RADAR:ECONOMICS

ANALYSIS OF THE TRENDS THAT MATTER

Friday 17 March 2017

UK MANUFACTURING OUTLOOK (Q1 2017)

UK manufacturing production rose sharply in the last few months of 2016. January did see a modest setback but this is likely to be temporary as orders certainly look strong enough to generate further output gains. As a result, 2017 will probably see a further acceleration in output growth. Near term, the boost to competitiveness from sterling's depreciation last year last is probably a key driver of this upturn, although some surveys show domestic sales rising more quickly than external sales. Looking further out relatively weak productivity growth remains a key issue for the sector, while the outcome of Brexit negotiations is a major area of uncertainty.

Manufacturing output is on an uptrend

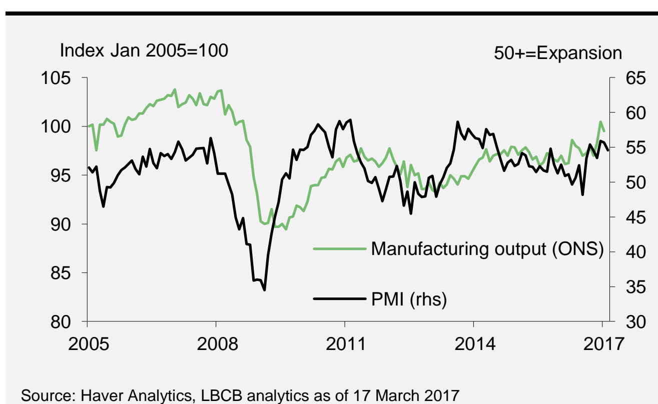
Clear signs are now emerging of an acceleration in UK manufacturing activity. In our last quarterly note we highlighted a strong likelihood that output growth had picked up in late 2016 and that this would continue into 2017. Recent data has confirmed the first of those predictions, as manufacturing output rose by 1.2% in quarter four of last year. Admittedly, that followed a drop in output in the previous quarter. Nevertheless, the underlying trend is clearly upward, as is indicated by the 1.9% rise in Q4 production when compared to the same quarter a year ago (Chart 1).

Buoyant orders suggest that manufacturing activity will continue to rise.

Manufacturing's upturn has probably continued into early 2017. Official data did show a small fall in output in January, while the February purchasing managers' survey showed a modest decline in the level of the headline index when compared to January. But both of these are probably just temporary retreats after outsized gains in previous months. With orders as measured by both the PMI and CBI surveys strong enough to point to further output gains over the next few months, the sector still seems on course for further expansion (Chart 2).

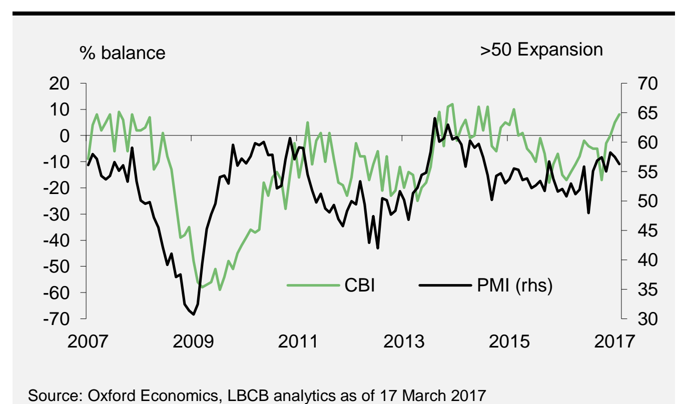
While it is tempting to see the recent turnaround as being driven by competiveness gains from last year's sterling depreciation, the evidence for this is mixed. Indeed some business surveys show domestic orders rising more sharply than export orders. But that may also be due to the impact of the currency as UK producers win market share from importers, while at least some of the rise in domestic demand will be exporters purchasing intermediate or investment goods from UK suppliers. Moreover, other data sources such as ONS calculations of the export share of manufacturing sales point to stronger export growth

Chart 1: Manufacturing output growth has accelerated



Source: Haver Analytics, LBCB analytics as of 17 March 2017

Chart 2: Surveyed orders point to further gains in output



Source: Oxford Economics, LBCB analytics as of 17 March 2017

across a range of key manufacturing industries (Chart 3).

