

>> Marc, thanks for being here. I know you have a lot going on. Let me first humanize you. Most people listening or watching know that you've worked at the highest levels of the US government at the White House during the Bush years. Most people know that last year you were in the running for Fed chair, at least that was what was reported. And most people know for many years you've advised the good and the great on the global economy. But how did growing up outside the East Coast bubble shape the way you see the world? Houston's an energy town; DC is a swamp town.

>> Yeah, interesting. Interesting. I mean, definitely growing up in Texas, you do end up with a little bit of an independent streak. You know, for better or worse, Texans like to think that they're more the center of the world than they are. And so you get a little dose of confidence. And I think Texans are, you know, we follow the energy stuff really closely. So that's helpful in times like today when it matters a lot. And it is just good to always go somewhere where it's a, I can get out of DC, go home, people think differently. And I think you and I share something in common where we like to hear different opinions and just kind of open-minded about why, why do people think this way in a different area. And so I would say that, I think, makes me better.

>> How often do you get back?

>> You know, I'll probably go back, I go to see clients about six times a year and family about four times a year. So I'm probably going every six weeks or so. So I try to -- I keep a foot in the, you know, the South and the West a little bit.

>> I know what you mean. I'm from North Carolina. I try to get back as often as I can, A, to relax, but B, just to talk to people who know nothing about what you and I probably live and breathe each day.

>> I mean, I like to go places when they ask you, how are you, they're actually interested in your answer.

>> It's not a polite euphemism.

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>> Okay, well, let's bring your perspective, your independent streak to the analysis of the economy. So as I look at the demand side, I see the US economy booming. I think it's fair to say before the Iran shock, at least, we were seeing gathering strength from AI CapEx, from consumption by wealthy cohorts. And then we have a looming fiscal impulse from tax refunds. But I will say I worry that the demand side boom is colliding with supply-side constraints, a growing list of supply-side constraints in the labor force, in the tradable sector, now the energy supply chain, and all the products that are downstream. That doesn't strike me as a setup for disinflation, but how do you see it?

>> Yeah, I mean, so great question. So I would say the economy is very strange. It's different from ones that we've seen in the past. And so we have high nominal growth. We have no job creation. That tells you by

definition that we're in a high productivity standpoint, and productivity can be pretty elastic in the short run. It doesn't really tell us where long run we're at. Right now we have high productivity. And when we look at like what is the economy running off of, it's running off of two things. And I would generally like it a little broader. And so we've been creating about \$10 trillion of wealth a year. And the consumption effect of that is about \$400 billion a year. And so the biggest thing that is driving the economy right now is the wealth effect. And that's bigger than the AI effect, the way I measure it when you count how much of the AI products are imported and other things. And so what we're not seeing is a lot of income growth. And so that to me is the concern is that we are dependent on ongoing increases in wealth to keep the high-end consumer spending going that's carrying us. When if I was in my old job in the White House, I'd rather see some more ongoing, like real income growth. And we see this all confirmed by the savings rate just going down. And so we'll get the tax cuts will provide us a temporary income boost. But a strong labor market provides you with ongoing income, which we would -- which we won't see -- which we don't have right now. And so it's a strong economy for a lot of people, but it's not -- it's a little narrower in the drivers than I would prefer, all else equal.

>> So when you think about the durability of the wealth effect you just described, I mean, how much of it is reductive to AI? You know, many people estimate that 50% of the S&P 500 is AI related. Let's say the market cap of the entire index is 60 trillion, so 30 trillion is AI related. US residents own two-thirds, so 20 trillion. And you mentioned about a 4-cent wealth effect in terms of your estimates out of every 100 cents of wealth created. So how much is at risk if there's a sharp and sustained correction to AI valuations?

>> Yeah, I mean, I think a, you know, the main recession risk would be if we had a, you know, 20% sustained fall in the stock market, you would run the risk of that going in reverse. And I think the positive thing is that we have enormous corporate profit growth going on, which is also the flip side of, I mean, or just a side effect of having high nominal growth and no hiring, you're going to kick off corporate profits. And so we're kind of -- the market, there is a scenario where we just keep growing into the valuations we have. But when I talk to tech people, one of the questions I always ask them is like, is this a winner take all on AI? And they tend to say yes more than no. And then that makes me very nervous about, well, what happens to the valuations of like let's say it's Google that wins and four that lose, is Google going to -- is the loss of value in all four of those going to be capitalized into Google or not? And so it's hard to know whether you're going to, on net, be at a real risk.

>> Oh, I see.

