Uncertainty replaces 2020 Vision

Contents

We intend to focus on 8 critical questions during the year

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Executive Summary

Last week's chaotic and ultimately tragic developments in the Middle East, confirm that 2020 is likely to reward those who focus on managing uncertainty and contingency planning, rather than simply hoping for perfect vision and a return to 'Business as Usual'.

Chart 1: Perfect vision is unlikely in 2020

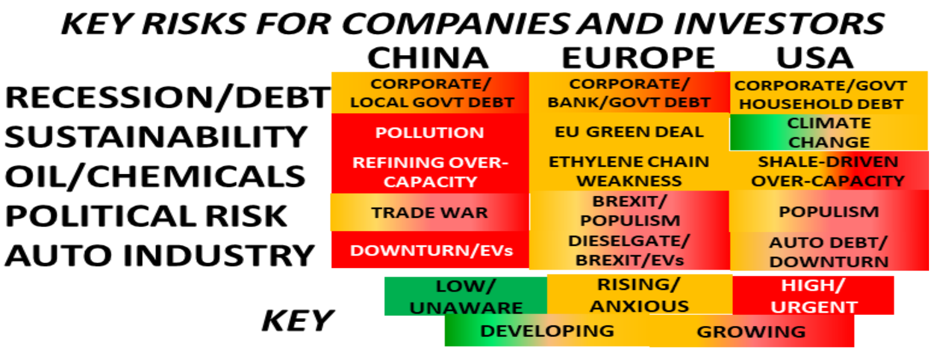
As a result, we intend to focus on 8 critical questions during the year, and to update our assessments each month of their likely impact on your business and investments:

- **Economic Outlook:** Will there be a recession in 2020?
- **Financial Markets:** Do they face a Minsky Moment due to the BBB debt overhang?
- **Sustainability:** What will be the key impacts of the EU Green Deal, rising concerns over waste plastics and moves towards a circular economy?
- **Chemicals:** Will growing shale gas-based polyethylene over-capacity lead to major dislocation in the main petchem value chains?
- **Oil markets:** Will oil prices remain range-bound in 2020?
- **China:** Will the US trade war calm down to allow its economy to reaccelerate?
- **Brexit:** Will UK-EU trade face major disruption to supply chains at the end of 2020?
- **Auto industry:** Our Quarterly update will analyse the key paradigm shifts underway

In this month's Report we therefore set out our rationale for why we believe these 8 areas are important in their own right, and are also critical within the wider landscape. Our experience suggests it is often the second-order effects from developments in an individual 'silo' that create the real "surprise" in related silos, - positively or negatively. We have also realigned our Heat Map presentation below with these key areas.

In addition, as we discuss in the Sustainability and Petrochemicals sections, we expect that the combination of recession with paradigm shifts will create major challenges. The reason is that the end of the recession, whenever that occurs, will not return us to today's market environment, as the competitive landscape will have changed.

This combination of recession and paradigm shifts was last seen in the early 1980s, when globalisation began to become a key driver for the economy. This time round, we see globalisation being replaced by sustainability. Today's ageing BabyBoomers no longer need lots of "stuff" - instead, like their Millennial children, they now want to "do more with less".



GLOBAL ECONOMIC OUTLOOK

There are few signs of imminent recovery

1. Recession nears as downturn continues

The IMF has now confirmed that the world economy has moved into the synchronised slowdown that we forecast a year ago (The end of business as usual). Its analysis also confirms the importance of the issues we highlighted then, including "rising trade barriers and increasing geopolitical tensions", a sharp decline in manufacturing, auto industry contraction and structural forces such as the impact of ageing populations.

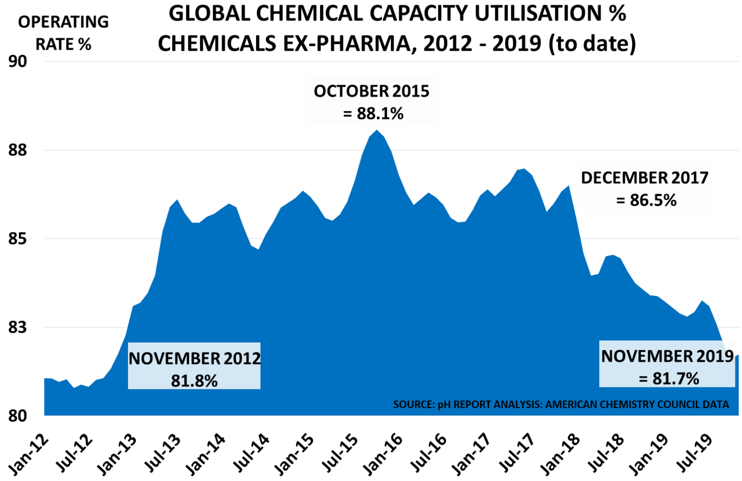


Chart 2: Capacity Utilisation is warning of a sharp slowdown

Unfortunately, as chart 2 confirms, there are few signs of imminent recovery, despite the continued euphoria evident in financial markets. Instead, Capacity Utilisation (CU%) data from the American Chemistry Council suggests that a sharp slowdown is now underway, which has already taken the CU% back to end-2012 levels.

