# MANUFACTURING OUTLOOK

## MARCH 2010

*EEF's snapshot survey of business conditions in engineering and manufacturing companies*

eef The manufacturers' organisation

In partnership with BDO

# Contents

# Foreword

Welcome to the first edition of Manufacturing Outlook, our new quarterly report on the state of manufacturing produced by EEF in partnership with BDO.

The report expands the coverage of our long-running Business Trends Survey to include a wider range of manufacturing sectors and analysis. In addition to our standard engineering sectors, the new report will also cover food and drink, chemicals, rubber and plastics and non-metallic mineral products. And for the first time we will report responses for manufacturing as well as engineering.

The launch of our extended report coincides with a more upbeat assessment of conditions across the industry following one of the worst recessions for three decades. The official data show that manufacturing emerged from recession in the final months of 2009 and a range of other evidence has also started to point in a more positive direction. Our latest survey builds on this, showing a broad-based return of confidence across manufacturing, with output and orders both showing continued improvement.

While manufacturing now appears to be on the road to recovery a number of economic and political uncertainties remain. In addition to our UK macroeconomic and sector forecasts our new report will also provide more extensive commentary on the economic environment for manufacturing. This will include analysis and forecasts for the indicators that companies will be watching out for this year – including exchange rate movements and commodity prices. And because of manufacturers' significant exposure to international markets, we have expanded our forecasts to include the outlook for growth in key markets.

As the world economy returns to growth, and manufacturing with it, our new report will continue to report the most up to date trends and outlook from across the UK.

*Tom Lawton Head of manufacturing, BDO LLP*

*Lee Hopley Chief Economist, EEF*

# Summary

- Output and orders turn positive
- Job losses continue to level off
- Margins remain under pressure
- Companies much more optimistic about next quarter
- But investment set to be last indicator to recover

Manufacturing and engineering ended 2009 on a positive note as both sectors officially emerged from recession following significant peak to trough falls in output of 15% and 21% respectively. Over the past 18 months few sectors have emerged unscathed from the recession. Efforts to boost demand through various stimulus packages in the UK and other parts of the world provided some temporary respite, limiting the extent of the potential downturn.

In our previous report we outlined a degree of caution amongst manufacturers about recovery prospects as conditions had stabilised but there were few indications of when we'd see clear signs of an upturn. Our latest survey shows a modest improvement in the first quarter, with the balance of responses on both output and orders turning positive for the first time since 2008q3. As expected, new export orders have led the way, with more sectors positive about recent demand in overseas markets than at home.

On the whole, the first quarter of this year turned out to be rather better than companies were expecting across a range of our survey indicators. This has contributed to a further slowdown in the rate of job cuts across manufacturing. In the past three months a balance of 6% of companies reduced employee numbers, compared with a peak of 40% in 2009q2. Moreover, this is expected to turn into some modest levels of recruitment in the next three months, although this is likely to be confined to a relatively small number of sectors and regions.

On prices and profit margins, there has been little movement since the last quarter. Any price increases have also been limited to a few sectors, particularly those that have started to see the cost of materials start to increase. And a weaker exchange rate has not yet contributed to an easing in the squeeze on margins. The main negative point in the survey remains companies' investment intentions. Historically, our survey has shown that investment plans are slow to follow other indicators back into positive territory after a recession. On going pressure on cashflow and a recovery still in its early stages means manufacturers are continuing to keep new investment plans on hold.

However, companies' assessment of prospects for the next quarter is the most upbeat since mid-2007. Our survey shows strong positive balances on output and new orders in the next three months as more companies expect to demand to pick up. This, more optimistic, outlook is also reasonably broad-based across manufacturing and engineering. And our forecasts reflect this. This year we expect manufacturing to post 1.5% growth and engineering is forecast to expand by 3.5%. Next year, growth rates are predicted to come in at 3.6% and 3.5% respectively. There are, however, a number of downside risks which could knock growth off track. Access to finance could become more of a problem as there is more demand for it and an export led recovery will hang on the UK's major markets continuing to expand throughout this year.

## *Manufacturing - Headline survey results*

*% balance of change*

| | Past 3 months | Next 3 months |
|---|---|---|
| Output | 9 | 27 |
| Total orders | 3 | 29 |
| Employment | -5 | 3 |
| Export prices | 0 | 2 |
| Export margins | -14 | -14 |
| Cashflow | -5 | -12 |

Source: EEF Business Trends Survey

## *Economic data during survey period*

*28 January - 17 February*

| | Start | End |
|---|---|---|
| €/£ | 1.16 | 1.15 |
| $/£ | 1.61 | 1.57 |
| £ index | 81.3 | 80.5 |
| Oil price | 70.7 | 74.9 |

Source: Bank of England and Energy Information Agency

## *Key economic forecasts*

*% change except where stated*

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| GDP | 2.6 | 0.5 | -5.0 | 1.1 | 2.3 |
| Inflation – CPI | 2.3 | 3.6 | 2.2 | 2.5 | 1.4 |
| Inflation – RPI | 4.3 | 4.0 | -0.5 | 3.2 | 2.1 |
| World trade | 6.9 | 2.8 | -13.6 | 5.7 | 7.6 |
| Base rate ( % ) | 5.5 | 4.7 | 0.6 | 0.5 | 1.0 |

