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# ENGINEERING OUTLOOK

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SEPTEMBER 2009

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

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## Summary

- Output and orders balances rise in 2009q3
- Fewer companies cutting jobs
- Investment intentions remain low despite better cashflow position
- Manufacturers less downbeat about the future
- Weak recovery expected in manufacturing

Last quarter our Business Trends Survey reported the weakest output balance on record. The latest survey shows manufacturers have overcome the worst and the pace of decline in output and new orders has begun to ease. Both output and orders balances posted gains in 2009q3, coming in at -25% – the highest since 2008q4. Nevertheless 2009q3 marked the fourth consecutive quarter of double-digit decline for both indicators.

Improved balances were reported across all sectors, with metal products and electronics posting the largest increases. Electronics also recorded the strongest orders balance, and was the only sector to report an overall increase in orders. After recording the weakest orders balance last quarter, motor vehicles also saw an improvement in headline balances in the third quarter as the implementation of the government's car scrappage scheme took effect.

The collapse in global trade has weighed on export demand in recent quarters, but in the last three months there have been some tentative signs of recovery in emerging economies. This may have benefited some UK exporters as the export orders balance improved to -19%, from -44% in 2009q2. The balance of responses on domestic orders also rose, from -50% to -26%.

The employment balance edged higher in almost all sectors and regions, as a significant proportion of manufacturers had previously carried out job cuts, particularly at the end of 2008 and earlier this year. Electronics was the only sector to post a positive employment balance, as a balance of companies reported they had increased their workforce.

Investment intentions have been weak in recent quarters as uncertainty about the demand outlook, cashflow pressures and credit constraints have caused manufacturers to pull back investment. In the past three months, investment intentions have shown few signs of coming back, despite the cashflow balance rising significantly to -8%, from -29% in 2009q2.

Looking ahead to the next three months, manufacturers are less downbeat than last quarter as the forward-looking output and orders balances came in at their highest level for more than a year. 28% of companies expect to see an increase in new order intake compared with 18% in 2009q2. On the back of this fewer manufacturers are expecting further cuts in output in the next three months.

## Headline survey results

% balance of change

	Past 3 months	Next 3 months
Output	-25	-2
Total orders	-25	-2
Employment	-29	-15
Export prices	-17	-14
Export margins	-22	-21
Cashflow	-8	-5

EEF Business Trends Survey

## Economic data during survey period

August 5 - August 26

	Start	End
€/£	1.18	1.14
\$/£	1.69	1.62
£ index	84.79	81.62
Oil price	\$73.37	\$73.20

Source: Bank of England and ICE

## Key economic forecasts

% change except where stated

	2006	2007	2008	2009	2010	2011
GDP	2.9	2.6	0.7	-4.5	0.6	2.2
Inflation – CPI	2.3	2.3	3.6	1.9	0.8	0.9
Inflation – RPI	3.2	4.3	4.0	-0.9	1.6	1.6
World trade	9.7	6.7	2.9	-14.2	4.6	9.1
Base rate (%)	4.7	5.5	4.7	0.6	0.5	1.0

Source: Oxford Economics and EEF

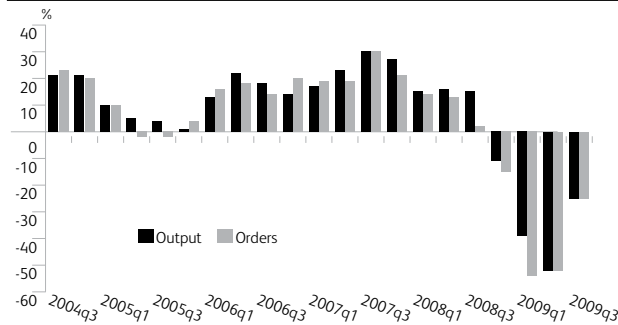
Our survey results continue to point to a gradual recovery in manufacturing and the UK economy, rather than a sharp rebound. After significant falls in manufacturing and engineering output at the end of 2008 and early part of this year we are forecasting contractions of 10.5% and 15.7%, respectively. However, 2010 should bring better news with growth will returning. The economy as a whole is forecast to post growth of 0.6% in 2010, with manufacturing coming in at 0.5%.

