

UK Manufacturing

Sector outlook

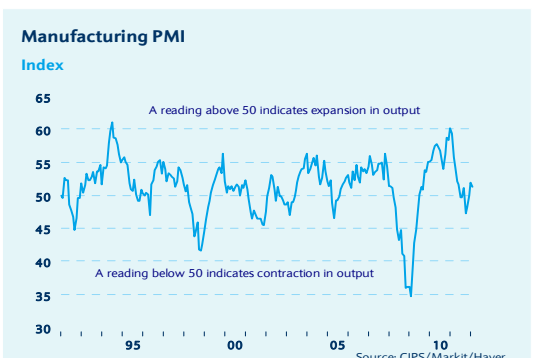
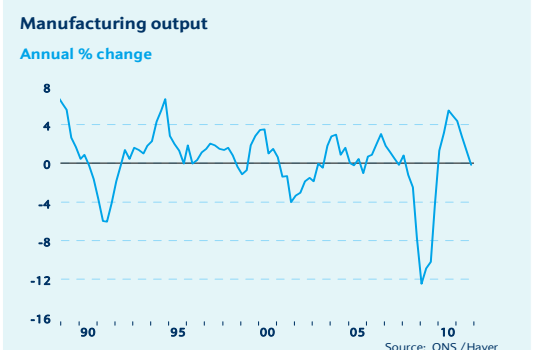
First quarter 2012

Summary

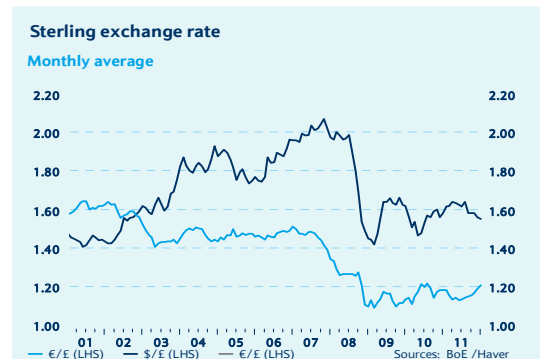
- The manufacturing sector recorded growth of 2% last year, but this largely reflected strong growth during the first half of the year, with the recovery in the sector stalling in the second half of 2011.
- While the latest PMI survey suggests that output may have begun to pick up once more in Q1 2012, the rate of growth is likely to be modest.
- Although the gap between input and output cost inflation has begun to narrow, the manufacturing sector continues to contend with high input costs (energy and raw materials), which are dampening profitability.
- The manufacturing sector should be a major beneficiary of the rebalancing of the economy and the sharp depreciation of sterling. Indeed, several large manufacturers have confirmed substantial investments in the UK to serve European markets. However, much will depend on developments regarding the sovereign debt crisis in the major European export market, which typically accounts for around 40% of overseas shipments.

UK Manufacturing overview

- Output in the manufacturing sector rebounded strongly during 2010 and the first half of 2011, following a sharp contraction in 2008-09. However, recent data suggest that the recovery has stalled. Output contracted by 0.8% q/q in Q4 2011. This was the second consecutive quarterly fall in manufacturing output.
- Recent survey data suggest that manufacturing output growth has begun to pick up once more. The Purchasing Managers' Index (PMI) for the manufacturing industry remained in positive territory at 51.2 in February, although it was down slightly from January's level of 52.0. Together, these readings point to a resumption in output growth (albeit modest) in Q1 2012. However, manufacturers reported that volumes of new orders from domestic and overseas clients had stabilised in February suggesting growth may begin to level off in the near term. In the domestic market, reduced levels of new business from the public sector weighed on order inflows. On the export front, improved demand from Asia and the US were offset by lower intakes of new work from mainland Europe. The CBI Industrial Trends Survey showed a balance of +15% of respondents expected production to rise over the next three months. However, although the balances on total and export order books improved in February, they remained negative.
- Despite worsening global economic conditions, the export market has remained relatively resilient, with the value of manufacturing exports increasing by 4.7% in the year to December 2011, on a seasonally adjusted basis. Sterling has been relatively stable against the euro and the dollar since 2009, after depreciating sharply during the financial crisis of 2007-08. This has given UK manufacturers a competitive advantage.