>> Yeah.

>> So you were talking about winner take all in terms of the competitive landscape among businesses. I thought you were saying it's a winner take all in the sense that corporations earn a lot of profits but people don't earn a lot of income, and that may not be politically sustainable.

>> Yeah. Oh yeah, no, I was talking about in terms of the tech thing. And so we have five companies that are priced like winners right now, but it might be one. It might be multiple ones, like I don't know, but that makes me nervous. And so I do believe then AI is going to be helpful for a lot of corporations.

>> Yeah, that makes -- it does. And you said something before that I thought was kind of striking, that productivity is elastic, at least in the short term. If you talk to a lot of economists, they will say technological breakthroughs tend to depress productivity before it accelerates, that there's a J-curve. And in the case of AI, firms need to cleanse and structure their data sets, re-engineer their business processes, train their workers, and so on. But are you seeing microeconomic firm-level evidence that would suggest this upturn we've seen in the productivity data, the official data, is the real thing.

>> Yeah. No, I mean, I don't think this is AI yet in the productivity data. And so what's interesting about productivity and the way -- the reason I say it's elastic is we'll see this often when an economy goes into recession, and you'll see labor being released, which is kind of the definition of a recession. And at that point, though, each individual firm is trying to keep the same level of output. And so you weirdly see productivity go up when people are being fired. And so what we've seen this year is when I look at the data, I see, basically starting with Liberation Day, we've had no net hiring, especially outside of healthcare. And the monthly numbers are pretty striking how it flatlined. And that's continued. And I can't prove why, but anecdotally, when I talk to corporate CEOs, what I get is, well, the first couple of months we were terrified of tariffs and we didn't know where we were going. And that kind of -- that initially froze the hiring. And then when, and this is the part where we're starting to see AI, is in now the companies are starting to believe that AI is going to happen. And for most companies, when you hire someone, it takes you like a, sometimes a year to get real value out of them. And like we, you know, you invest a lot of time to get them up to speed in your company and all of that. And so some of the companies are telling me like, I just don't know if I'm going to need this new person in two years, and we don't really like to fire people. And so therefore, we're kind of just still seeing how far we can go without hiring. And so it's almost like a tariff story transitioned into an AI story. And so that's not AI like actually giving productivity to companies right now, it's actually a little bit of like the effect you're talking about. And so with just no new hiring, you know, output is just hours worked times productivity. And so if you're not increasing people or hours and there's demand for the economy, in the short term, productivity will just be the result.

>> Yeah, I very much agree. If people ask me, why is job growth so low, I typically point to the uncertainty shock from last April, and that's a public sector choice. But now you're describing a private sector choice to begin implementing AI and perhaps to just hold off on hiring until you understand how it changes your business model. And then maybe there is some post-pandemic labor hoarding that's unwinding and you kind of get to the flat line. I wonder if you have a view on how AI valuations could be put at risk by politics from both sides. Because when I hear Steve Bannon

talk or Bernie Sanders talk, I hear a lot of the same things. And that makes me pay attention. You know, they're both flagging the risk of an evisceration to the labor market, the spike of energy prices around data center clusters, and maybe the need to regulate algorithms or break up the hyperscalers. And maybe that's just talk. But when do you -- do you agree that this is more than just talk? And do you think valuations will have to adjust for the risk of an actual policy backlash, maybe after 2028.

>> Yeah, I do think it's a risk, and I think it's sooner than that. What's striking to me is if you go back to last summer, I think kind of the defining narrative was like, we're in this AI and power race against China and we have to win it. And I think there's a lot of validity to that narrative. And the main concerns on AI were people were -- they didn't want their electric bills to go up. And now in the last six months, if you just look at the polling data, the concerns on AI have gotten way broader. And it seems like the average American now thinks like AI is going to do two things. It's going to take my job and it's going to jack up my electric bill. And so that's not a strong, that's not a strong selling point. And so I do think that regulation is coming. And it will be, you know, and so it might be, it might be clumsy, but I think the last couple of years, which were a rerun of the '90s of just like, do whatever you want, just go fast as you can, is going to be slowed down.

>> Okay, let's turn from a positive supply shock to a negative one. What I do want to ask you is, for the Fed, in a world of intensified geopolitical competition in which the shocks are going to keep coming, or they're very likely to keep coming in various forms, and the interplay between the demand side and the supply side of the economy is more complex than any other point in our lifetimes, perhaps. Is the Fed well-equipped to make forward-looking policy judgments that advance its dual mandate when there's so many unknowns, especially on the supply side?