History shows that the peak of the recovery was back in 2015, when the CU% hit 88.1%, after which support from central bank stimulus and President Trump's tax cuts enabled it to plateau for 2 years. But since then, the downturn from December 2017's level of 86.5% has been relatively sharp. Seasonally strong months have been notable for their relative weakness, and have failed to reverse the downturn. And now November's data sees the CU% back at the 81.7% level last seen 7 years ago.

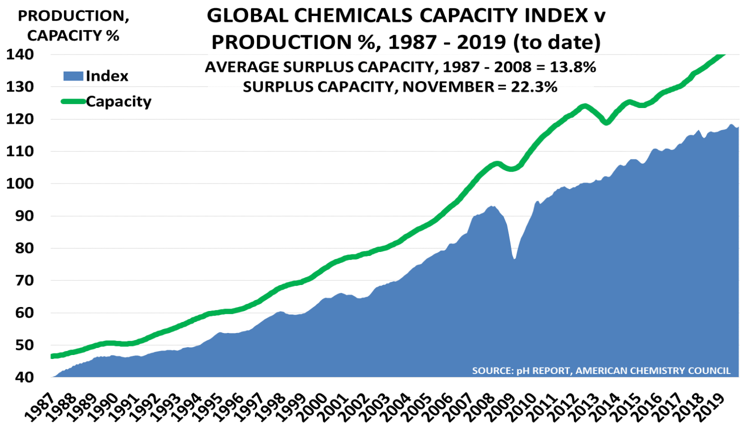


Chart 3: Production data shows that demand continues to weaken

Chart 3 confirms that the key to the downturn is slowing demand. Capacity has only been increasing at 3.4% pa, below its long-term average of 4% pa between 1987-2008. But recent downstream weakness in key industries such as autos, electronics and construction means that surplus capacity at 22.3% is now 61% higher than the long-term average.

Official readings of recession are always retrospective - as when the start of the Crisis was officially backdated to December 2007. In terms of contingency planning, this suggests that it would be prudent to include contingency planning for a recession this year.

FINANCIAL MARKETS

The Fed has had to provide $390bn of support to the supposedly 'risk-free' NY repo market over the past 4 months

2. 'Minsky Moment' risks rise in debt markets

The World Bank this month confirmed our fears over the risks created by:

"The largest, fastest and most broad-based increase in Emerging/Developing Market debt" .

And the New York Federal Reserve then reminded investors in US markets that :

"Growth in business debt has outpaced GDP for the past 10 years, with the most rapid growth in debt in recent years concentrated among the riskiest firms"….On a net leverage basis, investment-grade firms are now as risky as, if not riskier than, lower-rated firms".

Similarly, many now share our worries over the risks revealed by the US Federal Reserve's need to provide $390bn of support for the New York 'repo market' over the past 4 months. At the risk of being complacent, however, we doubt that the Fed will allow a major bank to fail - as would happen if it couldn't borrow overnight on the repo market to balance its books. But we are not so relaxed about the corporate debt market, and BBB rated debt.

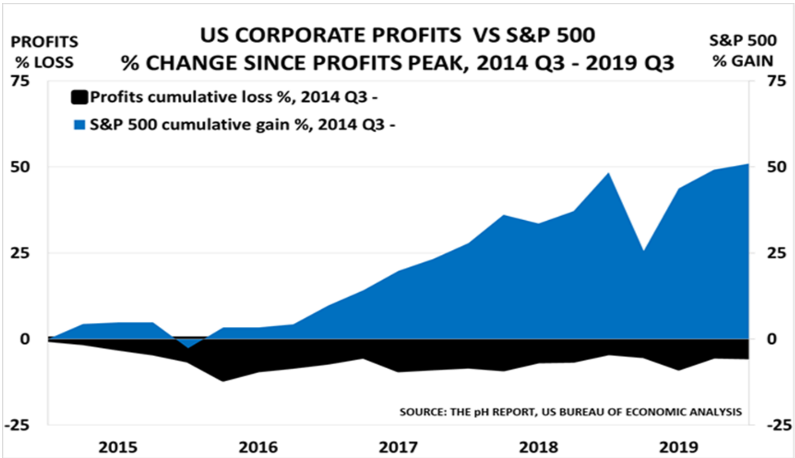


Chart 4: The S&P 500 has risen 50% in the past 5 years whilst profits fell by 5%

Why is the BBB debt market a concern?

As the IMF described in October, the global outlook is "*precarious*", with an ongoing slowdown underway across industry. This is inevitably squeezing cashflow as volumes reduce and margins come under pressure, particularly in commodity sectors:

- Our concern focuses on the $3tn of BBB corporate debt in the US ($7tn worldwide)
- If recession causes cash-flow to reduce in BBB-rated companies to the point where their debt is downgraded below 'investment grade', most major investors would have to 'rush for the exit' as they cannot hold what would become "junk debt"'
- Companies who are being impacted by over-capacity and/or adverse paradigm shifts – such as geopolitics, protectionism, the rise of sustainability, changing demographics - will likely be amongst those most at risk

We recognise, of course, that a large-scale rout would be required to upset the Fed's decade-long support of financial markets. As chart 4 shows, its stimulus and President Trump's tax cuts have allowed the S&P 500 to rise 50% since 2014, despite a 5% fall in profits. And we assume it will continue to prioritise the objective of a rising stock market in line with Ben Bernanke's concept from November 2010 that:

"Higher stock prices will boost consumer wealth and help increase confidence".

