UK MANUFACTURING OUTLOOK (MARCH 2018)

Manufacturing output grew at a rapid pace last year, outperforming the economy as a whole for the first time since 2011. That improvement was part of a more global pickup in manufacturing activity. A slightly less positive picture is emerging for early 2018. Output growth seems to have slowed in a number of markets and, for the UK, a particular issue is that the boost to competitiveness from sterling's depreciation may be starting to fade. One downside risk to global growth is that escalating anti-free trade rhetoric may turn into something more serious. Nevertheless, the positives for manufacturing continue to outweigh the negatives and so 2018 should be another good year for the sector.

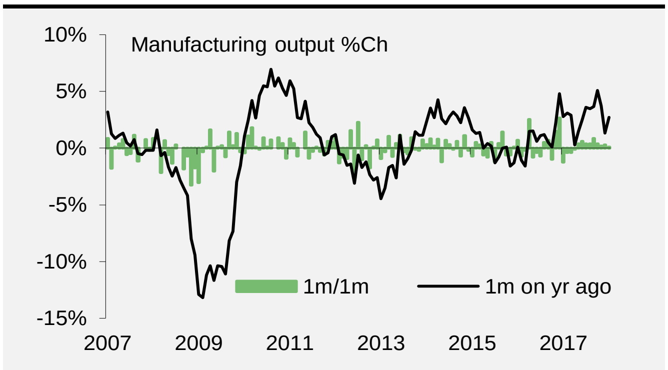
Manufacturing grew more quickly than GDP in 2017

UK manufacturing output continued to grow at a rapid pace in late 2017 (Chart 1). Output increased by 1.3% in the fourth quarter of last year, only slightly down on the 1.5% rise seen in quarter three. That meant production grew by 2.8% in 2017 as a whole, its best performance since 2014. Growth was more than three times the 0.9% rise seen in 2016 and was well above the 1.7% increase in output in the economy as whole. That outperformance is particularly significant as it was the first time since 2011 that manufacturing output had grown more quickly than GDP.

The improvement in UK manufacturing is part of a wider pickup in global activity. Production in the US rose by 1.5% in quarter four, in Japan it increased by 1.8% and in the Eurozone by 1.6%. The demand for many manufacturing products can be highly cycle so it is not surprising that the sector is seeing a particularly marked boost from the acceleration in global economic activity and world trade that has been seen in recent quarters.

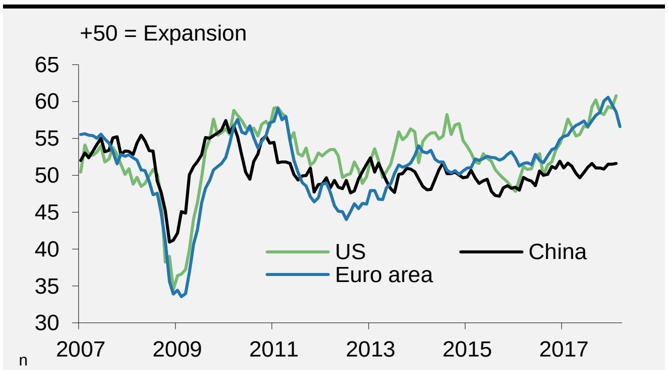
A slightly less-positive picture is emerging for early 2018. Official data showed another rise in output in January. That was the ninth consecutive monthly gain, the first time that has occurred in more than fifty years. However, January's rise was minimal and a number of industrial surveys point to a further slowdown. For example, the Confederation of British Industry's (CBI) monthly industrial trends survey shows weaker growth in both orders and output expectations in the first three months of the year. Similarly the widely watched Markit purchasing managers survey has posted declines for the past three months through February, after reaching its highest level for more than four years in November. The slightly

Chart 1: UK manufacturing output continues to grow



Source: Haver Analytics, LBCB analytics as of 22 March 2018

Chart 2:Activity has picked up in many major economies



Source: Haver Analytics, LBCB analytics as of 22 March 2018

weaker tone is echoed in the Eurozone PMIs, which have also posted modest declines in the last three months, from what was admittedly a record high in December. In contrast, however, the US ISM survey has continued to post rapid gains in early 2018.

