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Webinar

Moderator: Lisa Abramowicz
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Introduction

President Barbara Van Allen

Good afternoon and welcome to the 741st meeting of The Economic Club of New York. I'm Barbara Van Allen, President and CEO of the Club. Our Club is known as the nation's leading nonpartisan forum for discussions on social, economic, and political issues. And we've had more than 1,000 prominent guests appear before the Club over the last century and have, as a result, established a great tradition of excellence which continues up to today's event.

I'd like to extend a warm welcome to students joining us from several different schools virtually – Rutgers University, the Gabelli School of Business at Fordham, the Macaulay Honors College at City University of New York, and Mercy University. Also, congratulations are in order, and welcome to the new Class of Fellows, the Class of 2024, who are joining us today for the first time. On behalf of myself, our board, and the entire membership, we look forward to getting to know you and having you enjoy this year's special programming and opportunities.

For today's program, we're honored to welcome Joe Davis. Joe is Vanguard's Global Chief Economist and Global Head of the Investment Strategy Group. He leads a global 75-person research organization that's responsible for Vanguard's thought leadership agenda as well as the development and oversight of the firm's investment methodologies and models.

Joe chairs the firm's Strategic Asset Allocation Committee, which governs multi-asset class investment solutions. He's also a member of the Senior Investment Committee for Vanguard's Fixed Income Group. He also holds roles on global advice and product committees.

The format today will be a conversation, and we're honored to have Club member, Lisa Abramowicz, as our moderator. We will promptly come to an end at 12:45. Any questions that were submitted to the Club were submitted in advance, and in addition we'll have the chat box open so that those wanting to enter questions directly can do so and Lisa will use them time permitting. As a reminder, this conversation is on the record, and we do have actually a number of media outlets on the line today. So, Lisa, if you're ready, I'm happy to pass the time over to you.

Conversation with Joseph H. Davis

LISA ABRAMOWICZ: Barbara, thank you so much. I really appreciate it. And I've got to say it's a really timely conversation. Joe Davis is someone who I've always respected, and there is this point at which we've gotten time and time again, one person after another, coming on our show on Bloomberg Television, coming on radio, talking to us in the hall, saying it's almost a certainty to be a soft landing. Joe Davis pushes back against that. Joe, let's start there. Why do you push back against the fact that people are so optimistic?

JOSEPH H. DAVIS: Well, again, thanks, Lisa. Thanks, Barbara, for the invitation. I push back more than anything, just we always know the range of outcomes, it's always wider than even sometimes the market anticipates. My alarm bells go off and our analytics also underscore the fact that the probability of a soft landing is well below 100%. I hope it's high. I'm not cheering against a soft landing.

But in many ways it's the inverse of last year, Lisa, right, where there was very high, at least some in the economics community think there was a recession. And that's in the back of my mind, increasingly to the front of my mind because now the narrative is exactly the opposite, that it's almost highest conviction of a soft landing. What history shows, and more likely than not, will continue to play out is that they're just very tough to achieve and they're inherently unstable. And we can get into why that is, and I think the risks are actually bimodal. Soft landing is in the middle. The risks are actually skewed on both sides. And I'm not trying to hedge my insights there. That's genuinely how we diagnosed the current picture.

LISA ABRAMOWICZ: So the idea is that you think that there's a risk of an overheating and there's a risk of recession. What data are you watching to kind of dictate where you lean, as you craft some sort of investment thesis?

JOSEPH H. DAVIS: Yes, so on the downside, it would be modest. And I'd say, for the record, if any firm, in terms of our outlook, if any firm should have a soft-landing view, I would argue Vanguard should be one of them. And why that is, it's because for some time, well over a year, our research has pointed to the fact that that high level, unobservable neutral rate is higher than it was in the past. And so although policy is restrictive, it's not that restrictive. That is context. There's a number of indicators that would suggest that we will continue to see slowing.

One of the most powerful ones that we look at is actually even the job hirings, you know, the BLS puts out JOLT surveys. We have our own because we have millions and millions of plan participants, and if you join a 401K plan at Vanguard you are enrolled. You are a new hire. It sounds like a hiring, right? We have 5 million in our sample and that has continued to slow. So I think it's consistent with the labor market indicators. Not cratering but continuing to cool. And so that would be consistent with continued further slowdown.

And some of the offsets that we saw last year, I think they propped up the economy a little bit more than expected. Consumer excess savings from the fiscal thrust. Some of them will moderate. So that's where our baseline is. Very modest. It's more just a modest rise in the unemployment rate rather than a full out contraction in economic activity. That's our baseline. But the risk on the right is growing.