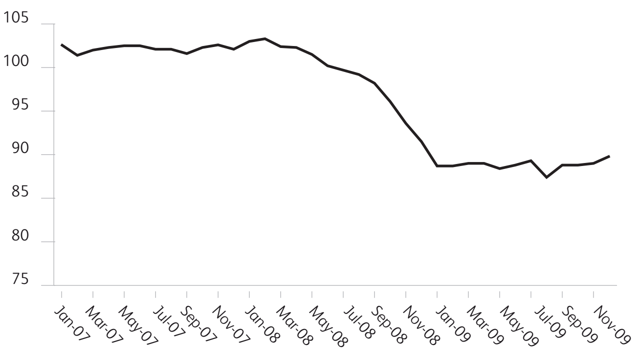
Source: Oxford Economics and EEF

# Manufacturing outlook

## Chart 1

### *Manufacturing output increases*

*Manufacturing index of production 2005=100*



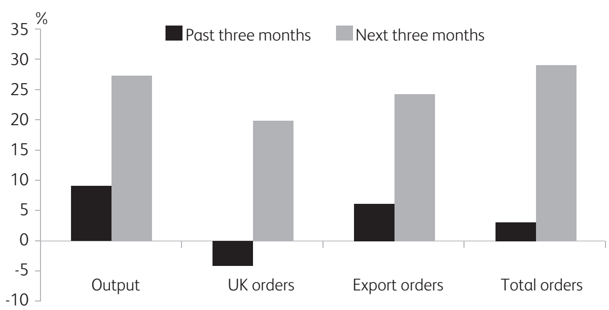

Source: National Statistics

Chart 1 illustrates the impact of the recession on manufacturing over the past 18 months. According to official statistics output started to decline in March 2008 and the peak to trough contraction was over 15% by the middle of 2009. The severity of this recession was on a par with the steep downturn in manufacturing at the beginning of the 1980s. The sector has, however, recorded four consecutive monthly increases, albeit modest ones. Stimulus measures – both in the UK and in many of the UK's major markets – will have helped to kick start growth. But output levels are likely to remain some way below pre-recessions levels for a number of years to come.

## Chart 2

### *Companies look ahead with optimism*

*% balance of change*




Source: EEF Business Trends Survey

While the declines in manufacturing have been significant, a balance of companies across the sector reported rising output in the past three months. In addition a third of companies also saw new export orders rise, compared with 27% seeing further declines. The domestic market appeared somewhat weaker for manufacturing but a positive total orders balance should support some output growth in the short term. Encouragingly, many more companies expect the next three months to be better than the past quarter. The proportion of companies expecting output and orders to expand in the coming three months came in at 43% and 45% respectively.

### *Summary*

*% balance of responses (% up minus % down)*

| | Past three months | Next three months |
|---|---|---|
| Total output | 9 | 27 |
| UK new orders | -4 | 20 |
| Export new orders | 6 | 24 |
| Total new orders | 3 | 29 |
| Employment | -5 | 3 |
| Capital expenditure plans | -7 | [•] |
| Average price of domestic orders | -7 | 1 |
| Average price of export orders | 0 | 2 |
| Margins on domestic orders | -30 | -16 |
| Margins on export orders | -14 | -14 |
| Levels of cashflow | -5 | -12 |

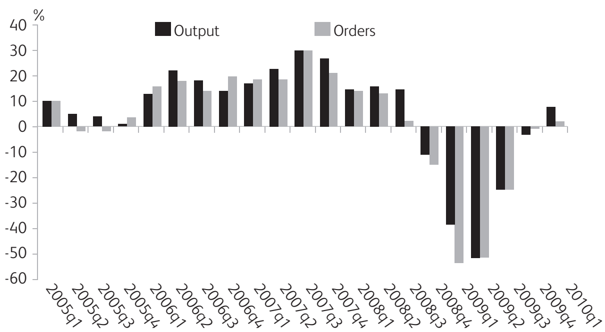
Source: EEF Business Trends Survey

# Recent trends

## Chart 3

### *Output and orders turn positive*

*% balance of change in past three months*



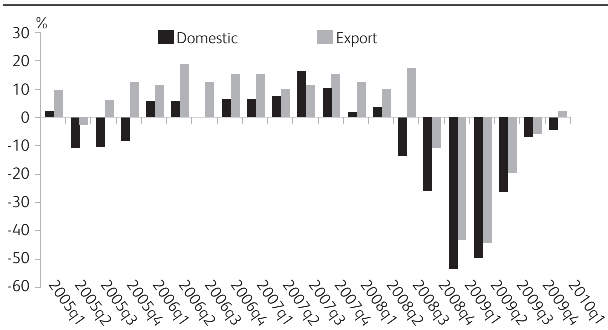

Source: EEF Business Trends Survey

At the end of 2009 we reported that conditions across the sector had stabilized with companies expecting similar trading conditions in the early months of 2010. This tallied with the official data for engineering and manufacturing, which showed both emerging from recession in 2009q4. Our latest survey shows that the first quarter was better than companies were expecting. A balance of 8% of companies reported an increase in output over the past three months – the best outturn since 2008q3. Responses on new orders also turned positive for the first time in six quarters. Taken together with other survey evidence, our survey indicates further growth in the first quarter of 2010.

