Financial markets face paradigm shift as China focuses on "Common Prosperity"

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The potential default of Chinese property developer Evergrande, with $305bn of debt, may prove a turning point

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new normal
new-normal.com

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Executive Summary

This month's Report highlights growing risks to the seemingly unstoppable rise of the West's major financial markets. As chart 1 describes, the last "bears" have finally decided to become buyers - in turn, creating the potential space for a new paradigm to appear.

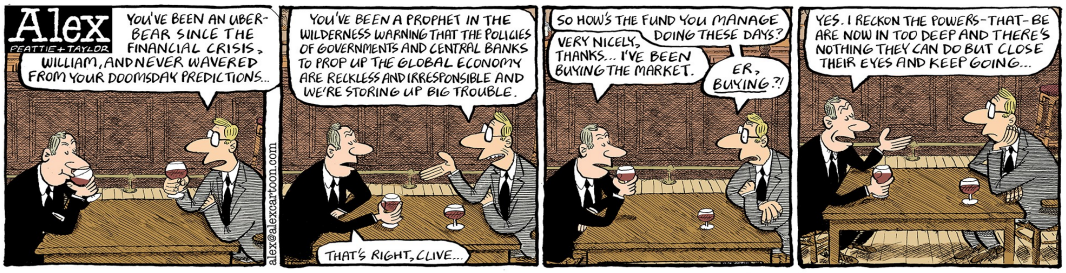


Chart 1: Even Alex's ever-bearish fund manager, William, has finally decided to buy the market

We begin in our Economic Outlook, where the continuing chaos in global supply chains suggests that these have reached their "sell-by date". In turn, this is leading to major changes in business models, as companies are forced to develop more local operations. And as we note in Financial Markets, the coming earnings season is likely to see a rise in profit warnings as a result. We also highlight the IMF's warning on the lack of consistent vaccination policies, which threaten to "*split the global recovery into two blocs*".

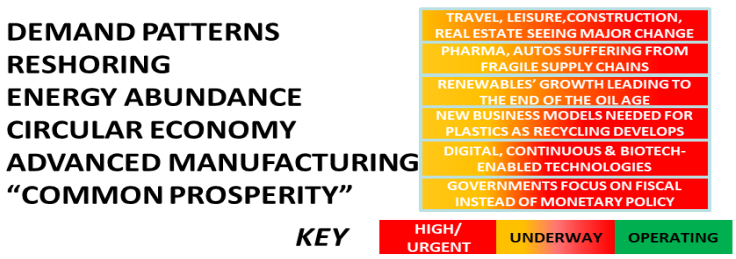
We remain positive over the longer-term outlook, but suggest that Presidents Biden and Xi are both focused on jobs, rather than market indices, as an indicator of economic success. This suggests that traders may well be disappointed when the next 'correction' takes place, by a failure to respond with new stimulus. We take this analysis further in our China section, where we note Xi's new focus on "Common Prosperity" and suggest that property developer Evergrande's potential default, with $305bn of debt, may prove a turning point.

Our Sustainability section highlights the move by industry body, PlasticsEurope, to support the EU Commission's call for a mandatory 30% recycling content for plastics packaging by 2030 - based on the use of chemical recycling. This confirms our view that recycling is starting to reach the acceleration point on the adoption S-curve. As our Politics section notes, a Scholz win in Germany's election could provide further support. It would likely lead to an SPD-Green coalition and allow greater flexibility in the use of EU own resources.

Energy Markets are further along in their paradigm shift to renewables. In general, this is likely to lead to more local supply chains. But we suggest 'green hydrogen' could well be an exception, as the ammonia production on which it depends needs a cheap and reliable supply of renewables, suggesting the Middle East/N Africa could become major players.

We close with an analysis of the negative impact of China's growing self-sufficiency in petrochemicals on industry profitability. China's focus is on job creation rather than margins, and the example of the important polyester chain suggests these are coming under major pressure. Finally our Volume Proxy confirms the unseasonal downtick in Western demand levels, and suggests we may see growing pressure on oil prices.

PROGRESS ON THE KEY PARADIGM SHIFTS



We add "Common Prosperity" to the list of key paradigm shifts, as this seems set to impact financial markets and economic policy

GLOBAL ECONOMIC OUTLOOK

The global supply chains created during the Boomer-led SuperCycle have now reached their 'sell-by date'

1. Supply chain chaos set to extend into 2022

It's now 18 months since the first lockdowns began outside China. And developments since then tend to confirm our core forecast back in March 2020 that:

"Companies and investors need to prepare for major paradigm shifts as well as recession. The end of the recession, whenever it comes, will not mark a return to 'business as usual'. Those who have recognised that sustainability is replacing globalisation as a driver for business, are therefore most likely to see an enduring recovery in revenue and profits. "

