Fed battles economic slowdown as bond market challenges mount

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Executive Summary

Every year, at about this time, it becomes clear that the world is on track for a repeat of Stanley Fischer's lament when deputy chair of the US Federal Reserve in August 2014 :

"Year after year we have had to explain from mid-year on why the global growth rate has been lower than predicted as little as two quarters back."

But as with the movie Groundhog Day, there is presumably a moment when we stop repeating the cycle and move on - as Harald Malmgren, former aide to Presidents Kennedy, Johnson, Nixon and Ford now suggests:

"World markets, increasingly moving together, are engaged in a historic struggle between hope and despair, stocks elevated by central banks & equity investors, but bond holders & bond buyers preparing for market breakdown and painful global collapse."

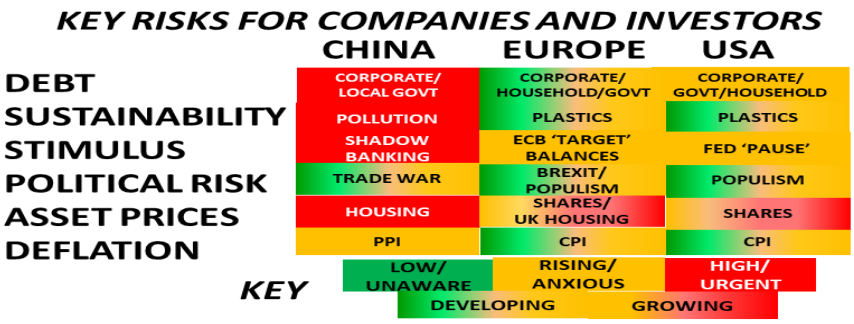
Chart 1: Bond markets have suddenly reversed track, and now expect major rate cuts

In this month's Report, we focus on this key issue and its potential impacts. As we note, chemical markets continue to suggests a slowing economy. We also remain concerned that the impact of China's deleveraging - with $2tn taken out of shadow lending since 2017 - is being ignored. And whilst we welcome the Fed's belated recognition of the risks in the corporate bond market, we do not share their view that these are relatively minor.

We also maintain our focus on the US-China trade war, highlighting the boost it is giving to the SE Asian economies and to the roll-out of China's Belt & Road Initiative. We then analyse supply-side developments in energy markets, and the potential for renewables growth to reverse the "vicious circle" described by BP - whereby more extreme weather drives greater use of fossil fuels for heating/cooling, and hence increases CO2 emissions.

Finally, we update on Brexit and the potential implication of No Deal for the Irish border, before summarising the latest outlook from our Volume Proxy Index.

World markets are engaged in a historic struggle between hope and despair



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GLOBAL ECONOMIC OUTLOOK

The Federal Reserve may not be able to restore demand growth with a wave of its magic interest rate wand

1. Recession risks rise as China deleverages

Global chemicals capacity utilisation (CU%) as measured by the American Chemistry Council continues to warn of an economic downturn. As chart 2 shows, April data showed a further fall to 83%, reinforcing the failure to sustain previous attempts to rally in May and December 2018. This weakness is also now being confirmed by a broader range of indicators, including the OECD's leading indicators as Reuters commented:

"In March, the OECD's composite leading indicator of economic activity in the advanced economies and major emerging markets fell to its lowest level since the recession of 2008/09. Since 1970, whenever the OECD indicator has fallen this low, the U.S. economy has always entered a recession, and taken the other advanced industrial economies with it."

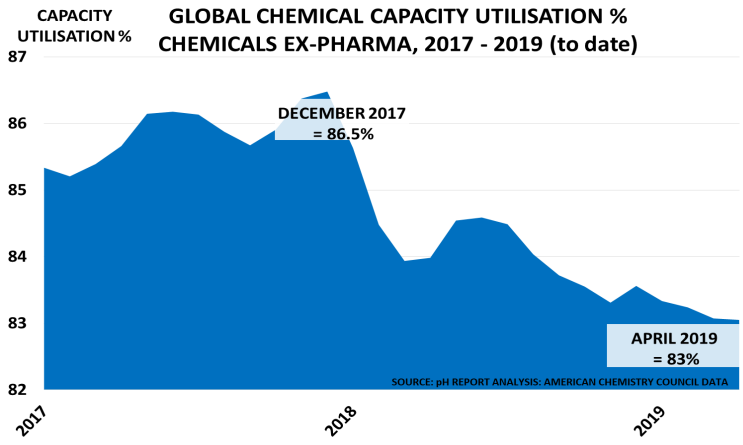

Chart 2: Global chemical CU% fell further in April

Of course, many commentators still cling to the belief that the US Federal Reserve can restore growth with a wave of its magic interest rate wand. But major financial media are now starting to confirm our concerns over the level of debt generated by the central banks' stimulus policies, with the New York Times warning that:

"Money is bypassing the traditional, and heavily regulated, banking system and flowing through a growing network of businesses that stepped in to provide loans to parts of the economy that banks abandoned after 2008. It's called shadow banking, and it is a key source of the credit that drives the American economy. With almost $15tn in assets, the shadow-banking sector in the United States is roughly the same size as the entire banking system of Britain, the world's fifth-largest economy."

