Ukraine, pandemic herald market shift

Demographics, volatility drive a slow growth world which will end globalisation, boost shift to net zero. New future-proof chemicals business models are required

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"We are living through a watershed era. And that means the world afterwards will no longer be the same as the world before."

This insight from German Chancellor Olaf Scholz's (*pictured*) historic February speech to the Bundestag highlights the challenges we face.

First, we had the COVID-19 pandemic. It has killed millions of people, and created chaos in supply chains. Then we had war in Ukraine and major sanctions against Russia. This will accelerate localisation and the transition towards a Net Zero economy. Now the third Horseman of the Apocalypse seems set to appear. Not only are fertiliser costs spiralling along with natural gas prices. But Ukraine and Russia account for 29% of global wheat supply. So there is an increasing risk of famine in certain parts of the world.

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Olaf Scholz
Chancellor, Germany

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Where do we go from here?

Clearly the unique period of the BabyBoomer-led SuperCycle has come to an end. Favourable demographics led to a 35-year period of virtually constant growth between 1980-2015, as the number of young Wealth Creators (those aged 25-54), doubled from 1.5bn to 3bn.

But today, the collapse of fertility rates and the rise in life expectancy means that the ageing Boomer Perennials (aged 55+) now account for the majority of global population growth. They already own most of what they need, whilst their incomes decline as they enter retirement.

Unsurprisingly, therefore, as John Richardson and I forecast in our book *Boom, Gloom and the New Normal*, social unrest is rising within countries, and between countries. The SuperCycle created a larger "economic pie", so everyone could benefit.

But now, the size of the pie is starting to decline, and we have reverted to the pre-SuperCycle model where different groups fight to increase their share of it.

Globalisation, based on supply chains that linked producers with world-scale plants to their customers, has reached its "sell-by date".

Rising volatility in energy markets and interest rates is another sign of the paradigm shifts underway.

In the space of just two years, Brent oil prices have risen from $16/bbl in April 2020 to $139/bbl last month. Interest rates have also been giddy, with the benchmark US 10-year Treasury rate rising from 0.4% to 2.4%. And inflation has taken off around the world, due to the Covid-induced supply chain chaos and the rise in energy prices.

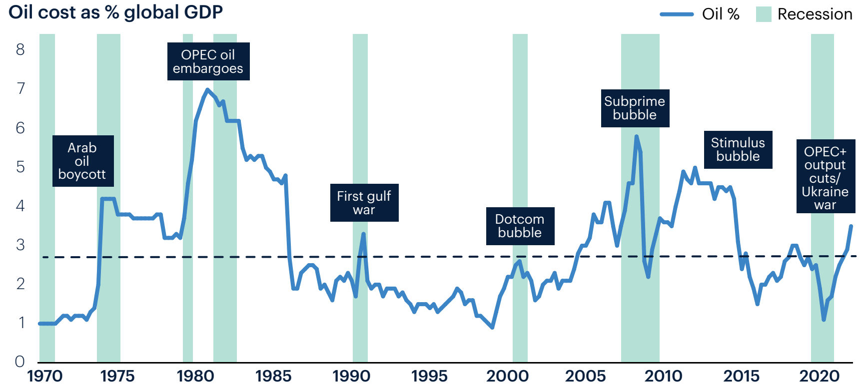
These developments confirm Scholz's sense that we have reached a watershed moment. And as the International Energy Agency has warned, Net Zero needs require us to develop new business models based on accelerating the transition away from fossil fuels.

We need to rethink the way we do business, if we want to be successful in the future. The winners in the future will be those companies with locally-based production and a more sustainable and circular way of operating. Scenario planning, with a wide range of potential outcomes, will also be key to success given today's levels of volatility. We can no longer simply tweak a base case to reflect whether we are feeling optimistic or pessimistic.

Financial risks are increasing

Unfortunately, energy and financial markets are exacerbating the risks ahead. Oil prices at current levels – they now account for more than 3% of global GDP – have historically led to recession as the chart shows. The reason is that consumers have to cut back on their discretionary spending, which drives economic growth, in order to heat their homes and travel to work and school. Today's high levels of natural gas prices add to this risk.

US recessions and the oil price



Source: New Normal Consulting, BP Energy Statistics, EIA, NBER, IMF, UN

Even more importantly, central banks are finally abandoning the Bernanke Theory that has driven monetary policy since 2010. This essentially argued that "what is good for financial markets is good for the economy".

