Resilience amid headwinds is key

With multiple headwinds and a range of possible scenarios, companies must create contingency plans for the potential coming storm. Hope is not a strategy

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Resilience is set to become the key issue as we look forward to the second half of the year. None of us have ever seen the combinations of events that are potentially ahead of us, and none of us can be sure which way they will develop. So it seems essential that we start to create contingency plans to build corporate resilience ahead of their possible arrival.

Of course, we can all hope that we are just seeing a series of false alarms, and that business as usual will end up as the outcome. But hope is not a strategy. Even if we optimistically believe business as usual is an 80% probability, the scale of the potential problems under more pessimistic scenarios suggests it would be prudent to decide ahead of time how to tackle them. Everyone will have their own list of possible outcomes. Mine is as follows:

- Business as usual - central bank rate cuts mitigate recession risk; Presidents Trump and Xi reach stable agreement to roll back tariffs; oil market tensions disappear in the Middle East; Brexit uncertainty is put on hold with another extension period; sustainability concerns over single-use plastics are put on back burner.
- Gathering clouds - China's vast offshore borrowing creates increasing risk of corporate defaults as growth slows, particularly if the trade war continues; geopolitical risks mount in the Middle East; Brexit leads to major friction between the UK and EU27; more major consumer products companies decide to end use of single-use plastics.
- Storm warnings issued - Debt problems morph into major bankruptcies, impacting a range of supply chains around the world; US-Iran tensions mount in the Middle East causing oil prices to rise sharply; regional tensions mount as the world settles into a new cold war between the US and China; polymer volumes are hit by a rapid escalation of consumer concerns over single-use plastics.

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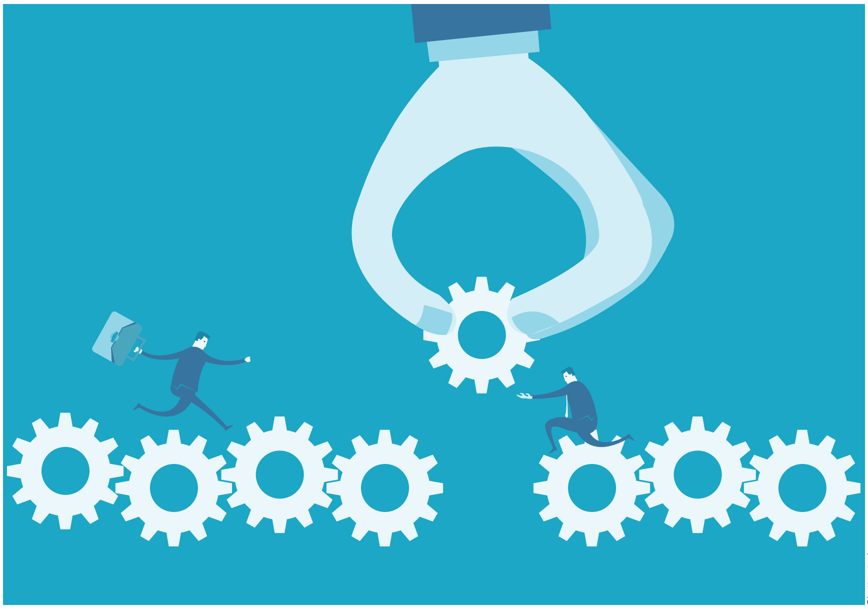

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Benzene has always been a reliable indicator of economic conditions, due to its widespread use in the economy. And today, as the chart of European contract price spreads (opposite) versus naphtha suggests, it may be flagging a return to the more turbulent politics of the 1970s-1980s, after a near 20-year period where it has instead faithfully forewarned of the highs and lows of central bank interventions. It highlights how spreads have rather suddenly returned to the pre-stimulus era before 2001, when they normally fluctuated in a tight range between $100-300/tonne.

Certainly, the range of potential geopolitical challenges is now starting to rival those seen in the 1970s-1980s, before the collapse of Soviet communism in 1989 ended the Cold War between the West and the Soviet Union.

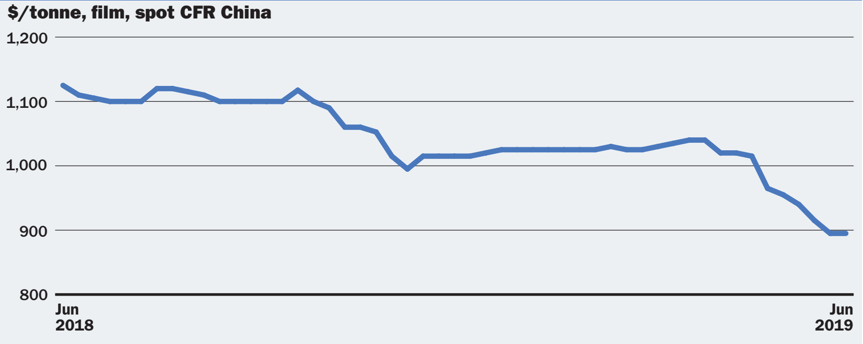
China's polyethylene market is sending out further warning signals, as the chart of LLDPE prices over the past year shows. They have fallen by more than 20%, and market sentiment remains weak

Those decades witnessed two oil price crises in 1974-1975 and 1979-1985, the US Savings & Loan financial crisis, and the UK becoming known as "the sick man of Europe" after being bailed out by the IMF in 1976. Environmental issues were also high on the agenda, with the 1976 Seveso and 1984 Bhopal disasters being followed by the crisis over CFCs and the ozone layer.

