

eef

The manufacturers'
organisation

In partnership with

RSM! Robson Rhodes

March 2007

Engineering Outlook



Contents

Summary	1
Recent trends	2
Sector trends	4
Regional trends	5
Economic environment	6
Future trends	7
Sector forecasts	8

RSM Robson Rhodes

RSM Robson Rhodes is a national firm of chartered accountants and consultants providing a full range of business services to the UK private and public sectors.

We have worked in partnership with EEF for the past 10 years, and are proud to be involved with an organisation which has established itself as a key provider of support and advice to manufacturers. Engineering Outlook provides EEF members with a clear idea of how the sector is performing and any issues facing it, whether positive or negative.

To show our commitment to the sector, we are keen to continually develop our relationship with EEF and are very excited about the future.

Our Manufacturing Industry Group offers a wide range of financial and advisory services to both private and listed manufacturing companies. This national based, multi-disciplinary team provides advice on mergers and acquisitions, raising finance, tax-efficient investments/deal structuring, manufacturing/business strategy, recruitment/remuneration and accounting and tax issues.

Through membership of RSM International, a top seven global accounting and consulting association, RSM Robson Rhodes is also active in advising multi-national manufacturing businesses on cross-border transactions, structures and international operations.

Summary

- Output and orders remain firm.
- Exports continue to drive orders.
- Limited jobs cuts in recent months.
- Investment intentions still in positive territory.
- Companies confident about next three months.

Manufacturing and engineering saw a significant turnaround in trading conditions in 2006. After seeing output fall in 2005, engineering and manufacturing rebounded in 2006, recording growth of 3.2% and 1.3% respectively. Our survey results for the first quarter of 2007 suggest this positive trend is set to continue. Output and orders balances remained firmly in double digits, coming in at +17% and +19% respectively. Firms may have been less confident about the future at the end of 2006, but their forecast slowdown in output and orders did not materialise.

Solid growth in the UK's main markets continued to support order books, with exports continuing to lead domestic sales. And with the exception of metal products, this was the case for all engineering sectors. On output, the sector picture was more mixed. Electrical equipment saw the strongest response balances on both output and orders. In contrast, basic metals and electronics saw quite a significant turnaround in confidence as the balance of responses on output fell back quite sharply.

While the overall picture on output and orders remains a positive one, a balance of companies continued to report job cuts. However, at -1% responses suggest that firms are not reducing headcount at anything like the pace they were in 2005. Furthermore, a majority of companies plan to leave employment levels unchanged in the next three months.

Looking towards the next quarter, manufacturers remain optimistic that growth in output and orders is set to continue. The balance of responses on output, for example, rose significantly to +25% from +6% in the previous quarter. This was the strongest showing since 2004q3. In addition, positive output balances were recorded across all sectors for the first time in a year.

Confidence about output and orders is likely to have contributed to a further improvement in investment intentions. Positive investment responses have now been reported in each of the past five quarters, with the balance rising to +10% in the past three months. This is the strongest showing for nine years.

Overall, therefore, our forecasts for engineering and manufacturing are little changed from the previous quarter. We continue to expect manufacturing to expand by 0.7% in 2007, rising to a little over 1% next year. Engineering

Headline survey results

% balance of change	% balance of change	
	Past 3 months	Next 3 months
Output	17	25
Total orders	19	27
Employment	-1	0
Export prices	2	6
Export margins	-20	-9
Cashflow	-1	3

Source: EEF Business Trends Survey

Economic data during survey period

February 1 - February 21	February 1 - February 21	
	Start	End
€/£	1.51	1.49
\$/£	1.97	1.95
£ index	105.9	104.4
Oil price	56.40	57.61

Source: EEF Business Trends Survey

Key economic forecasts

% change except where stated	% change except where stated			
	2005	2006	2007	2008
GDP	1.9	2.7	2.7	2.5
Inflation – CPI	2.0	2.3	2.4	2.0
Inflation – RPI	2.8	3.2	3.9	2.5
World trade	8.6	9.0	7.3	7.5
Base rate (%)	4.7	4.8	5.4	5.0