China has taken $2tn out of shadow banking in 2 years

The key issue for us is that China's stimulus was the key driver for the post-2008 recovery. Therefore China's policies - not those of the Fed, ECB or Bank of Japan - are key to understanding what happens next. And so far, China is standing by its commitment to deleveraging, as China's financial newspaper, Caixin confirmed earlier this month:

"China has been cracking down on the shadow banking sector, reducing high-risk financial assets by a net 13.74 trillion yuan ($1.98tn) over the past two-plus years, the country's top banking regulator said Thursday in Shanghai."

$2tn is a lot of money to take out of the system in 2 years. And the reduction is doubly significant as financial bubbles - like balloons - need more and more air pumped into them, if they are to avoid bursting. It is therefore no great surprise that the decline in speculative lending has led to a sharp slowdown in many areas of the Chinese economy - with auto sales down 17% in May, continuing the major decline discussed last month.

Last month's official takeover of troubled Baoshang Bank has already exposed a funding crunch in the highly secretive structured bond market. And the People's Bank of China's (PBoC) restatement of total social financing data since 2017 provides further clues as to the scale of deleveraging underway, by splitting out data for "local government special bonds" (LGSB) issuance. As the PBoC has explained:

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Further evidence of China's wasteful investment in subway development is emerging

"*Local government special bonds refer to government funds issued by local governments for public welfare projects with certain income, and which are agreed to be public welfare projects within a certain period of time. Since August, the issuance of LGSB has accelerated, and there are obvious replacement effects on bank loans and corporate bonds. In order to provide comparative data since 2017 for the scale of social financing, the PBoC has restated this to include LGSBs into the statistics.*

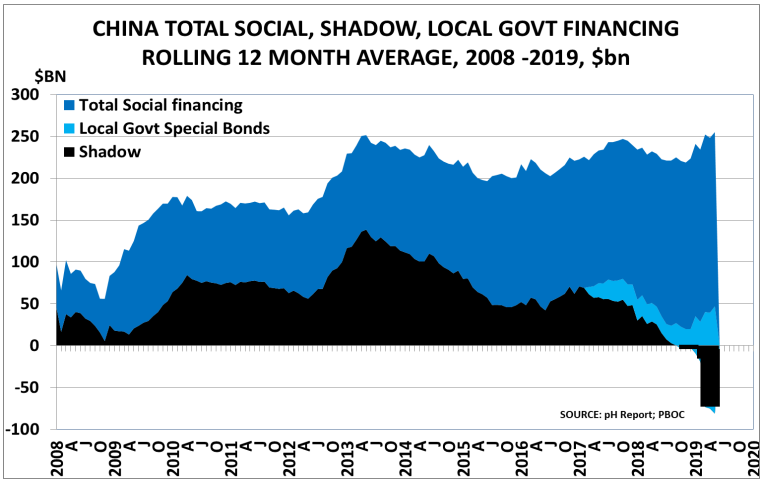

Chart 3: Traditional shadow bank lending appears to have gone negative in 2019

Chart 3 shows the effect of the restatement, using a rolling 12-month average to avoid the distortions caused by the seasonal bunching of lending data in January and quarter-ends:

- Shadow bank lending was a negative $81bn in May on a rolling 12-month basis
- LGSB volume, however, reached $128bn on the same basis

This rapid increase confirms our concerns in April (Oil market outages boost apparent demand as buyers stock up), when Caixin reported on the risk that local government debt "*is threatening to overwhelm dozens of authorities across the country".*

An example of the problems being uncovered relates to our March discussion (China's lending boost highlights debt risks) of the wasteful investment by many local governments in extensive subway systems, which now total 4600km, with further expansion still planned. As state-owned China Daily reports:

"The financial situation in operating these urban rail networks was not satisfactory. While over Rmb 600bn($86.69bn) was invested into the sector in more than 30 cities last year, only a few cities managed to break even...Only four cities — Hangzhou, Qingdao, Shenzhen and Beijing — achieved balance last year."

Deleveraging is shifting weaker borrowers offshore

China's real estate developers are finding it hard to break their borrowing habit, however, with Caixin reporting that '*Tight Credit Drives Chinese Developers Abroad for Financing*'. In turn, this seems to be leading into Stage 3 of the 'Red Arrow' Decision Tree discussed in the July/August Report (Confusion now has made his masterpiece) where we suggested:

- Stage 1. Synchronised global economy proves a dream and economy weakens
- Stage 2. The US$ and EM interest rates rise - a double whammy for their economies
- Stage 3. Rising $ pressures Chinese developers, a major can't repay offshore $ debt

As we noted then, some $2.5tn of EM debt needs to be refinanced by the end of 2019, and our conclusions over the potential impact on the Asian economies still seem to be valid:

*"**China/Asia.** Any bursting of China's housing market bubble will impact consumer spending across Asia. Much of this has effectively been financed either directly from housing market gains, or indirectly from China's shadow banking and the $9tn of Wealth Management Products where it has been the key source of funding. Companies such as HNA appear to have been heavily involved in this area at its peak. Trade wars are also likely to increase China's focus on its Belt & Road Initiative, and away from engagement*

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S&P report that the total size of the riskiest tranche of US BBB corporate debt has now reached $1tn

with the West. This could become critical if, as seems entirely possible, President Trump's deal with N Korea fails to lead to full denuclearisation."