## Chart 4

### *Export orders start to recover*

*% balance of change in orders in past three months*



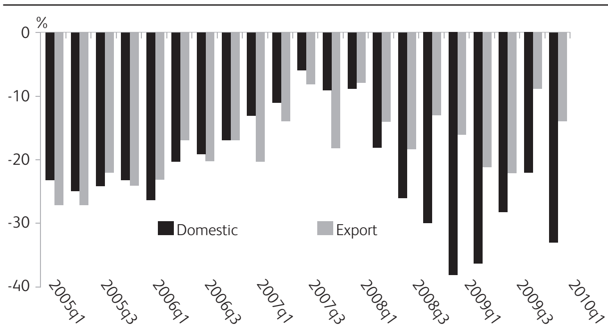

Source: EEF Business Trends Survey

Data from National Statistics have shown a gradual recovery in manufactured exports since October 2009. A balance of 4% of companies saw an increase in export orders over the past three months. World trade volumes finally turned a corned towards the end of last year and UK companies' exposure to overseas markets combined with a weaker Sterling exchange rate have seen orders recover in 2010q1. However, export balances still remain significantly below pre-recession levels. Domestic orders balances have yet to turn positive. Weaker UK demand over the past three months has been a drag on the overall orders responses.

## Chart 5

### *Prices and margins remain negative*

*% balance of change in margins in past three months*



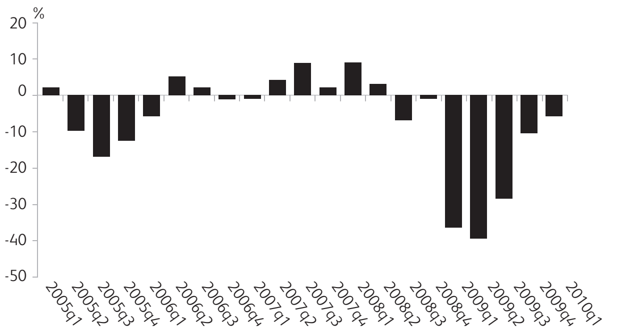

Source: EEF Business Trends Survey

While the orders picture has improved over the past quarter, responses on prices are little changed in the previous three months. Sluggish domestic demand led a balance of 15% of companies to reduce prices in the quarter, the same proportion as in 2009q4. And the balance of companies cutting prices on export sales has moderated from -17% to -13%. Exchange rate effects have provided some help for margins on exports, but rising prices and the higher cost of imports has left the margins balances firmly in negative territory. Consequently, there has been no movement in responses on cashflow over the past quarter.

## Chart 6

*Job losses continue to ease*

*% balance of change in employment in past three months*



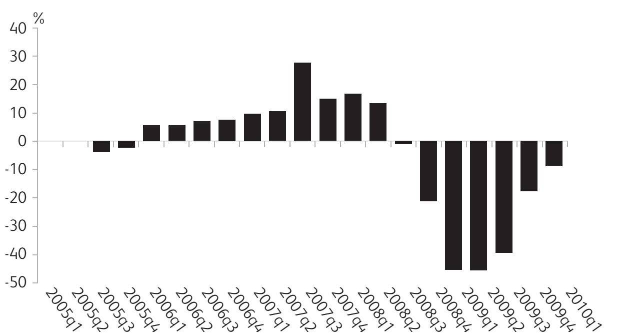

Source: EEF Business Trends Survey

The balance of companies cutting jobs continued to moderate in the past three months. Job losses across the sector picked up quickly at the beginning of 2009 following the onset of the recession. But to date job losses have been less than predicted as companies and employees have worked together to minimise cuts and retain skills. While overall a balance of companies continued to reduce headcount, one company in seven reported increasing employee numbers over the past quarter on the back of better demand prospects. And a similar proportion plan to recruit over the coming three months.

## Chart 7

*Little sign of investment recovery*

*% balance of change in investment plans*




Source: EEF Business Trends Survey

Our survey shows a more upbeat picture for manufacturing and engineering compared to what companies have been reporting over the past 18 months. However, the investment balance is the main weak spot in our latest survey. A balance of companies reported scaling back future investment plans for the seventh consecutive quarter. While output and orders now look like they are starting to recover, the continued squeeze on cashflow, a degree of uncertainty about the strength of the upturn and availability of credit is leading companies to scale back investment intentions or keep them on hold. If investment balances follow the path of previous recessions it could be a number of years before they are firmly back in positive territory.

## *Summary: past three months*

*% balance of responses (% up minus % down)*

| | 2008 | | | 2009 | | | | 2010 |
|---|---|---|---|---|---|---|---|---|
| | q2 | q3 | q4 | q1 | q2 | q3 | q4 | q1 |
| Total output | 16 | 15 | -11 | -39 | -52 | -25 | -3 | 8 |
| UK new orders | 4 | -13 | -26 | -54 | -50 | -26 | -6 | -4 |
| Export new orders | 10 | 18 | -10 | -43 | -44 | -19 | -5 | 3 |
| Total new orders | 13 | 2 | -15 | -54 | -52 | -25 | -1 | 2 |
| Employment | 3 | -7 | -13 | -37 | -40 | -29 | -11 | -6 |
| Capital expenditure plans | 14 | -1 | -21 | -45 | -45 | -39 | -17 | -8 |
| Average price of domestic orders | 18 | 27 | 6 | -7 | -16 | -15 | -15 | -8 |
| Average price of export orders | 12 | 18 | 1 | -6 | -18 | -17 | -13 | 0 |
| Margins on domestic orders | -18 | -26 | -30 | -38 | -36 | -28 | -22 | -33 |
| Margins on export orders | -14 | -18 | -13 | -16 | -21 | -22 | -9 | -14 |
| Levels of cashflow | -1 | -1 | -17 | -36 | -29 | -8 | -8 | -7 |

