The Linneman Letter

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Let Markets Work

We have long known that centrally controlled economies generate massive distortions and chronic shortages. For reasons well described by Milton Friedman, Friedrich Hayek, and many others, government planners simply cannot replace the myriad decisions made by millions of incentivized private decision makers. In addition, central planning replaces economic motives with political motives.

The various shutdowns associated with COVID policies in the U.S. and most of the world are extreme examples of centrally controlled decision making. Suddenly, private decision makers were told that they could not work, shop at malls, get elective surgery, travel, etc. These were healthcare and political, not economic, decisions. Given the unprecedented scale of these centralized decisions, it is not surprising that we now have a massively distorted (though improving) economy characterized by widespread shortages. The U.S. and most of the world largely followed China's authoritarian example and shut down vast swaths of the economy for many months. Unprecedented controls created unprecedented economic distortions, which will take time to resolve.

When demand recovered faster than supply in most sectors of the economy, inflation resulted. Of course, this is far better than either the stagnation of demand or the widespread deflation which would have accompanied supply recovering faster than demand. This is not to say these interventions were necessarily wrong (though we consistently said from day one that we thought that they were excessive). But it vividly demonstrates what happens when government planning of economies replaces markets.

It is taking longer than we thought for these distortions to fully resolve themselves. But if allowed to respond to the incentives offered by high prices, most markets will achieve supply and demand balance within the next 12 months. As supply returns, inflation will recede. The U.S. (and the world) does not need cooler demand, it needs hotter supply. And increased supply is not encouraged by more regulations and higher taxes.

Near-zero interest rates are an example of an economic distortion. Things that are valuable — including money — should not be free because they will be overused. The problem when money is effectively free is that it causes debt to be overused. This is particularly true of the largest (and least fiscally responsible) borrower in the world: the U.S. government. It is not a coincidence that the polar opposite Trump and Biden Administrations/Congresses both spent like there was no tomorrow. Most of this spending was low value-add, with the notable exception of CARES 1. Government spending generally transfers resources from higher to lower productivity activities, creating negative economic arbitrage and reduced economic growth.

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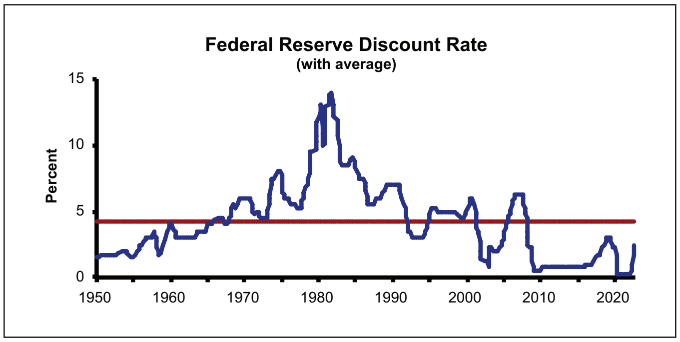


figure 1

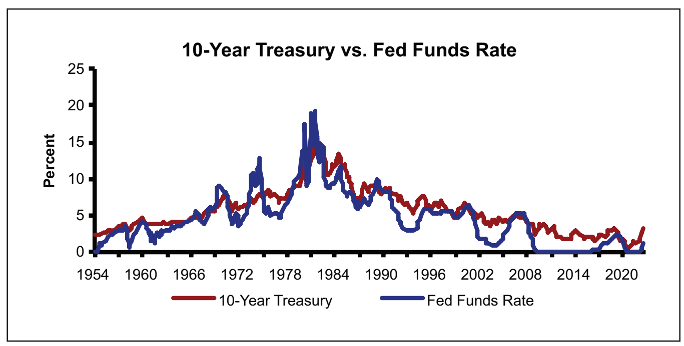
To make the situation worse, artificially low interest rates during the shutdown met a fundamental housing supply shortfall and exploding down payment capacity due to COVID-induced involuntary savings, the combination of which fueled booming home prices. Meanwhile creeping NIMBYism (not-in-my-backyard) means fundamental housing supply shortfalls will push up prices faster than consumer goods inflation, particularly where demand growth is highest. A notable exception exists in Texas where there are few supply constraints. But even Texas has more NIMBYism today than 15 years ago

The increases in interest rates to date will enhance economic growth, not cause a recession. This is because higher interest rates will result in a more productive allocation of capital. Higher short-term interest rates will also allow intergenerational wealth transfers that were not possible in most of the 2010s due to near-zero short-term interest rates robbing safe savers of income. These transfers will assist young households in assembling down payments to purchase homes. Thus, as interest rates, supply chains, and labor markets normalize and move away from the pandemic anomalies, sustained growth has a fighting chance.

The Tricky Business of Raising Rates and Reducing Reserves

Households, businesses, and even state and local governments are flush with cash, relative to their respective pre-Financial Crisis and pre-pandemic balance sheets. From year-end 2019 through the second quarter of 2022, cash holdings (checking, savings, and money markets) by households and firms rose by almost $3.4 trillion and $500 billion, respectively. Over the same period, state and local governments saw a $100 billion rise in their cash positions. Thus, in aggregate, the three groups have roughly $4 trillion more in available cash than what they had before the pandemic. During this time, M2 (cash, savings and checking deposits, and money markets) rose by roughly $6.3 trillion, meaning that almost 65% of the increase in the money supply (crudely measured by M2) is not circulating. Instead, it is still being held as part of wealth in the form of cash in personal and business bank accounts. In response to the pandemic, we effectively borrowed $6.3 trillion from our future selves but have saved $4 trillion of this borrowing, putting only $2.4 trillion "to work." Stated differently, we used about $2.3 trillion (about 10% of GDP) of the COVID monetary injections to tide us over as we shut down the economy, and saved the rest. As a result, the velocity of money (as proxied by M2) fell by a stunning 20% as M2 grew by an equally stunning 41%.

