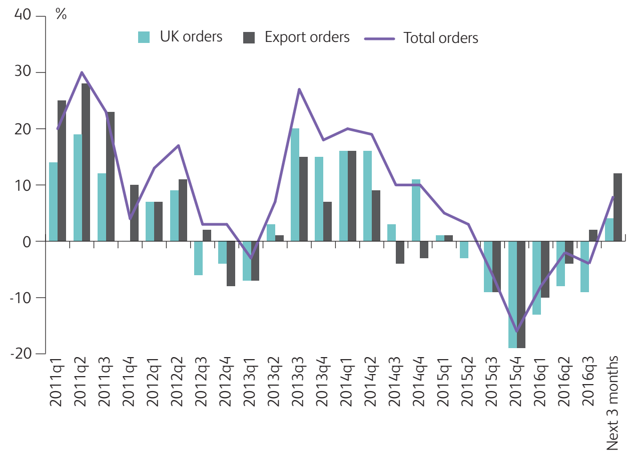
The total orders balance in our survey has been negative for the past five quarters running and in the most recent quarter new order in-take fell short of last quarter's expectations of a return to growth. Nevertheless the pull back in the balance was relatively modest suggesting the demand environment for manufacturers overall was still better in the past three months than that seen through the second half of last year and into the first quarter of 2016.

The main area of weakness appears to be UK customers. Three months ago, manufacturers across all sectors, except basic metals, were forecasting positive UK orders balances in 2016q3. However, virtually all sectors under-performed against expectations. Mechanical equipment posted one of the weakest UK orders balances, coming in at -17%; this contrasts with a long-awaited return to growth in UK demand for the sector. The uncertain outlook for investment, in part a consequence of the referendum result, is likely to weigh on not only this sector, but also domestic demand for electronics – also linked to demand for capital goods.

The net balance for metal products UK orders also fell back into the red for the first time since the end of 2015. Other sectors with construction connections, including non-metallic minerals, also reported flat UK sales.

ORDERS IMPROVEMENT HELD BACK BY WEAK UK DEMAND

% BALANCE OF CHANGE IN ORDERS



Source: EEF Manufacturing Outlook Survey

Manufacturers are not, however, planning for persistent sluggishness in domestic demand. Rather the improvement that was pencilled in for this quarter has been pushed out until the end of the year with a balance of 4% of manufacturers planning for a pick in UK sales in the next three months. In line with expectations in 2016q2, basic metals is the exception to this.

EXPORT ORDERS

Export sales, on the other hand, have surprised by moving in a more positive direction. A net balance of 2% of companies reported increased overseas sales in the past three months – a small positive, but the highest export orders balance since 2014q2. The sectoral picture was, however, far from uniform, suggesting that the benefits from the plunge in Sterling at the end of July has not been the only factor supporting sales abroad.

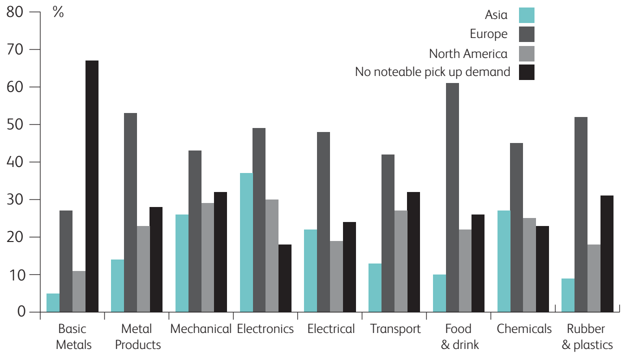
The most positive export balances in the past three months were posted in the electronics and electrical equipment sectors – both of which had signalled positive export growth expectations last quarter. Since the start of this year, both of these industries have been more optimistic about improving demand conditions, underpinning expectations that export orders will sustain some momentum in the final months of the year.

Across other sectors, improving demand from the EU seems to have been the biggest driver of stronger export sales. The food and drink sector, for example, has been consistently positive about demand conditions in EU markets since the start of the year and this is translating into healthy export balances over the past three months and into the final months of the year. The recent depreciation of Sterling may have boosted sales in recent months, but strengthening household demand in Europe will also be playing a role.

In contrast, the export outlook for the basic metals industry continues to look extremely challenging; the balance of companies reporting falling export sales has deteriorated further in the past three months and that negative trend is forecast to continue into the next quarter. While mechanical equipment also had a disappointing sales performance this quarter, the more competitive exchange rate and a stronger US market should propel export growth back into the black by the end of this year.

EU DEMAND MOST POSITIVE ACROSS ALL SECTORS

% OF COMPANIES REPORTING POSITIVE DEMAND CONDITIONS BY MARKET (2016Q1-Q3 AVERAGE)



Source: EEF Manufacturing Outlook Survey

ORDERS SUMMARY

% BALANCE OF CHANGE

	UK ORDERS		EXPORT ORDERS		TOTAL ORDERS	
SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS
Basic metals	0	-13	-33	-36	6	-19
Metal products	-6	9	0	0	-12	6
Mechanical	-17	8	-10	25	-12	13
Electrical	0	13	13	33	0	40
Electronics	0	8	38	14	19	7
Other transport	0	-9	-11	-22	0	-9
TURNOVER						
£0-9m	-12	-2	-12	3	-10	4
£10-24m	5	19	17	17	2	7
£25m and over	27	21	24	21	25	28