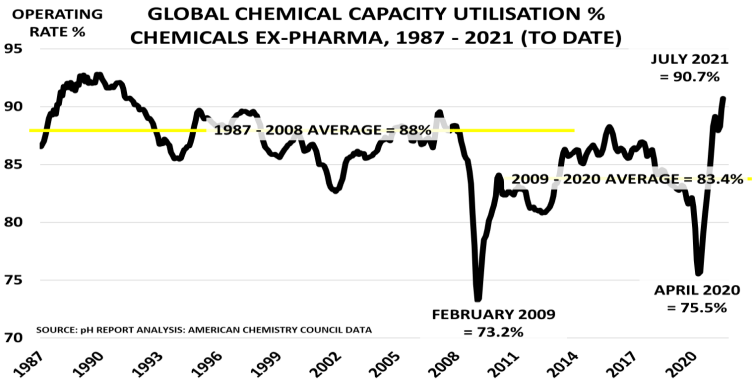


Chart 2: Chemicals Capacity Utilisation is back at near-record levels

As American Chemistry Council data shows in chart 2, production has rebounded very quickly since then. It is already higher than in the 2009-2020 period, and back at levels last seen in the 1980s. Of course, the semiconductor chip industry is much weaker, but that is because companies cancelled orders - and are now finding it takes time to re-order.

Chart 3: Covid port restrictions delay shipping

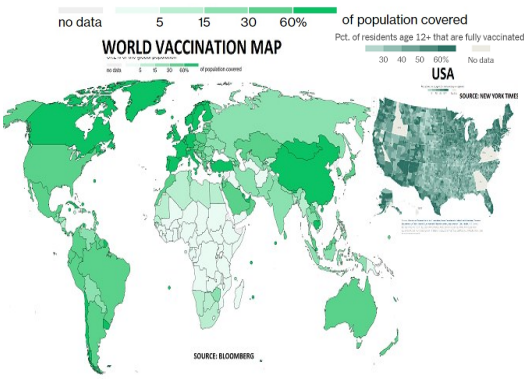


Chart 4: Countries have different Covid responses

The main problem relates to the collapse of global supply chains, as chart 3 confirms. Asia has largely adopted "Covid-free" policies based on lockdowns - either as a matter of policy, or because of a lack of vaccines. Lack of adequate healthcare is another major deterrent to opening up, and taking a risk of Covid spreading. Even today, major ports are being closed on a random basis - and <40% of shipments have been on time so far in 2021. Disruption therefore seems set to continue into at least 2022, until supply chains are localised.

In the West, Europe has focused on vaccinations as the control mechanism, and is set to achieve >70% coverage this month as chart 4 confirms. But President Biden has faced much greater resistance in the USA from anti-vaxxers and conservative politicians. In addition, as the Texas freeze and Hurricane Ida confirm, its vulnerability to weather-related disruptions creates further uncertainty for global supply chains.

This analysis suggests it is unlikely that the 1970s demand-led inflation is being repeated today. The real issue is that global supply chains created in the Boomer-led SuperCycle have reached their 'sell-by date'. 'Just in time' schedules have morphed well beyond the occasional 'Just too late' moment, as in the past, to 'Just doesn't seem to be arriving at all'. Simple pragmatism, along with Net Zero concerns, would therefore suggest companies need to replace these with local supply chains as fast as possible.

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FINANCIAL MARKETS

We see financial markets as being liable to a paradigm shift of their own in coming months

2. Paradigm shift could start to impact markets

Various explanations exist for stock markets' seemingly unstoppable rise since the early 1980s. One key contributor was the purchasing power generated by the BabyBoomers as they moved into their Wealth Creator 25-54 years. But other factors - the end of the Cold War; the positive impact of globalisation from the mid-1980s until recently; central bank support from stimulus since 2000; passive investing via ETFs etc have all played a part.

In addition, of course, corporate taxes have remained low as chart 5 confirms. Income tax receipts from workers have been relatively steady as a percentage of GDP since 1940 (orange line). But corporate tax receipts (blue line) fell sharply till 1980, and have since stayed at low levels - boosting earnings and hence stock valuations.

The result of these factors is that few market participants have experienced the impact of business cycles. So any return to these would effectively represent a major paradigm shift for financial markets - especially as any unwinding of the current paradigm will likely take place over years rather than months, whilst players learn to adjust to the new rules.

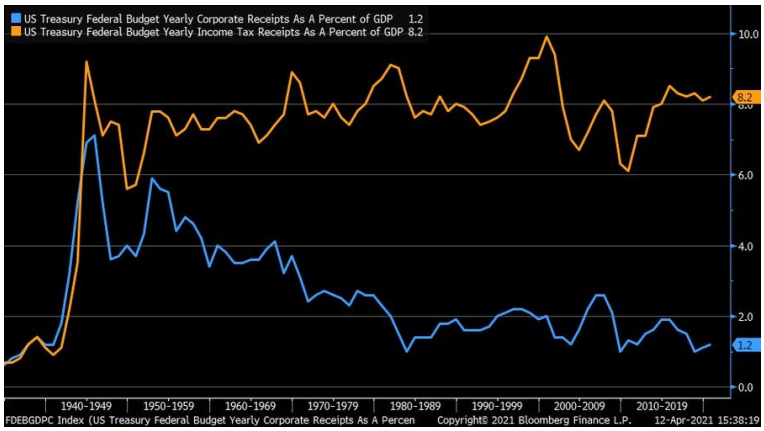

Chart 5: Corporate tax receipts as % of US GDP are much lower than income tax receipts

We are naturally reluctant to call attention to the downside potential, but it does also seem worth remembering that Q4 is the traditional "minefield" for markets, as traders seek to wind up their positions and secure their bonuses at Christmas. Even in a normal year, one would expect volatility to increase during Q4. And 2021 is clearly not a 'normal year'.

