
MANUFACTURING OUTLOOK

JUNE 2011

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

Foreword

Welcome to the second edition in 2011 of Manufacturing Outlook, our quarterly report on the trends in UK manufacturing produced by EEF in partnership with BDO. Our latest report continues to bring positive news from across the manufacturing sector. The official statistics have now shown six consecutive quarters of expansion in manufacturing output and our latest Business Trends Survey points to another three months of growth in the coming quarter.

The momentum behind the sector's recovery appears to have been maintained in the first half of 2011 and the performance of manufacturing is set to continue to outpace that of the wider economy. Our recent surveys have begun to point to a gradual improvement in confidence with positive investment intentions maintained and recruitment plans translating into the first increase in manufacturing workforce jobs since 1998.

A key driver of growth remains robust demand from overseas markets. The balance of responses has been considerably higher than the long-term average for over a year as companies capitalise on strong growth in world markets. Official statistics show that emerging Asian markets and the Middle East have been significant sources of export growth over the past two years.

Lee Hopley, Chief Economist, EEF

However the pattern of exports to Europe reflects the two-speed recovery, with demand holding up in France and Germany compared with a much less positive outlook for exports to periphery economies. While the gap between export and domestic orders balances widened further over the past three months, responses on UK orders are still elevated compared with long-term trends.

While manufacturing and its contribution to export growth remain one of the bright spots in the UK economy, challenges to growth that many companies have been navigating since the end of the recession are unlikely to recede in the coming quarters.

Overall manufacturers remain optimistic about output and order books in the short term, but some downside risks have increased. For example, commodity prices are likely to be high and volatile for the time being, access to credit remains difficult or costly for some small companies and the path of the global recovery could yet hit a bump in the road. Nevertheless, 2011 has got off to a solid start and we should see above trend growth in the sector this year and next.

Tom Lawton, Head of Manufacturing, BDO LLP

Summary

- Manufacturing expands in six consecutive quarters
- Survey points to growth in 2011H2
- Positive investment and recruitment intentions signal gradual increase in confidence
- But companies may struggle to pass on cost increases
- Solid growth forecast through 2011 and 2012

The tide of positive manufacturing news has largely continued over the past quarter. Against a backdrop of fairly mediocre growth of 0.5% across the economy in the first quarter of 2011, manufacturing posted its sixth consecutive quarter of growth. With a further expansion in output of over 1% on the quarter, manufacturing has had its strongest 18 month period since 1989.

EEF's latest Business Trends Survey suggests that the official statistics will continue to show manufacturing growing in the coming quarters. The balance of companies reporting an increase in output rose to 28%, up from 25% in the previous quarter. This was broadly in line with what companies had been expecting. Manufacturers' order intake also appeared to remain firm with a balance of 30% of companies reporting an increase in total orders.

However over the past few quarters the gap between the export and domestic balances has widened. The orders from overseas balance remained near record highs at 28% over the past three months, while the UK orders balance edged up to, a still respectable, 19%. This gap, at nine percentage points, is close to what was seen in 2011q1, which was wider than at any earlier point in the recovery. The official statistics point to strong growth to both emerging markets in Asia and the Middle East over the past year, and also to the strongly performing core European economies of France and Germany.

This pattern of demand is expected to continue over the next quarter and a balance of 27% of companies is planning for continued output growth. The consistently positive results that we've seen over the past 18 months, in addition to a positive growth outlook in many of the UK's key export markets, continues to translate into a gradual improvement in confidence across the sector. The balance of responses on recruitment and investment remained firmly in positive territory over the past three months. And the increase in manufacturing workforce jobs reported in the official statistics points to much of this recruitment being for permanent employees.

The plans to increase capital expenditure that our survey has shown over the past year have not,

however, translated into growth in official business investment data. In the first quarter manufacturing investment fell again by just over 1%. This may simply reflect a lag between companies planning a new investment and new equipment coming on stream. Or it could reflect ongoing hesitancy from manufacturers to commit resources in a market environment characterised by persistent uncertainty on both the demand and supply side.

While the overall story from our survey is a positive one, there are lingering signs that challenges remain. The global recovery has brought significant rises in input prices for manufacturers. Towards the end of last year more companies were starting to increase prices in both export and UK markets, but this trend has slowed in the past three months, as downward pressure on margins and cashflow has returned. Nevertheless we continue to expect firm growth across the sector for the remainder of this year and manufacturing should outpace the economy both this year and next.