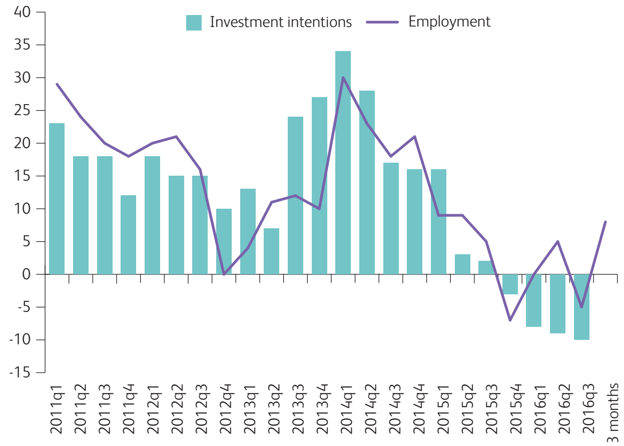
Source: EEF Manufacturing Outlook Survey

EMPLOYMENT & INVESTMENT

Manufacturers' recruitment of new employees lost momentum in 2016q3 as the balance of companies taking new employees turned into negative territory. However, future hiring intentions edged up. In contrast, we see no improvement in investment prospects as the balance for planned capital expenditure continued in its downward trend.

INVESTMENT SHOWS NO SIGN OF TURNING A CORNER

% BALANCE OF CHANGE



Source: EEF Manufacturing Outlook Survey

EMPLOYMENT	PAST 3 MONTHS	↓	-5 %	NEXT 3 MONTHS	↑	8 %
INVESTMENT	NEXT 12 MONTHS	↓	-10 %			

The employment balance turned negative in 2016q3 to -5 %, exceeding last quarter's expectations of a freeze in recruitment. However, the trend was unequal across sectors. Rubber and plastics and non-metallic minerals reported the most significant drop. This is consistent with their fall in output and orders in the backdrop of the slowdown in the construction sector. Similarly, hiring activity declined in mechanical and electrical equipment, as demand for capital goods continued to be subdued. In contrast, the food and drink, chemicals and transport sectors saw an increase in headcount.

Yet, the fall in manufacturers' hiring activity is likely to be short-lived as the employment balance over the next three months edged up. The expansion is common across most sectors, except for basic metals where job losses will continue amid pressure on the steel industry.

Investment prospects continued to deteriorate in 2016q3. The balance for planned capital expenditure was trapped in negative territory for the fourth quarter running down to -10 % from -9 % in the previous quarter. Although the decline was smaller than what has been previously reported, and was concentrated in specific sectors, manufacturers' uncertainty about future demand is likely to weigh on investment prospects.

EMPLOYMENT AND INVESTMENT SUMMARY

% BALANCE OF CHANGE

	EMPLOYMENT		INVESTMENT
SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS	NEXT 12 MONTHS
Basic metals	6	-7	-25
Metal products	0	12	-13
Mechanical	-9	7	-15
Electrical	-13	7	4
Electronics	0	19	5
Other transport	18	9	-17
TURNOVER			
£0-9m	-2	4	-4
£10-24m	-5	16	-5
£25m and over	13	16	-2

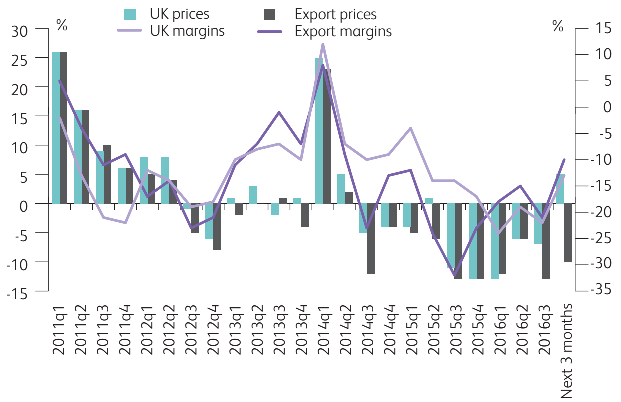
Source: EEF Manufacturing Outlook Survey

PRICES & MARGINS

Manufacturers' profit margins were squeezed considerably in 2016q3 on both domestic and overseas sales as a result of rising input prices following the Sterling depreciation. Forward looking balances, however, suggest a pick-up in domestic output prices over the next quarter which will partly offset the negative impact of the exchange rate depreciation on manufacturer's profit margins. Similarly, export margins are projected to improve.

PRICE RISES IN THE PIPELINE

% BALANCE OF CHANGE



Source: EEF Manufacturing Outlook Survey

UK PRICE	PAST 3 MONTHS	↓	-7%	NEXT 3 MONTHS	↑	5%
EXPORT PRICE	PAST 3 MONTHS	↓	-13%	NEXT 3 MONTHS	↓	-10%
UK MARGINS	PAST 3 MONTHS	↓	-22%	NEXT 3 MONTHS	↑	-13%
EXPORT MARGINS	PAST 3 MONTHS	↓	-21%	NEXT 3 MONTHS	↑	-10%

