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The Manufacturers' Organisation

MANUFACTURING OUTLOOK

2022 QUARTER 1

With support from:

Scottish Engineering

and Manufacturing NI

FOREWORD

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In 1962 the world stood still as the Russia, or more correctly the Soviet Union, began amassing troops and weaponry in Cuba under the pretext that the United States and its allies were increasingly encroaching into a country Russia considered part of its sphere of influence. The advice of Robert McNamara has widely been credited with helping to diffuse the Cuban Missile Crisis but at a time when the West appears once more to be at the beginning of a Cold War with Russia, another lesser known insight gleaned from the then US Secretary of Defence has again become relevant.

An intellectual prodigy who began his professional career in manufacturing at the Ford Motor Company, while at the White House McNamara developed a list of metrics he thought would enable policymakers to accurately monitor US military progress in wars. His one-size-fits-all approach, however, masked wide variations hidden within separate sub-groups that were not being picked up in the data.

McNamara's Fallacy as it has become known by economists has had significant impact on public policy making. The most recent of these was here in Britain when a series of tweets by the food writer Jack Monroe convinced the Office for National Statistics (ONS) to change how it calculates UK inflation. Monroe pointed out that the basket of goods used to quantify the inflation rate failed to take account of the ways poorer people rely disproportionately more on certain household essentials so their lived experience of the effects of inflation diverge considerably from the national average. The implications for Government could be noteworthy as the UK grapples with rising rates this year.

The impact of those growing price pressures is already being borne out in the results of Make UK and BDO's latest *Manufacturing Outlook* survey. Manufacturers are experiencing the highest cost increases since 1980, when disrupted global supply chains triggered a surge in energy prices.

Both energy prices and global supply chain disruptions are again increasing costs at the factory gate with the result that Producer Price Inflation (PPI) is ticking up. PPI is a leading indicator that points to coming rises in Consumer Price Inflation (CPI) and Retail Price Inflation (RPI) and, as expected, many manufacturers are now indicating they will pass on these increased costs to consumers.

Profit margins have declined recently suggesting firms are struggling to cut costs at a sufficient rate to compensate for the rising input prices of labour and materials. The impact is being felt across the board, not just by the food & drink producers Monroe mentioned but Food & Drink is UK manufacturing's largest subsector, so it is the industry most acutely exposed to war in the so-called breadbasket of Europe, Ukraine.

Happily, UK domestic and export orders remain very high, especially in the electronics and electrical equipment industries as the backlog from the worldwide computer chip shortage lingers on. However, if demand continues to exceed supply it could contribute further to the growth in inflation. That Russia is among the world's largest precious metals producers - key components for making computer chips and batteries – does not bode well for manufacturers reliant on these materials.

Manufacturers are taking the right actions by spending more on recruitment and skills, and investing in factories and new machinery. But as Robert McNamara discovered, sometimes the things we cannot account for have the biggest impact. Russia's unaccountable decision to go to war threatens to turn what was an already uncomfortable inflationary situation into something worse.

HEADLINES

Make UK's Q1 2022 *Manufacturing Outlook* report, in partnership with BDO, provides an update on the activities of UK manufacturers and the sector's progress in the context of growing inflation.

The previous quarter reported that for the first time since early 2021 UK manufacturing experienced a slow-down in output and orders indicating the pandemic rubber band effect was fading. However, in *Manufacturing Outlook's* almost 30-year survey history the previous quarter, as well as the latest one, continue to produce high balances. Therefore, the industry continues to grow, albeit it is losing momentum.

This latest quarter's research shows manufacturers continue to perform well on most fronts as key metrics remain positive. However, a major concern highlighted in this edition reports margins have effectively collapsed as inflationary pressures reach new heights. Indeed, prices have once again expanded across the sector, with the domestic market leading the way in growth. In more positive news, the latest figures show both manufacturers having also seen an increase in early retirement over the course of the pandemic. Investment intentions, on the other hand, have shown signs of improvement as businesses seek to expand capacity.

The mainline challenge in this edition remains inflation following a series of record-breaking positive balances for UK and export prices. As it stands, the main culprit has been input prices, followed by expensive logistics and recruitment. However, the coming months will see an increase in taxation and energy costs as well as workers seeking pay rises as both the cost of living and cost of doing business increase. Domestic prices increased to a balance of 58% of manufacturers, the highest on record, whilst export prices increased for a balance of 50%. The resulting impact has seen margins fall sharply reporting at -21% and -13% for UK and export margins.

Both business and economic confidence have fallen for the second quarter in a row following their peaks in Q3

INDICATOR	BALANCE	CHANGE	
Confidence	7.1	↓	Business confidence remains high but falls again
Output	24%	↓	Output balance growth slows further
UK orders	30%	↓	Domestic market going strong
Export orders	18%	↓	Export orders growth slows further
Employment	26%	↑	Jobs improves on balance
Investment	27%	↑	Investment intentions recover following slowdown

Source: Make UK Manufacturing Outlook Survey

employment and intentions to invest capital have picked up slightly this quarter.

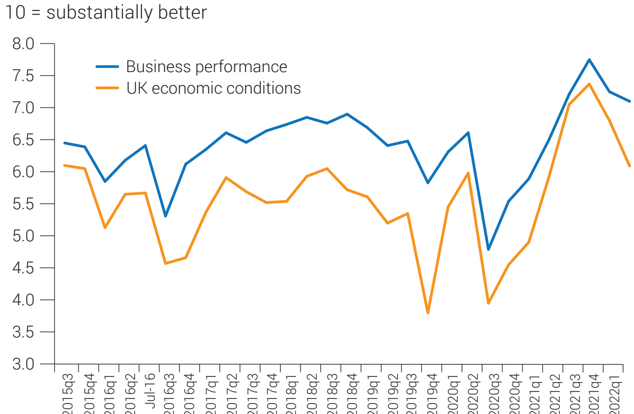
An output balance of 24% this quarter indicates that overall, a greater share of manufacturers are reporting higher output volumes than those that are seeing lower volumes, but that share has continued to decline at an accelerating rate. However, the gap between supply and demand continues to widen as total orders reported at 42%, only a 1% slowdown indicating demand for goods is almost twice that of output.

UK and export order balances have reported positive balances this quarter, at 30% and 18% respectively. Both balances are lower than reported in the previous quarter. However, the domestic market continues to substantially outperform export orders for the sixth quarter in row. Nevertheless, exports have continued to recover slowly following the change in the UK-EU relationship and official statistics indicate trade with non-EU countries is also on the rise.

Following a slowdown last quarter both employment and investment intentions have recovered and accelerated their rate of growth. Employment reported a balance of 26% while investment intentions reported at 27% suggesting that market conditions may be improving. However, the level of hiring continues to fall short of manufacturers needs as labour shortages continue to impact the industry with some 2021. However, confidence remains relatively high, and manufacturers remain optimistic about the future as the wider economy returns to normal.

Confidence continues to dip but overall optimism remains high

Confidence in the next 12 months 1 = substantially worse, 10 = substantially better



Source: Make UK Manufacturing Outlook Survey

OUTPUT

Production pressures have been mounting for manufacturers since the run-up to the end of last year, with these challenges translating into reduced expectations for output in the new year. Now, as we analyse the results for the first quarter of 2022 the balance figure for Output has come in moderately below expectation at 24%.