Engineering – Headline survey results

% balance of change

| | Past 3 months | Next 3 months |
|----------------|---------------|---------------|
| Output | 28 | 27 |
| Total orders | 30 | 20 |
| Employment | 24 | 22 |
| Export prices | 16 | 15 |
| Export margins | -4 | -1 |
| Cashflow | 0 | -3 |

Source: EEF Business Trends Survey

Economic data during survey period

4 May – 25 May

| | Start | End |
|-----------|-------|-------|
| €/£ | 1.11 | 1.16 |
| \$/£ | 1.65 | 1.63 |
| £ index | 78.9 | 80.4 |
| Oil price | 121.6 | 112.5 |

Source: Bank of England and Energy Information Agency

Key economic forecasts

% change except where stated

| | 2009 | 2010 | 2011 | 2012 | 2013 |
|-----------------|-------|------|------|------|------|
| GDP | -4.9 | 1.3 | 1.5 | 2.3 | 2.9 |
| Inflation – CPI | 2.2 | 3.3 | 4.3 | 2.1 | 1.7 |
| Inflation – RPI | -0.5 | 4.6 | 5.2 | 3.4 | 3.4 |
| World trade | -12.7 | 12.4 | 6.5 | 7.6 | 8.0 |
| Base rate (%) | 0.65 | 0.50 | 0.64 | 1.54 | 3.16 |

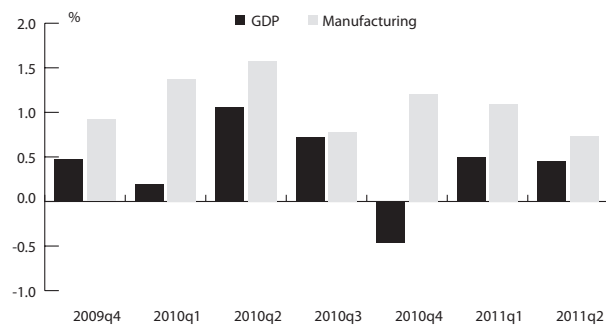
Source: Oxford Economics

Manufacturing outlook

Chart 1

Manufacturing continues to outpace the rest of the economy

% quarter on quarter change in output



Source: National Statistics

Manufacturing continues to drive the economic recovery. Over the last six months, when the economy as a whole stagnated, manufacturing grew by 2.3%. In fact, since the recovery began, despite only accounting for around 13% of the economy, manufacturing has been responsible for one third of economic growth. Even in the first quarter of 2011, where the industry's growth rate slowed a little, manufacturing accounted for approximately one quarter of total economic growth. This quarter, our survey suggests manufacturing will continue to grow strongly. There is, however, still some way to go before manufacturing output returns to its pre-recession peak.

Chart 2

Growth driven by strong export demand

% balance of change in past three months



Source: EEF Business Trends Survey

Balances on orders and outputs strengthened in the second quarter of 2011. In keeping with the trend since the end of the recession, although UK orders balances strengthened, it was export orders that looked particularly strong. Anecdotal evidence points to continued demand in a broad range of markets including core EU economies and emerging markets in the Middle East and Asia. This should support further positive contributions to growth from net trade in the coming quarters. However, challenges remain; commodity prices have been more volatile in recent months and the last quarter's positive responses balance on margins may be fleeting if manufacturers are unable to pass through rising input costs.

Summary

% balance of responses (% up minus % down)

| | Past three months | Next three months |
|----------------------------------|-------------------|-------------------|
| Total output | 27 | 21 |
| UK new orders | 17 | 10 |
| Export new orders | 29 | 18 |
| Total new orders | 29 | 17 |
| Employment | 22 | 19 |
| Capital expenditure plans | 17 | |
| Average price of domestic orders | 21 | 18 |
| Average price of export orders | 19 | 17 |
| Margins on domestic orders | -16 | -10 |
| Margins on export orders | -6 | -4 |
| Levels of cashflow | 1 | -4 |

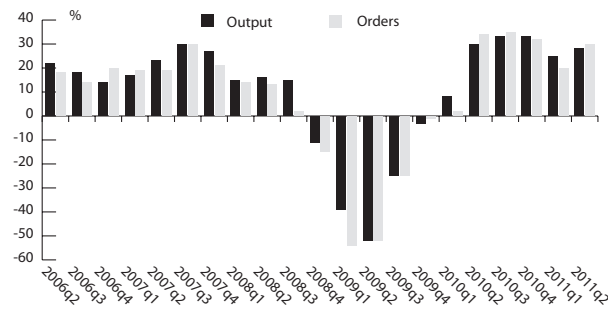
Source: EEF Business Trends Survey

Recent trends

Chart 3

Output and orders strengthen in q2

% balance of change in past three months



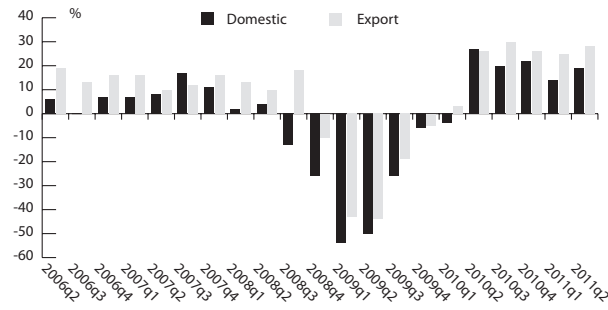
Source: EEF Business Trends Survey

Just as the official statistics have continued to show a strong recovery in manufacturing, so has our survey. The second quarter of 2011 marked the sixth consecutive quarter of positive orders and output balances for manufacturers. Our survey suggests that q2 was another particularly strong quarter with the output balance strengthening to 28%, up from 25% last quarter. The orders balance also strengthened, with a balance of 30% of companies seeing an increase in new orders in the past three months, compared with 20% previously; this is firmly positive and suggests the sector's recovery should continue apace.

