Experience and Insight on Demand

Research Note **24 September 2012**

Central banks will make global downturn worse

The US Federal Reserve and the European Central Bank have adopted new and aggressive monetary measures to try and boost US employment and stabilise peripheral Eurozone bond markets. Unfortunately, their actions are more likely to increase the chances of a deeper global downturn than to create economic growth.

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Their previous liquidity injections, undertaken in the spirit of doing "whatever it takes" to achieve these goals, have already helped to drive up the price of oil. Investors became concerned about currency risk for both the US$ and the euro, and about inflation risks. They have instead seen crude oil markets as a potential 'store of value'. Some now even believe oil markets should be seen as part of a broader commodities-based asset class, rivalling equities and fixed interest markets.

Oil markets have proved unable to absorb these one-sided flows of money. Those value investors who attempted to realign the market with the fundamentals of supply and demand were swept away. Thus today, the cost of oil has reached a level which has historically always led to recession. More central bank liquidity injections can only make the situation worse.

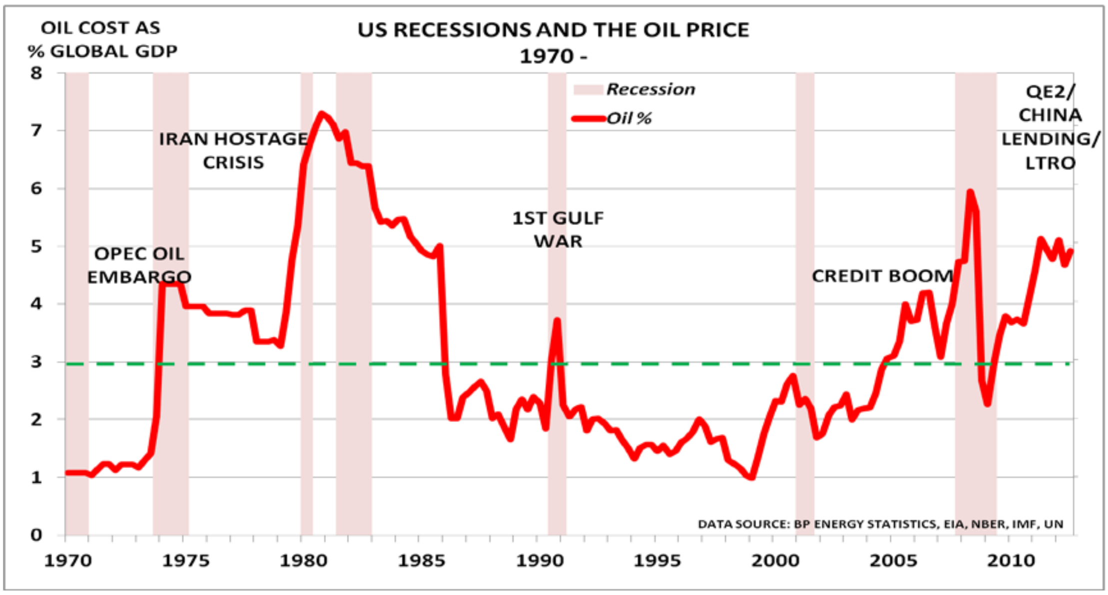

Chart 1: Very high oil prices trigger global recessions – QE3 and OMT are likely to make it worse

As Chart 1 shows, oil prices currently account for 5% of global GDP. This compares to the more 'normal' level of below 3%, as indicated by the dotted line. The mechanism by which this translated into recession is easily understood:

- Consumers have little choice but to pay up for higher transport fuel and heating costs. They cannot simply abandon their cars, or sit shivering in the cold in their homes.
- Similarly manufacturers cannot absorb the increased cost of energy in their processes, and in their logistic operations, no matter how efficient they have become.

Employees are generally unable to fully compensate for these higher costs via wage increases. Thus the end result is to reduce consumers' discretionary spending power, forcing them to cut back on non-essential purchases. In turn, this reduction in demand then makes it difficult for manufacturers to pass on their higher costs, causing profit margins to weaken.