While this figure still indicates output growth in the industry, this is now the second consecutive quarter where the rate of output growth has been cut, tumbling from a high of 42% in the third quarter of 2021. This slowdown in output growth signals that the industry is now being significantly supply-side limited as our Orders metric remains high.

The leading factor restricting manufacturers' output growth this quarter has been the continued input price inflation the industry has faced both in the labour and material markets. The industry is struggling to meet demand, particularly in instances where orders and quotes were given months ago and the prices of manufacturing inputs have continued rising in the intervening period, leaving manufacturers in the challenging position of either renegotiating existing contracts or absorbing the reduction of their margins.

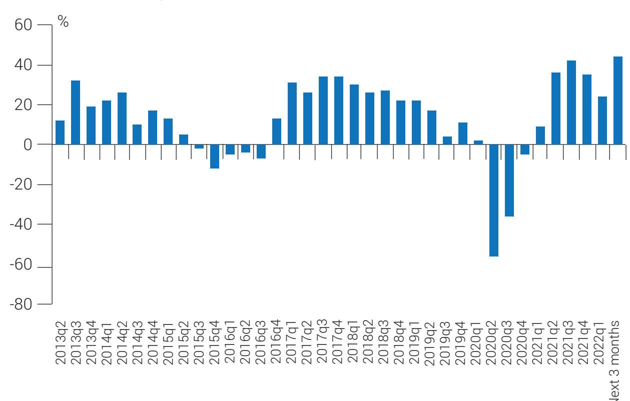
By comparison, expectations for the second quarter of the year are markedly higher, perhaps indicating a second coming of the frenzied recovery activity we witnessed in the third and fourth quarters of last year. There are two main reasons why the industry expects such an upswing in output next quarter. The first, that manufacturers foresee the supply constraints on material and labour abating sooner than expected, allowing the industry more leeway to fulfil orders at pace in the second quarter. The second, following consecutive quarters of sustained input cost inflation, manufacturers have adjusted their business models to better accommodate for the soaring input cost levels. In practice, it's likely a combination of factors that is colouring manufacturers' expectations so positively for the coming quarter, but the meaningful question is whether this output growth will be sustained through 2022 or whether it will be a single quarter blip.

In our previous analysis of the sector at the end of 2021, we noted that output levels, when analysed by business turnover size, saw significantly greater growth in larger turnover companies than smaller ones. This had been a phenomenon we had observed for a few quarters in the so-called recovery period. Now, in the first quarter of 2022, we can report a significantly more even distribution in output growth across manufacturing business sizes, although a mild skew towards larger companies remains. We had forecast this disparity between larger and smaller businesses' output growth to reduce in our previous edition of this report, and this gap is expected to remain relatively stable as the economy continues to recover from the pandemic.

PAST THREE MONTHS	↓ 24%	NEXT THREE MONTHS	↑ 44%

Output slowdown continues but manufacturers expect further growth in Q2

% balance of change in output



Source: Make UK Manufacturing Outlook Survey

Output summary

% balance of change

SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS
Basic Metals	30%	60%
Metal Products	11%	23%
Mechanical	23%	47%
Electronics	13%	56%
Electrical	17%	42%
Rubber & Plastics	20%	80%
TURNOVER		
£0-9m	23%	48%
£10-24m	24%	43%
£25m and over	28%	51%

Source: Make UK Manufacturing Outlook Survey

ORDERS

The total orders balance for Q1 2022 indicates demand has continued to grow at a sustained pace. The latest balance of 42% is only 1% less than its previous level last quarter suggesting that the rate of expansion remains relatively steady. This contrasts with output volumes which have been observing slowdowns.

The resulting impact of recent quarterly trends between output and orders exemplifies supply-shortages getting worse, rather than better. Fortunately, output growth is expected to meet the growth of orders next quarter suggesting, if manufacturers are right, that the next few months may be marginally easier.

around trade as well as unreliable and expensive global logistics have made domestic trade more attractive. Even as the domestic market begins to slow down it is not clear how long this rate of growth can be sustained. Particularly since the UK market is obviously much smaller and therefore offers less opportunity by way of expansion.

Eventually export growth will need to accelerate if industry is to continue its recovery and expansion.

The latest balance for intermediate subsectors reports overall growth across the board. This quarter includes the Electronics and Electrical Equipment subsectors which have

UK ORDERS	PAST THREE MONTHS	↓	30%	NEXT THREE MONTHS	↑	43%
EXPORT ORDERS	PAST THREE MONTHS	↓	18%	NEXT THREE MONTHS	↑	32%
TOTAL ORDERS	PAST THREE MONTHS	↓	42%	NEXT THREE MONTHS	↑	44%

However, the widening gap between demand and supply is resulting in significant inflation across the value chain with some businesses reporting their current business models are already unviable unless costs are passed on at a rate of 100%.

Manufacturers predictions for Q2 suggests orders across the board will expand at a greater rate when compared to this quarter. Firms expect the balance of growth in total orders to report at 44%, an improvement of 2%. However, these forecasts should be treated with caution as the latest results show that manufacturers vastly underpredicted their orders performance for the start of this year, originally expecting a balance of 33% for Q1 2022.

UK ORDERS

Following the record-breaking balance of 48% in the third quarter of last year, UK orders growth has continued to slow down, finally reporting at 30% in the latest survey. However, in isolation this balance is still very strong by historical standards and better than export orders by almost double in our measures.

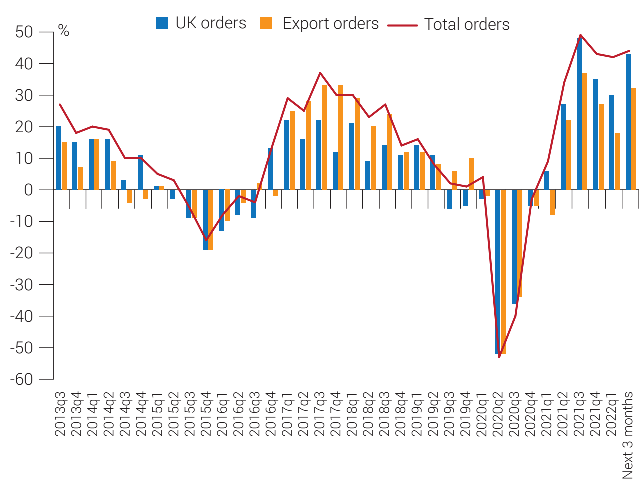
This marks the sixth quarter in a row the domestic market has expanded in terms of orders. It is likely that challenges

reported a balance of 20% and 27% respectively for domestic orders, but output balances for these subsectors have fallen short of demand, a fact likely exasperated by the shortage of semi-conductors.

The strongest domestic performance was reported by Rubber & Plastics, as construction activity continues to

Orders performance indicates industry is still experiencing a slow down

% balance of change in orders



Source: Make UK Manufacturing Outlook Survey

recover, whilst Metals have grown too, albeit the balances are lower in comparison to the final quarter of 2021.

