A new recession era to emerge

Contingency planning has become mission-critical. The longer the coronavirus pandemic continues, the more it will expose the underlying fragility of today's debt-laden global economy.

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PAUL HODGES INTERNATIONAL ECHEM

The sudden shock created by the coronavirus pandemic has already begun to puncture the financial bubbles created by central bank stimulus policies over the past decade.

Oil prices have crashed from $50/bbl at the start of the month, towards to their long-term median value around $25/bbl. And they may well go lower, with the International Energy Agency forecasting the first decline in oil demand since 2009.

With recession increasingly likely, and climate change risks forcing countries to move away from fossil fuels, former Saudi Oil Minister Sheikh Yamani's warning in 2000 therefore looks increasingly prophetic today:

"30 years from now, there will be a huge amount of oil – and no buyers. 30 years from now, there is no problem with oil. The Stone Age did not end because the world ran out of stones, and the Oil Age will not end because we run out of oil. I am a Saudi and I know we will have serious economic difficulties ahead of us."

We must all hope that the virus spread will be quickly contained, and that government action will prove effective in reducing the risk to human health.

However, even if this proves to be the case, we cannot ignore the impact that the virus has already had. Central banks cannot, unfortunately, wave a magic wand to cure coronavirus, just as their stimulus programmes have proved unable to effectively "print babies" to generate sustainable demand growth.

As always, the chemical industry has proved the best leading indicator for the wider economy. As the chart shows, our Volume Proxy Index provides an excellent real-time view of the crisis' development:

- Markets were hoping for a seasonal upturn in January, after a lacklustre Q4
- Coronavirus led to a collapse in Asian markets as China's lockdown took hold
- Europe and the US then attempted to rally, until the virus arrived in Europe

One problem, as Reuters has noted, is that: "Most western policymakers and journalists view the world economy through a framework that is 10-15 years out of date, failing to account fully for the enormous shift in activity towards China and the rest of Asia."

China is responsible for around 30% of global demand for cars and smartphones, and both are key downstream markets for the chemical industry.

China is also key to global supply chains - 70% of all smartphones, for example, are manufactured in China. And now, of course, the virus is exposing the underlying weakness created by a decade of stimulus policies in other major global economies including Japan, South Korea and Italy.

As the OECD chart confirms, the virus is essentially acting as the catalyst for recession, with global GDP growth forecast to fall below the 2.5% level normally seen as the global dividing line between expansion and recession.

The OECD also warns that an even more alarming downside scenario is possible with growth at just 1.5%, if the "intensity of China's impact is repeated in the northern advanced countries severely hitting confidence, travel and spending".

We are therefore moving rapidly away from a world of 'business as usual' and into one of increasing uncertainty. It has already taken China three months to bring the virus under control, and there is no guarantee that a revival might not take place. And the impact in Europe, the US and elsewhere is only just starting to be seen.

Even so, some major industries including travel and leisure are already in a major downturn. The airline industry alone has warned of a potential $113bn hit to profits in 2020, and the downturn seems likely to extend into all those industries that serve business and leisure travellers.

Hopes of a V-shaped recovery are therefore just wishful thinking, as millions of people have already lost significant income through being unable to work. And common sense tells us that many small businesses, the key to employment in most countries, risk bankruptcy due to the disruption caused by the draconian measures being used by governments to try to contain the spread of the virus.

Companies therefore have to move into crisis management mode, with a number of key areas requiring immediate attention:

- Employee health and safety is clearly the top priority. Governments are slowly waking up to the risks and are starting to provide expert advice. In the meantime, of course, many companies have already taken steps to reduce all unnecessary travel and to encourage home working wherever possible. It would be prudent to assume their measures will last for longer than initially expected, as nobody will want to take the risk of problems arising as a result of precautions being relaxed - especially in litigious countries such as the US.
- Value chain risks are clearly a key area of concern for the business itself. Upstream, the oil price collapse means that the new US shale gas expansions have lost their hoped-for feedstock advantage versus European and Asian producers. Downstream, China's auto sales fell by 80% in February, while smartphone sales were down by 55%. We must assume that other affected countries will also see major declines, even if hopefully not on the same scale.
- Supply chain risks are another major area for review. Anyone who has tried to map a modern supply chain knows that the exercise quickly reveals a number of 'black holes' where nobody really understands all the inter-dependencies. For example, although it might seem obvious in hindsight, did anyone really expect freight volumes in Los Angeles to fall by 25% last month - even given its role as the largest gateway for seaborne China imports? And even if China does now return to normal, it will still take weeks for new shipments to arrive given the disruption that has occurred to freight and logistic operations.

