IeC Budget Outlooks 2007 - 2019
October 2019

Paul Hodges +44 (0) 7785 354809, phodges@iec.eu.com

CONTENTS

Executive Summary 1
2007 2
2008 2
2009 3
2010 5
2011 6
2012 8
2013 9
2014 11
2015 13
2016 14
2017 16
2018 21
2019 23
About The pH Report 25

Executive Summary

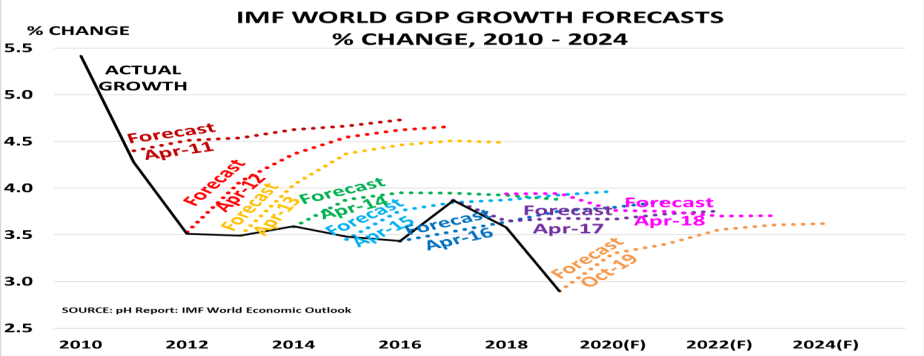


Chart: IMF growth forecasts have been over-optimistic since 2007

This year's Budget Outlook suggests it is prudent to prepare for a New Normal - which will see paradigm shifts and a debt crisis take centre stage. As we have discussed in previous Outlooks, these developments have been inevitable for some time, as a result of policymakers' failure to understand the magnitude of the demographic changes now underway, and their belief that stimulus could allow them to overcome this issue by effectively "printing babies".

One key question has always been around the timing and the potential implications of these developments, and we set these out this year. Another is how did this potential disaster develop, with all the risks for economic and social stability that it creates? To answer this question, we have assembled the Budget Outlook posts that we have published in October each year since 2007. They show it was by no means inevitable, had more realistic policies been adopted.

- **The Outlooks start in 2007 by forecasting the major financial Crisis.**
- **In 2008, they provided advice on how best to survive it, and in 2009 argued policymakers should 'take the pain' of adjusting to the New Normal of lower growth, created by globally ageing populations.**
- **2010 focused on the Uncertainty surrounding future demand; 2011 on the impact of Austerity; and 2013 on the L-shaped recovery.**
- **2013 highlighted how policymakers had created a VUCA world of Volatility, Uncertainty, Complexity and Ambiguity by ignoring the New Normal.**
- **2014 focused on how this failure had created a Cycle of Deflation.**
- **2015 focused on the need to anticipate a Great Unwinding of stimulus.**
- **In 2016 we argued that the Great Reckoning was now about to begin.**
- **In 2019, we suggest it is prudent to prepare for a New Normal**

IeC has won a reputation for independent thinking since it correctly forecast in the Financial Times and elsewhere that the US subprime market would cause a major financial crisis.

These Outlooks represent an ongoing example of our continued ability to see beyond the consensus viewpoint, and to highlight the key issues for the future.

© The pH Report 2019

2007. Budgeting for a Downturn

By **Paul Hodges** on 22 October, 2007

The 'consensus forecast' for 2008 is very optimistic, as I commented in my post-EPCA note. It says oil will remain at $70/bbl, that debt market problems will be contained, and margins will remain at 2007 levels. This is unusual, as the consensus is normally a base case scenario, with upside and downside variants.

And since EPCA, oil has already increased to around $90/bbl. Back in early July, when it was still 'only' $70/bbl, I noted that it had the potential to approach $100/bbl, and this still seems a real possibility. In these circumstances, it is perhaps no surprise that we are seeing an apparent 'boom' in demand, as downstream consumers rush to cover themselves before product prices move higher.

I first saw this effect happen in 1979, when the industry had a record year. It was only in 1980 that we discovered that the apparent ease with which the economy had weathered a rise in the oil price to $30/bbl (around $95/bbl in today's money), was a mirage. Could the same be happening today? I think it is worth considering very carefully as a possibility.

After all, whilst history never repeats itself, the underlying position in financial markets is clearly deteriorating. Bank of America (the 2nd largest US bank), came out with truly shocking Q3 results on Thursday, whilst on Friday Caterpillar's CEO Jim Owens said the US was already 'near to, or even in, a recession'. And new housing starts and US house prices were already very weak, even before the recent credit crunch.

There must surely be a real possibility that this latest upward rush by the oil price will be the catalyst that finally causes the US consumer to cut back on non-essential spending. Equally, the continuing problems in the banking sector may well turn off the tap of consumer, and maybe even corporate, lending.

If I was drawing up budgets for 2008, I would be putting in place contingency plans for just such an outcome, even whilst crossing my fingers that I would not have to use them.

2008. Budgeting for Survival

By **Paul Hodges** on 19 October, 2008

I prefer to be optimistic. But 30 years in industry has taught me to be extremely realistic. So my motto for 2009 Budgets is 'batten down the hatches'.

Companies are likely to be sailing in some very rough seas, with treacherous currents and plenty of dangerous rocks. Survival, not growth, is therefore the prudent objective.

The key question is whether your business is robust enough to survive an extended period of low volumes and margins, against a background of tight credit markets, and continuing volatility in oil and currency markets?

Companies therefore need to change their 2009 budget process in response to this challenge. Normally, they would develop a 'base case', and then investigate 'upside' and 'downside' scenarios. This year, companies should instead focus on the key variables around their survival Budget, so that they are prepared for most possible outcomes.

Demand. 2009 is likely to see global recession (less than 3% GDP growth). Chemical demand will be badly hit, as it is focused on consumer spending, particularly housing/construction and autos. Hopefully, these areas may begin to bottom during 2009, but any real recovery is unlikely before 2011. Housing is at the

heart of the current economic crisis, and it is hard to see demand recovering quickly. Unemployment is likely to rise, and banks will be reluctant to lend when house prices are still falling. Auto sales will also be weak, for similar reasons. Even companies selling into more favoured sectors, such as agrochemicals or pharmaceuticals, will probably see lower demand, and pricing pressure.

Oil prices. I have correctly forecast every major movement in oil prices over the past year. This makes it easier to admit that I find 2009 very difficult to predict. The most likely outcome is that OPEC will cutback production and seek to hold $70/bbl. But there are risks to this outlook. OPEC is bringing on major new production. Cutting production will also unleash a political storm. So OPEC will find it hard to make major cutbacks, and prices could temporarily fall as low as $20/bbl, if the global recession proves deep. Yet supply/demand balances remain very tight. Surplus production is only c6% (5mbd). So a relatively small disruption could easily cause prices to rocket above $100/bbl again.

China and Asia. I am most concerned about likely levels of demand in this area. China's exports were 37% of GDP last year. These volumes will inevitably decline whilst the west is in recession. And although some governments do have the financial reserves to respond by stimulating their domestic economies, many do not. Major over-capacity is also developing in the main 'building block' petchem products, which will pressure prices and volumes. Most forecasters suggest that 8% growth could be the low for China's economy, compared to the 10%+ seen in the past decade. I worry that it could fall to 5% at the eventual bottom of the cycle. This would have serious implications for the region.

Credit. Governments have just spent $3.5 trillion to rescue the global banking system. I believe they were right to do this, as otherwise the world faced a certain Depression. But governments will have to fund this spending, and so will 'crowd out' other borrowers. As a result, credit is likely to remain tight, causing major problems for some companies. In turn, the chemical industry's well-known inter-dependency means that there is a serious risk of a domino effect, whereby the collapse of one company brings down others in the value chain. We are already seeing this occur amongst suppliers to the US auto industry, with multiple collapses taking place as one company goes under. Those exporting or importing will also have to manage continuing currency volatility. CFOs will need maximum support from their commercial colleagues, in order to correctly identify and manage these risks.

By now, you may be asking whether I see no 'silver lining' amidst the storms I am forecasting? Indeed, cash -rich companies will certainly find themselves in a powerful position to negotiate better terms, and to undertake M&A. But I would be cautious about M&A opportunities. 2009-10 is not likely to be a repeat of 1997-8, or 2002-3, when there was a strong rebound. Therefore I would suggest that any opportunity, or 'rescue', should be assessed against the possibility that we are now in a multi-year recession which may last to 2011-12.

Last year, I challenged the consensus, correctly forecasting the 2008 downturn. Today, I certainly hope that this 2009 forecast will prove too pessimistic. Its aim is to provide CEOs and business managers with a realistic scenario, so you can 'test' your own thinking. I welcome debate on these key issues, and will be happy to provide further advice on the practical issues raised by the analysis.

2009. Budgeting for a New Normal

By **Paul Hodges** on 17 October, 2009

2010 should be a better year as demand grows in line with a recovery in global GDP.

But a quick V-shaped return to the 2003-7 Boom years in terms of volumes/margins seems unlikely.

Governments will worry about budget deficits, and may well scale down support for critical end-uses such as autos and housing. Equally, major amounts of new capacity, planned during the Boom years, will start to

come onstream in the Middle East and Asia.

In effect, therefore, 2010 will be a year of transition to a 'new normal'. I expect global GDP growth rates to average around 2.5%- 3% for the next few years, the 1980-2000 average. This will be a significant reduction from the 3.5%-4% levels seen in the Boom years.

