Black Swan versus Gray Rhino…A Possible Coming Event

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What Is a Black Swan?

A "black swan" is an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences. Black swan events are characterized by their extreme rarity, severe impact, and the widespread insistence that they were obvious in hindsight.

What Is a Gray Rhino?

A "gray rhino" is a highly probable, high impact yet neglected threat: kin to both the elephant in the room and the improbable and unforeseeable black sawn. Gray rhinos are not random surprises but occur after a series of warnings and visible evidence. The bursting of the housing bubble in 2008, the devastating aftermath of Hurricane Katrina and other natural disasters, the new digital technologies the upended the media world, the fall of the Soviet Union…all were evident well in advance.

Globally, the economy continues to recover from the recession triggered by the pandemic. However, markets remain unsettled, supply-chain issues persist, and inflation pressure poses complex challenges to central banks.

Compared to a decade ago, debt levels—both private and public—are much higher. Looking back twenty years, the global debt to GDP ratio was about 200% of GDP. Today, it is 360% of GDP and rising. In advanced economies, it is 420% of GDP and rising. In China, it is 330% of GDP and rising.

My concern is that we are in a “debt trap”. When Central Banks are going to want to essentially phase out unconventional monetary policy given the current debt ratios, there could be a risk of a correction (2013 taper tantrum) in the bond market, in the credit market, in the stock market, and the economy. In this debt trap, Central Banks will not be able to normalize policy rates and that is why I see inflation ahead.

We are in a situation where, even when times are good, we are not willing to reduce debts and deficits. Subsequently, whenever there is a crisis, the Federal Reserve ends up backstopping the financial system with quantitative easing—tapering and zero and negative policy rates. We are in what I would identify as a “debt super cycle” where debt ratios are rising, and the Central Banks have placed themselves in a potential trap.

As a result, given the current debt ratios, the path of least resistance is to wipe out the real value of nominal debt at fixed interest rates which will bring about significantly higher levels of inflation.

Since we have enormous debts and deficits, what are the options? Are we going to cut government spending? Politically, the solution around the world is to spend more. How does one deal with income and wealth inequality? Are we going to raise taxes on the wealthy and the rich? There are going to be constrains on that—and there are going to have to be constraints on *everything*. Over time, the Federal Reserve will re-price short term debt and as a result, we will have have higher interest rates with higher and more volatile inflation.

The inflation risk premium is going to go higher so that is going to be a solution. The debt ratios of real rates rising over time are going to imply debt defaults. Because this is an unsustainable debt situation in both the private and public sectors for a number of countries, we all should be concerned about significantly higher inflation along with another debt crisis ahead.

What about growth over the next ten years? We have debt ratios that are unsustainable and a current mild "stagflation" (when growth is slower and inflation is higher) driven by short term supply bottlenecks both in the goods market and the labor market. As I've pointed out previously, I see numerous negative supply shocks over the medium term that are going to reduce potential growth and increase the cost of production time. Over time, we may see:

- Deglobalization and protectionism, and Balkanization of global supply chains
- Aging of population in advanced economies and emerging markets
- Restrictions to migration from South to North
- Decoupling between US and China on trade, technology, data and information
- A rise in the cost of energy and the cost of food due to climate change
- Another disruption of global supply chains caused by the next pandemic
- Cyber warfare disruption
- A rise in income and wealth inequality which implies that there will be monetary and fiscal policy to help workers and labor unions, putting upward pressure on wages.

The situation over the medium term is coupled with loose monetary, fiscal and credit policies and these negative supply shocks. Potential growth is going to be lower; the cost of production is going to be higher, putting us in a situation of "stagflation" similar to that of the 1970s. This is the situation I am most concerned about.

I agree that aggregate demand will create an overheating over the next 10 years, but we should also worry about the aggregate supply of the economy. These global trends are the reversal of the forces over the last 30 years that have kept inflation low.

The most positive thing about the US economy is that there is going to be a huge amount of technological innovation from AI, machine learning and robotics to automation (and all the applications coming of it) that will increase productivity growth significantly over time. However, I worry that these technological innovations are going to have negative spillovers that will augment income disparities and wealth inequality, and, eventually, lead to massive technological unemployment.

Today, I am more concerned that Central Banks have become less independent. As they veer off course from their single and dual mandates (inflation and labor) in addition to macroprudential framework (macroprudential policies were a result of the 2008 Global Financial Crisis and the regulatory environment). This "mission creep" will lead to higher inflation as a result of Central Banks' unconventional monetary policy for much longer than otherwise anticipated.

A Notable Quotable: Economics is often referred to as the "dismal science." However, the 19-century polymath Henri Poincaré's jibe is that it "has the most methods and the fewest results." Poincaré added that "absolute truth in science is unattainable and that many commonly held beliefs of scientists are held as convenient conventions rather than because they are more valid than the alternatives."

O'Neill Maximum: "Most American aren't trained to save...rather they are pre-conditioned to saving in reverse...through installment purchases."

Terry O'Neill is Founder and Chairman Emeritus of The O'Neill Company. Specializing in the engineering of corporate employee benefit planning, executive benefit planning, and business succession planning for organizations since 1978, The O'Neill Company also offers comprehensive financial and wealth creation planning, estate and retirement planning, and multi-generational estate wealth conservation for families and individuals.

Mr. O'Neill was nominated to be an advisor to the Federal Open Market Committee, was an advisor to the Small Business Council of America, was an Associate Member of the Milken Institute and formerly a Member of Roubini Global Economics. Mr. O'Neill has advised two California Governors on economic and business issues. He has served on committees that have advised the U. S. Treasury and Congress on numerous financial topics. He has been a member of many national and international boards in the financial sector including the International Forum, the Planned Giving Advisory Board at the University of California, Irvine and the Association for Advanced Life Underwriting.

He is the author of The Life Insurance Kit (1993: Dearborn Financial Publishing), and has written for numerous publications in the financial industry including Financial Services Week, Employee Benefit Plan Review and The National Underwriter. Mr. O'Neill has appeared frequently as a guest on television and radio to discuss the economic ramifications of issues in health care, employee benefits and retirement planning and was profiled in Leadership Magazine and the Orange County Register. He speaks regularly on economic and financial topics at national conferences.

In 2016, Mr. O'Neill retired from daily operations from The O'Neill Company and works exclusively on special consulting projects, and the majority of his time at the Institute for the Study of Global Economics and Finance Institute which he founded in 2015. The Institute focuses on the democratization of global economic information and advancing the frontiers of economic thought.

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