Crystal blog

They say nobody could see it coming. But readers of the ICIS Chemicals & the Economy Blog were well forewarned about the full-blown global financial crisis

PHOTOLIBRARY/GARETH JJ BURGESS

Consultant's corner

PAUL HODGES
INTERNATIONAL ECHEM

A YEAR ago, world stock markets were close to their all-time highs. They had seemingly shrugged off earlier US subprime mortgage problems, with US Federal Reserve chairman Ben Bernanke saying that while these were "fairly significant," he only expected "between $50bn [€39bn] and $100bn of losses."

And the chemical industry was similarly optimistic about the outlook for 2008. The consensus forecast was that volumes and margins would be similar to those enjoyed in 2007, while oil prices would remain around $70/bbl.

But the new ICIS Chemicals and the Economy Blog saw things differently. On October 22, 2007, it used the title "Budgeting for a downturn" for its 2008 Outlook. And it suggested that the consensus was "very optimistic."

We warned there was a real danger that a continuing surge in oil prices would

> We worried about the growing weakness in new housing starts

cause the industry to overestimate the strength of underlying demand, as it had done with such disastrous results in 1979–1980.

The blog also failed to share Bernanke's optimism over financial markets, as we felt that "the underlying position is clearly deteriorating." We worried about the growing weakness in new housing starts and US housing prices because these are key drivers for chemical demand.

We feared that the "latest upward rush by the oil price will be the catalyst that finally causes the US consumer to cut back." Equally, we warned: "The continuing problems in the banking sector may well turn off the tap of consumer, and maybe even corporate, lending."

The blog therefore advised its readers to consider "putting in place contingency plans for just such an outcome." Since then, of course, our worst fears have indeed been realized.

The blog has also accurately forecast devel-

HE TRUTH IS OUT THERE

Charting a course in stormy waters

Extracts from the ICIS Chemicals & the Economy blog

www.icis.com/blogs/chemicals-and-the-economy

OCTOBER 22, 2007
BUDGETING FOR A DOWNTURN

The "consensus forecast" for 2008 is very optimistic, as I commented in my post-EPCA note. It says oil will remain at $70/bbl, that debt market problems will be contained, and that petchem margins will remain at 2007 levels. This is unusual, as the consensus is normally a base case scenario, with upside and downside variants.

And since EPCA, oil has already increased to around $90/bbl. Back in early July, when it was still "only" $70/bbl, I noted that it had the potential to approach $100/bbl, and this still seems a real possibility. In these circumstances, it is perhaps no surprise that we are seeing an apparent "boom" in demand, as downstream consumers rush to cover themselves before product prices move higher.

I first saw this effect happen in 1979, when the industry had a record year. It was only in 1980 that we discovered that the apparent ease with which the economy had weathered a rise in the oil price to $30/bbl (around $95/bbl in today's money), was a mirage. Could the same be happening today? I think it is worth considering very carefully as a possibility.

... There must surely be a real possibility that this latest upward rush by the oil price will be the catalyst that finally causes the US consumer to cut back on nonessential spending. Equally, the continuing problems in the banking sector may well turn off the tap of consumer, and maybe even corporate, lending.

If I was drawing up budgets for 2008, I would be putting in place contingency plans for just such an outcome, even while crossing my fingers that I would not have to use them.

SEPTEMBER 12, 2007
OPEC SEEKS LOWER OIL PRICES

OPEC is sounding a note of concern about the impact of high oil prices on the world economy. Hasan Qabazar, OPEC's chief economist said yesterday: "We are trying, hopefully, to reduce high oil prices, to have prices that are more conducive to economic development."

My own view is that the liquidity boom in financial markets and the high oil price may well have been interconnected. The ready availability of credit meant that consumers (and governments) could borrow, instead of having to cut back expenditure as the higher costs of oil reduced their cash flow. Now, however, we are entering a credit squeeze, and growth in US gasoline demand has already begun to slow.

Futures traders may well continue to ignore OPEC for a while, and the risk to supply from geopolitical events remains very real, so one cannot discount the potential for even higher prices, if circumstances conspire together. This could make an already difficult situation worse. Higher oil prices have always slowed the world economy in the past. Their impact may have been deferred this time, but it is hard to believe that it has been avoided.

FEBRUARY 21, 2008
FOUR ISSUES DRIVING TODAY'S OIL PRICE

The downturn in the global economy has been impacting chemical margins since the summer. Profits have been hit, as key customer industries such as housing, autos, and retail became more price-conscious. Demand has also been slowing, as higher oil prices acted as a tax on Western consumption. Now feedstock volatility is likely to increase, due to the growing influence of financial players. CEOs and chief financial officers therefore need to ensure that proper risk management tools are in place to protect margins.

JULY 13, 2008
OIL PRICES – THE IRAN FACTOR

Nothing is certain in life, except death and taxes. But it is hard to see markets becoming less volatile until either an attack takes place, or a peaceful solution is confirmed. And with oil now around $150/bbl, two quite different outcomes seem possible:

- In the event of an Israeli attack, prices might well rise by $50/bbl to reach $200/bbl, at least temporarily
- But if diplomacy works, they could easily fall by $50/bbl to $100/bbl

Both would cause problems from a chemical industry viewpoint. If prices do hit $200/bbl, it will be impossible to pass them on downstream. If they fall back, then working capital (stocks and so on) will take a massive short-term hit. Prudent chief financial officers and business managers might well wish to consider hedging their purchases and sales against these possibilities.

