The great unwinding

The removal of central bank stimulus and a major policy shift in China will have broad implications for chemical markets. Are companies prepared for a China recession?

Rex Features

PAUL HODGES INTERNATIONAL ECHEM

The Great Unwinding of policymakers' stimulus programmes is now underway around the world. Its first signs have been seen in financial markets since August:

• Oil and commodity prices have tumbled as supply/demand once again becomes the key driver for prices.
• The US dollar has strengthened and liquidity has tightened across the world.
• Equity markets have seen sharp falls, as investors begin to realise they have overpaid for future growth and rush for the exits.
• Interest rates have become more volatile as some investors seek a "safe haven", while others worry that stimulus policy debt may never be repaid.

Even more importantly, it has become clear that China's economy is slowing fast. Two key indicators used by Premier Li Keqiang to measure growth are flashing red. Electricity consumption growth has fallen to less than 4%, and lending growth to 5%. And steel prices in some parts of the country are now as cheap as cabbage on a per tonne basis, due to the slowdown now underway in the construction industry.

WHY IS THIS TAKING PLACE?

China is thus the epicentre of the Great Unwinding now underway across the world economy. Its growth surge since 2009 appeared wonderful at the time, rescuing a wide range of industries, including chemicals, from a major downturn. But it was created by a dizzying rise in lending to over $10 trillion. By comparison, lending by the US Federal Reserve totalled "only" $4 trillion.

The new leadership has faced a two-fold challenge since its appointment last year:

• It has to reverse this lending bubble and tackle the problems of pollution and corruption that were created as a result.
• It also has to set the country on a more sustainable course, in line with the plan set out in the World Bank's "China 2030" report.

The scale and urgency of these challenges means there is no "business as usual" option available. The Great Unwinding of the stimulus policy has to be fast and comprehensive.

The steel price collapse highlights the disastrous waste of resources during the stimulus programme, which created a property bubble on an epic scale. Apartment prices in Tier 1 cities such as Beijing and Shanghai have been selling at multiples of 30 to average earnings, several times the US subprime peak. We all know how that ended.

Faced with that recent example, China's leadership knows that the bubble has to be burst before it destroys the whole economy.

Equally important for most ordinary people » is the horrendous pollution created during the stimulus-inspired "dash for growth". How would you react, if your country's Ministry of Environmental Protection reported that "one-sixth of arable land – nearly 50m acres – suffers from soil pollution and more than 13m tonnes are contaminated with heavy metals"? This is the scale of the problem reported by China's Ministry last year.

CHINA RECESSION LIKELY

The scale of policy reversal underway makes it is highly likely China will go into recession next year. This will come as a major shock for those who have wanted to believe the official GDP reports, suggesting it is a nirvana of constant growth. But there is strong evidence for regarding these as being completely fictitious. Two facts highlight the problem:

- How can China possibly produce accurate GDP data within three weeks of the end of each quarter?
- And how can it possibly never need to revise the data, once published?

Other countries take far longer to produce their initial data, and are still revising it years later, as more accurate numbers become available. China's data however, as Premier Li has commented, are essentially "man-made and essentially unreliable".

China's new leadership have already published proposals for a complete overhaul of this critical area. But in the meantime, companies may find it helpful to use data prepared by veteran China-watcher Simon Hunt. His chart presents a far more realistic view of the past 25 years, showing two major recessions – in 1993 when President Jiang Zemin tackled hyper-inflation, and in 1998-1999 after the Asian Crisis.

Hunt's chart reminds us that China's leadership is unlikely to panic at the thought that a recession may be inevitable in the short-term. They know the country has survived them in the past and come out stronger.

A WIDE-RANGING IMPACT

China's slowdown began last year, after the new leadership took office in March 2013. Since then, its imports of raw materials and machinery have been tumbling, stalling growth rates in export-dependent countries.

Countries from Latin America through Asia and into the Middle East suffered the immediate impact. This year the downturn hit Europe, with Germany seeing a sudden slowdown.

Now a second phase of the Great Unwinding is underway. Commodity prices have been tumbling across the board as the "wealth effect" created by China's property bubble comes to a sudden end.

Cotton, copper and more recently oil markets have seen major falls. Suddenly the world is waking up to the fact that China's post-2008 growth surge was based on a lending bubble, not the overnight creation of a vast new middle class.

Critical growth drivers such as car sales were among those turbocharged by the lending bubble. And as always with bubbles, what goes up, comes down again.