And it led the US Federal Reserve to hand out $8tn of stimulus to Wall Street in pursuit of this objective. Essentially this meant that the past decade has been 'subprime on steroids' for financial markets.

The result is that valuations for a wide variety of financial assets – shares as well as housing – are at record levels, along with debt levels. But now the party is coming to an end as political pressures finally force the central banks to return to their original mandate of fighting inflation, and begin raising interest rates.

Challenges create opportunities

Scholz's analysis is therefore a critical insight for companies and investors. They can, of course, decide to continue with business as usual, in the hope that today's problems will somehow disappear and the world will return to the Old Normal.

But this is a high-risk strategy, given the range of paradigm shifts now taking place. More far-sighted managements will instead look to focus their resources on building out the new business models required for today's New Normal world.

They will recognize that this is truly a once-in-a-lifetime opportunity to change the basis of competition. As discussed here in October (ICB 4-11 October 2021), the key need is to develop a more service-oriented portfolio. This will enable companies to move away from simply providing products – valuable though these are – and focus on providing solutions to many of the pressing problems that are now facing us.

Just as in the 1960s, we need to reinvent our portfolio for a new era. This will enable us to look forward to decades of profitable growth, based on the provision of sustainable and affordable products and services. The time for action is now, as delay could be fatal.

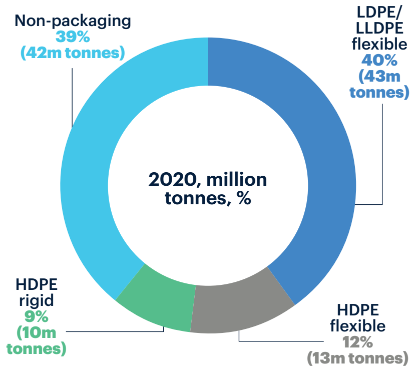
The winners in the future will be those companies with locally-based production and a more sustainable and circular way of operating.

Polyethylene highlights challenges

Polyethylene (PE), the largest volume polymer, is already in the eye of the storm. Its problems began a decade ago with the decision by US producers to dramatically expand production. Unfortunately, this was based on a false assumption of continued double-digit GDP growth in China, and a consequent need for increasing volumes of PE imports. And since then, China's market dynamics have continued to move in the wrong direction in terms of both demand and supply:

- China's ageing population means its economy is even more dependent on exports for growth, rather than domestic demand
- And on the supply side, President Trump's trade war led China to focus on increasing its own capacity in order to increase self-sufficiency
- As a result, 2021 saw China's demand fall by 4%, whilst domestic production rose to take a record 59% of the market – and both trends seem set to continue

Recycled plastic puts 61m tonnes of PE demand at risk



Source: New Normal Consulting, ICIS

Overcapacity isn't the only problem, however, as the chart confirms. More than half of PE demand goes into single use packaging, where its continued use is under increasing threat, as the chart shows.

Companies such as L'Oréal have already set a clear target that "50% of the plastics used in our packaging will either be of recycled origin or bio-sourced" by 2025. In addition, the EU is introducing an €800/tonne charge on virgin plastic packaging, as part of its Recovery & Resilience programme.

And the recent UN Environment Assembly voted unanimously to negotiate a legally-binding treaty on plastics pollution, along the lines of the landmark Paris Agreement on climate change.

Now the Ukraine war has led the influential International Energy Agency to enter the debate. It has already called on countries to accelerate the adoption of electric vehicles and plastics recycling so as to reduce their reliance on Russian oil and gas exports.

This will likely increase the pace of refinery closures, thereby reducing feedstock naphtha availability. It will also encourage retailers and brand owners to accelerate their move away from virgin plastic packaging.

The short-term is obviously going to be difficult. But the new direction is very clear, and will require a new and more robust business model based on a more circular and sustainable economy. China is already moving in this direction and is aiming to become a global leader in the supply of Electric Vehicles and use of plastics recycling.

The real need now for the polymer industry is to develop an operational model that enables pyrolysis oil to replace fossil-fuels as cracker feedstocks, based on greatly improved collection and sorting of waste plastic.

Some major steps have already been taken in this direction, most notably the EU's 'Holy Grail project'. This will enable the high-speed sorting of waste plastic via the use of digital watermarks.

The polymer industry now has to step up and resolve the technology challenges which remain with the use of chemical recycling, if it wants to secure its future prosperity. ■

Paul Hodges is chairman of New Normal Consulting, who offer Challenge Workshops on Net Zero strategies. He also publishes *The pH Report* and writes the ICIS Chemicals & the Economy blog