2017: a risky year ahead

Chemicals industry faces a stormy year beset by uncertainty

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With the rise of protectionism and signs that a recession could be around the corner, the year that lies ahead could prove to be difficult to navigate

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It is hard to be optimistic about the outlook for 2017.

As I suggested last year (ICB, 11-17 January 2016), policymakers have now given up on the idea that stimulus could somehow enable today's ageing populations to maintain the level of economic growth seen when the Baby Boomers were young. As a result, markets are returning to being based on supply and demand fundamentals, rather than central bank money-printing. Unfortunately, just as I feared, it will be companies and investors who will now bear the costs of this failed experiment.

Essentially, there are now five major risks facing the global economy:

■ Global recession: The American Chemistry Council (ACC) index of global capacity utilisation is the best indicator that exists in terms of the outlook for the economy. As the chart shows, it has been falling since December 2015, and its latest reading is close to the all-time low seen in March 2009.

■ Populist policies are gaining support: Populists provide simple answers to complex questions, and 2016 saw them gain major success with the Brexit vote for the UK to leave the EU, Donald Trump winning the US Presidency, and Italy's referendum creating the potential for the country to vote on leaving the euro.

■ Protectionism is replacing globalisation: One key result of these changes is that countries are turning inwards. The Doha and Transatlantic Trade and Investment Partnership trade deals are effectively dead, and President-elect Trump has promised to cancel the Trans-Pacific Partnership deal on coming into office.

■ Interest rates have begun to rise around the world: Investors have begun to worry about return of capital, rather than just return on capital. Benchmark 10-year interest rates have more than doubled in the US since the summer. They have also trebled in the UK and doubled in Italy, while negative rates in Germany and Japan have turned positive again.

■ India's economy is under major strain as a result of the currency reforms, while China's debt levels remain far too high for comfort. China's housing bubble has reached price/earnings ratios in the tier 1 cities that are double those seen at the height of the US subprime bubble. Unsuprisingly, the value of its currency has been falling, adding potential for major trade friction with the new Trump administration.

A GROWING DISCONNECT

It is clear, therefore, that we are now moving into a New Normal world. In consumer-led economies such as those in the west, the major changes that have taken place in life expectancy and fertility rates since 1950 inevitably have an impact on the economy. As I have discussed before in these pages, demand growth is created by young people as they enter the workforce, set up home and have children. Older people already own most of what they need and so today's ageing western societies, where fertility rates have also been below replacement levels for 45 years, are inevitably going to see growth prospects reduce.

Essentially, we have swapped an extra 10 years of life expectancy for economic growth. I doubt that any reader will feel this is a trade that needs to be reversed. But it does mean that we face a growing disconnect between perception and reality. Most people now working in industry or finance have no memory of the pre-1983 period, before the Boomer-led SuperCycle began. They therefore still assume that the global economy will always be growing, and that chemical demand will be a multiple of this growth. They also assume that any downturn will be short-lived, as central banks will always be able to quickly step in and reverse any decline.

This, of course, is why companies have continued to invest in new capacity, particularly in the US. They have assumed that shale gas would give

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them long-term competitive advantage as oil would always be priced above \$100/bbl, and China's import volumes would always be increasing. They also assumed that globalisation would continue forever. It would have been bad enough if just one of these core assumptions had proved incorrect. The fact that all three have disappointed means that the future has become most uncertain indeed.

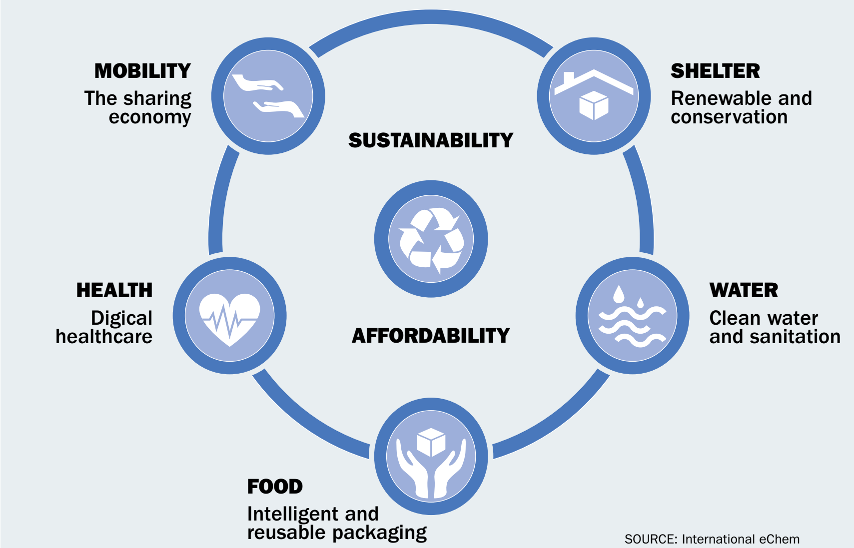
It is always tempting at such times to simply double-down on one's bets. Tempting, but potentially disastrous when the real issue is an urgent need to develop new business models, more suited to the challenges ahead. The oil industry provides a clear warning of the problems that can be created by this type of wilful blindness, with OPEC and many western companies simply refusing to accept the advice from the auto companies that the days of constant demand increases for transport fuel are over.