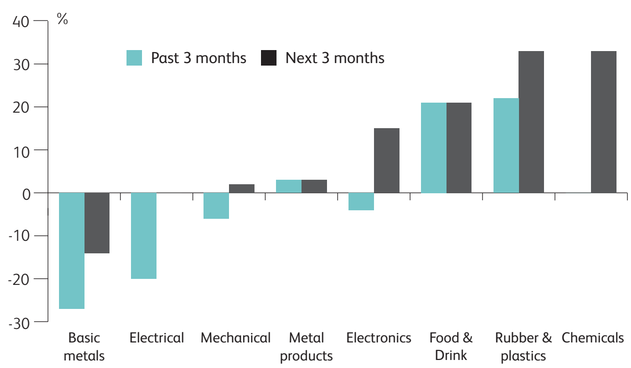
The Sterling depreciation put upward pressure on manufacturers' production costs as import prices edged up. However, recent data suggest that the pickup in UK CPI inflation has been moderate so far as the pass-through of the Sterling depreciation into consumer prices takes time to materialise. This is in line with manufacturers reporting lower output prices for the past three months. As a result, profit margins significantly tightened in 2016q3 continuing the downward trend that has been observed for more than a year.

Price pressures are likely to ease in 2016q4 as balances for UK prices over the next three months substantially improved, turning positive for the first time since 2015q2. As output prices adjust upwards, this will provide some relief to manufacturers' profit margins on domestic sales which are expected to recover in the next three months. The trend is common, to a varying extent however, across all sectors. The only exception lies in the basic metals industry, where deteriorated competitiveness gives little ground for price adjustment, hampering profit margins.

In contrast, export prices continue to decline over the next three months as manufacturers anticipate the weak Sterling to prevail, but this has a limited impact on export margins.

SECTOR VARIATION IN PRICE RISES

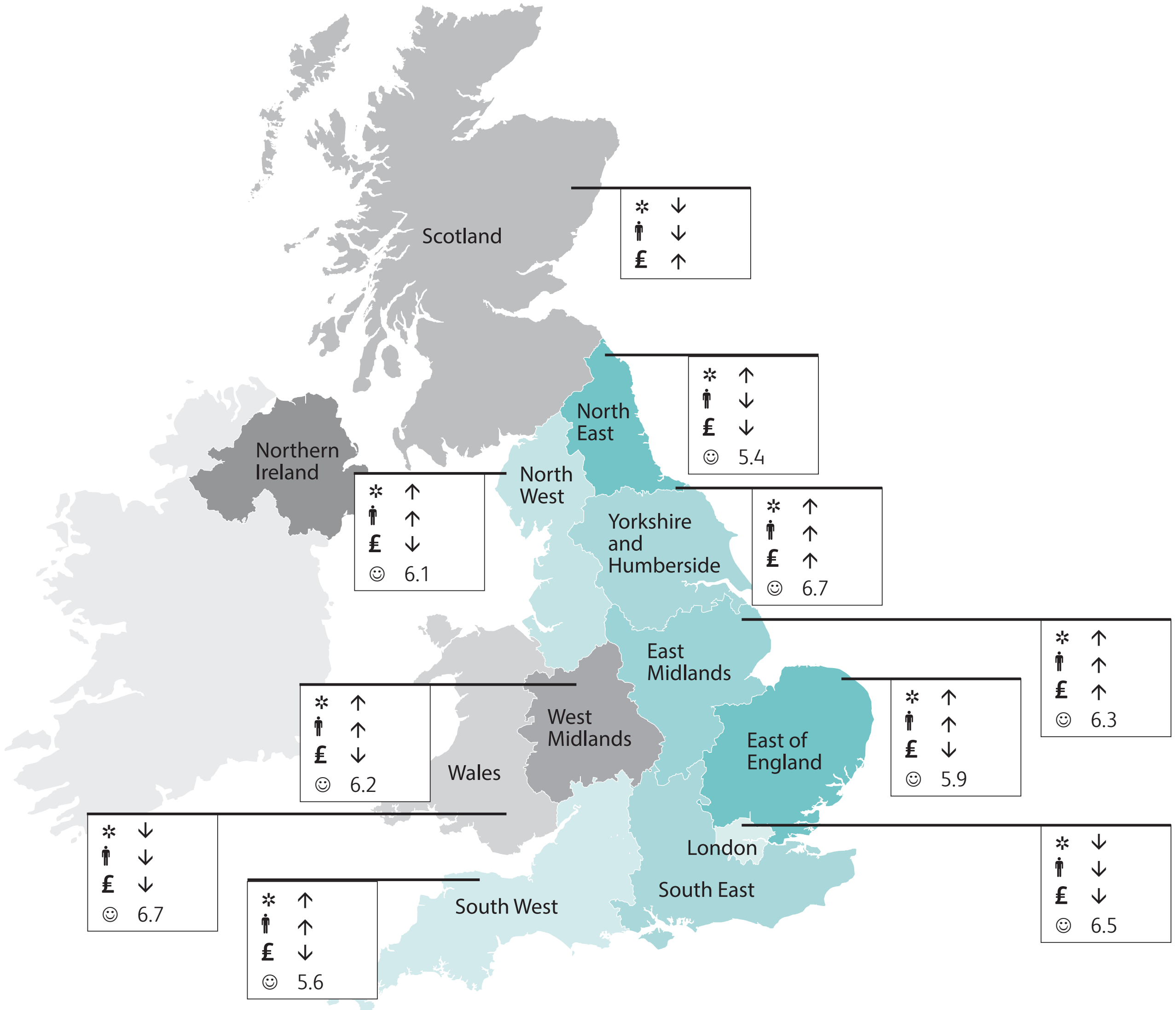
% BALANCE OF CHANGE IN UK PRICES



Source: EEF Manufacturing Outlook Survey

REGIONAL TRENDS

While the national picture has been slightly softer this quarter than expected, there have been some significant movements in both directions across different regions. The effects of the steel crisis are still evident in the results for the North East and while manufacturers in Scotland have not shaken off the effects of the low oil price, they also seem to be weighed down by renewed political uncertainty. The bright spots in the UK have broadened out from the South East and London, to the East Midlands and Yorkshire and Humberside.