A further cause for concern is that US market commentary seems now to be based on the idea that new daily highs for the S&P 500 are "normal", and that failure to make a new daily high is a newsworthy event. Similarly in bond markets, yields have been falling for so long that those for highly-risky junk bonds are alarmingly close to risk-free Treasuries.

This does seem to be alarmingly complacent, especially when it is clear that 'business as usual' is under increasing threat from the major paradigm shifts now underway in the wider world. Investors in the past, up until 2000, were always very alert to the signs of an impending top. But that was in the days when investment success was based on the principles of fundamental analysis, rather than on correctly second-guessing central banks.

With some trepidation, we therefore feel the need to suggest we may now be approaching the endgame for the long-running bull-market. Market euphoria is always a warning sign, especially when based, as today, on the Fear Of Missing Out. Stimulus policies mean there is too much liquidity chasing too few buy-able assets. But liquidity doesn't last forever.

We also suspect future historians might highlight two key areas as being the catalyst for the paradigm shift we see starting to develop in financial markets:

- China's new "Common Prosperity" policy marks the end of 40 years when the focus was on Deng Xiaoping's acceptance of the need for rapid, if unequal, development
- Similarly, the US now has a president who is focused on jobs rather than market indices - another sign that the period that began in the 1980s is drawing to a close.

Chart 6 therefore explores this key issue in more depth.

The Positives. We are very positive over the long-term outlook, even though cautious in the short-term. These factors include the new focus on rebuilding infrastructure (after 40 years of relative neglect), and on building the new sustainable industries of the future.

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We are positive for the longer-term, but cautious over the short-term

The Positives

Factor	Possible impacts
Biden's environmental and infrastructure plans offer scope for substantial job and wealth creation	Will improve outlook for some household incomes and corporate growth in relevant areas
His firm line on Federal vaccination mandates will encourage waverers to take their jabs	Need for return to widespread lockdowns looks limited.
Current vaccines mostly working well against early variants, with boosters available	Supports the hope that the Western world can learn to 'live with Covid'

Market risks

Factor	Possible impacts
Biden is focused on politics, not markets, so interventions will centre on real economy (and voters), not market support measures	Central banks including the Fed are starting to move away from monetary stimulus – leaving the market without its "backstop"
Fed plans for taper could spook the overly-calm bond market	Prices for junk bonds might start to reflect underlying default risks
Q321 earnings season likely to show widespread reports of serious supply-chain disruptions to business: profits warnings	Markets likely to be sceptical about the "temporary" nature of the disruptions. Chemical sector already reflecting downside

Net Zero/COP 26 'jokers'

What?	Possible impacts
Net Zero: Realistic pathways imply a need for major paradigm shifts in business	Most traders are focused on evaluating 'Fed speak' and don't understand 'fundamentals'
COP26: Governments' pledges potentially include accelerated paths to Net Zero	This will highlight downside of 'stranded hydrocarbon assets' to a larger audience
Geo-politics: Governments likely to play their cards close to their chest ahead of Glasgow	Potential for wide range of 'scare headlines' suggesting agreement is unlikely

Chart 6: The market outlook contains risks and 'jokers' as well as positives

Equally, we are positive about the progress being made with vaccination in the countries where it is being adopted as policy. Such policies have always proved successful since their adoption with the very first vaccine, smallpox (discussed in our special edition marking its 225th anniversary in May). Equally encouraging is that current vaccines, plus boosters, should enable the Western world to 'live with covid' - as we live with other viruses/diseases. The corollary is unfortunately also likely to be true as the IMF has warned: "vaccine access is the fault line which splits the global recovery into two blocs".

Market risks. The risks are therefore focused on financial markets themselves, given that they have largely ignored developments in the real world outside Wall Street. They may well for example, have reason to wake up to the fact that President Biden is unlikely to see a market downturn as an emergency. The next correction may well, therefore, spook some traders who expect the Federal Reserve to rush to their rescue with new stimulus. In fact, central bank liquidity seems set to reduce around the world - just as the supply chain chaos leads many companies to start issuing profit warnings.

The 'jokers'. Life also contains unexpected events - or rather, events that play out in unexpected ways. Net Zero policies are a potentially classic example of this in action, particularly as COP26 draws near. Governments always play their cards close to their chests, and China will have few concerns about pushing for trade-offs on climate policy in areas that matter to it. Equally important is that Net Zero will create Winners and Losers. To date, the focus has been on potential Winners, such as Electric Vehicles. The pendulum is overdue to swing to focus on potential Losers, such as stranded oil/gas assets.

Overall, therefore, there appear to be more negative risks in the short-term as we look forward to Q4. But the past 18 months have seen markets recover in weeks from the worst industrial dislocation in living memory - and ignore the political chaos around the US election results. So we can understand traders continuing to believe that '*everything is for the best, in this best of all possible worlds*'. They have, after all, been right so far.