The rationale for this change is that we will start to see a rebalancing of the global economy.

The West will see lower consumption, as people rebuild their savings, and borrow less. In turn, this will mean lower export demand for the emerging economies. The outcome will be a more sustainable world economy, but it will be a difficult journey.

Growth Forecasts. Most markets are mature, and growth rates are therefore tied to GDP. I would therefore suggest that companies review their forecast growth rates for individual businesses in the light of their expectations for global GDP growth. One of the problems of the Boom years was that arbitrary growth rates (often of 5% or more), were assumed for many products. This also led to a perception that major amounts of new capacity were needed to meet this assumed demand. A more realistic view of demand would highlight potential problems of over-capacity, and perhaps encourage companies and governments to address the problems this will bring.

Demand. On a global basis, chemical output is now back at 2006 levels, having lost 3 years of growth. If GDP now grows as I expect, then demand from key sectors such as construction/housing, autos and electronics should improve next year. But the impact of government stimulus measures will make for a bumpy ride. The end of specific measures will cause major falls in perceived demand, whilst new stimuli will create short-term upward fluctuations. Excellent supply chain management will therefore be required, and Boards will need to keep a very careful eye on underlying trends.

Protectionism. Unemployment is set to become a key political issue in the West, as economies adjust to the 'new normal'. Hopefully, it should peak in 2010, but is unlikely to quickly return to previous levels. Arguments about the 'export of jobs' will therefore increase, and lead to a rise in anti-dumping activity. In turn this will cause job losses in emerging economies. Chemical companies will need to keep a close eye on the political arena, as they operate in a complex value chain, and may not otherwise appreciate the potential impact of a development in a key supplying or consuming industry.

Credit issues. A recovery in demand puts great strains on cash-flow, and many companies go bankrupt as a result. This could be a particular problem in the current recovery, given the underlying fragility of large parts of the banking system. CFOs will need to institute robust monitoring mechanisms, and be prepared to keep customers on 'cash before delivery' terms if they have grounds for concern. New customers represent a particular risk, if their credit history is weak, even though their promised volume may be attractive.

Oil prices. These are likely to remain volatile in 2010, as speculative price movements linked to traders' bets on the US$'s value will continue. Neither $100/bbl, nor a return to $40/bbl, would be a great surprise on a day-to-day basis. But underlying supply/demand balances may well remain weak in 2010, in spite of the expected economic recovery. Thus we might see prices coming under more pressure during 2010. $50/bbl might be an average price, in the absence of major geo-political events.

Overall, I expect 2010 to be a transition year. Full economic recovery is unlikely to take place much before the 2011/13 timeframe. But the return of economic growth will offer companies the opportunity to identify likely future market needs. Those that focus on this new reality, rather than simply hoping for a quick return to the Boom years, will position themselves for future success.

2010. Budgeting for Uncertainty

By **Paul Hodges** on 23 October, 2010

SCENARIOS 2011-13

BASE CASE	GLOBAL GDP 3% AVERAGE, OIL $60-80/bbl OIL, CONTINUED FINANCIAL MARKET VOLATILITY
UPSIDE CASE *Inflation returns*	GLOBAL GDP >3.5% AVERAGE, OIL >$80/bbl, RECESSION BOTTOMED 2009/10, THEN RECOVERY
DOWNSIDE CASE *Deflation emerges*	GLOBAL GDP 2.5%, OIL PRICE <$60/BBL BANKING SYSTEM UNDER MAJOR STRAIN

REGIONAL DIVERSITY

G7 ECONOMIES DEMOGRAPHICS WILL LEAD TO LOWER GROWTH
BRIC/EMERGING ECONOMIES THEREFORE NEED GREATER DOMESTIC FOCUS

THE 'JOKERS'

GEO-POLITICS, DEBT MARKETS, US $: €, PROTECTIONISM, EUROZONE PRESSURES, CHINA DEVALUATION

When elephants fight, those around them need to be cautious. And this is the prospect for 2011-13, as the Western countries try to force the BRICs (Brazil, Russia, India and China) to export less and import more, the so-called 'rebalancing' strategy.

Thus Budgeting for Uncertainty seems the right title for my annual Outlook for the chemical industry. Key factors that will contribute to this uncertainty include:

The USA is aiming to rebalance the world economy by forcing the BRICs to reduce exports and instead focus on expanding domestic demand. This proposed rebalancing represents a major change from the past 20 years of export-driven development by the emerging economies, and will not be achieved overnight.

Europe is making a 180 degree shift in policy, by abandoning previous efforts to stimulate its economy. It is instead planning to achieve budget balances by reducing spending and increasing taxes. It is also lining up alongside the USA in hoping to increase its exports to the BRICs, whilst reducing imports from them.

The BRICs themselves are between a rock and a hard place. They were not the cause of the financial Crisis, but they are the ones on whom the major burden of adjustment may fall. The principal instrument of change will be the exchange rate, as the West aims to force China and others to revalue their currencies quite sharply.

These macro factors clearly raise more questions than answers. Even the issue of timescale is unclear, with the US suggesting it might take a full Budget cycle of at least 3 years for real changes to be observed. Plus, of course, there is absolutely no guarantee that the West will get its way, or that the whole exercise may not end in tears.

On the other hand, everything might go extremely well, with a renewed burst of co-operation as seen immediately after the Lehman collapse in Q4 2008. If the G20 Group of the major economies really worked together, then demand could easily be stronger, rather than weaker.

My view is that Scenario planning is the only solution when faced with so many different variables. The idea

is to establish a Base Case, and then develop Upside and Downside Cases which are reasonable projections of what might happen if everything went very well, or very badly. My own effort to help kick-start this process is shown in the chart above:

BASE Case. This suggests we will see global GDP growth of 3%, with oil staying in the $60 – $80/bbl range of the past 18 months. We will still see financial market volatility, but no major collapses. It is the classic 'muddle through' type of Scenario.

UPSIDE Case. This assumes that the G20 achieves a 'grand bargain' to rebalance the world economy, allowing GDP to grow at above 3.5%. Inflation would probably become a major issue under this Scenario, causing oil prices to move above $80/bbl.

DOWNSIDE Case. Instead of increased international co-operation, countries put their own interests first and adopt beggar-my-neighbour policies. GDP growth would probably fall to 2.5%, and the oil price below $60/bbl, with the banking system under major strain as Deflation took hold.

The slide also suggests a number of 'Jokers' that companies may want to consider. These include changing demographics, such as the ageing of the Western baby-boomers. And, of course, one can never ignore the potential impact of geo-political events, such as a bombing of Iran's nuclear plants, or new tensions with N Korea.

Of course, it would be possible to simply adopt a Base Case Scenario, and assume that this will work out. But the chances of this occurring are probably less than 50%, so it would be highly risky. Instead, I would strongly recommend businesses to adopt a version of the above framework, using their own ideas for Base, Upside and Downside Scenarios.

By adopting this process, businesses can then test out key assumptions in advance. They can also develop mitigation strategies, in case events begin to diverge from the Base Case view. As always, I will be very happy to advise on the process, if this would be helpful.

2010 has been a surprisingly good year for many companies. We can certainly hope that current performance will continue, but hope is not a strategy.

Scenario planning will give businesses the chance to adopt the wisdom of the Scouting movement. Its motto, *'Be Prepared'*, seems the best possible approach in today's increasingly uncertain New Normal environment.

2011. Budgeting for Austerity – the Challenges and Opportunities

By **Paul Hodges** on 25 October, 2011

The 2012-14 Budget period offers great opportunities, as well as great challenges.

In the short-term, the challenges may well seem more important.

But they should not blind companies to the fact that the opportunities have probably never been greater.

Of course, it is hard to be very optimistic about the shorter-term outlook for the global economy and chemical demand:

Oil prices are at levels that have always led to recessions in the past

Western governments are cutting back on spending and raising taxes

- Emerging economies are raising interest rates to contain inflation
- Individuals are suffering from squeezed incomes and job insecurity
- Too many people are retiring with inadequate pension provision

The short-term risks are also more weighted to the downside:

- Many people still need to adjust to working in a more turbulent world. The BabyBoomer SuperCycle of demand meant major economies suffered only 16 months of recession in 25 years between 1982-2007
- Governments have failed to recognise the impact on demand of demographics and the ageing western populations. They have raised debt levels via stimulus programmes for no real gain
- The banking system remains under severe strain:
    - It is dramatically undercapitalised in Europe
    - USA banks face problems if property prices weaken again
    - China's banks face losses from non-performing loans after the credit bubble of the past 3 years

And then, of course, there are the risks of rising social unrest in many countries as austerity programmes bite. Equally, the current generation of politicians has failed to display any real leadership that would help to move us beyond today's more difficult times. And, as always, there remain geo-political threats, such as the potential for Middle East wars.

Thus I feel there is only one possible title for this year's Outlook, 'Budgeting for Austerity, and New Opportunities'. This is because the real question, of course, is what happens next?

As **individuals**, will we lapse into apathy, and just give up in the face of the perceived difficulties? Or will we do as previous generations did, and confront today's problems with a view to setting out in a new direction?

I will discuss these opportunities in more detail tomorrow.

Budgeting for Austerity – the Opportunities

By **Paul Hodges** on 26 October, 2011

The 2012-14 Budget period offers great opportunities, as well as great challenges.

