IeC Experience and Insight on Demand

The pH Report

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THE GREAT GNIDNIWNU CONTINUES

Executive Summary

It is exactly a year since we forecast that a Great Unwinding of stimulus policies was about to begin. We argued that a major slowdown was underway in China, which would lead to a collapse of oil prices and a major rise in the value of the US$:

"Large economies are like supertankers. There are no brakes to use if you want to change direction in a hurry. Instead, you have to put the engine into reverse, and hope you can slow down fast enough to avoid the rocks. That is what happened in China last month, as the new leadership began to unwind the largest lending bubble ever seen."

Since then, oil prices have halved and the US$ Index has risen 19% - in the process breaking out of its 30-year downtrend since the 1985 Plaza Agreement. Both trends seem set to continue and are, of course, mutually reinforcing:

- China's slowdown has led to a collapse in the value of many Emerging Market currencies, thus enhancing the attractions of the US$ as a 'safe haven'
- The rise of the US$ means pension funds no longer need to use commodities as a 'store of value' against a continued decline in the value of the currency
- In turn, this means that price discovery on the basis of the fundamentals of supply and demand is now returning to oil and commodity markets

One clear sign of this paradigm shift is that real world issues such as Greece, Iran and China's economy are starting to dominate the headlines. And few people now believe that printing more money is the way to solve these issues. Instead, political leaders are starting to be forced to take the hard decisions they have ducked for so long.

Developments in oil markets remain the key indicator for this paradigm shift. This Note therefore focuses on explaining the rationale for our view that oil prices are now heading back towards their historical trading range around $25/bbl. It also sets out 5 key implications of this development for investors and chemical companies.

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1. Oil markets have begun to slide as Great Unwinding resumes

Financial players clearly misread the market earlier this year, when they assumed that oil prices would 'inevitably' move higher. They first began to believe in higher prices after the SuperBowl coup in January, when prices jumped 20% in 2 days in thin trading. But as Chart 1 shows, they missed the fact this was just a very clever trading move, and not a repeat of the Q1 2009 rally which took prices from a low of $36/bbl to peak at $123/bbl.

Chart 1: January's trading coup did not mark a repeat of the 2009 rally

The problem with the rationale for the rally was that central banks were most unlikely to add another $35tn of stimulus to that supplied from 2009 onwards. And so as Chart 2 shows, we now have record inventory levels in the US. Equally important for Asian markets is that China is probably close to ending its buying to build its strategic oil reserve to cover 100 days of demand.

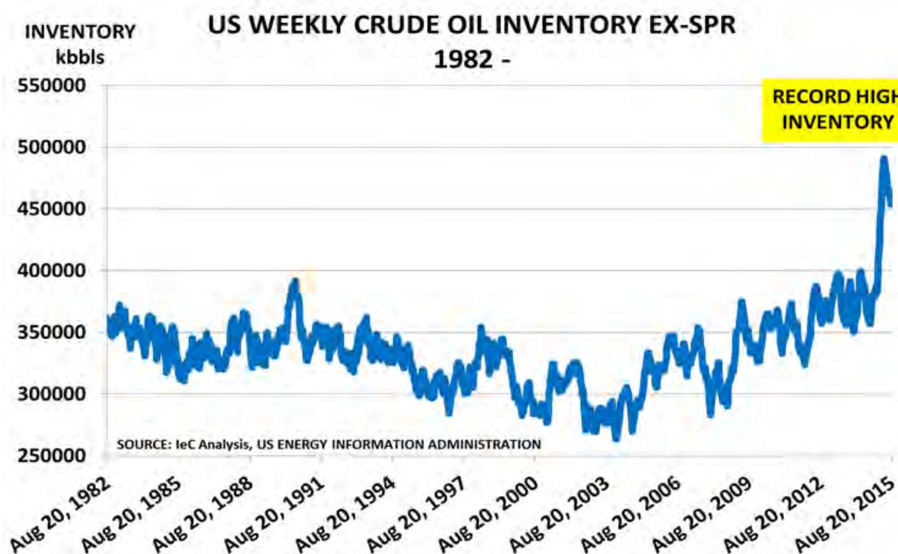

Chart 2: US oil inventories are at record levels

The rally thus created a world where oil markets are now "massively oversupplied", as the International Energy Agency highlighted in its July report:

"It remains that the oil market was massively oversupplied in 2Q15, and remains so today. It is equally clear that the market's ability to absorb that oversupply is unlikely to last. Onshore storage space is limited. So is the tanker fleet. New refineries do not get built every day. Something has to give."