"Don't fight the Fed" is a powerful trading maxim. But it seems unlikely that the Fed can continue to boost markets forever in this way. And once one accepts the inevitability of an end to current policies, then it makes sense to understand the potential risks involved.

In our view, a possible worst case would involve a panic in the BBB debt markets which led on to a further panic in the pension fund market itself. Pension funds are major players in the debt markets, due to their need to meet their target returns.

If this higher risk translated one day into portfolio losses, rather than the anticipated higher returns, then their parent company would face a difficult decision. The Board would

If our concerns over the combined impact of recession and major paradigm shifts are realised, the risks to low-rated corporate bonds rise exponentially

have to choose between either (a) reducing retiree benefits, as has already happened with a number of under-funded funds, including GE or (b) making up the lost capital from internal funds, and thereby reducing their own earnings.

The example of GE shows the dilemma this could create, as the Financial Times reported:

"GE's pension obligations stood at $91.8bn at the end of 2018, significantly higher than the industrial conglomerate's $66bn market value on December 31. It faces a funding shortfall of $22.4bn across its US and international pension funds. GE aims to reduce this by up to $8bn by cutting benefits and moving staff into a defined contribution scheme".

Of course, it is certainly possible that the Fed would recognise this risk in time, and move into action to maintain confidence - perhaps by changing the rules around debt ratings, or even by simply 'lending' money to the affected companies. It is an election year, after all, and President Trump's Trade Adviser, Peter Navarro, has already promised that

"It's going to be the roaring 2020s. "Dow 32,000 is a conservative estimate of where we'll be at the end of the year."

What does this mean for managers and investors?

The question, however, is whether these concerns are remote to the point where they can be safely ignored. The answer to this really depends on the likely scale of the problem.

If one believes there is, at most, only a risk of a minor US slowdown, followed by a V-shaped recovery, then one would assume that any problems would be relatively isolated and could be contained. But if our concerns over the combined impact of global recession and major paradigm shifts are realised, then the potential risks rise exponentially.

Exhibit 3: "Superstar" firms made the largest positive return contributions
as of December 31, 2019

Top 10 contributors to S&P 500 2019 return

Ticker	Company	Market cap weight Dec-18	Market cap weight Current	Total return	Fwd P/E	Consensus 2020 growth EPS	Consensus 2020 growth Sales	Contribution to SPX return
AAPL	Apple Inc.	3.4 %	4.6 %	88 %	23 x	11 %	6 %	303 bp
MSFT	Microsoft Corp.	3.8	4.5	57	29	13	11	217
FB	Facebook Inc.	1.5	1.8	57	23	36	22	86
GOOGL	Alphabet Inc.	3.0	3.0	28	26	15	18	86
JPM	JPMorgan Chase	1.6	1.6	46	13	2	NM	72
AMZN	Amazon.com Inc.	3.0	2.9	23	80	26	18	69
BAC	Bank of America	1.1	1.1	46	12	10	NM	50
MA	Mastercard Inc.	0.8	1.0	59	35	18	14	49
V	Visa Inc.	1.1	1.2	43	30	15	11	48
T	AT&T Inc.	1.0	1.1	44	11	2	0	44
Top 10 contributors		**20 %**	**23 %**	**50 %**				**1023 bp**
S&P 500		**100**	**100**	**31**	**19 x**	**9 %**	**6 %**	**3149**

Source: FactSet and Goldman Sachs Global Investment Research

Chart 5: Apple and Microsoft 's stock market outperformance is unusual

We also wonder whether Apple and Microsoft's position as the top performing stocks in 2019 may be a 'straw in the wind' that indicates some investors share our concern?:

- It stretches the imagination to believe that either are capable of the rapid increase in profit that would justify their 88% and 57% returns, as shown in chart 5
- Apple's profits have in fact been falling for a year, as we forecast in November 2018, and whilst the Cloud offers good opportunities for both companies, there are plenty of deep-pocketed competitors, including Amazon to keep profits under control

But if one was a fund manager whose mandate forced them to stay invested throughout market cycles, a different perspective might come into play.

These two shares are unlikely to be caught up in a 'rush to the exits' caused by problems in the BBB debt market. Instead, they might well benefit by being seen as a 'safe haven' during any shake-out - particularly by less fortunate investors deciding to operate on the "once bitten, twice shy" principle, having suffered from any downgrades or defaults.

Recent years have seen a growing number of "unexpected events". This suggests that managers might find it prudent to undertake contingency planning over the likely implications of a debt market crisis for their business, ahead of possible trouble in the future. Such an exercise might be particularly valuable for companies with high debt levels themselves, or those who rely on supply chain partners with high debt.

SUSTAINABILITY

Paradigm shifts are inevitably messy and not well understood in real time when they actually happen. They usually develop on a "two steps forward, one step back" or even "one step forward, two steps back" basis

3. Sustainability replaces globalisation

"Its Morning in America', President Reagan's 1984 re-election campaign ad, summed up the optimism at the start of the globalisation era, as the BabyBoomers moved into the Wealth Creator, 25-54 cohort. By contrast, President Trump's 2016 theme of 'Making America Great Again' mirrored the caution of ageing blue-collar Boomers as they joined the Perennials 55+ cohort - and their desire to hang on to what they have.