Will **companies** continue to focus on short-term developments in financial markets? Michael Porter's Shared Value concept instead offers us a powerful model for creating future growth.

Will **policymakers** stop focusing on the 24 hour news cycle and instead begin to set out the bigger picture? We need a vision for the future, and a clear idea of how to get there.

Are these decisions hard to take? No.

Has the world the resources to start in this new direction? Yes.

Would we enjoy the challenge? Yes

Can we start today? Yes.

We all know that companies are going to have to set difficult budgets for the next few years. They will also have to deal with continued uncertainty. We cannot rely on wise and all-seeing policymakers to lead us forward. They may well decide to do more of the things, such as Quantitative Easing, that will make the situation worse instead of better.

But larger companies, in particular, could also start to examine how to expand long-term R&D. And every company could add a future dimension to its Budget in respect of the opportunities that will arise from the new markets being created by today's demographic and societal changes:

- Nearly a third of the Western population is now in the **55+ age bracket**. They have the incredible benefit of an extra decade of life expectancy, compared to previous generations. And they have money

– maybe not a lot, but enough to buy useful products and services. Yet they remain woefully underserved and often unrecognised by most companies.

People in emerging economies are starting to **move out of poverty** in large numbers. This 'bottom of the pyramid' market represents a wonderful opportunity to develop new products and services. Millions now have some money to spend for the first time in their lives.

The great megatrends of the future also offer vast opportunities for future growth. These involve the need to increase food production, improve water availability and reduce carbon footprint. They are vitally important, and also offer the potential for profitable future growth. So, of course, do the opportunities associated with increasing life expectancy.

Companies therefore have a clear choice as we move into the Budget period. I believe a New Normal lies ahead, as we are describing in the new Boom, Gloom and the New Normal eBook, co-authored with John Richardson.

Winners will accept the challenges that it offers, and begin to move in a new direction. Losers, however, will remain frozen in the headlights, unable to take the first steps that will lead them to success.

Collectively, as the world's 3rd largest industry, chemical companies have enormous potential to do good at this most difficult time. But progress depends on each of us as individuals being prepared to adopt a positive outlook in the face of the problems with which we are surrounded.

As always, of course, I will be delighted to help any company that wishes to accept the challenges that offered by the transition to the New Normal. I am confident that they will discover a potential to be successful beyond their wildest dreams.

2012. Budgeting for an L-shaped recovery

By **Paul Hodges** on 20 October, 2012

As companies finalise Budgets for 2013-15, many will be thinking long and hard about the implications of the IMF's new economic forecast:

"The recovery continues, but it has weakened. In advanced countries, growth is now too low to make a substantial dent in unemployment. And in major emerging market economies, growth that had been strong earlier has also decreased."

This is a sad reflection on the failure of the policies followed since March 2009.

The reason for the disappointment is simple. As any business executive knows, demographics drive demand. But central banks and governments, with the exception of the Bank of Japan, continue to ignore this vital fact.

This is why I have co-authored 'Boom, Gloom and the New Normal'. Its aim is two-fold:

- To provide a robust and well-researched alternative view of likely future growth prospects
- To support Boards, investors and business managers in charting a new course to success and profitability

The key issue is that 297m people in the West will be in the New Old 55+ generation by 2015. They will be 31% of the population. Thus growth will inevitably be very much slower than in the 1982-2007 Supercycle.

The reason is simple:

- When people are young, they need to buy new things
- And the Western BabyBoomers had lots of money to spend
- But now the kids have left home, and they don't need many new things
- Instead, they mainly buy replacement products, and only when these wear out

Equally, the economies of the developing world now have to refocus on domestic demand, and away from exports to the West. Their populations are very poor by comparison with the West, so they cannot replace the lost spending there. These New Poor have money to spend for the first time in their lives, but their purchases also have to be both essential and affordable.

Thus I suggest that companies should budget for a continued L-shaped recovery. I first suggested this back in December 2008. Sadly, events since then have only confirmed its analysis:

- Originally it was widely assumed we would see a quick V-shaped recovery
- Then a U-shape was expected, as recovery seemed delayed
- Next a W-shape was forecast, as new stimulus would finally lead to recovery
- But in reality, there has not been a sustained recovery
- Instead, we have seen volatile markets, as stimulus ebbs and flows

Clearly central banks and governments still believe they will eventually return the world to the SuperCycle. But as the great scientist Einstein wisely remarked, a good definition of lunacy is to repeat the same action, and expect different results.

Far-sighted companies will therefore ignore the temptation to believe that the next stimulus programme will be different. Instead, they will focus on what they can do to insulate their business from the turbulence around them, by focusing on the key issues that they can control.

The good news is that almost nobody is producing goods and services for the New Old 55+ generation in the West. And only a few, like Nissan, are starting to manufacture affordable goods for the billions in the New Poor generation in emerging economies. Therefore competitive pressures in these two vast and growing sectors are very low.

These are the two great business opportunities of our lifetimes. The companies that now use the 2013-15 period to access these, will be building the foundations for decades of future success.

2013. Budgeting for a VUCA world

By **Paul Hodges** on 26 October, 2013

"I use the term VUCA to describe the world – volatile, uncertain, complex and ambiguous. It is very difficult for people to get a total picture."
Paul Polman, Unilever CEO

The title for the 2013 Budget Outlook chooses itself. If the CEO of Unilever, one of the world's great companies, can't get a "total picture", then what hope is there for the rest of us?

Of course, we might get lucky and come up with the winning numbers in the lottery. But that is not the approach most companies would want to take.

The range of genuine uncertainties is unprecedented:

Financial markets. Central banks and policymakers have so far added $33tn of stimulus – nearly half the size of the global economy. It is the biggest financial experiment in history by a very long way. Therefore we cannot have any confidence that we know what happens next. Do they keep adding more stimulus forever? Do they try to 'taper' and stop the money printing, as the US Federal Reserve has suggested? Or ????

Debt bubbles. The only central banker to forewarn of the financial crisis in 2007 was William White, then BIS chief economist (the central banks' bank). Ominously, he warned last month that "*This looks like to me like 2007 all over again, but even worse…And we have added a whole new problem with bubbles in emerging markets that are ending in a boom-bust cycle*"

Oil and commodity markets. It is clear that I am now not the only one to believe that central bank liquidity has caused these markets to lose their power of price discovery. Today's consensus assumption of $100/bbl oil forever is in fact the least likely option. Whilst Ed Morse, commodities head at Citi, has just published a detailed outlook titled 'The end of OPEC'

The Four Butterflies. The Eurozone crisis; US political dysfunction over the debt/budget issues; rising interest rates; China's new economic policies. All are now flapping their wings very hard, as I feared back in August. Each has the potential to deliver a cold winter on their own. And now there is the spying scandal, causing further mistrust between Western leaders

Demographics. Although still largely unrecognised, the world's ageing populations are the real cause of today's New Normal and its changing demand patterns. Sadly, out of touch policymakers still seriously argue that demographics don't impact the economy. And the longer this core issue is ignored, the more problems it stores up for individuals, companies and countries for the future

How can companies possibly deal with this long, but by no means complete, list of major uncertainties? Should they simply throw up their hands in despair, and stick with a consensus forecast that they know will be wrong?

This may seem tempting. And indeed, it has been the default policy until recently. But today, the balance of risk and reward is starting to change. Staying with the status quo is more painful than adopting a New Normal-based approach. After all, how many more times can you explain to your boss that your budget has not been delivered? And how many more times can your management tell shareholders that key targets continue to be missed?

Thus in different ways, and at different times, companies are starting to look at the world from new angles. Instead of relying on growth forecasts based on ratios to IMF forecasts of GDP, they are instead thinking about the potential needs of people at different income levels, and at different ages. And they are starting to find that it might not be so difficult after all to make the transition. It might even be that it is the first step, that is the most difficult.

This is certainly my experience as I continues to work with Boards, ExCos and management teams around the world on these super-critical issues. The release of energy, when reality is acknowledged, goes a long way towards putting that critical first step in place.

The key, I have found, is for each company to then develop its own VUCA for success:

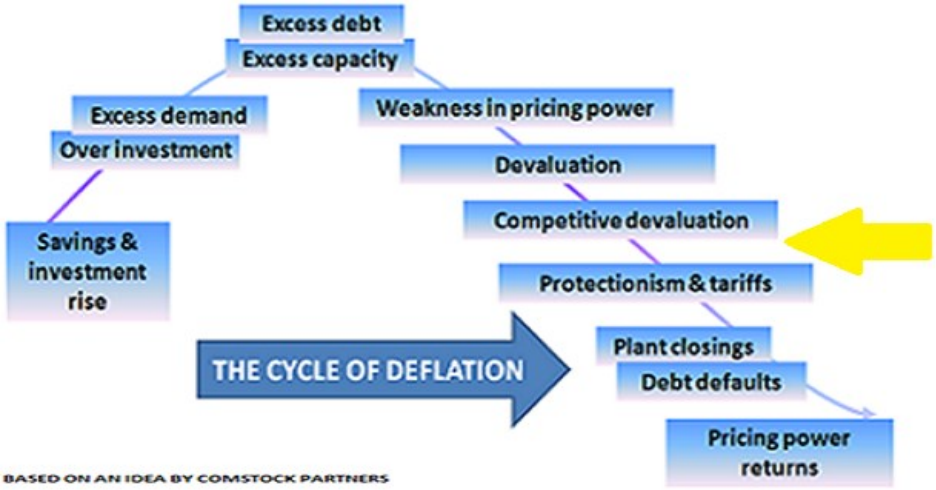
- **Volatility**. Developing a road-map requires ***Vision***
- **Uncertainty**. A strategic ***Understanding*** of the changes underway is essential
- **Complexity.** The planning process requires ***Clarity*** over implementation
- **Ambiguity**. Unforeseen events will place a premium on ***Agility***

Nobody said business was meant to be easy. But companies and investors who take on the challenge of

today's VUCA world will be increasingly successful as we move through the 2014 – 2016 budget period.

