
ENGINEERING OUTLOOK

DECEMBER 2009

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

Summary

- Output and orders stabilise
- Employment and investment cuts continue
- A rapid rebound in activity is not expected
- But export prospects have improved
- Growth forecast to return in 2010

The official data point to continued contraction in both the UK economy and manufacturing of 0.3% and 0.1% respectively. But after a particularly difficult 12 months across manufacturing trading conditions have finally stabilised. While not yet suggesting a rebound in activity the improvement in the output balance from -25% to -3% in the past three months does suggest that manufacturing is now on the road out of recession. The outturn in output and new orders was broadly in line with what companies have been expecting in the previous quarter.

However, companies remain cautious about recovery prospects. The forward looking questions pointed to muted growth in the early months of 2010. An equal proportion of companies expect output to rise as those expecting a further fall over the next quarter. However, this masks some significant sector differences. The incentives that supported the automotive sector will soon come to an end, pushing production levels down in the new year. However, growth in mechanical equipment and electronics will be expected to strengthen over the course of 2010.

One of the biggest areas of improvement looks likely to come from new export orders. A balance of companies expects demand in key markets to pick up in the next few months. Most developed economies have now pulled out of recession and emerging market growth is approaching more normal level, both of which will boost demand. In addition the weaker Sterling exchange rate will also work in manufacturers' favour. That said, our survey does highlight significant concern about exchange rate volatility, which could only add to uncertainty for companies. This could lead to a more cautious approach to new market entry.

Companies also cite concerns about their ability to finance new capital investment, which could hinder longer term productivity across the sector. While conditions have levelled off over the past three months and cashflow pressures have eased a balance of companies continues to report plans to scale back new investment in machinery and equipment. Labour market prospects have also not changed in over the past quarter as companies continue to reduce employment levels. Next year, however, the pace of job losses should slow considerably, with 92,000 forecast compared with 192,000 in 2009.

Headline survey results

% balance of change

	Past 3 months	Next 3 months
Output	-3	0
Total orders	-1	-4
Employment	-11	-15
Export prices	-13	-13
Export margins	-9	-21
Cashflow	-8	-14

Source: EEF Business Trends Survey

Economic data during survey period

4 November - 25 November

	Start	End
€/£	1.118	1.106
\$/£	1.658	1.665
£ index	81.0	80.3
Oil price	78.21	75.35

Source: Bank of England and Energy Information Agency

Key economic forecasts

% change except where stated

	2006	2007	2008	2009	2010	2011
GDP	2.9	2.6	0.5	-4.5	0.7	2.3
Inflation – CPI	2.6	2.4	3.3	2.1	1.8	1.1
Inflation – RPI	3.2	4.3	4.0	-0.6	2.4	2.0
World trade	9.4	6.9	2.5	-13.8	4.8	8.0
Base rate (%)	3.0	4.3	4.0	-0.6	2.5	1.9

Source: Oxford Economics and EEF

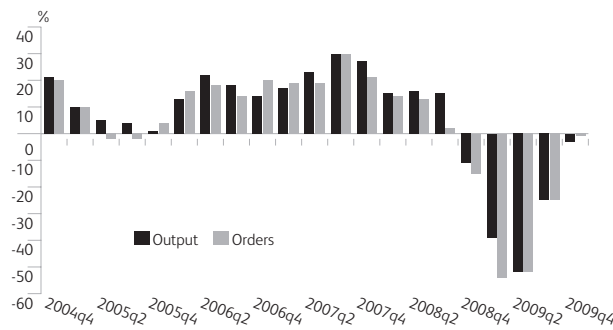
Growth will return to manufacturing in 2010. After a weak first quarter output is forecast to pick in the Spring with manufacturing set to expand by 0.9% in 2010, following a 10.4% fall in 2009. Growth across the economy as a whole will also be relatively modest in the first half of 2010, gaining some momentum in the second half of the year. For 2010 UK GDP is forecast to expand by 0.7%, picking up to 2.3% in 2011.