LISA ABRAMOWICZ: And there are shades of gray here, and I think, just sort of taking a step back from an asset allocation point of view, there's a real issue of what's most leveraged to the soft landing. I was speaking, for example, with a couple of people, Mandy Xu, in particular, of Cboe. And she was saying that basically risk assets, stocks in particular, are pricing in almost a 100% chance of a soft landing. How do you sort of adjust Vanguard's positioning or your recommendations based on what you think is maybe overly priced optimism?

JOSEPH H. DAVIS: Well, I think that's where you can think about, and it depends upon a lot, as you know, everyone on the call, Lisa, will have different objectives, different goals, different risk tolerances. That said, I think if you have somewhat of a balanced portfolio, you have risky assets, equity, private, public, and then you have more conservative assets, say from an income stream. I think you want to stick; you don't want to be too far away from those benchmarks.

And why I say that is, on the conservative side you're harnessing a risk premia, that,

___ if you have economic weakness. But you're not so convicted that you're short, you know, the risky parts of the market, which surprised last year and that we're counting on for long-term, you know, outperforming CPI. And so whether you're a private investor, a public investor, a Vanguard investor or not, I think that's at least where we start investors.

And then valuation will push you one way or another. The valuation is what pushes you away from the U.S. equity market, not in a market timing way, but in a risk-to-reward perspective. I wouldn't say go into cash. It would be more looking overseas or making sure that if you're going to stay very aggressive in the U.S. equity side, it's to pair it with Treasury exposure. Because if we do have the downturn, there will be that flight to quality.

LISA ABRAMOWICZ: You know, one thing that people keep talking about is will, in a heated market – I don't want to say overheated – but will an enthusiastic risk asset market create a real problem for the Fed? Create a real problem for the economy where essentially it allows growth to move at a hotter pace given all the high yield bond issuance we've seen, the investment-grade bond issuance. People are thinking about doing deals and IPOs. Is it almost a self-fulfilling prophecy that because the market is anticipating this soft landing, this sort of easy-glide path, some sort of neutral, that we're not going to get there because of the incredible, frankly open gates that we've seen from a lot of these markets?

JOSEPH H. DAVIS: Well, we do know financial conditions matter. You talk about it a lot, Lisa, day to day. Yes, I mean I go back to a law of physics or founding physics. It's called the Heisenberg Principle, which is a fancy way for saying the very fact that you and I are observing the phenomena will change the trajectory of that outcome. And so, ourselves, policymakers, increasingly confident in a soft landing, lead to it becoming more unsustainable because of risk taking. Now that starts to feed into another dynamic.

And so I'm not saying this is fully going to happen. That's why the risk of almost a no-landing is starting to increase in our mind. If you asked me at this time last year, I would have said that was lower, 10 or 15%. We have it as high as 30% and rising. That's good news because it sounds like a soft landing but we've seen this once before, and I call it the ghost of '67, where the economy decelerated, did not, actually pulled off a soft landing. GDP held up. Curve inverted. But we avoided it. But within a year to two – the Federal Reserve, by the way, cut rates 200 basis points during that period. It all felt very good. I'm not blaming this on the Federal Reserve. I'm not. What I'm saying is, it was a year later, the labor market cooled, but it re-tightened. And so that's what I'm watching as something that not many are talking about this year. It would feel good for the next six months, but I think that would change the narrative in the marketplace and introduce other risks that people aren't talking about.

LISA ABRAMOWICZ: Some people say that's like the worst-case scenario. A 30% risk that you could have a Fed, I mean if you just extrapolate this out, that's forced to re-tighten, for example, that's forced to raise rates again and engage in other tools to try to control inflation. Not to mention sentiment would get a real hit as well because people are kind of normalizing now. So how do you sort of hedge against that? Or is that just something you're watching to figure out whether or not it's something to take into consideration?

JOSEPH H. DAVIS: Right now, it's watching. And I would humbly ask all policymakers to keep their eye – they're clearly are looking at inflation, very good news – but look at the labor market. It's the balance of vacancies, unemployment rate. It's a really simple measure. It's the only measure that in 1967 would have told us that we're slowing, but we're starting to re-accelerate a year out.

Now, I don't anticipate this time of year out we play through that scenario. We go through the soft landing. It starts to open up the narrative of, maybe inflation is not continuing to fall. A year out, we're starting to rise slightly. That's the scenario I'm talking about. I think what you do is I don't think we'd see really aggressive hikes unless the Fed was very aggressive in cutting. I think what it would say is higher for longer. It's not a temporary phenomenon. This is a much more secular view. And I think that risk would be consistent with that outcome.

LISA ABRAMOWICZ: What does high mean, or higher? I mean this is sort of a key question that people ask when they say, well, if the Fed cuts to 3%, that still is higher in terms of the fed funds rate, than zero, right? What constitutes something that is more of an equilibrium to you, that could control things in terms of inflation?