EXPORT ORDERS

Export orders reported a balance of 18%, the lowest balance since Q1 2021.

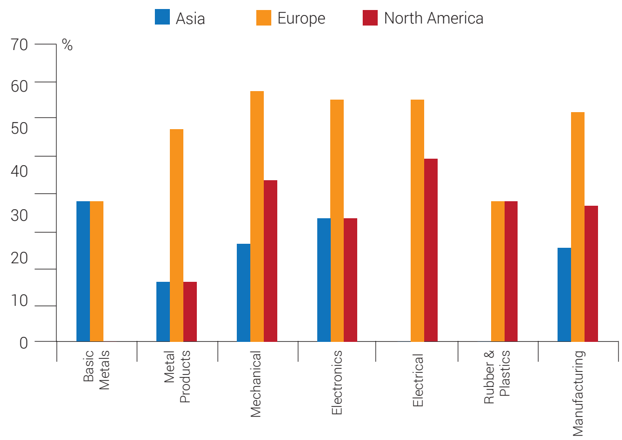
Since the end of the transition period last year, export orders have failed to keep pace with the domestic market as international customers shied away from UK markets, and domestic suppliers began to seek new relationships at home. Despite this, there has not been a strong drive towards reshoring amongst UK manufacturers, and according to official statistics, exports to the EU have been slowly recovering too. Alongside this, imports from non-EU countries have been increasing as manufacturers look to alternative sources to meet their input needs.

The start of this year saw new post-Brexit import controls come into effect but as of now there is little indication of what impact this may have on manufacturers in Great Britain, though firms in Northern Ireland appear to have benefitted relatively significantly from the Northern Ireland Protocol. There were no signs of stockpiling by manufacturers just before the start of the New Year, but a recent increase in exports to the EU does suggest that manufacturers on the continent may have been building safety stocks prior to import controls.

Manufacturers continue to report positive demand conditions in the rest of Europe. However, the average share for European demand has fallen from around 70% to 54% suggesting businesses are seeing overseas markets weakening slightly. North America maintains a strong second place for positive demand conditions, whilst Asia remains third.

Demand conditions in Europe remains robust but weakens slightly

% of companies reporting positive demand conditions by market



Source: Make UK Manufacturing Outlook Survey

Orders summary

% balance of change

	UK ORDERS		EXPORT ORDERS		TOTAL ORDERS	
SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS
Basic Metals	11%	0%	38%	25%	30%	30%
Metal Products	22%	20%	-7%	-7%	28%	14%
Mechanical	32%	53%	31%	48%	44%	57%
Electronics	20%	47%	7%	29%	38%	50%
Electrical	27%	45%	0%	9%	33%	42%
Rubber & Plastics	40%	60%	0%	0%	40%	80%
TURNOVER						
£0-9m	26%	41%	18%	30%	33%	47%
£10-24m	25%	42%	12%	28%	30%	45%
£25m and over	29%	41%	37%	46%	50%	58%

Source: Make UK Manufacturing Outlook Survey

EMPLOYMENT & INVESTMENT

Our Employment and Investment intentions metrics have both seen a moderate increase in the positivity of their balance of change figure this quarter, raising by 4 and 6 percentage points respectively.

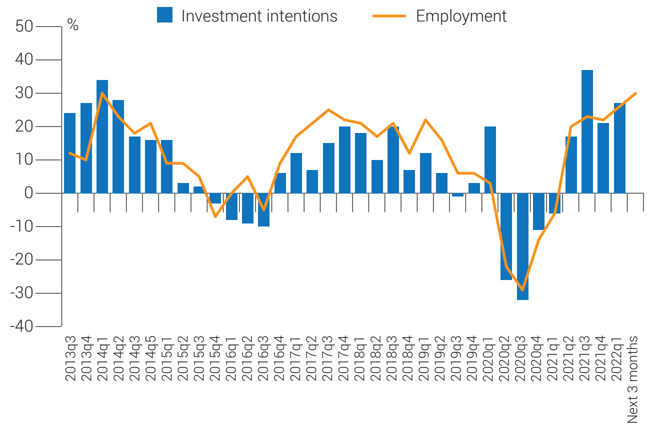
Employment in the industry has been receiving a lot more focus over the last few quarters as the labour shortage in manufacturing continues to weigh on businesses' ability to raise output levels to their post-pandemic recovery potential. While a balance figure of 26% for employment is certainly strong by historic *Manufacturing Outlook* standards, it must be stressed that this employment growth comes following the deep gouges in employment levels that occurred during the height of the pandemic.

What's of more importance, is that despite these relatively strong employment growth figures we are reporting, they are still falling significantly below the demand the industry has for yet more skilled workers. The latest ONS data[1] shows that vacancies in the manufacturing industry are at an, at least, 20 year high - this is how far back the time series runs. The current rate of vacancies in the industry stands at 4.0 roles per 100 employed. By way of comparison, the average figure across that same twenty-year period is only 1.9, demonstrating just how inflated demand for labour is in the manufacturing sector now.

Following a fairly disheartening dip in investment intentions between the third and fourth quarters last year, this quarter, the industry sees this downward trend cease and enjoy some moderate growth in these intentions. Many in industry are watching the Chancellor closely as they wait, and hope, to see an extension or other pro-investment amendment to the existing, but time-limited, Super Deduction investment policy.

Employment and investment intentions growth accelerates

% balance of change



Source: Make UK Manufacturing Outlook survey

EMPLOYMENT	PAST THREE MONTHS	↑ 26%	NEXT THREE MONTHS	↑ 30%	
INVESTMENT	NEXT TWELVE MONTHS	↑ 27%			

There are a multitude of factors that are exacerbating the challenges manufacturers are facing when it comes to accessing labour, with the leading issues being: increased difficulty sourcing labour from the EU following the UK's exit from the Bloc, an expensive labour market, changing workforce attitudes towards flexible working, and reduced hours or early retirement.

While the all-UK economy vacancy rate has also grown significantly between March 2020 and now, by approximately 65%, the manufacturing vacancy rate has grown by a staggering 91% in that same period, highlighting the severe shortage manufacturing businesses face for what is typically on-site labour, even despite the manufacturing industry offering 12% higher wages on average than the wider economy.

Employment and Investment summary

% balance of change

	EMPLOYMENT		INVESTMENT
SECTOR	**PAST THREE MONTHS**	**NEXT THREE MONTHS**	**NEXT TWELVE MONTHS**
Basic Metals	10%	40%	10%
Metal Products	31%	28%	6%
Mechanical	24%	23%	41%
Electronics	6%	44%	13%
Electrical	0%	17%	8%
Rubber & Plastics	20%	20%	-20%
TURNOVER			
£0-9m	17%	33%	23%
£10-24m	27%	32%	11%
£25m and over	37%	45%	32%

Source: Make UK Manufacturing Outlook Survey

1 ONS Vacancies by Industry data, Published 15th February 2022, accessed 23rd February 2022

PRICES & MARGINS

The biggest challenge manufacturers are facing right now revolve around cost. Most will know by now that the cost of living has been rising fast, with the CPI reporting at 5.5% by January 2022. However, there has been little attention garnered for the cost of doing business which has become significantly more expensive in recent months. From rising input prices to logistics, energy, wages, and higher tax bills looming in the months to come businesses are feeling the pinch more than they have ever before.