2014. Budgeting for the Cycle of Deflation

By **Paul Hodges** on 4 November, 2014 in **Economic growth**



There is no "business as usual" scenario possible for the 2015-2017 Budget period. Over the past 15 years (since the "dotcom bubble" burst in 2000), policymakers have provided increasing amounts of stimulus to support the economy. Now, finally, we are in the endgame, as the Great Unwinding takes place.

This presents us all with major challenges:

- Most executives and investors under the age of 40 have spent their working lives in the post-'dotcom bubble' world. They have learnt to expect that central banks will intervene more or less continuously to support the economy. They have no experience of a world where markets are left to balance supply and demand
- Equally, those over 40 have recognised there is no going back to the Boomer-led SuperCycle that dominated their working lives before the 'dotcom bubble'. There is instead an increasing acceptance that a move into a New Normal is underway. China recently announced its economic policy will "adapt to the New Normal state"

Thus our past experience may well not be a good guide to the future.

3 SCENARIOS FOR THE 2015 – 2017 PERIOD

What does this mean for Budgets?

Firstly, it means we likely have a very hard road ahead. China and the US are both now ending their vast stimulus programmes – but not before China's debt increased by $11tn, and US debt increased by $10tn. Globally, around $35tn has been spent in the major economies just since 2009.

Two developments on Friday highlight the risks we face:

- One is that policymakers may panic and rush to expand stimulus programmes again. Friday saw this happen in Japan, with the Governor of the Bank of Japan deciding to 'double down' on the failing Abenomics policy, warning *"We are at a critical moment. There is a risk that victory over deflation may be delayed."*
- A second is that price wars become common. Energy markets face major supply gluts, leading Iraq's oil minister to tell Parliament *"There is a price war within OPEC. The market's fundamentals have changed, with an extra 3 million barrels/day of crude entering the market at a time when growth in*

China and India has slowed."

The result is that the world faces 3 quite distinct outlooks for the 2015 – 2017 period:

All's well that ends well. Of course, we must all hope that policymakers have been right all along. In this case, we will still face a bumpy ride for the next few years. But over time, confidence will grow as it becomes clear that strong economic growth is being restored.
Global hard landing. The opposite is argued by those who believe stimulus programmes have put the global economy at risk. They fear a global 'hard landing' is the likely outcome, as stimulus is withdrawn and underlying problems are exposed to view

My own view is that whilst both of these outcomes are certainly possible, neither are very likely. Demographics must drive demand, and today's globally ageing populations cannot recreate the Boomer-led SuperCycle of economic growth. Equally, policymakers would have to be completely incompetent to allow a global 'hard landing' to occur.

The most likely Scenario focuses on the Great Unwinding of policymaker stimulus now underway. This is taking us into the final stages of the Cycle of Deflation, which has been building since the 'dot-com bubble' burst in 2000.

THE CYCLE OF DEFLATION
The key feature of this Scenario is that **the world is now becoming demand-constrained**. In the past, advantaged-cost supply was key to success. "If you build it, they will come" was the motto.

But today, it is becoming recognised that we have a supply glut in most key areas – certainly in energy and commodity markets, and further down most value chains. As the chart shows, we are thus now moving from the stage of Competitive Devaluation into Protectionism, as all the new capacity comes online:

- **Competitive devaluation.** This began with China in 2001, as part of its export-oriented development model. The US followed in 2009 with QE – again with the aim of promoting exports. Japan has tried the same policy since 2012, and more recently the Eurozone has followed. All, of course, are responding to a lack of domestic demand
- **Protectionism**. Globalisation is already becoming a memory. Sadly, the World Trade Organisation has recently failed even to streamline customs procedures. Instead, countries are moving towards bilateral agreements. This makes it much easier for them to protect jobs by imposing tariffs
- **Plant closings.** Only a small number of plants have closed to date. But Protectionism means that any plant which depends on exports is at risk, as low-cost will no longer be key to success
- **Debt default.** Cash is king in a deflationary environment. Default risks are already rising, with Blackrock (the world's largest asset manager) warning secondary markets are "broken". Companies need to pay down debt as fast as possible, and watch working capital like a hawk

It is impossible to overestimate the shock that the Great Unwinding is already creating. **The critical issue is that Deflation is now becoming inevitable.** It has two key effects:

- **Debt becomes very expensive**, as its cost is rising in real terms. So instead of borrowing, people focus on repaying debt as a top priority
- **Purchases are postponed** because prices will be cheaper tomorrow. So demand slows even further, as people see no rush to buy

Of course, deflation wouldn't be a major issue today if markets had been allowed to operate normally after 2000. Most Western countries had moved into budget surplus, and were not burdened with today's debt levels.

But we are where we are.

2015. Budgeting for the Great Unwinding of Policymaker Stimulus

by Paul Hodges on 25 October, 2015 in Economic growth

There have been 35 "flash crashes" in US oil markets so far this year, when prices swung up or down by 200 basis points (2%) – before reversing the move by > 0.75%. That's 35 occasions when the markets were out of control.

It is tempting to blame this on misfiring algorithms at the high-frequency traders. Regulators have been asleep at the wheel, and allowed them to dominate energy markets (and most other major financial markets). They are now responsible for half of all energy trading each day.

But there is a bigger issue underlying this problem, and one that must greatly concern companies as they finalise Budgets for 2016-18. This is the Great Unwinding now underway of the policymaker stimulus that pushed oil and other prices higher after 2008 – and led to China's property and other bubbles now being unwound by President Xi:

- They have given companies a completely false view of underlying demandThis $35tn of stimulus has made it appear that poor people in emerging countries (earning $2/day – $20/day) had become middle class by Western standards
- It disguised the fact that 1bn people in the world are moving out of the high-earning, high-spending Wealth Creator generation (those aged 25 – 54), into the low-earning, low-spending New Old 55+ generation

As a result, the industry has vastly over-expanded its capacity. It always does this at market peaks, as executives – cheered on by investors – rush to build new plants on the basis that demand growth will continue forever. The post-2008 market cycle has been even worse than normal for 2 key reasons:

- Most companies knew very little about China before 2008, and were easily persuaded that it would continue to see double-digit growth. They were also fooled by consensus thinking into believing that 3bn people in the emerging economies were becoming middle class
- Companies also put on their rose-tinted glasses when it came to assessing the impact of ageing populations on demand. They wanted to believe that "this time would be different", and 65-year-olds would suddenly start spending as if they were 20 years younger

Now the Great Unwinding of these policies is underway, and all this excess capacity will force companies to compete fiercely on price and battle for market share. Even worse is the risk that, unlike in the past,

demand may never catch up with all this new supply. It will take decades for the supposed 'middle class' in emerging economies to actually become middle class – if all goes well. And it would take 25 years for new babies to grow up and become Wealth Creators, even if women suddenly started tomorrow to reverse the decline in fertility rates and have more babies.

And this is where the problem of those 'flash crashes' becomes serious. It seems very unlikely that policymakers outside China will suddenly realise the error of their ways, and abandon stimulus. Far more likely, as the European Central Bank suggested last week, that they will do more and more stimulus to try and hide the failure of their policies. So markets will be pushed higher by the lure of unlimited amounts of free money from the central banks, and then brought low by the return of reality in terms of slowing demand and increasing debt levels.

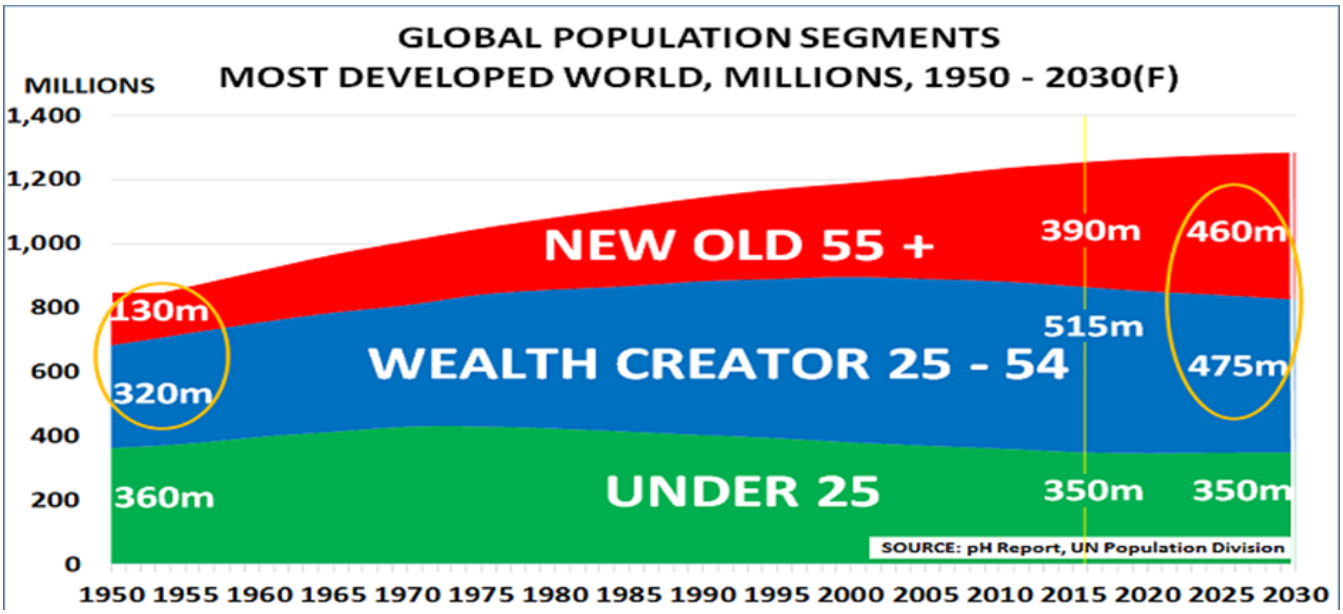
As the map above shows, stimulus has effectively created fault-lines throughout the global economy. Those connected to emerging economies which have lost Chinese markets, have already started to open (thick lines). The developed economies will follow as the impact of China's slowdown spreads (dotted lines). It will be a bumpy ride for the next few years. And companies should plan for the bumps in the road to be particularly large next year:

- China accounted for half of all stimulus in the 2008 – 2012 period before President Xi took office
- Since then he has been focused on unwinding the lending bubble he inherited
- He has also redirected the economy into a services-led New Normal, based on the mobile internet
- This means that China's Old Normal economy will slowly wither away, never to return

2016 is critically important for his policies. He is due to seek re-appointment for a second 5-year term in November 2017. And it would make no sense for him to do this with the job half-done. Political necessity suggests he must try to 'take the pain' of adjustment by the end of 2016. Then he can approach the November 2017 Plenum with a platform that can not only claim to have resolved the problems he inherited, but also point to the sunlit uplands ahead – as his major initiatives of the Asian Infrastructure Investment Bank and the 'One Belt, One Road' start to become reality.

So 2016 will see China putting its foot hard on the brakes of the Old Normal economy – whilst Western policymakers compete to ramp up stimulus to compensate. It could easily prove to be as difficult a year as 2008. Companies owe it to themselves to plan ahead for this Scenario. 'Flash crashes' take place in a flash, not over months. It could prove too late afterwards to regret that you had failed to put the necessary contingency plan in place.

2016. Budgeting for the Great Reckoning



One thing is certain about the 2017 – 2019 Budget period. "Business as usual" is the least likely Scenario to occur. One thing stands out from the past 5 years of IMF forecasts: its consistent expectation of a return to "normal" levels of growth have proved over-optimistic:

- Back in 2011, the IMF was forecasting growth of almost 5% in 2016
- It was still forecasting 4% growth as recently as 2013
- Today, however, it is forecasting just 3.1% as the actual out-turn for 2016

This false optimism has now created some very negative consequences:

- Companies committed to major capacity expansions during the 2011 – 2013 period, assuming demand growth would return to "normal" levels
- Policymakers committed to vast stimulus programmes, assuming that the debt would be paid off by a mixture of "normal" growth and rising inflation
- Today, this means that companies are losing pricing power as this new capacity comes online, whilst governments have found their debt is still rising in real terms

This is the Great Reckoning that now faces investors and companies as they plan their Budgets for 2017 – 2019.

Even more worrying is that most people began work after the start of the BabyBoomer-led economic SuperCycle in 1983. They have no experience of living through today's more uncertain economic, political and social times:

Economics. Many major countries have already seen growth disappear (Brazil, Russia of the BRIC nations)
Politics. Populists are gaining support everywhere, as people feel failed by current political leaders
Social. Tolerance is breaking down, particularly with regard to immigration

The chart explains why the IMF have been wrong. It shows the change that has taken place in the population of the Most Developed Regions (Northern America, Europe, Australia/New Zealand and Japan) since 1950. The Regions dominate the global economy with 57% of total global GDP in 2016 ($43tn out of $75tn).

1950. There were 320m in the Wealth Creator 25 – 54 cohort that drives economic growth, and they were 39% of the population. By comparison, there were only 130m in the over-55 cohort (16%), where spending declines as older people already own most of what their need, and their incomes reduce as they enter retirement
2016. Today, there are 515m in the Wealth Creator cohort (41%). But the number of over-55s (the New

Old 55+ segment) has trebled to 390m, and they are nearly a third of the population **2030**. The UN forecasts there will be 475m in the Wealth Creator segment (37%), almost exactly the same as the 460m New Olders (36%)

The key issue is changing demographics:

Fertility rates. These have been below the replacement level of 2.1 babies/woman for the past 45 years
Life expectancy. Someone aged 65 can now expect to live for another 20 years

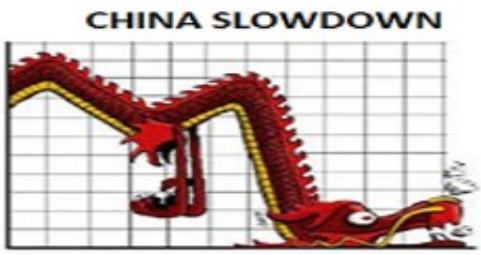
As I noted in my Financial Times letter on Friday:

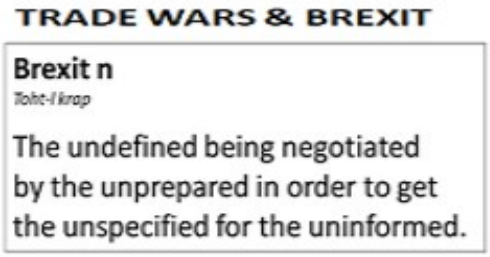
"It is good to see that the US Federal Reserve is finally beginning to address the impact of demographics on the economy, after years of denying its relevance. But its continued focus on supply-side issues means it is looking down the wrong end of the telescope… Policymakers need to urgently refocus on the demand-side implications of ageing, if they want to craft suitable policies for this New Normal world."

The problem, of course, is that it will take years to undo the damage that has been done. Stimulus policies have created highly dangerous bubbles in many financial markets, which may well burst before too long. They have also meant it is most unlikely that governments will be able to keep their pension promises, as I warned a year ago.

Of course, it is still possible to hope that "something may turn up" to support "business as usual" Budgets. But hope is not a strategy. Today's economic problems are already creating political and social unrest. And unfortunately, the outlook for 2017 – 2019 is that the economic, political and social landscape will become ever more uncertain.

2017. Budgeting for the Great Unknown in 2018 – 2020





"There isn't anybody who knows what is going to happen in the next 12 months. We've never been here before. Things are out of control. I have never seen a situation like it."

This comment from former UK Finance Minister, Ken Clarke, aptly summarises the uncertainty facing companies, investors and individuals as we look ahead to the 2018 – 2020 Budget period. None of us have ever seen a situation like today's. Even worse, is the fact that risks are not just focused on the economy, or politics, or social issues. They are a varying mix of all of these. And because of today's globalised world, they potentially affect every country, no matter how stable it might appear from inside its own borders.

This is why my Budget Outlook for 2018 – 2020 is titled 'Budgeting for the Great Unknown'. We cannot

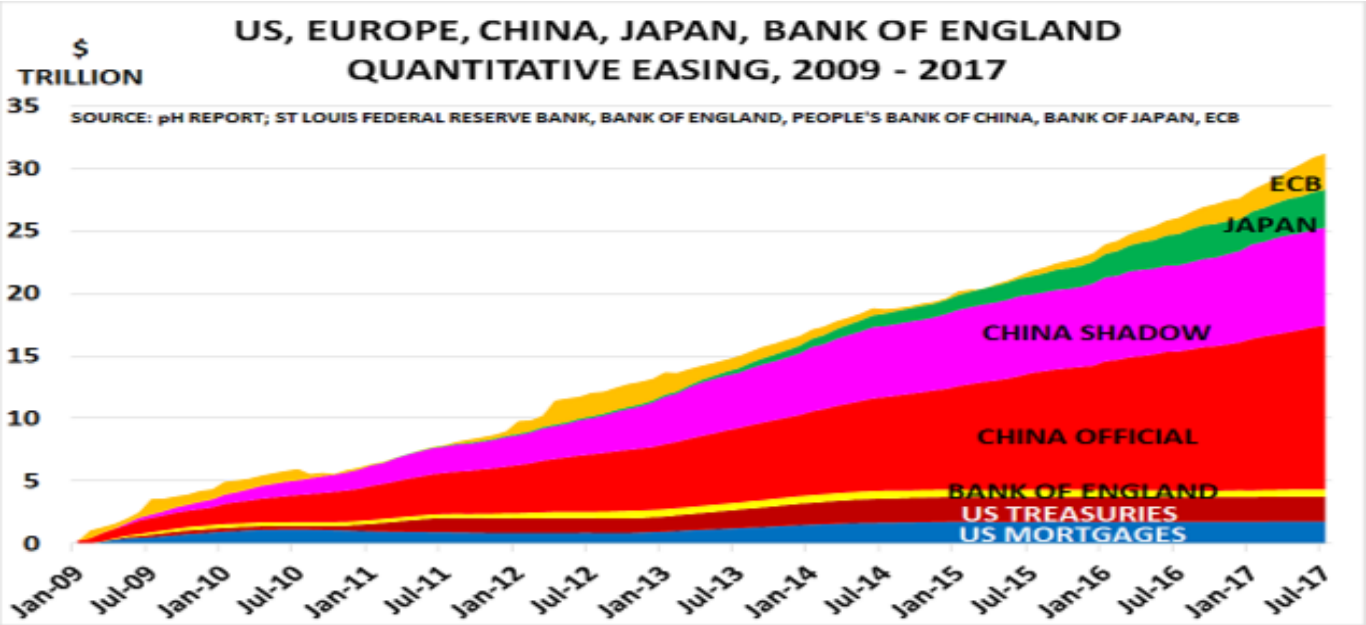
know what will happen next. But this doesn't mean we can't try to identify the key risks and decide how best to try and manage them. The alternative, of doing nothing, would leave us at the mercy of the unknown, which is never a good place to be.