JOSEPH H. DAVIS: Well, we spend a lot of time, no one knows exactly what that equilibrium level is, but I can tell you we've spent years doing this. And our theme, and now I think what's coming into play, and the forecast in the market, Lisa, is that neutral, short-term cash rates is around 3½%. Some still believe it's lower, 2, 21⁄2 is what some call the new normal, coming out of the Global Financial Crisis. There's a number of reasons that have pushed that up. And we've come at the same conclusion using the best techniques from four different angles.

And so what this means is normal interest rates are roughly 4%. If you're about a 10-year Treasury yield, obviously there's a premium to that for corporates or munis. But I think this, by the way, this was our hope, it's now becoming our baseline. It's what we call the era of sound money. This is not a cyclical thing. Now, the Federal Reserve may cut rates below that for this year because of weakness or something. But this is, in our mind, permanent. And this is, in my mind, the single best financial market development we've seen, without a doubt, in 15 or 20 years.

Because the converse was five years ago we were stuck at the zero bound or near it. And what that was ultimately going to do to risk assets was the power of compounding was going to become a headwind. Compounding at a zero risk-free rate and really extending people to take on duration risk or price risk. So I think, I've been surprised the market has digested it so easily, which is why I'm still a little concerned about the market pricing in a full soft landing. But this is clearly a positive long-term trend.

LISA ABRAMOWICZ: I want to make sure I understand that. In other words, the neutral rate, from your analysis, could be 4% now.

JOSEPH H. DAVIS: Totally. Oh, yes. And we're highly convicted on that. And it's not because of higher growth. There's a lot of things that move this rate. And all I would say is that if you believe the framework that before Covid, and during the Global Financial Crisis, we were down around 2, 2½, right, if you believe that framework, then we would argue you have to believe it's roughly 4% today, 3½, 4.

The biggest driver of that is structural deficits which means not the temporary Covid recession that was very deep and deficits blew out. It's the fact that they were accruing on a permanent basis that are acyclical. And that's starting to push up borrowing costs underneath the surface. I am not being alarmist. I'm just saying that's starting to equate this global imbalance of savings that was keeping that neutral rate low for an extended period. Those forces are starting to ebb.

LISA ABRAMOWICZ: So if you just take a step back, there's a lot to unpack there, and I want to get into the deficits and the issues there, especially in an election year. But I am curious, when you take a look at 4% as the new neutral, why should anyone get out of cash? Why not just stay in cash? You're basically earning that. And essentially if everything else is fluctuating around, fully pricing in the soft landing, isn't cash still a good risk-reward?

JOSEPH H. DAVIS: Yes, for saving. But if you're putting principal at risk for a long term, Lisa, you have to have a very good exit strategy because you stick there over a long period of time, history shows that even if we're right and neutral is higher, you're still not outperforming inflation by a material margin over a long period of time. And so you want to have exposure to what economists call risk premia, which is corporates, Treasury, long-end Treasury, and you want to have equity risk exposure because that's all above that risk-free rate that you and I just talked about. So if it was 2½ before, if it was 3½ before, now, that's great. That's a one percentage point increase at least in nominal returns. But that's not going to be enough, I think, for most investors' goals long term.

Bequests outperform inflation. You have to take on market risk. That's beyond the savings vehicle. And that's a cornerstone, not just of Vanguard's investment philosophy, I think of many investors around the world.

LISA ABRAMOWICZ: Yes, the reason why I say this is because there's a lot of disagreement that I've experienced with respect to the value in, say, credit, even riskier credit, given that spreads have tightened. You have seen people basically flood in, you're seeing people borrow, at a time when you're taking on both rate risk and credit risk. It hasn't fully been acknowledged. What's the counter argument to that? Why it's still a good value proposition even though it's kind of a tension right now given that both have rallied at the same time, the rate component and the credit component.

JOSEPH H. DAVIS: Well, it's just because the returns outside of cash are really lumpy, and you're going to miss the timing to get back in. So, I mean, unless someone is really good, and history shows most aren't – I can tell you I'm not. And that is, I'm going to sit in cash waiting for the all clear sign and the very thing that will make me feel better is equities up another 15%. The short end of the curve just rallied big time. Treasury funds are up 15%. And then I'm saying to myself, well, now I should get in. More than half of the risk premium of the stock market occurs in less than 5% of the daily observations. That's the risk is that you're stuck and you miss. Even when we go down, you may avoid the downside, but then you're going to miss the upside because there's a lumpiness to market returns.