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SUSTAINABILITY

Pilot projects based on chemical recycling now need to move forward in all the EU's major cities

3. EU plastics firms support mandatory recycling

The auto industry was the first to realise, back in 2015/16, that 'business as usual' was no longer an option. Spurred on by the Dieselgate scandal in Europe, and by governmental pressure in China, companies began to announce plans for a major move into Electric and Autonomous Vehicles. 5 years later, it is now the plastics industry's turn to start moving in the same direction - in this case, away from virgin plastics to produce recycled product.

Last week, EU industry body Plastics Europe issued an important call for:

*"A mandatory EU recycled content target for plastics packaging of 30% by 2030 (*adding that) *An enabling policy framework and collaboration with the value chain are essential."*

This call will change the industry as it ripples out to the other major regions. And having set 30% as the initial target, it would be no great surprise if companies end up over-achieving on the goal. After all, feedstocks such as naphtha and even ethane are likely to become scarcer, and less socially acceptable, as countries and companies ramp up the shift to renewable energy as they move to adopt Net Zero targets in line with COP26.

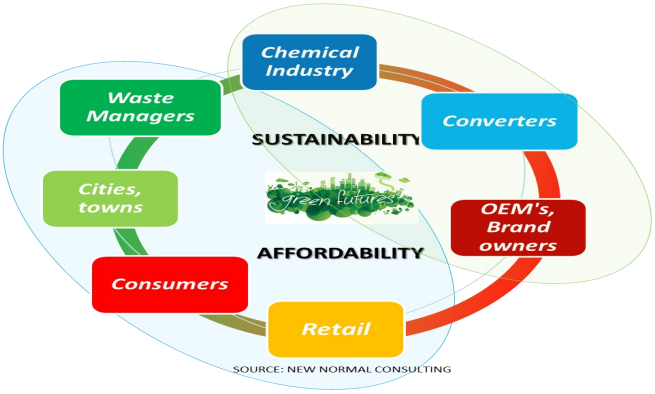

Chart 7: Collaboration needs to intensify amongst the key partners

The original debate on plastics recycling owed its prominence to Ellen MacArthur, the yachtswoman who sailed round the world and was appalled by the volume of plastic waste in the oceans. This led her to set up her Foundation, which soon began to work with the World Economic Forum in developing the New Plastics Economy concept.

The issue was then brought into the wider public domain with Sir David Attenborough's BBC series, Blue Planet 2 in 2017. In turn, of course, this quickly brought brand-owners and politicians into the debate, as consumers also have votes. But in reality, little has yet changed on the ground. There are a number of start-up companies working to launch chemical recycling processes - which will be the essential work-horse to enable recycling targets to be met. And now, we have a definitive statement of industry intent.

The issue, as chart 7 shows, is that no single company can develop a recycling industry on its own. If one looks at today's landscape, it is clear that collaboration must intensify:

- **Producers** mainly work with converters and OEMs/brand owners (yellow oval)
- **Waste managers** mainly work with consumers, retailers and cities/towns (blue oval)

The term "waste manager" highlights the gulf that will now have to be bridged. Plastic can no longer be seen as "waste", just because it has fulfilled its original purpose in packaging or other single-use applications. It needs to be viewed as a critical resource, as the Nova Institute have argued in an important report for Unilever:

"It is not possible to decarbonise chemicals and products. The renewable carbon family is the only pathway to a sustainable future for commonly used materials such as plastics, fibres, surfactants and other materials based on organic chemistry, and the industries that produce them. In other words, renewable carbon production will have to be increased by a factor of 15 by 2050 to cover the needs of the sector."

The EU industry's adoption of a 30% target is a critical first step on the road to realising this vision. Intensifying collaboration between all the relevant partners will now be key to realising this objective on a timely basis, via pilot projects in all the EU's major cities.

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ENERGY MARKETS

"Green hydrogen" will require large volumes of extremely cheap and reliable renewable electricity

4. Hydrogen an exception as energy output goes local

Reshoring is one of today's major paradigm shifts. And it applies just as much to energy markets as manufactured goods. Renewable energy in terms of wind and solar is much easier to manage on a local, distributed basis - with links to storage and the grid for back-up purposes. In turn, this will deliver major cost savings to consumers. Local solar / wind costs are now starting to fall below fossil-powered costs, as a new Fraunhofer Institute study of German costs confirms in terms of Levelized Cost of Electricity;

- **Photovoltaics (PV) range from €0.03 to €0.11/kWh**
- **Hybrid PV linked to battery systems ranges from €0.05 to €0.20/kWh**
- **Onshore wind turbines range from €0.04 to €0.08/kW**
- **Offshore wind turbines range from €0.07 to €0.12/kWh**
- **Conventional gas turbines cost a minimum €0.075/kWh including carbon costs**

This means that energy will no longer be "something that happens" in the Middle East or in Texas, but a more local, community-based activity. This will be a sharp contrast to post - War history. This period saw a steady rise in inter-regional trade for oil and gas - along with periods of major disruption and price spikes. Local supply will reduce these problems, assuming sufficient storage is installed for when the sun doesn't shine or the wind blow.