Chart 4

Overseas demand near-record high

% balance of change in orders in past three months



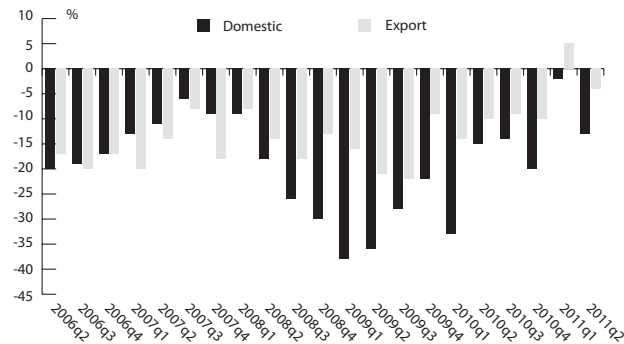
Source: EEF Business Trends Survey

Orders balances have also been positive for both domestic and export markets for six consecutive quarters, but the gap between export and domestic orders balances has widened over the past six months. A balance of 19% of manufacturers reported that domestic orders had risen in the past three months, while the balance for export orders crept up to a near-record high of 28% in the second quarter. Domestic orders balances remain well above historical averages, and the balance strengthened in q2, but export orders balances have continued to prove remarkably strong, exceeding even last quarter's expectations.

Chart 5

Pressure on margins returns

% balance of change in margins in past three months



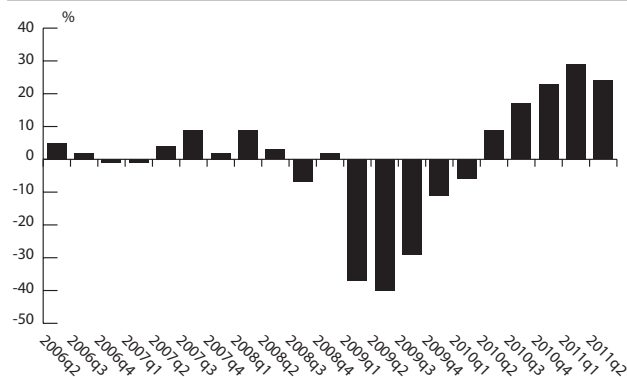
Source: EEF Business Trends Survey

Last quarter's survey showed that a balance of companies has seen an improvement in profit margins. This has gone into reverse in the past three months. Last quarter's expectations that there would be further improvements in margins have not been borne out. Over the last three months a balance of 13% of companies saw domestic margins deteriorate and 4% saw a similar picture on export margins. While a balance of 16% of companies increased both domestic and export prices in the past three months, this was considerably lower than in the previous quarter, which is unlikely to be explained solely by the volatility in commodity prices in recent months.

Chart 6

Manufacturers continue to recruit

% balance of change in employment in past three months



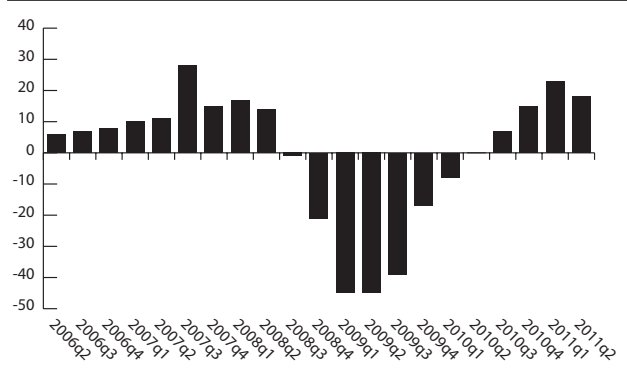
Source: EEF Business Trends Survey

2011q2's survey marks a fifth quarter of positive recruitment balances. This is in line with official statistics, which showed that the number of manufacturing vacancies grew at a record rate of nearly 60% in the year to April. Although down a little from last quarter's record high of 29%, a strongly positive balance of 24% of manufacturers reported that they had taken on workers in the last three months. Employers are still taking on workers on a temporary and agency basis, but a significant proportion of new hires will be permanent. Anecdotal evidence suggests that skill shortages are becoming an issue that might prevent companies from hiring more quickly.

Chart 7

Investment balance remains strong

% balance of change in investment plans



Source: EEF Business Trends Survey

Investment intentions have rebounded much more quickly than following the previous recession. The second quarter of 2011 marks one year of positive investment intentions. A balance of 18% of companies said they were planning to increase their capital expenditure in the next twelve months. There may, however, be problems for companies looking to invest, as cashflow has become more of a concern. This is more notable in smaller companies, with less than 100 employees, where a balance of companies saw cashflow weaken in the last three months.