LISA ABRAMOWICZ: And that's what we talk about all the time, that as a class, bonds and stocks are both the only kind where when it's on sale, nobody wants it, and when it's being sold at a premium, everyone wants it. And it seems to be the case. I am wondering on the deficit point, how concerned you are. I know that we have $162 billion of Treasury auctions just this week alone. The sizes are getting bigger and bigger. Depending on what you project out, they're going to have to get that much bigger to really cover some of the entitlements as well as other spending. When will that become more of a front and center, bond vigilante, back to this age kind of issue?

JOSEPH H. DAVIS: Well, that's a million-dollar question. Where's the Rubicon that over you cross? You have to really start paying higher borrowing costs. Our analysis says, you know, the U.S. is still, we're not at that doorstep but it's starting to, we have to pay a little bit more than we did, underneath the surface. It's not obvious to just interest rates when you look at them on the screen. And so I'd say, you know, again the U.S. is always a special case – international reserve currency, we have deep liquid bond markets. Where else are people going to put their long-term principal holdings? Is it Europe? Is it Japan? It's certainly not China, I think, just from convertibility of assets.

That said, I am not implying that that doesn't matter. It's just that we have a higher threshold to get there. But at some point we will have to reconcile it. In our analysis of mega-trends, which means all these forces in the world – aging, AI, demographics – it says the future is, of course, a race between how transformative AI is versus our debt, because that's going to be a headwind going forward, without a doubt, because it's tied to the aging of society and the entitlements that you mentioned.

LISA ABRAMOWICZ: Let's go there with artificial intelligence. We just got back from Davos and that was literally every storefront had AI, which makes you know that it's definitely the hot topic. I'm curious, at what point, first to start with the churn that we see in the labor market, how difficult this is going to be to really measure whether it's increasing productivity, whether it's causing people to leave the workforce, just the messiness of this transition over the next few years.

JOSEPH H. DAVIS: It's going to be messy, but that messiness is positive long term. It's what economists call creative destruction. That's a code word for saying AI can do roughly 70% of human tasks, not 100%. But it's not going to automate everything. Think of it like the computer. Our analysis, which again is just hitting the wire, it's going to be more transformative than the personal computer and the internet. Closer to electricity. So if you're not an economic historian, that's just code word. That's a big impact.

It's more power tools than automation, but the irony is, is that what has been holding growth back in the United States is not a lack of workers. It is the lack of automation in the service-based economy. That's why we have full employment but everyone still says 2% trend growth. How do we get higher growth? And you get it through automation because we're not going to have enough workers if we do work today the same way ten years from now. And so that's what AI has the potential to do. I'm not being just a technical optimist that it's going to cure all things. I am not saying that. I am saying the odds are skewed to have a higher growth than what economists and most policymakers are assuming ten years out.

This is not going to happen tomorrow. Electricity took 30 years to transform the economy, the computer, at least 20. Our window will be shorter, but it's going to take some time for businesses to change their practices, for you and I, Lisa, or at least for me, to get more comfortable using it. It just takes time. It takes time, but it will happen. It's not a foregone conclusion, but the future, bottom line, it is a horse race between AI that could push up growth above our borrowing costs. If it's not transformative enough, then that's when the debt issues start to crowd out the growth. So it really is a bimodal outcome going forward.

LISA ABRAMOWICZ: Which raises this question of how you best, I guess, bet on that? You just go into Nvidia. Is this the reason why indexes especially, how sort of top-heavy they are with the Magnificent Seven or the couple that are more specifically in AI? Do you just sort of board that boat?

JOSEPH H. DAVIS: I would say, actually I'm the exact opposite. I don't know individual companies. I am not picking on any tech company. I'm really not. All I can say is what I have done a lot of my academic career through history. Now, it doesn't repeat, but I can tell one thing that's saliently clear, and that is when technologies transform an economy, it's transformative because it affects all other sectors beyond the sector that that originated.

So when the locomotive came along, the best stock to own was not the locomotive companies. It was the companies that were harnessing that technology to do all other sorts of things. Think about the computer. I'm not saying it's bad that we long computer manufacturers. But the computer was transformative because of what it did for retail, for what it did for healthcare. So if AI is as transformative as that, I'm not saying I would short growth company stocks. I'm just saying if it's only helping those companies, then it's a dud. It's not going to be transformative.

So if it is transformative, I would be long to equity risk premium, and I would be long value companies over growth. Because I can tell you this, the growth stocks in general are discounting higher growth already. The value-based companies are not. And so from a relative valuation perspective, if I was going to be long in one part of the market for the next ten years and close my eyes, it would easily be value companies over growth. Not because I'm anti-technology. I'm actually telling you there's upside risk to technology, but you have to marry that with the valuation. And if it's transformative, it's got to get outside of its own sector. That's what history tells you.