The Bank of England responded by raising interest rates to 0.5% and further rises are possible, but how effective this will be remains to be seen, especially given interest rates mainly impact demand whereas business inflation is currently driven by supply challenges.

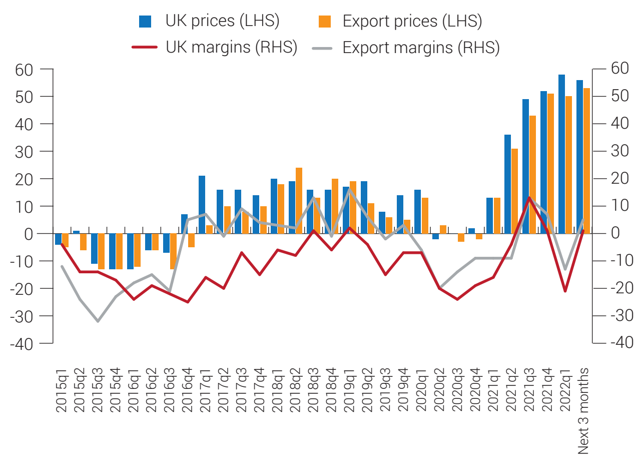
Make UK's Q1 *Manufacturing Outlook* reports that prices for UK goods have expanded at the fastest rate yet, reporting a balance of 58%. This is followed by export prices which has reported an insignificant slowdown in price growth reporting a balance of 50%. These continue to be some of the highest balances in our survey history and given that it has been ongoing for a sustained period, the trend does not bode well for the UK as higher prices become locked in.

From a business's perspective rising costs are not an issue if they can be passed on as higher prices, thereby ensuring margins stay more or less at the same levels. However, the latest balances show a large share of manufactures are reporting declining margins, with a balance of -21% of manufacturers reporting worse UK margins. Similarly, a balance of -13% reported the same for export margins.

The figures may indicate that costs are rising at a speed that's faster than manufacturers are able to respond to resulting in margins declining in the short-term before they return to growth. Manufacturers expect margins to recover slightly by next quarter, whilst prices report a mixed bag.

Prices continue to grow as margins collapse

% balance of change

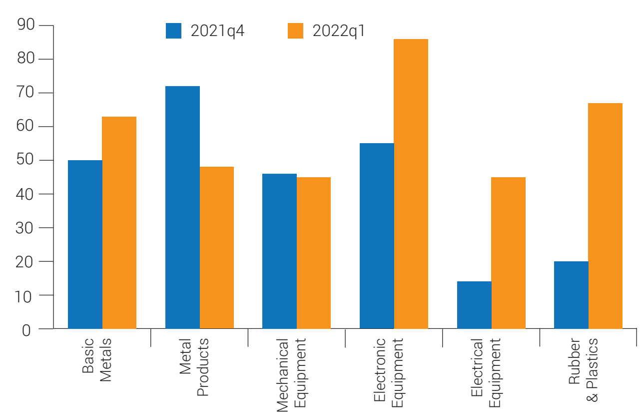


Source: Make UK Manufacturing Outlook Survey

UK PRICES	PAST THREE MONTHS	↑	58%	NEXT THREE MONTHS	↓	56%
EXPORT PRICES	PAST THREE MONTHS	↓	50%	NEXT THREE MONTHS	↑	53%
UK MARGINS	PAST THREE MONTHS	↓	-21%	NEXT THREE MONTHS	↑	1%
EXPORT MARGINS	PAST THREE MONTHS	↓	-13%	NEXT THREE MONTHS	↑	5%

Export prices of materials rising for most manufacturers

% balance of change in export prices in the past three months

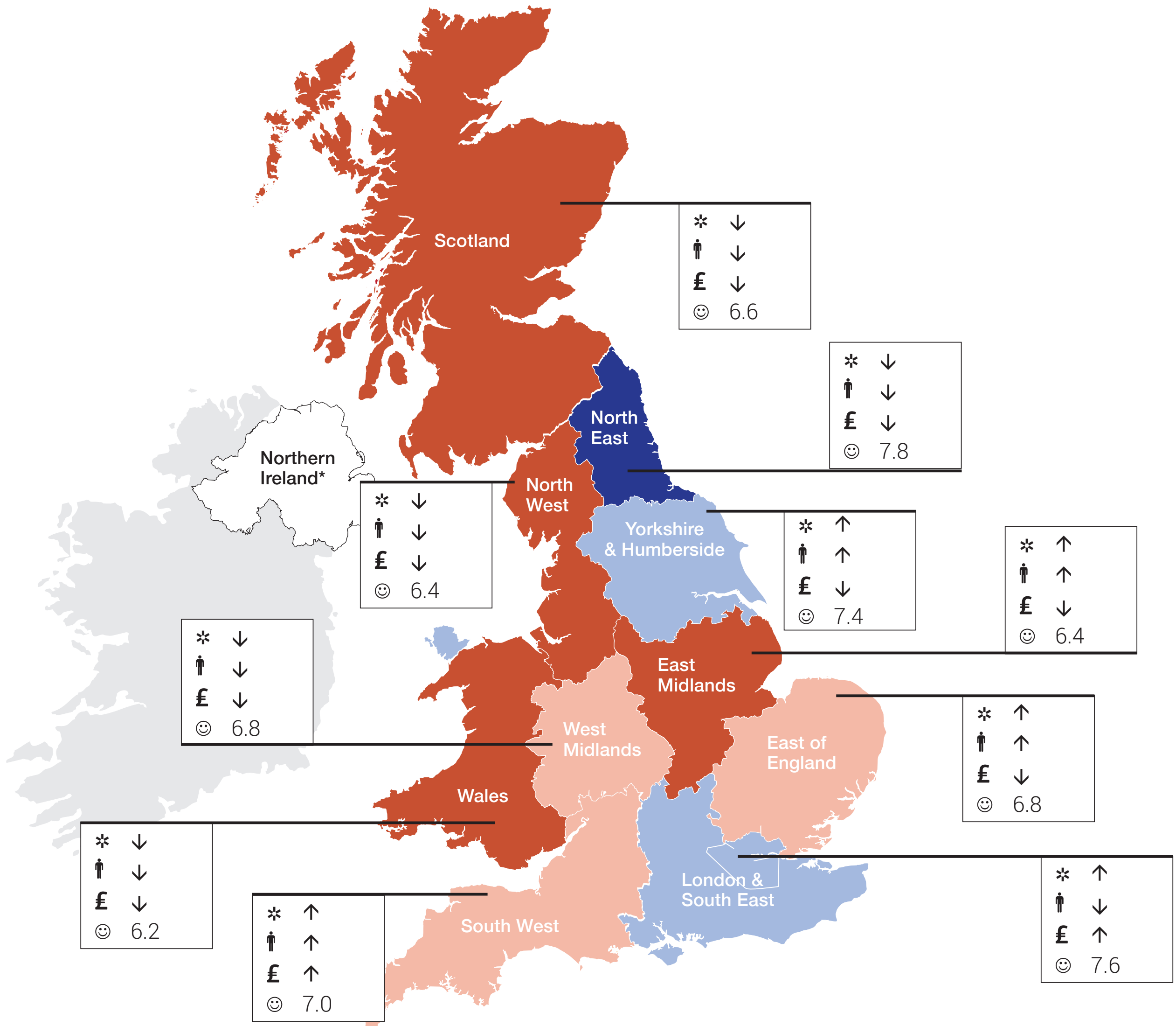


Source: Make UK Manufacturing Outlook Survey

NATIONAL & REGIONAL

This quarter's *Manufacturing Outlook* report finds that firms' confidence in business conditions and the UK economic environment remains high in historical terms. However, following on from the slow-down last quarter, manufacturers have once again lowered their enthusiasm of the future. Despite this both average business and economy confidence remains positive (above the "5" inflexion point), showing how mentally resilient manufacturers remain regardless of the challenges ahead of them.