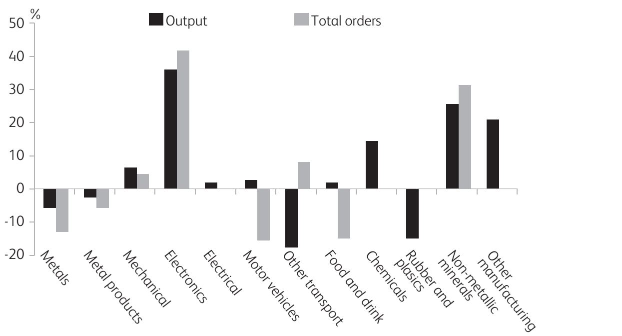
Source: EEF Business Trends Survey

# Sector trends

## Chart 8

### *Mixed picture across manufacturing*

*% balance of responses in past three months*



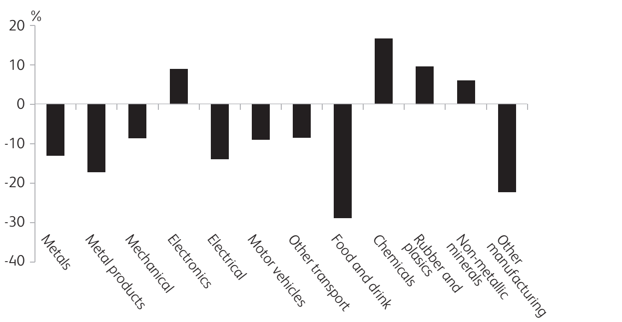

Source: EEF Business Trends Survey

While the balances on output and orders have turned positive across manufacturing as a whole, the fortunes of individual sectors over the past three months has been very mixed. Over the past quarter electronics stands out as one of the strongest performing sectors, following good growth in precision instruments in recent months. Motor vehicles, helped by the scrappage scheme, also saw an increase in the output balance for the first time 2008q3, but a weaker orders balance leaves question marks over future output. Food and drink has been more stable over the recession than engineering sectors, and output growth looks set to continue in the first quarter.

## Chart 9

### *Investment cuts continue in most sectors*

*% balance of change in investment plans*




Source: EEF Business Trends Survey

Investment cuts have been particularly savage during this recession and few sectors have bucked the downward trend. This looks set to remain the case over the next 12 months. Only a minority of sectors are now planning to upwardly revise their investment plans over the coming year. Strong output balances in the past three months and expectations of continued growth in the next quarter have led to more positive investment plans across chemicals, non-metallic minerals and electronics. In contrast, concerns about the prospects for metals and motor vehicles this year on the back of a very difficult 2009 have prompted further planned investment cutbacks.

### *Sector Summary*

*% balance of responses (% up minus % down)*

| | Past three months | | | | | Next three months | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Output | Total orders | Employment | Export price | Cashflow | Output | Total orders | Employment | Export price | Cashflow |
| Metals | -5 | -12 | -21 | 2 | -13 | 23 | 25 | -4 | 21 | -9 |
| Metal products | -2 | -5 | -12 | -9 | -25 | 29 | 38 | 3 | 10 | -22 |
| Mechanical | 7 | 5 | -5 | 1 | 13 | 31 | 24 | -1 | -3 | -1 |
| Electronics | 36 | 42 | 0 | 0 | 3 | 25 | 31 | 17 | 6 | -22 |
| Electrical | 2 | 0 | -4 | 5 | 0 | 36 | 32 | 6 | -10 | -14 |
| Motor vehicles | 3 | -15 | -17 | 0 | -12 | 14 | 18 | -9 | -3 | -16 |
| Other transport | -17 | 8 | 0 | 22 | 0 | 25 | 50 | -8 | 33 | 17 |
| Food and drink | 2 | -14 | -29 | 14 | 40 | -43 | -14 | -43 | -43 | -40 |
| Chemicals | 15 | 0 | 8 | 18 | -15 | 62 | 69 | -15 | -9 | 23 |
| Rubber and plastics | -14 | 0 | -5 | 0 | -10 | 19 | 33 | 5 | -5 | -24 |
| Non-metallic mineral products | 26 | 32 | 11 | -7 | -22 | 32 | 21 | 37 | -13 | -11 |
| Other manufacturing | 21 | 0 | -3 | -9 | 15 | 15 | 21 | 15 | 4 | -9 |

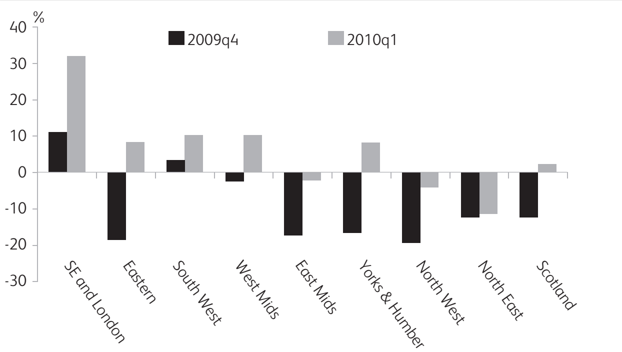
Source: EEF Business Trends Survey

# Regional trends

## Chart 10

### *All regions report improvement*

*% balance of change in output in past three months*



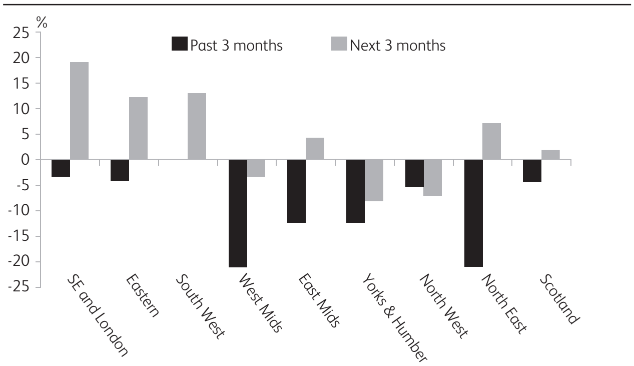

Source: EEF Business Trends Survey

In the past three months six out of nine regions has seen a balance of companies report rising output, up from only two in the previous quarter. Nevertheless responses across all regions were an improvement on the preceding three months. The biggest swings were reported in East of England and Yorkshire and Humberside. The rebound in electronics has provided a boost for the South East, South West and Scotland. However, ongoing weakness in the metals sectors and a patchy automotive performance has left output in the Northern regions below the UK average.