LISA ABRAMOWICZ: What frustrates you when you talk to clients? Because one thing that I've noticed is just how sticky the cash has been. And how even though we're talking about this consensus trade at the beginning of this year of enthusiasm and bullishness, some people are saying you're not quite seeing that yet with the average investor. Do you get that sense? Or do you get the sense that truly people are all in and don't want to hear the gloom that was wrong last year.

JOSEPH H. DAVIS: I think, yes, I mean we may have a slightly different perspective, but we have millions and millions of investors, Lisa. We're seeing two things. There's been a little more gravitation towards cash, but I think that's coming from banks and CDs with a very low interest. But, by and large, despite the headlines most investors are deploying capital, nibbling at the margins, but nothing going either de-risking or really up-risking.

The great news is that most people, most investors have participated in the upside. It's positive for the economy, positive for the financial conditions. And so we're not seeing huge swings, unlike we saw, say at the end of '99, and what we saw on the ___ right after the GFC where there was more, I think, genuine real concern. I don't know how to interpret it. In one sense, that's good because people aren't really offsides and they're participating, but it also means maybe there's a little bit more risk out there than we think.

LISA ABRAMOWICZ: If we are in this new higher normal, which I think a lot of people think, especially post-pandemic, supply chains, aging population, bigger deficit, does that mean that it's going to be a higher return world as well? Just given the fact that if you hold cash, if you get 4%, 5%.

JOSEPH H. DAVIS: Well, I look further out. I mean, again, we have bond markets, you know, the curve is inverted so in that sense the risk premium is negative. We've got equities that are really slim equity risk premium over cash rate. So let's get through the transition, and say, okay, I've got to outperform inflation for my goals, my institution, my state, whatever it is, for the next 20, 30 years. So I'm looking through the near-term dips. Then you want to be long risk premium. Get out of cash. I mean that's just going to dilute yourself. You're going to, even if you outperform inflation, it's a savings vehicle. It's not going to grow wealth. It'll preserve it. It may not grow it. And so I think that's it.

Now the question is, is the higher rate world, is the more mix on inflation, or is it on growth? That's really the composition. And some worry about the, you know, we're in a higher inflation world. What our analysis shows is that there's greater trend inflationary pressures, a little bit on deficit, a little bit on deglobalization. Right? And modestly on aging, but not much. But I don't think central banks will just sleepwalk through that on a trend basis. That's what we get to a higher rate world because you have to offset modest inflation pressures and keep rates above that pressure cost.

So we have price stability in the long run as our baseline. But it's not magically because we have disinflation around the world like we've had for 40 years. That's not the case. It's going to take a modestly higher neutral rate, to your question, it's not 2. It's closer to 4. And that wedge is going to help preserve, on average, keep those inflation pressures at bay.

LISA ABRAMOWICZ: Do think the Fed is going to eventually have to move, migrate from a 2% target inflation to 2-point something, 3% inflation target in this new world?

JOSEPH H. DAVIS: I think so. Now again, if they don't, that means our research is wrong. That's always possible. We keep coming back to it. And I see this very mindfully. These are unobservables that no one knows. If history is any guide is that we, including Vanguard, we need to see the data actually hold up to that theory and that empirical research that we've done. That will take some time because this is based on long run trends and they're slow moving.

As you recall, the Federal Reserve lowered their dots, those long-term numbers to 2½%. They didn't do that until 2013, '14. It was a time after the Global Financial Crisis. It wasn't apparent to me in 2008 that trend growth was permanently lower. It was only after time, it was accumulating, that a lot of people started to say, you know what, interest rates should be lower because trend growth is permanently impaired for a time.

If this is an unwind of some of that, then it's going to take some time for the dots. And I think that would be prudent. I mean as a policymaker, you don't want to change, you know, raise them, and then the next day say, oops, you know what, we overshot a little bit. These are supposed to be long run values. And so we're offering research that would be suggestive of them eventually modestly raising them.

LISA ABRAMOWICZ: You talked about investing overseas. Where in particular is attractive? Is China?

JOSEPH H. DAVIS: Well, from a valuation perspective, yes, but it's an emerging market for a reason. And so you have to go with that. You know, I think the areas that would point you towards, certainly overseas or valuation-based, now full disclosure, they would have said the same thing three years ago. And the U.S. market has just destroyed, outperformed every other market on the planet.

Now, this would say, well, internationals, my argument is not international is going to outperform in the next ten years because of simple mean reversion. That's the most powerful force in finance. It's also the most dangerous. It will only happen, it's likely to happen because valuation, for the U.S. to continue to outperform, valuation multiples are going to have to continue to exceed the previous pace. But there's not been fundamental economic and profit margins. That's been some of it, and currency has been some of it. But the vast majority of the U.S. outperformance in non-U.S. markets over the past decade has been multiple expansion.

