The Linneman Letter

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The following is an excerpt from the Spring 2023 edition of The Linneman Letter.

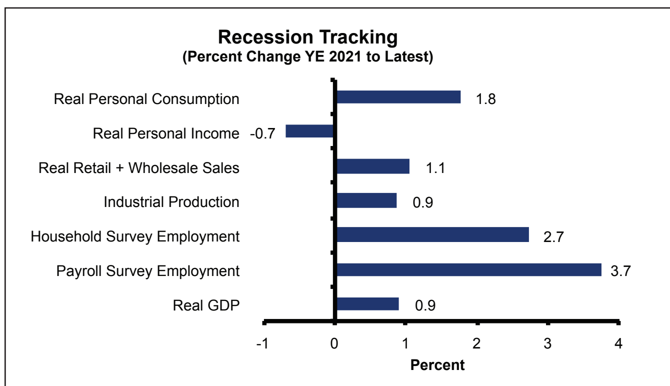
Will We Have a Recession?

Do we think a recession will occur over the next 12-18 months? No, in spite of the Fed's best efforts to create one. We have an ongoing war between the Fed, which is aggressively trying to create a recession, and the consumer/private sector which is in quite good shape but still lagging pre-COVID trends. Between year-end 2021 and February 2023, the U.S. added 5.6 million jobs to the payrolls but just 3.8 million people to the labor force, increased industrial output by nearly 1%, and witnessed real retail spending growth of 0.5%, all while the unemployment rate averaged 3.6%.

Real private wealth is 9.2% above the pre-pandemic level (despite being off 2021 highs); the labor market has no shortage of job opportunities; debt service is low (with 42% of homeowners paying 2% interest or less on their mortgages for the next 30 years); and wages have outstripped inflation since the onset of the pandemic. Household cash holdings (checking accounts and currency) are still high despite burning down a bit from the $5 trillion peak to about $4.9 trillion. Both households and firms still enjoy huge cash cushions compared to what they held before the pandemic. Thus, the spending capacity of the private sector has a lot of room to run, trips to take, cars to buy, etc.

Homebuyers paused as interest rates rose, but the pause appears to be ending, with residential mortgage applications rising in the first quarter of 2023. This is despite the spike in interest rates, because potential homebuyers can only forestall so long before having to "get their kids in school." Those who forestalled were rewarded with declines in both interest rates and spreads on mortgages of about 125 basis points.

The labor market is recovering. Seniors who planned to work another few years but lost their jobs during the pandemic are becoming less of a hindrance to the labor force as younger workers replace them. Over the trailing three months through February, employment rose by almost 1.1 million jobs. This is hardly the widely prophesied recession. Anyone who wants a job has



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one. It is estimated that one million tech workers were laid off in 2022, but studies indicate that most of these workers found new jobs within three to five weeks. We like to track the 16-19-year-old demographic because it is relatively easy to hire and fire teens. The teen unemployment rate tends to experience large spikes and is a hyper-indicator of labor trends. At 10.2% in the fourth quarter of 2022, the teen unemployment rate was at its lowest since 1956 (when we were five).

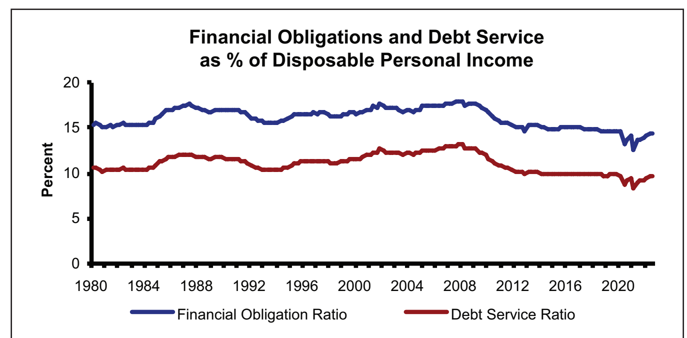
You have seen alarmist headlines about year-over-year inflation, but the only reason it has been so high is that prices 12-18 months ago were abnormally low during the pandemic. The media headlines try to scare you, but these high year-over-year rates do not capture what is happening today. We have already accelerated the automobile; what we now care about is our current speed.

A wonderful quote from 1918 by H. L. Mencken states "The whole aim of practical politics is to keep the populace alarmed (and hence clamorous to be led to safety) by an endless series of hobgoblins, most of them imaginary." Which is to say that the media and politicians are intent on frightening us so as to make themselves indispensable. That has not changed in the decades since Mencken wrote this line. What you see in the press is "financial obligations have risen a lot from their low in early 2021." That is factually true, as they went from just under 13% of disposable income to over 14%. But such a headline is misleading because household financial obligation ratios are still well below both the historical norm and the level we saw throughout the 1990's and 2000's. But "the consumer is still in pretty good shape" is not a sufficiently scary headline.

