



Paul Hodges

# Chemicals and the Economy



## Restocking begins but the downturn continues

Recently the blog has identified a number of **signs** that US **housing** and **auto** markets are stabilising, at least temporarily. This should feed through into chemical demand during Q2, and enable production volumes to show some improvement.



*What happens next?* In order to answer this critical question, we have to understand where we are today, and where we have been:

### Where we have been

The blog identified the start of the crisis in its August 2007 posting '**The end of the prologue**'. This argued that, far from being a minor hiccup, problems in the financial markets were about to become very serious. The catalyst for this view was the news that US house prices had fallen nationally for the first time since the Great Depression.

Although this leading indicator was flashing red, other important indicators such as chemical production were still showing broad-based improvement. These continued to show growth for another 9 months, distorted by stock-building down the value chain in advance of oil price-related increases. **Many stock markets** also went on to set new highs in October, with some emerging markets not peaking until early 2008.

This was due to sentiment being strongly positive after a 4 year bull run. Leading central bankers were also over-optimistic in their statements, with Fed Chairman Ben Bernanke reassuring investors that any financial market losses would be **less than \$100bn**. Stock markets thus staged several bear market rallies before the major collapse took place a year later, in September - October 2008.

The blog warned that the collapse was close in its 7 September 2008 posting '**The price of all assets will go down**'. And it also warned in an **ICIS radio interview at EPCA** that chemical production was on the point of a major collapse, as the speculative inventory built up during oil's run to \$147/bbl began to be liquidated.

Then, following President Obama's election, it noted in '**The end of the beginning**' on 23 November that the end of the destocking period was likely to lead to a sudden rally, possibly as early as Q1, "when stocks had become too low".

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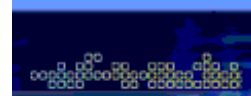
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### Where are we now?

In an important, but hardly reported, speech last week, Fed Governor Kevin Warsh argued that the period from August 2007 - February 2009 deserved to be called '**The Panic of 2008**'.



He claimed that it could only be understood by comparison with the Panics of the 19th century, and 1907. And it was therefore very different from a 'normal recession', such as those of the early 1980's, 1990's or 2000's.

He argued that "in Panics, once firmly held truths are no longer relied on... and the very foundations of economies and markets are called into question". Panics were "generally marked by widespread bank runs, as depositors lose confidence in large segments of the banking system". And the last 18 months have certainly seen many such **events** .

Warsh concluded that "the breakdown in the financial sector has contributed to, and exacerbated, the economic downturn". As a result, he said he was "decidedly uncomfortable forecasting a sharp and determined resumption of growth in the coming quarters".

In support of this conclusion, he noted that median US household net worth fell 23% in 2008, "the largest annual decline recorded". And he said he expected it to have fallen a further 7% during Q1.

The blog endorses Warsh's view. Whilst welcoming any temporary upturn, it continues to believe that several years will have to pass before sustainable growth resumes.

### Where are we going?

Yet spring is in the air, and speculation is gaining strength around the world. For example:

- **Chow Bee Lin** highlighted in ICIS news on Thursday that trading on China's Dalian futures exchange in Linear Low Density Polyethylene (LLDPE) has reached record levels. Almost **24 million tonnes** was traded in just the first two weeks of April, more than forecast global demand in 2009. By comparison, just 150KT was traded in the same period last year.
- **John Richardson**, ICIS' expert Asian commentator, has also noted recently that "The big worry remains how much of (China's current production and increased import volume) is going into inventories because of the easy credit in China."
- The same phenomenon can be seen in crude oil markets. Financial speculators still believe in imminent economic recovery, and continue to pay \$50/bbl, even though OECD oil stocks are 13% above 2008 levels at 62 days, and the International Energy Agency has **just reported** that "The pace of contraction in oil demand is close to early 1980s levels".
- Similarly, stock markets in many part of the world have embarked on their 7th bear market rally since October 2007, as investors again worry that they may miss out on the start of economic recovery.

The blog has several trader friends who are doing very well out of these events, and it certainly respects the power of sentiment. It also recognises

that this is particularly strong at the moment, as most of us have only known bull markets for the past 25 years.

Thus we have all been progressively trained, as Barton Biggs (formerly of Morgan Stanley) has noted, to "buy on the dips". So sentiment and speculation are racing ahead, even whilst the fundamentals worsen, as it seems inconceivable that recovery cannot now be just around the corner.

Of course, many also have a desperate need for recovery to arrive quickly. As the blog noted **last week**, the banks have hardly written down their corporate loans, even for the most highly-leveraged companies.

Remarkably, these loans are still on their books at an average of 98% of face value, even whilst volume and pricing power has disappeared from most markets. Yet General Motors is on the edge of bankruptcy, which alone could cause further massive losses to its supplier base in the chemicals and polymers industries, and many others.

### Pimco's analysis similar to Warsh's



Warsh's theme is echoed by Pimco's Bill Gross, who runs the world's largest bond fund.

His insights have, like Warsh's, been very much 'on the money' in recent years. And the blog takes seriously his **recent argument** that "the future of the global economy will likely be dominated by deleveraging, deglobalisation and reregulating".

**Leverage.** Gross starts from the assumption that the "prior half-century of leverage was growth positive, and notes that "Major G-10 economies became dominated by asset prices and asset-backed lending, most clearly evidenced in housing markets." This focus, of course, was also very positive for the chemical industry, given the importance of housing/construction markets for its sales.

But Gross forecasts that households, having seen their asset-backed wealth destroyed last year, will now increase their savings rate. And he expects investors, such as Pimco, to require companies to have greater equity on their balance sheets in future.

**Globalisation** has equally been of major benefit to chemical industry growth, particularly in the last 20 years, as trade barriers have disappeared. Gross suggests that its glory days are past, and that governments are likely to become increasingly protectionist, not only in jobs, but also in requiring their many newly nationalised banks to focus lending domestically.

**Risk.** Gross also believes that investor preferences towards risk are being reshaped. He argues that we have been brought up to "believe in stocks for the long run, and home prices that cannot go down". But he points out that "for the past 10, 25 and 40 years, total returns from bonds have exceeded those from stocks!". And as the blog noted **recently**, US home prices, adjusted for inflation, are now back at 1979 levels.

### Conclusion

Warsh and Gross are two of the very few "financial experts" who correctly warned that a financial crisis, based on a collapse in housing markets, was

virtually inevitable. **A year ago**, for example, Warsh argued that seemingly abundant "liquidity should not be mistaken for capital".

Of course, it would be wonderful if a real recovery did begin soon. But whilst restocking should continue through Q2, there are few fundamental signs that this in itself will provide more than temporary relief.

The blog therefore continues to believe, as it did in November, that "it would be very risky to assume this rally also marked the end of the downturn, particularly if credit markets remain difficult".

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