Recent trends

Chart 1

Output and orders stabilise

% balance of change in past three months



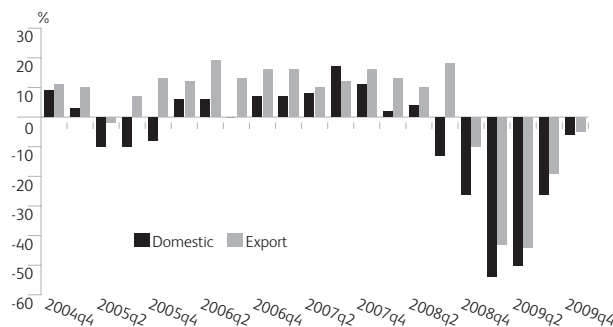
Source: EEF Business Trends Survey

Last quarter, the balance of companies reporting declining output and orders remained firmly negative. After a year of sharp declines in activity both in the UK and across the global economy manufacturers' had been expecting conditions to stabilise. Over the past three months, the proportion of companies seeing output and orders decline has almost moved into balance with those recording an increase. Responses on both indicators were the best since 2008q3. Our latest survey confirms that the worst of the global downturn is now behind us and the rapid contraction in activity that companies have been dealing with over the past year has finally levelled off.

Chart 2

Decline in new orders eases

% balance of change in orders in past three months



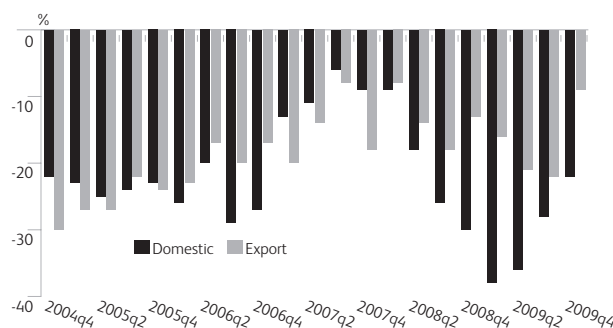
Source: EEF Business Trends Survey

Most of the developed world is now officially out of recession and growth in emerging markets is returning to pre-recession levels. The sharp falls in world trade flows over the past 18 months have also started to go into reverse and this is reflected in our survey results. The balance of responses on export orders has improved from -44% to -5% in six months. However, the global recovery remains in its early stages so UK companies have not yet seen a return to growth, despite the weaker Sterling exchange rate. The improvement in the world economy has also translated into a relative improvement in the domestic orders balance.

Chart 3

Margins' squeeze moderates

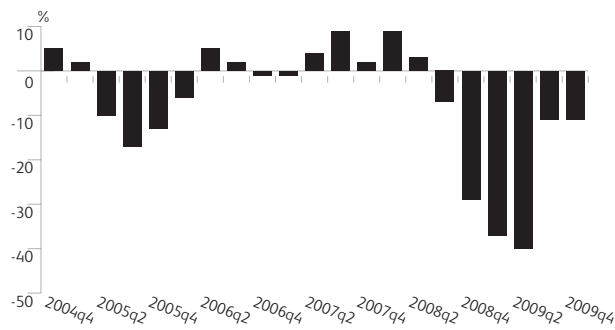
% balance of change in margins in past three months



Source: EEF Business Trends Survey

While the orders balances have yet to move into negative territory the weaker pound is helping with profit margins on export sales, despite a balance of 13% of companies reporting cutting prices. At -9% the balance of responses on export margins is the least negative since the beginning of 2008. But a significant gap has opened up between responses on export and domestic margins. The squeeze on margins on UK sales has eased but the balance of responses remains around its long term average.