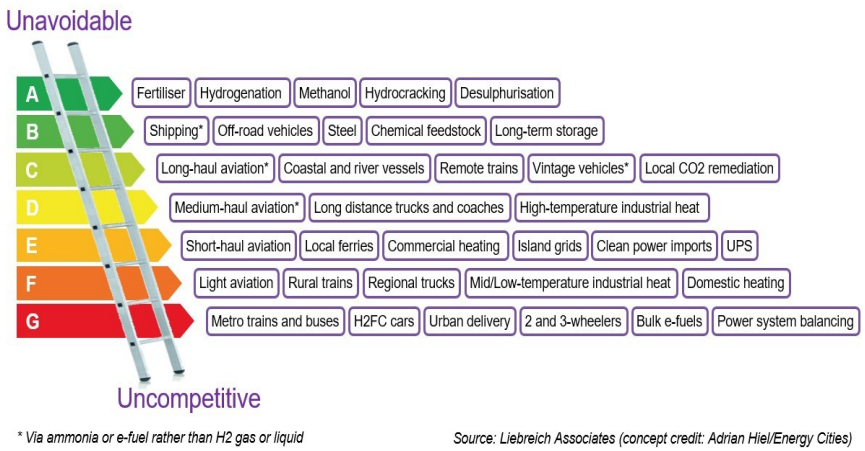

Chart 8: Hydrogen production is currently responsible for 2% of global CO_2 emissions

Hydrogen (H_2), however, is likely to be one of the exceptions to this trend. As discussed in March, it is likely to become an important component of the energy mix in certain niche applications. This is due to the need to replace current H_2 output, which is responsible for 2% of global CO_2 emissions. The reason is that "green hydrogen" production will require large volumes of extremely cheap and reliable renewable electricity. It therefore seems likely that the Middle East and North Africa will become major players.

Projects such as NEOM in Saudi Arabia are likely to be the model for the new plants, given the extreme difficulty of transporting hydrogen. Instead, the NEOM complex will convert the hydrogen on-site into 1.2 Mt/yr of ammonia using conventional technology, and this "green ammonia" will then be exported. This is not an ideal solution, however. Moving hydrogen in the form of ammonia currently requires a reverse "cracking" process to convert the ammonia back into nitrogen and hydrogen at the point of use.

Existing ammonia "crackers" are unfortunately highly energy inefficient, although several companies are already working to find new and more efficient ways to carry out this reaction. Whilst this work is underway, there is therefore a need to maximise the decarbonisation effect of green hydrogen, as part of the wider moves towards Net Zero.

As chart 8 from Liebreich Associates suggests, the optimal route would be first:

- **To replace the world's current 200 Mt of conventional ammonia demand (mainly for fertilisers) with green ammonia from renewable hydrogen**
- **In an ideal world, only then would other uses of green hydrogen be considered**

But the world is not ideal however. And so in the short-to-medium term we expect significant quantities of green ammonia / hydrogen to be instead diverted into hard-to-decarbonise transport applications such as shipping and remote trains.

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POLITICS

Scholz seems to favour the development of "new European own resources", to replace Germany's traditional focus on national resources

5. Scholz takes lead in Germany's election polls

Germany's election on 26 September is shaping up to deliver the reverse outcome to the 2017 campaign. Then the SPD's Martin Schulz lost a commanding lead during the campaign. This year has instead seen a swing to the SPD as first the Greens, and then the CDU/CSU, stumbled when leading in the polls. Back in May, the Greens and CDU/CSU were neck and neck back at around 25%. But as we noted then, the mood was volatile:

"The Greens and CDU/CSU have all to play for in the next few months….after 16 years of Merkel, German voters seem ready for change. And importantly for the EU, Green policies are likely to dominate the agenda, whoever wins the Chancellorship."

Chart 9: July's flooding was bad news for the CDU's Armin Laschet

The issue is simply that voters and the media tend to focus, for good or ill, on the leading candidate. The Green's Annalena Baerbock was the first to wilt in the limelight, with allegations surfacing of plagiarism in her recent book, along with doubts over her CV. Then July's floods similarly undermined the CDU's Armin Laschet, who was caught laughing on camera during a tour of the devastated regions. These two setbacks encouraged voters to look again at the SPD, given they had always preferred Olaf Scholz as a candidate.

He is currently preferred by 32% of the electorate, with Baerbock at 15% and Laschet at just 10%. And his ratings have pulled the SPD up to 25%, with the CDU/CSU on 21% and the Greens at 16%. Voters seem to be happy with his performance as Finance Minister, and prepared to overlook his role in the Wirecard scandal.

The problem for the CDU/CSU lies in Merkel's success in sidelining potential rivals over the years - including current Commission President, Ursula von der Leyen. 16 years is a long time for one leader to remain in charge, and she has no potential successors waiting in the wings, who are known and liked by the public. This has allowed Scholz to make inroads into the centre ground, even mimicking Merkel's trademark hand gesture to promote a sense of continuity.

Chart 10: Scholz mimics Merkel's hand gesture

Importantly for the outcome of the election, the liberal FDP are holding steady at 12% - making a "traffic light coalition" (red for the SPD, amber for the FDP and the Greens) a real possibility. The alternative would be "red-red-green" and include the left-wing Linke, currently on 6%, as the SPD has ruled out working with the far-right AfD, now on 11%.

Understandably, Scholz has held back from focusing in domestic debates on areas where he would promote real change, given the febrile state of the electorate. But as chart 9 confirms, the floods mean that climate change is now rivalling the pandemic as voters' key concern. Issues such as migration, inequality, pensions and education are all down the list. And he has been less guarded with the foreign press, suggesting that:

"Progress for the European Union has to be Germany's most pressing mission right now ."