And so I'm not anti-U.S. market. You know that. But I'm just saying if I was deploying some fresh capital, I'd be looking outside of growth, technology, and outside of the United States to round out because those parts of the market have outperformed massively. It's unlikely they will continue at the same pace in the next five or ten years.

LISA ABRAMOWICZ: What about Europe?

JOSEPH H. DAVIS: Europe would be clearly one. I mean where our analytics point is Europe and Japan. Lesser than emerging markets. These valuation-based frameworks when you account for interest rates, Lisa, and everything, it hasn't been really pointing on EM. You know, there used to be, I hear from some investors, why wouldn't I invest in the countries that grow the fastest?

The irony is that there's a zero correlation between GDP growth and stock returns over a long period of time. It's the price one pays for growth, which is why value companies on average actually outperform growth companies, even though growth companies grow faster in revenue. And that's why they're classified as growth. But it's the price paid for growth.

What history shows is that investors, over the long run, tend to underpay for more boring, lower beta companies. And so on a country perspective, this would push you to Europe and Japan. Low economic growth expected, poor demographics, but there's some valuations that are discounting some of those poorer fundamentals relative to EM markets that have high growth rates but have valuation headwinds. That started to change more recently with EM.

LISA ABRAMOWICZ: When you take a step back, this is going to be a really volatile year potentially, at least on a rhetorical standpoint. It is an election year. We are probably going to be talking ad nauseam about this heading into November. Some people are saying that it's not going to have a very big impact on markets one way or another just because everyone has always gotten sort of the presidential trade wrong and the intermediate aftermath. Other people are saying that deals are going to slow down because why do a big deal if the regulatory environment is highly uncertain. How important is the fact that we're in an election year when you're taking a look at 2024?

JOSEPH H. DAVIS: It's not that important when you look through the history of markets, Lisa. I am not saying that government policy doesn't matter and that political party changes don't matter. But when they do matter, it's because there's been a regime change or something else that's more economic fundamental. And so generally speaking, it's noise. It's certainly more noise relative to a pattern.

And so I would say, as an investor, I certainly don't have an edge in the insight in terms of political diagnosis. I think it's fair to ask about different policies and what economic impact they may have for an investment strategy in regards to what political party that is. But I'd say if one was looking at information, of all the millions of data points in the world, I would say spend less time on the election cycle and more on things that can cut through both political parties. That's where areas of technology, demographics and those sorts of things have a little bit more enduring value.

LISA ABRAMOWICZ: There is this question, though, about geopolitical risk, especially if someone tries to take advantage of a volatile political year to engage in further conflict somewhere. We've already seen plenty of potential hot spots. Does that factor in? I mean it's sort of a hard thing. People tend to ignore it just simply because it's unpriceable. But, you know, is it something that you're modeling out, for example, with the Red Sea and what that could do to inflation or say, some sort of disruptions to the oil patch?

JOSEPH H. DAVIS: We do, but I'd say we have no edge in doing it. We're trying to handicap. This is risk management. This is how we phrase it. I phrase it as risk management. And then the fact that risk management is comparing two distributions, bell curves so to speak – your own view of the world and the market's view of the world. So today, the market view of the world is a soft landing. There's a very low risk. It's like a little spike. My view of the world is, I don't have perfect foresight, far from it, but I can tell you it's wider than what the spike is.

So from a risk management perspective, this gets to your question, though, of geopolitics. Geopolitics always just widen the distribution. And so that's how we'll look at it. We don't have any single, there's not a really good metric where you can say, oh, I proxy from certain...I mean there's measures out there. It'll lead you to the same point, which is things can always be better and worse than expected in the baseline. And think about dry patterns, in terms of cash, to deploy capital, particularly when markets are frothy.

That doesn't mean your timing. It just means you're going to have to put up capital, more capital, and make sure you're not fore-selling in periods of dislocation. Because, as you mentioned, that's precisely when you want to harvest those returns and the risk premium. You actually want to be deploying capital when others are avoiding it. So that's how we think about geopolitics. We're not going to be able to know exactly when it happens. Think about risk management and having some powder dry to deploy capital, not from a timing perspective, but when others are fore-sellers.

LISA ABRAMOWICZ: It sounds really complicated. I mean when it's bimodal, it's hard to even know how you hedge. How do you hedge? Right? I mean that's sort of one key question if it's not necessarily clearly in longer term bonds since they might actually lose value, if it's an inflationary spike or higher growth. And it's not necessarily, you know, big tech because it's already priced in all of that growth. So what's sort of your ballast? Does 60/40 still work in the same kind of way or we have kind of abandoned that for a much more calibrated types of approaches that you were just talking about?