Despite the moderation of inflation, the Fed is still intent on raising rates, saying the economy is overheated. But as we have consistently noted, demand is not overheated, but rather supply has lagged. Real GDP remains below its pre-pandemic trend. That is the definition of an underheated, not overheated, economy. An overheated economy has notable sectors where activity is well above historic norms. Most typical in this regard are autos, housing, and travel and leisure. But all of these are at levels notably below their historic norms.

The Fed continues to misread the inflation picture. They fret that wage inflation is feeding consumer goods and services inflation. But annualized inflation between October 2022 and February 2023 was just 1.9%. And for the seven months from July 2022 through February 2023, it was only 2.6% annualized. Most recently, annualized wage inflation in February was just 2.5%. When one accounts for an annual real productivity growth factor of 1.5%, this suggests that pure wage inflation was a mere 1% in February. The year-over-year wage increase of 4.8% in February says nothing about what is happening now, but after adjusting for productivity growth, it is only a 3.3% increase.

These are hardly problematic inflation rates, and they occurred despite a labor shortage of 1-2 million



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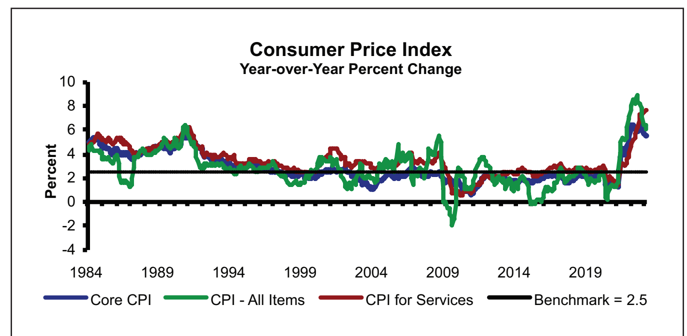

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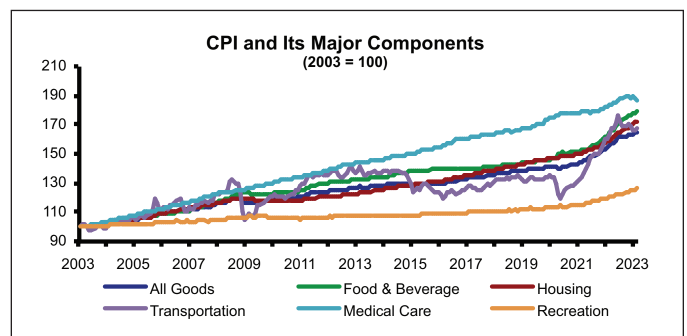

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workers. That is, inflation is largely dead, the victim of rebounding supply and the melting away of supply chain bottlenecks. The reduction of inflation over the last half year is primarily the result of the normalization of supply chains as producers responded to the high prices driven by excess demand across the economy. This is the price moderation we had predicted, though it came about 6-8 months later than we anticipated. But left to their own devices, markets tend to work, and supply adjusts to demand.

Why is wage inflation moderating? Workers are taking jobs and by doing so, they shrink the labor market shortfall. The roughly 800,000 jobs added year-to-date through February 2023 have reduced the economic long COVID shortfall by roughly 500,000. At the end of February 2023, the economy was only about 1-1.2 million jobs short of the pre-pandemic trend. And as more jobs are added to close this gap, wage growth will further moderate.

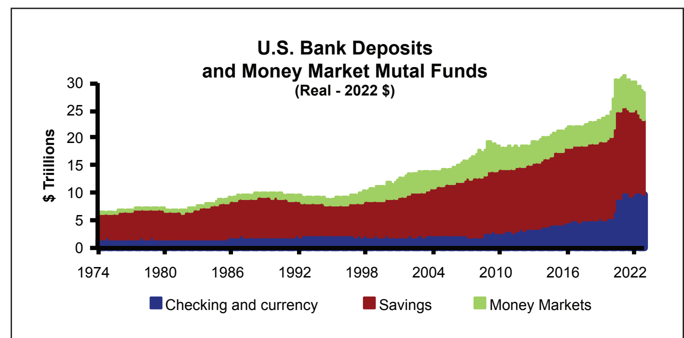
By the way, the death of inflation over recent months is not the result of the Fed's policies. Research shows that it takes 6-18 months for monetary policy to have an impact. Therefore, inflation could not have fallen so low this fast as the result of Fed behavior. Rather, the current 1-2.5% annualized month-over-month inflation rates were determined by interest rates in May-July of 2022 (at the earliest) when the Fed's key rates were hardly inflation-killing levels, at only 1.5-2.5%. No, the easing of inflation is basically attributable to supply rebounds.

