

STAGFLATION ALERT

HUGHES ECONOMICS (HE) – May 2022

In the latest issue of *Project Syndicate* (May 1, 2022), Nouriel Roubini warns of a coming stagflation, *The Gathering Stagflationary Storm* (April 25, 2022). Some of his reasons are paraphrased below:

- Re-shoring, near-shoring or friend-shoring of production now being re-allocated to higher-cost regions to guarantee supply chains.
- Demographic aging and/or immigration backlash in major manufacturing countries reducing labour supply.
- Sino-US decoupling leading to higher-cost equipment as in 5G communications.
- Fossil fuel politicking leading to lower supply of carbon-based fuels before renewable sources are producing sufficiently.
- Higher cost of new inputs such as demanded by ESG considerations, cybersecurity etc., and then passed onto consumers.
- Risk of escalating military conflict and the necessity to prepare for the worst.

When we also factor in the ongoing ramifications from COVID, Roubini’s case seems very convincing.

Of course, a miraculous end to the Ukrainian conflict with Ukraine integrity intact would be an incredible boost to the world economy, but this seems very unlikely at this point. Some form of compromise ending the conflict is the best we can hope for currently.

The above means a re-thinking of our customary probability judgments on world financial markets, the Sino-US rivalry, and the world economic outlook. The probabilities for scenarios for the world financial markets follow.

PROBABILITIES ON FINANCIAL MARKETS FOR UP TO THE NEXT 6 MONTHS

SCENARIO	Pairwise Values		Final Probabilities			Current More Likely Value
	Low	High	Average	Percent	Previous	
TINA	1.00	1.00	0.0398	4	9	Base = 1.00
BB	10.00	15.00	0.4800	48	41	48/4 = 12.00
SQ	1.00	1.00	0.4800	48	50	48/48 = 1.00
			0.9998	100	100	

To restate the scenarios: **TINA** = there is no alternative and markets go higher, **BB** = bubble bursts and **SQ** = status quo with no significant market moves from a Dow of 35,000.

The **BB/TINA** ratio changes from a more likely range of 4 – 5 last time to 10 – 15 as above (more than doubling). This forces the resulting probability for the denominator event **TINA** to more than halve. Currently, **BB** and **SQ** are now seen as equally likely with a Dow on 3rd May at 33,129. A 20%+ correction in the Dow from 35,000 (or a **BB scenario**) would result in a level around 28,000.

Last time **HE** saw **Cold War 2** increasing in likelihood and sees no reason to change the resulting probabilities as shown below.

PROBABILITIES ON THE WORLD ECONOMIC ORDER EVOLVING OVER THE NEXT DECADE

SCENARIO	Pairwise Values		Final Probabilities			Current More Likely Value
	Low	High	Average	Percent	Previous	
China	1.00	1.00	0.0386	4	3	Base = 1.00
Cold War 2	10.00	12.00	0.4211	42	33	42/4 = 10.50
USA	1.10	1.50	0.5403	54	64	54/42 = 1.29
			1.0000	100	100	

USA stands for US hegemony continuing and maintains the highest likelihood. **Cold War 2**, however, is now a significant chance.

The Roubini observations significantly increase the pairwise ranges of the recessionary scenarios as shown in the following table. **D** goes from a more likely range of 5 – 6 to 8 – 10 now and **MR** goes from a 3 – 4 to a 5 – 6 range. **SQ** is now seen as equally likely with **MR**. Note that **MB** = mild boom, **D** = depression, **MR** = mild recession and **SQ** = status quo or no major moves in the world economy with markets, employment etc., stable or showing only minor moves.

PROBABILITIES ON THE WORLD FINANCIAL STATE FOR THE NEXT 6 MONTHS

SCENARIO	Pairwise Values		Final Probabilities			Current More Likely Value
	Low	High	Average	Percent	Previous	
MB	1.00	1.00	0.0094	1	2	Base = 1.00
D	8.00	10.00	0.0831	9	11	9/1 = 9.00
MR	5.00	6.00	0.4537	45	40	45/9 = 5.00
SQ	1.00	1.00	0.4537	45	47	45/45 = 1.00
			0.9999	100	100	

Hopefully, policy makers around the world can coordinate and avoid a major recession but the likelihood of **MR** is now quite high allowing for Roubini’s insights. If the Ukrainian war escalates then **D** will become more likely as the West’s resources are diverted to prevent a Russian success.

Word count 682, 4th May 2022.