NEW BUSINESS MODELS ESSENTIAL

It is important, however, not to get carried away. China will likely come through this recession, as in the past. Its leaders have a comprehensive plan, the China 2030 report, prepared by the World Bank and its own National Development and Reform Commission. And it is clear that they are focused on implementing it successfully and setting a new course for the future.

Companies and investors thus need to move quickly to respond to the challenges created by China's move into the New Normal. Many areas of the global economy have begun to be impacted by the changes underway in China. But its major impact is still ahead of us, as the Great Unwinding gathers momentum around the world.

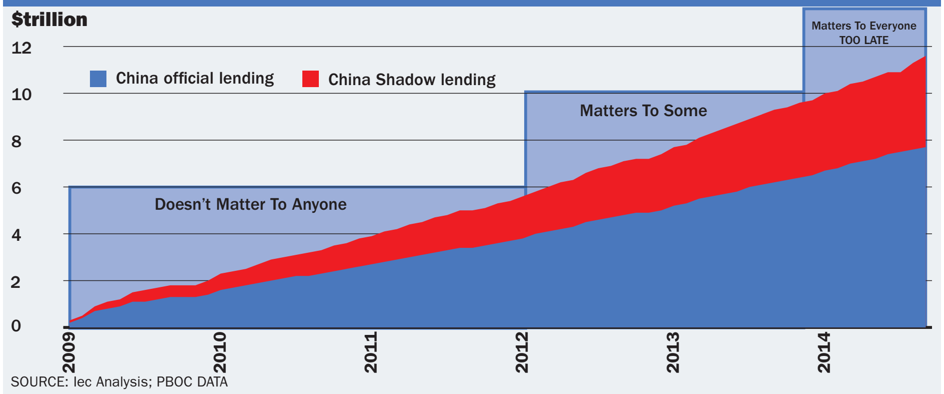
One obvious result is that strategies based on concepts of "affordable luxury", and the sale of "value-added products" will now need to be abandoned. "I want" will no longer equal "I need" for most consumers, as the days of easy credit fade into the past.

Instead mass-market business models must now refocus on affordability via a "design to cost" model. Successful companies will be those offering products and services that meet real needs – such as improving water quality and food production; providing affordable shelter, health and mobility; and cleaning up pollution.

It would have been much better if policymakers had accepted the warning signs given by the financial crisis in 2008, and not tried to stimulate the world back to supercycle levels of growth. But we are where we are. As the Great Unwinding gathers momentum, we have little choice but to plan for a New Normal world.

Paul Hodges is chairman of International eChem (IeC), trusted advisers to the chemical industry and its investment community. With John Richardson, he authored "Boom, Gloom and the New Normal", published by ICIS (www.new-normal.com)

CHINA LENDING SINCE 2009

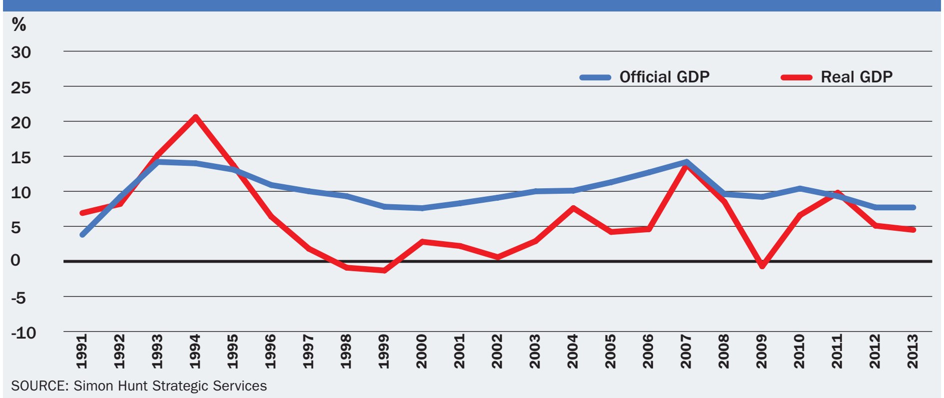


SOURCE: Iec Analysis; PBOC DATA

The pH REPORT

The pH Report aims to guide investors and companies through the Great Unwinding of central bank and government stimulus policy now underway. It is action-oriented, and supported by follow-up webinars with Q&A sessions, newsletters and detailed research papers. Download a free sample copy of the first issue at http://internationalechem.com/the-ph-report.

CHINA GDP NOMINAL AND REAL % GROWTH, 1991 - 2013



SOURCE: Simon Hunt Strategic Services