The Linneman Letter

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The following is an excerpt from the Winter 2022-23 edition of The Linneman Letter.

The Fed's Misguided Path

The Fed has a dual mandate of maximizing employment while keeping prices stable, with the latter benchmarked by a 2% PCE target. To achieve these mandates, the Fed adjusts interest rates and adds (or removes) money to the money supply through quantitative easing (or tightening). In Keynesian theory, raising interest rates slows the economy by making capital more expensive and vice versa. Through quantitative easing, the Fed buys assets (usually Treasuries) from U.S. banks to add liquidity to bank balance sheets. As a result, banks potentially have more capital to lend. The opposite is true with quantitative tightening, when the Fed sells Treasuries.

Price Stability. How does the Fed gauge inflation? If asset and commodity prices move at roughly the same rate as consumer prices (though perhaps with greater volatility), no great injustice occurs by proxying inflation with changes in consumer prices. But when commodity and asset prices move dramatically differently than consumer inflation, only a fool would measure inflation by consumer prices.

This divergence was the case in the 2010s, when movements in consumer prices were modest, while increases in asset prices were substantially higher. For example, core CPI inflation was an annual average of 1.9% from 2010-2019, while S&P stock prices rose at an annual average of 13.4%, home prices by 4.8%, gold prices by 5.4%, oil prices by 3.7%, apartment prices by 7.4% and industrial prices by 5.2%. Clearly, as we regularly noted throughout the 2010s, the system was disproportionately seeing money flowing into assets rather than consumer goods and services. As a result, those monetary infusions primarily drove up asset prices rather than consumer prices. Thus, while there was little erosion of consumer purchasing power in the 2010s, asset purchasing power fell notably, as consumers and investors could buy fewer square feet of housing or less operating income, etc. with a dollar.

Over the past year, as the Fed has recklessly pursued its policies, the reverse has happened. On an annualized basis from May through the end of November 2022,

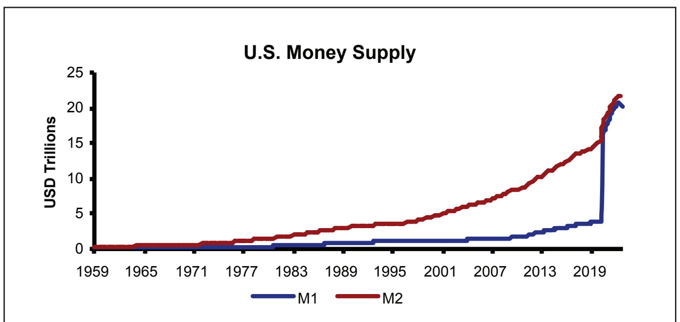

figure 1

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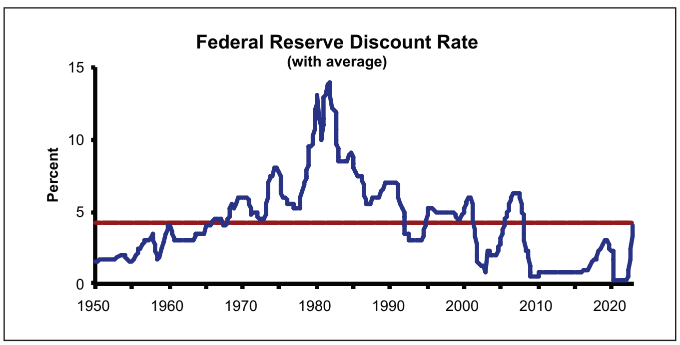
consumer inflation (as measured by core CPI) rose a torrid 5.9%, while S&P stock prices (-3%), home prices (-10.8%), gold prices (-9.3%), oil prices (-46%), and 10-year Treasury bond prices (-68%) were all down over the same period. Clearly, consumer inflation is once again not providing an accurate picture of the inflation of "all prices." In short, the Fed has been driving their policies using a seriously misleading inflation metric for over a decade. And the fact that it is challenging to incorporate asset and commodity prices into inflation metrics does not excuse this error, as consequential policy decisions are made based on the seriously flawed metric.

The Fed is seeking to put the brakes on the economy, but their premise that it is overheated is flawed. The prevailing narrative driving the Fed's effort to raise rates at breakneck speed is that aggregate demand is "overheated." But the data show that the U.S. economy is far from overheated. In fact, despite a heroic rebound in economic activity since the probably ill-advised shutdown in 2020-2021, the economy remains under-heated. Industrial output is up 2.8% versus pre-shutdown, which is about what would be expected, but the growth has all occurred recently (not over an extended period). Meanwhile, employment is only up about one million jobs since the pandemic began, versus 2.5-3.5 million based on trend. And real per capita GDP versus pre-pandemic is only up 1%, while at least 3% would have been expected based on trend.



