Year-end survey of business conditions

Industrial chemicals

CHEMISTRY INDUSTRY ASSOCIATION OF CANADA

Responsible Care®
Our commitment to sustainability.

INDUSTRIAL CHEMICALS PERFORMANCE IN 2019

Each year the Chemistry Industry Association of Canada (CIAC) conducts a survey of its members for their thoughts on the year's operating environment. Responses to the survey are combined with analysis of major trends in the global industrial chemistry industry to create a report of the previous year's performance and offer guidance on the opportunities and challenges for the sector in the year ahead.

For 2019, it is estimated that year-end sales of industrial chemicals will be down 5% compared to 2018 at $28.4 billion. Using constant-dollar shipments as a proxy for volume, production volumes will rise by about 1% for the year. This indicates that, on an aggregate basis, selling prices decreased over the year, resulting in lower dollar sales from essentially the same volume of production. This estimate from members aligns with a trend that the CIAC has observed throughout 2018. The most recent quarterly statistics show that, on a dollar basis, shipments of industrial chemicals have declined 3.9% so far in 2019, with a particularly stark drop occurring between Q2 and Q3 2019, where shipments fell by 12.3% from the preceding quarter.

Exports in 2019 are projected to be 5% lower than in 2018 at $19.5 billion. The Canadian industrial chemical industry is export-intensive, with 69% of production exported in 2019. The United States received 79% of those exports, followed by China (6%), and Mexico (2%). Again, these estimates align with recently observed trends where exports of industrial chemicals have declined by 6.4% so far in 2019 from 2018 levels.

Operating profits remained strong in 2019 and are projected to reach an all-time high of $4.5 billion for the year.

Capital expenditures for 2019 are projected to be $3.1 billion, which is a very high level in historical terms, although down 25% from the peak observed in 2018.

OUTLOOK FOR CANADIAN INDUSTRIAL CHEMICALS IN 2020

- CIAC respondents are forecasting a 2% decrease in sales next year, while production volumes are expected to remain essentially the same.
- Exports are forecast to decline by 3%.
- Operating profits are projected to fall 11% but will remain high by historical standards.
- The level of capital investment is expected to increase by 5%.
- Total employment by the industry is projected to grow by 1%.

KEY OPPORTUNITIES

NEW INVESTMENT

North America continues to have abundant low-cost feedstock for chemical production. Federal government Accelerated Capital Cost Allowance provisions, combined with incentives in the provinces of Alberta, Ontario and Quebec make petrochemical investment attractive in these provinces.

TRADE POLICY

In mid-December 2019, Canada, the United States and Mexico agreed to a series of amendments to the 2018 CUSMA trade agreement. The amendments aim to address U.S. concerns regarding: State to State Dispute Settlement, Rules of Origin for steel in the auto sector, the environment, labour and intellectual property. The accepted amendments increase the likelihood of the agreement being ratified in all three countries at some point in 2020 and will remove a significant cloud of uncertainty that has hovered over the continental economy for the last three years.

The Comprehensive and Progressive Agreement for Trans-Pacific Partnership came into force on January 1, 2019. Currently, 7 of the 11 participating countries, including Canada, have ratified the agreement facilitating the export of Canadian goods into these markets.

The Comprehensive Economic and Trade Agreement between Canada and the European Union entered into force on January 1, 2017 and continues to improve the trading relationship between Canada and the European Union.

Canada continues free trade negotiations with Latin American nations in the Pacific Alliance (Chile, Mexico, Peru and Colombia) and in the MERCOSUR (Brazil, Argentina, Paraguay and Uruguay) common market area.

KEY CHALLENGES

ECONOMIC UNCERTAINTY/SLOWDOWN

There continues to be a concern that the rise of protectionism in various parts of the world could limit the ability of export-intensive economies like Canada to access foreign markets.

Trade tensions between the U.S. and China could trigger a global economic downturn. Even with the recent announcement of the "Phase One Deal," it is important to remember that many of the underlying trade issues between the two nations remain unresolved and billions of dollars' worth of tariffs remain in place. Additionally, the recent deceleration observed in China's economy does not appear to be abating. Given the Chinese federal government's stated role of transitioning to a consumer-lead model of growth, it may take time for the Chinese economy to rebound which will impact overall global economic growth.

A similar story can be told in Europe, where export and manufacturing heavy national economies led by Germany have seen steep contractions in 2019. Reductions in international orders for capital equipment and components combined with broader malaise in the Euro area automotive and transportation manufacturing sectors is intensifying.[1] While the effects of the auto slowdown are perhaps most acute in Germany, the overall slowdown in autos sales is a global phenomenon and 2019 is expected to be the steepest decline in sales since 2009.[2]

With the United States heading into a Presidential election year, volatility in the U.S. economy could ensue which would have negative consequences for the Canadian economy.

RAIL TRANSPORTATION

The recent eight-day strike by CN, and the impact it had on multiple sectors including chemicals, reinforced the message to politicians that reliable rail service is crucial to the health of the economy. CIAC and its members believe that effective, efficient, competitive rail service is critical to the success of the Canadian chemistry industry. CIAC and its members are hopeful that forward planning efforts undertaken by the railways will lead to minimal disruption in the shipments of chemistry products during the winter 2020 season.