US corporate debt risks are recognised, but downplayed

A further potentially significant development in relation to our Decision Tree is the belated recognition by US Federal Reserve chairman Jay Powell of the mounting risks in the US corporate debt market, with his warning earlier this month that:

"Business debt is near record levels, and recent issuance has been concentrated in the riskiest segments. As a result, some businesses may come under severe financial strain if the economy deteriorates. A highly leveraged business sector could amplify any economic downturn as companies are forced to lay off workers and cut back on investments."

Of course, as with his predecessor Ben Bernanke in 2007 (who suggested that any subprime crisis would only involve $100bn of losses), Powell then went on to downplay the absolute level of risk, suggesting corporate debt:

"*Does not appear to present notable risks to financial stability...and overall funding risk in the financial system is moderate.*"

But this depends on whether one sees risk as being essentially in silos, where a default in one area has no meaningful impact on adjacent silos.

2008, however, provided a good illustration of the potential for contagion, with subprime loan defaults leading to a near-collapse of the western economy, as lenders worried that collateral was disappearing. 2008 was therefore a liquidity crisis *and* a solvency crisis. Today's problem is that policymakers have only addressed the liquidity issue, and refused to recognise that this was actually created by a solvency crisis.

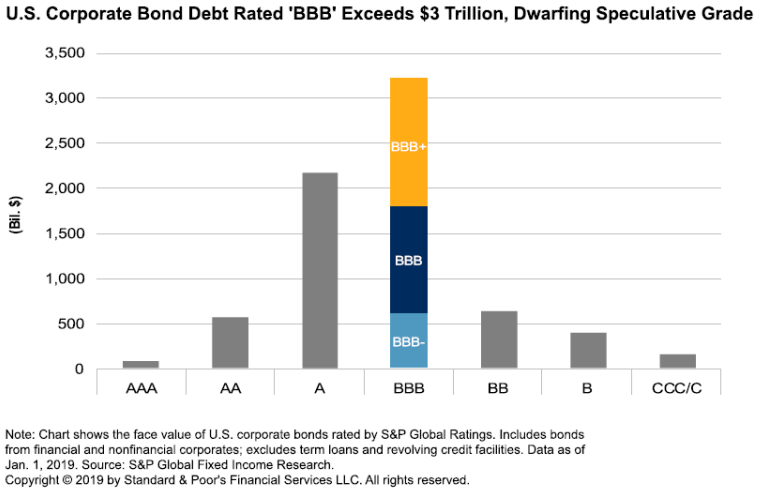

Chart 4: S&P report the lowest investment grade of US corporate debt exceeds $3tn

Chart 4 highlights the scale of the risk that this blindness has created, with S&P reporting that BBB grade debt, the lowest grade in which most funds are allowed to invest, is now more than $3tn, with 19% of this total ($579bn) in the very lowest BBB– grade. And this BBB– total jumps to $1tn if one includes financial sector debt. S&P also report that global BBB debt is now $7tn, with US companies accounting for 54% of the total.

The problem is that BBB- debt becomes speculative debt if it is downgraded by just one notch to BB grade. And most investors are then forced by their mandate to sell their holding in a hurry, creating the potential for a vicious circle, as the most liquid bonds will inevitably be sold first. In turn, this creates the potential for a "waterfall effect" in the overall bond market - and to contagion in the stock market itself.

Most investors complacently assume that the Fed's promise to support the economy will avert this risk. But as we note in the Financial Markets section, some chemical company stocks have decoupled from this optimism, and may be acting as an important warning indicator of potential problems ahead.

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FINANCIAL MARKETS

Some chemical industry shares have decoupled from the S&P 500 bubble as downside risks become clearer

2. Chemical stocks warn of deflation and downside risk

The chemical industry's role as the best leading indicator for the global economy is becoming more widely accepted. Now, there are some signs that chemical industry shares are also starting to reflect a more realistic view of the economic outlook, compared to the stimulus-led bubble that has developed in the S&P 500 and other major indices.

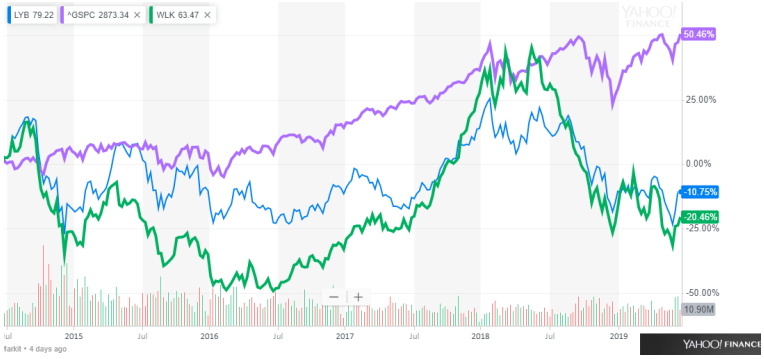

Chart 5: Shares prices for LyondellBasell and Westlake have diverged from the S&P 500

Chart 5 confirms that some chemical industry shares - for example LyondellBasell and Westlake - have decoupled from the S&P 500 over the past year. While the Index has raced ahead, following Fed Chair Powell's reassurance in January and earlier this month that the Fed was prepared to cut interest rates, shares linked to the growing downside in US shale gas-related ethylene/polyethylene expansions have moved in the opposite direction, in line with the sharp downturn in ethylene margins shown in Chart 6 from ICIS.