By contrast, after benzene's negative spreads forewarned of the 2001 recession, the supply/demand imbalances caused by the post-2001 subprime stimulus experiment saw them race to a peak of $700/tonne. They then fell back with a bump as the 2008 financial crisis developed, returning to negative levels. But central bankers' devotion to the cause of money-printing then saw volatility return on a major scale, with spreads ranging between $70-500/tonne as underlying supply/demand balances were again distorted by renewed bursts of stimulus.

The spread's fall back to $100/tonne earlier this year may therefore be a warning sign that trouble lies ahead, reinforcing the concerns generated by the continuing collapse of interest rates for western government bonds into negative territory. Another cautionary note is that the peaks seen since the early 2000s have failed to reach previous highs, which also suggests that central bankers' power to influence the economy is on the wane.

CHINA LLDPE



CHINA PE WARNING SIGNAL

China's polyethylene (PE) market is sending out further warning signals, as the chart above of LLDPE prices over the past year shows. They have fallen by more than 20%, and market sentiment remains weak. US export prices have also continued to weaken as new supply comes online just when the tariff barriers established by the trade war are reducing its access to the world's largest import market.

We have argued here over the past decade that the economic boom set off in the 1980s owed much to the arrival of the Baby Boomers into their peak wealth creation period, between the ages of 25-54. The collapse in western fertility rates below replacement levels after 1970 also allowed women to return to the workforce after giving birth, creating two-income families for the first time in history and turbocharging demand growth.

Today, of course, the Boomers have another surprise for us, due to life expectancy having extended well beyond pension age to create a completely new generation of "perennials" over the age of 55. They already own most of what they need and their income reduces quite sharply as they move into retirement.

It is therefore no surprise that central banks, having mistakenly claimed credit for eliminating business cycles during the Boomer-led SuperCycle, have been endeavouring to maintain demand since 2001 via stimulus programmes – effectively aiming, therefore, to print babies.

In reality, of course, demographics are destiny as far as the economy is concerned. And so far, the net result of their activities has been record levels of both government and corporate debt. And it is this that poses the greatest short-term risk, if the 'business as usual' scenario fails to develop.

The central bankers' own bank, the Bank for International Settlements, has already warned in a 2017 study of companies over 10 years old, that more than 10% of EU firms, and more than 15% of US firms, were "zombies". They cannot repay their debt and rely on rolling over loans for their survival, as their interest bill exceeds their EBIT (earnings before interest and tax).

Their numbers have probably increased since then - and unfortunately these companies are most likely to fail, if profits continue to fall as a result of supply chain pressures from the issues described above.

ASIA THE CATALYST FOR CRISIS

Asia is likely to prove the catalyst for this potential next crisis. China has begun to deleverage over the past two years, taking $2 trillion out of its high-risk shadow banking sector. But unfortunately this tightening has driven many of the riskiest businesses into the offshore dollar markets, where naive western fund managers have rushed to place their bets – driven by their need to achieve higher returns than are available in their domestic bond markets.

If world trade continues to slow, and the remnimbi (RMB) starts to weaken, then some of these borrowers will inevitably default. In turn, this risks a chain reaction across the world markets, impacting not only the zombies but also their supply chain partners.

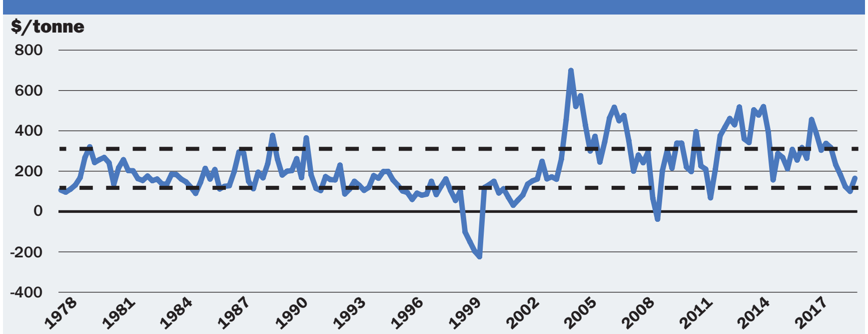
What would your company do in these circumstances? As the American writer Ernest Hemingway noted in 'The Sun also Rises', there are two ways to go bankrupt - "gradually, then suddenly". And the suddenness of the final stage makes it almost impossible for companies to survive if they have not used the gradual stage to create contingency plans. History unfortunately shows that when markets turn, executives suddenly find they have very little time in which to think through how to respond.

Governments will also be in the line of fire, due to their debt levels. And it is unlikely that politicians will know how to respond. They used to be clear about the key issue for the voters, as US President Bill Clinton famously observed in 1992 - "it's the economy, stupid".

But today's politicians instead simply assume that central banks can always print more money to overcome financial and economic crises. They have forgotten the simple mnemonic that many of us learned at school, namely "to ASSUME can make an ASS of U and ME".

Time spent now on building your company's resilience to potential future challenges may therefore prove time very well spent, if hopes for "business as usual" turn out to have been wishful thinking. ■

EUROPE BENZENE SPREAD OVER NAPHTHA



NOTE: Typical spread is $100-300/tonne
SOURCE: International eChem, ICIS

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