[1] Arnold, Martin., "German Industry Hit by Biggest Downturn Since 2009," Financial Times, Dec. 6, 2019
[2] Miller, Joe., "Global car market shrinking at fastest rate since financial crisis," Financial Times, Dec. 4, 2019.

OVERCAPACITY

Significant quantities of new petrochemical capacity, particularly in North America, will come on-stream in 2020. This increase in supply will outstrip the growth in demand, at least in the short-term, and is likely to lead to lower commodity selling prices until the supply and demand re-balance. The evidence of constrained margins has been experienced throughout 2019. Third Quarter 2019 earnings calls saw many public companies note the impacts of strained margins and competitive pressures impacting profitability. Similarly, the consultancy IHS Markit has analyzed supply/demand imbalances across a range of base chemicals such as Styrene and Ethylene and has noted that when compounded by trade tensions, pricing pressure is likely to increase in 2020.[3]

This phenomenon is not unique to North America; globally speaking, margins are being pressured in key markets in China and Europe. In some cases, these spillovers are a direct result of new capacity additions in North America[4], but increasingly overcapacity issues within China are having an impact. Both Sinopec and PetroChina have highlighted domestic overcapacity in recent earnings calls.[5]

CLIMATE CHANGE

Climate change was a key theme in the October 2019 federal election. However, there remains disagreement about how Canada can best contribute to the global effort to reduce greenhouse gas emissions. Notably, the provincial governments in the key chemical-producing provinces of Alberta and Ontario are at odds with specific policy actions being taken by the federal government.

Following the elimination of the provincial cap and trade program in July 2018 by the then newly elected government, Ontario has since fallen under the auspices of the federal backstop program at both the consumer and large final emitter levels. Ontario is currently developing the Emissions Performance Standards program for large final emitters, which is modelled on a similar program in Saskatchewan, but as of publication, the EPS has not received federal equivalency.[6]

In Alberta, individual consumers will fall under the federal backstop for consumer-related carbon charges, but large final emitters will be subject to the Technology Innovation and Emissions Reduction (TIER) program which has been deemed equivalent to the federal approach.[7]

---

[3] IHS Markit, "Key Strategic Issues Impacting the Global Ethylene Markets," IHS Markit: Chemicals. Nov. 13, 2019
Kristen Hays et al. "New capacities, weaker downstream markets to weigh on ethylene in 2020," S&P Global, November 26, 2019.
Lee, Brian., "Styrene: The Calm Before the Storm," IHS Markit: Chemicals, Dec. 6, 2019
[4] Naylor, Lind., "ExxonMobil shuts French PE production on "significant financial pressure,"" ICIS, Dec. 13, 2019.
[5] Alperowicz, Natasha and Kartik Kohli. "*Sinopec, PetroChina report lower chemical earnings*," Chemical Week, November 11, 2019
[6] Government of Ontario, "Emissions Performance Standards Program," Ministry of the Environment, Conservation and Parks, Nov. 8, 2019
[7] Government of Canada., "Alberta's New Approach to Pricing Pollution for Heavy Industry Meets Federal Benchmark," Environment and Climate Change Canada, Dec. 6, 2019

In 2019, three provinces (Saskatchewan, Ontario and Alberta) filed challenges with provincial appellate courts over the constitutionality of the federal pollution pricing plans. To date, two judgements in Saskatchewan and Ontario ruled that the federal government does indeed have the constitutional ability to regulate and price pollution, however, the split decisions in each judgement have left uncertainty. With these two provinces filing appeals, it will be the Supreme Court of Canada who issues the final say. A Supreme Court hearing is tentatively scheduled for the Spring of 2020.

Quebec continues to operate a cap and trade program as a formal participant in the Western Climate Initiative (WCI) with California. Recent legal developments in the United States, where the federal government has questioned the constitutionality of the program have cast a shadow over the WCI.[8] However, there remains significant support for the program at the State level and legal procedures will take time to materialize, we expect the WCI to continue normal operating procedures in the meantime.

Canada's chemistry industry supports actions to mitigate climate change but strongly recommends that these policies be developed transparently, with input from affected stakeholders, while avoiding costly duplication between jurisdictions and regulations and protecting trade-exposed sectors of the economy.

TRADE POLICY

Since the Canadian industrial chemistry industry is highly export-oriented, it is a strong supporter of free trade, particularly with the United States.

Ongoing U.S.-China trade tensions continue to pose a risk to global economic health.

ELECTRICITY COSTS

For CIAC members, the cost, availability and reliability of electricity continue to be a competitiveness concerns in all provinces, even those that have historically enjoyed a cost advantage such as Manitoba, Quebec and British Columbia. The impact is particularly acute for those firms producing inorganic chemicals.

In 2019, the government of Ontario completed a consultation on industrial electricity pricing. The consultation is looking at ways to lower system costs and make rates more affordable for large baseload customers. We expect the government policy responding to the consultation in Budget 2020.