Last month's historic agreement with Iran on the nuclear issue has since acted as the catalyst for a reassessment of the fundamental position. Iran has already started to sell some of its estimated 40 million barrels (mbbls) in floating storage, and the IEA forecasts that it could increase production by up to 800kb/day within a few months of sanctions being lifted.

Of course, US-focused observers rightly point out that Congress has still to ratify the agreement. But whilst this remains a possibility, it is unlikely that the other 5 parties to the agreement (China, Russia, Germany, France and the UK) would follow such a move. The far more critical issue is that Iran's return to world markets is taking place as we move into the seasonally weaker Q3 period for demand.

2. A large volume of oil inventory is waiting to be released

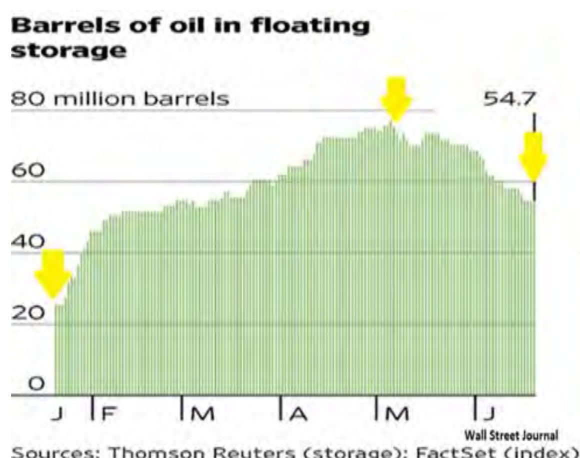

Chart 3: large volumes of oil are in floating storage

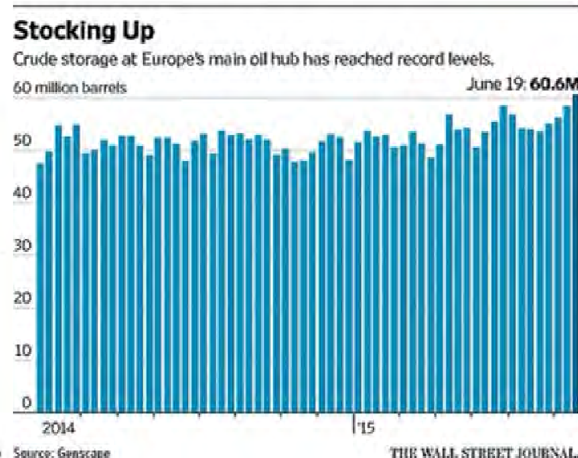

Chart 4: European oil storage is at record levels

This creates 2 risks for the oil price. One is that prices are likely to continue to decline. The second is that whilst it was easy for the speculators to buy all this oil given the massively over-supplied market, they now face the more difficult task of trying to resell it at a profit.

This risk is highlighted in Charts 3 and 4 from the Wall Street Journal. They highlight how the volume of oil in floating storage more than trebled between January – May, whilst European storage rose to a record 61 mbbls. In addition, of course, the US has seen inventories reach record levels. Two other factors are also relevant:

- US shale producers have held back production from 3000 wells capable of pumping up to 1.3mbbls/day of oil, on the assumption of higher prices
- Apparent demand in Asia had been increased by China's decision to increase its strategic petroleum reserve to 100 days of normal demand. But as a Sinopec executive told Reuters back in March, this programme will soon be complete

These developments have masked the fact that OECD inventories are at record levels according to the IEA, who also report there was 3mb/d surplus production in Q2. One clear sign of the imbalance between supply and demand can be seen in the fact that Nigeria has lost its entire export market to the US, worth 1.3mb/day, and is instead having to send its oil all the way to Asia. More recently, N Sea producers have been facing the same problem, with tankers forced to head to Asia instead.