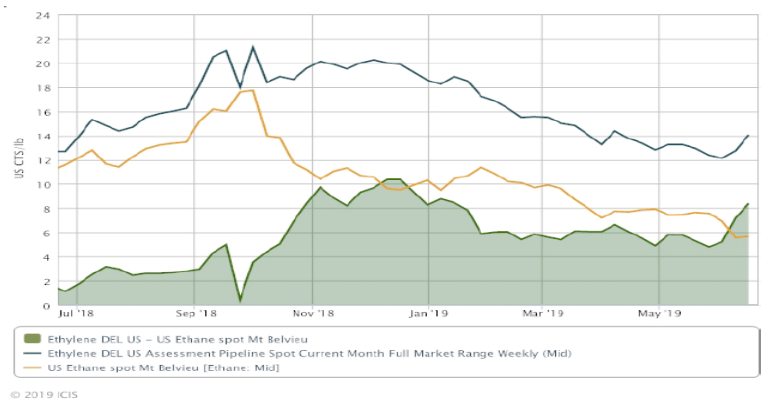

Chart 6: The narrowing gap between US ethane and ethylene prices has reduced margins

The chart also highlights the key risk to the US Fed's rosy scenario, that interest rate reductions may not always be able to support the financial economy. Investors are probably correct with this assumption as long as they can count on inflation to generate at least nominal GDP growth. But they will have an unpleasant wake-up call if it turns out that the key risk in 2019 is deflation rather than inflation , as we noted in January:

"*Given China's outsize role in the global economy, it is not hard to imagine that global deflation is a distinct possibility if we do now see a global recession. This outcome would, of course, completely undermine the belief that central bank stimulus policies had conquered the deflation risk. And it would focus attention instead on the risks generated by the debt levels they have created:*

- *The growth of Triple B ratings already implies a greater risk of default in a downturn*
- *The "zombie companies" identified by the BIS will be at major risk of default, as we warned In January 2018 (US PE expansions face 'moment of truth' as volatility rises):*

"A BIS analysis of companies over 10 years old shows over 10% of EU/UK firms, and over 15% of US firms are "zombies" – who rely on rolling over loans as their interest bill exceeds their EBIT. They are most likely to fail as liquidity starts to dry up" .

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Chemical industry share prices may be becoming a leading indicator for the wider market

Chart 7: German bond yields are now almost all in negative territory

This same message is also being signalled by global government bond markets, where over $13tn of bonds now have negative yields. As chart 7 from Bloomberg shows, in the German market only the 30-year bond is now, marginally, above negative levels.

Why is this happening?

Our experience is that many chemical companies have greatly improved their internal information systems since 2008, and there is a greater willingness amongst senior executives to challenge the "rosy scenario" views of Wall Street. One key factor is that they are less reliant on the appearance of the order book as an absolute guide to demand, as agility has become recognised as a key factor in a less predictable world.

Companies' communication has also improved, with Investor Relations departments no longer seeing their role as being to boost the share price in the short-term. Instead, there is a growing awareness that encouraging greater realism amongst analysts is now key to longer-term investor satisfaction.

Companies typically make formal adjustments to outlooks and guidance primarily at earnings announcements. By exception, *ad hoc* announcements will be made, to reflect changes in business outlook – particularly the dreaded profit warning. But it is clear that IR departments are increasingly using their informal discussions with analysts to nudge consensus estimates closer to reality - always, of course, within legitimate parameters.

The evidence for this can be seen clearly from the extent to which companies 'miss' or 'beat' estimates in quarterly results. In the past, analysts estimates at, say, the clean EBIT level, could easily differ from the 'actuals' by 5% to 10% in a company with substantial commodities exposure. These days, such companies rarely 'miss' by more than 3%.

Why might this matter?

This greater realism has at least 3 key potential implications:

- Chemical company share prices are better reflecting underlying operational outlooks
- These operational conditions are a key monitor for global economic conditions
- Share prices may therefore be become a leading indicator for the wider market

Given the concerns over corporate debt discussed above in the Economic Outlook section, this new realism may turn out to be providing an important signal for all investors, and not just for those interested in chemical industry stocks.

The decoupling now evident between some major chemical company shares and the S&P 500 suggests that the real economy is far more vulnerable to downside risk, and deflation, than most investors, and the Fed, seem willing to recognise.