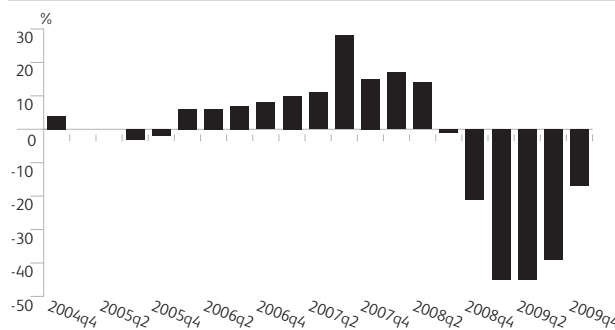
Chart 4

*Further job cuts reported**% balance of change in employment in past three months*

Source: EEF Business Trends Survey

The stabilisation in output and orders hasn't yet put a floor under job losses in manufacturing. The most significant job losses were made in the immediate aftermath of the onset of the recession. And while cuts have slowed, the balance of companies reducing headcount in the past three months was unchanged from the previous quarter. However, the sector composition of cuts has changed. There was some recruitment activity in the automotive sector and electronics, in contrast a majority of companies in basic metals cut employment levels in the past quarter. Our survey also shows that a sustained improvement in labour market conditions across the sector is not yet in sight.

Chart 5

*Investment plans still being scaled back**% balance of change in investment plans*

Source: EEF Business Trends Survey

Alongside the gradual improvement in profit margins recorded in recent surveys companies have also seen an easing the downward pressure on cashflow. Historically, there has been a good correlation between cashflow and investment intentions, but this link has been broken during the recession. In the first three quarters of this year investment balances have remained significantly below their long term average as companies rapidly scaled back plans for capital expenditure over the next 12 months. There has been some improvement over the past three months, but at -17% the balance does not indicate a recovery in investment plans in the near term. Rather, it appears that the biggest cuts have been made and companies are keeping plans on hold until there are clearer signs that demand has returned.

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

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

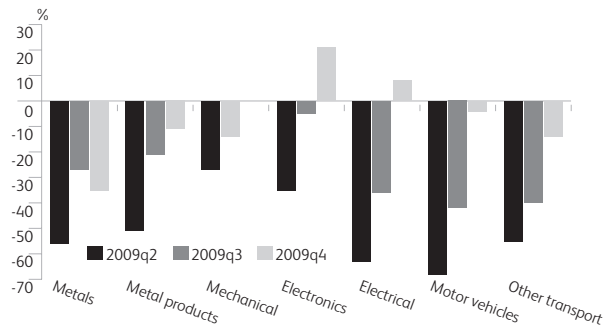
Source: EEF Business Trends Survey

Sector trends

Chart 6

Most sectors continue to see improvement

% balance of responses on output in past three months



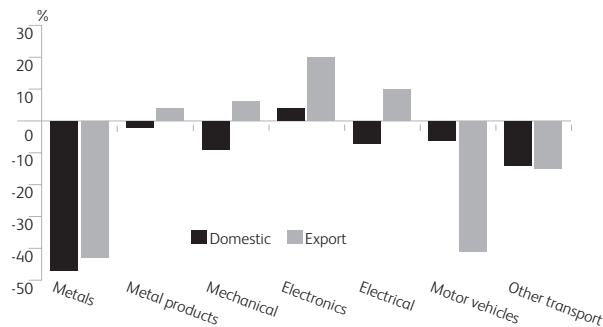
Source: EEF Business Trends Survey

Last quarter we reported improvements across all engineering sectors. Following the historic lows of the second quarter, the third quarter saw fewer firms reporting declining output across the board. With the exception of basic metals this trend continued in the past three months. This was broadly in line with companies' expectations in the previous quarter. Encouragingly, a balance of companies reported increasing orders in mechanical, electrical and electronics. Our survey suggests that this growth is coming from increased demand in export markets. While the responses in motor vehicles are the best since 2008q3, this is not expected to continue as the scrappage incentive and VAT cut ends at the end of 2009.