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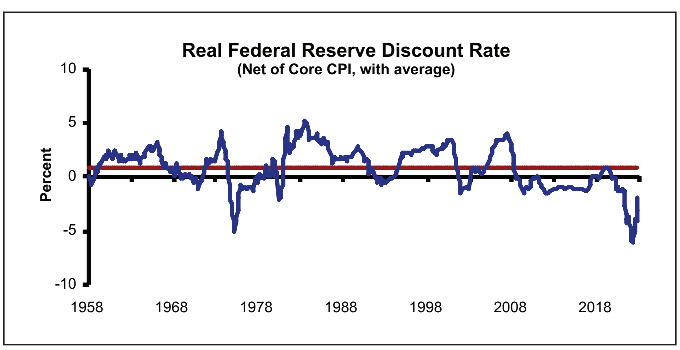

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Additional examples abound:

- Real gross national income (GNI) is 4.2% below where it would be, had it grown by 2.5% annually since the end of 2019
- industrial output is 8% below trend
- November 2022 daily clearances by TSA are 5.8% below November 2019
- employment is 9% below trend

These metrics all indisputably confirm that the economy is not overheated. Instead, it is under heated and even more so undersupplied.

Inflation is still primarily the result of economy wide lags in rebounding supply versus "rebounded (though still under-heated)" demand. Simply stated, when supply systematically lags demand throughout the economy, prices rise no matter the level of interest rates.

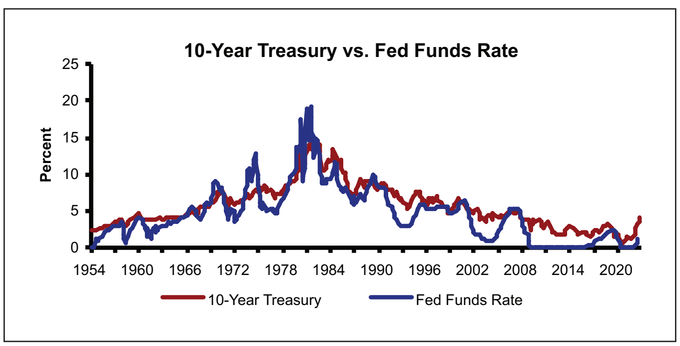
A vivid example of the cause of inflation is provided by air travel. In 2019, there was no notable inflation of air travel despite strong demand, as seat capacity kept pace. If 2022 inflation of air travel was caused by monetary expansion, you would expect that seat capacity (supply) and TSA clearances (demand) grew at about the same rates. That is, prices increase due to excessive money in the system bidding them up (even as supply and demand are balanced). But airfares have risen even though TSA clearances during the 2022 Thanksgiving weekend (Wednesday-Monday) were down 11% versus Thanksgiving weekend 2019. This is because seat capacity was down about 15% (and even more for international flights). Air travel prices are up because muted demand exceeds supply that has not fully recovered from the shutdown. The Fed raising interest rates will not increase seat supply, though it may reduce the quality of our lives by reducing our ability to travel. This lagging supply situation is occurring in most markets for most products.

And if inflation is about excessive stimulus in the economy, why have African countries (which did not engage in massive stimulus) also experience high inflation?

Compounding this flawed reliance on consumer prices to measure inflation is the fact that the Fed (and other central banks) are forming their policies based on the Phillips Curve theory. This long debunked and disproven theory asserts that there is a predictable trade-off between more inflation and less unemployment. Hence, Fed Chairman Powell's shocking statement that rates will continue to rise until unemployment notably rises. Putting aside for the moment the many theoretical reasons why there is no such thing as the Phillips curve, more relevant is the mountain of empirical research that has failed to find any such stable relationship. Yet, the Fed is raising rates until unemployment notably rises. This is as much malpractice as a doctor saying they will continue to bleed a patient until they "get all the ill humors out." This is very dangerous policy. It is bad enough when someone does not know what to do, but it is tragic when they act on something known to be false.

The Fed is absolutely insane in its pursuit of 2-3% higher unemployment rates as the route to reducing inflation. Can you imagine how a member of Congress would be received if they introduced legislation that required every employer to fire 3% of their workforce? They would rightly be pilloried for being insane. Yet, when the Fed says the same thing, people (including most economists) nod approvingly. We never want to waste human capital, as the U.S. economy needs more, not less, employment. We have only added 1.04 million jobs since February 2020, far from the 2.5-3.5 million based on trend.

