Shutterstock

Prepare for the coming crisis

Few have experienced a 1970s style recession but a similar situation is developing today – a toxic combination of geopolitics, energy shortages and rising inflation

Paul Hodges New Normal Consulting

Two famous comments come to mind as we look ahead to the end of the year. The first is from the former chair of the US Federal Reserve, William McChesney Martin. He argued that a key role of a central bank was "to take away the punch bowl just as the party gets going". The second, again highly relevant to today's position, came from former UK Prime Minister Harold Macmillan. When asked what kept him awake at nights? "Events, dear boy, events" was his reply.

We are seeing the application of these two concepts today. As John Richardson and I discussed in our ICIS eBook, *Boom Gloom and the New Normal: How the Western BabyBoomers are Changing Demand Patterns Again*, demographics are destiny.

And with today's ageing populations in all the major regions – Europe, the US and China – we cannot expect growth to rival that seen in the Boomer SuperCycle. However, central banks have until recently refused to accept this logic. Instead, they decided from 2003 onwards that they could effectively 'print babies' by overturning Martin's key principle.

One might have hoped they would reconsider after the near-disaster of the subprime bubble in the early 2000s. But instead they doubled down from 2009 onwards, with China even launching a 'subprime on steroids' stimulus programme. In total, they have so far added $70tr to their balance sheets since 2003. And some central banks not only reduced interest rates to zero, but even introduced negative rates.

This recklessness set the stage for "events" in the real world to intervene. First there was the pandemic and associated supply chain chaos. Then this year has seen the rise of 'Putinflation' as Russia's invasion of Ukraine creates a growing risk of energy, food and financial crises.

As the head of Germany's Employers' Associations warned earlier this month: "We are facing the biggest crisis the post-war Federal Republic has ever had. We have to be honest and say: First of all, we will lose the prosperity that we have had for years".

Similarly, BASF has warned that its entire Ludwigshafen complex, the world's largest chemicals hub, may be forced into major cutbacks due to the reduction of Russian gas supplies.

As discussed here in April (Ukraine, pandemic herald market shift, ICB, 1-7 April), we are essentially still suffering from the impact of the Three Horsemen of the Apocalypse:

- First there was the pandemic, which has not gone away. China is particularly impacted due to its lack of effective vaccinations, with Shanghai's GDP declining 5.7% in H1. In turn, the continuing lockdowns are playing havoc with global supply chains.

■ Then there was the energy crisis, as natural gas prices rose to record levels in Europe. Germany is the powerhouse of the European economy, and it has allowed itself to become heavily dependent on Russian gas. If its economy now stumbles under the impact of gas rationing – as seems inevitable – the impact will be felt around the world.

■ Plus there is the rising risk of food shortages, as higher gas prices lead to dramatic fertiliser cost increases. The impact has been hidden so far as we have been eating last season's food. But farmers are now having to either increase their own prices for the new season, or to cut back on production.

■ Problems are also developing in financial markets. China's real estate bubble is 29% of its economy, and it is now starting to burst in epic fashion. Western housing markets also look vulnerable, as do stock markets, as interest rates start to return to more normal levels. And currency markets are adding to the problems as the traditional flight to safety pushes the US dollar higher.

None of us have ever seen circumstances like this. But there are certainly some similarities with the oil price crises of the 1970s/1980s. These also involved a toxic combination of geopolitics, energy shortages and rising inflation and interest rates. And there was the same initial refusal, as today, to accept that we faced major problems.

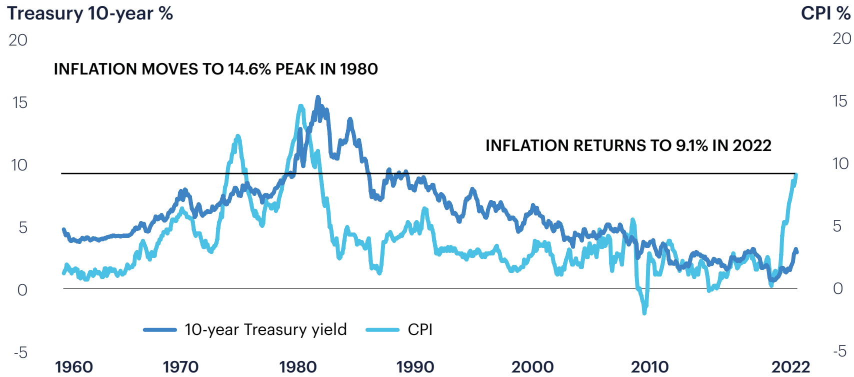
Policymakers were slow to respond when inflation began to spike during the first oil crisis in 1973/1974, and so they were already on the back foot when the second oil crisis occurred in 1979. As a result, the benchmark US 10-year Treasury rate was still playing catch-up as inflation rate reached its 14.6% peak in 1980.