Chart 6: Communications went through a paradigm shift in the 1980s

The 1980s saw a series of major paradigm shifts take place, culminating with the fall of the Berlin Wall in December 1989 - which ended the threat of nuclear annihilation from the Cold War. Globalisation as a concept had been building during the 1970s, and it powered ahead as new industries began to provide the tools that it required:

- IBM introduced the first PC in 1981 with 16k RAM, no disk drives, priced at $1565
- Microsoft introduced the first 'must-have' software, MS-DOS, at the same time
- International direct dialling began to replace operator connection in the early 1980s
- Email also began to spread as an internal tool within companies

These developments meant that employees gradually became able to manage their own communications, removing the need for the typing pools, telex rooms and telephone operators shown in chart 6.

It is easy, of course, to look back in hindsight and imagine that globalisation's progress was seamless and trouble-free. But in reality it proceeded in the messy way common to all major change - "two steps forward, one step back', and sometimes 'one step forward, two steps back' after a false turn. And this is how sustainability is also proceeding today.

It is also unlikely that anyone at the time foresaw the detailed outcome of the globalisation concept. And even if they had, the wealth that it would create would have seemed far-fetched to most people. US GDP/capita rose by ~50% between 1980–2020 in inflation-adjusted terms - an astonishing increase.

This history highlights the important conclusion that paradigm shifts are inevitably messy and not well understood as they develop. Machiavelli's insight is also critical that:

"There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things. Because the innovator has for enemies all those who have done well under the old conditions, and lukewarm defenders in those who may do well under the new."

It is therefore not surprising that most companies and investors have ignored new EU Commission President Ursula von der Leyen's launch of the EU Green Deal last month:

"I am convinced that the old growth-model that is based on fossil-fuels and pollution is out of date, and it is out of touch with our planet. The European Green Deal is our new growth strategy – it is a strategy for growth that gives more back than it takes away. And we want to really make things different. We want to be the frontrunners in climate friendly industries, in clean technologies, in green financing."

There could hardly be a greater contrast between her view and President Trump's denial of the importance of climate change. President Xi's mid-way position - signing up to the Paris Agreement, but also expanding China's use of coal-fired power stations - further highlights the challenges for managers as they develop their thinking on the potential impact of sustainability replacing globalisation as a key driver for business and society.

PETCHEMS & POLYETHYLENE

"Build it and they will come" has been the motto for the supply-led capacity expansions since the early 2000s

4. Petchem markets risk repeat of 1980s crisis

History doesn't always repeat, but it often rhymes, as US author Mark Twain reminds us. And petrochemical markets seem to be seeing an example of Twain's insight, with oil/gas majors busy repeating the 'dash for petchem growth' that took place in the late 1970s - and which then led to major over-capacity and negative margins through the early 1980s.

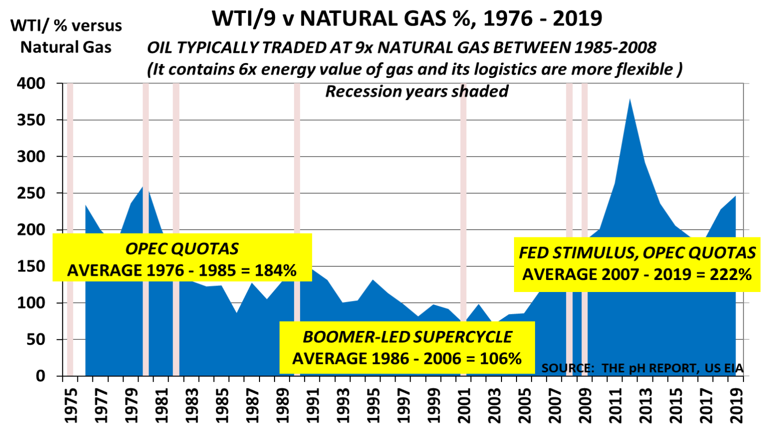


Chart 7: Oil prices have again been well above their relative value to natural gas

The relative level of oil to natural gas prices over the 1975-2019 period highlights the similarity between the two periods, as chart 7 confirms. It shows US WTI prices adjusted (a) to reflect that oil's energy value is ~6x the energy value of natural gas and (b) that its logistics are far more flexible. Typically, one would expect oil to trade at around 9x the value of natural gas, as happened between 1986-2006 with oil at 106% of natgas prices.

- From 1976-1985, however, oil traded above this ratio at an average 184% of natgas value, due to the impact of the Arab Oil boycott and then OPEC quotas
- This provided windfall profits for the major oil companies, which they were unable to fully invest in new production due to the OPEC countries' nationalisation programme
- Exxon typified the frantic search for potentially profitable diversification with ventures such as Exxon Office Systems selling typewriters, fax machines etc
- IOCs also looked for more-related areas of opportunity, and the Boston Consulting Group provided a famous study suggesting they could gain petchem market leadership by investing in new technology - principally larger-scale crackers
- The result was a disastrous increase in petchem capacity in the early 1980s during the recession, which meant petchem businesses suffered major losses till c1985

Unfortunately, the past few years have seen a similar development, with oil prices moving to an average 222% of natgas value as a result of the shale gas phenomenon and, more recently, the return of OPEC quotas. US-based companies have gained windfall profits, and have again looked to petchem markets as a promising step-out area.