Some investors, after all, have also begun to recognise that there is a rising risk of defaults amongst over-leveraged BBB rated companies - for example, in the shale sector, where the Fed's zero-interest rate policy encouraged investors to place huge bets on the outlook without bothering to analyse fundamental supply/demand balances.

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CHINA

China is offshoring more of its polluting and labour-intensive industries

3. Trade wars accelerate Belt & Road Initiative

With Presidents Trump and Xi meeting at the G20 in Tokyo at the end of this week, it seems possible that some form of truce may be agreed in the trade war, and perhaps an agreement to avoid imposing new tariffs. But behind the scenes, the key topic will be the Huawei question, as this involves the critical issue of the technology race.

We therefore maintain a cautious approach as it is now more than a year since the first US import tariffs on Chinese-origin goods, and it is clear that these are having a permanent impact on manufacturing, on supply chains, and on trade routes. Many manufacturers, both Chinese and foreign, have moved some or all of their manufacturing out of China, or have moved final product assembly using Chinese-made components offshore. Apple is just the latest company to confirm that it is examining its options in this area.

SE Asia countries are the main 'winners' from this paradigm shift, particularly lower-wage countries such as Vietnam, Cambodia, Indonesia and even Laos and Myanmar. This might seem to be bad news for the Chinese economy, and undoubtedly there will be a short-term impact. But as chart 8 illustrates, the main effect is to accelerate the development of the Belt & Road Initiative (BRI), and allow China to mitigate its own demographic deficit by accessing the demographic dividend of younger people available in the BRI countries.

As of today, the main focus is on offshoring low-level manufacturing industries such as textiles and footwear. These are often polluting and labour-intensive, and the move therefore also helps China to accelerate the achievement of its core strategic goals of (a) reducing domestic pollution and (b) moving up the value chain towards a more service-based economy, and away from being the 'manufacturing capital of the world'.

Chart 8: The trade war is accelerating the move of less attractive industries into younger countries

Nobody ever "wins" a trade war, contrary to President Trump's belief that "trade wars are good and easy to win". The growth of global trade has, after all, been a key contributor to economic growth since 1945, as chart 9 from Our World in Data confirms. But for the moment, at least, countries in SEA are becoming winners:

Indonesia: Footwear exports to the US rose by 6.7% in January - April, the largest increase ever, whilst Chinese exports dropped 1%. Analysts expect total 2019 exports to rise 23% versus 2018. to a total of US$ 6.5bn. Batam, the free trade zone, is also doing well, based on being an hour's ferry ride from Singapore. Pegatron is moving its iPhone assembly company there from China, whilst Philips has also established a major plant there, for production of products such as shavers and irons.

Vietnam: As the South China Morning Post noted recently, the trade war is "*the gift that keeps on giving for Vietnam*", with the country seemingly set to gain the largest benefit from it. Nomura estimate that so far it has boosted the economy by 8%, with foreign investment rising 69% in January-May to a 4-year high of $16.7bn, with Chinese investment accounting for half of that. Recently Intel, Samsung and LG have all made very substantial investments in the country.

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We expect rivalry between the 2 superpowers to continue intensifying, no matter what happens at the G20

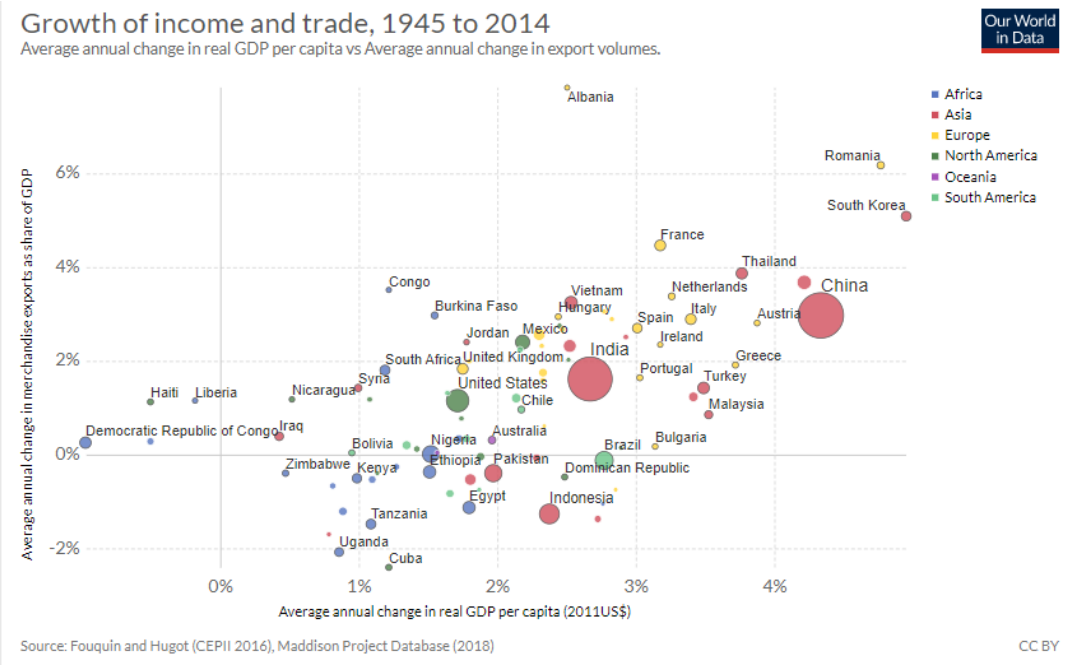

Chart 9: There is a strong correlation between global trade growth and economic growth

The manufacturing move from China to Vietnam has been so sudden, that it has led to unexpected bottlenecks at ports, and major traffic jams on important routes. Prices for industrial land have also exploded, while skilled labour is harder and harder to find.