KEY:

↑/↓ INCREASE/DECREASE ON PREVIOUS QUARTER

✲ OUTPUT

EMPLOYMENT

£ INVESTMENT

☺ BUSINESS CONFIDENCE

Source: EEF Manufacturing Outlook Survey

Positive output balances look more consistent across UK regions this quarter, with solid gains reported in the East of England, Yorkshire and Humberside and the North West. The dominant food and drink sector in each of these regions is likely contributing to the improving outlook in addition to the fairly stable performance of the transport sector in the North West. However, weaker than average investment intentions in the North West and Eastern regions suggest that the turnaround in trading conditions are not yet well-rooted.

Taking a turn in the opposite direction were output and orders balances in Wales and Scotland, both of which reported a marked deterioration in key survey indicators relative to three months ago. Scottish manufacturers have seen falls in UK and export orders over the past three months, which are forecast to persist next quarter. While in Wales, it is the future that seems to be of greater concern, with manufacturers in the region particularly downbeat about export prospects in the coming quarter.

The North East continues to be amongst the more pessimistic parts of the country. While the output balance has increased in the past three months it remains amongst the lowest, at zero, in the UK. Concerns about future UK and overseas demand are also evident as the region continues to struggle with the effects of the crisis in the steel sector.

BUSINESS CONFIDENCE INDICATORS

Following the referendum the gap between business confidence and confidence about the performance of the UK economy has widened significantly across all regions, with the exception of the North East. In line with trends seen over the past two years, all regions have manufacturers more confident about their own business performance than that of the UK economy more widely. Indeed, concerns about the UK economic outlook are most acute in the Northern regions and the South East and London.

CONFIDENCE ABOUT UK OUTLOOK TAKES A DIVE POST-REFERENDUM

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

Source: EEF Manufacturing Outlook Survey

REGIONAL SUMMARY

% BALANCE OF CHANGE

	OUTPUT		TOTAL ORDERS		EMPLOYMENT	
SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS
Scotland	-27	-5	-19	-3	-10	3
North East	0	40	-20	20	-20	-20
North West	42	25	50	25	25	17
Yorks & Humber	29	24	35	31	18	6
East Mids	45	27	27	18	27	18
Eastern	21	22	11	26	5	11
South East & London	23	27	19	24	24	24
South West	18	19	6	31	12	19
West Mids	20	27	-7	-14	7	0
Wales	0	20	0	0	-20	25

Source: EEF Manufacturing Outlook Survey

ECONOMIC ENVIRONMENT

The economic backdrop for manufacturers has shifted from concerns around global growth and the outlook for commodity prices in the first half of 2016 to domestic prospects in the wake of the UK's vote to leave the European Union in the second half of the year.

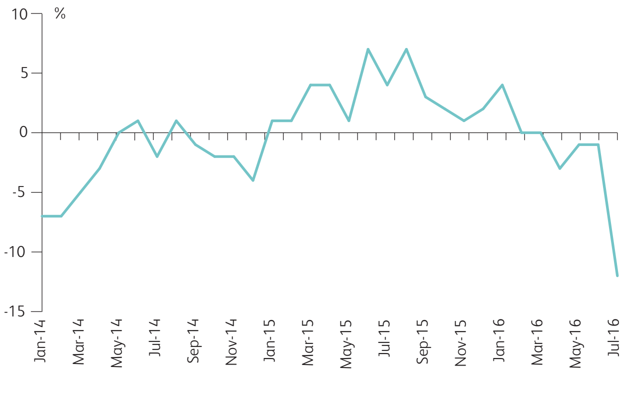
Pre-referendum UK GDP growth accelerated from a weak start to the year, with manufacturing accounting for a third of the 0.6 % quarter on quarter expansion. Survey indicators released since the end of June suggest this pace of growth is unlikely to be repeated in the second half of 2016.

UK HEADLINES

- Growth forecast to stall in 2016H2 and remain weak through 2017
- Referendum impact seen in falling confidence and rising prices
- Bank of England reacts with targeted policy package
- New government has taken the reins with possible fiscal measures to follow in the Autumn

CONSUMER CONFIDENCE DECLINES SHARPLY

CONFIDENCE INDEX FIGURE



Source: GFK NOP

Clearly the most significant economic development facing UK manufacturers is the outcome of the EU referendum and the subsequent uncertainty this has generated right across the economy. The assumptions underpinning our forecasts three months ago assumed a 'remain' outcome and with few signs that activity had been hit pre-referendum, real GDP growth was expected to gradually strengthen through the rest of 2016.

The chronology of economic reaction since the referendum was first a violent response from financial markets, a sharp decline in confidence indicators and some tangible evidence of Brexit effects in official statistics.

As economists had predicted, the market reacted negatively to the referendum outcome with Sterling bearing the brunt, falling by 8 % against the US dollar between the 23rd and 24th June and stocks also fell sharply. While the FTSE indices have since recovered, Sterling remains weak against major currencies.