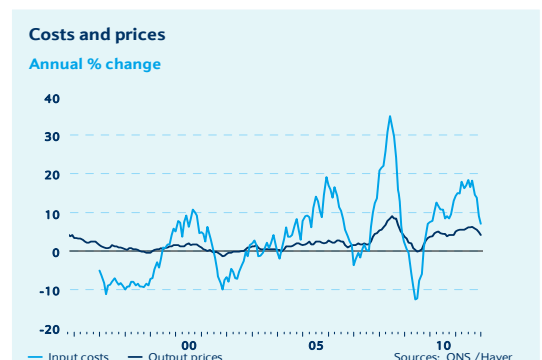


- In 2011 as a whole, manufacturing output grew by 2.1%. The strongest sub-sectors last year were other machinery and equipment (10% growth), transport equipment (8.9% growth), food, drink and tobacco (6.6% growth) and other manufacturing and repair (5.6% growth). High growth in the manufacture of food, beverages and tobacco was driven by a marked increase (33.6% y/y) in the production of alcoholic beverages. This was driven, in turn, by strong export growth. The sub-sectors seeing the biggest declines in output in 2011 were pharmaceuticals, with a 14% fall, (reversing the sectors' previous strong growth), wood, paper and printing (down 5.2%) and electrical equipment (down 2.3%). The decline in output in these last two sub-sectors marks the continuation of a longer-term trend that pre-dates the recent recession.
- Overall, manufacturing growth was flat in the decade prior to the recession. Between 1998 and 2008, manufacturing saw no growth overall and only one sub-sector (pharmaceuticals) achieved annual average growth in excess of 1% during this period. Growth in pharmaceuticals output averaged 6% per annum between 1998 and 2008, but recent performance has been poor, with a 14% decline in output recorded in 2011. This reflects a tightening of UK and other European government healthcare budgets and a reduction in households' real disposable incomes, which has seen many consumers switch to cheaper products.
- The manufacturing sector as a whole is experiencing significant cost pressures, although the gap between input and output price inflation has recently started to narrow. Nevertheless, this trend may not last. In the February PMI survey, manufacturers reported the largest month-on-month rise in input prices for over 19 years. This was largely due to events in the Middle East, most notably the increase in tensions with Iran, which have resulted in a sharp rise in oil prices. As a result, companies reported higher prices, not only for oil, but also chemicals, feedstocks, metals, plastics and transportation.
- The biggest remaining gaps between input and output prices are to be found in the building materials and electrical equipment sub-sector, with companies experiencing difficulties in passing on increased costs due to the impact on the construction sector of reduced government expenditure and a flat housing market. As a result, margins remain under considerable pressure in these sub-sectors.
- Manufacturing companies' profitability is at the lowest level recorded by the ONS since the series began in 1997, with the net rate of return currently just 5.0%. Allied to the weak economic climate, both nationally and internationally, declining profitability will have been a key factor in the 2.4% q/q decline in manufacturing investment in Q4 2011.



Manufacturing output				
Sub-sector	Ave. Annual Growth Pre-recession 1998-2008	Annual % Change 2011	Annual Change Q3 2011 / Q3 2010	Annual Change Q4 2011 / Q4 2010
Food, Drink & Tobacco	-0.1	6.6	6.9	2.0
Textiles & Clothing	-3.7	1.6	-2.9	-0.9
Wood, Paper & Printing	-0.6	-5.2	-2.4	-2.5
Coke/Refined Petroleum	-1.7	1.0	-2.9	-5.2
Chemicals/Chem. Prods.	1.0	2.4	4.3	3.6
Pharmaceutical Products	6.0	-14.0	-16.8	-15.1
Rubber/Plastic Products	-0.1	-0.7	-1.7	-0.9
Metals & Metal Products	-0.2	2.5	0.8	-2.8
Computer, Electronic & Optical Products	-1.2	-0.7	-1.1	-2.0
Electrical Equipment	-0.8	-2.3	-6.5	-8.6
Other Machinery/Equip.	0.4	10.0	8.6	4.3
Transport Equipment	1.0	8.9	6.6	6.6
Other Manu. & Repair	0.4	5.6	5.4	5.3
Manufacturing Total	0.0	2.1	1.3	-0.2

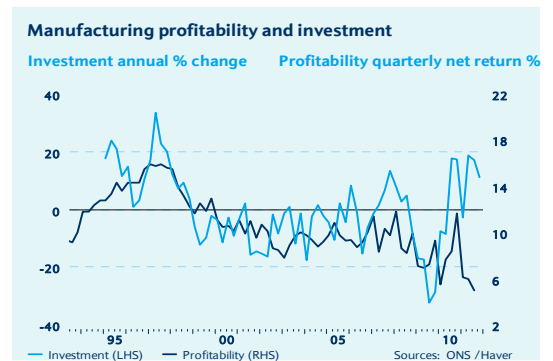
Source: ONS



- Short-term indicators suggest that manufacturing output growth will be subdued over the course of 2012. With the consumer sector in the UK likely to remain under pressure, much will depend on developments in key export markets, particularly Europe, which typically accounts for around 40% of overseas shipments. In the longer term, the manufacturing sector should be a major beneficiary of the rebalancing of the economy and the sharp depreciation of sterling. Indeed, over the past six months, several large manufacturers have committed to making substantial investments and/or creating new jobs in the UK to serve European markets. However, near term prospects remain significantly clouded by the on-going eurozone sovereign debt crisis.