RISING INTEREST RATES COULD SPARK A DEBT CRISIS

Central banks assumed after 2008 that stimulus policies would quickly return the economy to the BabyBoomer-led economic SuperCycle of the previous 25 years. And when the first round of stimulus failed to produce the expected results, as was inevitable, they simply did more…and more…and more. The man who bought the first $1.25tn of mortgage debt for the US Federal Reserve (Fed) later described this failure under the heading "I'm sorry, America":

"You'd think the Fed would have finally stopped to question the wisdom of QE. Think again. Only a few months later—after a 14% drop in the U.S. stock market and renewed weakening in the banking sector—the Fed announced a new round of bond buying: QE2"

And the Fed was not alone, as the chart below shows. Today, the world is burdened by over $30tn of central bank debt:



- The Fed, European Central Bank, Bank of Japan and the Bank of England now appear to "*own a fifth of their governments' total debt*"
- There also seems little chance that this debt can ever be repaid. The demand deficit caused by today's ageing populations means that growth and inflation remain weak, as I discussed in the Financial Times last month

China is, of course, most at risk – as it was responsible for more than half of the lending bubble. This means the health of its banking sector is now tied to the property sector, just as happened with US subprime. Around one in five of all Chinese apartments have been bought for speculation, not to be lived in, and are unoccupied.

China's central bank chief, Zhou Xiaochuan, has warned that China risks a "Minsky Moment", where lenders and investors suddenly realise they have overpaid for their assets, and all rush together for the exits – as in 2008. Similar risks face the main developed countries as they finally have to end their stimulus programmes:

- Who is now going to replace them as buyers of government debt?
- And who is going to buy these bonds at today's prices, as the banks back away?

- $8tn of government and corporate bonds now have negative interest rates, which guarantee the buyer will lose money unless major deflation takes place – and major deflation would make it very difficult to repay the capital invested

There is only one strategy to manage this risk, and that is to avoid debt. Companies or individuals with too much debt will go bankrupt very quickly if and when a Minsky Moment takes place.

THE CHINA SLOWDOWN RISK IS LINKED TO THE PROPERTY LENDING BUBBLE

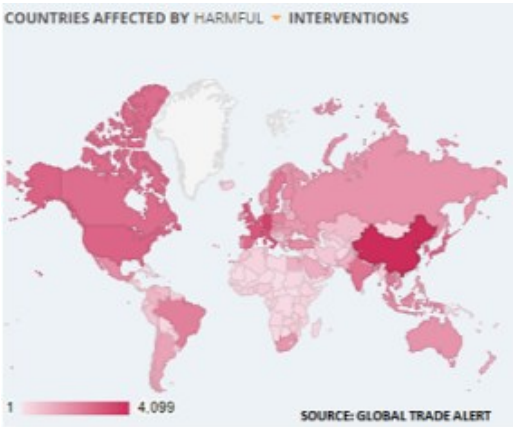
After 2008, it seemed everyone wanted to believe that China had suddenly become middle class by Western standards. And so they chose to ignore the mounting evidence of a housing bubble, as shown in the chart above.

Yet official data shows average incomes in China are still below Western poverty levels (US poverty level = $12060):

- In H1, disposable income for urban residents averaged just $5389/capita
- In the rural half of the country, disposable income averaged just $1930
- The difference between income and expenditure was based on the lending bubble

As a result, average house price/earnings ratios in cities such as Beijing and Shanghai are now more than 3x the ratios in cities such as New York – which are themselves wildly overpriced by historical standards.

Having now been reappointed for a further 5 years, it is clear that President Xi Jinping is focused on tackling this risk. The only way this can be done is to take the pain of an economic slowdown, whilst keeping a very close eye on default risks in the banking sector. As Xi said once again in his opening address to last week's National Congress:



"Houses are built to be inhabited, not for speculation. China will accelerate establishing a system with supply from multiple parties, affordability from different channels, and make rental housing as important as home purchasing."

China will therefore no longer be powering global growth, as it has done since 2008. Prudent companies and investors will therefore want to review their business models and portfolios to identify where these are dependent on China.

This may not be easy, as the link to end-user demand in China might well be further down the supply chain,

or external via a second-order impact. For example, Company A may have no business with China and feel it is secure. But it may suddenly wake up one morning to find its own sales under attack, if company B loses business in China and crashes prices elsewhere to replace its lost volume.

PROTECTIONISM IS ON THE RISE AROUND THE WORLD

Trade policy is the third key risk, as the chart of harmful interventions from Global Trade Alert confirms.

These are now running at 3x the level of liberalising interventions since 2008, as Populist politicians convince their voters that the country is losing jobs due to "unfair" trade policies.

China has been hit most times, as its economy became "the manufacturing capital of the world" after it joined the World Trade Organisation in 2001. At the time, this was seen as being good news for consumers, as its low labour costs led to lower prices.

But today, the benefits of global trade are being forgotten – even though jobless levels are relatively low. What will happen if the global economy moves into recession?

The UK's Brexit decision highlights the danger of rising protectionism. Leading Brexiteer and former cabinet minister John Redwood writes an online diary which even campaigns against buying food from the rest of the European Union:

There are many great English cheese (sic), so you don't need to buy French."

No family tries to grow all its own food, or to manufacture all the other items that it needs. And it used to be well understood that countries also benefited from specialising in areas where they were strong, and trading with those who were strong in other areas. But Populism ignores these obvious truths.

- President Trump has left the Trans-Pacific Partnership, meant to link major Pacific Ocean economies
- He has also said he will probably pull out of the Paris Climate Change Agreement
- Now he has turned to NAFTA, causing the head of the US Chamber of Commerce to warn:

"There are several poison pill proposals still on the table that could doom the entire deal," Donohue said at an event hosted by the American Chamber of Commerce of Mexico, where he said the "existential threat" to NAFTA threatened regional security.

At the moment, most companies and investors seem to be ignoring these developments, assuming that in the end, sense will prevail. But what if they are wrong? It seems highly likely, for example, that the UK will end up with a "hard Brexit" in March 2019 with no EU trade deal and no transition period to enable businesses to adjust.

Today's Populist politicians don't seem to care about these risks. For them, the allure of arguing for "no deal", if they can't get exactly what they want, is very powerful. So it would seem sensible for executives to spend time understanding exactly how their business might be impacted if today's global supply chains came to an end.

POLITICAL CHAOS IS GROWING AS PEOPLE LOSE FAITH IN THE ELITES

- Adults in the other 7 major economies feel they are going in the wrong direction, sometimes by large margins
- 59% of Americans, 62% of Japanese, 63% of Germans, 71% of French, 72% of British, 84% of Brazilians and 85% of Italians are unhappy

This suggests there is major potential for social unrest and political chaos if the elites don't change direction. Fear of immigrants is rising in many countries, and causing a rise in Populism even in countries such as Germany.

CONCLUSION

"Business as usual" is always the most popular strategy, as it means companies and investors don't have to face the need to make major changes. But we all know that change is inevitable over time. And at a certain moment, time can seem to literally "stand still" whilst sudden and sometimes traumatic change erupts.

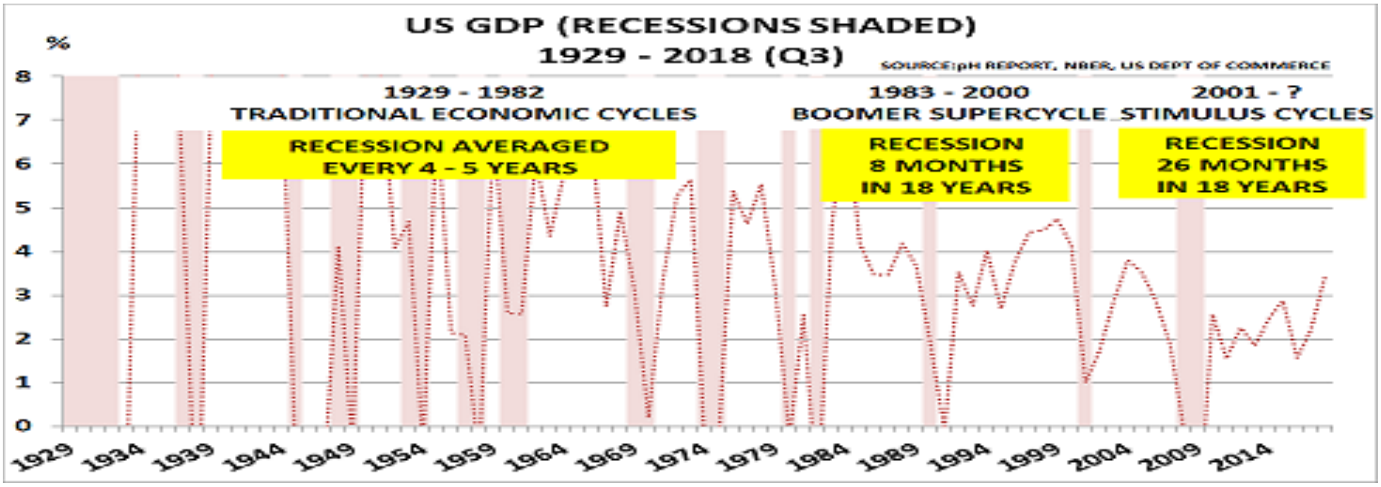
At such moments, as in 2008, commentators rush to argue that "*nobody could have seen this coming*". But, of course, this is nonsense. What they actually mean is that "*nobody wanted to see this coming*". The threat from subprime was perfectly obvious from 2006 onwards, as I warned in the Financial Times and in ICIS Chemical Business, as was 2014's oil price collapse. Today's risks are similarly obvious, as the "Ring of Fire" map describes.