JOSEPH H. DAVIS: It's a fair question. I mean I clearly think bonds are back. I'm a little skeptical on the list. That's Vanguard, you expect them to say that. Right? They're 60/40. But I'll tell you why. I mean 2022 was painful. Interest rates rose. Inflation was higher than expected. Bonds and stocks both went down. By the way, that will happen again. I don't know when but that will happen again. It has happened before. That does not eradicate the case for a 60/40 portfolio. Because for someone to say it's dead, what they are assuming is that inflation will always be higher than expected and consecutively so for the infinite horizon. That's just, it's mathematically impossible.

And so what happens is every so often, inflation may spike. Interest rates rise and stocks and bonds fall for a time. But that very unfortunate underperformance is the natural defense mechanism for bonds in a portfolio because now the term structure, the interest rates have reset. Correlations come back down. I'm not saying that there wasn't some pain. There was some pain. But that's the very natural defense mechanism that leads to higher returns on the fixed income side going forward.

Now, if one is looking for an investment strategy that avoids all that inflation dynamic, then you have to de-risk those risk premiums and invest in things that correlate with inflation, but now you're not going to get the same principal return that you were banking on. You can sit in cash. I correlate with inflation, I'll just follow the Fed. That's great. But now I gave up the very returns I was banking in the 60/40, so I don't think...that dynamic is still with us going forward, Lisa. But we think this is an era of fixed income. Interest rates are above inflation. That is a positive real yield. We did not have that for 15 years. So I think there's a positive tailwind for fixed income for the next several years.

LISA ABRAMOWICZ: How do you deal with the fact that so many people are talking up private credit as sort of taking over for a lot of public markets? Considering that a lot of those are not as accessible. It's the average investor in a 401K. And yet the flood of institutional cash in some of these asset classes has been really hard to ignore.

JOSEPH H. DAVIS: Yes, and there's been change in how we provide assets, and there's some change in disintermediation between banks and private assets. I would say from an investment strategy perspective, thinking about the role of privates, I mean these are assets. They have expected return, cash flow, dividends. The trick is, in my counsel to investment committees, endowments, individual investors is just think about it as deploying capital as you would any active strategy.

And what I mean by that is sometimes I see these studies of, oh, private assets, private equity, private credit. They're low-correlated with stocks. And they'll do a simple thing of an average return, and it's a low correlation. They'll say, oh, fill your bucket with 20% or 30% privates. Completely wrong strategy. Why is that wrong? Because I cannot buy that private stream that I just put in my Excel spreadsheet to give me the 20% recommendation. You can only buy individual strategies.

So I am not saying do not have exposure to private assets, private credit, private equity. It is an active strategy allocation. And if you can find top managers, then you would be well above 20% allocation. If you can't, and you're just going to fill the bucket with expensive fund to funds, then it'll push you, that's a very high index, that's a very costly index fund. It'll push you to zero. So when I say it's an active strategy, I am not against private assets. And that may sound sensational coming from Vanguard. It can have a very powerful role, but it comes down to manager selection and being able to weather periods of illiquidity and underperformance. So for many investors on the call, that may suit them fine, and that's wonderful. But you have to find top decile performance.

LISA ABRAMOWICZ: Are you guys getting involved at all?

JOSEPH H. DAVIS: Well, we offer private equity now to select clients. But again, Vanguard better have identified a very talented manager. Because if they're not top quartile, they're going to lag the S&P500. And we're providing this, you know, with a lower cost than average. I am not against private investments. They can be opaque, some expensive. And others on the call may expect the opposite, Vanguard speaking against private assets. No, these are assets with cash flow, but how costly are they? And can you identify skill?

Because you cannot buy the private equity S&P500 equivalent. It would be like me saying, Lisa, I'm going to give you the S&P500 but I'm only giving you one stock. That's how most institutions employ their investment strategy. I'm saying that's a lot of idiosyncratic risk. That can pay off, but it really comes down to the manager you get.

LISA ABRAMOWICZ: I want to just sort of end on this idea of where we were six years ago, seven years ago, even in 2013, when people were talking about, I remember the Dallas Fed President, Fisher, talking about people wearing beer goggles and buying stuff that they think looks good but it's terrible because you got bonds yielding below 5%.

And we were talking about how when rates went up to a certain level or inflation ticked up, that all of a sudden everything was going to fall out of bed and we were going to get a massive way of defaults. We'd get a massive wave of distress. It hasn't happened. It's been anything but. Is it deferred? Is it sort of just indefinitely put off because of the fundraising during the pandemic? Or was it just delayed and we're going to get it later on in pockets, as sort of the rolling recovery and the rolling recession continues for the foreseeable future?