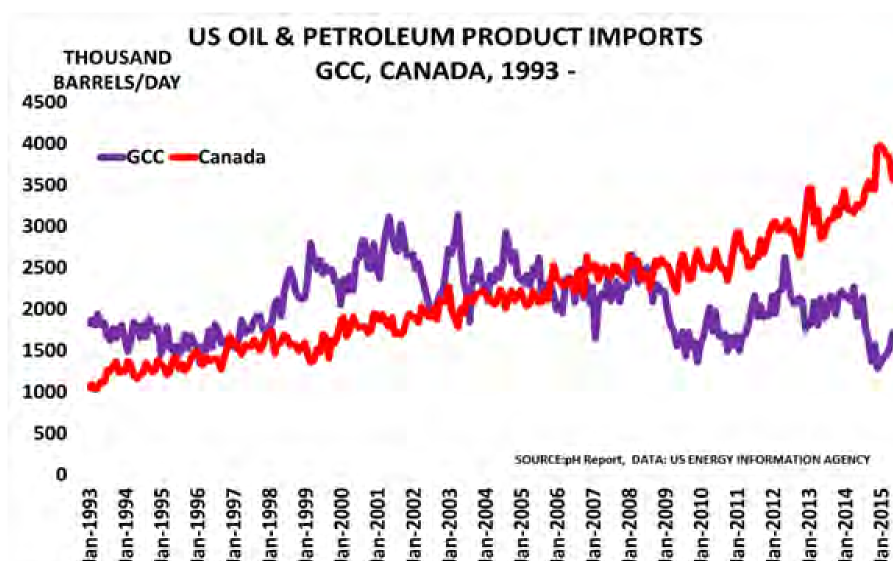

Chart 5: Canada's oil exports to the USA now exceed those of the Gulf Cooperation Council countries

Another key issue is that many commentators continue to misread Saudi Arabia's policy intentions. It is commonly believed to be targeting a collapse of US shale oil production. But as we argued last year, Saudi policy is far more realistic:

- It is well aware that the G7 is targeting a phase-out of fossil fuels, and that this December's Paris conference on climate change may well take significant steps in this direction. Its market share strategy is therefore simply a sensible response to this development, as it has made clear. *"Saudi Arabia wants to extend the age of oil. We want oil to continue to be used as a major source of energy and we want to be the major producer of that energy."*
- In addition, it needs to maintain its oil exports to the US, in order to maintain the 'oil for defence' strategic alliance established back in 1945 by King Saud and President Roosevelt. In this context, the key target is to roll back the dramatic increase in high-cost Canadian oil-sand exports. As Chart 5 shows, this increase has come at the expense of Gulf Cooperation Council exports. Clearly it will take time for the deep-

pocketed Canadian producers to cut back. But Saudi knows very well that if Canadian volumes continue to grow, its own exports will inevitably follow the Nigerian example - and it will risk having to face its local enemies without US support

- A third factor is also important, namely that the Kingdom needs to provide work for its young and rapidly expanding population, over 50% of whom are under the age of 30. Thus its position in the value chain is undergoing major change: it is no longer simply an oil producer, seeking to obtain the highest possible value for its output. Instead, it is becoming ever-more linked to the needs of its downstream customers. Its continuing rise in refining capacity means that it is set to become the world's 2nd largest exporter of oil products by 2017. And the imminent start-up of its joint venture Sadara complex with Dow Chemical will reinforce its position as one of the world's leading producers of petrochemicals and plastics

Our analysis thus suggests that it would make no sense for Saudi to return to its pre-1985 position of being the 'swing producer' in world oil markets. With operating costs of below $10/bbl, it is also well-positioned to be one of the winners in the New Normal world. Thus its production continued to increase last month to an all-time record of 10.564 mbbls.

3. 5 key impacts of a return to $25/bbl oil

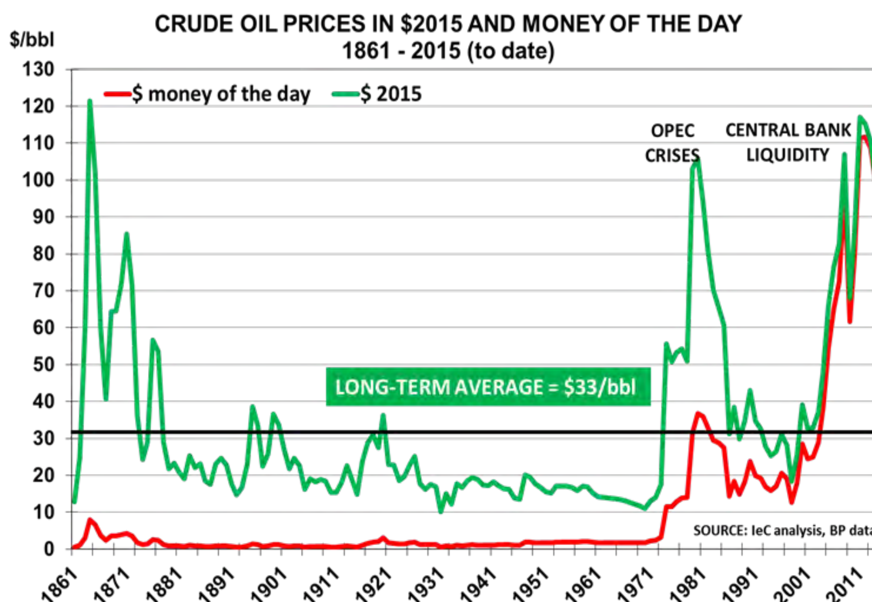

Chart 6: Oil prices have averaged $33/bbl in real terms since 1861

It therefore seems likely that it is only a matter of 'when', not 'if', oil markets will return to their historical trading range around $25/bbl. As Chart 6 shows, prices have averaged $33/bbl in real terms since 1861, and the fundamentals of increasing supply and slowing demand growth suggest there is little reason for them to be above this level, barring major geopolitical developments. In the short-term, the over-supply is such that prices may need to go much lower, perhaps to $15/bbl to enable the market to clear.