What is not so well understood is why the downturn only occurs *after* oil prices have risen sharply. Today, as in 2007/8 and previous episodes of high oil prices, many observers assume that higher oil prices are a sign of strong demand. 'Why else would they continue to rise', they ask themselves?

Our industry experience based on the impact of oil price hikes in 1979/80, 1990/1 and 2007/8 may therefore be helpful:

- Manufacturers cannot adjust their prices on a daily basis to reflect higher oil prices. They are locked into fixed price contracts with their end-user customers, often for 6 months or more.
- When oil prices start to rise, they cannot simply sit back and allow future margins to disappear. Instead, they are forced into the market to stockpile raw materials before prices rise.
- This process continues until it becomes apparent that prices have plateaued. Then companies seek to destock again, but find this difficult as their immediate customers are also destocking.
- At the same time, of course, end-consumers have all been reducing their purchases, due to the loss of discretionary income. This, of course, then creates a double whammy for profit margins.

Essentially the issue is one of a lack of visibility down the often complex value chains that exist between manufacturers and end-consumers. Initially, as oil prices rise, rising inventories hide the fact that end-user demand is slowing. Everyone, including those involved, assume that 'this time is different' and that demand is actually robust. Sadly, however, this is only perception, not reality.

Already, in the petrochemical industry – a cyclical sector, and an excellent barometer of the health of the global economy – **utilisation rates for European olefin plants were at just 80% during H1, and total output of ethylene (the major product) was back at 1998 levels in Q2,** suggesting demand for consumer items has been weakening substantially in recent months.

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Markets are no longer reliable forward indicators

The sad fact is that previous episodes of liquidity injections have sent false signals about the health of the economy and have confused policymakers, as well as company executives on the ground.

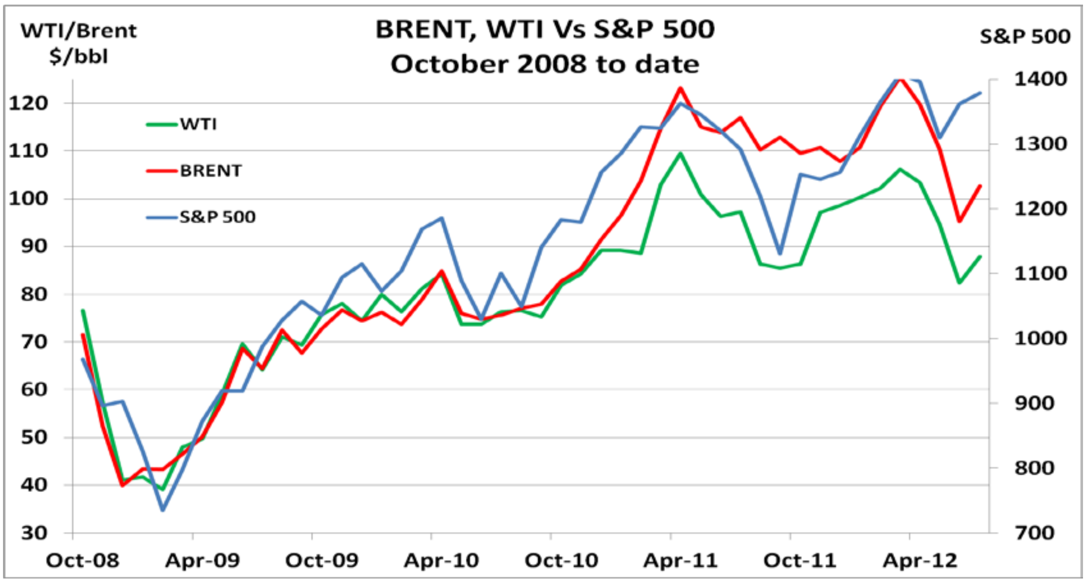

Chart 2: Central bank liquidity has fuelled the 'Correlation Trade' in financial markets

Central bank liquidity has also reversed the previous rules of investment. In the past, higher oil prices were seen as bad news for stock prices, as they would increase trade deficits in the West and cause central banks to raise interest rates to reduce consumption. But since 2008, as Chart 2 shows, stimulus measures have instead fuelled high levels of correlation across the major financial markets.