Summary: past three months

% balance of responses (% up minus % down)

| | 2009 | | 2010 | | | | 2011 | |
|----------------------------------|------|-----|------|-----|-----|-----|------|-----|
| | q3 | q4 | q1 | q2 | q3 | q4 | q1 | q2 |
| Total output | -25 | -3 | 8 | 30 | 33 | 33 | 25 | 28 |
| UK new orders | -26 | -6 | -4 | 24 | 20 | 22 | 14 | 19 |
| Export new orders | -19 | -5 | 3 | 23 | 30 | 26 | 25 | 28 |
| Total new orders | -25 | -1 | 2 | 34 | 35 | 32 | 20 | 30 |
| Employment | -29 | -11 | -6 | 9 | 17 | 23 | 29 | 24 |
| Capital expenditure plans | -39 | -17 | -8 | 0 | 7 | 15 | 23 | 18 |
| Average price of domestic orders | -15 | -15 | -8 | 5 | 5 | 0 | 26 | 16 |
| Average price of export orders | -17 | -13 | 0 | 2 | 4 | -1 | 26 | 16 |
| Margins on domestic orders | -28 | -22 | -33 | -15 | -14 | -20 | -2 | -13 |
| Margins on export orders | -22 | -9 | -14 | -10 | -9 | -10 | 5 | -4 |
| Levels of cashflow | -8 | -8 | -7 | 10 | 7 | 14 | 6 | 0 |

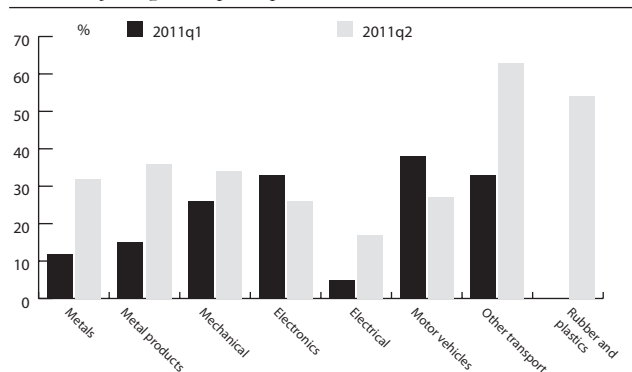
Source: EEF Business Trends Survey

Sector trends

Chart 8

Strong output balances in all sectors

% balance of change in output in past three months



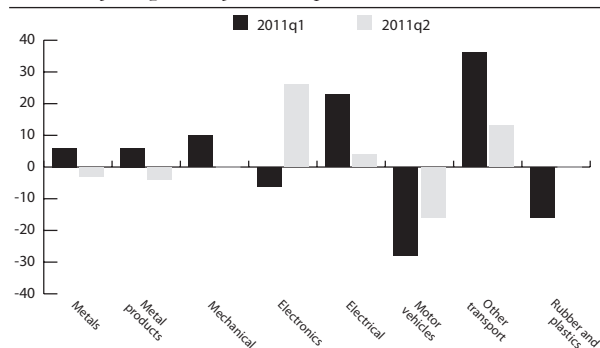
Source: EEF Business Trends Survey

Output balances were strongly positive across all sectors. Once again the other transport sector saw some of the strongest balances. A balance of 63% of companies in other transport saw output increase. Motor vehicles had a weaker quarter, with several shutdowns in the sector, but still a balance of 27% of companies reported increased output, and orders balances were particularly strong. The electrical engineering and rubber and plastics sectors – which looked weaker in 2011q1 – saw a much stronger second quarter, with balances of 17% and 54% of companies in these sectors having seen output grow in the last three months.

Chart 9

Cashflow weak for metals and automotive sectors

% balance of change in cashflow in the past three months



Source: EEF Business Trends Survey

Commodity price rises over the past year have put pressure on manufacturers' margins across the board, but particularly in metals and automotive sectors. This is now hitting cashflow with, for example, a balance of 16% of motor vehicles manufacturers reporting that cashflow had weakened. In part this is a result of companies being unable to pass on the full extent of cost increases they have experienced. Last quarter saw strong balances of companies planning to put up prices, for example, a balance of 40% of metal products manufacturers intended to raise domestic prices, but in this quarter a balance of only 20% of companies reported that they had done so.

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 | 32 | 31 | 25 | 30 | -3 | 12 | 16 | 25 | 24 | -3 |
| Metal products | 36 | 31 | 25 | 18 | -4 | 37 | 30 | 33 | 12 | 1 |
| Mechanical | 34 | 33 | 21 | 13 | 0 | 27 | 16 | 16 | 19 | 14 |
| Electronics | 26 | 52 | 22 | 0 | 26 | 9 | 22 | 27 | 0 | -18 |
| Electrical | 17 | 29 | 21 | 9 | 4 | 25 | 21 | 12 | -3 | -21 |
| Motor vehicles | 27 | 47 | 33 | 12 | -16 | 33 | 10 | 26 | 24 | -26 |
| Other transport | 63 | 50 | 25 | 25 | 13 | 25 | 38 | 13 | 25 | -13 |
| Food and drink* | | | | | | | | | | |
| Chemicals* | | | | | | | | | | |
| Rubber and plastics | 54 | 50 | 29 | 41 | 0 | 17 | 21 | 17 | 45 | -17 |
| Non-metallic mineral products* | | | | | | | | | | |