Unfortunately, we seem to be in the same position today. Few people in the markets have ever experienced a 1970s-style recession, and they instead continue to assume that the problems will all be over by Christmas. But in the real world, policymakers are far from even normalising policy, let alone tightening.

The US 10-year rate has indeed risen from its recent lows. But it is still only at 3% or below, while inflation has already reached 9.1%. We have no idea what will happen to major asset markets such as housing and stocks if interest rates continue to normalise, but we can guess that the impact will not be positive.

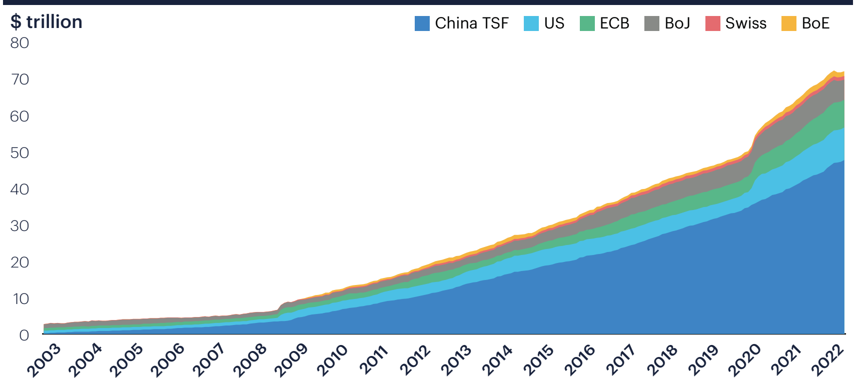
What does this mean for chemical companies as we move into budget season? One key issue is that the supply chain chaos has led many buyers to increase their inventory levels, by moving from 'Just in Time' to 'Just in Case' policies. In turn, this has given a false picture of underlying end-user demand. Businesses therefore need to be very cautious in their assumptions, and focus on 5 key areas:

US 10-year treasury yield vs CPI inflation



Source: New Normal Consulting, Professor Robert Shiller, Federal Reserve Bank of St Louis

Major central bank stimulus spending



Source: New Normal Consulting, Central Bank Data

■ Scenario planning, based on a wide range of potential outcomes, will 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 marginally more optimistic or pessimistic.

■ Recession until 2025. We need to be realistic about the outlook and not assume the current recession will be over by Christmas. The issues we face are more likely to take years to resolve as they involve deep-seated problems.

■ China is changing. It has bankrolled chemical industry growth since 2009, but now its model is shifting to self-sufficiency, alongside a major move into mechanical and chemical recycling to meet net zero targets. Its real estate market has been 'subprime on steroids' and its bursting will have far-reaching consequences for the global economy.

■ Food shortages. Emerging markets are already being badly hit by the current problems. As Sri Lanka's suffering has shown, social unrest is rising around the world as food shortages increase along with prices for other essential goods. In turn, this will inevitably destroy the myth that demand growth in developing countries can somehow balance the downturn in developed markets.

■ Invest for the future. Recession will accelerate the transition to a net zero economy. The invasion is already reducing fossil fuel demand. And demand patterns are changing very quickly as people refocus on 'needs' rather than 'wants'.

We are living in a world where geopolitical, economic and sustainability goals are all pointing in the same direction. As the International Energy Agency (IEA) has highlighted, it is critical that we accelerate the move to electric vehicles and increase output of recycled plastics.

We can, of course, all hope that today's problems find a way of magically resolving themselves. But hope is not a strategy. Tomorrow's winners will be those companies that accept today's challenge of planning for a more difficult and uncertain future.

Manufacturing, in particular, has a vital role ahead. It is key to implementing safer, greener, faster and cheaper continuous processes. These will be essential. ■

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