Nevertheless, confidence is a volatile metric and can change dramatically depending on the day-to-day performance



KEY:

↑/↓ INCREASE/DECREASE ON PREVIOUS QUARTER
✲ OUTPUT
EMPLOYMENT
£ INVESTMENT
☺ BUSINESS CONFIDENCE
* INSUFFICIENT NI DATA FOR CALCULATION IN THIS INSTANCE

HIGH CONFIDENCE

LOW CONFIDENCE

The map is coloured according to the business confidence levels difference from average UK business confidence

Source: Make UK Manufacturing Outlook Survey

of a business, as well as the news surrounding the UK economy and politics. It does not necessarily always correlate with future performance. However, in this case the decline in confidence is in line with a decline in the output performances we have been observing.

This is unsurprising given the situation businesses are facing with rising costs, and international political instability growing. The cost of and access to inputs remain a priority, but with higher energy prices, wages, logistics and taxes around the corner businesses risk becoming operationally unviable if the situation is not managed. Understandably, manufacturers are slightly less confident than they were three months ago.

In line with the national average, most regions and devolved nations reported a slight fall in business confidence compared to last quarter. However, all regions and nations remain within positive territory[2].

Headline business confidence reported at 7.1, a decline of 0.15. The change is a smaller one than the one reported last quarter which saw business confidence fall by 0.5. However, the change highlights that manufacturers continue to temper their expectations downwards as the reopening of the economy and apparent "end" of the pandemic has not led to the promised recovery. On top of this, difficulties in accessing labour and sourcing inputs are making running a business more difficult every single day. It is difficult to say for how long manufacturers will remain above the '5' for business confidence should current trends continue.

However, not all regions and nations reported a decline in business confidence between Q4 2021 and Q1 2022. Manufacturers in the South West reported the biggest improvement in confidence, increasing by 1.4 points to 7.0. However, this region is not the most confident across the sample. That title is held by the North East this quarter, reporting a confidence of 7.8, followed by the South East and London at 7.6. Although, the latter reported a slight decline in confidence too.

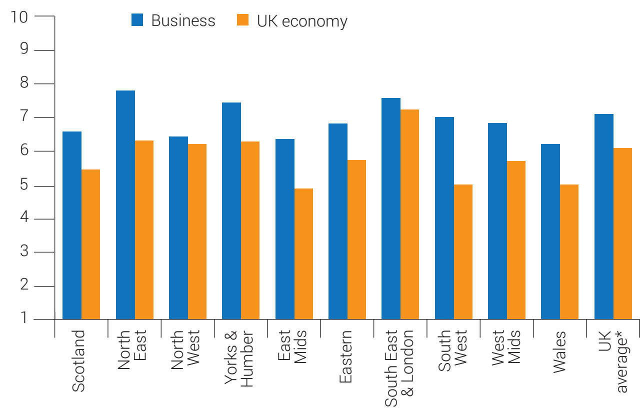
In reverse, the data finds Wales to have reported the biggest decline in confidence, falling by 1.5[3]. Alongside Wales and the South East and London, the East Midlands and North West also reported slight declines in confidence.

UK ECONOMY CONFIDENCE

Manufacturer's views of the overall UK economic condition came in at 6.09, experiencing a more severe dip this quarter as market conditions appear to be bleaker than previously thought. Though businesses are speeding ahead, and order books are robust the current economy sentiment has been negatively impacted as news and stories of a cost crisis circulate across the nation.

Business confidence positive for all regions and nations

Confidence in the next 12 months 1 = substantially worse, 10 = substantially better



* Average =/= component parts due to instances of undeclared regionality

Source: Make UK Manufacturing Outlook Survey.

2 This includes Scotland which follows a different survey elicitation method, which means Scottish confidence values should be compared with other Scottish confidence values only.

3 The sample size for Wales is small relative to other regions/nations and should be treated with caution.

Regional summary

% balance of change

	OUTPUT		TOTAL ORDERS		EMPLOYMENT	
REGION	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS
Scotland	19	46	35	45	16	34
North East	50	64	43	57	29	57
North West	0	0	0	20	-13	0
Yorks & Humber	55	55	65	75	50	60
East Mids	29	35	24	35	35	41
Eastern	27	36	30	20	40	20
South East & London	11	61	34	46	37	21
South West	56	56	56	50	56	67
West Mids	17	35	41	48	17	22
Wales	-50	67	33	50	-33	0
Northern Ireland*	–	–	–	–	–	–

* Insufficient NI data for calculation in this instance

Source: Make UK Manufacturing Outlook Survey

ECONOMIC ENVIRONMENT

As the New Year settles in the worst of the overall pandemic economic hit is now (hopefully) behind us but aftershocks remain. The economy is recovering rapidly, yet significant risks to recovery persist and there are signs that growth may become sluggish as the year progresses.

The most obvious is Russia's invasion of Ukraine. Oil prices surged past $113 (£85) a barrel, tightening the squeeze on UK consumers in the process. Stock markets collapsed and the price of gold keeps rising, a classic insurance measure for investors in times of war.

The UK sources just 6% of its oil and less than 5% of its gas from Russia so the war will have little direct impact on our domestic energy bills, but our European neighbours rely heavily on Russia - the second biggest exporter of crude oil and the world's largest natural gas exporter - for their energy so sanctions could constrict supplies thus driving up prices worldwide.

Consequently, the cost of travel is set to rise as airlines face soaring overheads. Air freight prices have already hit levels never seen before of $15 (£11) per kg and with planes now avoiding Ukrainian airspace, Russian airlines banned from Europe and North America, and UK airlines banned from Russia, the cost of flying will increase further still. That is not good news for manufacturers, many of whom had switched in recent years from shipping cargo to air freight as a result of delays and diversions experienced at ports and harbours. Road travel is not getting cheaper either because automakers continue to struggle to secure supplies of semi-conductors.

That Russia is among the world's largest precious metals producers – especially aluminium, copper, nickel, and platinum, all key components for making batteries and computer chips – does not bode well for manufacturers reliant on these vital input materials.

The cost of living unavoidably hit a fresh 30-year high as energy, fuel and food prices continue to soar and retailers rein in seasonal discounts.