- As McKinsey have identified, expansion has gone ahead on a supply-led basis: *"Since the early 2000s, over half of petrochemical investments have been based on advantaged feedstock, in particular in the C_1 and C_2 chains. Companies have not been concerned about the impact this new capacity would have on the industry's supply-demand balance, because they knew they were investing with such decisively low costs that they would be far below the marginal cost of production."*
- More recently, of course, Middle Eastern players have also begun to worry over the downside risk for oil demand into transport, and have begun to focus on major oil-to -chemicals projects as a hedge against this possibility
- "Build it, and they will come'" has been the motto. And unfortunately the lessons of the early 1980s have been forgotten, with euphoria over the role of monetary policy leading to an assumption that recessions are a thing of the past. In addition, there has also been a failure to appreciate the massive support provided for demand from the mid-1980s as the Boomers moved into their peak consumption period
- A further issue is that most 'long-term' planning is now based only on 10-year price histories, meaning that even the 2008 Crisis is now fading from memory. And, of course, corporate memory of the 1980s disaster has virtually disappeared due to the retirement of those who could remember it.

We worry that few managements are focused on risks to 'business as usual'

These developments highlight our concern over the lack of preparedness for a major downturn. As we discussed last month, a major downtrend is already underway on polyethylene margins - since then, SE Asian margins have joined NE Asian margins in going negative. NW European margins have also tumbled from $800/t in June to $200/t today, with US Gulf and Middle East margins also being impacted.

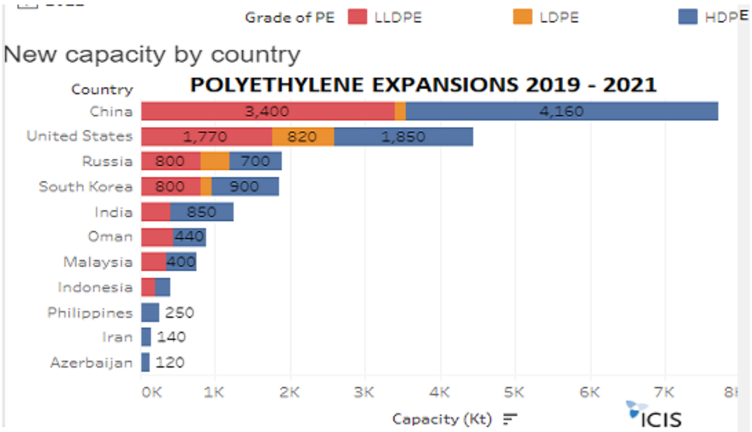


Chart 8: PE capacity is continuing to expand

Equally worrying, as chart 8 confirms, is that around 20Mt of new PE capacity is scheduled to arrive in the 2019-2021 time period. And yet it is already clear that the potential for demand destruction is increasing, as major brand-owners commit to ambitious targets for the use of recycled plastic. Similarly legislators, as with the EU Green Deal, are now starting to consider a waste plastic tax and a carbon tax.

The problem, as Hyman Minsky highlighted, is that a long period of stability eventually leads to major instability. In the period before the Boomer SuperCycle, managements routinely expected a recession every 5 years and prepared contingency plans in advance. Investors would similarly build cash reserves, rather than seeing any downturn is a buying opportunity. These 'stabilisers' were invaluable when the downturn came.

The 1980s shows important parallels with today

We believe that history does repeat, albeit not exactly, and that the next few years will see a repeat of the position in the early 1980s where recession combined with paradigm shifts. At that time, we saw the beginnings of the rise of globalisation, which was to transform business models over the next 30 years. Today, we are seeing its replacement by sustainability as a key driver for the petchem industry and the global economy.

The parallel with today's mounting over-capacity in the critical ethylene chain highlights the industry and company-specific risks from these developments. The key risk is that a slowdown in ethylene demand will inevitably impact supply/demand balances in co-products such as propylene, butadiene, benzene and the C8 chain as naphtha-based crackers cut back. In turn, this will create knock-on impacts down the value chains.

As we noted in January 2018, non-integrated olefin producers are most at risk, given their inability to access the roll-through margins available to those companies integrated from the well-head through to refining. But another lesson from history is that rebalancing supply/demand is very difficult to achieve via closures.

'Swap shops' and other ideas for rebalancing supply in the 1980s all failed to achieve the desired result on the scale required. The problem was simply that cracker closures meant compensation payments would have to be made to refineries that could no longer sell the feedstock naphtha. And governments were generally reluctant to allow actual refinery closures, due to the risks this would create for the domestic economy.

We therefore worry that contingency panning today is still the exception rather than the rule, with most assuming the next few years will be 'business as usual'. Yet as the 1980s proved, it is very difficult to manage through a recession when it is combined with major paradigm shifts. The issue is that profits are in major decline, just at the moment when large investments have to be made in the areas of potential future growth.