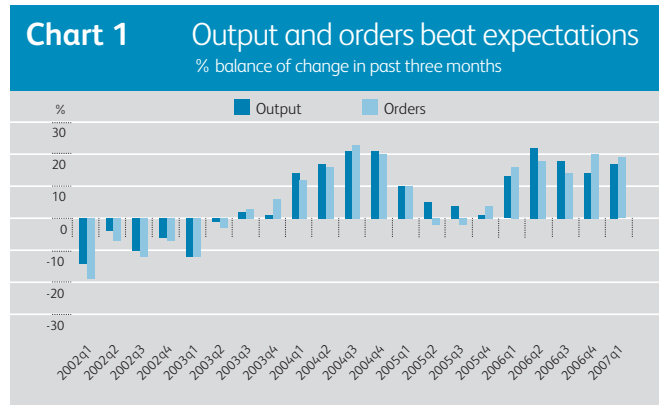
Source: Oxford Economics

growth is expected to be a little stronger at around 1.5% this year and next. Other transport looks set to be the strongest sector this year, but electrical equipment should see its second year of strong growth.

Recent trends

Output and orders beat expectations

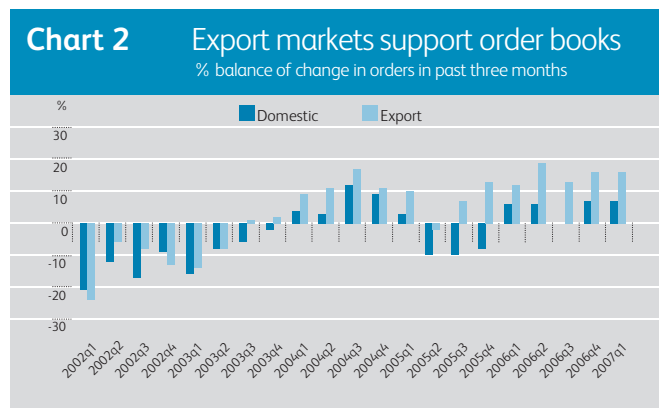
Last quarter our survey showed that, despite continued growth in output and orders, firms were somewhat less confident about future trading conditions. However, output and orders in the past three months have surpassed expectations. Engineering reported its sixth consecutive quarter of positive balances. At +17% the balance of responses on output was a touch stronger than the +14% reported in the previous quarter. Orders balances also remained in double digits over the past quarter, although at +19% total orders were marginally down on the previous three-month period. These results should be consistent with continued growth in engineering and manufacturing.



Source: EEF Business Trends Survey

Export markets support order books

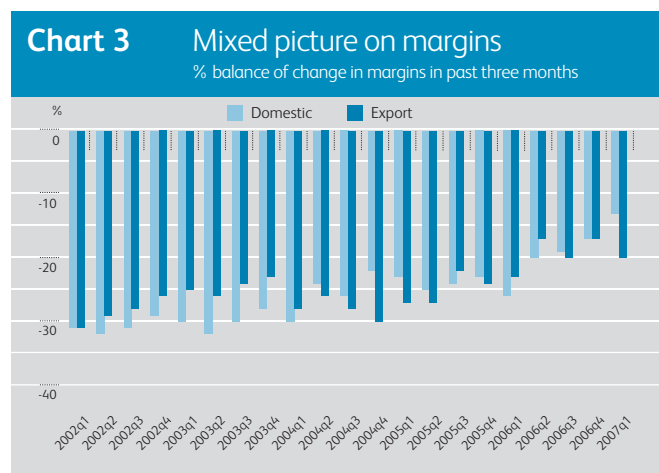
Balances on both domestic and export orders were unchanged from the previous quarter at +7% and +16% respectively. Strong global economic growth in recent years has provided a boost for manufacturers' order books. This trend continued in the past three months as the response balance on exports outpaced that on domestic orders once again. Both EU and non-EU markets appeared to sustain order books over the last quarter. Nevertheless, the recent good performance of the UK economy is feeding into fuller order books and firms expect this to improve further in the coming three months.