If all we want is less demand, the government should simply order people to buy nothing over the next month! If the goal is to destroy employment and growth, we have a suggestion: why don't they start by reducing federal staff (including senior staff) by 2-3%. And let's start at the Fed! Maybe even a Fed Governor would agree to resign. After all, why shouldn't they step up and lead by example? In fact, extending this effort to eliminate a quarter of all civilian federal workers would result in more than 500,000 of the 3.2 million "targeted 2%" necessary firings. But how could that possibly help the economy? Yet, that is what the Fed says it is trying to achieve. Reducing employment is



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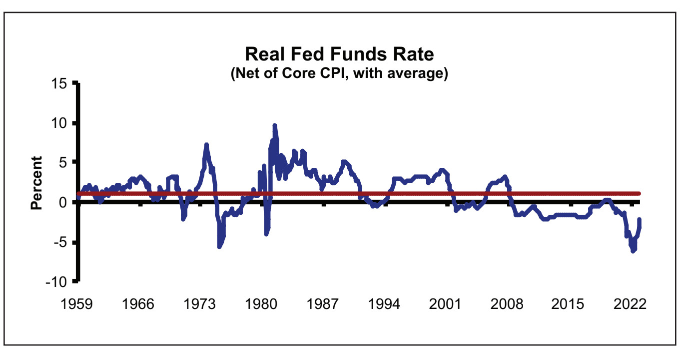

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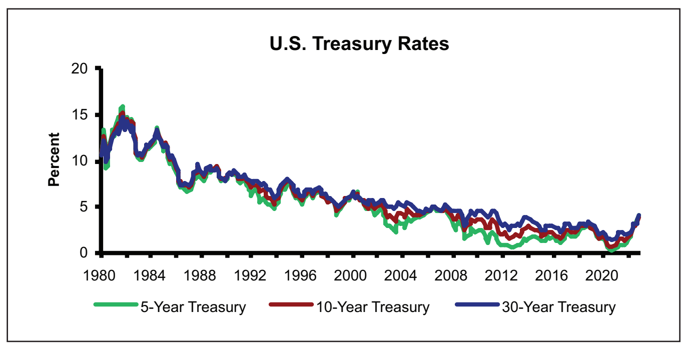

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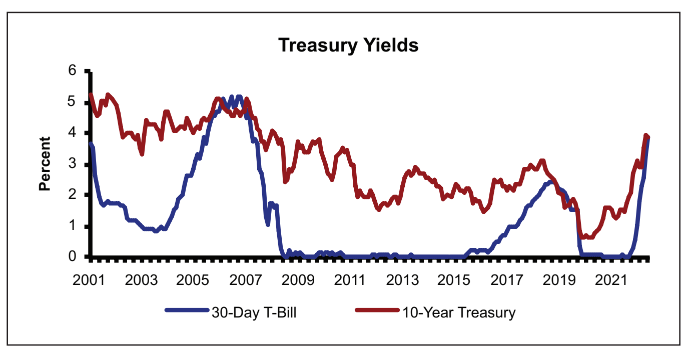
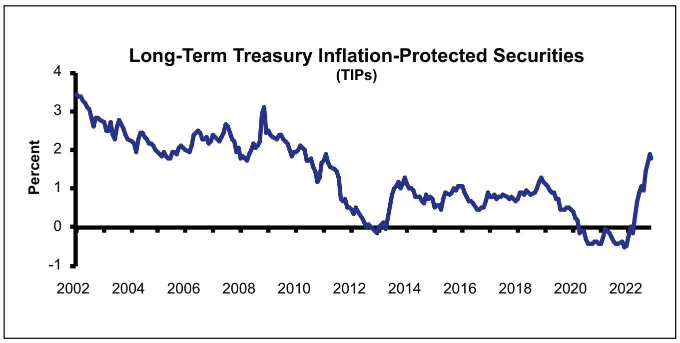


figure 7

simply an absurd goal, particularly at a time of widespread labor shortages, which are a key source of inflationary pressures. Not only is this bad policy, it is insane!

We got into this economic mess by substituting government economic mandates (no elective surgery, no sporting events, no malls allowed to be opened, etc.) for market decisions (e.g., "Do I want to run the COVID risks of elective surgery?"). Similarly, the Fed (which is nothing more than a price-planning agency) mandated that the price of borrowing (interest rates) for the U.S. government should be zero. This



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created massive distortions in capital markets, and now they have embarked on a warp speed reversal of interest rates.

Higher rates (up to a point) are good for the economy. But recklessly raising them creates needless uncertainty which harms the economy. These actions also needlessly punish economic actors, who in good faith relied on the stability of the Fed's "plans." Citizens have a right to expect an orderly transition of government policies so that they can make orderly transitions of their activities. Look no further than the disastrous 44-day tenure of Liz Truss as the UK's Prime Minister for the destructive effects of too rapid policy changes. The whiplash resulting from her changing policies earned her a humiliating exit.

The bottom line is that what has been desperately needed for the last 18 months is much more supply, not less demand. The expansions of oil exploration and chip delivery have had a real impact on inflation. The Fed may get the credit, but economic growth is really on the backs of those who expanded capacity and came back to work.

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*.