The likelihood that some of the positive impact of recent competiveness gains are yet to come through is one reason to expect a further rise in manufacturing output in 2017. Another cause for optimism is evidence of a rebound in manufacturing across a range of economies including the US, China and Germany, which suggests that the UK's upturn may be just part of a broader expansion. Whatever the driver of demand, a partial counterweight is that manufacturing's input costs are now rising strongly fuelled by sterling's slide (Chart 4). This will eat into profit margins unless industry raises prices or find economies elsewhere. But for the majority of producers the effect should not fully offset competiveness gains.

Will this improvement last?

While the short-term position for UK manufacturing looks better than it has for some time, more long-term concerns persist. Manufacturing investment probably fell by more than 4% last year, its weakest performance since 2009. Whether spending will rebound in 2017 remains unclear. Many UK businesses, including significant parts of manufacturing, face a cocktail of cost increases from April including changes to business rates, the new 0.5% Apprenticeship Levy and an increase in the National Living Wage from £7.20 to £7.50. With input costs already moving higher due to sterling's depreciation and ongoing 'Brexit' uncertainty, it is not difficult to see why manufacturers may continue to delay investment decisions. Investment intention surveys so far point to only modest growth at best.

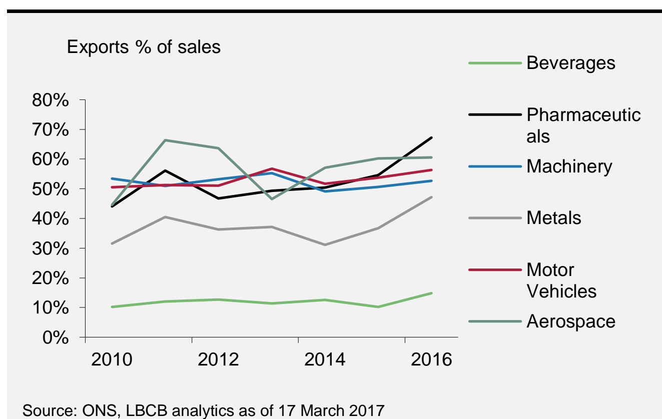
Continued sluggish investment growth may add to concerns about the UK's modest productivity performance. Over the twelve months to 2016Q3 manufacturing productivity, grew by only 0.6%. Based on early data it probably accelerated in Q4 but will still have been well below the growth rate in previous economic cycles and less than that in most other major economies. If the persists any competiveness gains brought about by the weaker pound will prove to be ephemeral.

Better news is that the UK government acknowledges the importance of boosting productivity and has already taken some steps. Measures to raise infrastructure spending were announced in last year's Autumn Statement, while changes to technical training was one of the few policies moves of any significance to come out of the Spring Budget. The government also published a consultative document on its Industrial Strategy earlier this year and, asked for feedback by 17th April. This may lead to a further policy shake up in the second half of the year, possibly around the time of the Autumn budget.

Outperformers and underperformers

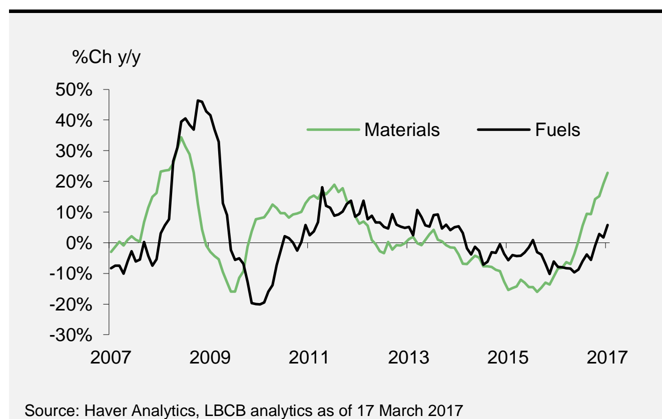
The acceleration in output growth has been seen across most parts of UK manufacturing in recent months. Nevertheless, there continues to be significant difference in relative

Chart 3: Exports are up as a proportion of overall sales



Source: ONS, LBCB analytics as of 17 March 2017

Chart 4: The weaker pounds is boosting input costs



Source: Haver Analytics, LBCB analytics as of 17 March 2017

performance. Chart 6 shows some of the significant outperformers and underperformers.