A key result of this is that no single market now knows what it is meant to be pricing. In oil markets, there have been no shortages of product to cause prices to rise. Similarly, inventories in the US (the world's largest consumer) have often been at near-record levels.

Analysts have therefore been reduced to inventing explanations for these historically abnormal price rises. But with the benefit of hindsight, it is clear that none of the most prominent arguments – such as major and sustained growth in China's demand; massive supply disruption due to Libya and the Arab Spring – have proved to be valid.

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'It's the demographics, stupid'

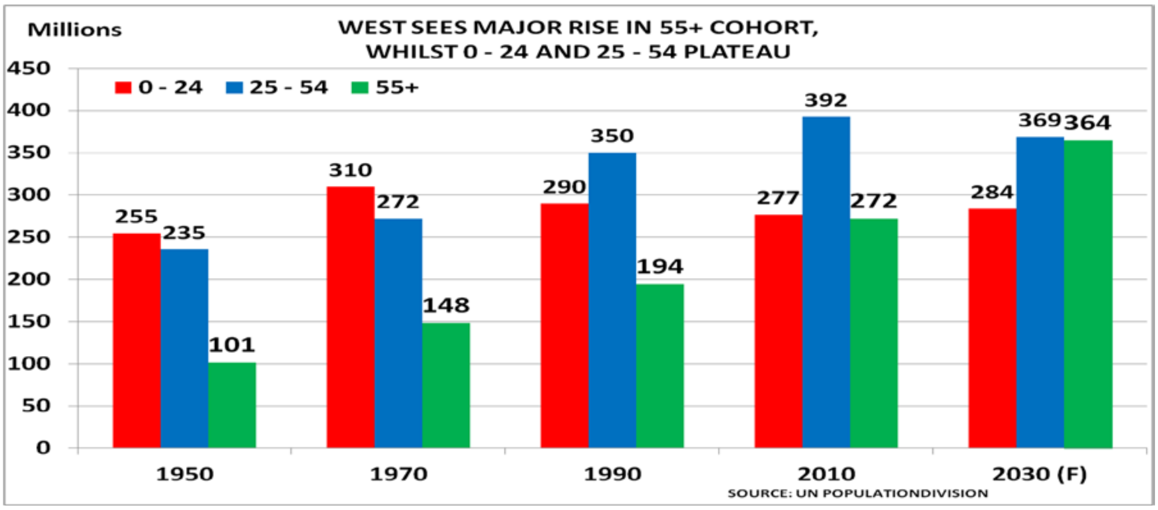

Chart 3: The New Old 55+ generation is the only cohort still growing in the West

The underlying issue is that central banks appear to be missing the key factor behind the current slowdown in Western growth rates. To paraphrase a slogan from Bill Clinton's successful 1992 presidential campaign – 'it's the demographics, stupid'.

The Western BabyBoomers, those born between 1946-70, are the largest and wealthiest generation that the world has ever seen. As they entered their wealth creating period, aged 25 – 54 years, they powered an economic SuperCycle between 1982-2007. This is when people normally settle down, have children and move ahead in their careers. But since 2001, the oldest Boomers have been leaving this period of their lives and joining the New Old 55+ generation.

They can look forward to an extra decade of active life compared to previous generations, thanks to increasing life expectancy. But the failure to properly anticipate this change means that people now have to spend less, and save more, in order to finance their extended lifespan. As chart 3 shows, **29% of the Western population (272m) are already in the New Old 55+ generation, and their numbers are increasing year by year.** Thus it is inevitable that the West is seeing slower growth.

Central banks therefore seem to be pushing on the proverbial string with their efforts to stimulate the economy. The West's ageing population means the days of pent-up demand are over. Even worse, their efforts have already increased oil prices to levels that make it more likely we are now on the verge of a new recession.

About IeC: **IeC is a London-based strategic consultancy advising Fortune 500 and FTSE 100 companies, investment banks and fund managers.**

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