Cambodia: Developments in Cambodia highlight the complex rules that have to be negotiated to become a winner, with companies exporting to the US from the Sihanoukville Special Economic Zone being fined, due to it being a Chinese-Cambodian JV. But generally speaking, Cambodia is also a major winner, particularly in the apparel area, due to its traditionally close relationship with China. It also signed a US trade agreement in 2016 that allowed duty-free exports of suitcases, handbags, backpacks, wallets etc

The US-China trade dispute will continue as rivalry grows

Our view remains that the rivalry between the two super powers is likely to continue intensifying, as this is a symptom of the 2 countries' desire to dominate global technology markets - which are likely to be key to future economic growth. In turn, this rivalry will continue to drive the shift of manufacturing from China to SE Asia - and probably to other BRI countries in due course.

This offshoring will support China's ability to access the demographic dividend available from the much younger populations within the BRI. But it is unclear whether it will create similar mitigating benefits for the USA.

Certainly some supply chains will relocate as President Trump hopes, but in many areas the necessary skill-base will first have to be recreated, as Deloitte's 2018 Report on the skills gap and future of work in manufacturing confirmed. This will require long-term investment in retraining and education, to parallel China's planned $1tn investment in the BRI. But so far, there are few signs that this has been understood in either the White House or Congress.

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OIL MARKETS AND SUSTAINABILITY

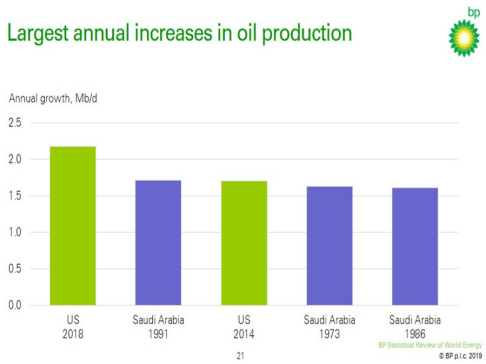
Renewables continue to see exponential growth

4. Oil and renewables production see rapid growth

BP's latest Statistical Review of World Energy provides little comfort for those who see supply shortages leading to higher prices in the next few years. As chart 8 from the Review confirms, the US has now seen 2 of the 3 largest-ever annual increases in oil production since 2014. In turn, this contributed to total world oil production increasing by 2.5mbd, more than double the average 1mbd rate seen before shale began to take off.

At the same time, renewables in the form of solar and wind have continued to grow exponentially, up by 14.5%, as chart 10 illustrates. Last year, China installed more capacity than the whole of the OECD area. Clearly, renewable technology will become a major export opportunity for China, although as the Wall Street Journal's Russell Gold notes in "SUPERPOWER: One Man's Quest to Transform American Energy":

"The US has massive amounts of inexpensive wind and solar in the middle of the country."



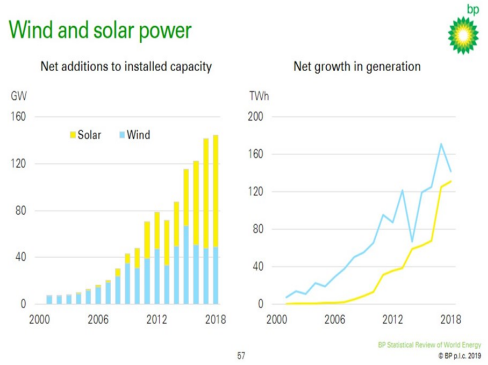


Chart 10: Oil production saw a major increase in 2018 Chart 9: renewables grew exponentially

More than 2/3rds of global energy demand growth last year was due to demand in China, India and the USA - with weather effects playing a large part in the rise (via increased heating/cooling days). This underlines BP's concern that the world could enter a vicious circle of more extreme weather leading to greater energy use and CO2 emissions.

Renewables could, however, create a more virtuous circle given they are now 9% of electricity production in China and 8% in India, and solar/wind prices are falling at double-digit rates. Their solar output rose 51% and 43% respectively in 2018, suggesting output could now double every 2 years. Renewables growth could then start to out-strip electricity demand growth by c2024, causing fossil fuel demand to begin a rapid decline.