2018 should still be another good year

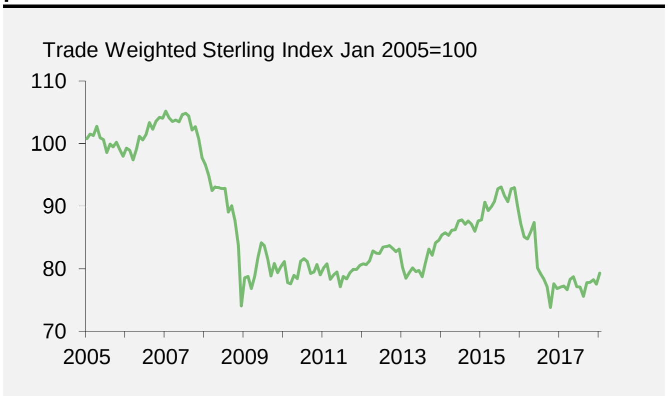
On balance and despite the modest weakening in some business surveys near-term global conditions for manufacturing remain very positive. The pickup in global trade and high levels of consumer and business confidence in many major economies suggest that the demand for cyclical products such as investment goods is likely to be buoyant. Consequently, 2018 seems likely to be the best year globally for manufacturing output growth since 2011. A particular issue for the UK, however, is that the boost to competitiveness provided by sterling's depreciation between late 2015 and late 2017 (Chart 3) is now starting to fade. Surveys suggest that growth in export orders has peaked in the near term, although current levels are still high by recent standards (Chart 4). Consequently, while strong growth in world demand still seems likely to lend considerable support to UK manufacturing activity, the sector may struggle to match 2017's output gains. However, it would be no surprise if manufacturing activity grew more strongly than the economy as whole for a second successive year.

One area of potential downside risk is the escalation in anti-free trade rhetoric. US President Trump's decision to impose substantial tariffs on steel and aluminium imports initially prompted threats of retaliatory action from a number of other major economies. So far, however, no country has followed through and subsequent clarifications from the US suggest that a number of countries will receive exemptions. The likelihood is then that these developments will amount to little more than geopolitical sabre rattling.

Nevertheless, the risk of further action cannot be entirely dismissed. Follow up comments from the US President suggesting that tariffs could be imposed on a wider range of Chinese imports point to that possibility. His comments confirm that China, rather than industrial sectors in the more developed economies such as the UK, would be the primary target for any US action. Nevertheless, a trade dispute between the world's two largest economies seems unlikely to be positive for anybody. Moreover, as a high percentage of UK manufacturing output is traded across borders, the sector is particularly vulnerable to any disruptions to global trade.

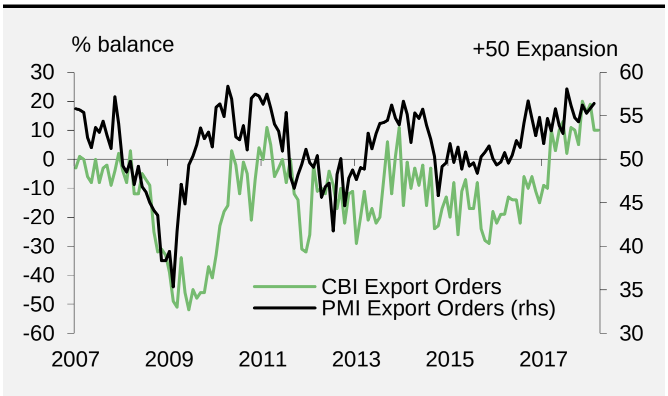
Other issues highlighted in our previous reports remain of key importance to manufacturing. Brexit negotiations continue to progress but many uncertainties persist, particularly regarding the UK's long-term relationship with the EU. Against this background it is probably not surprising that many businesses have concerns whether now is an appropriate time to boost investment (Chart 5). That in turn may have implications for manufacturing's longer-term performance. Recent work at the Bank of England has highlighted that the slowdown in UK productivity growth over the last decade has primarily been concentrated in a small

Chart 3: The impact of sterling's depreciation may have peaked…



Source: Haver Analytics, LBCB analytics as of 22 March 2018

Chart 4: Export order growth has slowed



Source: Haver Analytics, LBCB analytics as of 22 March 2018

number of sectors. Prominent amongst these is manufacturing and while the UK is not alone in having seen a deceleration, it remains notable that UK productivity continues to run below that in many other economies. The reasons behind this are complex but the UK's relatively low level of business investment is almost certainly a contributor and so the ongoing shortfall suggests that the UK may continue to underperform on the productivity front.