Importantly for the future of the EU, he seems open to the idea that loans granted under the Recovery & Resilience Fund could be repaid "*from new European own resources*". This would be a major departure from Germany's traditional focus on national contributions.

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CHINA

Xi Jinping aims to achieve the second part of Deng's vision, the achievement of "Common Prosperity", by the time of his expected retirement in 2035

6. China resets its economy for a "New Journey"

July saw China celebrating the first of its two "Centenaries" - to mark the founding of its Communist Party in 1921. Unsurprisingly, President Xi Jinping used the occasion to look back at the successes of the past, and to look forward to the second Centenary in 2049, which will mark the anniversary of the People's Republic. As China Daily headlined the event next day, China is now "At Start of New Journey" (sic).

Source: Caixin

Chart 11: "Common prosperity" aims to reshape society to support the middle class

China's major achievement since 1949 has clearly been the eradication of extreme poverty, and the achievement of a "moderately prosperous society". This has involved lifting 770m people out of poverty, with 100m lifted out in the past decade. In 1979, when Deng Xiaoping went to New York to take up China's seat at the United Nations, China had virtually no foreign reserves: Hong Kong tycoons had to pay his travel costs.

Deng's vision changed everything, as he pushed to create Special Economic Zones and to allow "people to get rich" for the first time under communism. As he argued:

"Let part of people get rich first. Some areas and some people can get rich first, lead and help other regions and people, and gradually achieve common prosperity".

Now Xi is aiming to tackle the second part of Deng's vision, the achievement of "common prosperity". The aim is that by 2035 (his likely retirement date), China will be a modern:

"Socialist country - prosperous, strong, democratic, culturally advanced and harmonious".

This is a very important new emphasis, and was formalised last month by Xi himself at the Party's traditional summer workshop at Beidaihe. The issue is simply that Deng's "get rich" concept has led to a widening of the gap between rich and poor. China's Gini Coefficient is currently 38.5% - just below the USA at 41.4%, and well above Germany at 31.9%. The obvious risk is that adverse economic developments could lead to major social unrest.

One also doesn't have to look far to spot potential sources of instability - most obviously in the property market, which has been "subprime on steroids" in recent years as a result of China's massive stimulus programmes. Property sales fell 16% in the 4 main Tier 1 cities last month, and last week saw a warning by Evergrande - the world's most indebted property developer with an estimated $305bn of debt - that it might be forced to default.

Many US investors seem to be ignoring this risk, on the principle that Evergrande is "too big to fail" and will be bailed out by its friends in the government. But this overlooks Xi's constant refrain in recent years that "*houses are for living in, not for speculation".* He might well bail out homeowners who lose their deposits in a default. But Evergrande's US$ loans are already at record lows, as foreign investors are not likely to get off so lightly.

"Common Prosperity" is therefore not likely to prove just a marketing slogan. Instead, as Caixin suggests, it instead signals a root-and-branch reordering of Chinese society:

"Common prosperity is to reshape the societal structure from a pyramid-shaped structure to an oval-shaped one with the widest part representing the middle class".

Companies and investors should therefore plan for major changes in the months ahead, rather than assuming there will be 'business as usual'. The recent moves against the tech sector are likely to prove to be just one sign of things to come, with companies such as Alibaba and Tencent finding it prudent to make $bn "donations" in response to Xi's call for regulation of "*excessively high incomes*" and for *"enterprises to return more to society".*

Xi began in the same way, after all, with his anti-corruption campaign on taking office in 2013, when he made a number of headline arrests. And the tactic served him well then.

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600m Chinese have to survive on an income of less than $140/month, according to premier Li - and 2/3rds live on less than $280/month

Xi Jinping's 12 key policies for Common Prosperity

President Xi launched the Common Prosperity policy at a briefing session for "provincial and ministerial level officials" in January, in preparation for its Centennial Day roll-out in July. Official media has now highlighted the 12 new policies for implementation:

1. **People-centered philosophy of development.** *"The people yearn for a better life, our goal is to help them achieve it, and we must unswervingly follow the path of common prosperity."*
2. **GDP growth is no longer the sole barometer of success.** *"We need to shift the focus to improving the quality and returns of economic growth, to promoting sustained and healthy economic development, and to pursuing genuine rather than inflated GDP growth and achieving high-quality, efficient, and sustainable development."*
3. **The economy is in an uncertain state.** *"Our economy is now in a slowing growth phase, a painful structural adjustment phase, and a phase of absorbing the adverse effects of previous stimulus policies. The world economy is also in a period of profound adjustment, which makes for an extremely complex economic development environment."*
4. **China has entered a New Normal.** *"Understanding the New Normal, adapting to it, and guiding its development constitute the major theme of China's economic development."*
5. **The domestic market is to play a decisive role in resource allocation.** *"The environments and conditions that facilitated largescale imports and exports are no longer in place. In today's world, markets are the scarcest resource. China's market is thus a huge advantage of our country. We must make full use of this factor and continuously consolidate it to make it a strong pillar for creating a new development dynamic. Expanding domestic demand is not a temporary policy to cope with financial risks and external shocks."*
6. **We need to build an ecological civilisation** *"with blue skies, green fields and clean waters. We have committed to the idea that lucid waters and lush mountains are as precious as mountains of silver and gold."*
7. **We have introduced a new development philosophy.** *"This is based on the idea of innovative, coordinated, green, open, and shared development. The introduction of the new development philosophy marks a fundamental change for the entire development context of our country."*
8. **We have initiated supply-side structural reform.** *"The five priorities in promoting supply-side structural reform are cutting overcapacity, reducing excess inventory, deleveraging, reducing costs, and strengthening areas of weakness."*
9. **We must deal with unbalanced and inadequate development.** *"The principal challenge facing Chinese society has evolved into one between unbalanced and inadequate development and the people's growing needs for a better life. This represents a historic shift that affects the whole landscape."*
10. **We must transition from a phase of rapid growth to a stage of high-quality development.** *"We have arrived at this conclusion based on the change in the principal challenge facing Chinese society. In this stage, we need to follow the new development philosophy."*
11. **"We must modernize our economic system.** *"This is both an urgent requirement for getting us smoothly through this critical transition and a strategic goal for China's development."*
12. **We have moved to create a new development dynamic.** *"This focuses on domestic economic flow and features positive interplay between domestic flow and international engagement."*

Why the change? China has made major progress since 1980 in moving 770m people out of extreme poverty. But as premier Li noted, 600m still live on <Rmb 1k/month ($140). And 2/3rds of the population survives on <Rmb 2k/month ($280). So the focus has now moved to improving the lives of these 965m people, to avoid potential social unrest.

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PETROCHEMICALS

China's focus is on creating jobs and maintaining employment. This is depressing margins for Western producers, as it undermines the benefits provided by the Experience Curve

7. China's self-sufficiency hits polyester chain margins

The history of petrochemical markets over the past 60 years, since they were established in the 1960s, has confirmed the value of the Boston Experience Curve. This suggests that production costs fall by ~20% for every doubling of accumulated production volume. But more recently, however, a new dimension has been added to the mix with China's emergence as a major petrochemical producer in its own right - rather than as a buyer.

The logic of the Boston Curve was based on companies' ability to find new ways of improving efficiency, as they became more experienced in the manufacture of the individual product. This theory is still valid in the West, but is now facing a commercial challenge as China moves to become self-sufficient and reduces its imports.

The issue is that China has always been focused on creating jobs and maintaining employment as its main priority. Communist Party rule would be threatened by social unrest if it fails to meet this priority. The State Owned Enterprises (SOEs) clearly have it as their objective, and the nominally 'private' producers all rely on state-provided loans to run their business and fund investments. Plus, of course, those producers outside China are reluctant to close when they lose China exports, and so cut prices to maintain volume.

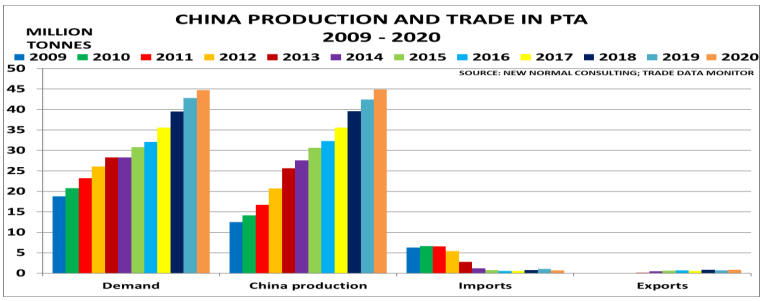

Chart 12: China has now become self-sufficient in PTA

The polyester chain has been the first to experience the impact of this change. Clothing and the manufacture of PET bottles was a natural fit for China after it joined the World Trade Organisation in 2001, and became the manufacturing capital of the world. It took some time to complete the initial build-out of modern refining capacity by 2010, but then it began to focus downstream, starting with the polyester (C8) chain.

As chart 12 confirms, based on Trade Data Monitor data, China's net PTA imports (the raw material for polyester fibre and PET), peaked in 2010-11 at 6.5 million tonnes. Domestic output has since nearly trebled from 17Mt to 45Mt in 2020 - but net imports fell to ~1Mt.

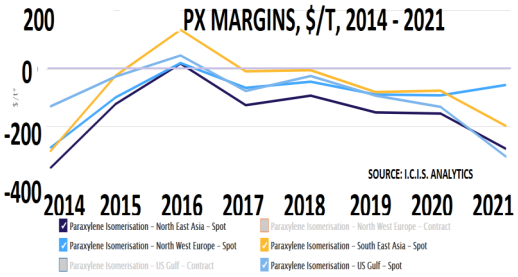

Chart 13: PX margins are now negative

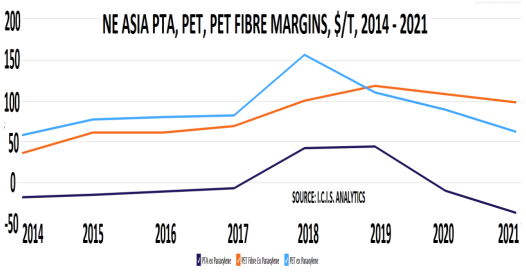

Chart 14: PTA, PET, PET fibre margins are weakening

Charts 13 & 14 highlight the impact of this change from imports to self-sufficiency on chain margins, based on I.C.I.S Analytics data. China is now 64% of global PX (paraxylene) demand and PX margins have been negative on a spot basis since 2016. PTA, PET/PET Fibre have recently moved in the same direction. Pandemic-related demand for PPE and masks helped to keep PET fibre margins positive. But NE Asia margins for PTA margins went negative in 2020, and PET bottle margins are near break-even.

