Prepare for 2018 risks

Jubilant stock markets are taking no notice of risks such as oil and interest rate volatility, protectionism and public disquiet about political elites and living standards

PAUL HODGES INTERNATIONAL ECHEM

We are living in a strange world. As in 2007-2008, financial news continues to be euphoric, yet the general news is increasingly gloomy. As Nobel prizewinner Richard Thaler has warned: "We seem to be living in the riskiest moment of our lives, and yet the stock market seems to be napping." Both views can't continue to exist alongside each other for ever. Whichever scenario comes out on top in 2018 will have major implications for the chemical industry.

Companies and investors might therefore find it prudent to start building scenarios around some of the key risk areas – increased volatility in oil and interest rates, protectionism and the threat to free trade (including Brexit), and political disorder. One key issue is that the range of potential outcomes is widening.

Last year, for example, it was reasonable to use $50/bbl as a base case forecast for oil prices, and then develop upside and downside cases using a $5/bbl swing either way. But today's rising levels of uncertainty suggest such narrow ranges should instead be regarded as sensitivities rather than scenarios. In 2018, the risks to a $50/bbl base case appear much larger.

In the downside case, US output is now rising very fast given today's higher prices. The key issue with fracking is that the capital cost is paid up front, and once the money has been spent, the focus is on variable cost – where most published data suggest actual operating cost is less than $10/bbl. US oil and product exports have already reached 7m bbl/day, so it is not hard to see a situation where oversupplied energy markets cause prices to crash below $40/bbl at some point in 2018

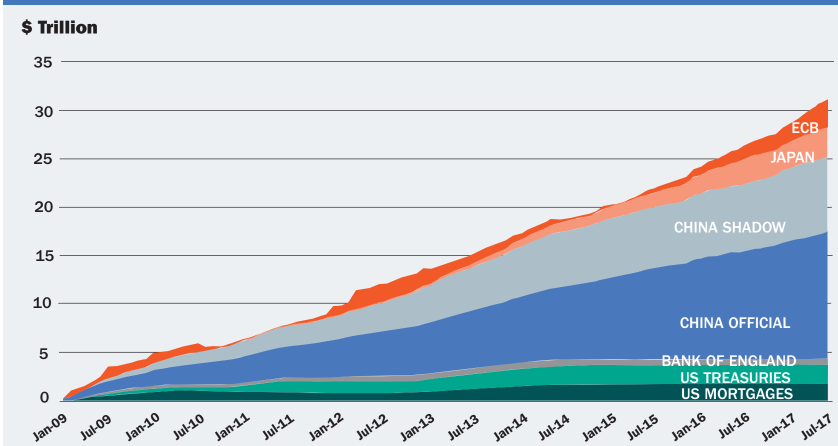
In the upside case, instability is clearly rising in the Middle East. Saudi Arabia's young crown prince, Mohammad bin Salman, is already engaged in proxy wars with Iran in Yemen, Syria, Iraq and Lebanon. He has also arrested hundreds of leading Saudis. If he proves to have over-extended himself, the resulting political confusion could impact the whole Middle East, and easily take prices above $75/bbl.

Unfortunately, oil price volatility is not the only risk facing us in 2018. As the chart, below left, shows, the potential for a debt crisis triggered by rising interest rates cannot be ignored, given that the current $30tn total of central bank debt is approaching half of global GDP. Most media attention has been on the US Federal Reserve, which is finally moving to raise rates and "normalise" monetary policy. But the real action has been in the emerging markets.

Ten-year benchmark bond rates have risen by a third in China over the past year to 4%, while rates are now at 7% in India, 7.5% in Russia and 10% in Brazil.

Volatility is making the future difficult to predict

US, EUROPE, CHINA, BANK OF ENGLAND QUANTITATIVE EASING, 2009-2017



SOURCE: pH Report, St Louis Federal Reserve Bank, Bank of England, People's Bank of China, ECB

DEFLATION THE LIKELY OUTCOME

As with oil prices, we cannot know what will happen next. But this does not mean we have the luxury of being able to sit back and do nothing. The demand deficit caused by today's ageing populations means that growth remains well below the pre-2008 trend, as I originally discussed with John Richardson in our ICIS-published ebook Boom, Gloom and the New Normal: How the Ageing BabyBoomers are Changing Demand Patterns, Again. If a debt crisis does occur, it could be too late to then identify the key risks and decide how best to manage them.