OIL MARKETS

Brent's 'flag shape' is gently closing, suggesting that a major move, up or down, is becoming inevitable

5. Will oil remain range-bound in 2020?

Recent tensions in the Middle East have barely moved crude oil pricing, just as happened after the drone attacks on Aramco facilities in September. Similarly, fears in some quarters that the new IMO Maritime fuels quality standards would disrupt oil product markets have proved groundless. Businesses and forecasters have therefore begun to assume that a price of $65-70/bbl is the "new normal" for Brent.

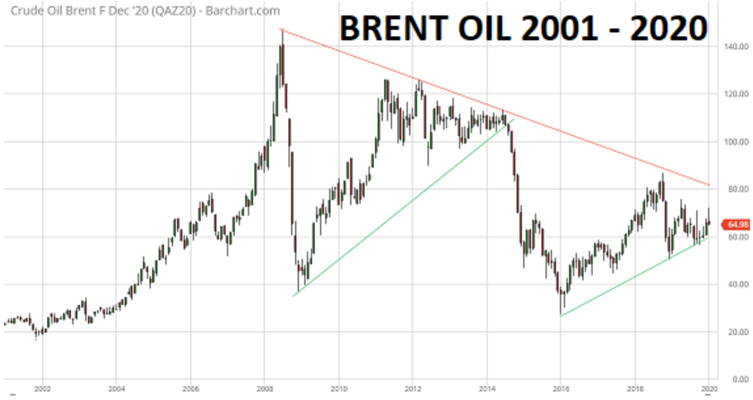


Chart 9: Brent continues in the 'flag shape' which began in 2008-2016

This month's annual Reuters survey of energy professionals also confirms that:

"Response clustering has been increasing in recent surveys, suggesting the anchoring of long-term expectations around the $65-70 per barrel level is becoming stronger."

Yet as chart 9 confirms, history shows that oil's current stability is of very recent origin:

- From 2004, prices leapt from $25/bbl to $150/bbl, collapsed to $30/bbl, jumped to $125/bbl and then collapsed again to $30/bbl before rising to today's range
- And now that oil markets are dominated by hedge funds, not producers/consumers, one has to look beyond the fundamentals, at the 'technicals' that guide their trading

Our analysis suggests the 'technicals' are the reason for today's stability. They indicate we are in a second 'flag shape', matching 2009-2014 - when we successfully forecast oil's fall to $30/bbl in August 2014. Today, the lines of the 'flag' are again gently closing, with bears selling at the top of the range, and bulls buying at the bottom. At some point in the next 12-18 months, this battle will finally be "won" and prices will move wildly again.

The downside risks currently seem greater, although of course geopolitics can always upset everything. But even the head of the International Energy Agency (which aims to encourage investment to ensure stable oil supplies) currently believes:

"I can tell you that the markets are, in my view, very well supplied with oil"

Our concern is therefore that this is another area where contingency planning is essential.

On the upside, the issue is whether OPEC will continue to cede market share to non-OPEC producers, as their output continues to increase? Now that the minimalist Aramco privatisation has taken place, the Saudis have less incentive to support prices - and latest data on OPEC quota adherence suggests nobody else is willing/able to take their place.

On the downside, the question is whether the IEA's forecast of a 1mbd increase in 2020 comes true? This number is essentially based on the IMF's forecast of a recovery in global growth. But this looks optimistic given that China and India - the key drivers of both GDP and oil demand growth - are clearly slowing. And whilst forecasters continue to suggest the shale boom will run out of road, we can see little evidence of this in reality.

Our view is that the fundamentals of supply/demand will remain weak as the world heads into recession, and that the rising support line from the 2014 lows will come under increasing pressure. If the 'flag' is broken, the market will move very rapidly out of its recent range, as hedge funds abandon today's long positions and focus on the short side.

Our focus during 2020 will therefore be on the potential "trigger" for any move out of the 'flag shape'. Major military disruption to Middle East oil supply or other geopolitical crises would easily take the market much higher to $100/bbl. Similarly, a recognition of demand weakness, or a Saudi decision to again prioritise market share over price, would likely take prices down to $25-35/bbl range.

US-CHINA TRADE WAR

Average US tariffs with China will have risen from 3% to 19.3% under President Trump, despite the Phase One trade truce

6. Will the US trade war calm down sufficiently to allow the Chinese economy to reaccelerate?

We plan to focus on this question in coming months, as it is key both for the global economy and for relationships between the two economic superpowers. 2020 is also key to the outlook for China itself as it marks (a) the end of the current Five Year Plan and (b) the year by when the Communist Party has promised that China will become a "moderately prosperous society" where as China Daily describes:

"All citizens, rural and urban, enjoy high standards of living. This includes building a "moderately prosperous society" by doubling 2010 per-capita GDP to $10k by 2021."