China is now becoming self-sufficient in a wide range of basic petrochemicals, as we discussed in our July/August Report. We can therefore expect the same impact on global profitability to occur, as other major petrochemicals follow the polyester chain pattern.

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VOLUME PROXY

There are few signs of the traditional pick-up in demand, as buyers return after the summer lull

8. Aromatics signal rising pressure on oil prices

Our overall Index has fallen in recent days after peaking back in June, as chart 15 confirms. And yet, we would normally expect demand to pick up at this time of year, as purchasers return to their desks after the summer period. In the West at least, the reverse seems to be happening.

The Regions chart also shows a marked difference between the West and Asia. The US and Europe have fallen sharply, but the latter remains in positive territory.

The Products chart is perhaps the most interesting. Aromatics, closest to the oil markets, have moved into negative territory, suggesting that buyers are anticipating a fall in oil prices. Olefins is also negative, although Polymers continues on its recent uptrend.

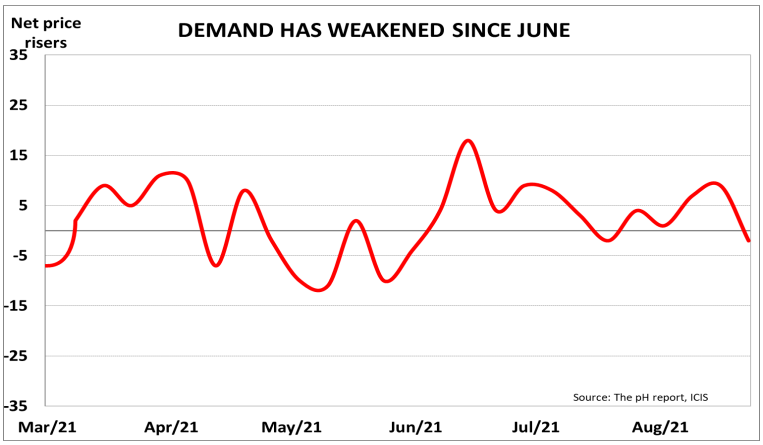

Chart 15: Overall demand peaked in June

- As chart 16 shows, Asia remains in positive territory, having recovered from its previous slump
- US and Europe have fallen in concert, with the latter being particularly marked
- This contrasts with the typical behaviour of purchasers returning to the market after the summer break

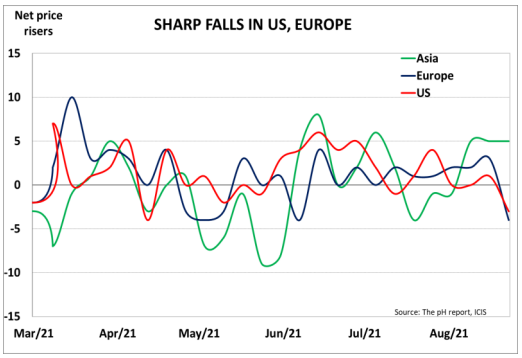

Chart 16: Europe and USA have fallen sharply

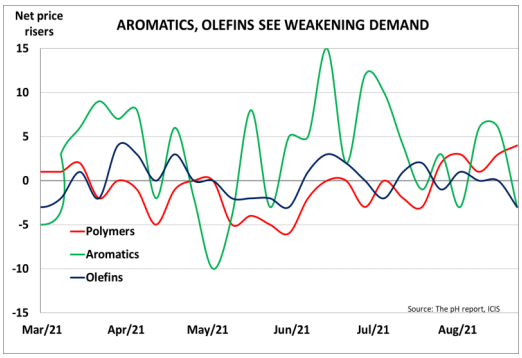

Chart 17: Aromatics and Olefins have also fallen

- Aromatics has shown a very dramatic reversal, suggesting buyers expect a fall in the oil price, as chart 17 shows
- Olefins is now negative and trending down
- Polymers continues its recent uptrend

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About The pH Report

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

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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 is chairman of New Normal Consulting and a Global Expert with the World Economic Forum. His analysis of the key role of demographics in driving the global economy has attracted increasing interest from senior policymakers and executives.

Paul also serves as Advisory Board chairman for Infinity Recycling and non-executive Chairman of NiTech Solutions, and is a senior adviser to I.C.I.S Pricing and Recycling Technologies. Prior to moving into consulting in 1995, Paul spent 17 years with Imperial Chemical Industries (ICI) in the UK and USA. He held senior executive positions in petrochemicals and chloralkali, and was Executive Director of a $1 billion ICI business.

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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.

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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.

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Is an expert in financial markets. Previously he was a Managing Director-level equity analyst, working 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. Prior to this, he spent 16 years in the industry itself, mainly with BP/BP Chemicals. He recently completed a four-year term as Honorary Treasurer of the Royal Society of Chemistry and previously chaired its Investment Committee.

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