You may well have your own concerns about other potential major business risks. Nobel Prizewinner Richard Thaler, for example, worries that:

"We seem to be living in the riskiest moment of our lives, and yet the stock market seems to be napping."

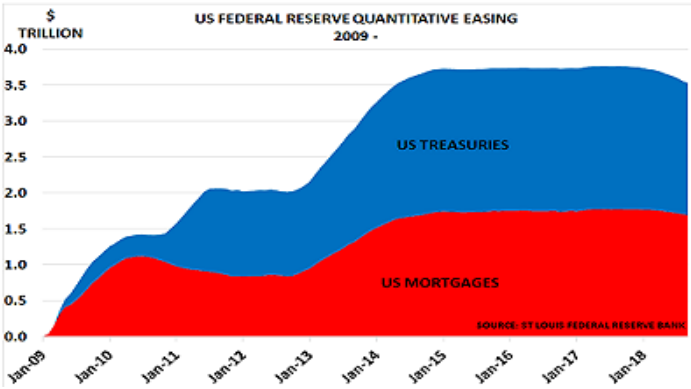
We can all hope that none of these scenarios will actually create major problems over the 2018 – 2020 period. But hope is not a strategy, and it is time to develop contingency plans. Time spent on these today could well be the best investment you will make. As always, please do contact me at phodges@iec.eu.com if I can help in any way.

2018. Budgeting for the end of "Business as Usual"



Companies and investors are starting to finalise their plans for the coming year. Many are assuming that the global economy will grow by 3% – 3.5%, and are setting targets on the basis of "business as usual". This has been a reasonable assumption for the past 25 years, as the chart confirms for the US economy:

- US GDP has been recorded since 1929, and the pink shading shows periods of recession
- Until the early 1980's, recessions used to occur about once every 4 – 5 years
- But then the BabyBoomer-led economic SuperCycle began in 1983, as the average Western Boomer moved into the Wealth Creator 25 – 54 age group that drives economic growth
- Between 1983 – 2000, there was one, very short, recession of 8 months. And that was only due to the first Gulf War, when Iraq invaded Kuwait



Since then, the central banks have taken over from the Boomers as the engine of growth. They cut interest rates after the 2001 recession, deliberately pumping up the housing and auto markets to stimulate growth. And since the 2008 financial crisis, they have focused on supporting stock markets, believing this will return the economy to stable growth:

- The above chart of the S&P 500 highlights the extraordinary nature of its post-2008 rally
- Every time it has looked like falling, the Federal Reserve has rushed to its support
- First there was co-ordinated G20 support in the form of low interest rates and easy credit
- This initial Quantitative Easing (QE) was followed by QE2 and Operation Twist
- Then there was QE3, otherwise known as QE Infinity, followed by President Trump's tax cuts

In total, the Fed has added $3.8tn to its balance sheet since 2009, whilst China, the European Central Bank and the Bank of Japan added nearly $30tn of their own stimulus. Effectively, they ensured that credit was freely available to anyone with a pulse, and that the cost of borrowing was very close to zero. As a result, debt has soared and credit quality collapsed. One statistic tells the story:

"83% of U.S. companies going public in the first nine months of this year lost money in the 12 months leading up to the IPO, according to data compiled by University of Florida finance professor Jay Ritter. Ritter, whose data goes back to 1980, said this is the highest proportion on record. The previous highest rate of money-losing companies going public had been 81% in 2000, at the height of the dot-com bubble."

And more than 10% of all US/EU companies are "zombies" according to the Bank of International Settlements (the central banks' bank), as they:

"Rely on rolling over loans as their interest bill exceeds their EBIT (Earnings before Interest and Taxes). They are most likely to fail as liquidity starts to dry up".

2019 – 2021 BUDGETS NEED TO FOCUS ON KEY RISKS TO THE BUSINESS

For the past 25 years, the Budget process has tended to assume that the external environment will be stable. 2008 was a shock at the time, of course, but time has blunted memories of the near-collapse that occurred. The issue, however, as I noted here in September 2008 is that:

"A long period of stability, such as that experienced over the past decade, eventually leads to major instability.

"This is because investors forget that higher reward equals higher risk. Instead, they believe that a new paradigm has developed, where high leverage and 'balance sheet efficiency' should be the norm. They therefore take on high levels of debt, in order to finance ever more speculative investments."

This is the great Hyman Minsky's explanation for financial crises and panics. Essentially, it describes how confidence eventually leads to complacency in the face of mounting risks. And it is clear that today, most of the lessons from 2008 have been completely forgotten. Sadly, it therefore seems only a matter of "when", not "if", a new financial crisis will occur.

So prudent companies will prepare for it now, whilst there is still time. You will not be able to avoid all the risks, but at least you won't suddenly wake up one morning to find panic all around you.

ECONOMY	
CONSUMER	– AUTO, HOUSING SALES DECLINE
LIQUIDITY	- CHINA SLOWDOWN SPREADS TO WEST
CURRENCY	– US$ STRENGHENS AS €, ¥, £ WEAKEN
MARKETS	- STOCK MARKETS DECLINE
GDP	– MAJOR RECESSION BEGINS

BUSINESS	
TRADE	– WORLD TRADE GOES NEGATIVE
POLITICS	– CONSENSUS REPLACED BY DIVISION
GEOPOLITICS	- VOLATILITY INCREASES
FINANCE	- 'RETURN OF CAPITAL' PRIORITISED
COMPANIES	– BANKRUPTCIES INCREASE

The chart gives my version of the key risks – you may well have your own list:

- Global auto and housing markets already seem to be in decline; world trade rose just 0.2% in August
- Global liquidity is clearly declining, and Western political debate is ever-more polarised
- Uncertainty means that the US$ is rising, and geopolitical risks are becoming more obvious
- Markets have seen sudden, "unexpected" falls, causing investors to worry about "return of capital"
- The risks of a major recession are therefore rising, along with the potential for a rise in bankruptcies

Of course, wise and far-sighted leaders may decide to implement policies that will mitigate these risks, and steer the global economy into calmer waters. Then again, maybe our leaders will decide they are "fake news" and ignore them.

Either way, prudent companies and investors may want to face up to these potential risks ahead of time. That is why I have titled this year's Outlook, 'Budgeting for the end of "Business as Usual". As always, please contact me at phodges@thephreport.com if you would like to discuss these issues in more depth.

2019. Budgeting for paradigm shifts and a debt crisis

It is now 8 years since John Richardson and I published our 10-year forecast for 2021 in Boom, Gloom and the New Normal: How the Western BabyBoomers are Changing Demand Patterns, Again'. Remarkably, its core conclusions are very relevant today, as the summary confirms.

Unfortunately, as we feared, policymakers refused to junk their out-of-date models, despite the lesson of the 2008 financial crisis. Instead, they doubled down on their failed stimulus policies.

- Yet nearly 1/3rd of the world's High Income population are in the Perennials 55+ age group and are a replacement economy
- As a result, and as we suggested in 2011, central bank policies have not, and cannot, produce sustainable growth or inflation

As a result, they have created record levels of government, corporate and individual debt – which can never be repaid. Even the IMF has now started to recognise the timebomb that has been created:

"We look at the potential impact of a material economic slowdown – one that is half as severe as the global financial crisis of 2007-08. Our conclusion is sobering: debt owed by firms unable to cover interest expenses with earnings, which we call corporate debt at risk, could rise to $19tn. That is almost 40% of total corporate debt in the economies we studied."

