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ICIS Chemical Business

Independent Commodity Intelligence Services

10-16 January 2020

MAKING SENSE OF CHEMICAL PRICES

COMMENTARY

GLOBAL 2020 OUTLOOK IN FLUX

US-Iran tensions, a pending US-China trade deal and weak manufacturing cloud the chemicals outlook

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Synchronised slowdown to persist in 2020

It seems likely that 2020 will see the synchronised slowdown continuing to challenge consensus optimism. Contingency planning around recession risks should therefore be top of the agenda

PAUL HODGES INTERNATIONAL ECHEM

The IMF has now confirmed that the world economy has moved into the synchronised slowdown that I forecast here a year ago (ICB 11-17 January 2019). Its analysis also confirms the importance of the issues highlighted then, including "rising trade barriers and increasing geopolitical tensions", a sharp decline in manufacturing, contraction in the auto industry and structural forces such as the impact of ageing populations.

Capacity utilisation data from the American Chemistry Council (ACC) has therefore once again proved to be the best leading indicator for the global economy. It has been far more reliable than stock markets, where valuations continue to be massively distorted by central bank stimulus. And unfortunately, the latest data shows no sign of any improvement.

Of course, it remains very easy to ignore the warning signs. "Business as usual" is always the most popular forecast, as we saw a year ago when the consensus assumed a sustainable economic recovery was finally underway. And it would be no great surprise if, in a year's time, consensus opinion starts to claim that "nobody could have seen the recession coming".

This is why it seems likely that the industry will now start to divide into winners and losers. As the IMF notes in its analysis, the current situation is "precarious", with a number of potential downsides starting to crystallise.

BREXIT TRADE RISK

On a macro view, these include the growing supply chain risks created by Brexit, where the UK expects to leave the EU at the end of this month.

Anyone with experience in trade negotiations knows that these normally take years rather than months to complete. No Deal is therefore the most likely outcome in a year's time at the end of the transition period.

This will have a major impact on the chemical industry, given our dependence on complex and highly integrated downstream value chains. Contingency planning is therefore on the critical path for any company that currently relies on product flowing seamlessly and tariff-free across the UK-EU27 border. Of course, potential losers will continue to nurse the hope that the UK government might reverse its refusal to accept the 2-year extension offered by the EU. But anyone who followed the recent UK election campaign knows this is an unlikely outcome.

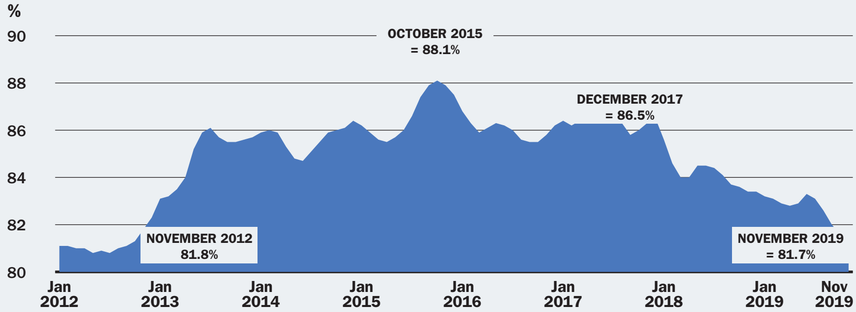
The industry also has its own specific challenges to face, given the growing impact of US shale gas-based expansions in the polyethylene (PE) area. This is no great surprise, as I have been warning about the likely consequences of these supply-led expansions since they were first announced in 2014 (ICB, 24-32

March 2014). But unfortunately, the combination of stock market euphoria over the shale gas revolution and the US Federal Reserve's easy money policy meant that the core assumptions were never properly challenged.

Euphoria remained the rule even after the oil price collapse at the end of 2014 disproved the assumption that prices would always be above \$100/bbl. And it continued despite US President Trump's election. As a self-confessed "tariff man", his policies were always likely to upset the idea that plants could be sited halfway across the world from their markets.

