Scenario planning key amid volatility

With major risks rising, the key benefit of a scenario approach is that it will provide a structure with which to tackle the challenges ahead

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The Four Horsemen of the Apocalypse have begun to canter since August, when we highlighted the likely crisis ahead ('Prepare for the coming crisis', ICB, 5 August). Companies and investors clearly face a very difficult autumn and winter with the global economy now facing a major downturn. Scenario planning, based on a wide range of potential outcomes, has therefore become mission-critical 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.

The problems began with the supply chain crisis caused by the pandemic. Russia's war in Ukraine then created a further challenge. And by weaponising natural gas supplies, food prices began to rise as fertiliser costs became unaffordable and the IMF warned of famine.

In turn, inflation has now moved back to levels last seen in the 1980s, and caused central banks to start to lose control of global interest rates. Almost inevitably, therefore, housing, auto and electronics markets are starting to take major hits as consumers are forced to cut back sharply.

Survival is obviously the main concern for most companies at this point. The key need is to focus on the major risks, and move forward quickly with a plan to mitigate them. Essentially, there seem to be five major areas for focus:

- High and volatile pricing environment for energy, food and other products
- Interest rates continue rising alongside rising inflation and US dollar strength
- Stock and housing market downturn reduces consumer spending power
- Corporate earnings start to reduce down the value chain and debt risks rise
- Plastics industry hit by over-capacity and growing environmental pressure

It will also be essential to identify the 'hidden risks' for your business from each scenario. These are usually the second and third-order impacts which don't necessarily follow a linear pattern

Each of these would be a major challenge on their own. Together, they clearly create the worst crisis that any of us have faced in the post-War period. But it is also important not to panic. We will come through these challenges, just as our predecessors came through even greater challenges including world wars and depressions.

But our planning has to reflect the critical need to expect the unexpected. Essentially this means identifying the likely potential scenarios ahead and the tail risks they create. We can then start to identify in advance how we should respond if/when they start to occur.

The first chart highlights my view of the main scenarios, with the aim of stimulating debate. Essentially, it suggests there are 2 key questions to answer:

1. Are we in recession or not?
2. Is the landscape changing or just the nature of the risks?

The chemical industry is the best leading indicator for the global economy. And the data has been warning of recession risk for some time, just as it correctly warned of rising inflation risk last year.

But policymakers preferred to focus on their own computer models instead of looking out of the window at what was happening in the real world. It was only in August that they began to wake up to reality, with the president of the European Central Bank, Christine Lagarde, finally accepting:

"There are things that the models don't capture. Sometimes the unexpected hap-

The 4 Horsemen

		Temporary risks	Permanent risks
Global growth	Recession	**Inflation peaks** Today's rise in inflation leads to recession, and then a return to "Business as u sual"	**New Normal** The 4 Horsmen risks combine with recession & Net Zero to change the future landscape
	No recession	**Business as usual** Companies continue to face traditional risks	**Challenges ahead** Economic recovery accentuates need to focus on new risks (Geopolitics, Energy markets, Demographics

pens. So we have to pay attention to traditional indicators while also monitoring empirical data and what we expect to happen in terms of geopolitics, energy price developments and demographics."

The first step is therefore to form a view on whether US and other policymakers are right to deny that we are moving into a global recession. It would make life much easier if they were right, as it would mean we were simply in 'business as usual' mode, facing only traditional risks. If, on the other hand, we are either in recession or moving into recession, the question then becomes one of whether it will be followed by a return to 'business as usual'.

The second step is then to form a view on whether the landscape in which we are operating is now starting to change. Lagarde's comments are helpful as a starting point. She highlights three main areas where the outlook could be seeing fundamental change – geopolitics, energy price developments and demographics.

Essentially the question we face is (a) Are new risks are emerging, as Lagarde suggests? and (b) Could these fundamentally change the landscape in which we operate?

The major area with the potential to fundamentally change the landscape is, of course, Net Zero, given its likely impact on the petrochemical business. It involves two areas of potential major change.

First, governments around the world including the US, China and the EU, are accelerating the transition to electric vehicles (EVs). Russia's invasion has led the International Energy Agency to add its support to this move. In turn, this threatens future supplies of our main feedstock, naphtha. Refineries are already starting to close as demand for gasoline and diesel disappears.

The second issue is the growing consumer pressure to move away from virgin plastic packaging. As discussed here in April (Ukraine, pandemic, herald market shifts, ICB 1 April), this puts polyethylene demand at risk, as well as demand for other plastics. And it seems highly likely that legislative, brand owner and investor pressure will continue to intensify.

One way forward would be to debate and then rank these four scenarios in terms of (a) your view of their likelihood, and (b) the potential scale of their impact.

Recent history suggests that none of them are impossible, given current volatility. And even if you believe, for example, that a move to a New Normal scenario is unlikely, it could be risky to completely ignore the issue, given that its implications could so easily prove far-reaching.

The next step would then be to develop a draft Action Plan for each of your main scenarios. If, for example, you think that 'Business as usual' is the most likely option, then your focus will probably be on cash conservation and fixed cost reductions, with the main objective being to survive.

If, however, you believe that the challenges posed by the New Normal scenario also need to be tackled, then your focus will be two-fold: survival in the short-term, while also investing to develop new business models aligned to the Net Zero agenda.

It will also be essential to identify the 'hidden risks' for your business from each scenario. These are usually the second and third-order impacts which don't necessarily follow a linear pattern.

For example, the current downturn has already had a second order impact, with interest rates finally breaking out of their 40-year downtrend. And as market guru Bob Farrell's Rule number four reminds us: "Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways."

So you would need to consider the potential impact of rising interest rates on rate-sensitive areas such as housing, autos and electronics – all of which are key markets for the petrochemical business. And you also need to be mindful of the potential for a 'double whammy'. Any decline in consumer spending will inevitably have a ripple effect on employment.

The key benefit of this scenario approach is that it will provide a structure with which to tackle the challenges ahead. The intuitive response to a crisis is often to slam on the brakes, cut costs everywhere, and wait for better times ahead. But this could itself prove a high risk option, if taken on its own.

Russia's invasion is providing a major wake-up call about the danger of assuming business will always be "as usual". And in turn, this suggests that the window of opportunity for investing in future growth is starting to close.

As the famous author Ernest Hemingway highlighted in his classic novel "Fiesta", major changes (such as Net Zero) usually occur "gradually, then suddenly". ■

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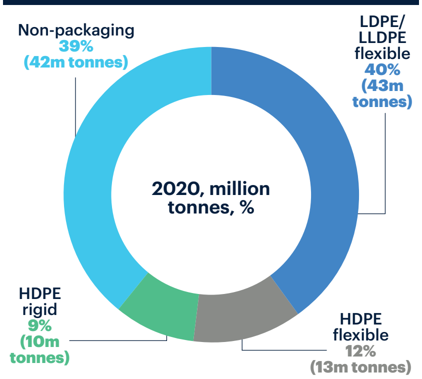
Recycled plastic puts 61m tonnes of PE demand at risk



Source: New Normal Consulting, ICIS

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