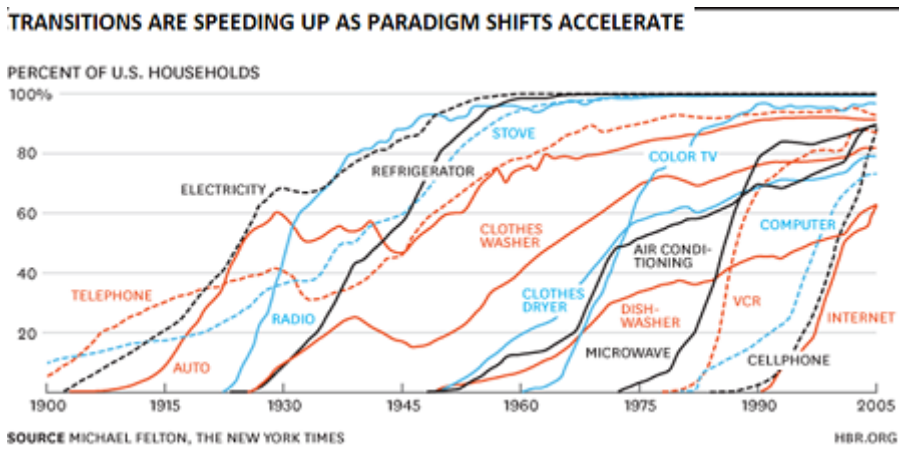
Already we are starting to see the unwinding of some of the most extreme examples of the bubbles that have been created in asset prices:

- WeWork – which hoped for a $100bn IPO valuation last month – is now "worth" just $8bn after a $9.5bn rescue rights issue
- New York City property prices are described as in "freefall", with median prices down 17% in Q3

And if the IMF are right, which is almost certain, we must expect major bankruptcies to take place over the next few years. Over-leveraged businesses go bust very quickly when profits decline, as they can no longer pay their interest bills.

As with the run-up to the 2008 crisis, the signs of trouble are already building. The Fed has had to provide $200bn of support to overnight money markets in New York over the past 6 weeks, and is having to add another $60bn/month into next year.

- Companies now face a binary choice as they finalise their Budgets for 2020-2022.
- They can choose to ignore what is happening in the real world and continue to hope 'business as usual' will continue? Or they can start contingency planning by working through the implications of our forecasts for their Downside Scenario?



One key issue is that our 2021 predictions included paradigm shifts as well as economic forecasts. And as the chart above shows, the transitions associated with paradigm shifts are now accelerating:

- It took decades for the telephone, electricity, autos and even the radio to reach most Americans
- But it took only years for the microwave, computer, cellphone and internet to become mainstream

It is clear that a whole series of major paradigm shifts are now underway, as I noted 2 weeks ago:

- Climate change is finally being taken seriously by legislators and many companies
- This will lead to dramatic declines in the use of fossil fuels for both transport and petrochemicals
- It highlights how sustainability is now the key issue for corporate strategy, replacing globalisation
- Affordability is also moving up the agenda, and will become critical as the debt crisis starts to impact

The problem is that incumbents, as we have seen with central banks, are usually very slow to notice what is happening in the real world outside their office or factory. The reason is simple – they forget what they have discussed with their friends and family once they go to work. Group-think instead takes over, and everyone goes blindly on believing their own propaganda until it is too late.

German car company VW was a classic example of a blinkered strategy. As top executives now recognise, it was only the "dieselgate" emissions disaster that enabled new management to introduce the Transform 2025 strategy based on a transition to Electric Vehicles.

Most companies don't face the near-death challenge faced by VW in 2015. But they do face major challenges over the next 2-3 years, which will require them to implement major shifts in their strategy if they want to continue to grow revenue and profits in the future.

The good news is that these challenges can be turned into opportunities with hard work and imagination.

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.

Paul Hodges phodges@thephreport.com

Is a trusted adviser to major companies and the investment community, and has a proven track record of accurately identifying key trends in global marketplaces. He has been widely recognised for correctly forewarning of the 2008 global financial crisis. His analysis of the key role of demographics in driving the global economy is now attracting increasing interest from senior policymakers and executives.

Paul is Chairman of International eChem (IeC), non-executive Chairman of NiTech Solutions and Ready for Brexit, and senior adviser to I.C.I.S. and Recycling Technologies. Prior to launching IeC in 1995, Paul spent 17 years with Imperial Chemical Industries (ICI), both in England and the USA, where he held senior executive positions in petrochemicals and chloral-kali, and was Executive Director of a $1bn ICI business. Paul serves as a Global Expert with the World Economic Forum and is a Freeman of the City of London. He is a graduate of the University of York, and studied with IMD business school.

Daniël de Blocq van Scheltinga daniel.dbvs@thephreport.com

Was the first foreigner to be granted permission to run the finance company of a top-tier Chinese State Owned Enterprise, when establishing and managing ChemChina Finance Company. Previously, Daniël held a variety of senior positions in corporate and investment banking, including as Asia Pacific Head of Chemicals and Asia Head Asset Based Finance for ABN AMRO. He moved to Hong Kong in 2001, and continues to spend much of his time in China, advising international and Chinese firms, as well as leaders in the public and private sectors. Daniël is a graduate of Leiden University, the Netherlands, with a Master of Law degree with a specialty of International law.

David Hughes dhughes@thephreport.com

Is an expert on the Middle East, having lived and worked in Riyadh, Saudi Arabia for 5 years after leading SABIC's global business redesign programme in 2009. He has held a range of senior executive positions with SABIC, Huntsman and ICI, where he led a range of global $1bn+ businesses based in the Middle East, Europe and the USA. He also served on a number of industry bodies, including as Vice-Chairman of the Board of Petrochemicals Europe, the Asian Clean Fuels Association and the Methanol Institute.

Paul Satchell psatchell@thephreport.com

Has worked in the chemical industry as an equity analyst with some of the world's leading investment banks, and directly with chemical companies. For 21 years to 2017, he covered the global chemical industry for banks including ING, Merrill Lynch and Investec, making market recommendations and undertaking advisory work in M&A and lending. He was particularly well known for his development of the Chemicals Volume Proxy, a unique real-time monitor of chemicals demand. Before this, he spent 16 years in the industry itself, mainly with BP/BP Chemicals. He is Honorary Treasurer of the Royal Society of Chemistry and previously chaired its Investment Committee.

Disclaimer

This Research Note has been prepared by IeC for general circulation. The information contained in this Research Note may be retained. It has not been prepared for the benefit of any particular company or client and may not be relied upon by any company or client or other third party. IeC do not give investment advice and are not regulated under the UK Financial Services Act. If, notwithstanding the foregoing, this Research Note is relied upon by any person, IeC does not accept, and disclaims, all liability for loss and damage suffered as a result.

© IeC 2020

Our approach is data-driven, and we cover areas where the team has long-term expertise. Our current focus is on the following key issues:

- The warning signs over the outlook for the global economy provided by chemical industry sales. Over the past year, we have particularly emphasised the worrying rise in corporate debt, and the role of leverage in sustaining US/China auto demand. We also provide analysis of key regional and national markets, and of application areas including consumer products, plastics, fibres and other major sectors.
- Detailed coverage of oil/energy markets and geo-political developments including identification of likely turning points and their rationale – such as the current uneasy balance between fears of supply shortages caused by war in the Middle East and a sharp slowdown in demand due to the US-China trade war.
- The implications for businesses of the rise of populism in the US, UK/EU and other major countries. Having correctly forecast President Trump's success and the UK's Brexit result, we focus on the increasing role being played by politics in formulating economic policy, at the expense of economic logic.
- Our expertise includes the key areas of chemical demand - autos, housing and electronics. In autos, we are currently focused on the growth of alternative business models including Electric Vehicles and ride-hailing, and are suggesting the used car market will become the main growth area in both China and the USA. In 2018, we called the start of the downturn in the smartphone market, ahead of the market.
- We naturally also focus on the growing impact of Europe's sustainability agenda and moves towards a circular economy. In particular we have highlighted the conflict this creates for US-based producers who need to sell major new quantities of single-use polymers into Europe, given the tariff barriers now impacting exports to China

We provide clients with a monthly Report covering the above topics, and are also available for telephone discussions and in-house workshops on specific areas of client interest.

Our value proposition is based on our ability to view the economy through the lens of capacity utilisation in the chemical industry. This is proven to be the best leading indicator for the global economy, with a 56% correlation to IMF GDP data over the past 30 years. We also benefit from the insight we have developed into the growing importance of demographics, since the 2011 publication of our book 'Boom, Gloom and the New Normal: how the Ageing BabyBoomers are Changing Demand Patterns Again'.

Key successes have including being recognised in the Financial Times as one of the few to accurately forecast the 2008 global financial crisis, our forecast in August 2014 that the oil price would likely crash from over $100/bbl to under $50/bbl, and our timely warnings in early 2020 on the likely economic and health impacts of coronavirus.

Our team has a unique capability in these areas and a proven ability to understand industry needs. **Paul Hodges** is a Global Expert with the World Economic Forum: he speaks regularly at international conferences and writes for the Financial Times. **David Hughes** is an expert on the Middle East, and worked in Saudi Arabia for 5 years. **Paul Satchell** understands financial markets, having been an equity analyst with several leading investment banks. **Daniël de Blocq van Scheltinga** Is Hong Kong-based with a background in investment/ corporate banking; he was the first foreigner to run an SOE's finance department in China.

Order Form

Please return this form to:

Paul Hodges
Chairman
The pH Report GmbH
Goethestrasse 21
Staefa 8712
Switzerland

Tel: +44 (0)7785 354809
Email: phodges@thephereport.com

Yes, I would like to subscribe to 'The pH Report' US$9995 per year

I would like extra copies for subsidiary or affiliate companies US$999 per year

Please state number of extra subscriptions required

Name:	
Position:	
Company:	
Address:	
Email:	
Tel:	
Fax:	
VAT number: (if applicable)	
Signature:	
Date:	

GOETHESTRASSE 21 • STAEFA 8712 • SWITZERLAND
VAT NO CHE 411 920 616 MWST
phodges@thephreport.com www.thephreport.com Tel: +44 (0)7785 354809