Chart 7

Market strength varies by sector

% balance of change in orders in past three months



Source: EEF Business Trends Survey

In the previous quarter our survey pointed to ongoing weakness in both domestic and export markets, but some sectors have reported a notable shift in the past three months. Increased investment outside the UK, for example, has provided a small boost for the mechanical equipment sector. Electronics manufacturers, suppliers in a broad range of sectors, have seen an improvement in both export and domestic markets. The difference in UK and export markets for the automotive sector is striking. The UK scrappage scheme is still providing some support but most European programmes have now come to an end. Basic metals, however, is still facing extremely tough trading conditions across all markets.

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	-35	-52	-51	-23	-21	-23	-21	-37	-33	-35
Metal products	-11	-2	-16	-20	-21	2	-3	-11	-17	-14
Mechanical	0	3	-16	-10	5	7	3	-17	-13	5
Electronics	21	24	8	-19	-4	11	4	-18	-9	-10
Electrical	8	5	-7	-7	9	0	2	-7	3	-7
Motor vehicles	-4	-23	36	-2	-6	-39	-57	-19	-23	-44
Other transport	-14	-4	-44	-11	-15	27	44	-4	3	10

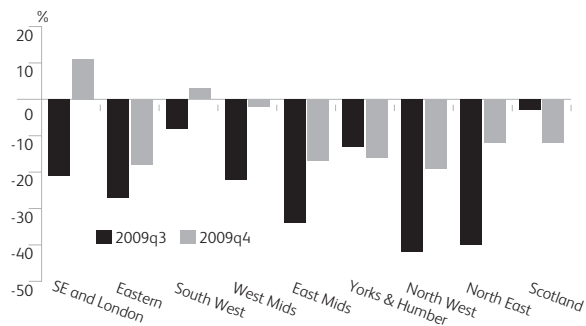
Source: EEF Business Trends Survey

Regional trends

Chart 8

Conditions improve in most regions

% balance of change in output in past three months



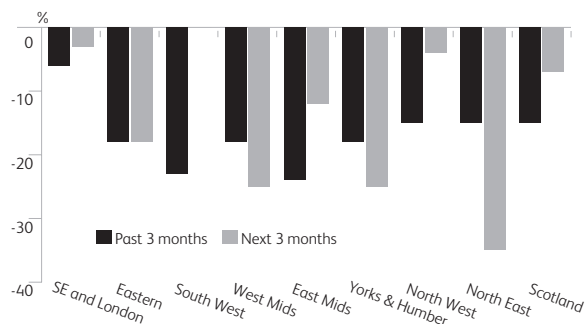
Source: EEF Business Trends Survey

In line with the improvement in output balances nationally, most UK regions have seen output improve from the lows reported over the past six months. In the South East and South West, a balance of companies saw output return to growth over the past quarter. The upturn in motor vehicle production since the Summer has also helped the output balance in the West Midlands to edge nearer to the zero balance. However, the continued weakness in metals has kept some of the balances in the Northern regions below the UK average. In addition, the relative weakness of other transport will have held down output in the North West.

Chart 9

Job cuts look set to continue

% balance of change in employment



Source: EEF Business Trends Survey

Activity may have turned a corner, but our survey suggests that manufacturing jobs will continue to be lost into 2010. Despite efforts to retain skilled employees, jobs were shed across all regions in the past three months. Across the sector as a whole the balance of companies expecting to cut jobs increased slightly compared to the past three months. There are some significant sector and regional differences. Motor vehicles, for example, had increased head count in the past three months in response to growing production levels, however, the expected decline in orders in the New Year mirrors the planned job reductions. The North East and West Midlands look set to be particularly hard hit.

