UK MANUFACTURING OUTLOOK

UK manufacturing activity surged in April according to the official data. The underlying position, however, is less positive, as UK output has only grown modestly over the past 12 months. Within this, aerospace and motor vehicles have fared particularly well, while engineering, pharmaceuticals and metals have experienced more difficulties. As manufacturing has also struggled in many other economies, the explanations for the weakness are probably primarily global, such as sluggish world trade, rather than UK specific. Sterling's strength against the euro, however, has been a hurdle for at least parts of UK manufacturing. The modest upward trend in orders suggests that the buoyant April figures do not herald a sustained near-term pickup in activity. Nevertheless, there are some positive signs ahead.

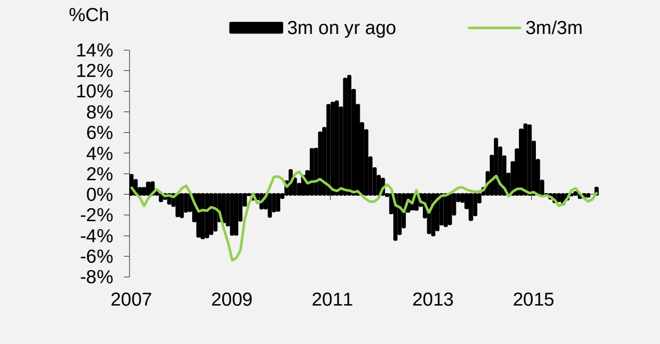
A tricky start to the year

UK manufacturing output has had a difficult twelve months. The latest data, for April, showed an unexpected rapid gain of 2.3% during the month. The underlying pace of growth, however, is more modest. Even after April's rise, output has risen by only 0.1% and 0.9% over the past three and twelve months respectively (Chart 1). Moreover, the more medium-term trend since the financial crisis has also been tepid. Output declined last year. Indeed it has fallen in three of the last four years. As a result, manufacturing activity is still about 6% below its pre-recession level. This is in line with a generally gloomy global picture, as manufacturing production has, at best, stagnated across a broad range of developed economies (Chart 2). With the pace of manufacturing activity also slowing in China, it would seem that at least some of the reasons for UK manufacturing difficulties are global.

Obstacles to growth in manufacturing are primarily global

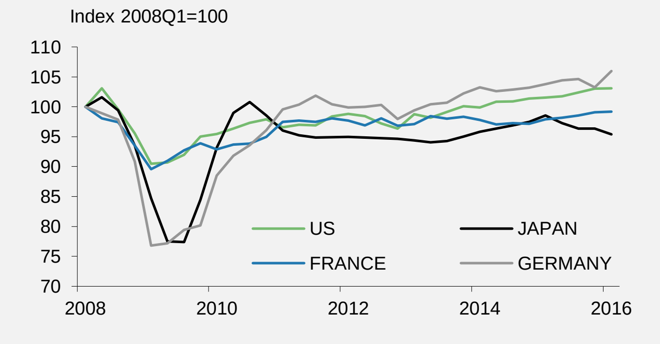
A key issue has been a lack of world trade growth (Chart 3). Latest estimates suggest that world trade volumes by the end of 2016Q1 were less than 1% higher than a year ago. That reflected not only slow trade within the developed world, but also more sluggish trade flows to and from emerging markets. As manufacturing is highly exposed to world trade (in the UK about 60% of manufacturing production is exported), it is likely that the slowdown has had a particularly marked effect on the sector. This seems to have been primarily driven by weaker capital spending, due in part to lower oil prices, which have caused oil companies and related producers to cut back on investment. Meanwhile, other parts of manufacturing have reacted cautiously to the boost provided by lower energy costs because of a number of

Chart 1: Manufacturing output growth has been sluggish



Source: Office for National Statistics, LBCB Analytics as of 9 June 2016

Chart 2: UK manufacturing not alone in experiencing problems



Source: Oxford Economics, LBCB analytics as of 9 June 2016 concerns about the global economy, not least the outlook for China. An additional issue for UK manufacturers is likely to have been the negative impact on competitiveness of a strong pound, particularly versus the euro (Chart 4).