Source: EEF Business Trends Survey

Mixed picture on margins

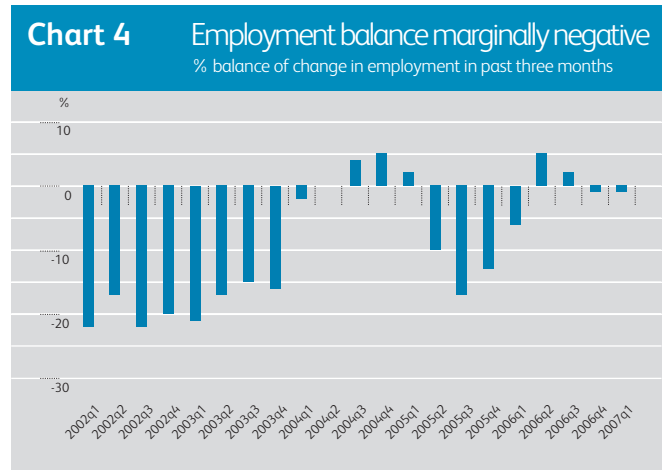
The balance of responses on margins continues to be negative on both export and domestic sales. On domestic orders, however, the downward pressure on profit margins has been easing over the past year. The balance has improved from a low of -26% in 2006q1 to -13% over the past three months. Responses on prices have also turned marginally positive over the same period. A combination of positive price balances and strong orders have most likely contributed to the easing in the profits squeeze. Export margins, on the other hand, deteriorated in the first quarter. Movements in the dollar exchange rate towards the end of last year may be taking effect.



Source: EEF Business Trends Survey

Employment balance marginally negative

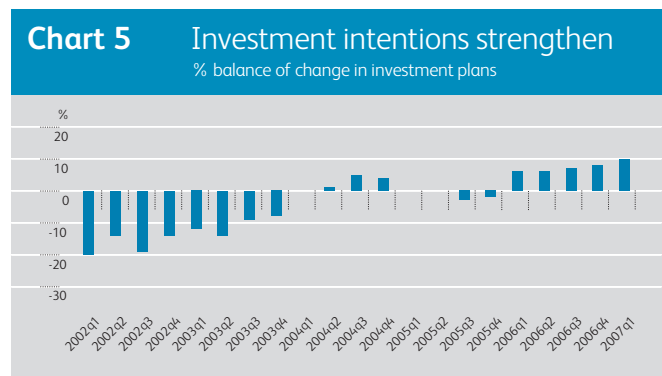
While output and orders balances remain firmly in positive territory, employment balances were again negative in the past quarter. Around a quarter of companies carried out staff cutbacks compared with 20% recruiting. At only -1% the balance was unchanged from the previous quarter. Furthermore, responses were considerably less negative than during 2005 when output balances were much weaker. There were variations by sector and firm size. Larger companies reported a higher incidence of job shedding in the past three months and cuts were most significant in motor vehicles and electronics.



Source: EEF Business Trends Survey

Investment intentions strengthen

While the official figures indicated a patchy performance of investment spending last year, our survey shows firms' plans to increase investment spending continued in the past three months. The start of this year therefore represents the fifth consecutive quarter of positive responses. The balance of responses picked up again to +10% from +8% in the previous three months and was the highest since 1998. This is a further welcome sign of a recovery in investment spending after several years of cutbacks. With the exception of electronics, intentions were positive across the board. Mechanical equipment and motor vehicles recorded the strongest response balances.