## Recent trends

Chart 1

### Both output and orders balances highest since 2008q4

% balance of change in past three months



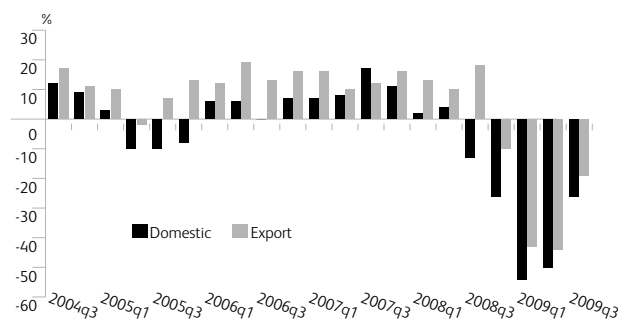
Source: EEF Business Trends Survey

Reponses on output reached record lows last quarter but companies' expectations suggested the worst had passed and the pace of decline was set to ease. In the past three months, both the output and new orders balances did improve, but not to the extent that had been predicted. Coming in at -25%, both balances were the highest since 2008q4 but marked the fourth consecutive quarter of double-digit decline. In addition, the widespread downturn in demand across all the UK's markets has kept responses below the levels seen during the recession in manufacturing earlier this decade (when in 2001q4 the output and orders balances fell to -16% and -23% respectively).

Chart 2

### Domestic and export balances edge higher

% balance of change in orders in past three months



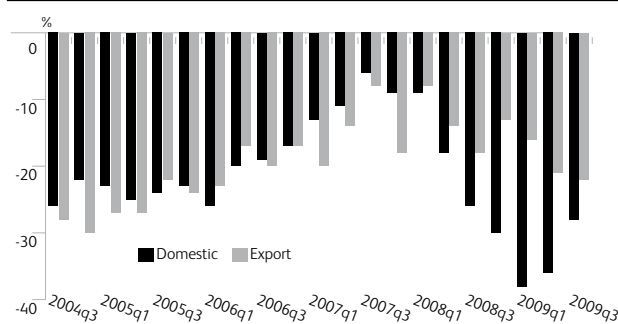
Source: EEF Business Trends Survey

Some improvement was reported in both the domestic and export orders balances in the third quarter. The worst of the contraction in world trade was felt in 2008q4 and 2008q1, coinciding with the biggest falls in our survey's export responses. Over the past quarter there have been some signs of life in emerging markets, but this has had a limited impact on UK exporters, as a balance of 19% of companies reported further declines in export orders, although this was an improvement on last quarter. The balance of responses on domestic orders also edged higher, from -50% to -26%. Domestic demand has been very weak over the past year and is forecast to remain so in the remainder of this year.

Chart 3

### Domestic margins balance highest in a year

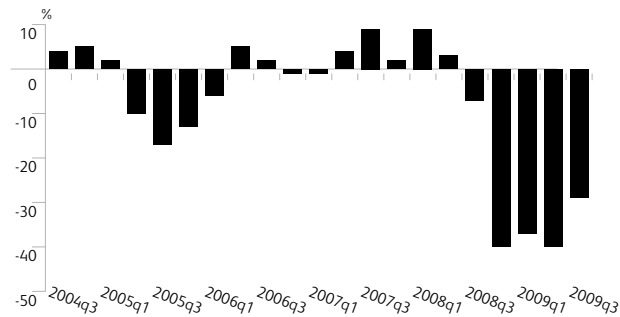
% balance of change in margins in past three months



Source: EEF Business Trends Survey

After falling into negative double-digit territory for the first time in more than five years in 2009q2, the domestic and export price balances remained largely unchanged in 2009q3. Last quarter companies had been expecting the pace of price cutting to moderate. At -15% and -17%, the domestic and export price balances were slightly lower than predicted. This has a knock-on impact of the degree of improvement in profit margins. The balance of companies reporting higher margins on domestic and export sales increased to -28% and -21%, respectively. Continued weakness in demand is holding prices down, but an increase in some commodity prices will have eaten into margins. The weakness in Sterling will, however, have had some offsetting effect on export margins.