Tentative signs that things will improve

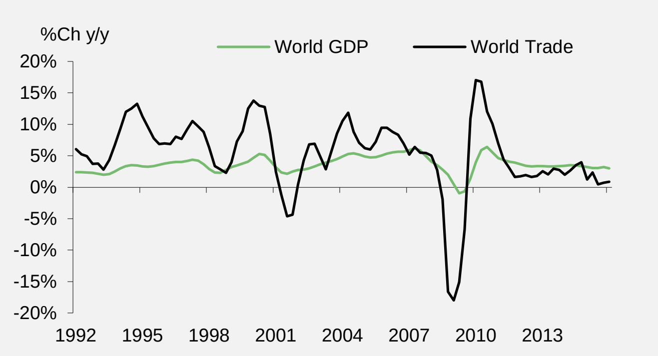
Still, the outlook may be starting to brighten. There are several reasons why UK manufacturing conditions may start to improve in the second half of this year and into next. First, with the oil price rebounding and forecast to strengthen further, the bulk of any negative impact from lower oil prices on energy-related companies should start to fade. Second, as some of the uncertainties hanging over the global and domestic economic outlook dissipate, business confidence and spending should pickup. Third, we expect resilience in activity in some of the UK's biggest international markets in particular the Eurozone, supported by substantial policy easing. Fourth, sterling's depreciation since the autumn of last year should have provided a boost to competiveness that typically leads to an acceleration in export growth.

Nevertheless, even with the improvement, manufacturing is likely to continue to underperform the economy as a whole. This year's fall in sterling looks modest compared with earlier depreciations and has already been partially reversed (Chart 4). Moreover, the May manufacturing PMI survey, while providing some evidence that manufacturing activity is rebounding, indicated that overall orders growth remains subdued, while export orders continue to contract (Chart 5). So there is little reason to expect a significant rise in activity in the near term.

Outperformers and underperformers

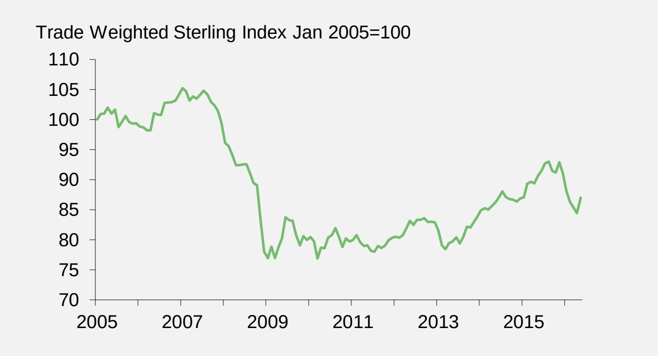
Recent relative performance of UK manufacturing has been distinctly uneven. Chart 6

Chart 3:Sluggish world trade growth is a key issue for manufacturing



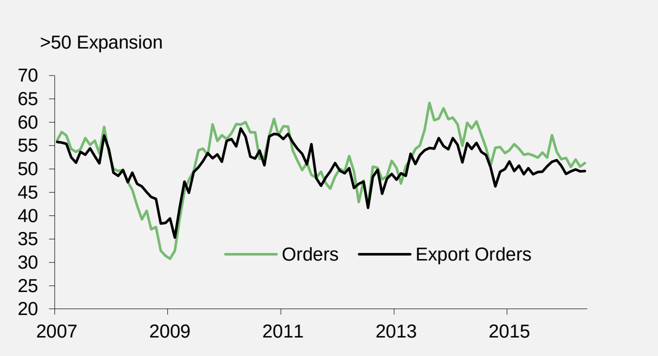
Source: CPB, LBCB analytics as of 9 June 2016