Source: EEF Business Trends Survey

Summary: past three months

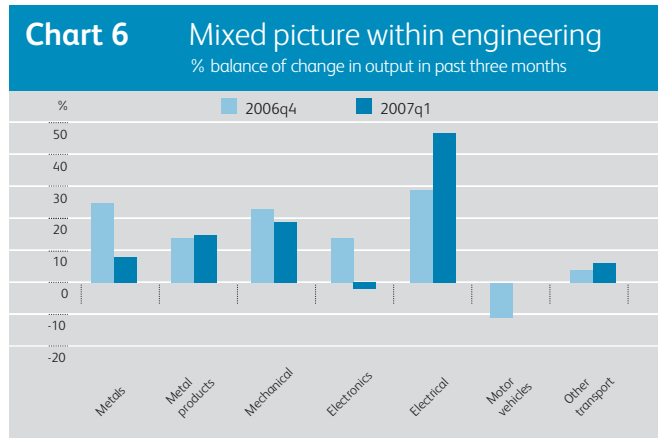
	2005			2006			2007	
	q2	q3	q4	q1	q2	q3	q4	q1
Total output	5	4	1	13	22	18	14	17
UK new orders	-10	-10	-8	6	6	0	7	7
Export new orders	-2	7	13	12	19	13	16	16
Total new orders	-2	-2	4	16	18	14	20	19
Employment	-10	-17	-13	-6	5	2	-1	-1
Capital expenditure plans	0	-3	-2	6	6	7	8	10
Average price of domestic orders	4	-5	-3	1	8	5	7	4
Average price of export orders	-2	-6	-8	-4	3	2	1	2
Margins on domestic orders	-25	-24	-23	-26	-20	-19	-17	-13
Margins on export orders	-27	-22	-24	-23	-17	-20	-17	-20
Levels of cashflow	-15	-14	-12	-6	-7	-7	2	-1

Source: EEF Business Trends Survey

Sector trends

Mixed picture within engineering

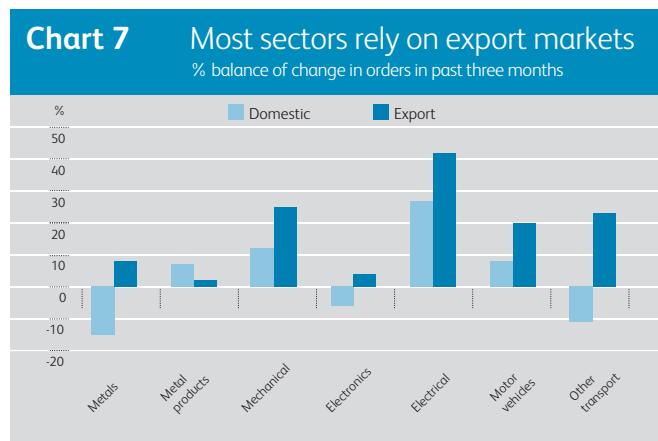
The sector picture continued to be rather mixed over the past quarter. Electrical equipment was again the most positive sector with the balance of responses improving further on the previous three months. Metal products and other transport also reported better trading conditions in the first quarter of this year with balances rising to +15% and +6% respectively. Similarly motor vehicles reported a balance of zero in the past three months recovering from -11% in the previous quarter. In contrast, the mechanical equipment output balance weakened slightly, but at +19% it remains in double digits for the twelfth quarter running.



Source: EEF Business Trends Survey

Most sectors rely on export markets

Basic metals was the only sector to see a balance of companies reporting a fall in total orders in the past three months. Across the remaining sectors balances on total orders were positive for the second quarter in a row. There was, however, some variation in the origin of orders. Electronics and other transport saw export orders compensate for negative domestic orders balances but for companies in metal products the fall in domestic orders more than offset the strength of overseas sales. However, electronics saw a significant dip in orders in the past three months, with export balances falling to their lowest level in almost two years.