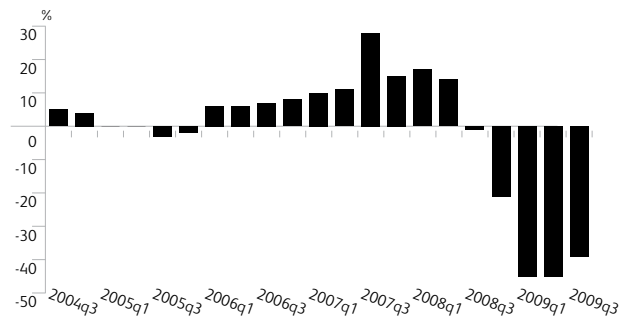
## Chart 4

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

Source: EEF Business Trends Survey

As expected, the proportion of companies cutting jobs outweighed those recruiting, as has been the case for the past year. The employment balance improved from -40% to -29% in the past three months. A significant proportion of manufacturers have previously carried out job cuts, particularly at the height of the downturn, in 2008q4 and 2009q1. Capacity concerns in some parts of manufacturing are likely to be keeping further significant workforce adjustments on hold for the time being. Smaller companies were the least likely to cut staffing levels, reporting an employment balance of -12%. Looking ahead, the employment outlook is less downbeat than the previous three months as the forward-looking employment balance rose to -15%.

## Chart 5

*Investment intentions remain at historic lows**% balance of change in investment plans*

Source: EEF Business Trends Survey

After holding steady at a record low of -45% last quarter, the planned capital investment balance rose to -39%. A number of factors are likely to have weighed on investment intentions in recent quarters – uncertainty about the outlook for demand, pressures on cashflow and credit constraints. The historical relationship between cashflow and investment in our survey reflects the importance of retained earnings to finance investment. However, despite the cashflow balance rising to -8%, from -29% in 2009q2, investment intentions remained in the doldrums. Investment has traditionally been slow to pick up after a downturn, but ongoing delays in investment could lead to concerns about the longer term productive capacity of the sector.

*Summary: past three months**% balance of responses (% up minus % down)*

	2007	2008				2009	
	q4	q1	q2	q3	q4	q1	q3
Total output	27	15	16	15	-11	-39	-25
UK new orders	11	2	4	-13	-26	-54	-26
Export new orders	16	13	10	18	-10	-43	-19
Total new orders	21	14	13	2	-15	-54	-25
Employment	2	9	3	-7	-13	-37	-29
Capital expenditure plans	15	17	14	-1	-21	-45	-39
Average price of domestic orders	1	6	18	27	6	-7	-15
Average price of export orders	-6	4	12	18	1	-6	-17
Margins on domestic orders	-9	-9	-18	-26	-30	-38	-28
Margins on export orders	-18	-8	-14	-18	-13	-16	-22
Levels of cashflow	3	5	-1	-1	-17	-36	-8

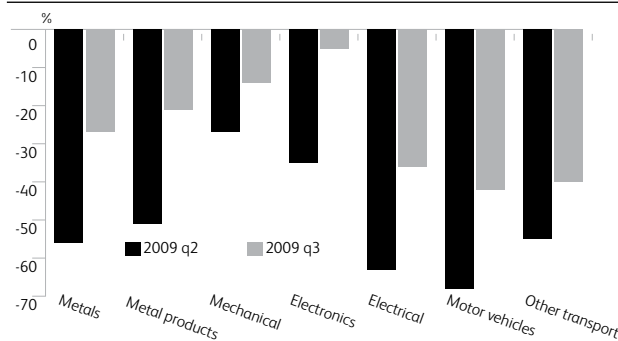
Source: EEF Business Trends Survey

## Sector trends

Chart 6

### All sectors report improved output balances

% balance of change in output in past three months



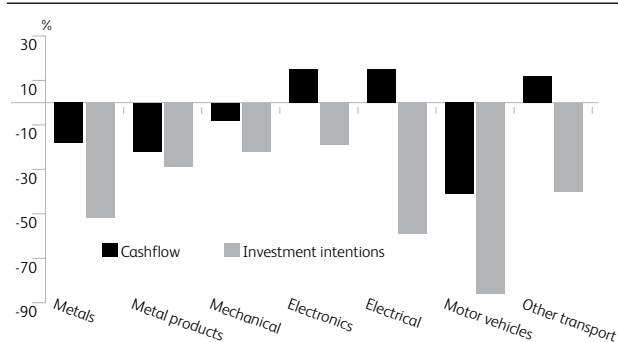
Source: EEF Business Trends Survey

In the past three months all engineering sectors reported an improvement in output balances, although all remain in negative territory. Metal products and electronics posted the largest increases. At -5%, the latter also reported the strongest output balance and came in higher than expected last quarter. Electronics also posted the strongest orders balance, coming in at 7% - the only sector to post a positive balance. With the exception of electrical equipment, all other sectors reported stronger order balances. The largest increase in the orders balance was in motor vehicles, which rose from -79% to -28%. This may be explained by the implementation of the government's car scrappage scheme, which is reported to have driven orders higher.