What does the Fed do in 2023? No one knows, including the Fed. The Fed historically has always been a terrible forecaster of their own behavior. We grant that the Fed did a great job of providing liquidity in the very early months of the COVID shutdown. But in late 2020, they sat on their hands rather than beginning a slow normalization. Even worse, they hinted that their rate policy would mirror that of the early 2010s, when they kept rates at zero for eight years even as the economy recovered. This led many financial players to plan for years of very low short-term rates. Even we took the Fed at their word (shame on us), though we said that they should be raising rates slowly back to 2.5-3.5%.

The bottom line is that despite positive economic indicators, we are witnessing a struggle between a consumer that has a lot of strength and the Fed that believes that it must create a recession. The Fed continues its war on the economy by raising interest rates and trying to compel firms to cut jobs. If the Fed created another 1-2 million unemployed, it would hurt the economy as each worker on average generates about $147,000 of GDP.

In addition, rapid rate increases are the prime driver of the problems of Silicon Valley Bank (SVB), Signature, and other regional banks. These banks followed the Fed's signals to seek interest rate-sensitive yield when the Fed said they would keep rates low. Then the Fed changed course and abruptly raised rates, clobbering the values of bank portfolios. This froze lending and torpedoed SVB and Signature.

We hope that the Fed will finally realize that a recession is not needed and will back off from increasing interest rates over the next few months. They need to realize that we have low month-to-month inflation and that the last thing we need is to try to push interest rates up further. There is no question that the fault lines in the economy that we are seeing are the results of the Fed's misguided excessive actions. We expect that by summer of 2023, they will see that they have misdiagnosed inflation and the economy. Only



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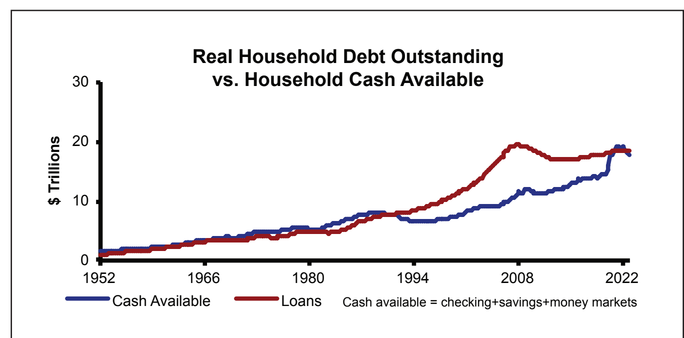

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then will they start cutting rates, which should have begun in November 2022.

We still expect real GDP growth of about 3% in 2023 and 2.5% per year in 2024-2026, due to pent-up demand for autos, homes, and travel. We project that the U.S. will add 2.7 million new jobs in 2023, 3 million in 2024, 2.5 million in 2025, and 1.7 million per year in 2026 and 2027.

If not in the next 12-18 months, when do we see a recession coming? This is incredibly difficult to predict, as recessions are rare events even though they will eventually occur. We similarly know that you are going to catch colds but trying to predict precisely when is a futile exercise. We might predict it will occur in the cold and flu season, but we have all had a summer cold. Even during the cold and flu season, try predicting the day or week. Simply stated, it is very difficult to statistically predict rare events, including recessions.

You often hear that negative yield curves are a predictor of recessions. However, history shows they are far from reliable in this regard. We believe that the best indicator is new weekly jobless claims. When claims start rising very rapidly, particularly as they rise above 280,000 per week, you tend to see recessions. If that level is sustained for a month, we get very nervous. New unemployment claims averaged 215,000 per week in 2022 and were below 200,000 year-to-date through mid-March 2023. These sustained levels indicate that the labor market is still quite robust.

What should you do when the long forecasted (and inevitable) recession does occur? First, remember that cash is king in such times. Forestall cap ex spending and hoard cash. Also realize that if you survive, you will generally be much better positioned when it ends, as the recession will kill off some of the competition. Remember that operations become more important in hard times, so focus on your core business and achieving improved cost efficiencies rather than strategy initiatives. Use the tough times to go through your team and trim the least productive. Remember that for everything, there is a season.

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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