## Chart 11

### *Some recruitment expected*

*% balance of change in investment plans*




Source: EEF Business Trends Survey

The pace of job losses may have eased across manufacturing, but cuts are still being felt in automotive and metals. At the regional level this translates into further significant employment reductions in the Midlands, North East and Yorkshire and Humberside. Indeed the West Midlands and North East were the only regions to report lower employment balances compared with last quarter. However, the labour market situation should improve in the majority of regions in the next quarter. Indeed, some positive employment balances suggest a degree of recruitment activity in six out of the nine regions.

### *Regional Summary*

*% balance of responses (% up minus % down)*

| | Past three months | | | | | Next three months | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Output | Total orders | Employment | Export price | Cashflow | Output | Total orders | Employment | Export price | Cashflow |
| SE and London | 32 | 35 | -3 | 3 | 3 | 30 | 24 | 19 | 3 | -8 |
| Eastern | 8 | 0 | -4 | 20 | 24 | 12 | 4 | 12 | 5 | -4 |
| South West | 10 | 0 | 0 | 9 | 0 | 27 | 33 | 13 | 9 | -7 |
| West Mids | 10 | 7 | -21 | -8 | -21 | 33 | 44 | -3 | 14 | -12 |
| East Mids | -2 | 6 | -12 | 6 | 4 | 22 | 31 | 4 | 15 | -15 |
| Yorks & Humber | 8 | 6 | -12 | 2 | 0 | 33 | 43 | -8 | 7 | -26 |
| North West | -4 | -11 | -5 | -5 | -13 | 27 | 24 | -7 | -3 | -13 |
| North East | -11 | -14 | -21 | -4 | -21 | 29 | 57 | 7 | 0 | -18 |
| Scotland | 2 | -3 | -4 | 1 | | 24 | 14 | 2 | -13 | |

Source: EEF Business Trends Survey

# Economic environment

- UK economy emerges from recession
- Inflation picks up at the start of 2010
- No more quantitative easing
- Mixed recovery outlook in the rest of the world

In our last report we were still waiting for the official confirmation that the UK had joined most other developed economies on the road to recovery. Growth continued to disappoint in 2009q3 with another quarter of contraction, but UK GDP finally expanded by a meagre 0.3% in the three months to December. While stronger High Street sales at the end of December led to some upward revision to the numbers, the bigger question is what a stronger end to 2009 will mean for the economy in 2010, especially as previously announced stimulus measures start to run out.

Previously, our central forecasts pointed to a somewhat anaemic recovery in the UK. Consumer confidence is likely to remain subdued; pay settlements are likely to remain muted, the concerns about unemployment have diminished but not gone away and household indebtedness will continue to be a drag on spending. Government spending and investment are unlikely to provide much of a boost to growth this year, which will leave the traded sector to pick up the baton.

Our latest survey results continue to support the view that a recovery will be led by the rest of the world and exports are the best prospect for growth this year. That said, while growth in most of the UK's major markets is forecast to be stronger than at home, there are clearly uncertainties around the strength of the upturn, particularly in Europe.

Growth in the final months of 2009 came in lower than expected. And early indicators for 2010 have softened, with the German IFO index of business confidence slipping back in February and household spending in France edging down on the back of the car scrappage scheme ending. Similarly the end of stimulus measures in Italy is also driving a number of short-term plant closures. However, more significantly the risk of sovereign default in Greece and what any eurozone intervention might involve will weigh on the euro and confidence across the region, particularly if there are lingering concerns about the risk of default in other parts of the eurozone.

In contrast, forecasts for the US point to a more upbeat outlook – GDP expanded by a better than predicted 5.9% in the fourth quarter of last year. Much of the growth came from inventories, but growth in consumer spending and exports pointed to a more broad-based recovery. Strong growth in emerging markets, particularly in Asia, has aided US growth in recent quarters. In China, growth surprised on the upside in q4 with GDP growing at an annual rate of nearly 11%. While a year ago there were concerns that the Asian engine of growth would enter recession, the Chinese government is now attempting to manage a soft landing for the economy with further regulations to control bank lending and improve risk management.