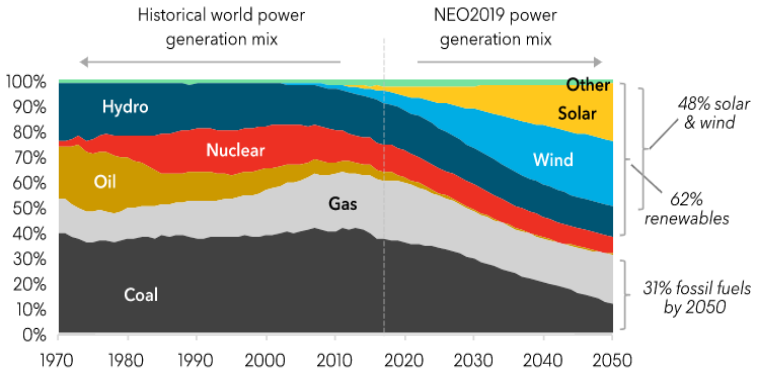


Chart 11: Bloomberg expect wind and solar to be c50% of global electricity output by 2050

Chart 11 from Bloomberg New Energy highlights how power generation patterns are now changing very quickly. And UK electricity market developments confirm the same trend:

- Coal was responsible for 40% of UK electricity production in 2013
- 3 years later, the UK went without coal for one complete day for the first time
- So far this year, coal has supplied just 2.3% of UK generation

Over-supply in energy markets therefore seems the most likely outcome in the next few years, but whether the world can avoid a continuing vicious circle remains to be seen.

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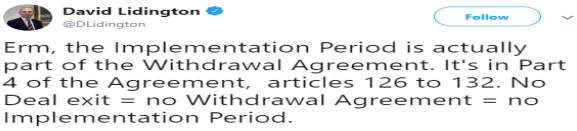
BREXIT

Facts have become more or less irrelevant in the Tory Party leadership debate

5. Johnson's election 'reality show' distracts Brexit debate

Most people in the UK seem to have "switched off" from the Brexit debate, as instead they follow the daily "reality show" fronted by Boris Johnson as he campaigns for the Tory leadership. Few would have imagined, even a few weeks ago, that the UK's deputy prime minister would have had to issue a corrective tweet to the country's likely future premier:



Lidington's intervention highlights how facts seem to have become more or less irrelevant to the candidates, especially since Johnson has now committed to leaving the EU on 31 October, with or without a deal. Understandably this has led Donald Tusk, President of the EU Council, to suggest the UK is in danger of "wasting" the extension granted in April.

Similarly, the Institute for Government has warned it will be difficult for Parliament to block a No Deal exit on 31 October, given that it will break for the summer two days after the new leader is announced. After that, there are "*little more than 20 Parliamentary sitting days from September to end of October*". But nobody seems to care.

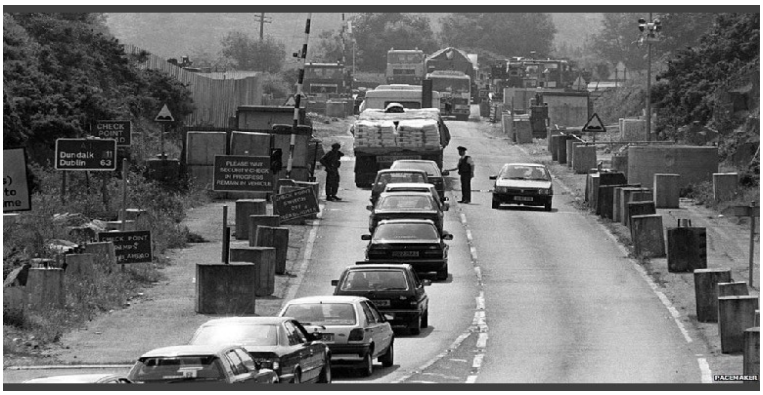


Chart 12: A return to border checks between Ireland and N Ireland looks increasingly likely

One casualty of this fact-free debate is the likely impact of a No Deal Brexit on the Irish border, which would need to have physical barriers restored to protect the integrity of the EU Single Market. Understandably, this has alarmed N Ireland's Freight Transport Association, who have analysed the likely impact on the main A1 Newry-Dundalk border:

- *"The average delay time on the Sweden-Norway border for trucks is 10mins, because although Norway is in the EU Single Market, it is not in the Customs Union*
- *The A1 crossing at Newry/Dundalk is currently a frictionless efficient strategic road*
- *Over the 24hr period of Wednesday 5 June 2019, 8,390 Goods Vehicles crossed the border. 4,022 (avg 167 per hour) went into Ireland ie EU avg 1 every 35 secs*
- *Approx 1,300 carried agri-food which would be subject to sanitary (SPS) checks*
- *In morning peak time from 06.00 - 09.00, this equates to 347 lorries carrying agri-food, or one every 32 seconds.*
- *SPS checks involve stopping for Doc & ID checks + up to 50% physical inspections*
- *SPS checks can last 10 - 30 mins, a lot longer if tests required.*
- *If an A1/N1 Border Inspection Post has a 1 hour delay for traffic at peak times, then within that hour there could be a backlog of 70 Goods Vehicles awaiting processing*
- *This is where problems get even worse: - a queue of 70 trucks on the A1 would be over 1km long - the running cost for a HGV is £1 per minute*
- *The delivery window for perishable goods to Distribution Centres is 45min*"

It is hard to imagine any UK government would seek to inflict this disruption on a key part of the economy. And even more unimaginable that it would take the risk of the new border posts becoming again a magnet for terrorist attacks. But the evidence of the Johnson leadership campaign and its supporters is that nobody cares - becoming prime minister is seemingly all that matters. What will happen after No Deal is no longer being discussed.