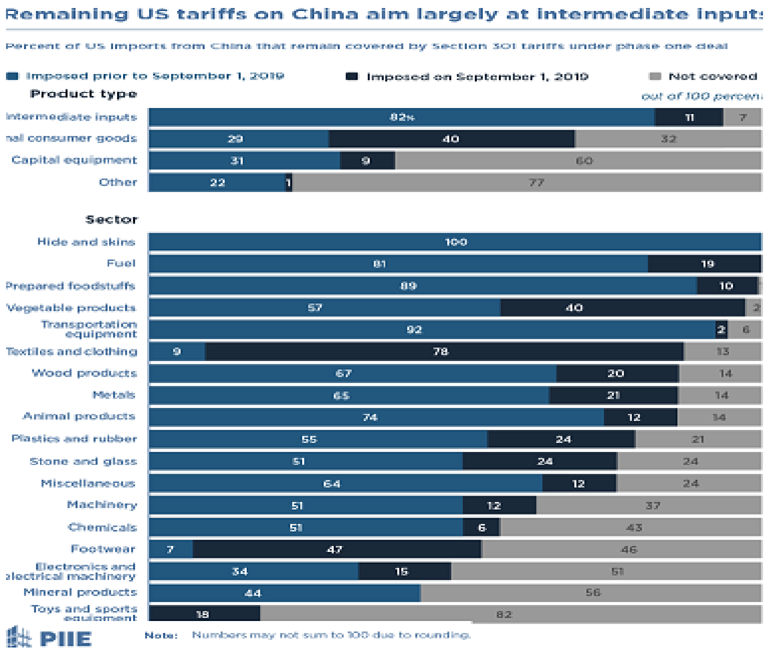


Chart 10: The Phase 1 trade truce still leaves 2/3rds of US import tariffs in place

President Trump's announcement of the Phase 1 'trade truce' agreement before Christmas highlighted his concern to keep stock markets moving upwards ahead of the election. Its key elements were the withdrawal of the threat to impose $162bn of new US import tariffs on toys, consumer electronics and other goods, along with the halving to 7.5% of the $100bn of import duties imposed in September.

But as chart 10 from the Peterson Institute confirms, the $250bn of 25% tariffs prior to September remain in place. Overall, Trump will still have increased average US tariffs from 3% in January 2018 to 19.3%. And on the Chinese side, average import tariffs will have increased from 8% to 20.9%, despite further duties on autos and auto parts continuing to be suspended, and the new exemption of $660m of chemical exports.

The election-related background to the announcement was highlighted by US Trade Representative Robert Lighthizer choosing to focus on the potential doubling of Chinese purchases from the 2017 level of $128bn - with agricultural purchases doubling from the 2017 baseline of $24bn. These are major issues for several key farming states. There was little detail on supposedly critical issues such as intellectual property, although the Wall Street Journal reports that President George W Bush's 'Strategic Economic Dialogue' will be reborn as the 'Comprehensive Economic Dialogue'.

Our China watchlist for 2020

2020 is a key year for the Chinese Communist Party and President Xi Jinping, due to the critical commitments that have been made on building a "moderately prosperous society" ahead of 2021's centenary celebrations of the Party's founding. The US-China relationship will also continue to be key for President Trump as the election nears.

We therefore plan to focus on these critical areas each month, given that they impact the 2 economic superpowers and other major exporting regions such as the EU and SE Asia, as well as the global economy itself. The key question, of course, is whether enough progress is made to enable the Chinese economy to stabilise or even reaccelerate.

BREXIT
UK ministers downplay the concerns of industries such as autos, aerospace and pharma with complex supply chains

7. EU plans 'bare-bones' trade deal by December

The UK government failure to find £500k so that Parliament's Big Ben bell can sound on 31 January, as the UK exits the EU, may prove an omen for Brexit itself. Certainly Michel Barnier's New Year resolutions for the negotiations reflect a downbeat assessment:

"These are our three goals for 2020: to maintain a capacity to cooperate closely at the global level; to forge a strong security partnership; and to negotiate a new economic agreement (which, most likely, will have to be expanded in the years to come). If we achieve these three objectives, we will have made the most of the next year."

Chart 11: Brexiters wanted Parliament's Big Ben to chime at 23.00 hrs on Brexit Day

A detailed reading of Barnier's policy statement and EU President Ursula von der Leyen's LSE speech this month, suggests the EU27 have now reluctantly accepted that Brexit is likely to change key elements of current trading arrangements. As she noted:

"The truth is that our partnership cannot and will not be the same as before. And it cannot and will not be as close as before – because with every choice comes a consequence. With every decision comes a trade-off. Without the free movement of people, you cannot have the free movement of capital, goods and services. Without a level playing field on environment, labour, taxation and state aid, you cannot have the highest quality access to the world's largest single market.

"The more divergence there is, the more distant the partnership has to be. And she added with regard to financial services: "*One question is whether some equivalences can be reached for some sectors which will allow banks to operate in that way. But this would be a unilateral decision from the EU."* EU Trade Commissioner Phil Hogan has since confirmed that in return, *"The EU will be seeking concessions on fishery access".*

Understandably in view of the EU's Green Deal, Barnier suggests that close co-operation to achieve a successful Climate Change Conference in Glasgow in June is a top priority:

"Setting ambitious targets will require a strong common position. If the EU and the UK cannot align on such a critical issue, there is little hope others around the world will do so."

Security is then the second priority, where the issues are more complex as he notes:

"The UK's departure from the EU has consequences. The strong security cooperation that EU member states have put in place is linked to the free movement of people. It works because we have common rules, common supervision mechanisms, and a common Court of Justice….The same degree of cooperation is simply not possible with a third country ."

