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BUSINESS

It Feels Like ‘Lehman II’ in This Crucial Industry

Analysis by Chris Bryant | Bloomberg
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Last week, German specialty chemical maker Lanxess AG warned recent declines in sales volumes were more severe than during the 2008/2009 recession. To bludgeon home his point, Chief Executive Officer Matthias Zachert added: “This feels like Lehman II.” Gulp.

Lanxess’s European and US chemical peers, plus a host of companies in other cyclical sectors, face similar problems as elevated customer inventories meet the most rapid interest rate hiking cycle in decades, as well as a stuttering Chinese economy.

Whether you call it the “Great Destocking,” an “inventory recession,” or just a plain old recession, it looks increasingly like the materials and industrial world is either in, or heading for one – an impression reinforced by last week’s bleak US and European manufacturing purchasing managers’ data.

Though admittedly a less sexy topic than artificial intelligence, chemicals still deserve attention: They are often a reliable leading indicator of the global economy, owing to their upstream position in value chains and diverse end-use applications. The recent deluge of chemical company profit warnings is therefore concerning.

Lanxess expected customer destocking that began last year to be short-lived, but the slump has instead become more pronounced. Demand weakness has spread from construction and electronics to typically resilient consumer-facing segments; the expected rebound in China has not materialized.

European fragrance and vitamins giant DSM-Firmenich AG joined the profit-warning stampede on Wednesday, citing pricing pressure and destocking for a roughly 30% year-on-year drop in second-quarter adjusted earnings(1). Earlier this month, UK polymers producer Victrex Plc warned of a 40% decline in sales volume in the April to June quarter compared with last year’s record haul. In the same week, US specialty chemical maker Cabot Corp withdrew guidance for its fiscal year ending in September, blaming a “prolonged destocking cycle” and the weak recovery in China.

The chemicals sector is in an “08/09-style deep recession” and the mood is “atrocious,” Exane analyst Laurent Favre told clients.

Companies in adjacent industries, such as packaging and logistics, have also warned on profits as customers deplete inventories rather than place new orders. Mentions of “destocking” on corporate earnings calls have soared.

Yet, helped by robust US employment and consumer confidence, global stock markets remain remarkably sanguine. “Either chemical markets are wrong or the financial markets are wrong and obviously we think it’s the latter,” New Normal Consulting Chairman Paul Hodges, a chemicals expert, told me. “People thought China was going to bounce back rapidly after Covid but China’s growth since 2008 was the product of massive stimulus and property speculation which couldn’t go on forever.”

The positive spin on these recent profit warnings is they’re just another example of the supply chain “bullwhip effect” that affected retailers and memory-chip manufacturers last year.

Like retailers, chemicals buyers overordered in 2021 and the early part of 2022 to ensure they could meet demand, and to avoid paying even higher prices as inflation and energy costs spiraled. With supply chains normalizing, industrial customers are able to destock, but memories of that upheaval are still fresh; they won’t want to draw down inventories too far and hence will start restocking again soon, the argument goes.

Unfortunately, the arrival of that rebound keeps getting pushed back, which increases my concern that this isn’t just inventory overhang but rather a problem with underlying demand. “Having a year and a half of destocking, I’ve never heard of that,” one bemused analyst commented when chemical company Croda International Plc warned on profits earlier this month.

Demand weakness wouldn't be surprising given central banks remain hellbent on crushing inflation via rate hikes, and businesses may wish to preserve cash by optimizing working capital.

Although consumers have so far continued to splurge on travel, music events and socializing, durable goods purchases such as home appliances and electronics have been more muted. Massive government subsides such as those made available by the US Inflation Reduction Act are stoking a capex boom, and automotive and aerospace still look relatively resilient. Even so, capital goods could be the next sector to experience inventory problems once order backlogs are depleted, say analysts at Morgan Stanley.

Don't forget, shipping and trucking companies have been warning of recessionary conditions for months. Ocean freight prices have collapsed, while inbound container volumes received at the top 10 US ports plunged 20% year-on-year in May, according to data compiled by shipping expert John McCown. Cardboard-box shipments — a decent gauge of goods sales — are contracting at the fastest pace since the Great Recession, and last week Fedex Corp. announced it would cut more aircraft from its fleet due to moderating demand.

You don't need to believe that we're heading for a downturn as severe or systemic as the one that followed the collapse of Lehman Brothers — and I don't, by the way — to worry that financial markets aren't positioned for what I've described may portend. What starts in chemicals rarely stays in chemicals.

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(1) At the mid-point of the provided range. 'Earnings' are adjusted earnings before interest, tax, depreciation and amortization.

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