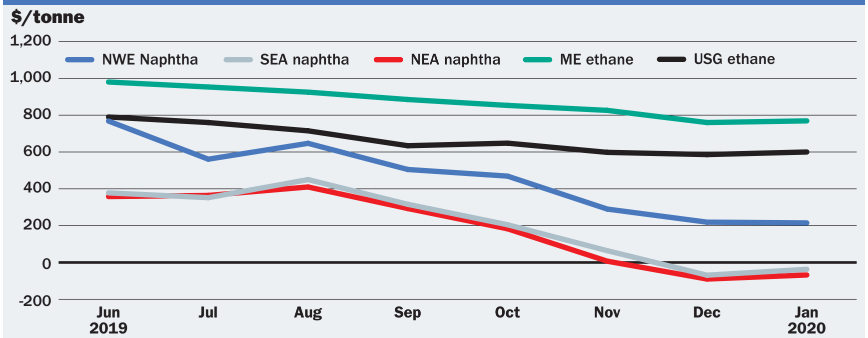
Warning signs were also obvious around the assumption that China's growth would remain at double-digit rates, creating an ongoing need for major imports. And more recently, concerns over climate change and plastic waste issues have created further question marks over the outlook for single-use plastics demand.

GLOBAL CHEMICALS CAPACITY UTILISATION



SOURCE: pH Report analysis, American Chemistry Council data

GLOBAL LLDPE MARGINS



SOURCE: ICIS Petrochemical Annalytics

PE MARGINS COLLAPSE

The destruction caused by 2017's US hurricanes delayed the reckoning, but the last few months have seen the inevitable impact of mounting overcapacity in the major regions, as the chart of linear low density PE (LLDPE) spot margins shows:

- Asian markets were first to be hit, with margins collapsing from over \$350/tonne in June and going negative in November.
- Northwest European margins have tumbled from over \$750/tonne to \$200/tonne today as US exporters target the market as a replacement for lost Chinese volume.
- As a result, Middle East and US Gulf ethane margins have also begun to sink, falling from \$980/tonne to \$760/tonne, and from \$790/tonne to \$580/tonne, respectively.

Unfortunately, margins are unlikely to stabilise even at today's levels, given the expansions still to come. More than 8m tonnes of new LLDPE capacity is planned to arrive in the 2019-2021 period, and nearly 10.9m tonnes of high density PE (HDPE).

And the potential for demand destruction is increasing as major brand-owners commit to ambitious targets for the use of recycled plastic, while the new EU Green Deal seems very likely to introduce a plastics waste tax. Geopolitical tensions in the Middle East create further downside potential, as higher oil prices always force consumers to cut back on discretionary spending.

Equally worrying is that the mounting chaos in the ethylene chain is now starting to impact the other major value chains, as naphtha-based European and Asian crackers cut back co-product output due to the pressure on ethylene margins.

NEW OPPORTUNITIES

This is why prudent managements will ignore the siren voices prophesying that "all will be well", and instead focus on what needs to be done to survive the downturn. Change is never comfortable, but CEOs will likely be encouraged by the fact that major new opportunities are emerging for revenue and profit growth as a result of the paradigm shifts now underway.

In the plastics area, for example, mounting problems for virgin material translate into a major new growth opportunity for recycled plastic production. Similarly, the current rapid development of electric vehicles will create a number of new markets to replace those lost due to the downturn in conventional auto sales - particularly in China and Europe.

The impact of ageing populations highlights the division between winners and losers that is starting to emerge, as the global downturn combines with major paradigm shifts. Losers will no doubt continue to hope that consumer spending patterns will eventually readjust and return demand growth to the levels seen in the Baby Boomer supercycle. But potential winners have moved on from this wishful thinking, and are instead already starting to develop the new, more service-based businesses of the future.

Older people are essentially a replacement economy in terms of product demand, as they already own most of what they need. But there are still major opportunities to create sustainable and affordable new offerings to meet their ongoing needs in essential areas such as water, health, housing, mobility and food. Recycling is one example of the new business models being developed.

Incumbents are often slow to understand the likely impact of potentially disruptive developments on their businesses. Our colleagues in the upstream oil industry are currently providing a classic example of this phenomenon as they promote the idea that despite mounting concerns over the role of fossil fuels in climate change, chemicals can somehow replace lost oil demand into transport.

CONTINGENCY PLANNING

Unfortunately, it seems likely that 2020 will see today's synchronised slowdown continuing to challenge consensus optimism. Contingency planning around recession risks should therefore be top of the agenda, particularly for companies with high debt levels. But at the same time, better placed companies have a once-in-a-generation opportunity to take advantage of the paradigm shifts now underway. These winners are likely to discover that the industry's best days still lie ahead of them, given the range and scale of the new opportunities that are emerging. ■

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