On this basis, we continue to fear that No Deal remains the likely end-point - unless senior Tories vote with the Opposition to refuse a Confidence vote to a new Johnson government.

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VOLUME PROXY

Petrochemical buyers seem reluctant to build precautionary inventory as Middle East tension rises

6. Buyers remain on the sidelines as demand disappoints

Our own Volume Proxy continues to confirm the downbeat message from the Capacity Utilisation data, as Chart 13 confirms. In more normal times, oil markets would have reacted strongly - at least on a short-term basis - to the recent escalation in Middle East tension. And buyers would have decided it was sensible to add at least a modest volume to their inventory, just in case prices started to rise and supply tighten. But so far, they have only brought inventory back to more normal levels, rather than adding to it.

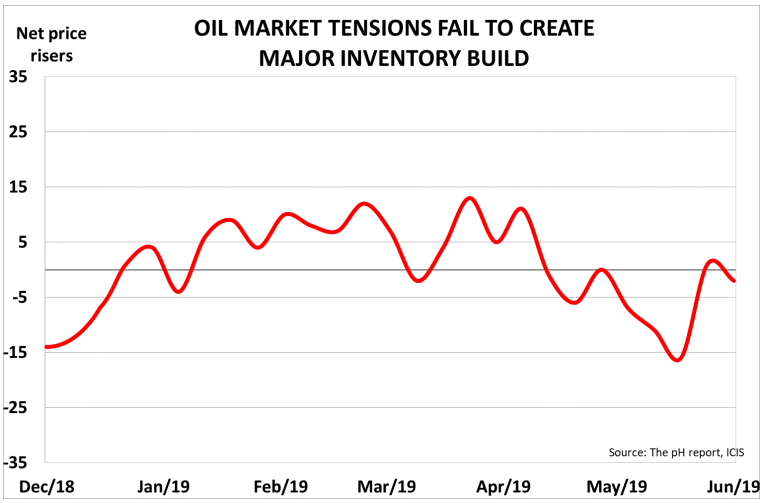
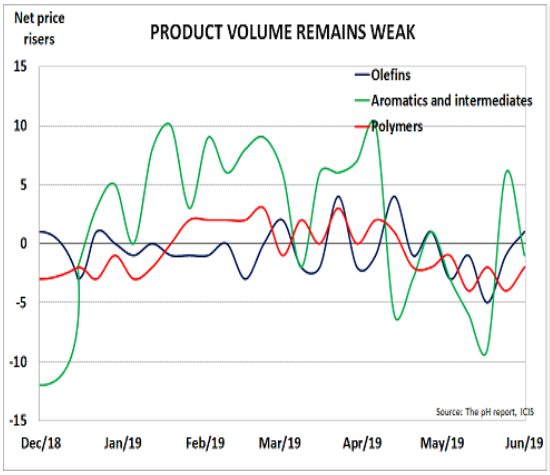


Chart 13: Buyers seems to see no need to build precautionary stocks

- Demand has rebounded modestly since the escalation of Middle East tension
- It is still weak by comparison with normal seasonal strength in Q2
- Q3 risks seeing a new slowdown as buyers prepare for holiday shutdowns



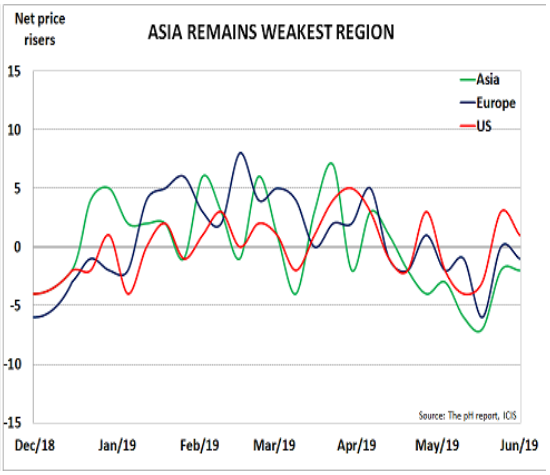


Chart 14: Polymer demand remains very weak *Chart 15: Asia shows no sign of recovery*

The most striking feature of the Products chart 14, is the downturn in the aromatics area:

- Normally aromatics would be most responsive to any oil price excitement
- But it has actually turned downwards again, with olefins also cautious
- Polymers, closest to the end market, remain very weak

A similar pattern can be seen in the Regional chart 15, with all 3 regions turning down:

- Asia remains the weakest region, confirming the Chinese slowdown
- Europe has also turned down, with buyers downbeat over end-user demand
- The USA has also now turned down, despite the prospect of new interest rate cuts

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About The pH Report and IeC

The pH Report is published by IeC, a London-based strategy consultancy advising Fortune 500 and FTSE 100 companies, investment banks and fund managers.

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