This return to historical levels is likely to have 5 key impacts for companies and investors:

❖ **Deflation is now looming in the major economies.**

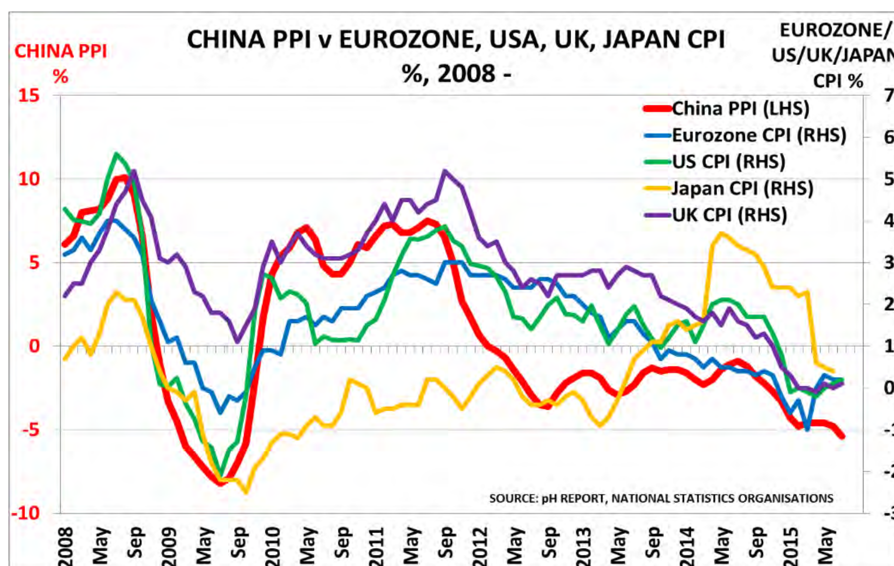

Chart 7: China's negative PPI is driving CPI deflation in major economies

China's Producer Price Inflation (PPI) fell further last month to -5.4%. Its role as the 'manufacturing capital of the world' means that this is inevitably impacting consumer inflation outside China as Chart 7 highlights. It shows that the post-2008 stimulus programmes only led to a temporary rise in inflation. Inflation has now fallen back again, and it seems logical to assume that the ongoing collapse in commodity prices, coupled with China's devaluation, will now lead to deflation.

❖ **Bankruptcies are becoming inevitable.** The end of the dot-com and subprime bubbles led to major bankruptcies including Enron and WorldCom; Lehman and GM. It is likely that this pattern will repeat now the commodities super-bubble is ending, and investors' focus returns to the fundamentals of earnings and debt. The phrase "cash is trash" will in turn probably be replaced by a belief that "cash is king", as prudent investors increasingly favour those companies who have sustainable revenue streams, and high levels of cash rather than debt on their balance sheets.

❖ **Competitive advantage will come from a focus on demand**. Cost-advantage has been key to competitive success in recent years. But the ageing of the BabyBoomers, and the consequent decline in global growth prospects, means that we will return to the pre-1990s world where companies focused on creating demand, rather than assuming it was constantly growing

❖ **Protectionism is likely to spread**. Nigeria has become the latest country to effectively introduce protectionism, with its central bank governor telling the Financial Times "*What I'm trying to say is there are items that can be produced locally, and we are doing demand management and saying let's produce them locally rather than import…I don't know why that is really of so much concern even when government itself will say, we will not import petroleum products.*"

❖ **Expansion plans for new US petrochemical capacity will need to be cancelled.**