The shock of the referendum outcome and the resignation of the Prime Minister, took their toll on business and consumer confidence. Huge falls were seen in the PMI indicators across industry, services and construction, as well as in other survey indicators, including a July survey of manufacturers by EEF, which has been sustained in our latest report.

The hit to sentiment is unsurprising, but this has not translated into collapse in sales on the High Street or a deterioration in labour market conditions in July. However, Brexit effects were evident in recent official data showing upward pressure on input costs from the weaker Sterling. In July producer input prices rose by 3.3 % in the month to July, the fastest pace of increase since December 2010. The flow through to factory gate prices and CPI inflation will surely follow in the coming months

EARLY ACTION FROM THE BANK OF ENGLAND

But it is not the prospect of rising prices that prompted action from the Monetary Policy Committee in August. The Bank of England's *Inflation Report* noted significant downside risks to growth following the referendum, and substantially downgraded its forecasts for all expenditure components of GDP. Weaker consumer spending, a postponement of businesses' investment plans, supported by our survey, and falling housing investment account for most of the revised forecast, which now sees GDP increasing by 0.8 % in 2017 from 2.3 % in their May *Report*.

UK ECONOMIC FORECASTS

% CHANGE EXCEPT WHERE STATED

	2015	2016	2017
Trading environment			
Exchange rate (€/£)	1.38	1.23	1.21
Exchange rate ($/£)	1.53	1.36	1.28
Exports	4.8	2.6	2.5
Imports	5.8	3.0	1.4
Current account (% GDP)	-5.3	-5.7	-3.9
Output			
Manufacturing	-0.2	0.4	-0.7
GDP	2.2	1.7	0.8
Costs and prices			
Average earnings	2.3	1.8	1.1
Oil price (Brent Oil $/bl)	52.4	34.8	41.0
Employment			
Manufacturing (000s)	2,662	2,657	2,599
Rest of economy (000s)	31,289	31,624	31,511
Unemployment rate (%)	5.4	5.0	5.5

Source: Oxford Economics and EEF

In response the MPC announced a pre-emptive monetary policy strike on a potential downturn, cutting the Bank Rate to 0.25%, expanding the asset purchase programme by £70bn and introducing a new Term Funding Scheme to providing funding for banks at interest rates close to the Bank rate. Depending on how the data evolve, more action may yet follow.

The Bank's view of UK economic prospects is in line with our latest projections, which see the UK avoiding outright recession but with growth slowing to 1.7% this year and 0.8% next year. Manufacturing is unlikely to escape recession, with output set to contract next year by 0.7% – the next section will look in more detail at how this breaks down by sector.

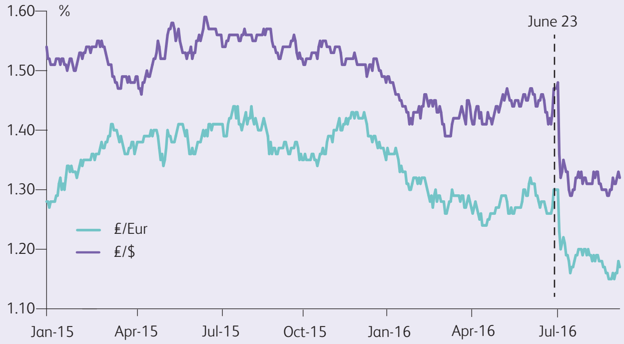
GLOBAL HEADLINES

- Global growth to trough this year before picking up in 2017
- Brexit adds downside risks to eurozone growth prospects in 2017
- Financial market volatility likely to delay the hike in US interest rates
- China's growth to moderate next year but encouraging signs from other large emerging economies

EXCHANGE RATE SPOTLIGHT

STERLING FELL SHARPLY AGAINST THE EURO AND THE DOLLAR

STERLING EXCHANGE RATES



Source: Bank of England and EEF analysis

The Sterling exchange rate depreciated by 11% in the aftermath of the EU referendum and by 17% since its peak in November 2015, having weakened against both the euro and the US dollar.

Recent policy actions would help sustain this trend. In its August MPC meeting, the Bank of England loosened monetary policy through a package of instruments including a 25bp cut in the Bank Rate. Abroad, markets expect any hike in the Fed's rates to be postponed until the end of this year while the ECB said it was ready to act should activity in the eurozone slow down as a result of Brexit.

The impact of exchange rate depreciation on UK manufacturers is mitigated. While a weak Sterling is likely to boost exports, subdued global demand growth gives limited ground for rising export volumes. Furthermore, Sterling depreciation increases input prices, particularly for import-intensive sectors, putting pressures on manufacturers' margins.

BREXIT TO ADD DOWNSIDE RISKS TO GLOBAL GROWTH IN 2016-2017

The outlook for the world economy remains subdued over 2016-2017. Global growth is expected to slow to 2.9% in 2016, revised down by 0.2 percentage points from last quarter's forecasts on the back of slower-than-expected activity in advanced economies. The world economy is set to accelerate to 3.4% in 2017, although at a slower pace than previously expected (-0.1 percentage points from last quarter's forecasts) reflecting growing economic and political uncertainties.