Chart 7

### Investment intentions remain low across all sectors

% balance of change in cashflow in the past three months, % balance of change in investment plans



Source: EEF Business Trends Survey

Cashflow balances improved across all sectors in the last three months. One of the largest improvements was seen in motor vehicles where the cashflow balance rose from -69% to -41%. A number of car plants have come back on line in recent months, after being shut down at the end of 2008 or earlier this year. Despite the improvements in companies' cashflow positions, three of the seven sectors reported weaker investment intentions. Planned capital expenditure balances fell in electrical equipment, motor vehicles and other transport. Given motor vehicles was one of the worst affected by the downturn it follows that many firms would be reluctant to invest until they see a sustained recovery. Growing uncertainty about public sector orders is likely to lead many firms in other transport to put investment plans on hold.

## 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	-27	-44	-26	-23	-18	-4	-19	-10	-13	5
Metal products	-21	-23	-21	-24	-22	6	12	-9	-19	-16
Mechanical	-14	-24	-16	-12	-8	-11	-6	-25	-6	-2
Electronics	-5	7	1	-14	15	3	18	9	-11	-1
Electrical	-36	-59	-42	-10	15	2	-1	-9	9	-3
Motor vehicles	-42	-28	-38	-32	-41	-9	-22	-28	-48	-12
Other transport	-40	-32	-69	-1	12	-5	-21	-36	-1	6

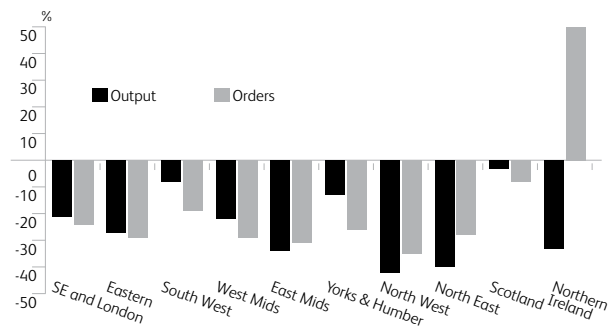
Source: EEF Business Trends Survey

## Regional trends

Chart 8

### Downturn moderates in almost all regions

% balance in past three months



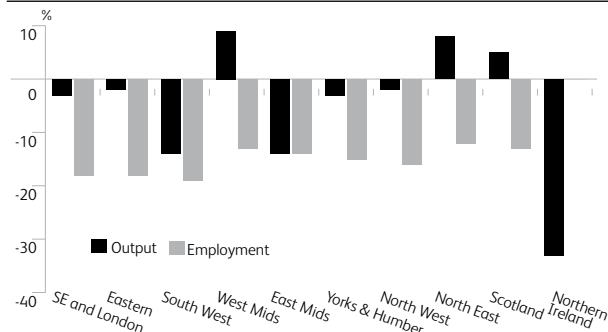
Source: EEF Business Trends Survey

Companies continued to scale back production across all regions in the past three months, but there was some improvement in output balances in nine of the ten regions compared with last quarter. The exception was the North East, where the output balance fell by 4 percentage points. At -8%, the output balance recorded in the South West was among the strongest. The balance of responses on orders also improved across the board. A marked improvement was seen in Yorkshire and Humber, as the orders balance rose to -26%, after recording one of the lowest balances of -58% last quarter. The weakest orders balance in 2009q3 was reported in the North West, at -35%.

Chart 9

### Weak employment outlook in all regions

% balance in next three months



Source: EEF Business Trends Survey

Looking to the next three months, all regions are less downbeat on both output and orders. Three of the nine regions posted positive forward-looking output balances for the first time since 2008q2. At -14%, the forward-looking output balances for the South West and East Midlands were among the weakest. Turning to employment, the forward-looking balances were weak in all regions. Despite more optimism on output in some regions, the employment outlook remains weak across the board. This indicates a lack of confidence among manufacturers, who are unlikely to increase their headcount until they see a more sustained improvement in their order books.