Fluctuations in *pharmaceutical output* explain much of the recent volatility in manufacturing production. According to ONS estimates pharma output rose by 9.5% in the last quarter of 2016 but then declined by more than 13% in January. Much of this volatility, however, may reflect measurement difficulties rather than actual performance. Pharma output is still more than 20% below its pre-recession level, a disappointing position for an industry that has usually been seen as one of the UK economy's success stories. But recent signs are more positive, output is 6.5% above its level of a year ago, suggesting that the weaker pound may be helping to restore competitiveness.

Food and drink should be another sector that benefits from the competitive advantage of sterling's depreciation. Consequently, while output fell modestly in 2016Q4 and by 1.4% in January, the outlook for the rest of the year is more promising.

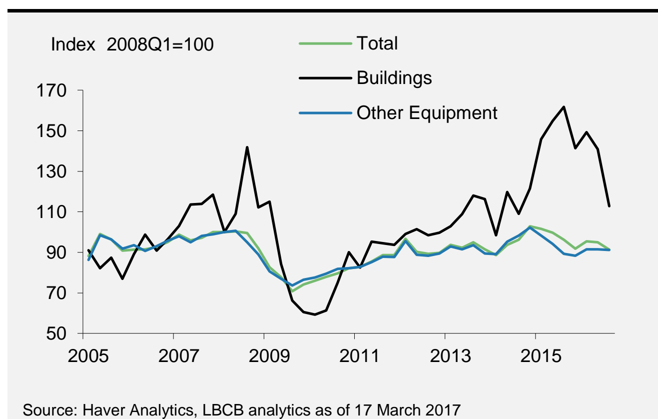
Motor vehicle production rose by 4.7% in January and is currently 8.5% higher than a year ago. The car market was buoyant last year across the US, UK and much of Continental Europe, but there must be doubts this level of demand will be sustained in 2017. Meanwhile, there are conflicting reports on the future of volume car production in the UK. Both Nissan and Vauxhall's new owners have forecast a positive outlook post-Brexit, although they suggested that this is at least partly dependent on more investment in UK supply chains. In contrast, Ford has cast doubt on the future of production at its Bridgend plant.

While *aerospace* output fell modestly in January production is still almost 5% higher than a year ago in real terms. Buoyant order books at Airbus and Boeing suggest that the global industry is in good shape. But the UK industry's close links to production in other EU countries means that EU exit negotiations will be particularly important for this sector.

We have previously noted that the sluggish performance of *engineering* was probably linked to stagnant business investment. Output has recently accelerated despite ongoing weakness in UK business investment. This may in part be due to a pickup in external demand, while sterling's depreciation may have allowed UK producers to raise their market share. These factors may continue to support growth this year.

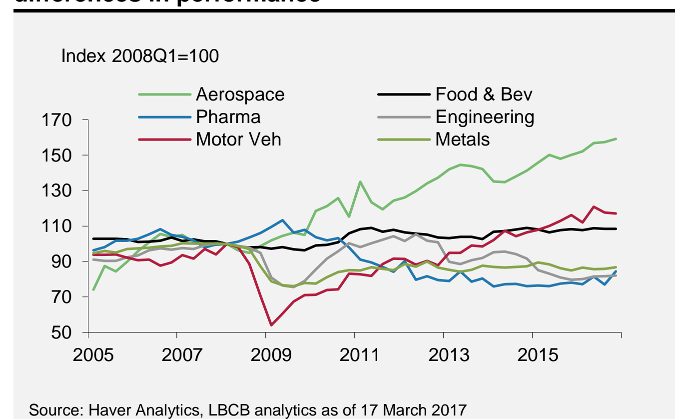
In summary, UK manufacturing is in a 'sweet spot' for now as it benefits from the competitiveness boost generated by a weaker pound. In this environment those industries whose products are price sensitive are likely to be outperformers.

Chart 5:Manufacturing investment fell in 2016



Source: Haver Analytics, LBCB analytics as of 17 March 2017

Chart 6: Manufacturing sectors still show substantial differences in performance



Source: Haver Analytics, LBCB analytics as of 17 March 2017

CONTACT DETAILS

Rhys Herbert

T: 0207 158 1743
E:rhys.herbert@lloydsbanking.com

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