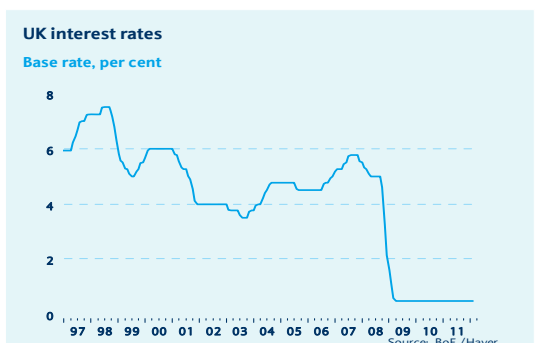
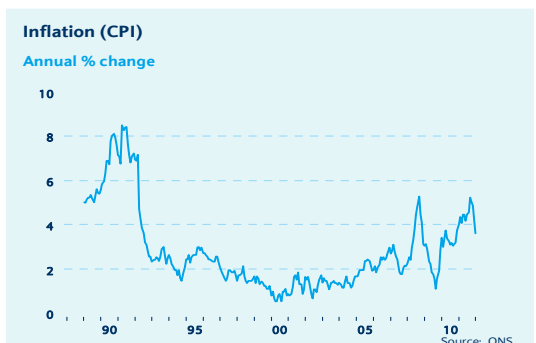
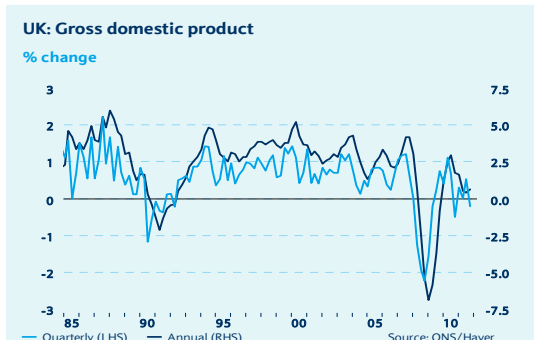
Manufacturing prices - annual % change				
	Input costs		Output prices	
	2011	Jan 12	2011	Jan 12
Chemicals	6.4	3.0	5.0	2.0
Motors	2.6	2.0	0.9	1.3
Food, Drink, Tobacco	5.7	4.7	7.2	6.1
Machinery and Equipment	3.9	3.2	3.6	2.8
Basic Metals	6.4	4.4	4.7	2.3
Fabricated Metal Products	4.5	2.9	3.5	3.2
Computer and Electronic Equipment	2.5	2.1	0.3	0.6
Electrical Equipment	3.5	2.3	1.0	-1.0
Other Transport Equipment	3.0	2.2	1.3	1.8
Building Materials	9.2	6.9	2.7	2.8