Source: EEF Business Trends Survey

Sector summary

% balance of responses (% up minus % down)

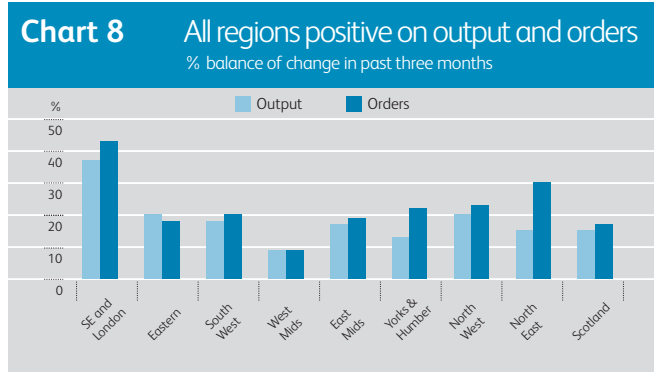
	Past three months					Next three months				
	Output	Total orders	Employment	Export price	Cashflow	Output	Total orders	Employment	Export price	Cashflow
Metals	8	-1	-12	-1	-19	14	5	-11	-1	-11
Metal products	15	13	9	0	-15	29	28	9	15	0
Mechanical	19	29	0	11	3	35	37	7	6	11
Electronics	-2	3	-19	3	-4	20	35	2	14	18
Electrical	47	47	14	1	17	18	22	-8	10	20
Motor vehicles	0	25	-18	-2	12	27	18	0	-15	-6
Other transport	6	9	-11	-9	6	13	16	-19	10	-25

Source: EEF Business Trends Survey

Regional trends

All regions positive on output and orders

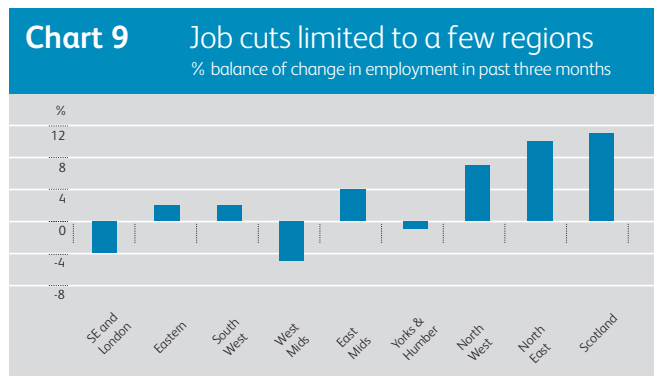
Output balances were positive across all regions for the third quarter running. Responses were the most positive in the South East and London and the North West, which put in a good performance last quarter, saw output and orders remain buoyant over the last three months. The East of England and the North East saw the largest turnaround with output balances improving to +15% and +20% respectively. In contrast the downturn in electronics output and orders did not appear to have a significant impact on overall Scottish balances.



Source: EEF Business Trends Survey

Job cuts limited to a few regions

Despite the positive trading conditions across the country, job losses were felt in some regions over the past three months. Despite seeing the strongest positive responses on output and orders, a balance of firms cut jobs in the South East and London. Yorkshire and Humberside, which saw a big dip in orders responses in the past quarter, also experienced some job cuts. Conversely, some recruitment activity was reported in the North West and East Midlands, with particularly strong balances in Scotland and the North East.



Source: EEF Business Trends Survey

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	37	43	-4	12	0	26	20	6	20	24
Eastern	20	18	2	2	6	30	18	16	11	14
South West	18	20	2	0	-6	31	41	16	9	-4
West Mids	9	9	-5	3	-9	25	24	1	7	6
East Mids	17	19	4	-3	4	28	33	9	5	0
Yorks & Humber	13	22	-1	9	-19	42	44	19	9	13
North West	20	23	7	19	-18	45	37	21	11	9
North East	15	30	10	0	8	55	48	15	6	5
Scotland	15	17	11	16		26	17	15	9	

Source: EEF Business Trends Survey

Economic environment

- UK growth above trend in 2006.
- MPC acts to curb inflation.
- Positive economic news from the eurozone.
- Outlook for world economy remains upbeat.