In the eurozone, economic recovery lost momentum in the second quarter after a solid start to the year, due to a slowdown in domestic demand. Despite monetary and fiscal policies being supportive in 2016-2017, growth prospects are likely to be affected by the Brexit vote in the near-term. Firstly, net exports may suffer from a drop in UK demand – the eurozone's biggest trading partner - and the ongoing appreciation of the euro. In addition, the UK referendum and accompanying political and economic uncertainty could see a subsequent fall in consumer and business confidence, which would further weigh on domestic demand. Moreover, market concerns about European stressed banks raised significantly after the EU referendum, resulting in tighter lending conditions and hampering investment perspectives. As a result, GDP growth is expected to show at 1.6% in 2016 before slowing down to 1.5% in 2017.

US economic growth fell below expectations in the first half of this year driven by weak business investment both in energy and non-energy sectors, slowing private consumption and net exports contributing negatively to GDP growth. But as headwinds from a strong US dollar and weak commodity prices are fading, economic growth is expected to strengthen in the remainder of this year showing at 1.5% in 2016, and accelerating to 2.3% in 2017. While the impact of Brexit is projected to be muted for the US economy, heightened financial market volatility is likely to delay the path of monetary policy normalisation with the Fed postponing hikes in interest rates until the end of this year.

EMERGING MARKET OUTLOOK BRIGHTENS

Growth trends are diverse among emerging markets. China's rebalancing toward private consumption and its high level of private debt continue to pose serious challenges in the near-term. GDP growth is projected to slow down to 6.5% this year and 6.2% in 2017, despite large-scale fiscal stimulus and expansionary monetary policy. Moreover, net exports are set to drag on activity growth as external demand remain subdued. By contrast, the outlook for other large emerging markets improved slightly, with signs of moderation in Brazil's downturn and stabilisation in Russia as a result of the recovery in oil prices.

The risks to the outlook are skewed to the downside. With Brexit still unfolding, the impact on the eurozone is still uncertain. Moreover, elections in major advanced countries (US this year, France and Germany next year) increase political uncertainty.

INTERNATIONAL ECONOMIC FORECASTS

% CHANGE EXCEPT WHERE STATED

	GDP			INFLATION		
	2015	2016	2017	2015	2016	2017
France	1.2	1.4	1.6	0.0	0.4	1.5
Germany	1.5	1.8	1.5	0.2	0.6	2.1
Japan	0.6	0.4	0.4	0.8	-0.2	0.2
US	2.6	1.5	2.3	0.1	1.2	2.2
Eurozone	1.6	1.6	1.5	0.0	0.3	1.7
China	6.9	6.5	6.2	1.4	2.1	2.3
India	7.2	7.5	7.2	4.9	5.4	5.1
World (2010 PPPs)	3.1	2.9	3.4	2.8	3.3	3.7

Source: Oxford Economics

SECTOR FORECASTS

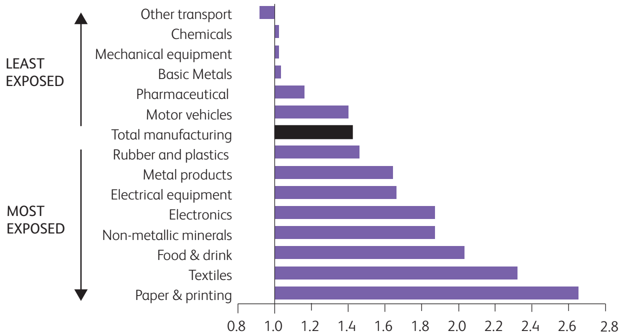
The past two years have seen variable performance across manufacturing sectors. While all sectors have seen confidence levels and growth expectations take a knock following the EU referendum, two key drivers are likely to generate further variation in their growth path – relative demand uncertainty and the impact of exchange rate movements.

First, uncertainty about demand prospects means capital goods manufacturers are likely to bear the brunt of companies' decisions to cancel or postpone investment plans. What's more, the downturn in the construction sector will weigh on demand for manufacturers embedded in its supply chain, such as non-metallic minerals and rubber and plastics. On the other hand, strong fundamentals and secure order books are likely to shield the transport and pharmaceuticals sectors from volatile demand conditions.

Second, significant movements in exchange rates are likely to create both winners and losers; the large depreciation in the pound will boost the competitiveness of export-intensive sectors but this benefit is likely to elude domestically-focused sectors with a heavy reliance on imported raw materials.

SECTORS' RELATIVE EXPOSURE TO RISING IMPORT COSTS

IMPORTS SHARE OF TOTAL SECTOR OUTPUT / EXPORTS SHARE OF TOTAL SECTOR OUTPUT (1 = BALANCED EXPOSURE)



Source: ONS (2014) and EEF analysis

SECTOR GROWTH RATES AND FORECASTS

% CHANGE

	OUTPUT			EMPLOYMENT		
	2015	2016	2017	2015	2016	2017
Basic metals	-10.6	-15.6	-4.2	1.4	-2.0	-5.2
Metal products	2.7	-0.2	-2.6	-8.0	-4.9	-1.1
Mechanical	-13.1	-2.6	-0.8	-5.1	-1.8	-7.1
Electronics	-2.1	-2.9	-1.3	1.7	0.9	-3.8
Electrical	0.8	-6.6	-3.5	4.0	0.6	-1.1
Motor vehicles	6.6	6.3	2.1	9.6	1.8	1.3
Other transport	6.2	3.4	1.0	-1.8	3.9	-0.7
Food and drink	0.0	0.8	1.0	5.9	0.9	-1.4
Chemicals	6.0	-4.0	-1.3	-5.4	-1.6	-4.0
Pharmaceuticals	0.5	5.1	2.1	-3.2	1.1	-5.7
Rubber and plastics	-3.4	-0.8	-0.8	4.3	-6.8	-0.1
Non-metallic minerals	-2.3	5.1	-4.5	5.3	6.0	-4.1
Paper and printing	0.4	-0.4	-2.1	-5.3	-6.7	-2.7
Textiles	-0.5	-6.7	-5.1	7.2	1.0	-8.1
Manufacturing	-0.2	0.4	-0.7	1.7	-0.2	-2.2