* Insufficient data

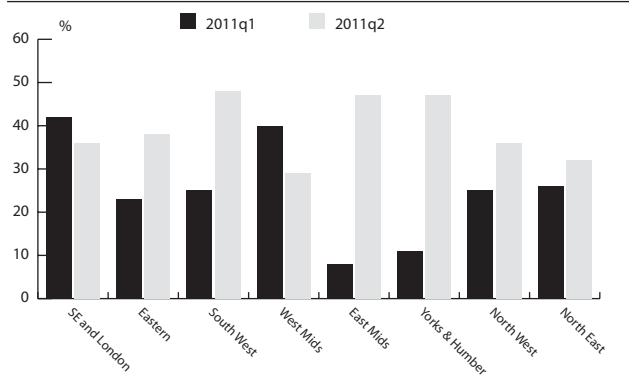
Source: EEF Business Trends Survey

Regional trends

Chart 10

Output balances positive across the UK

% balance of change in output in past three months



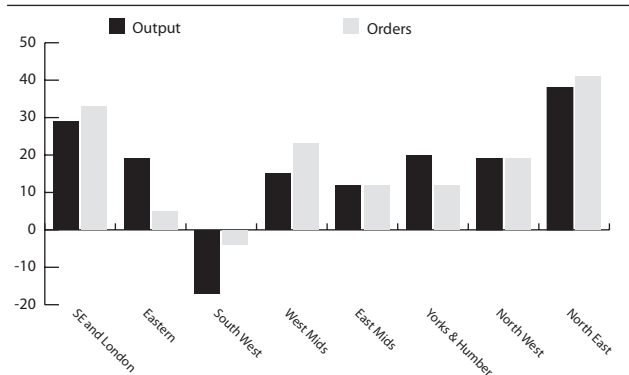
Source: EEF Business Trends Survey

Output balances were again positive across all regions over the last three months, a trend that we've seen consistently for over a year. In all regions, with the exception of the South East and London, output balances also strengthened over the quarter. However, with a balance of 36% of companies having seen output increase in the region, this is still a strongly positive figure. In the past three months, orders balances also looked strong in all regions, with the weakest figure – 25% in the East Midlands – still well above the average for the survey.

Chart 11

Generally positive outlook for next quarter

% balance of change in orders in next three months



Source: EEF Business Trends Survey

Almost all regions had positive orders and output expectations in the second quarter. The North East posted particularly strong balances with 38% of companies expecting output to increase, and 41% expecting orders to increase. Counter to the general trend, companies in the region were particularly upbeat about domestic orders. As with 2011q1, the South West was the most negative region. Balances of 17% and 4% of manufacturers expect output and orders to fall respectively. The region's relatively large share of aerospace and defence companies which are more dependent on longer-term and public-sector contracts may be influencing this, but it should be noted that last quarter's gloomy outlook did not bear out.

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 | 36 | 31 | 19 | 4 | 7 | 29 | 33 | 7 | -4 | 0 |
| Eastern | 38 | 25 | 30 | 25 | 19 | 19 | 5 | 10 | 44 | 0 |
| South West | 48 | 43 | 35 | 19 | 17 | -17 | -4 | 4 | 14 | -13 |
| West Mids | 29 | 31 | 14 | 25 | -11 | 15 | 23 | 27 | 30 | -9 |
| East Mids | 47 | 48 | 41 | 7 | 9 | 12 | 12 | 26 | 22 | -3 |
| Yorks & Humber | 47 | 42 | 28 | 27 | -10 | 20 | 12 | 10 | 13 | -4 |
| North West | 36 | 33 | 8 | 35 | 2 | 19 | 19 | 23 | 21 | -6 |
| North East | 32 | 28 | 28 | 15 | 6 | 38 | 41 | 25 | 0 | 6 |
| Scotland | 16 | 26 | 19 | 17 | | 24 | 12 | 20 | 16 | |

Source: EEF Business Trends Survey

Economic environment

- UK GDP growth in 2011q1 balances out contraction in 2010q4
- Net trade makes a record positive contribution to growth in q1
- Divergence between export and domestic market strength deepens
- Japan earthquake and tsunami impact likely less than first feared

The UK economy recorded weaker than expected growth in 2011q1. Growth of 0.5% was sufficient only to reverse the snow-induced contraction in 2010q4. However, doubts have been raised about the accuracy of ONS's assessment of construction output, which recorded a sharp 4% decline in 2011q1 that seemed somewhat at odds with industry sentiment. Manufacturing recorded another strong quarter with a 1.1% expansion led by strong export markets. Since the recovery began in 2009q4, manufacturing has now contributed 33% of the growth in the overall UK economy, well above its 13% of GDP share. After a marked 0.6% contraction of the services sector in 2010q4, growth returned in 2011q1 with an expansion of 0.9%. This was led by transport, storage, and communications services, but business services growth also returned.