Economic forecasts

% change except where stated			
	2006	2007	2008
Trading environment			
Exchange rate €/£	1.47	1.49	1.46
Exchange rate \$/£	1.84	1.97	1.89
Exports	15.2	-4.5	6.8
Imports	13.7	-3.3	6.2
Current account (£bn)	-36.2	-32.1	-35.3
Output			
Engineering	3.2	1.4	1.5
Manufacturing	1.3	0.7	1.1
Rest of economy	2.7	3.0	3.2
GDP	2.7	2.7	2.5
Costs and prices			
Average earnings	4.1	4.4	3.9
Oil price (\$/barrel)	65.5	60.0	58.3
Employment			
Engineering ((000s)	1,280	1,260	1,217
Manufacturing (000s)	2,956	2,898	2,807
Rest of economy (000s)	24,058	24,313	24,575
Unemployment rate (%)	5.4	5.3	5.2

Source: Oxford Economics

The UK economy ended 2006 on a positive note. Growth in the final three months of the year is estimated at 0.8%, putting GDP 2.7% higher in 2006 compared with the previous year. Growth in the service sector was particularly buoyant at 3.7%, but manufacturing also recovered from the previous year's contraction, recording an increase in output of 1.2%. Furthermore, early survey indicators point to a good start to 2007. The RBS/CIPS services and manufacturing indices of activity showed expansion in the first few months of the year.

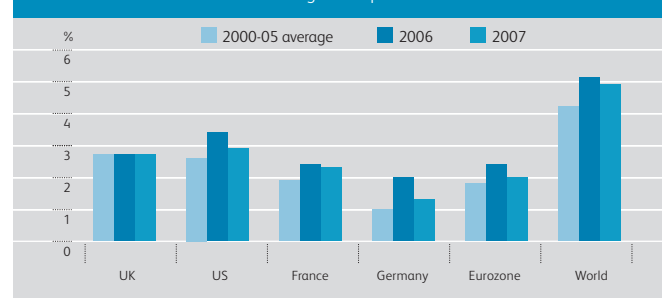
However, inflation also ended 2006 on a high note. CPI inflation rose to 3% - an 11-year high - in December 2006. Any further increases would prompt an open letter from the Bank of England Governor explaining what the MPC were doing to bring inflation back to its 2% target but since then inflation has fallen back to 2.7%. In January the MPC surprised markets by raising interest rates for the third time since August 2006 in a further attempt to rein in inflation. The Bank's latest Inflation Report hinted that further

monetary tightening may still be required. Concerns remain about inflation expectations and the level of pay settlements in the important January pay round.

The MPC had previously voiced uncertainty about the strength of the US economy. The possibility of a downturn would carry downside risks for the UK. However, latest estimates put growth at an annualised rate of 3.5%, which suggests that, despite slowing housing market activity, the US economy remains in reasonable shape. Even if the tide does turn in the US this year, other parts of the global economy are in better shape than they have been for some time to pick up the slack.

GDP per head, for example, is now growing faster in the eurozone than in the US. In the last three months of 2006 eurozone GDP expanded by 0.9%, with growth fairly evenly spread across the major economies. Overall, eurozone growth should come in at just under 2.5% for 2006 as a whole - the best performance for six years. And while growth should ease this year, it should still beat its 2000-2005 average. The eurozone will play its part in another above-par year for the world economy as a whole. Solid growth is also expected to continue across Asia. Forecasts suggest global growth will drop back slightly to 4.9% from 5.1% last year.

Chart 10 Growth to hold up in 2007
annual % change in output



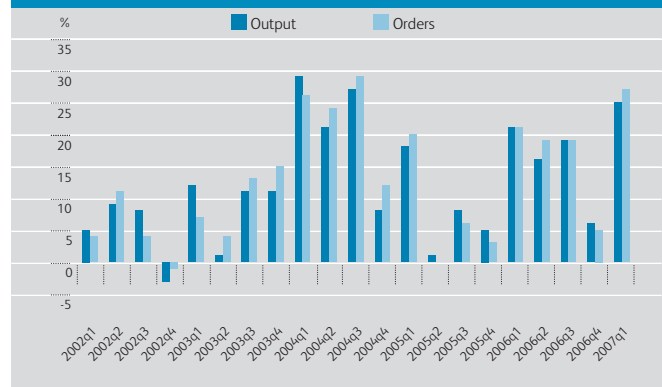
Source: IMF

Future trends

Firms more upbeat

After a drop in confidence at the end of 2006, this quarter's results point to a much more positive outlook for manufacturing in the next three months. The balance of responses on output rose to +25% from +6% in the previous three months. Furthermore, these were the strongest forward-looking responses since 2004q3, indicating that momentum in the sector should be maintained during the first half of this year. Firms also expect export orders to continue to support growth, though there is more optimism about the outlook for domestic order book. In addition, all sectors are confident about output and orders in the next quarter.