Source: EEF and Oxford Economics

CAPITAL GOODS TO BEAR THE BRUNT OF BREXIT UNCERTAINTY

While the lack of official data for the post-EU referendum period makes it hard to discern the full impact of the Brexit vote on demand and output, investment is usually the first casualty of elevated levels of economic uncertainty. This points to difficult times ahead for manufacturers of investment goods, like electronics, and mechanical equipment.

Subdued demand conditions are likely to drag on the **electronics** sector, where around 60% of output is comprised of precision instruments for industrial machinery and components for electronic products. With the sector already on a subdued growth path before the referendum, we see output falling by 2.9% in 2016.

Over the past two years, the **mechanical equipment** sector has struggled from weak oil and gas activity, as well as the overall slowdown in global manufacturing. However, the sector looked to be bottoming out in the start of 2016, with growth returning to positive territory after six consecutive quarters of contraction. Despite a timely export boost from the depreciation in the pound, this growth is now unlikely to be replicated in the second half of the year, where we expect output to fall by 2.6% over the year as a whole.

DOMESTIC FOCUSED, IMPORT-INTENSIVE SECTORS WILL FAIL TO SEE STERLING BOOST

The depreciation in the pound will lead to an improvement in export competitiveness across all manufacturing sectors, helping to compensate for some of the negative impact from uncertain demand prospects. However, there is a flip side to this; an increase in the price of imports will add to manufacturers' input costs.

While sectors with a high export-intensity will be able to offset some of this increase in costs through higher overseas sales, domestically focused sectors relying on imported materials will fail to see this benefit. The **food and drink** sector is two times more import-intensive than it is export-intensive; this means that manufacturers in the sector will struggle to maintain their profit margins. Combined with expectations of slowing household consumption, we forecast the sector to grow by just 0.8% in 2016.

The **textiles** and **paper and printing** sectors are more vulnerable to this trend. Both sectors are heavily import-intensive and focused on the domestic market. We see growth in textiles falling every quarter this year for a total contraction of 6.7% in 2016, while continued demand for cardboard packaging should cushion the blow for paper and printing where output is expected to fall by 0.4%.

The **electrical equipment** sector is likely to find itself in the wrong end of both the slowdown in demand for capital goods and an upward pressure in input costs. The sector's consumer-facing segment, previously seen as a strength for the sector, is now likely to prove a drag. The anticipated fall in consumer spending and the sector's high import-intensity and low export focus are likely to cause output to fall by 6.6% in 2016.

WEAK CONSTRUCTION TO WEIGH ON EXPOSED SECTORS

There is a widespread view that the construction sector is likely to be one of the biggest losers from the UK's decision to leave the EU. Unlike in other sectors of the economy, the construction industry has felt the impact of the EU referendum a good time before the actual vote. Manufacturers embedded in its supply chain are likely to see demand conditions deteriorate further.

The **non-metallic minerals** sector is the most exposed, supplying 62% of output to the construction industry. We therefore expect growth in the sector to fall sharply over the second half of the year. However, robust growth in non-metallic minerals in the first two quarters of the year will still propel the sector to growth of around 5.1% in 2016.

The **rubber and plastics** sector also sends a good chunk of output to the construction industry. However, the sector's demand base is significantly more diverse, with a decent exposure to motor vehicles likely to offset some of the drag from weak construction activity. We expect the sector to contract by 0.8% this year.

The **metal products** and **basic metals** sectors are also exposed to construction activity, albeit less so than the non-metallic minerals and rubber and plastics sectors. With the well-performing transport sectors driving a good proportion of demand for metal products, we see output falling only slightly by 0.2% in 2016. By contrast, the beleaguered basic metals sector is unlikely to recover this year, with output expected to drop by a hefty 15.6%.

TRANSPORT AND PHARMACEUTICALS TO SHRUG OFF BREXIT IMPACT

Strong fundamentals in the motor vehicles, other transport and pharmaceutical sectors should continue to drive growth in these industries. While output is expected to be weaker than before the EU referendum result, secure order books mean that growth is likely to remain solid.

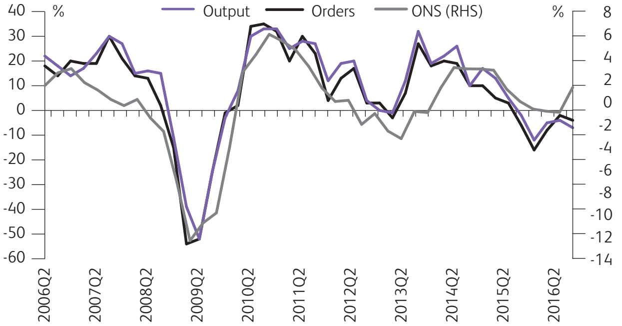
The **motor vehicles** sector has seen sustained levels of output over the past few years, supported by continued innovation and the introduction of new models. Existing long-term contracts for the production of new models in the UK should protect the sector from post-EU referendum demand volatility, allowing the sector to grow by 6.3% in 2016. Similarly, long order books for **other transport** manufacturers will ensure continued demand for aircraft, pushing through growth of 3.4% this year.