JOSEPH H. DAVIS: Our best estimate, it's roughly two-thirds and one-third, to your language. You know, one-third was it was, it's just resilient. I mean some of these are, it's always a little bit better than people expect. In fact, if the U.S. economy shares anything, it's resiliency. And then two-thirds, it's been delayed. There were offsets. There was lockup of interest rates, corporates, corporations did this. You know, you talked about, Lisa, right? The average mortgage is still like roughly 4%. It's not the 7% that's printed online. And so there's been a delay there. And maybe Federal Reserve policy can cut into this precisely when the interest rates really start biting. That's what the soft-landing narrative is banking on. I just think the timing is going to be tough to pull off either because it doesn't slow down enough or it's already baked in.

And so I think that's the calculus, right? But again, I never try to be too alarmed unless three things are all at once – markets are highly overvalued, no one is talking about the risk to the downside, and then the economics are massively deteriorating in the face of that. Rarely there's all three. Someone could argue we have two of the three. I am not alarmist given the fact that I have a long-term investment horizon.

LISA ABRAMOWICZ: There is this question about particular industries that do fit all three. Is there any area that you're staying away from? That you see as sort of being more vulnerable to this sort of shakeout, whether it's in certain pockets of retail, whether it's certain pockets of commercial real estate, whether it's in certain pockets of, say even healthcare, that are poised to be disrupted?

JOSEPH H. DAVIS: Well, I probably, maybe, I can't presume what the audience thinks. I can tell you what I will say. I'm being cautious here. I would tend to go towards the very largest mega tech companies. I'm not mentioning any by name because I think that would be inappropriate. Why I say that is that is discounting a lot of positive good news. Effectively they get close to 100% market share. They already exploit economies of scale and network effects. And that there's no new entrants to the very fields that they disrupted. And I say that because, I am not an equity analyst, but when I zoom out, that's generally the narrative.

And so I'm not against them, I'm just saying the high price paid for growth. These are explosive growth companies. But there's a limitation to their growth, and then it comes down to what's the price paid for that future growth. I just think that's at the high end of the distribution and so I would not be going aggressive in the part of the market. I mean at some point the price paid for growth does matter, even if growth is explosive.

LISA ABRAMOWICZ: Joe Davis, this was fantastic. Thank you so much. And I love that you have a lot of pushback really to some of the consensus, which is refreshing, in January where everyone seems to have already planned out through December. Thank you so much. And thank you, all of you, for listening.

PRESIDENT BARBARA VAN ALLEN: Lisa, thank you. And Joe, just so many great insights. Thank you. And I agree with Lisa. It's nice to get these different perspectives on the pressing issues here of the day. And Lisa, as co-host of Bloomberg Surveillance, you were the right person to do the interview for sure.

LISA ABRAMOWICZ: Well, thank you.

PRESIDENT BARBARA VAN ALLEN: So this year, by the way, for everyone listening, is shaping up to be an incredible year. We've confirmed quite a few events. I'm just going to quickly race through some of the upcoming. Monday, January 29th, we have Ian Bremmer, President of Eurasia Group, as you can see there for a luncheon in Manhattan. We will follow that with Tom Barkin, Head of the Richmond Fed, with a luncheon February 8th. February 13th, we're lucky enough to have Kai-Fu Lee – I recommend his books – Chair and CEO of Sinovation Ventures. We will then have Melissa Kearney, the Neil Moskowitz Professor of Economics at the University of Maryland, February 21st in a webinar. And she has written some groundbreaking, a book based on some groundbreaking research about the economic impacts of family in the economy.

We have a very cool event for the first time. We're leaving New York and going down to Miami, Florida. The Economic Club will host a dinner, off the record, featuring Tom Brady, Seven-Time Super Bowl Champion. And, of course, we will be talking about the NFL. We'll be talking about the nexus between football and business and, of course, what does it take to be a seven-time Super Bowl Champion.

This will be followed by Charlie Cook, who comes to us during the election cycle a couple of times. We're going to have him on a webinar February 26th and then we will have him in-person when we get closer to the general election in November. And then Eric Holder will join us February 27th, Former Attorney General. And we have actually many more. Jamie Dimon is going to be coming, John Williams, our Chair, will also be doing an event. We'll have David Ricks, the CEO of Eli Lilly and Susan Collins of the Boston Fed. So stay tuned. There's lots in the lineup for the weeks and months ahead.

As always, we like to recognize members of the Centennial Society who may have joined us today as they provide the financial backbone of support for the Club and our programming. So thank you to them. And thank you to everyone that attended today. We look forward to seeing you soon. And most of all, thank you, Joe. Thank you, Lisa. Just a great conversation. Really appreciate it. Have a good day.