## 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	-21	-24	-24	-19	13	-3	18	-18	-19	-8
Eastern	-27	-29	-11	-11	-20	-2	-11	-18	-5	-9
South West	-8	-19	-19	-3	-19	-14	-19	-19	-7	-19
West Mids	-22	-29	-27	-14	-12	9	7	-13	-18	0
East Mids	-34	-31	-33	-26	-6	-14	-16	-14	-21	-16
Yorks & Humber	-13	-26	-39	-19	-15	-3	7	-15	-4	-23
North West	-42	-35	-29	-12	-42	-2	-9	-16	-7	-25
North East	-40	-28	-20	-14	-12	8	0	-12	-4	-8
Scotland	-3	-8	-11	11		5	-5	-13	4	
Northern Ireland	-33	50	-33	-33	-67	-33	50	0	-33	-67

Source: EEF Business Trends Survey

## Economic environment

- Contraction in UK GDP exceeds expectations.
- Bank of England responds with further QE expansion.
- Global recession easing, but pace of upturn uncertain.
- UK recovery likely to be weak.

### Economic forecasts

% change except where stated

	2007	2008	2009	2010
<b>Trading environment</b>				
Exchange rate (€/£)	1.46	1.26	1.14	1.2
Exchange rate (\$/£)	2.00	1.85	1.58	1.7
Exports	-2.8	0.8	-11.4	0.7
Imports	-0.8	-0.6	-12.6	-0.1
Current account (£bn)	14.0	33.5	-25.2	11.4
<b>Output</b>				
Engineering	1.6	-3.2	-15.7	-0.2
Manufacturing	0.6	-2.8	-10.5	0.5
Rest of economy	3.0	1.4	-3.7	0.7
GDP	2.6	0.7	-4.5	0.6
<b>Costs and prices</b>				
Average earnings	5.5	3.6	1.0	2.4
Oil price (\$/barrel)	72.7	97.7	60.9	74.1
<b>Employment</b>				
Engineering (000s)	1,238	1,221	1,119	1,053
Manufacturing (000s)	2,824	2,763	2,569	2,465
Rest of economy (000s)	22,862	22,968	22,295	21,802
Unemployment rate (%)	5.3	5.8	8.1	9.1

Source: Oxford Economics and EEF

Last quarter we reported the steepest decline in the UK economy for thirty years and over the past year UK GDP has fallen by a total of 5.5%. More recent data show that the fall in output in 2009q1 was even greater than first thought and the second quarter contraction of 0.7% was also worse than most analysts were expecting. In the three months to June, further falls in household spending and investment continued to drag on growth.

The worse-than-expected outturn in the first half of this year points to a deeper recession in the UK than many had realised, including the Bank of England. This was one of the factors that prompted the MPC to expand its asset purchase programme by a further £50 billion in August. The move, which surprised markets, came on the back of heightened concerns about the inflation outlook and the risk of deflation, given the amount of spare capacity in the economy.

Despite the MPC's judgement that an expansion in quantitative easing was needed to keep inflation on track, its overall assessment of the economic outlook has become less downbeat. Many activity indicators are now pointing to a degree of stabilisation across both industry and services and

there are tentative signs of life in some of the UK's main markets. France and Germany, for example, posted growth in the second quarter and activity in emerging markets has also started to recover. If sustained, these factors will provide some support for exporters.

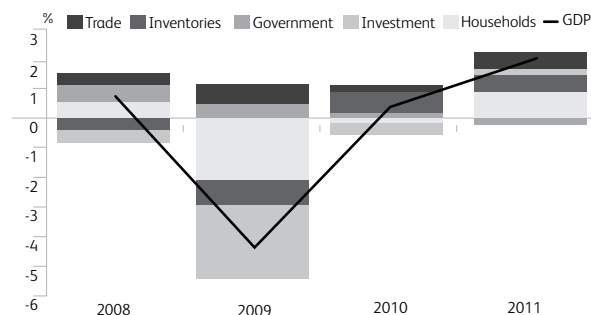
While some commentators are pinning hopes on a strong performance across the world economy in the third quarter, views on the sustainability of such a recovery are mixed. Most major economies are seeing the benefits of significant fiscal and monetary stimulus policies, but the timing of exit strategies from governments and central banks will be critical.