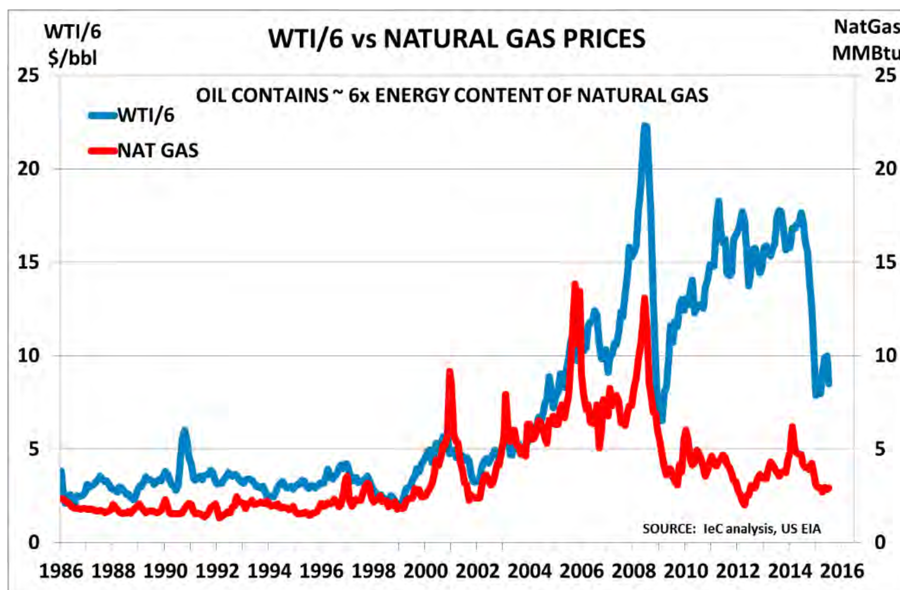

Chart 8: Relative levels of oil and gas-based feedstocks are returning to normal

These macro trends will in turn have a major impact on markets for petrochemicals and plastics, where global supply is now moving into sustained surplus. Equally important is that the return of the oil price to its historical levels means that relative feedstock prices between oil and natural gas will return to normal. This trend has been underway since last August, as Chart 8 shows. US WTI oil has an intrinsic energy value of around 6x that of natural gas, and in addition oil has logistic advantages versus gas, meaning that it has typically traded at around 10x natural gas prices. Thus $25/bbl oil will mark a return to the traditional relationship with natural gas, assuming its prices remain around $2.50/MMBtu.

In turn, this will mean that oil-based producers of petrochemicals and plastics outside the USA will no longer be disadvantaged versus gas-based producers. Clearly companies will then have to re-examine the economics of the proposed new US petrochemical crackers. It is always painful to have to cancel projects once construction has begun. But in this case it will be the lesser of two evils, as few companies would be able to afford the ongoing losses that these projects would likely sustain if they were actually to be completed.

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

Paul Hodges

is a trusted adviser to major companies and the investment community, and has a proven track record of accurately identifying key trends in global marketplaces. He has been widely recognised for correctly forewarning of the 2008 global financial crisis. His analysis of the key role of demographics in driving the global economy is now attracting increasing interest from senior policymakers and executives.

Paul is Chairman of International eChem (IeC) and non-executive Chairman of NiTech Solutions Ltd. Prior to launching IeC in 1995, Paul spent 17 years with Imperial Chemical Industries (ICI), both in England and the USA, where he held senior executive positions in petrochemicals and chloralkali, and was Executive Director of a $1 billion ICI business. Paul is an appointed member of the World Economic Forum's Industrial Council, a Freeman of the City of London, a graduate of the University of York, and studied with the IMD business school

Daniël de Blocq van Scheltinga

was the first foreigner to be granted permission to run the finance company of a top-tier Chinese State Owned Enterprise, when establishing and managing ChemChina Finance Company. Previously, Daniël held a variety of senior positions in corporate and investment banking, including as Asia Pacific Head of Chemicals and Asia Head Asset Based Finance for ABN AMRO.

He has lived in Hong Kong for 14 years, and continues to spend much of his time in China, advising both international and Chinese firms, as well as leaders in the public and private sectors. Daniël is a graduate of Leiden University in the Netherlands, holding a Master of Law degree with a speciality of International law.

James Gruber

is a 14-year veteran of financial markets, having covered them as a leading fund manager, stockbroking analyst and journalist. Most recently, he spent 20 months as the founder/publisher of the widely-followed investment newsletter, Asia Confidential, which focused on key macroeconomic issues facing the Asia Pacific region. Prior to this, he was a Portfolio Manager for Asian Equities at AMP Capital, managing Asian and China A-share funds totaling US$1bn, for two years.

The performance of the China A-share fund was ranked no. 1 globally over one and two years during his time there. For five years prior to this, James was a senior research analyst at leading Asian brokerage, CLSA, where he covered multiple sectors in Hong Kong, Australia, Malaysia and Indonesia. He began his working life as a news journalist at the Australian Broadcasting Corporation.

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