They have fallen into the trap of silo thinking, and of assuming that the world will never change. But in reality, very few trends last forever and as the president of General Motors, Dan Amman, noted earlier this year: "We think there's going to be more change in the world of mobility in the next five years than there has been in the last fifty".

Amman's warning followed that of Ford's chairman, Bill Ford, who highlighted the rationale for the paradigm shifts now underway: "The average American spends about a week a year stuck in traffic jams, and that's a huge waste of time and resources….The freedom of mobility that my great-grandfather brought to people is now being threatened, just as the environment is."

The oil industry is a classic example of the problems that can be created by ignoring changes in demand patterns. It is already clear, for example, that many young Americans do not share their Boomer-parents' love affair with cars. Latest data, for example, shows only around three-quarters of those aged 20-24 now have a driver's licence, compared to over 90% in the past. And young people without driver's licences are unlikely to be buying much gasoline in the future, and nor will they be buying too many cars.

THE NEW NORMAL WORLD HAS A WIDE RANGE OF NEW OPPORTUNITIES



SOURCE: International eChem

The problems caused by only focusing on supply-side issues are a wake-up call for all of us, especially given today's global energy glut. They emphasise that the future will belong to those who focus on end-user demand. We need to follow industries such as autos in developing new business models that include a service package, where the value proposition is based on the total value provided, rather than just the value of the physical product.

THE NEW NORMAL

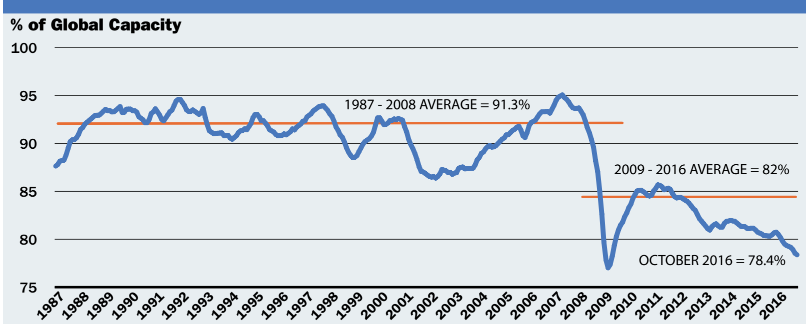
We can already see some of these new business models in action with the growth of car-sharing services and Uber-type taxi services, as well as the growing excitement over the potential for autonomous vehicles. As the second chart shows, these models highlight how the need for mobility is replacing the former focus on car ownership. Similarly, the need for shelter is replacing home ownership. Sustainability is also replacing globalisation as a key driver for revenue and profit growth. This is inevitable with today's ageing populations, where the Boomers' previous need for more "stuff" is being replaced by a need to "do more with less", and a focus on affordability rather than affordable luxury.

These trends have a long way to run, and will likely impact other functions as they develop. Already, for example, concerns are rising that some of today's production sites risk becoming white elephants, as the growth of the circular economy drives a move towards more local, smaller-scale and flexible production. We can, after all, already see this trend developing in another demand-focused industry, pharmaceuticals, where companies are moving away from the production of blockbuster drugs towards the adoption of personalised medicine.

As we move into 2017, it is clear that major challenges await us. Global recession will create volatility and uncertainty, particularly as it becomes obvious that stimulus policies are part of the problem, rather than the solution. But we have been through difficult times in the past as an industry. We know that the best way to survive and prosper is to develop a long-term view of the outlook, whilst keeping a close eye out for bumps in the road.

The Winners in today's New Normal world will be those who follow the auto, pharma and other industries in refocusing their business models on demand rather than supply issues. They will find their future revenue and profit growth becoming turbo-charged, as they benefit from investment in designing materials and providing sustainable solutions that can meet current and future market needs for mobility, shelter, health, food and water affordably. ■

GLOBAL CHEMICAL CAPACITY UTILISATION (%) 1987-2016 (TO DATE)



SOURCE: International eChem, American Chemistry Council