Thankfully HM Government struck an emergency deal last month with carbon dioxide maker CF Fertilisers' Billingham plant to keep supplies of industrial-grade CO2 flowing, most importantly to nuclear power and Food & Drink producers who had warned of impending shortages without an extension of the previous deal.

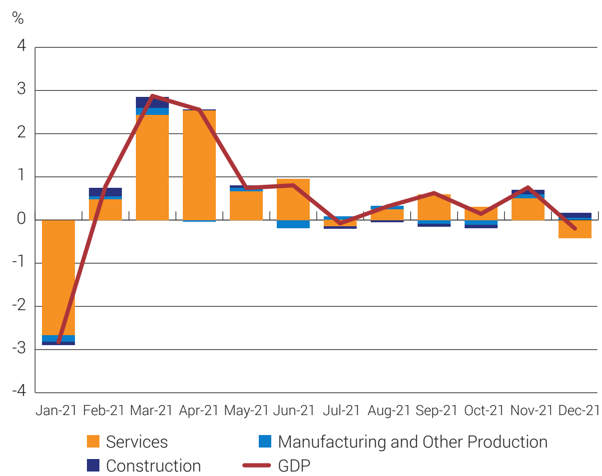
But property prices rose at the fastest annual pace for 17 years in January, amid robust demand and low supply. Already more than 17,000 business outlets closed across the UK last year, a trend that looks set to continue.

That's yet another example of the way inflation - expected to climb above 7% this year - is increasing at a rate at which wages can't compete. The Bank of England (BoE) says UK households must brace for the biggest annual fall in their standard of living since comparable records began. Trade unions reacted angrily to BoE Governor Andrew Bailey's call on workers not to ask for pay rises, an understandable response given annual food bills are set to rise by £180 on average over the course of 2022, having already risen by 8% last year.

The UK economy has seen nothing like this since the financial crash of 2008 and it's just the beginning. Analysts expect price increases to continue for two more years as

UK GDP grew marginally last quarter

Contributions to monthly GDP, percentage points, January to December 2021



Source: ONS

various input costs, supply problems, and demand reductions filter through the system.

The BoE's usual response to rising inflation is to up interest rates but because this time cause - the global squeeze on energy prices - is external, that traditional solution might not be the answer. Government must instead work to cut the cost of living for consumers and of recruitment and retention for businesses.

What's more, the UK has scant storage facilities, relying instead on a just-in-time model which means we'll be more affected by short-term price fluctuations in the wholesale gas market. HMG has the power to impose emergency measures, such as ordering industrial customers to temporarily stop using gas. This will be a worry for energy intensive manufacturers especially the UK steel industry.

A similar concern is that Chancellor Rishi Sunak has been urged by the International Monetary Fund (IMF) to raise taxes when he unveils the latest budget forecasts next month to address the demand-supply imbalances that are pushing up inflation. The budget is already likely to be a painful one for business. We know employers' National Insurance Contributions (NICs) will increase by 1.25% and a new plastic packaging tax will be introduced from April 1st impacting most manufacturers.

UK Economic Forecasts

% change except where stated

	2021	2022	2023
TRADING ENVIRONMENT			
Exchange rate (€/£)	1.16	1.2	1.2
Exchange rate ($/£)	1.38	1.39	1.42
Exports	-0.4	7.3	4.1
Imports	3.9	6.7	4.3
Current account (% GDP)	-3.0	-3.2	-2.9
OUTPUT			
Manufacturing	6.8	3.0	2.8
GDP	7.5	3.8	2.6
COSTS AND PRICES			
Average earnings	5.8	4.8	3.3
Oil price (Brent Oil $/bl)	70.7	86.3	73.9
EMPLOYMENT			
Manufacturing (000s)	2,533	2,532	2,534
Rest of economy (000s)	34,963	35,325	35,865
Unemployment rate (%)	4.5	4.0	3.9

Source: Oxford Economics and Make UK

International Economic Forecasts

% change

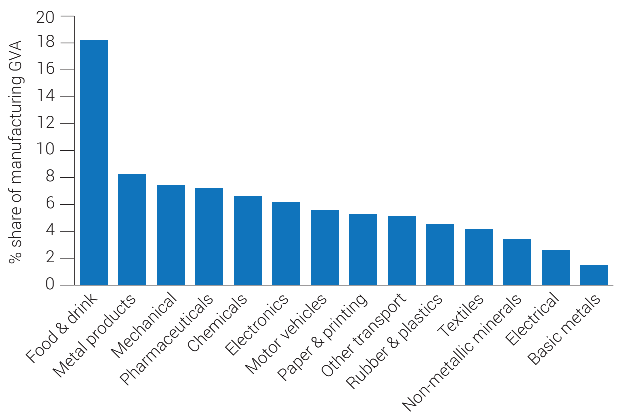
	GDP			INFLATION		
	2021	2022	2023	2021	2022	2023
US	5.7	3.5	2.5	4.7	5.1	2.0
Eurozone	5.2	3.7	2.7	2.6	3.9	1.0
France	7.0	3.4	2.1	1.6	2.9	1.0
Germany	2.8	3.5	3.0	3.1	3.9	1.0
Japan	1.6	3.1	2.2	-0.2	1.1	-0.4
China	8.1	5.0	5.5	0.9	2.4	2.4
India	8.3	7.7	6.9	5.1	6.3	4.7
World (2015 PPPs)	5.9	4.3	4.0	4.3	5.2	2.8

Source: Oxford Economics

SECTOR FORECASTS

Q1 2022 Manufacturing Sector composition by GVA (% share)

Subsector share of Manufacturing Gross Value Added



Source: Oxford Economics

FOOD & DRINK

The UK's largest manufacturing subsector, **Food & Drink**, has seen its total share of manufacturing gross value added (GVA) stay roughly unchanged in the intervening period between the last quarter of 2021 and now, responsible for 18.2% of all UK manufacturing's output value. With hindsight, the total value increase within the subsector was 4.2%, but now, as is the case for the whole manufacturing sector in 2022, output growth forecasts have been downgraded for the year. For the Food & Drink subsector, the output forecast for 2022 now stands at 2.8%, which is a significant downgrade over the previous 2022 forecast which was at 6.9%. Nevertheless, this downgrade is largely a result of a whole-economy growth downgrade, and not overtly specific to the subsector. By comparison, the average UK manufacturing growth forecast stand at only 3%, so the Food & Drink's forecast for 2022 is largely in line with it. It's a similar story with the employment forecast, which has received a downgrade for 2022 compared to the previous quarter, which stands at -0.2% for the year, only just slightly more negative than the UK manufacturing average 2022 employment forecast at -0.1%

ELECTRONICS

Continuing the unfortunate trend seen across most subsectors, successive output forecast downgrades are in order for the **Electronics** subsector. The current revised output forecast for 2022 stands at 1.2%, which is below half of what is expected of the wider manufacturing sector at 3%. The current Electronics subsector forecast has been halved from its previous value in the last quarter of 2021, which then stood at 2.4%. The employment figures for the subsector are standout, for unfortunate reasons. The subsector currently holds the second most negative employment forecast out of all our manufacturing subsectors, with a decline of -5% expected in 2022, which stands in strong contrast to the UK manufacturing average at only -0.1%.