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	11	3	-6	-31	0	9	16	-3	-23	6
Eastern	-18	-13	-18	3	-8	-13	-13	-18	3	5
South West	3	0	-23	-13	0	11	9	0	-3	-11
West Mids	-2	4	-18	-11	-5	-7	-5	-25	-19	-27
East Mids	-17	-5	-24	-27	-20	0	-2	-12	-24	-27
Yorks & Humber	-16	-12	-18	-9	-29	4	4	-25	-5	-12
North West	-19	-15	-15	-26	-22	6	13	-4	-20	-17
North East	-12	0	-15	-19	-19	-12	-12	-35	-19	-23
Scotland	-12	-6	-15	-3		2	1	-7	-3	

Source: EEF Business Trends Survey

Economic environment

- UK economy contracts in q3
- Bank of England responds with QE expansion
- Most other developed economies have pulled out of recession
- But strength of recovery in 2010 remain uncertain

The most surprising news over the past three months was the sixth consecutive quarter decline in UK output in the three months to September. Against consensus expectations of a modest return to growth in the third quarter, the UK economy contracted by 0.3%. Activity across all sectors of the economy was broadly flat, with only government spending making a positive contribution to output. Net trade and investment, however, continued to be the main drag on growth.

Before the news from National Statistics that the UK remained in recession, the MPC was widely expected to pause its asset purchase programme at the beginning of November. However, the Committee voted to expand quantitative easing by a further £25 billion to £200 billion in an attempt to support household and business spending. It was felt that additional asset purchases were needed given the ongoing weakness in the banking system and the fact that government spending would make a more limited contribution to the economy in 2010.

As consumers remain cautious and public spending is set to be reined in, the best prospects for growth next year would appear to be from a recovery in world trade flows. The US and most of Europe have now reported positive GDP growth and emerging markets in Asia are quickly returning to pre-recession growth rates following significant stimulus measures over the past year. The US economy expanded at an annualised rate of 2.8% in the third quarter, boosted by growth in household spending and exports. Solid quarterly growth rates are also forecast for the US in 2010.

While UK manufacturers should be able to capitalise on a weaker Sterling exchange rate many have concerns about significant volatility leading to a degree of caution about entering new markets. This adds to the uncertainty about how strong an eventual UK recovery will be. Chart 10 illustrates our forecasts for the next 12 months. We should see some growth in the fourth quarter of 2009, this will be largely driven by a jump in household spending as consumers bring forward purchases of big ticket items, such as cars, to take advantage to the VAT reduction and scrappage incentive.

This will also provide some temporary support for manufacturing. But for 2009 as a whole we should see overall falls of 4.6% and 10.4% for the economy as a whole and manufacturing respectively. Looking ahead to 2010, growth will get off to a slow start. The

expenditure that household brought forward into 2009 will go into reverse in the first quarter, leaving growth flat, but gradually gaining some momentum in the second half of the year. We are therefore forecasting output to grow by 0.9% in manufacturing and 0.7% in the economy as a whole.

Economic forecasts

% change except where stated

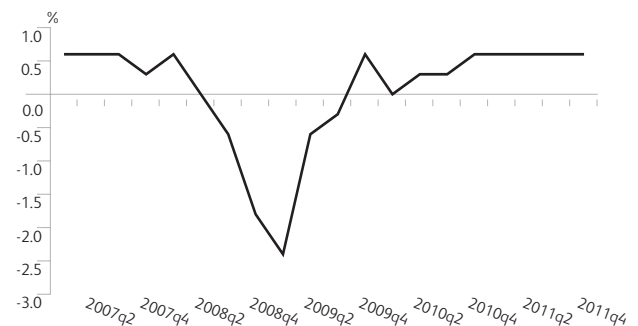
	2008	2009	2010
Trading environment			
Exchange rate (€/£)	1.26	1.12	1.16
Exchange rate (\$/£)	1.85	1.57	1.72
Exports	1.0	-10.4	2.7
Imports	0.8	-12.6	0.9
Current account (£bn)	-42.8	-50.5	-44.5
Output			
Engineering	-3.3	-16.0	0.0
Manufacturing	-2.9	-10.4	0.9
Rest of economy	1.2	-3.8	0.8
GDP	0.5	-4.5	0.7
Costs and prices			
Average earnings	3.7	1.4	1.6
Oil price (\$/barrel)	97.7	62.5	72.8
Employment			
Engineering (000s)	1,221	1,125	1,072
Manufacturing (000s)	2,763	2,571	2,479
Rest of economy (000s)	22,969	22,535	22,188
Unemployment rate (%)	5.8	7.9	8.6