SEPTEMBER 7, 2008
"THE PRICE OF ALL ASSETS WILL GO DOWN"

"Deleveraging" is an ugly word, and it has ugly implications. Bill Gross who manages the world's largest bond fund at global asset management firm Pimco, has done us all a favor by trying to explain its impact, and why it is likely to continue for some time to come.

He notes that all financial institutions are now reducing the leverage that they use, and as a result:

1. The costs of borrowing are rising, as more equity capital has to be used
2. These costs will continue to rise, until enough new equity capital has been raised
3. Whilst this happens, "the price of all assets will go down."

But deleveraging has other implications for chemical companies. Banks now need to cut back on corporate lending, to preserve their equity capital. Small companies have already seen overdraft limits cut back. Next, it will be the turn of larger companies.

This could be very painful. As recently as a year ago, you could still find companies who had convinced themselves that cyclicality was no longer a problem. As a result, debt levels were often much higher than considered prudent when I joined the industry.

This high leverage boosted earnings during the boom period. But as the blog warned back in August 2007, "when we go into the down cycle, leverage will exert its same impact on the downside."

Chief financial officers will be very busy people in the next few months, as they seek to identify and manage their credit risk.

opments in the oil price and its implications for the "real economy."

OIL FORECAST AND IMPACT

On July 5, 2007, when prices were still around $70/bbl, we were among the first to suggest that "$100/bbl is not impossible, if current geopolitical concerns continue."

We then returned to this theme in more detail on September 12, 2007, arguing that "the liquidity boom in financial markets and the high oil price" were interconnected.

The posting suggested that "the ready availability of credit meant that consumers (and governments) could borrow, instead of having to cut back expenditure as the higher costs of oil reduced their cash flow."

We then warned that "now, however, we are entering a credit squeeze, and growth in US gasoline demand has already begun to slow." Presciently, we concluded, "one cannot discount the potential for even higher prices, if circumstances conspire together. This could make an already difficult situation worse. Higher oil prices have always slowed the world economy in the past. Their impact may have been deferred this time, but it is hard to believe that it has been avoided."

The blog continued to post on these key issues in the new year, while regularly updating readers on the growing problems in the global housing and auto markets.

On February 21, with oil prices at $100/bbl, it sounded a warning about a likely rise in "feedstock volatility," suggesting that this was "likely to increase, due to the growing influence of financial players."

As with our warning on the 2008 Outlook, we proposed practical steps chemical companies could take to anticipate likely problems. We suggested that "CEOs and CFOs therefore need to ensure that proper risk management tools are in place to protect margins."

And the blog reemphasized the importance of hedging margins on July 13, when it was virtually alone in correctly analyzing the short-term outlook for oil markets.

The blog's analysis concluded, that with feedstock volatility continuing to rise in response to threats of an Israeli attack on Iran, and "with oil now around $150/bbl, two quite different outcomes seem possible:

- In the event of an Israeli attack, prices might well rise by $50/bbl to reach $200/bbl, at least temporarily
- But if diplomacy works, they could easily fall $50/bbl to $100/bbl."

We added that "if they fall back, then working capital will take a massive short-term hit. Prudent CFOs and business managers might well wish to consider hedging their purchases and sales against these possibilities."

We repeated this suggestion on July 18, when the US and Iran met to negotiate for the first time in nearly 30 years. And on September 10, it awarded itself "a pat on the back," as oil prices had just demonstrated that indeed they "could easily fall by $50/bbl to $100/bbl," once the prospect of military action had disappeared.

> We were among the first to suggest that "$100/bbl was not impossible"

ASSET DEFLATION

Already, however, on September 7, we needed to issue a new warning. The heading: "The price of all assets will go down," said it all.

We were now very worried about the state of the world economy and financial markets. The blog entry's opening sentence noted that "deleveraging is an ugly word, and it has ugly implications." And we went on to explain "why it is likely to continue for some time to come," quoting analysis published by global asset management firm Pimco, managers of the world's largest bond fund.

After noting the ongoing impact of deleveraging on housing, equity and commodity markets, the blog added that "deleveraging has other implications for chemical companies."

THE DOMINOS FALL

We suggested that banks were already cutting back on credit for small companies, and that "next, it will be the turn of larger companies." We were also concerned about debt levels in the industry, noting that while "high leverage boosted earnings during the boom period… leverage will exert its same impact on the downside." And we warned that "CFOs will be very busy people in the next few months, as they seek to identify and manage their credit risk."

Since that warning was posted, of course, the deleveraging crisis has forced governments to pump over $3.5 trillion into the financial system, in order to head off the threat of depression.

Within a month, the Dow Jones Industrial Average had fallen by 25%, and the oil price had slipped by 35%. We remain seriously concerned that the rest of the blog's analysis may also come true over the next few months.

ABOUT THE BLOG

The blog has now been running for nearly 18 months. This is time enough to begin to assess whether it is meeting its mission "to share ideas about the influences that may shape the chemical industry over the next 12–18 months."

As a blog, it is usually written quickly, outside the normal working day. It is not meant to provide lengthy and perfectly honed reports.

Rather, it aims to highlight relevant information for the busy executive, and to provide relevant and actionable analysis of key issues. I draw on my 30 years of industry experience in trying to achieve these objectives.

The blog's readership now extends to 84 countries and 1,045 cities. On behalf of ICIS, I would like to thank you for your support of the blog to date. We will do our best to ensure it continues to provide you with food for thought. We also hope it will continue to help you manage your business through these difficult times.

Paul Hodges is chairman of International eChem, trusted commercial advisers to the global chemical industry. He has written the ICIS Chemicals & the Economy Blog since it began in June 2007.