## *UK economic forecasts*

*% change except where stated*

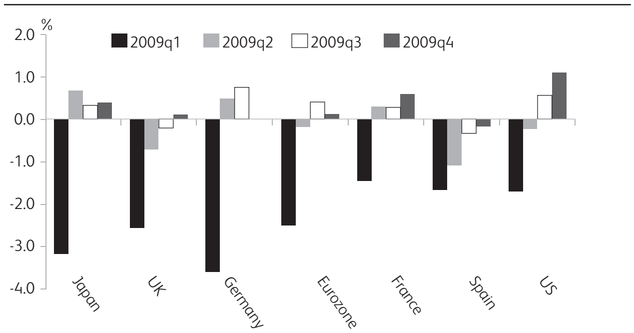
| | 2009 | 2010 | 2011 |
|---|---|---|---|
| **Trading environment** | | | |
| Exchange rate (€/£) | 1.12 | 1.16 | 1.20 |
| Exchange rate ($/£) | 1.57 | 1.59 | 1.63 |
| Exports | -11.1 | 3.9 | 6.6 |
| Imports | -12.5 | 3.2 | 3.4 |
| Current account (£bn) | -31.1 | -55.5 | -46.5 |
| **Output** | | | |
| Engineering | -15.1 | 3.5 | 3.4 |
| Manufacturing | -10.5 | 1.5 | 3.6 |
| Rest of economy | -4.1 | 1.0 | 3.2 |
| GDP | -5.0 | 1.1 | 2.3 |
| **Costs and prices** | | | |
| Average earnings | 1.5 | 1.9 | 2.8 |
| Oil price ($/barrel) | 61.6 | 76.4 | 79.7 |
| **Employment** | | | |
| Engineering (000s) | 1,126 | 1,075 | 1,036 |
| Manufacturing (000s) | 2,571 | 2,479 | 2,410 |
| Rest of economy (000s) | 28,385 | 28,318 | 28,381 |
| Unemployment rate ( % ) | 7.8 | 8.0 | 8.0 |

Source: Oxford Economics and EEF

**Chart 12**

## *UK emerges from recession*

*% quarter on quarter change in GDP*




Source: OECD

The size of the Chinese markets and dependence on industry has played a big role in the rollercoaster of commodity prices in recent years. After plummeting by 35-50% in the second half of 2008, commodity prices rebounded sharply through 2009. Price pressures returned, in part, through strong demand from emerging markets. China in particular fed a rise in prices both through an infrastructure boom and through restocking of key metals such as copper and iron ore. As metals prices rose in the back end of 2009, China began to sell its surplus stocks on global markets. But with the Eurozone, the UK and Japan struggling to find strong, sustainable recoveries, prices pressures have eased as demand remains weak. However, aside from isolated supply issues, for example from the unusually cold weather, commodity prices pressures are likely to moderate in 2010 in the face of weak demand.

The rise in the oil price has had an impact on producer and consumer prices, but the spike in CPI inflation has been largely driven by VAT changes. CPI inflation rose to an annual rate of 3.5% in January. Rising crude oil prices and the VAT rate returning to 17.5% helped push CPI inflation more than one percentage point above the Bank of England's 2.0% target prompting a letter from the Governor of the Bank. Over the past year inflation has come in higher than expected and we expect CPI inflation to remain at or above the 2.0% target rate until December 2010. However, with a large degree of spare capacity in the economy, the MPC are not unduly concern about growing inflationary pressures and expect CPI to trend downwards over the next two years.

At its meeting in February, the MPC unanimously voted to maintain its asset purchase programme at £200 billion. But recent statements from Mervyn King do not rule out a further expansion of the programme. At a Select Committee hearing he pointed to continued uncertainty about the strength of a UK recovery and the possibility that eurozone growth has stalled. In our view, the MPC should sit on its hands until after an election, when decisions on how and when the UK's fiscal deficit will be reduced will become clearer.

For businesses the forthcoming election is not only a major political event, but one that will have significant economic consequences. The public finances will be a key battleground during this election. But the current debate is very much focused on the timing of fiscal consolidation – when to start and how quickly progress needs to be made. However, for businesses, the issue is more about how the deficit is reduced. Most of the stimulus measures in the UK have come to an end and there will be some fiscal tightening on business in the next financial year. Yet without any details on the balance of tax rises and spending cuts it is difficult to say which of the parties has the most credible plan.

## *International economic forecasts*

*% change*

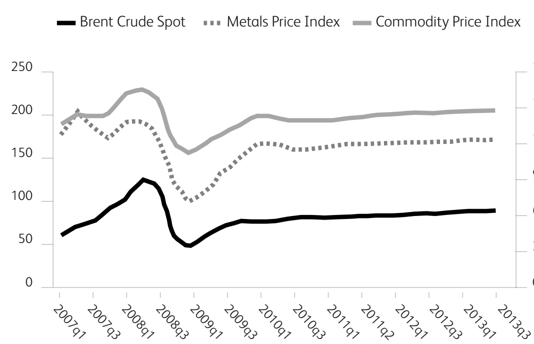
| | GDP | | | Inflation | | |
|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2009 | 2010 | 2011 |
| France | -2.2 | 1.2 | 1.4 | 0.1 | 1.3 | 1.6 |
| Germany | -5.0 | 1.5 | 1.9 | 0.3 | 1.3 | 1.6 |
| Japan | -5.2 | 1.5 | 1.6 | -1.4 | -0.2 | 0.2 |
| US | -2.4 | 3.3 | 3.2 | -0.3 | 2.6 | 2.3 |
| Eurozone | -4.0 | 1.0 | 1.6 | 0.3 | 1.2 | 1.7 |
| China | 8.7 | 9.6 | 9.1 | -0.7 | 4.3 | 4.1 |
| India | 6.7 | 7.4 | 9.1 | 10.9 | 9.6 | 4.7 |
| Emerging Asia | 4.9 | 7.3 | 7.6 | 2.8 | 4.4 | 3.6 |
| World | -0.9 | 3.8 | 4.5 | 2.3 | 3.5 | 3.3 |