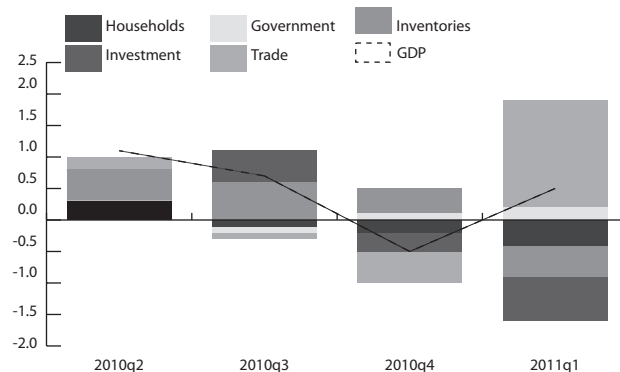
On the expenditure side, a contraction in 2011q1 household expenditure was offset somewhat by a 1% increase in government consumption. Business investment decreased dramatically in 2011q1 with a quarter-on-quarter decrease of 7.1% and within this manufacturing investment fell by 1.2%. This is concerning and apparently shows that firms are still cautious about transforming their consistently positive intentions into actual investment. Taken together consumption and investment show that domestic demand in the economy shrunk and only net trade supported growth in 2011q1.

Net trade made a very strong positive contribution to growth of 1.7 percentage points in 2011q1 with exports to both emerging markets and the EU growing over the quarter. In fact, this contribution to growth from net trade is the largest since records began in 1955. We have seen some volatility with net trade contributions to growth revised previously but the strong result chimes with positive sentiment coming from our 2011q1 Business Trends survey.

Chart 12

Strongest boost to quarter-on-quarter growth on record from net trade

Contributions to GDP growth



Source: National Statistics

A slight note of caution on the trade figures was the result in the final month of the quarter, where goods exports decreased, particularly to emerging economies. Monthly data tend to be very volatile so we would not suggest this is any kind of new trend but some analysts fear that recent softness in commodity prices might indicate weaker activity on the horizon in emerging markets. This is particularly important for manufacturers as emerging markets are where they have seen strength in the recovery. On the flipside, more traditional UK markets in Europe, notably France and Germany, are powering ahead, with the Germans in particular showing strengthening domestic demand and an impressive 1.5% q/q growth figure for 2011q1.

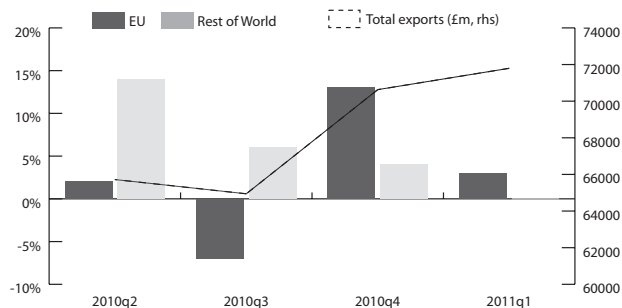
Looking further ahead there are reasons to think the recovery in trade will continue the pattern we have seen for the majority of the recovery in 2011q2. There are doubts whether France and Germany can sustain their strong growth and the periphery of the EU remains weak, with continuing anaemic growth recorded in q1. The sovereign debt saga also continues to drag on with the current focus on agreeing terms to Portugal's bailout and considering options for restructuring Greece's package, which is now widely viewed as unsustainable. Further, despite some softening in commodity prices, strength still remains in emerging markets. China beat expectations for retail sales growth in 2011q1 and with inflation also beating forecasts, pressure continues to build for an appreciation of the renminbi – which would make UK exports more competitive.

There will however be a negative impact on output in 2011q2 from the earthquake and tsunami that hit Japan in March, especially for the automotive sector. The disaster has rippled through global supply chains and has made it to the UK with Japanese-owned carmakers having some production restrictions. Initial fears of a serious and sustained impact of the earthquake thankfully seem unfounded though, with tentative indications that production in key suppliers in Japan is returning to normal. Some companies have even reported potential opportunities as larger companies seek to diversify their supply chains to insulate against risks of this nature. The Japan impact was perhaps part of the picture in May's Markit manufacturing Purchasing Managers Index (PMI), which declined to a twenty-month low of 52.1, following January's 61 all-time peak (though a score above 50 still indicates overall expansion).

Chart 13

Exports grow strongly, though 2011q2 bucks trend with strength from EU

Quarter-on-quarter export growth (% change, lhs) & value of total exports (£m, rhs)



Source: HMRC

Back in the domestic market, our latest Business Trends survey shows that the gap between export and domestic orders balances widened further in the past three months. Some temporary factors boosting consumption at the start of 2011q2 are unlikely to have altered the underlying factors that have been dragging on consumption so far in the recovery. Looking through the impact of warm weather and the extra bank holiday in April, retail sales growth is expected to be subdued.

In line with expectations inflation has again remained high, with CPI posting 4.5% in April. The MPC has remained divided on when interest rates should rise. The news over the past quarter, including the modest expansion in GDP in q1 was insufficient to convince a majority to vote for a rate rise in May. Providing higher inflation does not feed through into high pay deals, as has been the case so

far this year, November still looks like the most likely month for a rate rise.