Outperformers and underperformers

Activity across the sector continues to be mixed with some industries performing significantly better than others. Chart 6 shows recent relative growth across a range of key industries.

The *aerospace* industry remains one of the high achievers within UK manufacturing. It grew by more than 11.5% last year and has continued to post strong gains in early 2018. Lengthy order books at Boeing and Airbus testify to the global strength of the industry, which is the key determinant of UK output. Brexit remains a concern as Airbus is a key customer for many in UK aerospace but the likelihood is that this area will continue to grow strongly.

UK *motor vehicles* production slowed sharply last year with output for 2017 as a whole rising by only 0.2%. The domestic car market and some of the UK's key export markets saw a weakening in demand after several years of rapid growth. Neither the domestic nor the external environment seem likely to improve significantly in the near term. Meanwhile, Brexit is also a major issue for the sector both because the EU is a major market and because many component suppliers are based on the Continent.

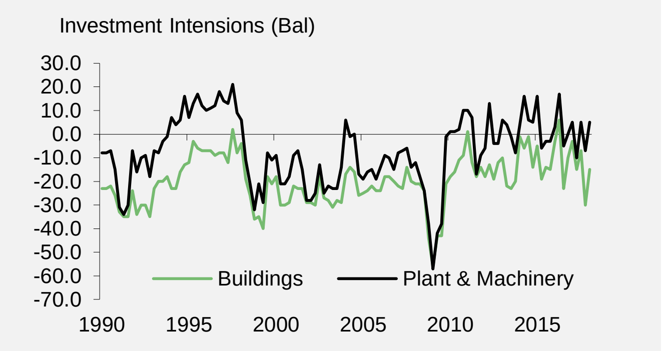
Metal production in the UK grew by 3.2% in 2017 and within that steel production increased by more than 6%. As around 60% of UK steel production is exported, the industry is vulnerable to trade restrictions, although the US is only its fourth biggest market. The UK industry is hoping for an exemption from the US tariffs and negotiations remain ongoing.

Food and drink output grew by 2% last year, with a rise in food production only partially offset by a decline in activity in the drink sector. The impact of sterling's depreciation has been mixed, with some producers hit by rising import costs but others benefitting from strong foreign demand.

Engineering performance improved markedly last year with output almost 8% higher than in 2016. Relatively subdued growth in domestic business investment has been a constraint on growth. However, there were some signs of improvement last year, while stronger world trade growth also provided a boost. The prospects for 2018 look relatively bright and engineering seems likely to again be one of the faster growth areas of UK manufacturing.

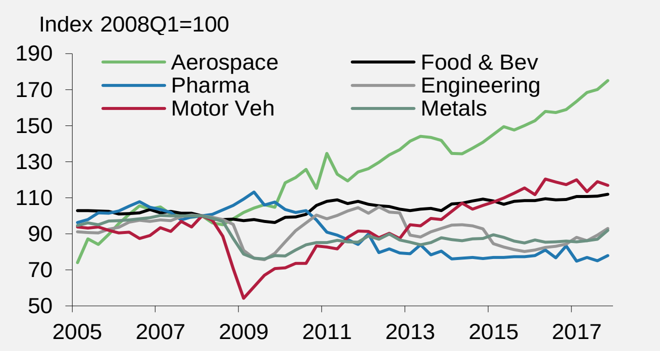
In summary, positives have continued to outweigh the negatives of late in UK manufacturing. We expect that to also be the case this year and anticipate a second successive year of manufacturing growing more quickly than GDP.

Chart 5: UK businesses remain reluctant to invest



Source: CBI, LBCB analytics as of 22 March 2018

Chart 6: Relative performance in UK manufacturing



Source: Haver Analytics, LBCB analytics as of 22 March 2018

CONTACT DETAILS

Rhys Herbert

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

DISCLAIMER