Finally, the **pharmaceuticals** sector is seeing a resurgence in output following the end of the patent cliff. A steady pipeline of new pharmaceutical products, as well as, the sector's resilience to demand fluctuations, will propel the sector to growth of around 5.1%, which should be the strongest rate since 2009.

HISTORIC MANUFACTURING TRENDS

OFFICIAL DATA SHOW Q2 OUTPUT SURGE

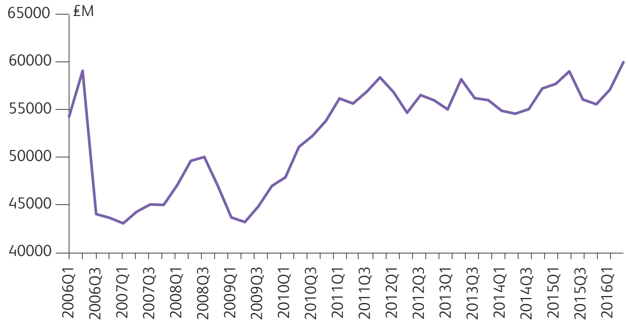
% BALANCE OF CHANGE IN THE PAST THREE MONTHS AND % CHANGE ON A YEAR AGO



Source: EEF Manufacturing Outlook Survey and ONS

STRONG START TO 2016 FOR EXPORTS

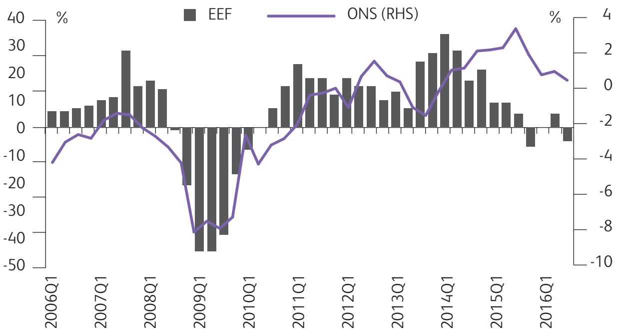
MANUFACTURED EXPORTS, VALUE (£M)



Source: EEF Manufacturing Outlook Survey and ONS

RECRUITMENT HEADS LOWER

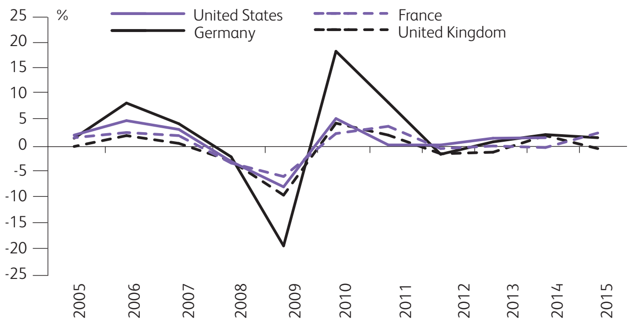
% BALANCE OF CHANGE IN THE PAST THREE MONTHS AND % CHANGE ON A YEAR AGO



Source: EEF Manufacturing Outlook Survey and ONS

UK LOSES GROUND IN 2015

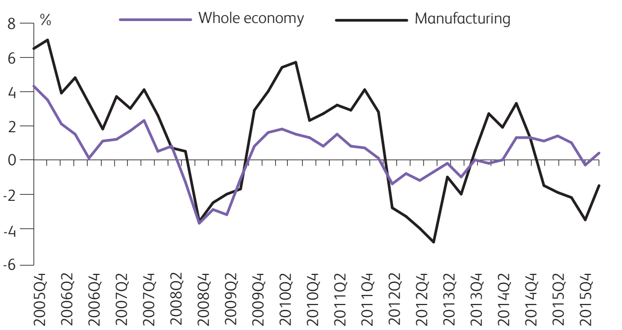
MANUFACTURED GVA, ANNUAL % CHARGE



Source: OECD

PRODUCTIVITY PICKS UP

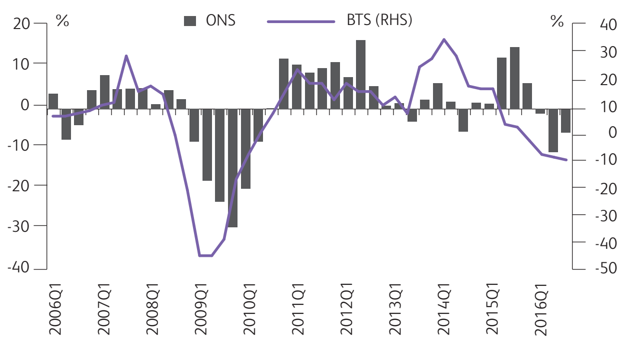
OUTPUT PER HOUR, ANNUAL % CHANGE



Source: ONS

INVESTMENT PLANS TO STAY IN DOLDRUMS

% BALANCE OF CHANGE IN THE PAST THREE MONTHS AND % CHANGE ON A YEAR AGO



Source: EEF Manufacturing Outlook Survey and ONS 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, 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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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 1,400 offices in 154 countries. We operate from 18 offices across the UK, employing 3,500 people offering tax, audit and assurance, and a range of advisory services.

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

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

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

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

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

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