Our survey results and forecasts point to a gradual recovery in both manufacturing and the UK economy as a whole. Chart 10 illustrates the likely contributions to growth over the next two years. We are forecasting a further modest fall in household spending in 2010. Consumer confidence remains below its long-run average, unemployment will continue to rise into next year and the recent rise in the savings ratio suggests that households are rebuilding their wealth in case the rainy days hit. Stock building and net trade, however, should make a positive contribution to growth next year. Overall, we expect GDP to grow by 0.6% next year, rising back towards trend in 2011.

Chart 10

### Modest growth forecast in 2010

contributions to GDP growth



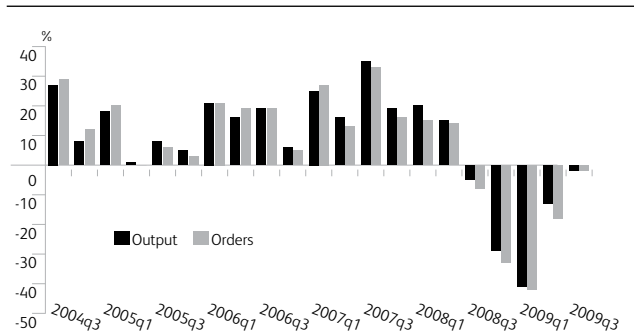
Source: Oxford Economics and EEF

## Future trends

Chart 11

### Production looks set to stabilise

% balance of change in next three months



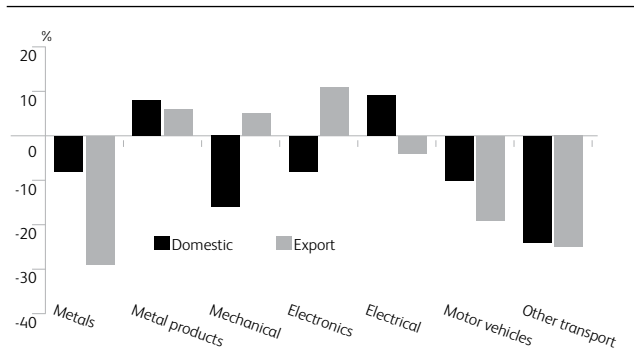
Source: EEF Business Trends Survey

Significant cuts to production have been reported across manufacturing over the past year. Last quarter our survey results suggested that the worst of the recession was behind us as companies' levels of pessimism has moderated. However, the extent of the decline in output and output turned out to be somewhat greater than expected. Looking ahead to the next quarter, 28% of companies expect to see an increase in new order intake compared with 18% in 2009q2. On the back of this, fewer manufacturers are planning further cuts in output in the next three months. While there are some sector variations, only motor vehicles has a gloomier outlook compared with the last quarter. The imminent end of the 'Cash for Clunkers' schemes in the UK and across Europe is likely to be a factor.

Chart 12

### Demand prospects mixed

% balance of change in orders in next three months



Source: EEF Business Trends Survey

Overall, manufacturers are expecting only a very modest decline in new orders in the coming quarter, in contrast to what we have reported previously. However, there is a mixed picture of the source of demand and prospects for individual sectors. Some sectors are expecting overseas demand to improve. Mechanical equipment is more optimistic about the outlook for exports as demand for investment goods looks set to grow. This is in contrast to the weak investment intentions in the domestic market. Neither domestic nor exports markets look set to provide much opportunity for motor vehicles and basic metals. Both sectors have seen a significant slump in demand and are exposed to particularly intense competitive pressures.

### Summary: next three months

% balance of responses (% up minus % down)

	2007		2008				2009		
	q4	q1	q2	q3	q4	q1	q2	q3	
Total output	19	20	15	-5	-29	-41	-13	-2	
UK new orders	4	12	3	-14	-40	-44	-19	-6	
Export new orders	17	14	14	2	-19	-32	-14	-4	
Total new orders	16	15	14	-8	-33	-42	-18	-2	
Employment	0	5	5	-10	-33	-42	-32	-15	
Average price of domestic orders	6	6	18	25	3	-9	-12	-12	
Average price of export orders	6	4	14	18	0	-7	-15	-14	
Margins on domestic orders	-5	-5	-13	-18	-28	-34	-27	-21	
Margins on export orders	-8	-5	-6	-11	-12	-17	-15	-21	
Levels of cashflow	2	9	-4	-6	-26	-38	-23	-5	

Source: EEF Business Trends Survey

## Sector forecasts

With a sustainable recovery yet to take root, the outlook for engineering and manufacturing growth in 2009 remains mixed. We have significant concerns about the strength and sustainability of any turnaround, as signs of growth in Europe, Asia and the US are tentative and uncertain. Any small bounce from restocking could prove temporary if world trade does not sustainably rebound or global economic stimulus is withdrawn too rapidly.

