Economy drives need for change

Central bank mismanagement and demographics mean the global economy could face a long downturn; new chemical industry business models are now required

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Two years ago, we suggested here that major paradigm shifts were underway, which would result in the emergence of winners and losers.

Little did anyone know then that Europe would find itself at war a year later, for the first time since 1945. As a result, the changes begun by the pandemic are accelerating in front of our eyes. As discussed in October, the world has begun to feel the impact of the Four Horsemen of the Apocalypse – War, Plague, Famine and Inflation.

The chemical industry is the best leading indicator for the global economy. And as Kevin Swift's data unfortunately confirms (see p36), today's economic outlook is already worse than in the financial crisis. Then, global Operating Rates bottomed at 73.2% in February 2009. Last October, they were just 67.7% and were almost certainly even lower in November and December.

Equally worrying is that none of the major Regions were in good shape. War-torn Europe was, of course, worst at 55.2%. But North America and NE Asia (including China) were only at 68.3% and 68.5% respectively. Even the Middle East only managed 76.1%. By comparison, average global Operating Rates between 1987-2021 were over 85%. Uncertainty clearly rules, as also noted in October,

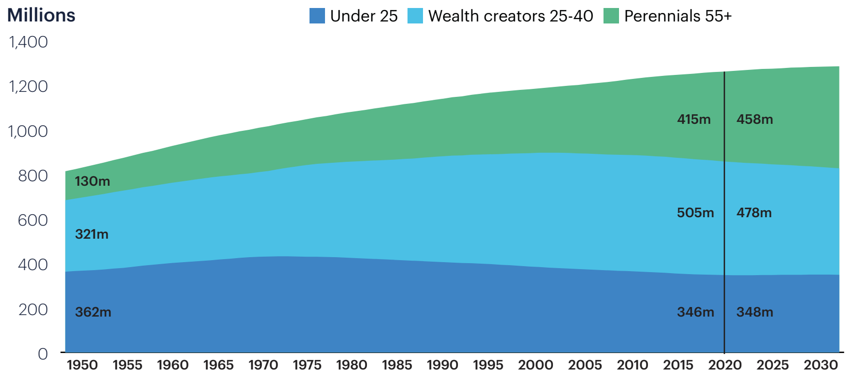
"We can no longer simply tweak a base case to reflect whether we are feeling marginally more optimistic or pessimistic."

Essentially, we are back to the world of the 1960s/70s, when geopolitics, energy market crises and the constant threat of the Cold War dominated the economy. And in some ways, we are in a worse situation. Then, we all knew that the role of the central banks was "to take away the punchbowl as the party got going", as Fed Chairman William McChesney Martin described in 1955. But for the current generation, the Fed's main role has been to irresponsibly keep the party going long into the night. As Bloomberg's respected financial editor, John Authers, noted last month:

"For a quarter of a century now, investors have worked on the assumption that the Fed (and other central banks) lack the nerve to press ahead with tight policy if it hurt asset prices. It's not an unreasonable belief, as the central bank has caved to market pressures at every time since its epochal decision to rescue Long-Term Capital Management in 1998."

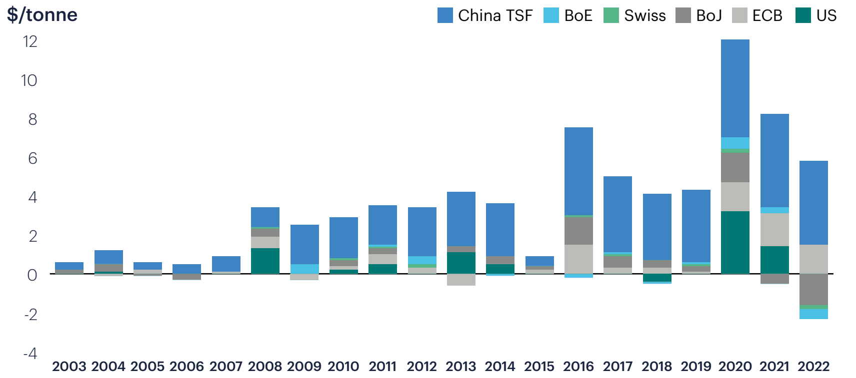
Control of fixed costs will therefore be critical for many companies in avoiding bankruptcy

Global population segments, most developed world, 1950-2030 (forecast)



Source: pH Report, UN Population Division

Annual stimulus in China, US, EU, Japan, Swiss – 2003-2022 (October)



Source: pH Report, St Louis Federal Reserve Bank, Bank of England, People's Bank of China, Bank of Japan, ECB

Central bank have over-stimulated

The theory behind this new approach was developed by Ben Bernanke, then a Princeton University professor, who went on to join and then chair the US Federal Reserve between 2002 – 2014. He built his career on the argument that JK Galbraith was wrong to conclude in his classic history, "The Great Crash", that the cause of the 1929 Crash was wild speculation. Instead, Bernanke argued that the Crash could have been avoided if the Fed had simply increased its support for stock and

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Demographic forces create new patterns of demand

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asset markets via major stimulus. As he noted after the financial crisis in 2010, his view was that “Higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending.”