More positively, a reduction in the unemployment rate to 7.7% in 2011q1, including a record level of vacancies in the manufacturing sector, indicates that firms may be starting to feel confident enough about their demand outlook to begin hiring. This is especially encouraging as April 2011 also represented the start of the new fiscal year, the first full year where reductions to government spending will begin to apply. So far at least, the private sector appears able to absorb public sector redundancies, but our central forecast suggests that unemployment is set to pick up in the second half of the year before easing back through 2012.

UK Economic forecasts

% change except where stated

| | 2010 | 2011 | 2012 |
|-----------------------------|-------|-------|-------|
| Trading environment | | | |
| Exchange rate (€/£) | 1.17 | 1.13 | 1.14 |
| Exchange rate (\$/£) | 1.55 | 1.58 | 1.55 |
| Exports | 5.3 | 7.4 | 7.5 |
| Imports | 8.5 | 4.3 | 3.9 |
| Current account (£bn) | -36.2 | -40.9 | -41.4 |
| Output | | | |
| Engineering | 7.9 | 6.1 | 5.0 |
| Manufacturing | 3.6 | 3.2 | 2.8 |
| Rest of economy | 0.3 | 0.8 | 2.1 |
| GDP | 1.3 | 1.5 | 2.3 |
| Costs and prices | | | |
| Average earnings | 2.9 | 2.6 | 3.0 |
| Oil price (Brent Oil \$/bl) | 79.5 | 113.0 | 109.2 |
| Employment | | | |
| Manufacturing (000s) | 2553 | 2526 | 2503 |
| Rest of economy (000s) | 28669 | 28671 | 28797 |
| Unemployment rate (%) | 7.9 | 8.1 | 8.1 |

Source: Oxford Economics and EEF

International Economic forecasts

% change except where stated

| | GDP | | | Inflation | | |
|---------------|------|------|------|-----------|------|------|
| | 2010 | 2011 | 2012 | 2010 | 2011 | 2012 |
| France | 1.5 | 1.8 | 2.0 | 1.5 | 2.1 | 1.9 |
| Germany | 3.5 | 2.8 | 1.8 | 1.1 | 2.2 | 1.8 |
| Japan | 4.0 | 0.1 | 2.8 | -0.7 | 0.1 | 0.7 |
| US | 2.9 | 2.7 | 3.1 | 1.6 | 3.1 | 2.1 |
| Eurozone | 1.7 | 1.7 | 1.7 | 1.6 | 2.5 | 1.8 |
| China | 10.3 | 9.0 | 8.4 | 3.3 | 5.2 | 3.2 |
| India | 8.6 | 7.6 | 8.4 | 12.0 | 8.5 | 5.5 |
| Emerging Asia | 9.0 | 7.2 | 7.2 | 5.9 | 8.8 | 5.4 |
| World | 3.9 | 3.3 | 3.7 | 3.4 | 4.3 | 2.2 |

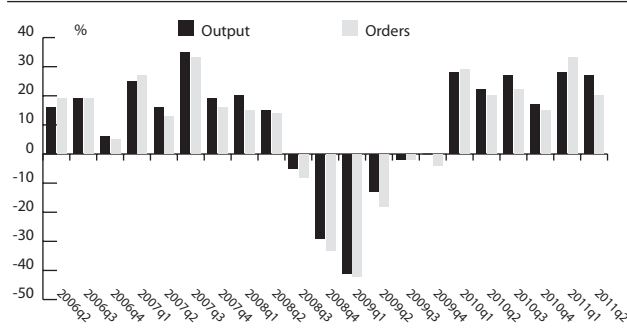
Source: Oxford Economics

Future trends

Chart 14

Another solid quarter expected

% balance of change expected in next three months



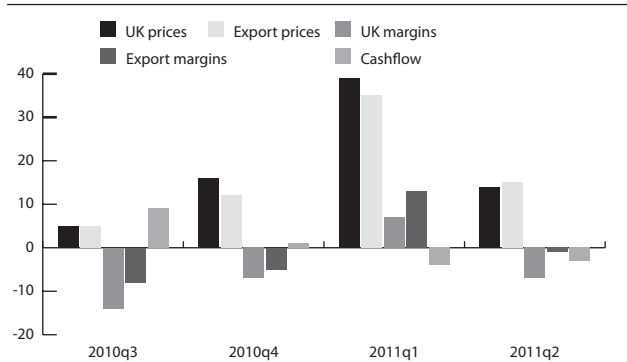
Source: EEF Business Trends Survey

The run of positive news from manufacturers is expected to continue in the next three months. A balance of 27% of companies expects output to increase in the coming quarter, broadly unchanged from three months ago. There has been a modest softening in the orders outlook with a balance of 13% of companies predicting growth in new orders from the domestic market and 20% in export markets, down from 25% and 29% respectively. However, the sector picture looks to be much more mixed in the coming quarter. The weaker outlook for UK orders is particularly apparent in electronics and rubber and plastics. But export demand for mechanical equipment and metal products should remain firm.