The latest official data estimate manufacturing output contracted by 2.8% year-on-year in 2008, and we expect manufacturing to fall by 10.5% this year before posting moderate growth of 0.5% in 2010. In engineering, output is forecast to fall by 15.7% this year and by 0.2% in 2010. The annual numbers, however, mask a quarterly return to recession for both manufacturing and engineering after a brief return to growth in 2009q3.

The fortunes of the motor vehicle sector over the next year will be central to the outlook for engineering. The government-backed scrappage schemes in the UK and in key European markets have helped provide a strong q3 bounce for the sector. But with the German and UK schemes set to run out of money, the industry could see output tumble if dealer-run incentives and pent-up demand fail to fill the gap. Despite a significant boost from the scrappage schemes, output will fall by 31% this year and continue to contract through 2010.

Weakness in other transport will also weigh on engineering in the next year. The aerospace and defence industries had been insulated from the onset of the downturn. But plunging airline profits has left the civil aerospace market struggling to cope with cancellations and fighting for new orders. Defence budgets in the UK continue to remain tight and the dearth of orders over the past 18 months is likely to hit the sector by the end of this year. Consequently, we expect other transport output to decline by 0.6% this year and 5.9% next year.

After declining by 27% in 2009, we expect a moderate restocking-driven rebound in basic metals output of 4.4% in 2010. The metal products and mechanical equipment sectors should also benefit from the inventory cycle as well as any

sustainable pick-up in world trade. Metal products will see modest growth of 0.7% in 2010, after contracting by 17% this year. Likewise, mechanical equipment will return to growth in the fourth quarter of this year and is expected to expand by 1.1% next year.

Weak consumer spending and business investment will weigh on the electronics sector which will only see a muted recovery of 0.1% in 2010. The sharp decline in output of 19% in the electrical equipment sector this year hides a gradual return to growth.

The employment outlook has weakened slightly since last quarter, reflecting the risks and uncertainties inherent to the recovery. Although we expect fewer jobs to be cut than in previous recessions, the sector could see the largest decline in employment levels for six years in 2009 and further job losses in 2010.

### Sector forecasts

*% change except where stated*

	2008	2009	2010
<b>Output (% change)</b>			
Basic metals	-4.1	-26.8	4.4
Metal products	-3.9	-17.1	0.7
Mechanical equipment	-1.0	-18.4	1.1
Electronics	-7.2	-6.4	0.1
Electrical equipment	-0.3	-19.3	2.2
Motor vehicles	-6.1	-31.1	0.9
Other transport	0.1	-0.6	-5.9
Engineering	-3.2	-15.7	-0.2
Manufacturing	-2.8	-10.5	0.5
<b>Employment (% change)</b>			
Basic metals	-2.6	-8.0	-5.5
Metal products	-2.3	-8.1	-6.1
Mechanical equipment	-0.2	-8.4	-7.5
Electronics	-2.9	-6.0	-4.5
Electrical equipment	-3.7	-10.3	-5.4
Motor vehicles	-2.1	-15.4	-5.9
Other transport	3.6	-3.1	-5.2
Engineering	-1.4	-8.3	-5.9
Manufacturing	-2.1	-7.0	-4.1

Source: EEF

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## 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.

**For further details concerning this survey please contact:**

**Lee Hopley**  
Head of Economic Policy  
020 7654 1537  
lhopley@eef.org.uk

**Jeegar Kakkad**  
Senior Economist  
020 7654 1585  
Jkakkad@eef.org.uk

**Chanderika Chouhan**  
Economist  
020 7654 1539  
cchouhan@eef.org.uk

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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 Stoy Hayward, on 0121 352 6200 or 07778 343346 or email [tom.lawton@bdo.co.uk](mailto:tom.lawton@bdo.co.uk)

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