The same analysis comparing cash today versus prior to the Financial Crisis reveals excess cash holdings of $9.2 trillion. Since 2008, M2 rose by $13.9 trillion, similarly indicating that about 65% of our borrowings are sitting idly. Since the Financial Crisis, M2 has risen by 180% but M2 velocity has dropped by 40%. Simply stated, the increase in the money



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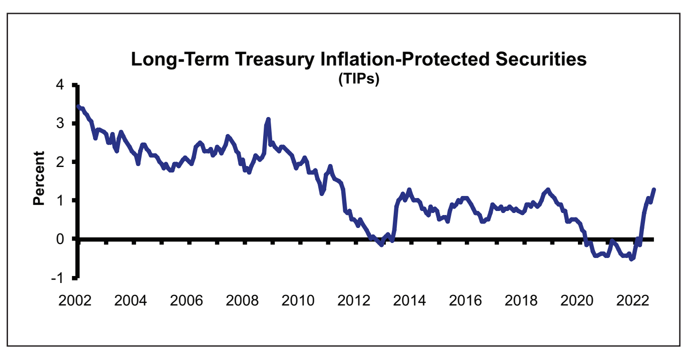

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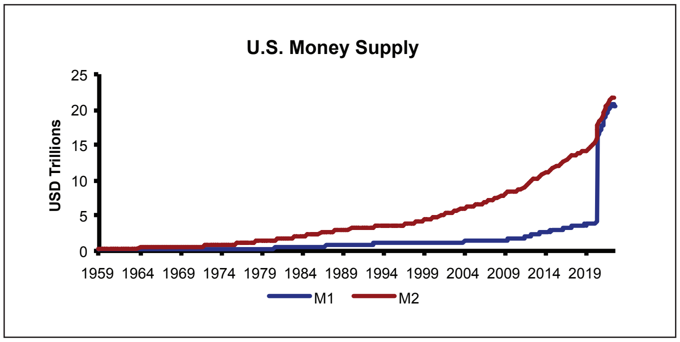

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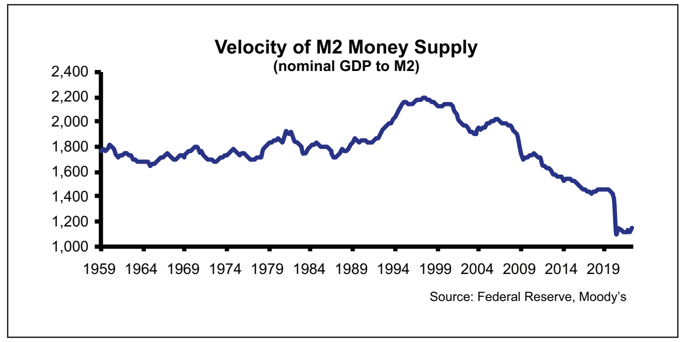

figure 5

supply was offset by the decrease in velocity as people held onto the monetary injections. The excess cash will generally be invested and bequeathed back to our future selves with interest.

The Fed will try to synch its balance sheet reduction with the movement of the excess cash holdings described above into other assets. This will generally support asset prices (including real estate). The exception is that assets formerly purchased by the Fed will face some displacement, as private investors will choose to invest their cash in different assets than did the Fed.

Will the Fed make a mistake? Of course. We all make mistakes every day. But the U.S. economy is resilient and either withstands Fed mistakes or overcomes them within about a year. We suspect the Fed will lag in shrinking its balance sheet relative to the excess cash being invested to avoid asset price collapses. After all, there is no pressing need to reduce the Fed balance sheet. Remember that the Fed views its mission as propping up banks, and by extension, propping up the economy. At the same time, the Fed may raise rates too high and reduce economic growth. The point to grasp is that just as driving either too slowly or too fast on an expressway is dangerous, rates that are too low and too high are economically dangerous. The Fed's search should be for that sweet spot, just as drivers search for a speed that fits the flow of traffic.

About Dr. Peter Linneman

Dr. Linneman, who holds both Masters and Doctorate degrees in economics from the University of Chicago, is the Principal of Linneman Associates. For nearly four decades, he has provided strategic and financial advice to leading corporations. Through Linneman Associates, he provides strategic and M&A analysis, market studies, and feasibility analysis to a number of leading U.S. and international companies. In addition, he serves as an advisor to and a board member of several public and private firms.

Dr. Linneman is the author of the leading real estate finance textbook, *Real Estate Finance and Investments: Risks and Opportunities*, now in its fifth edition. His teaching and research focuses on real estate and investment strategies, mergers and acquisitions, and international markets. He has published over 100 articles during his career. He is widely recognized as one of the leading strategic thinkers in the real estate industry. Most recently, Dr. Linneman co-authored (with Dr. Michael Roizen and Albert Ratner) the best-selling book *The Great Age Reboot: Cracking The Longevity Code For A Younger Tomorrow*.

He also served as the Albert Sussman Professor of Real Estate, Finance, and Business and Public Policy at the Wharton School of Business at the University of Pennsylvania until his retirement in 2011. A member of Wharton's faculty since 1979, he served as the founding chairman of Wharton's Real Estate Department and the Director of Wharton's Zell-Lurie Real Estate Center for 13 years. He is the founding co-editor of *The Wharton Real Estate Review*.

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