Chart 15

Price rises may have peaked

% balance of change in next three months



Source: EEF Business Trends Survey

Following the weaker price balances seen over the past three months, the proportion of companies planning to increase UK prices has dropped to 23% from 44% three months ago. At the same time greater downward pressure on margins is also expected to return and a balance of companies expects their cashflow to deteriorate for the second quarter running. While some input costs have become more volatile in recent months, the outlook for prices remains elevated in the short term. The drop in price balances could reflect companies experiencing some difficulties in passing through cost increases.

Summary: next three months

% balance of responses (% up minus % down)

| | 2009 | | 2010 | | | | 2011 | |
|----------------------------------|------|-----|------|-----|-----|----|------|----|
| | q3 | q4 | q1 | q2 | q3 | q4 | q1 | q2 |
| Total output | -2 | 0 | 28 | 22 | 27 | 17 | 28 | 27 |
| UK new orders | -6 | -9 | 21 | 12 | 15 | 7 | 25 | 13 |
| Export new orders | -4 | 6 | 24 | 15 | 19 | 18 | 29 | 20 |
| Total new orders | -2 | -4 | 29 | 20 | 22 | 15 | 33 | 20 |
| Employment | -15 | -15 | 1 | 15 | 14 | 16 | 30 | 22 |
| Average price of domestic orders | -12 | -4 | 2 | 10 | 5 | 16 | 39 | 14 |
| Average price of export orders | -14 | -13 | 4 | 8 | 5 | 12 | 35 | 15 |
| Margins on domestic orders | -21 | -24 | -15 | -15 | -14 | -7 | 7 | -7 |
| Margins on export orders | -21 | -21 | -11 | -8 | -8 | -5 | 13 | -1 |
| Levels of cashflow | -5 | -14 | -13 | 0 | 9 | 1 | -4 | -3 |

Source: EEF Business Trends Survey

Sector forecasts

Positive news from manufacturers continues. Despite weaknesses in the rest of the economy, manufacturing output grew by 1.1% in the first quarter of the year. Our survey indicates that this strong performance has continued into the second quarter, and that manufacturers are optimistic about the months ahead. Similarly, although recent monthly PMI surveys have softened from record-highs seen earlier in the year, manufacturers have consistently reported output and orders growth.

We expect manufacturing to continue to grow strongly in 2011 though our overall forecast has been revised down slightly, to 3.2%. This is largely a result of the challenges posed by high and rising input prices, as well as recent disruptions from the Japanese earthquake. Although concerns remain about Europe's periphery, demand from emerging markets as well as Germany and France looks set to remain firm.

Growth in basic metals has continued on the back of strong global demand. This demand has been driven by the automotive and energy sectors. However, reduced orders from the domestic construction sector following public sector cuts have started to bear down on growth. Consequently we have revised our forecasts for growth down slightly to 6.0% in 2011.

Weaker demand has also led us to revise down our forecast for metal products. Following softer orders balances at the end of the last year, output in the sector contracted in the first quarter of 2011. Some of the momentum behind the impressive growth rates in 2010 appears to have been lost and as such we are now forecasting growth of 2.4% this year.

The automotive sector was hit by supply-chain disruptions following the earthquake and tsunami in Japan. Although output will have dipped in 2011q2, underlying demand for automotive products has strengthened, and the sector is likely to bounce back strongly. Manufacturers' commitment to producing new models in the UK means that our forecast for growth in the sector has been revised upwards to 13.4%.

The outlook for other transport sector has seen a degree of divergence between defence, where some companies have begun to feel pressures as a result of public-sector budget cuts, and civil aviation which is looking stronger on the back of clear signs of recovery in the aviation market. We are forecasting growth of 6.5% in the sector this year.

Mechanical equipment had a weaker-than-expected first quarter, despite strong domestic orders. Capacity constraints and shortages of skilled labour have started to impact on the level of activity companies can sustain. Nevertheless continued strong demand from Germany and China means that we are forecasting only slightly slower growth, of 6.0%, in 2011.

Sector forecasts

| | 2010 | 2011 | 2012 |
|-------------------------------|------|------|------|
| Output (% change) | | | |
| Basic metals | 12.4 | 6.0 | 4.2 |
| Metal products | 8.1 | 2.4 | 4.3 |
| Mechanical equipment | 12.0 | 6.0 | 5.3 |
| Electronics | 1.9 | 4.9 | 1.1 |
| Electrical equipment | 3.6 | 5.5 | 4.8 |
| Motor vehicles | 18.5 | 13.4 | 8.3 |
| Other transport | 2.7 | 6.5 | 6.9 |
| Food and drink | 4.5 | 3.8 | 1.0 |
| Chemicals | -6.3 | -0.1 | 2.3 |
| Rubber and plastics | -1.2 | 3.3 | 2.9 |
| Non-metallic mineral products | 4.9 | 3.4 | 1.1 |
| Engineering | 7.9 | 6.1 | 5.0 |
| Manufacturing | 3.6 | 3.2 | 2.8 |

Source: Oxford Economics



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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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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