An inflation surprise could well prove the catalyst for such a reappraisal of market fundamentals. In the past, I have argued that deflation is the likely default outcome for the global economy, given its long-term demographic and demand deficits. But markets tend not to move in straight lines, and 2018

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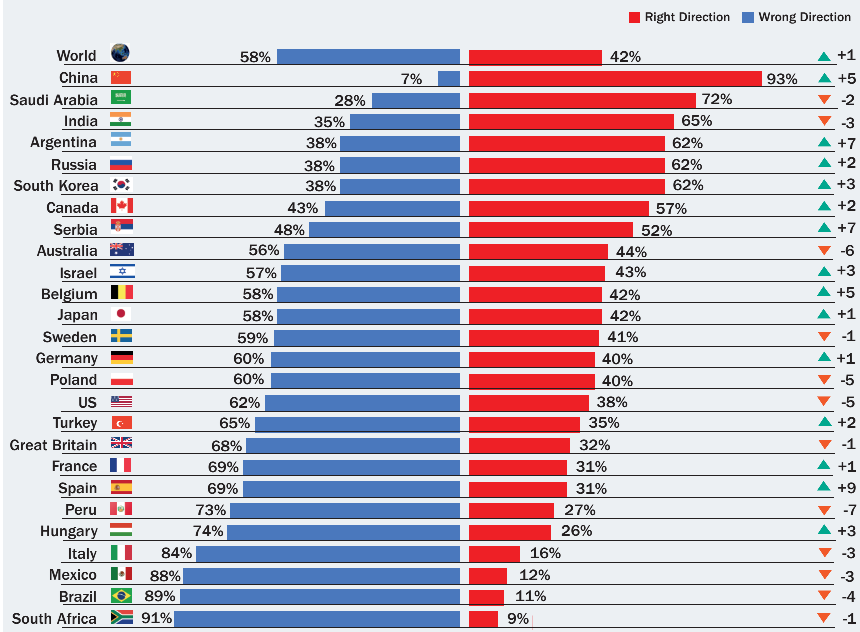
POLITICAL CHAOS IS GROWING AS PEOPLE LOSE FAITH IN THE ELITES



Survey – Base: Representative sample of 18,940 adults aged 16-64 in 26 participating countries, October 20-November 3 2017
SOURCE: Global Advisor

may well bring a temporary inflation spike, as China's President Xi Jinping has clearly decided to tackle the country's endemic pollution early in his second term.

He has already shut down thousands of polluting companies in many key industries such as steel, metal smelting, cement and coke. His roadmap is the landmark China 2030 joint report from the World Bank and China's National Development and Reform Commission. This argued that China needed to move "from policies that served it so well in the past to ones that address the very different challenges of a very different future".

But, of course, transitions can be a dangerous time, as China's central bank chief, Zhou Xiaochuan, highlighted at the five-yearly party congress in October, when warning that China risks a Minsky moment, where lenders and investors suddenly realise they have overpaid for their assets, and all rush for the exits – as in 2008 in the West.

PROTECTIONISM ON THE RISE

Trade policy is a third key risk given the threat posed by growing protectionism to today's global supply chains. The UK's referendum vote to leave the EU highlights this danger, as does President Donald Trump's decision to leave the Trans-Pacific Partnership trade agreement, which would have linked major Pacific Ocean economies.

The president has since also suggested the North American Free Trade Agreement (NAFTA) should be unwound, causing Thomas Donohue, the president and chief executive of the US Chamber of Commerce, to warn that this "existential threat" to NAFTA threatened regional security.

POLITICAL CHAOS IS GROWING

The key issue underlying all these risks is that voters no longer believe the political elites are operating with their best interests at heart. The elites have failed to deliver on their promises, and many families now worry that their children's lives will be more difficult than their own. This breaks a century of constant progress in Western countries, where each generation had better living standards and incomes. As the chart from Ipsos MORI confirms:

- Most people in the major economies feel their country is going in the wrong direction.
- Adults in only three of the 10 major economies – China, India and Canada – feel things are going in the right direction. Those in the other seven feel they are going in the wrong direction, sometimes by large margins.
- 58% of Japanese, 60% of Germans, 62% of Americans, 68% of British, 69% of French, 84% of Italians and 89% of Brazilians are worried.

This suggests there is major potential for social unrest and political chaos if the elites do not change direction.

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"Hope is not a strategy. Developing contingency plans for these and possibly other potential risks could be your best investment in early 2018"

CONCLUSION

Business as usual is always the most popular strategy, as it means companies and investors do not face a need to make major changes. But we all know that change is inevitable over time. And at a certain moment, time can seem to literally stand still, while sudden and sometimes traumatic change erupts.

At such moments, as in 2008, commentators rush to argue that 'nobody could have seen this coming'. But, of course, this is nonsense. What they actually mean is that 'nobody wanted to see this coming'. Nobody wanted to focus on contingency plans when everybody else seemed to be laughing all the way to the bank.

We can all hope none of these scenarios will actually create major problems during 2018-2020. But hope is not a strategy, and time spent on developing contingency plans for these and possibly other potential risks could well prove to be the best investment you will make in early 2018. ■

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