Chart 4: : And UK industry has also had to cope with a strong exchange rate



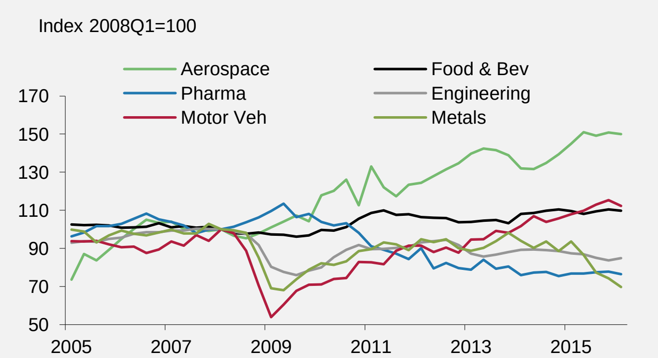
Source: Haver Analytics, LBCB analytics as of 9 June 2016

Chart 5: New orders do not suggest that things will get markedly better anytime soon



Source: Markit, LBCB analytics as of 9 June 2016

Chart 6: Despite the difficult environment there have been some outperformers



Source: Oxford Economics, LBCB analytics as of 9 June 2016 shows some significant outperformers and underperformers measured by output growth.

Aerospace and motor vehicle production are clear outperformers. In the case of aerospace, output hardly faltered during the recession, while production has grown strongly in the post-recession period. Rapid growth in global air traffic and sizeable order backlogs at both Airbus and Boeing suggest that aerospace will continue to see rapid rises in activity.

In contrast, motor vehicle production declined sharply during the recession but it has subsequently rebounded almost equally strongly. It has benefited both from a strong domestic markets for cars and from buoyant exports. A recent profit warning from Jaguar Land Rover, however, highlights potential downside risks for the industry particularly from the hitherto rapidly growing car markets in emerging economies.

The food and drink sector has also outperformed. Growth is less buoyant than in aerospace or motor vehicle production, but it is typically also less cyclical. So this sector stands out for the consistency of its growth. A challenge over the next few years will be responding to the sugar tax and other 'healthy living trends', which offers opportunities that are likely to see a change in the industry's product mix.

Three notable underperformers have been pharmaceuticals, engineering and metal production. The recent performance of the pharmaceutical industry has been particularly disappointing as historically it has been one of the most vibrant parts of UK manufacturing. Output rose modestly last year but that followed big declines in production in the previous five years. As a result, UK pharmaceutical activity is still more than 25% below its level in early 2009. Highly-regarded UK pharma companies face stiff competition from 'generic' producers and, partly in response to this, much production is being moved abroad.

Engineering covers a diverse range of industries, and, as a result, it is hard to generalise about developments. By and large, however, the sector has struggled in recent quarters, reflecting sluggish capital spending growth. Cutbacks by the oil sector have been a key issue for this sector, which so far at least has not been fully offset by higher spending from sectors who have benefited from low oil prices. Even after a surprisingly rapid rise in April activity, machinery and equipment production is about 6% below its level of a year ago and orders data do not point to a near-term acceleration in activity. Nevertheless, any improvement in business sentiment will lend a particular boost to this sector.

Metals production in the UK in April was almost 20% down on its level of a year ago and within that iron and steel production had fallen by almost 30%. UK producers, in common with the industry globally, face a major challenge from Chinese producers, who have reacted to a slowdown in their domestic market by switching to exports. In addition, UK producers face relatively high energy costs and an exchange rate level against the euro which makes UK steel production appear uncompetitive compared with some other parts of Europe. These trends resulted in the announcement by Tata Steel that it would be cutting back its UK production. While recent developments on that issue look more promising, the outlook for the industry remains particularly uncertain.

Overall, the performance of UK manufacturing has been distinctly mixed. The outperformers have been industries where specific demand is still growing strongly (aerospace) or that have been driven by buoyant consumer spending (motor vehicles or food and drink). The losers are those that have been more exposed to investment trends (engineering) or have been more impacted by sterling's strength against the euro prior to the start of this year.

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