Thirdly, and the order of precedence is significant in itself, he set out the need for:

"An economic partnership that reflects our common interests, geographical proximity, and interdependence….the UK government made clear that it will pursue a free-trade agreement with the EU, and rejected the idea that it would remain in the EU customs union. That means the UK and the EU will become two separate markets...Any free-trade agreement must provide for a level playing field on standards, state aid, and tax."

Separately, the Financial Times reported that UK ministers downplay the concerns of the "automotive, aerospace and pharma" industries with complex supply chains, as they are:

"Expecting the heaviest lobbying from industries that are in secular decline".

Johnson may, of course, change his mind as the June 30 deadline approaches for a Transition extension request. But this seems unlikely today, suggesting that companies with major EU27-UK interests need to develop contingency plans for new arrangements. The UK hasn't negotiated its own FTAs since 1973, so has a steep learning curve ahead.

VOLUME PROXY
We would have been more comfortable if polymers had led the recent upturn, as it would have reflected genuine demand rather positioning in a geopolitical crisis

8. Iran worries provide temporary buying boost

Geo-political concerns provided traders with a quick New Year bonus as oil prices jumped after the US assassination of Qassem Soleimani, Iran's military head in Iraq. But the excitement was soon over, and the revelation that Iran shot down a Ukraine airliner by mistake is likely to create a sense of deep unease over the whole sequence of events.

Oil's 14% rise from the end of November had already stalled before this news broke as chart 12 shows, highlighting the underlying weakness in the market.

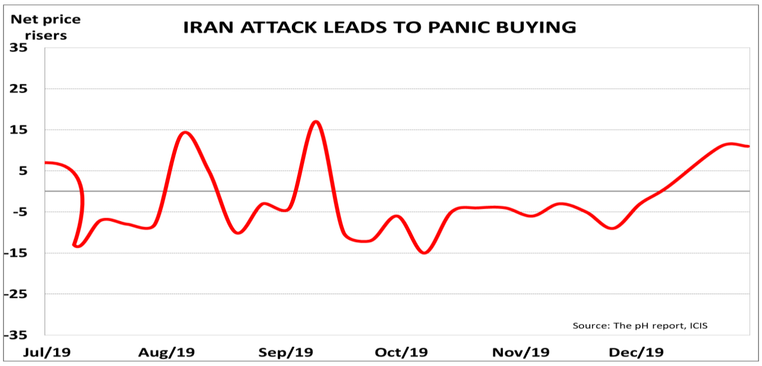
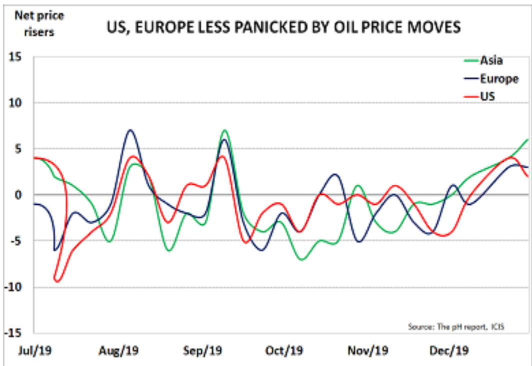


Chart 12: Panic buying boosted prices after Soleimani's assassination

In Asia, this unease is likely to play into the usual seasonal slowdown ahead of China's Lunar New Year holiday, which begins on 24 January. So the real test will only come after Chinese buyers return to their offices in February for the Year of the Rat, and begin to plan their future needs in the light of the Phase 1 trade truce.



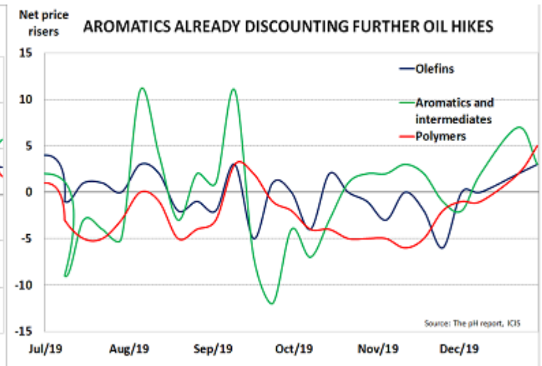


Chart 13: US/Europe seem to have already peaked *Chart 14: Aromatics, as usual, reacted first*

Chart 13 shows that oil market concerns drove purchasers across the three regions through year-end, over-riding typical seasonal pressures to destock. Interestingly, and in contrast to the US S&P 500's positive start to the year, the US was the first region to pull back as oil markets normalised.

In the products area, shown in chart 14, aromatics were as usual the bell-weather. Their prices leapt and then fell back again, with olefins and polymers following in their usual sequence. Aromatics are always closet to oil market pressures, with polymers reflecting end-user developments and olefins in the middle. We would therefore have been more comfortable if polymers had led the charge, as it would have reflected genuine demand rather than trader positioning in a geopolitical crisis.

About The pH Report and IeC

The pH Report is published by IeC, a London-based strategy consultancy advising Fortune 500 and FTSE 100 companies, investment banks and fund managers.

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