OECD INTERIM ECONOMIC OUTLOOK PROJECTIONS

Real GDP growth

%, year-on-year. Arrows indicate the direction of revisions since the November 2019 Economic Outlook

	2019	2020	2021		2019	2020	2021
World	2.9	2.4 ↓	3.3 ↑	**G20**	3.1	2.7 ↓	3.5 ↑
Australia	1.7	1.8 ↓	2.6 ↑	**Argentina**	-2.7	-2.0 ↓	0.7 →
Canada	1.6	1.3 ↓	1.9 ↑	**Brazil**	1.1	1.7 →	1.8 →
Euro area	1.2	0.8 ↓	1.2 →	**China**	6.1	4.9 ↓	6.4 ↑
Germany	0.6	0.3 ↓	0.9 →	**India**[1]	4.9	5.1 ↓	5.6 ↓
France	1.3	0.9 ↓	1.4 ↑	**Indonesia**	5.0	4.8 ↓	5.1 →
Italy	0.2	0.0 ↓	0.5 →	**Mexico**	-0.1	0.7 ↓	1.4 ↓
Japan	0.7	0.2 ↓	0.7 →	**Russia**	1.0	1.2 ↓	1.3 ↓
Korea	2.0	2.0 ↓	2.3 →	**Saudi Arabia**	0.0	1.4 →	1.9 ↑
United Kingdom	1.4	0.8 ↓	0.8 ↓	**South Africa**	0.3	0.6 ↓	1.0 ↓
United States	2.3	1.9 ↓	2.1 ↑	**Turkey**	0.9	2.7 ↓	3.3 ↓

↓ downward by 0.3 pp and more ↓ downward by less than 0.3 pp → no change
↑ upward by less than 0.3 pp ↑ upward by 0.3 pp and more

[1]Fiscal years starting in April

NOTE: Difference in percentage points based on rounded figures. The European Union is a full member of the G20, but the G20 aggregate only includes countries that are members in their own right.

SOURCE: OECD Economic Outlook database; and OECD calculations.

- Credit risks also have the potential to surprise the unwary. The lure of cheap money from the central banks, and investor pressure to maximise earnings, has unfortunately led many companies to over-leverage their balance sheets. Even a relatively small profit downturn will therefore put their financial viability at risk. And as we know, while banks are happy to lend when the outlook is sunny, they are very quick to withdraw when storms appear on the horizon.
- Paradigm shifts add to the complexity that we now face. Today's population growth is largely due to a major post-War rise in life expectancy, rather than a new baby boom. But older people already own most of what they need, creating a "demographic deficit" in terms of demand growth. As a result, sustainability is now replacing globalisation as a key driver for our business. Used car sales, for example, are already cannibalising new car sales in China and elsewhere. Similarly, analysts see the used smartphone market growing by 50% over the next three years from the current 207m unit sales.

Every business will have its own priority list of key risks. And, of course, I understand the feeling that "one can't plan until one knows what is happening".

But while this was entirely logical in a world of "business as usual", we now face the necessity of learning how to plan for uncertainty.

Reasonable people can disagree about whether the risks I have identified are a 10%, 50% or a 90% probability. But even if you assume they are just a 10% probability, their potential downside impact is so large that they cannot be ignored.

Contingency planning has therefore become mission-critical. One key uncertainty is that nobody can know how long the virus pandemic will last. But we can be sure that the longer it continues, the more it will expose the underlying fragility of today's debt-laden global economy.

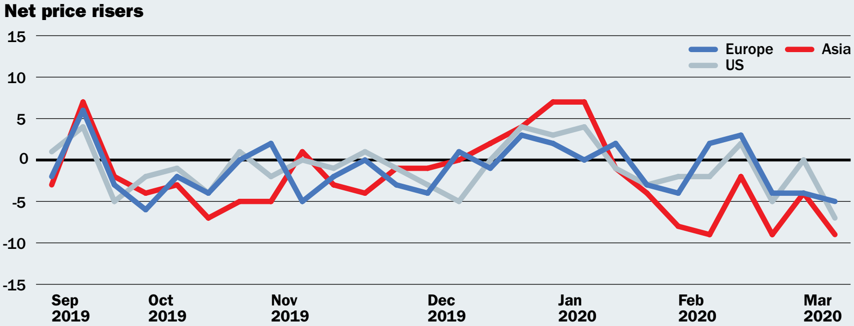
This crisis means it has therefore become mission-critical for businesses to build scenarios covering different timescales.

The aim is to understand what can be done today to mitigate the consequences of the epidemic extending beyond the end of this quarter, or into the second half of the year, in key markets.

It will also provide a framework for assessing how recession might impact prices and margins for your products, as well as accelerating the trend towards buying second-hand products. As the saying goes, "to fail to plan, is to plan for failure". ■

VOLUME PROXY

Net price risers



SOURCE: International eChem

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