BASIC METALS AND METAL PRODUCTS

The **Basic Metals** subsector, following a below average improvement in output growth in 2021, is expected to see 2022 output growth much closer to the average. The current forecast for the subsector's 2022 growth is at 2.3%, now less than a percentage point short of the UK manufacturing average forecast of 3%. Employment, on the other hand, is expected to shrink considerably, having the industry's fourth most negative employment forecast at -4.8%

The **Fabricated Metals** subsector enjoyed growth in 2021 of 7%, just outpacing the growth rate of the wider manufacturing average. However, a slowdown is expected in 2022, with the forecasted output growth of only 1.1% for the year. Not too dissimilarly to the Basic Metals subsector, despite moderate forecasted output growth, employment is set to decline, with forecasted employment levels within the Fabricated Metals subsector set to reduce by -1.1%.

MECHANICAL EQUIPMENT

Following significant headwinds that emerged just towards the end of 2021, the **Mechanical Equipment** subsector didn't quite achieve the significant 18.6% output growth bounce-back that was expected, as the final figure for 2021 was 14.6%. Nevertheless, the subsector enjoys the joint-strongest growth expectation for output growth in 2022 at 8.1%, which is more than double the manufacturing average of only 3%. Employment is also set to buck the trend this year, with total employment growth of 4.2% forecast. Although, this comes as the subsector endured a worse than average employment decline in 2021.

TEXTILES

The **Textiles** subsector's story at the start of this year is a trend defying one. It is one of the few industries that managed to see a hindsight-led positive revision to its 2021 total growth output, as the subsector fared better than expected despite the industry-wide challenges facing the manufacturing sector towards the end of 2021. The previous output growth forecast in the fourth quarter of 2021 already stood at a high value of 17.3%, approximately triple the 2021 manufacturing growth average, but with the year complete, we can report that the subsector achieved a staggering 18.4% output growth, the highest growth out of all manufacturing subsectors. While 2022's growth expectation is notably soberer, at a reserved 2.2%, it's still a positive indication for the subsector's prospects in the coming year. The employment forecast for 2022 is also above the manufacturing average, with a growth of 1.7% expected.

PAPER & PRINTING

The **Paper & Printing** subsector performed well above the UK average in 2021, showing growth in output for the year by 13.3%, approximately double the rate of the wider industry. As is the case across the board in this first quarter, forecasts for 2022 are more moderate, with only 3.8% growth expected this year in comparison. Nonetheless, this expected growth rate is still above the UK manufacturing average of 3%. Employment is not forecast to follow suit, with a decline in the total level of employment in the subsector of -3.4%, which stands well below the average.

ELECTRICAL EQUIPMENT

Following the growth that exceeded the trend in 2021, at 8.6%, the **Electrical Equipment** subsector receives an effective 'no change' forecast for 2022. Growth is forecast to be at 0.01% for the year, which is still positive but well below the manufacturing average of 3% meaning that the subsector's growth will lag. Despite this uneventful growth forecast, employment change is more promising, with a 6.3% growth forecast for 2022, the highest employment growth forecast out of all manufacturing subsectors.

NON-METALLIC MINERALS

The **Non-metallic Minerals** subsector is best known for manufacturers that primarily supply the construction market with bricks, mortar, and glass. As the subsector's downstream customers recovered last year, Non-metallic mineral manufacturers saw a growth of 15.1% in 2021, more than the 14.2% originally predicted. However, now that the pandemic-induced recovery has slowed down alongside rising prices for raw materials, the subsector is expected to grow by only 1.9% in 2022. In terms of employment, the subsector expects to recoup some lost jobs this year after declining by -1.4% in 2021 to growing by 2.3% this year.

PHARMACEUTICALS

The **Pharmaceuticals** subsector was one of the few winners during the pandemic thanks to their critical importance in the supply-chain for healthcare goods, particularly vaccines. The subsector, however, only experienced modest growth in 2021 expanding by only 3.7%, about half of the industry average. This was better than predicted as previous forecasts believed pharmaceuticals may even decline following the above average growth achieved in 2020. However, as vaccine effectiveness appears to wane after a few months many nations are engaging in booster programmes to offer third, or even fourth, doses of certain vaccines. Alongside this, the healthcare industry continues to deal with a backlog of treatments. As a result, the pharmaceuticals subsector could see growth reach 7.7% in 2022, more than double the manufacturing average of 3%. Employment, on the other hand, is expected to decline by -6.4% this year as businesses pull back on the extra resource needed during the height of the pandemic.

CHEMICALS

The **Chemicals** subsector growth closely tracked the performance of pharmaceuticals during the pandemic. However, this year expectations are for the industry to achieve significantly less growth than pharmaceuticals, with a forecast of 0.5% for 2022. This is partly down to supply-chain difficulties directly affecting the access and cost of different chemical compounds which have hampered the sector. Additionally, challenges around REACH continue to affect UK chemical manufacturers that trade with the European Union. Such cost rises are likely to affect employment expectations too, with the industry forecast to see jobs fall by -4.9%.

RUBBER & PLASTICS

Plastics continue to be a critical component for the manufacturing of many goods. However, as with the wider industry this sector, along with Rubber, was not spared from a downgrading of expectations. In addition, the plastic packaging tax will be enforced from April 1st which will place downward pressure on the industry in the short term.

Rubber has a strong association with the automotive market, being the supplier of tyres, with shortages in the material reported by various manufacturers. Inevitably the slow growth of automotive affected this subsector's performance in 2021, however as vehicle production ramps up opportunities for **Rubber & Plastics** may also improve. The subsector is now forecast to grow by 0.4% for 2022, and by the same fraction in 2023.

Unlike the manufacturing average, Rubber & Plastics employment is expected to grow by 1.3% this year, and by 3.8% in 2023.

MOTOR VEHICLES (AUTOMOTIVE)

The **Motor Vehicles** subsector has faced a whirlwind of challenges over the last few years. 2021 was originally due to be the rebound year for automotive manufacturers as the reopening of the economy meant demand for vehicles were rejuvenated. Unfortunately, the subsector was hit hard by a shortage of semi-conductors, exasperated by pandemic shutdowns across the globe. As a result, the 2021 forecast for Motor Vehicles was consecutively downgraded achieving a respectable growth of 3.1%.

However, reports of the semi-conductor issues subsiding are continuing to increase, and recent Purchasing Manager Index (PMI) figures suggest lead times are also improving for other materials. Therefore, the Motor Vehicles subsector is forecast to grow by 8.1% in 2022, more than twice the manufacturing average. This growth is expected to accelerate in 2023 to 9.7%. The big push back the industry could face is the rise in fuel prices which may negatively reduce the appetite for consumers to purchase vehicles. On the other hand, this issue may also incentivise consumers to switch to electric vehicles (EVs). Employment wise, the subsector is forecast to see jobs increase by 3.5% this year.

OTHER TRANSPORT

The **Other Transport** subsector, which encompasses a combination of aerospace, defence, shipping, and rail manufacturing, was the only subsector to decline in gross value-added output last year. It was one of the main subsectors to shut down during the pandemic and has since struggled to return to growth because of changing habits among consumers as well as rising fuel costs. The latest forecast for other transport indicates another contraction is on the horizon with a -0.2% change in output predicted for 2022.