Unfortunately, the evidence since then suggests that Galbraith was right. The chart shows the course of central bank stimulus policies since 2003 (when Chinese data was first collected). It highlights how the dotcom and subprime bubbles in 2000 and 2008 should have been a warning:

- But instead, central banks doubled down from 2009 onwards, with the Fed measuring “success” in terms of the S&P 500’s progress
- When this slowed, as in 2016, they quickly added more debt. And then, of course, they doubled down again during the pandemic
- Chinese lending data begins in 2003, and shows how it turbo-charged stimulus spending after the 2008 sub-prime crash
- It also led to major over-investment as companies came to believe that China would grow at double-digit rates “forever”
- And in the west, this concept of the “Fed put” saw the S&P break record after record, which investors assumed would never end

But, sadly, every party has to end sometime. And the chemical industry’s warnings of accelerating inflation proved its value once again as a leading indicator for the global economy. Similarly, as the International Energy Agency has argued, Russia’s invasion of Ukraine has actually accelerated the paradigm shifts towards more local supply chains and faster adoption of renewables/recycling,

Great challenges ahead

This sets out the great challenge for the next few years. On the one hand, we face a major and probably long-lasting recession. Bernanke’s flawed theory has created major bubbles in a wide range of asset markets. And so it will likely take years for the damage to be unwound as they burst. Control of fixed costs will therefore be critical for many companies in avoiding bankruptcy. But at the same time, there is unlikely to be any return to ‘business as usual’ when the downturn eventually ends. The second chart highlights one key reason for this – namely that the Perennials 55+ generation is now the key growth area in the world’s wealthier regions.

Back in 1950, the world was seeing a major increase in population as the Baby Boom began. This had a major impact on the economy. By the 1970s, the Boomers were settling down and having children. They created a massive increase in demand for housing, autos, electronics and other key elements of today’s consumer-based economy. The numbers confirm their impact. In the developed world, the number of these Wealth Creators aged 25-54 rose from 321m to peak at 520m by 2010.

But today, this core segment is in long-term decline. Instead, the ageing Boomers are joining the ranks of the Perennials 55+ generation. This is now the only growth segment of the population. They are lovely people, but they already own most of what they need. And their incomes usually reduce as they enter retirement.

Demand patterns are therefore seeing major change as sustainability replaces globalisation as the key driver for the economy. The Perennials need to do more with less, as their incomes decline. And their values are shared by their children, today’s Wealth Creators. Their increasing life expectancy means they are very concerned by climate change and understand the need for the net zero agenda. Companies therefore have little choice. They cannot just cut back on fixed costs to survive the recession. They also have to invest in the more service-based offerings needed in the future, if they want to grow revenue and profit.

China is likely to prove a test case for this paradigm shift in 2023. Many hope that it will quickly recover now that its failed zero-Covid policy has come to an end. But in reality, China is actually a very poor country. Average per capital household income was just $5250 in 2022. It was only the decision to follow Bernanke’s theory, and launch its $44tn “subprime on steroids” policy after the 2008 financial crisis, that created the illusion it had suddenly become middle-class almost overnight.

Today, reality is starting to return. Its export-oriented economy is already suffering as its major trading partners move into recession. And domestic consumption, already the lowest in the major economies on a per capita basis, is set to become a case study for the impact of ageing populations. China is now set to “become old before it gets rich”. The number of those in its low-earning, low-spending Perennials cohort is set to jump by more than 50%, from 300m today to 475m by 2030. At the same time, its low fertility rate means the number of Wealth Creators will fall by 100m.

Almost inevitably, we are likely to see Winners and Losers develop over the 2023 – 2025 period. People will still have the same basic needs for food, health, mobility, shelter and water. But they will need them to be provided in a more sustainable and affordable way. Winners will therefore recognise the need to move away from today’s product focus. They will invest in creating new business models, aligned with future market needs. ‘Business as usual’ has been a great strategy for the past 40 years. But nothing lasts forever. It has now – like the central banks’ stimulus policies – hit the inevitable brick wall. ■

Paul Hodges is chairman of New Normal Consulting, whose unique data-driven perspective supports companies in building a robust and sustainable future. He also publishes *The pH Report* and writes the ICIS Chemicals & the Economy Blog.