Source: ONS



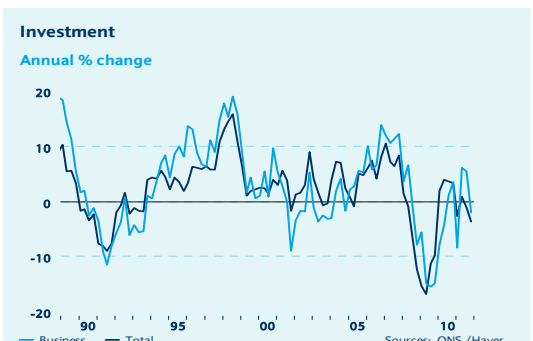
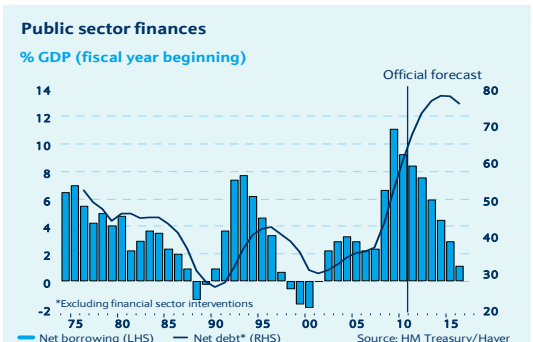
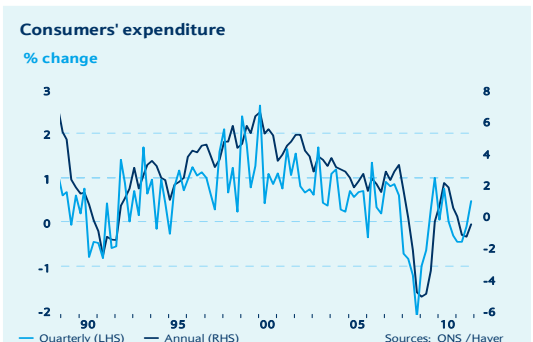
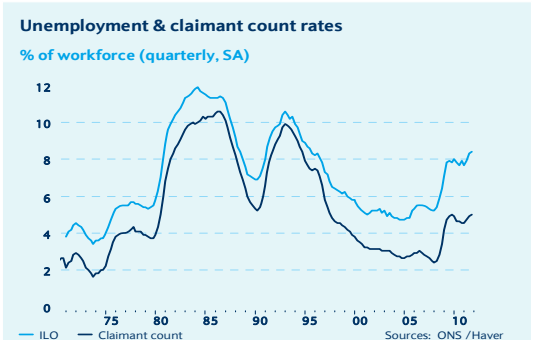
Appendix 1 – Summary of macroeconomic overview

- Official data suggest that the UK economy contracted by 0.2% q/q in Q4 2011, following growth of 0.5% in Q3. The distortionary impact of events, such as the Japanese earthquake, the Royal Wedding and the associated extra bank holiday, resulted in an uneven pattern of quarterly GDP growth during 2011 (events, such as the Olympics and Diamond Jubilee holiday, will result in similar distortions in 2012). However, over the year as a whole, growth slowed to just 0.8%, compared to 2.1% in 2010, with concerns about the pace of the global economic recovery and the escalating eurozone sovereign debt crisis weighing heavily on activity and confidence in the UK (and across the advanced economies), particularly in the second half of the year.
- Large-scale, long-term ECB liquidity provision and progress on a new support package for Greece appear to have eased eurozone tensions, for now, with the more positive tone of recent data from the US further bolstering confidence. Business surveys also suggest that UK economic activity has picked up once more (albeit modestly). However, whilst improving, confidence remains fragile and events in Europe continue to cast a shadow over both the UK and wider global economic outlook.
- The unemployment rate rose to 8.4%, with some 2.67 million people unemployed in the UK, in the three months to December 2011. Weak growth in private sector employment has failed to offset public sector job cuts over the past year and a continued rise in 'involuntary' part-time and temporary employment (by those seeking full-time, permanent posts) suggests that the degree of slack in the labour market is greater than the headline unemployment figures indicate.
- At 3.6%, inflation remains well above the 2% target rate, but has slowed markedly from its recent peak of 5.2%. With domestic inflationary pressures relatively subdued, and the temporary factors that contributed to high inflation last year (such as the increase in VAT and earlier rise in fuel and energy costs) set to fall out of the annual comparison, it is expected to continue to decline, although the recent rise in oil prices highlights the potential risks to this scenario.
- Allied to the weak prospects for the economy, the benign inflationary outlook has seen the MPC maintain interest rates at their historic low of 0.5%. In February, the MPC also sanctioned a further £50 billion of quantitative easing (QE), raising the limit on the Bank's asset purchase facility to £325 billion. Whilst financial markets now expect the MPC to pause QE, Bank Rate is expected to remain on hold during 2012-13.
- Despite a brief pick-up in the quarterly data in Q4, official figures show that consumers' expenditure declined by 0.8% during 2011. Falling inflation should gradually begin to ease some of the downward pressure on real disposable income (RDI). However, consumer spending is likely to remain weak over the next 12



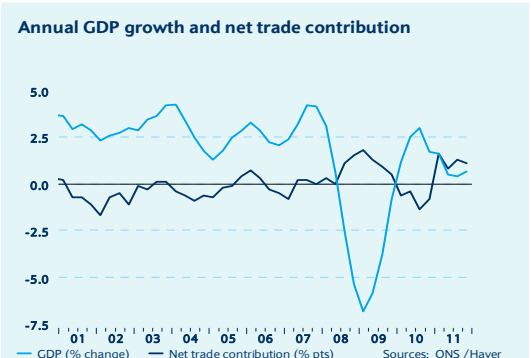
months, as households remain heavily indebted, confidence remains weak and, with wage growth likely to remain below the rate of inflation, RDI is likely to continue to decline (albeit more slowly) in the near term.