Source: Oxford Economics and EEF

**Chart 13**

## *Commodity prices to moderate*

*$ per barrel, index 2005= 100*



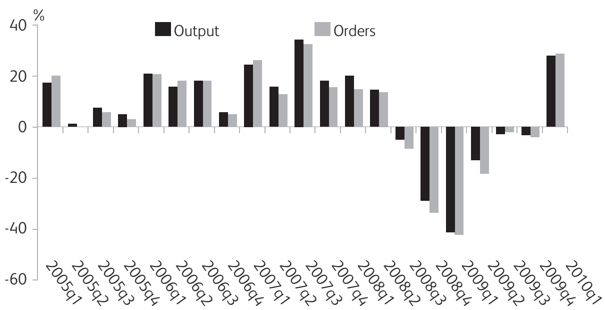

Source: Oxford Economics and EEF

# Future trends

## Chart 14

### *Sharper rebound expected*

*% balance of change expected in next three months*



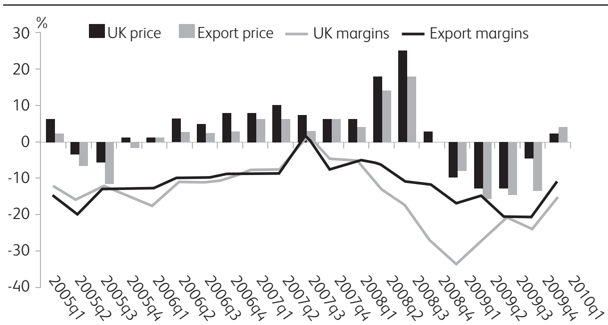

Source: EEF Business Trends Survey

In the past year the forward looking responses have swung from some of the worst on record to the highest since the series began. In the next three months 44% of companies expect output to be up on the previous quarter and 16% expect to see further falls. The balance of 28% was the highest since 2007q3. New orders are also predicted to pick up from the Spring, with a balance of 29% of firms expecting their order intake to grow. The rebound in responses points to a more broad based recovery, with the majority of sectors posting strong positive balances.

## Chart 15

### *Modest price increases expected*

*% balance of change expected in next three months*




Source: EEF Business Trends Survey

For the past twelve months companies had been expecting to reduce prices on both domestic and export sales in response to a weak demand outlook and falling input prices through much of 2009. However, since October the cost of inputs has been ticking up with a particularly sharp increase in oil and imported materials prices. Over the next quarter a balance of 2% and 4% of companies plan to increase prices on UK and export orders respectively. But price increases are largely confined to the metals and electronics sectors. Nevertheless, this should help ease the downward pressure on profit margins.

### *Summary: next three months*

*% balance of responses (% up minus % down)*

| | 2008 | | | 2009 | | | | 2010 |
|---|---|---|---|---|---|---|---|---|
| | q2 | q3 | q4 | q1 | q2 | q3 | q4 | q1 |
| Total output | 15 | -5 | -29 | -41 | -13 | -2 | 0 | 28 |
| UK new orders | 3 | -14 | -40 | -44 | -19 | -6 | -9 | 21 |
| Export new orders | 14 | 2 | -19 | -32 | -14 | -4 | 6 | 24 |
| Total new orders | 14 | -8 | -33 | -42 | -18 | -2 | -4 | 29 |
| Employment | 5 | -10 | -33 | -42 | -32 | -15 | -15 | 1 |
| Average price of domestic orders | 18 | 25 | 3 | -9 | -12 | -12 | -4 | 2 |
| Average price of export orders | 14 | 18 | 0 | -7 | -15 | -14 | -13 | 4 |
| Margins on domestic orders | -13 | -18 | -28 | -34 | -27 | -21 | -24 | -15 |
| Margins on export orders | -6 | -11 | -12 | -17 | -15 | -21 | -21 | -11 |
| Levels of cashflow | -4 | -6 | -26 | -38 | -23 | -5 | -14 | -13 |

Source: EEF Business Trends Survey

# Sector forecasts

Even as the economy managed to scrape out of recession at the end of 2009, the prospects for engineering and manufacturing growth are rapidly improving. The latest official data estimate that manufacturing output grew by 0.8% quarter-on-quarter in q4 – far outpacing the 0.1% growth across the whole economy. This strong finish to 2009, coupled with a relatively stable and weak pound should provide some momentum for an export lead recovery in 2010. We expect manufacturing output to have contracted by 10.5% in 2009 and to grow by 1.5% in 2010. With engineering output down by 15.1% this year, output should rebound from a low base to grow by 3.5% in 2010.

Yet there remains a large degree of uncertainty around this central forecast. The primary risks are to the downside. The rebound in export markets could falter as global economies are weaned off of economic stimulus. Political uncertainty in the UK, in particular on plans to repair the public finances is feeding uncertainty about the post-election business environment. But despite concerns about these economic headwinds, we believe that the UK should see a modest, export driven recovery in 2010.

The prospects for manufacturing sub-sectors vary greatly. For some sectors, such as basic metals and motor vehicles, strong annual growth in 2010 will simply reflect a modest rebound from extremely weak results last year. Others, such as electronics, rubber and plastics and non-metallic minerals are likely to lead the recovery through strong quarter-on-quarter growth.

The basic metals sector benefited from restocking in the second half of 2009, but could struggle in 2010 from weaker metals prices and a permanent loss in capacity. The government-backed scrappage schemes in the UK and in key European markets have helped provide a strong boost to motor vehicles output in the second half of 2009. But the industry is likely to see a sluggish first quarter which should carry on through the rest of 2010. A strong fourth quarter of 2009 and buoyant civil aerospace markets should mitigate the lack of new orders in defence markets, as the other transport sector will grow by 2.9% in 2010

The electronics sector rebounded from recession in q2 2009 and should grow by 4.5% this year. The rubber and plastics sector is likely to benefit from the weak pound and supply problems in Asian markets to grow by 4.8% in 2010. Chemical industry output is set to rise by 1.7% as rising healthcare demand from emerging markets is set to offset reduced demand in developed economies for flu vaccines.