However, this figure is subject to change and can be revised in either direction depending on the state of the global economy. A return to pandemic related restrictions seems unlikely on the cards, but an increase in infections or a new COVID variant could lead to the industry declining further. In reverse, if households return to their normal patterns of travel and the economy recovers then, aerospace and shipping may see a boost. Additionally, the recent Russian/Ukraine conflict may negatively impact the aerospace industry but could see a boost to defence spending. Despite negative growth expected this year, other transport manufacturers do expect to grow its work force by 2.4% in 2022.

Sector growth rates and forecasts

% change

	OUTPUT			EMPLOYMENT		
	2021	2022	2023	2021	2022	2023
Basic metals	1.8	2.3	-1.4	0.9	-4.8	-2.5
Metal products	7.0	1.1	0.9	0.5	-1.1	3.0
Mechanical	14.6	8.1	-1.6	-3.8	4.2	2.5
Electronics	1.4	1.2	3.6	-9.7	-5.0	-0.4
Electrical	8.6	0.01	5.8	-1.2	6.3	8.5
Motor vehicles	3.1	8.1	9.7	-3.1	3.5	-2.6
Other transport	-5.6	-0.2	11.0	-5.6	2.4	0.5
Food & drink	4.2	2.8	2.8	4.6	-0.2	-0.9
Chemicals	2.0	0.5	1.0	0.3	-4.9	-3.4
Pharmaceuticals	3.7	7.7	2.1	-7.4	-6.4	-4.8
Rubber and plastics	10.9	0.4	0.4	-9.1	1.3	3.8
Non-metallic minerals	15.1	1.9	3.6	-1.4	2.3	1.9
Paper and printing	13.3	3.8	0.2	-8.4	-3.4	-2.8
Textiles	18.4	2.2	-1.6	-13.1	1.7	1.7
Manufacturing	6.8	3.0	2.8	-2.6	-0.1	0.2

Source: Oxford Economics

Source: Oxford Economics

BDO VIEWPOINT

ATTRACTING AND RETAINING TALENT WITH THE RIGHT REWARD STRATEGY

Following the record-breaking recovery experienced in UK manufacturing in 2021, manufacturers entered 2022 in a relatively strong position. However, growth is being stalled as manufacturers face challenges with rising costs and supply chain disruptions, now exacerbated by the terrible situation in the Ukraine, as well as the prolonged issue of shortages in labour and skills.

Attracting and retaining talent – particularly now in what has been dubbed the post-pandemic 'Great Resignation' – is one of the sector's greatest long-term challenges. With manufacturers struggling to keep hold of or hire the people and skills they require, what can they do to attract and retain them?

The most common way is to use financial incentives. However, on their own, an increase in money rarely leads to a long-term increase in effort and performance. The best way is likely to be through a combination of financial and non-financial incentives.

So how can businesses make best use of a considered reward strategy? We commissioned the Behavioural Insights Team to conduct an evidence-based review of the structure and design of pay and reward, and the findings were very interesting.

A FRAMEWORK FOR EMPLOYERS

Although the skills shortage is not unique to the manufacturing sector, our recent survey of 225 manufacturers told us that:

- 59% see a need to improve remuneration structures such as salaries and bonuses;
- Only 54% were utilising the government's apprenticeship scheme; and
- Only 40% have a system in place already to measure reward satisfaction.

Many employers have too strong-a-focus on monetary aspects of the employment package, especially in an industry where it is harder to operate a 'work from anywhere' or flexible policy. However, our *practical and digestible framework* outlines recommendations around salary, flexible working, pension contributions, gender and ethnicity pay gaps, and company ownership, all of which can help manufacturers consider constructive improvements to make the most of their pay and reward strategies.

Outlined below are two of the recommendations included in our report:

- Ensure clear, transparent and honest communication with employees on salary:
  - Be clear on how salary is determined, including how it relates to performance or responsibility, and what it takes to increase it.
  - Share benchmarking information – paying market rate can offer reassurance that the salary on offer is fair.
  - Be transparent – being clear about what pay is available, and whether negotiation is acceptable, can also lead to fairer salaries for women.
- Explore and understand individual differences in peoples' values and motivations to determine the most effective approach for incentivising staff:
  - Consider a survey on motivations and reward preferences to better understand what employees really value.
  - Consider offering a combination of monetary and non-monetary rewards (e.g. more training opportunities, recognition, paid leave) rather than cash alone.
  - Age can play a part too – what an apprentice or junior values is different to an older worker thinking about their retirement.

Businesses have many levers at their disposal to build and maintain the workforce they need. Each lever will have distinct cost implications and will impact employees and the whole workforce in different ways.

Download our full report to help guide you in making the most effective use of the monetary and non-monetary tools at your disposal:
https://www.bdo.co.uk/en-gb/insights/tax/global-employer-services/how-pay-and-reward-impact-employee-outcomes-framework

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IDEAS | PEOPLE | TRUST

Make UK works for the success of more than 2.7 million men and women employed in UK manufacturing. Representing member companies – from small businesses to multinationals – across every industrial sector, we are the most influential voice of manufacturing, enabling our members to connect, share and create opportunities together.

We stimulate success for manufacturing and technology related businesses, enabling them to meet their objectives and goals. We empower individuals and inspire the next generation.

We create the most supportive environment for UK manufacturing growth and success and we represent the issues that are most important to our members, working hard to ensure UK manufacturing remains in the government and media spotlight.

Our extensive knowledge of manufacturing means that we're able to influence policy-making at local, national and international levels. We push for the policy changes that our members want to see. We are the voice of manufacturing.

MakeUK.org

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The data used in this survey have been provided by UK manufacturers including members of Scottish Engineering, Manufacturing NI, and Make UK. Contributing to our surveys helps to accurately reflect trends and behaviours that shape the UK manufacturing sector. If you would like to participate in future surveys, please contact our Information and Research team research@Makeuk.org

Accountancy and business advisory firm BDO LLP is the UK member firm of BDO International, which has more than 1,600 offices in 167 countries. We operate from 18 offices across the UK, employing 5,650 people offering tax, audit and assurance, and a range of advisory services.

Manufacturing is a priority sector for BDO and this focus enables us to tailor the wide range of services we offer and apply our skills and knowledge to help clients achieve their objectives.

We provide real solutions to industry issues, utilising our capabilities in everything from sector-specific tax, audit and business advice to patent box, research and development claims and acquisition opportunities to help our clients grow in the UK and overseas.

We have an excellent understanding of the issues affecting UK manufacturers as an industry sector, but we also focus on specific sub-sectors to improve our knowledge and our service to clients. These include: aerospace, automotive, building products, chemicals and pharmaceuticals, electrical, food and drink, industrials, technology and test and measurement.

Manufacturing remains one of the key industries of the UK economy. We are delighted to be able to play an active role in supporting the businesses that operate in this vibrant, changing and challenging sector.

For further information about our business and services, please visit our website: **www.bdo.co.uk**

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