- Fiscal tightening will also continue to bear down on the economy. Although official data suggest that the 2011-12 fiscal deficit will be lower than originally forecast, the Chancellor's Autumn Statement revealed significant downward revisions to the Office for Budget Responsibility's (OBR) medium-term economic forecasts. As a result, the Chancellor has stated that there will be no loosening of fiscal policy in the forthcoming Budget, which will be fiscally neutral. Indeed, the OBR's revised forecasts suggest that the austerity programme will likely have to be extended to 2016-17 to meet the government's medium-term fiscal targets.
- Business investment was volatile last year, but declined once more in Q4 (by 5.6% q/q and by 2% y/y), resulting in growth of just 0.2% over the year as a whole. The corporate sector has been running a sizeable aggregate financial surplus, raising hopes that investment would provide a catalyst for both the recovery and the rebalancing of the UK economy. However, firms have adopted a more cautious approach as a result of spare capacity and/or the increasingly uncertain outlook.
- Bolstered by the earlier sharp depreciation of sterling, the weak domestic UK performance was offset by a relatively strong contribution (1.2% points) to GDP growth from net trade last year. However, growth prospects for the UK's key European export partners have deteriorated markedly as a result of the eurozone sovereign debt crisis.
- Industrial production declined once more in 2011, with the pace of decline deepening as the year progressed. Following a period of robust annual growth at the beginning of the year, manufacturing activity stalled in Q4. Mining and oil extraction output also fell sharply (by 15.5%) in 2011, partly due to extra maintenance work in the North Sea, where production is now in long-term decline. Utilities output also declined last year, with relatively mild winter weather resulting in a particularly steep fall (10.9% y/y) in Q4. Annual growth in construction output also slowed markedly in the second half of 2011.
- Annual growth in services activity, which accounts for around 75% of UK GDP, proved more stable in 2011, although the quarterly pattern of growth was somewhat uneven. Growth in activity in this sector accelerated to 1.8% y/y in Q4, resulting in 1.6% growth during the year as a whole. However, performance was highly variable across the service industry's various sub-sectors, with business-oriented sub-sectors generally out-performing consumer-facing sub-sectors.
- UK economic forecasts have been revised downwards, with growth of just 0.5% expected this year and 1.8% next. As a result, recovery is likely to be protracted and weak, with risks weighted on the



downside, given continued concerns over events in the eurozone, tensions in the Middle East (and the actual and potential impact of these tensions on oil prices) and signs of slowing growth in key Asian economies.

- Although expected to gradually pick up, as pressures on RDI gradually ease, consumer spending is forecast to remain subdued, from a longer-term perspective, during 2012-13, while fiscal tightening will see public sector activity and demand fall. Net trade is expected to continue to make a positive contribution to growth, but weak prospects for the eurozone are likely to see this diminish. However, investment should gradually pick up as economic growth accelerates.
- Unemployment is likely to continue to rise, as a result of further public sector job losses and cautious private sector job creation, but slowing inflation should, in the absence of unforeseen price shocks, enable the Bank of England to keep interest rates low.



UK consensus economic forecasts: February 2012

Annual % change (unless otherwise stated)	2009	2010	2011	2012f	2013f
Real GDP	-4.4	2.1	0.8	0.5	1.8
Consumer spending	-3.5	1.2	-0.8	0.2	1.6
Government consumption	-0.1	1.5	0.3	-0.4	-1.0
Investment (total GFCF)	-13.4	3.1	-1.7	0.9	4.0
Stockbuilding (contribution to GDP growth)	-1.0	1.3	-0.1	0.0	0.1
Net trade (contribution to GDP growth)	1.1	-0.8	1.2	0.3	0.3
Unemployment rate %	7.6	7.9	8.1	8.8	9.2
Consumer prices (CPI)	2.2	3.3	4.5	2.0	2.1
Base rate (end period)	0.50	0.50	0.50	0.50	0.50

Sources: HM Treasury; Bank of England; ONS; Barclays Corporate Economics

Prepared by Economics Team, Client Capital Management, Corporate Banking, Barclays Bank PLC.

All data and factual information referred to in this report were correct as of March 2012.

Source of ONS data: National Statistics website: www.statistics.gov.uk
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