In 2019, we also saw the government of Quebec extend, for four years through 2025, the electricity rebate program for industrial customers who make investments in the province. The program allows for the recovery of up to 40% of electricity costs plus an additional 10% should investments reduce greenhouse gas emissions and helps ensure a predictable and cost-effective operating environment for chemistry companies.

[8] Phillips, Anna M., Alexa Diaz and Tony Barboza, "Trump Administration Sues California Over Cap-and-Trade Agreement with Canada," LA Times, Oct. 23, 2019

Following the provincial election in 2019, the government of Alberta terminated the planned transition of the current generation system to a capacity market opting instead to remain an "energy only" market.

ECONOMIC OUTLOOK FOR 2020

In its October 2019 Monetary Policy Report, the Bank of Canada projected that full-year GDP growth in Canada will be 1.5% in 2019, growing slowly to 1.7% in 2020, and 1.8% in 2021. The Ministry of Finance in the recently published Economic and Fiscal Update 2019 has estimated growth at 1.7% in 2019, 1.6% in 2020 and 1.7% in 2021.[9] The Ministry also expects business investment (a key metric for future growth) to remain restrained until trade policy and geopolitical uncertainty subside.[10] Given that many business sectors, particularly in manufacturing, are already seeing substantial weakness in supply/demand metrics as well as strong competition in export markets, continued uncertainty in trade policy only adds to the already strong headwinds that have developed in 2019.

It is projected that GDP growth in the U.S. will be 2.3% in 2019 before falling to 1.9% in 2020 and 1.7% in 2021. RBC is projecting 2.3% growth in 2019, 1.8% in 2020 and 1.7% in 2021, while BMO is projecting 2.3% in 2019 and 1.8% in 2020 for the U.S. [11],[12] Growth will mainly come from U.S. consumers and the vaunted services sector as industrial production is expected to be tepid after a sharp deterioration in the sentiment of manufacturers in 2019.[13]

Europe will finish 2019 with 1.1% growth and remain weak at 1.0% in 2020 and 1.4% in 2021. A key question for Europe in 2020 will be the health of the manufacturing sector. IHS recently noted that manufacturing continues to weigh heavily on private sector output, with faster decreases in factory production and employment in December, with a particularly stark decline again occurring in Germany, the regions' industrial power.[14] Despite the headwinds facing European manufacturers, the service sector has held up relatively well so far and more domestically focused economies (such as France) have actually seen strong growth in 2019 which looks to continue into 2020.[15]

Growth in China is projected to remain comparatively high but declining slowly over the next few years, coming in at 6.1% in 2019, followed by 5.9% in 2020, and 5.7% in 2021. Despite these headline numbers headwinds continue to build in the Chinese economy. The Bank of China and the Chinese federal government have implemented stimulus measures several times in 2019 to help ensure growth

---

[9] Ministry of Finance., "Economic and Fiscal Update 2019," Government of Canada, Dec. 16, 2019. P. 28
[10] Ibid. p. 19
[11] RBC Economics, "2020 Outlook – A Prolonged, Precarious Expansion," RBC Economics Macroeconomic Outlook, Dec. 2019.
[12] Guatieri, Sal., "2020 U.S., Outlook: Eyeing Potential, " BMO Economics: Focus., December 13, 2019
[13] RBC Economics, "2020 Outlook – A Prolonged, Precarious Expansion," RBC Economics Macroeconomic Outlook, Dec. 2019.
[14] Romei, Valentina., "Eurozone Manufacturing Activity Shrinks for 11th Straight Month," Financial Times Dec. 16, 2019.
[15] Ibid.

meets target levels as well as combatting the effects of the trade war with the United States.[16] [17] However, elevated debt levels at the corporate, state, municipal and household levels could act as a brake on future spending and investment a counterforce to the aforementioned stimulus efforts or any further easing in trade tensions with the United States. [18] [19]

The major Canadian banks are forecasting that the Canadian-to-U.S. dollar exchange rate will be in the range of $0.74-0.79 for 2020. The banks are projecting the average price for WTI crude oil will be in the range of US$55-60 in 2020, and Henry Hub natural gas will be in the range of US $2.45-2.80 per million BTU.

For More Information:
David Cherniak, Senior Policy Analyst, Business and Economics dcherniak@canadianchemistry.ca

Greg Moffatt, Senior Director, Business & Economics; Lead, Government and Stakeholder Relations - Western Canada gmoffatt@canadianchemistry.ca

[16] Stevenson, Alexandra., "China Injects $126 Billion Into Its Slowing Economy," The New York Times: Business., Sept. 6, 2019

[17] Deng, Chao., "China Signals More Efforts to Ensure Economic Growth," The Wall Street Journal, Dec.12, 2019.

[18] Reuters., "China's Private Firms Face Record Default Risk, to Stay High in 2020 – Fitch," The New York Times: Business. Dec. 10, 2019.

[19] Stevenson, Alexandra., "China's Companies Binged on Debt. Now They Can't Pay the Bill.," The New York Times: Business Dec.12, 2019