Mechanical equipment is set to benefit from a pick up in exports to Europe and Asia to grow by 0.4% in 2010. This rebound should feed through to the metal products industry which should grow by 0.5% this year. Similarly, the electrical equipment sector – which includes chip makers – will grow by 0.4% in 2010 as consumer demand for handheld electronics eventually returns.

The employment outlook continues to improve, reflecting improved prospects for activity. As a whole, manufacturing lost fewer jobs during the recent recession than in previous recession, and the pace of job losses is expected to slow further through 2010 and 2011.

## *Sector forecasts*

| | 2009 | 2010 | 2011 |
|---|---|---|---|
| **Output (% change)** | | | |
| Basic metals | -24.5 | 5.6 | 1.6 |
| Metal products | -16.7 | 0.5 | 3.8 |
| Mechanical equipment | -20.4 | 0.4 | 3.5 |
| Electronics | -5.0 | 4.5 | 0.6 |
| Electrical equipment | -21.0 | 0.4 | 3.1 |
| Motor vehicles | -29.1 | 9.3 | 3.4 |
| Other transport | 2.9 | 7.1 | 4.1 |
| Food and drink | -1.9 | -3.2 | 1.8 |
| Chemicals | -4.7 | 1.7 | 3.4 |
| Rubber and plastics | -13.2 | 4.8 | 3.6 |
| Non-metallic mineral products | -13.4 | 6.7 | 1.3 |
| Other manufacturing | -8.3 | 5.0 | 1.1 |
| Engineering | -15.1 | 3.5 | 3.4 |
| Manufacturing | -10.5 | 1.5 | 3.6 |
| **Employment (% change)** | | | |
| Basic metals | -9.2 | -9.4 | -12.6 |
| Metal products | -7.5 | -4.1 | -1.8 |
| Mechanical equipment | -7.6 | -5.9 | -4.6 |
| Electronics | -5.8 | -3.2 | -1.8 |
| Electrical equipment | -9.9 | -5.7 | -6.2 |
| Motor vehicles | -14.2 | -3.5 | -4.9 |
| Other transport | -2.4 | -2.7 | -0.8 |
| Food and drink | -2.1 | -1.3 | -1.5 |
| Chemicals | -5.0 | -2.7 | -2.5 |
| Rubber and plastics | -9.0 | -3.0 | -2.3 |
| Non-metallic mineral products | -14.0 | -3.8 | -2.6 |
| Other manufacturing | -7.4 | -1.9 | -0.9 |
| Engineering | -7.8 | -4.5 | -3.6 |
| Manufacturing | -7.0 | -3.6 | -2.8 |

Source: EEF

# BDO viewpoint

It is great news to see so many positive indicators from the EEF/BDO survey and hopefully these results do show that the tide has turned for the UK manufacturing sector and that we will see these more positive results repeated through 2010.

Over the past two years we have seen the deepest recession this country and developed world economies have experienced since the 1930s. There is little doubt that this recession and its impact on developed economies will have speeded up the transfer of economic power from West to East. It has also had a fundamental and massively detrimental effect on the UK economy; one-that is likely to be felt for several years.

But hopefully it might also change the way that manufacturing is perceived within the economy of the UK and provide a stronger basis for the idea that helping and supporting a strong and vibrant manufacturing base is central to the health of the British economy.

When discussing 'what happened to create this crisis', most economists and commentators now agree that the economy had become out of balance. Growth was driven too much by financial services and acquisitions that did not add value, fuelled by booming corporate debt – and consumer spending supported by over-valued housing and increasing personal borrowing – and not enough by strategic investment, manufacturing and exports.

The severity of the downturn highlighted the all too obvious structural weaknesses in the UK economy. This has rightly led to serious thought about the future economic direction of the country.

In the spirit of 'better late than never' we welcome the renewed emphasis on the importance of manufacturing and exports to a well balanced economy.

*Tom Lawton Head of manufacturing, BDO LLP*

## About us

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.

Around a quarter of the UK's manufacturing businesses are our members and many more use our services 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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## About BDO LLP

BDO LLP is the award-winning UK Member Firm of BDO International, the world's fifth largest accountancy network, with more than 1,000 offices in over 100 countries*. We operate from 14 offices in the UK with some 3000 partners and staff. We believe that clients want an adviser they can trust, one who understands them and their objectives. One way we do this is by continually building our sector related expertise, and applying this to the way we do business.

Most manufacturing clients are now active internationally. So are we and in regions that are important to manufacturing. Most are involved in acquisitions, public offerings and major capital projects. We have great experience in these areas. Our manufacturing clients have regulatory, reporting and legislative issues. We bring sector expertise and a proactive approach to assist. Our clients want to mitigate and manage tax liabilities globally. Our international specialist teams have the skills to assist. 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.

To talk about any issues your manufacturing business may be facing please contact Tom Lawton, Head of Manufacturing at BDO LLP, on 0121 352 6200 or 07778 343346 or email tom.lawton@bdo.co.uk

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The business trends data used in this survey has been provided by members of EEF and Scottish Engineering.

If you would like to participate please contact anorris@eef.org.uk


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