Source: Oxford Economics and EEF

Chart 10

UK will return to growth in q4

% quarter on quarter change in GDP



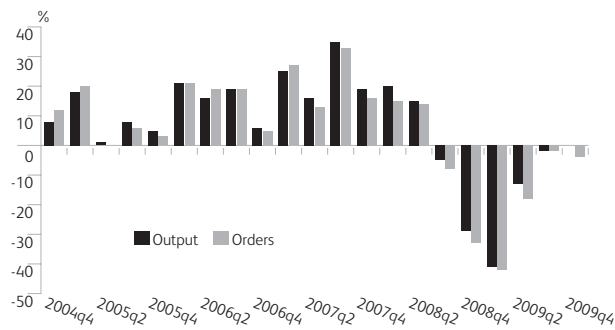
Source: National Statistics and EEF

Future trends

Chart 11

Rapid recovery not in prospect

% balance of change expected in next three months



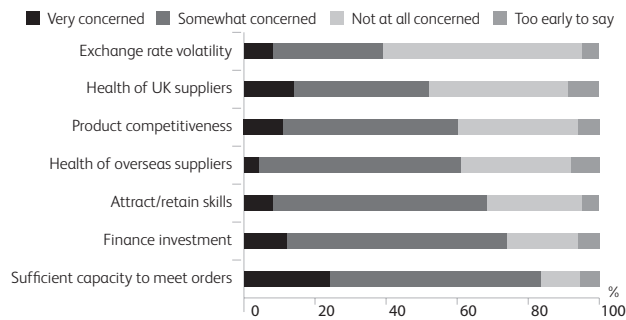
Source: EEF Business Trends Survey

In the third quarter manufacturers had been expecting trading conditions to stabilise by the end of the year. But rather than a rapid rebound in activity on the horizon, companies are expecting more of the same in the first three months of 2010. The main bright spot is some modest growth in export orders over the next quarter – the balance of 6% was the first positive response on exports since 2008q3. However, this growth will be concentrated in a few sectors. There is less optimism about the prospects for domestic orders, with a balance of 9% of companies expecting a decline in the next three months. Continued weakness in the UK economy and the end of a number of stimulus measures will be contributing to a more cautious outlook.

Chart 12

Recovery will bring new challenges

% of companies reporting concern



Source: EEF Business Trends Survey

While the worst is now clearly behind us companies have identified a range of issues that could constrain their ability to take advantage of an upturn in demand. Chief among these is a continuation of the exchange rate volatility we've seen over the past year. This could make companies more cautious when it comes to tapping into new export markets. However, one in seven companies is very concerned about their ability to finance investment in the new machinery and equipment that will give them a productivity and competitiveness advantage when the recovery becomes established. Similarly, an erosion in the supply base could also throw up significant hurdles as firms ramp up production next year.