Chart 11 Firms more upbeat
% balance of change in next three months



Source: EEF Business Trends Survey

Price rises in the pipeline?

Over the past three months a small balance of companies reported raising prices with some corresponding impact on profit margins. This was not, however, widespread across all sectors. A combination of input prices and demand has determined pricing power within manufacturing. This looks set to remain the case in the coming three months. Overall, a balance of 8% of firms expect to raise domestic prices in the next quarter and the corresponding figure for export prices in +6%. Metal products and electrical equipment are among the most confidence about future prices. That said, firms have tended to be somewhat over-optimistic about their ability to raise future prices.

Chart 12 Price rises in the pipeline?
% balance of change in next three months



Source: EEF Business Trends Survey

Summary: next three months

% balance of responses (% up minus % down)

	2005			2006			2007		
	q2	q3	q4	q1	q2	q3	q4	q1	
Total output	1	8	5	21	16	19	6	25	
UK new orders	-10	0	-4	17	9	7	-3	17	
Export new orders	3	10	8	16	16	14	6	22	
Total new orders	0	6	3	21	19	19	5	27	
Employment	-17	-8	-10	-3	3	-3	-12	0	
Average price of domestic orders	-3	-5	1	1	6	5	8	8	
Average price of export orders	-6	-11	-1	1	3	2	3	6	
Margins on domestic orders	-16	-12	-15	-18	-11	-11	-10	-8	
Margins on export orders	-20	-13	-13	-13	-10	-10	-9	-9	
Levels of cashflow	-6	-5	-5	-3	2	-1	-1	3	

Source: EEF Business Trends Survey

Sector forecasts

Output in engineering surpassed our expectations last year. Particularly robust growth in the first half of 2006 contributed to an expansion of over 3% for the year as a whole. Other transport put in an especially strong performance last year, expanding by over 16%. Mechanical equipment continued to benefit from investment spending, both in the UK and abroad, leading to a fourth consecutive year of growth. On the other hand, output contracted for the second year running in both electronics and motor vehicles.

For 2007 our headline forecasts for engineering and manufacturing are not significantly changed from last time. Manufacturing and engineering should continue to expand this year, albeit at a slower pace than in 2006, with some acceleration in growth in 2008. In 2007, therefore, engineering and manufacturing are projected to increase by 1.4% and 0.7% respectively, rising to 1.5% and 1.1% in 2008.

However, within this, there is quite a bit of sectoral variation. Other transport is forecast to put in the best performance again this year with growth of 4.4%, easing to 3.4% in 2008. Electrical equipment is also forecast to maintain some momentum throughout 2007 with growth coming in at around 3.6% in 2007. Mechanical equipment has been the most consistent performer in recent years – in 2006 output in the sector was almost 16% higher than in 2002. Growth in mechanical equipment should continue at a reasonable pace over the next two years.

After a difficult couple of years, growth in motor vehicles is forecast to return this year. Output is expected to increase by around 1% after declining by almost 5% between 2004 and 2006. The resumption of some vehicle production at the Longbridge plant should contribute to this. Electronics is the only engineering sector likely to see further falls in output this year. The office machinery sub-sector has been a particular drag on growth in recent years and we do not expect much of a turnaround in its fortunes over the forecast period. Other parts of the sector should fare better, particularly precision instruments, as increased investment intentions translate into orders.