>> I mean, I think you can always figure out what the optimal policy is. It just may be that like the best policy you can do isn't really good enough if the shock is bigger than monetary policy can handle. And so the way I think about an energy shock is you clearly look through it. And so we have evidence where in 1973, when the Fed eased into it and got an inflation spike, we can see other cases where central banks have hiked into it and rolled the economy over. And so the first right answer with an energy shock that's going to hit you on both sides is if you're hitting both demand and supply is to not do anything. And so I think you're going to get sort of a -- you're going to be frozen. And then I think what's really interesting, if we look at, you know, we can start getting into how the curve is priced, you know, where six months ago, the curve was like clearly inverted at the front end.

>> That's when you were calling for 50 bips, right?

>> That was why I advocated for 50 basis points. And, you know, I will say the Fed did cut 50 just in the next two meetings, so it was, it did happen. Right now, there is no inversion. You know, the two-year is sitting on top of the Fed funds. And if you're a policymaker, sometimes you just have to lead markets. But it is always an interesting question,

do markets think you have it about right? And the market is pricing that the Fed has it about right right now. And so that should give them a little more ability to hang out and wait. And even with the shock that we're getting, and I'm speaking relative to the interview we're doing today, but the EIA put out had one quarter of \$91 oil. And over that quarter, that would have cost about \$25 billion in higher gasoline prices. But we're getting about \$100 billion of One Big Beautiful Bill stimulus. And so by, at this moment, which will change, it looks like you're going to absorb about 25% of the expected stimulus, but there's still some hitting that also gives the Fed reason to wait because that's a little bit more powerful in the very short term than an interest rate cut. And so I think they'll wait. And then, you know, as markets, what we can observe is if jobs go persistently negative, the central bank tends - - central banks around the world tend to give faster on that. And so I think that there's, you know, it's not my expectation, but if that happened, then that's got to be part of the, what's priced in the market pricing. And so there's still some possibility for that outcome. I think this committee will be, it would take a lot for them to start hiking.

>> Certainly under Chair Powell, that seems to be the case is the first instinct is to buy time unless, as you mentioned, the second-round effects force your hand.

>> Yeah.

>> One more on the Fed. There's been a lot of speculation about structural reforms to the Fed, potentially including a new Treasury-Fed Accord. And just to give a bit of context for listeners or viewers, during World War II, the Fed basically surrendered its independence and pegged long-term rates at 2.5% to help Treasury fund the war effort -- at least, I don't know if you'd agree with that characterization.

>> A hundred percent, yeah.

>> And then in 1951, the Treasury-Fed Accord was agreed to formally separate Treasury's debt management from the Fed's conduct of monetary policy. I would say that arrangement became the bedrock of modern central banking, and it helped to end a period of so-called fiscal dominance and runaway inflation. So maybe you can help me, Marc, because I mean, what is the case today for potentially walking away from that principle of separation?

>> Yeah, you know, it is interesting because in that context, Fed-Treasury Accord was about splitting up. And in the context today, it's about coming back together. And so I think there are a couple of levels of what a Treasury-Fed Accord could be. And the people advocating for it generally so far that might be in charge haven't completely articulated what that would mean. I think at a very high level, the way I think about it is monetary policy and fiscal policy are more powerful together. And so if I was the Fed and you were the Treasury in a best first-case use, we would say, well, let's kind of figure out what we're trying to do here and be on the -- work together. The Fed always needs the option to say, well, we're going to go our own way because if you're Treasury, you're going to have a shorter optimal time frame, you know, and being involved

in terms of when the next elections are. So you always have to have that. But in general, you would like to have Treasury and Fed chair working, agreeing on the outlook is a good thing. So that could be like one level. And then the second level is it's often just about balance sheet implementation. And so there's a very technical argument about who has the right to set the net term structure for the public debt. And so Treasury does -- thinks about it and puts out, they decide how much we want to do in bills, how much we're going to do in notes. But the Fed can then undo that with QE and QT and changing it. And often in the past, they have worked against each other. And so, for some people, the Fed-Treasury Accord means trying to come up with a better agreement where on this technical issue that matters a lot for the bond market, of who actually has control of the term structure of the debt on net between the two entities.

>> Yeah, we mentioned polite euphemisms before. I guess what I worry about is that balance sheet coordination could be a polite euphemism for debt monetization, something I think both of us worry about. And so, you know, if the Fed's adjusting its balance sheet to accommodate the Treasury's fiscal ambitions, that's precisely the trap that the 1951 Accord was designed to escape, and we don't want to go there.