Summary: next three months

% balance of responses (% up minus % down)

	2008				2009			
	q1	q2	q3	q4	q1	q2	q3	q4
Total output	20	15	-5	-29	-41	-13	-2	0
UK new orders	12	3	-14	-40	-44	-19	-6	-9
Export new orders	14	14	2	-19	-32	-14	-4	6
Total new orders	15	14	-8	-33	-42	-18	-2	-4
Employment	5	5	-10	-33	-42	-32	-15	-15
Average price of domestic orders	6	18	25	3	-9	-12	-12	-4
Average price of export orders	4	14	18	0	-7	-15	-14	-13
Margins on domestic orders	-5	-13	-18	-28	-34	-27	-21	-24
Margins on export orders	-5	-6	-11	-12	-17	-15	-21	-21
Levels of cashflow	9	-4	-6	-26	-38	-23	-5	-14

Source: EEF Business Trends Survey

Sector forecasts

Although the worst of the recession is likely behind us, the prospects for engineering and manufacturing growth in 2010 remain muted. The latest official data estimate manufacturing output contracted by 0.1% quarter-on-quarter in q3. On the back of modest growth in q4, we expect manufacturing output to have contracted by 10.4% in 2009 and to grow by 0.9% in 2010. A tough start to 2009 should leave engineering output down by 16.0% this year and flat next year. The 2010 forecasts, however, mask a return to recession for both manufacturing and engineering in the first quarter of the New Year.

Long-lead times and public sector contracts protected other transport from the worst of the recession in 2009. But after contracting by 1.5% this year, the industry faces an even tougher 2010. Delays in big-ticket defence spending and over capacity in civil aerospace markets will weigh on the sector even as the rest of the economy begins to recover from the recession.

The government-backed scrappage schemes in the UK and in key European markets have helped provide a strong boost to the automotive sector in the second half of 2009. But with the UK scheme set to run out of money in the New Year, the industry could see output tumble in the first quarter if dealer-run incentives and pent-up demand fail to fill the gap. A contraction of 11.6% in the first quarter will give way to 0.1% annual growth in 2010.

The basic metals sector benefited from a rebound in metals prices and a moderate level of restocking in the second half of 2009. But the sector is likely to suffer from over capacity and falling metals prices. The sector will face a tough first half of 2010, before growing by 6.5% on the year. A sluggish recovery in domestic and export markets will hinder recovery in metal products. After contracting by 16.8% in 2009, the sector will see only modest growth of 1.0% in 2010.

Mechanical equipment could see some pick up in export orders for machine tools and components that feed into the capital goods supply chain through Germany and into fast-growing Asian markets. Consequently, the year-on-year forecast contraction of 0.1% masks four quarters of positive growth for the sector.

The electronics sector, which posted positive quarterly growth numbers for the last three quarters of the year, should see growth of 1.9% in 2010. Electrical equipment is set to benefit from a rebound in demand for handheld electronics and grow by 2.7% next year.

The employment outlook has improved slightly since last quarter, reflecting the more stable outlook. The sector has lost fewer jobs through this recession than in previous recessions, and we expect fewer job losses in 2010 than were lost, on average, each year from 2000–2008.

Sector forecasts

	2008	2009	2010
Output (% change)			
Basic metals	-4.2	-25.2	6.5
Metal products	-4.0	-16.8	1.0
Mechanical equipment	-1.2	-19.9	-0.1
Electronics	-7.1	-5.4	1.9
Electrical equipment	-0.1	-20.8	2.7
Motor vehicles	-6.2	-31.0	0.1
Other transport	-0.1	-1.5	-6.0
Engineering	-3.3	-16.0	0.0
Manufacturing	-2.9	-10.4	0.9
Employment (% change)			
Basic metals	-2.6	-9.0	-7.2
Metal products	-2.3	-7.5	-4.1
Mechanical equipment	-0.2	-7.9	-5.8
Electronics	-2.9	-6.0	-3.9
Electrical equipment	-3.7	-9.9	-4.4
Motor vehicles	-2.1	-14.5	-4.9
Other transport	3.6	-2.2	-3.5
Engineering	-1.4	-7.9	-4.7
Manufacturing	-2.1	-7.0	-3.6

Source: EEF

The survey was conducted between November 4 and November 25, with 618 companies responding

For more information on the survey results, please call Lee Hopley (Head of Economic Policy) – 020 7654 1537 or Jeegar Kakkad (Senior Economist) – 020 7654 1585

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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