Despite the promising outlook for growth over the next two years, the sector is likely to experience further job losses. Nevertheless the pace of job cuts in engineering and manufacturing should slow for the fifth year running in 2007. Job losses in motor vehicles are likely to be the most significant. Again, however, the proportion of jobs lost will be less than last year. In contrast, after a relatively small number of job cuts in other transport last year, we should see a modest increase in employment this year.

Sector forecasts

	2006	2007	2008
Output (% change)			
Basic metals	1.1	0.8	1.2
Metal products	1.7	1.6	0.3
Mechanical equipment	4.5	1.3	1.1
Electronics	-1.6	-1.6	2.2
Electrical equipment	4.7	3.6	1.2
Motor vehicles	-3.5	1.0	0.9
Other transport	16.7	4.4	3.4
Engineering	3.2	1.4	1.5
Manufacturing	1.3	0.7	1.1
Employment (% change)			
Basic metals	-1.6	-3.5	-7.2
Metal products	-2.1	-0.8	-3.4
Mechanical equipment	-1.4	-0.6	-3.3
Electronics	-3.8	-2.5	-1.0
Electrical equipment	-4.8	-3.1	-3.9
Motor vehicles	-5.7	-4.4	-4.9
Other transport	-0.2	1.7	-3.3
Engineering	-2.7	-1.6	-3.4
Manufacturing	-2.8	-2.0	-3.1

Source: Oxford Economics

About this survey

The survey was conducted between February 1 and February 21, with 915 companies responding.

About us

EEF is a trusted partner to thousands of employers around Britain. We work on behalf of over 6000 companies, in manufacturing, engineering, technology and beyond. Together, they employ close to a million people. On any given day you'll find us helping our members tackle a whole range of employment challenges.

Our regional Associations bring us much closer to the businesses we support, whilst our offices in London and Brussels stay equally close to government – influencing the way policy is made and alerting our members to any changes in legislation that might affect them.

For further details concerning this survey please contact:

Stephen Radley, Chief Economist
T 020 7654 1530
E sradley@eef-fed.org.uk

Lee Hopley, Senior Economist
T 020 7654 1537
E lhopley@eef-fed.org.uk

Broadway House

Tothill Street
London SW1H 9NQ
T 020 7222 7777
F 020 7222 2782
E enquiries@eef-fed.org.uk
www.eef.org.uk

East Anglia

32 High Street
Hadleigh, Ipswich IP7 5AP
T 01473 827894
F 01473 824218

East Midlands & Mid-Anglia

Barleythorpe
Oakham, Rutland LE15 7ED
T 01572 723711
F 01572 757657

Sandy

54 High Street
Sandy, Bedfordshire SG19 1AJ
T 01767 681722
F 01767 691773

ECIA

Broadway House
Tothill Street
London SW1H 9NS
T 020 7799 2000
F 020 7233 1930

Northern

Derwent House, Town Centre
District 1, Washington
Tyne & Wear NE38 7SR
T 0191 416 5656
F 0191 417 9392

Northern Ireland

2 Greenwood Avenue
Belfast BT4 3JL
T 02890 595050
F 02890 595059

North West

Mount Pleasant
Glazebrook Lane, Glazebrook
Warrington WA3 5BN
T 0161 777 2500
F 0161 777 2522

Scottish Engineering

105 West George Street
Glasgow G2 1QL
T 0141 221 3181
F 0141 204 1202

Sheffield

Broomgrove
59 Clarkehouse Road
Sheffield S10 2LE
T 0114 268 0671
F 0114 266 4227

South

Station Road
Hook, Hampshire RG27 9TL
T 01256 763969
F 01256 768530

Western

Engineers' House
The Promenade, Clifton Down
Bristol BS8 3NB
T 0117 973 1471
F 0117 974 4288

West Midlands

St James's House
Frederick Road, Edgbaston
Birmingham B15 1JJ
T 0121 456 2222
F 0121 454 6745

Yorkshire & Humberside

Fieldhead
Thorner, Leeds LS14 3DN
T 0113 289 2671
F 0113 289 3170

SEMTA (strategic partner)

14 Upton Road
Watford, Herts WD18 0JT
T 01923 238441
F 01923 256086