>> I agree with that.

>> Okay, let me turn from monetary policy to trade and industrial policy. As I look at China's external balance, it's the largest rolling 12-month surplus in financial history. And I at least think it was aided in part by the accumulation of hundreds of billions of dollars through its state banks. And I think that does help to entrench America's fiscal deficits and our borrowing binge. So I don't see this as particularly sustainable, but I wonder how you see it in terms of the external imbalances that are getting bigger and bigger, not smaller and smaller.

>> Yeah, no, absolutely. You know, if we, the market has a lot of -- they don't worry too much because China had banking crises in the late '90s and they had them in the early 2000s and they've always resolved them with state action, you know, and a planned economy can do a lot more than you and I could when we were in government. And so, but what people kind of underestimate is when they were doing that, China was growing at like 10, 11% nominal GDP growth, not the four that they're growing at now. And it was also during a real estate boom, and they have a full-on real estate crash right now. And so they're not, they don't have the strength in the economy that they had the last time they worked out these non-performing loans, which we estimate are like 30 to 40% of GDP right now.

>> Wow! Okay.

>> A lesson that I've learned the hard way is like planned economies can go in the wrong direction a lot longer than you think. So which is when for market participants, it's really hard to invest around them because your timing will not follow the same playbook that you get using an open capital market. And so with China, what they've done is they just said, real estate's collapsing and we basically just have to run a giant export machine to keep all of this kind of duct-taped together. And they've done

that and the tariffs haven't slowed them down at all. It just reorients who they're trading with. And so we're, you know, they're putting pressure on the whole world. Their currency is too cheap, but they're doing it because internally they've got these huge problems and it's the best that they can come up with.

>> It's often said that President Trump is among maybe the least hawkish members of the administration on China. But I'd not heard that said about President Xi, that he's actually on the more dovish end of the spectrum as it relates to relations with the US. But you think there's actually some symmetry there?

>> I think for him, I think, well, for President Xi, he's certainly hawkish at heart, but I think that he's still not ready to have the fight. That suggests that, that he's, you know, willing to, you know, bend a little bit on some of the things that are most important to President Xi as a way of keeping the economic relationship in this kind of balance we've ended up in.

>> Let me get you out of here on this one. In your world, however you define it, what's a conventional belief that you just think is flat wrong?

>> That's a good one. Yeah, I would say... I would say within markets, there seems to be this belief that the budget deficit is going to continue to go down. And so it dropped from, let's call it 6, 6.5% of GDP to something closer to 5.5% of GDP last year. It's much more likely to be 7 than it is to be 5 this year. And we are, and so we got a lot of tariff revenue and that's what drove the improvement last year. We now have to refund half of that. And then we have the stimulus for the One Big Beautiful Bill was all focused into this year. And so the deficit was going to go back higher automatically for that. Now we're going to need a supplemental for war. And the farmers are, farm community is not great, and they're asking for a supplemental too. And so by the time the One Big Beautiful Bill stimulus checks hit, the tariff refunds go out, if that's what the court orders, we have the lower rate of maybe we're collecting 80% of the tariff revenue with whatever new regime we get. And we do a, you know, maybe \$100 billion of supplemental spending for the war in Iran and farmers and whatever else happens. I think the deficit is going to, I think it's going to surprise investors at how big it comes in at the end of the year when people seem to believe that there's this plan to get it to 3% of GDP, which I would definitely support, and my guess is you would probably support. And I would say that would be the, if you want the Fed to cut rates, that would be the...

>> That's the way to do it.

>> That's the way to do it. And that's sort of the clear macro solution right now is fiscal tightening, which realize could allow for some Fed easing. And the reason that's important is if you look at real rates, which very striking is real rates are very high in the 10-to-30 year time frame for the US. And it's not because -- and inflation is not high at all out there. And so the market is pricing in, to me, it looks like more like a fiscal problem. And if you could solve that, you could also then

get monetary policy in a better place, help the mortgage market, housing, all of that. But if you're going backwards, then all of that runs in reverse.

>> If you want looser monetary, you'll need tighter fiscal policy. I mean, Marc, it strikes me listening to you speak, there's a lot more that we agree on than many might have assumed. Maybe we should start our own party.

>> You can always find that when we get together. Yeah, we should, for sure. Party of two.

>> There you go. Yeah, probably not many others, but hey, thanks very much for joining me and good luck. Good luck out there.

>> Awesome. All right. Thank you, Daleep, for having me.