The Linneman Letter

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What Happened To Inflation?

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We have been warning our readers of an impending inflation spike since the Summer 2009 issue, but the consumer price index has yet to show any significant increases. Inflation is caused by excessive amounts of money chasing limited goods and services. This concept is well known. Yet as the Fed has increased the monetary base by 279% since the end of August 2008 and M1 and M2 have grown by 81.4% and 38.4%, respectively, consumer prices have risen by just 1.5-3% per annum. These muted consumer price increases seem to refute the traditional model of excessive money creating inflation. This incongruity has been a puzzle to us and many other observers. After all, if the Fed can create infinite amounts of money without creating inflation, they should get on with it!

Reflecting on the absence of consumer inflation in the presence of substantial amounts of money, we have revisited the basic question of what is meant by "prices"? The theoretical concept does not distinguish between consumer and asset prices, assuming that the transmission mechanism of money is largely neutral across asset and consumer prices. A tremendous amount of research and data manipulation is done by the BLS and independent economists to ensure that comparisons of consumer prices over time do a credible job of comparing "apples-to-apples." In contrast, little work has been done to make it easy to track asset prices on the same apples-to-apples standard across a broad range of assets. Thus, since economists assume that money impacts asset and consumer prices roughly proportionately, and consumer prices are far better measured than asset prices, it is best to focus inflation discussions on consumer prices only. This is behind assertions by Mr. Greenspan and Mr. Bernanke (and almost all economists) that they track consumer price movements rather than asset price movements when monitoring inflation. Mr. Greenspan and Mr. Bernanke (and most economists, including us heretofore) remained untroubled by the massive inflation in the prices of homes, stocks, gold, government bonds, and other assets, comfortable in the belief that modest consumer price inflation meant inflation was under control.

In reviewing the literature on the transmission of money into the economy, it is assumed that the money enters neutrally. That is, all economic players receive their pro rata share (relative to their economic size) of any newly created money. If this occurs, it seems reasonable to assume that individuals chase goods, services, and assets in rough proportion to their initial demand for these items, resulting in roughly proportional increases in all prices. In such a

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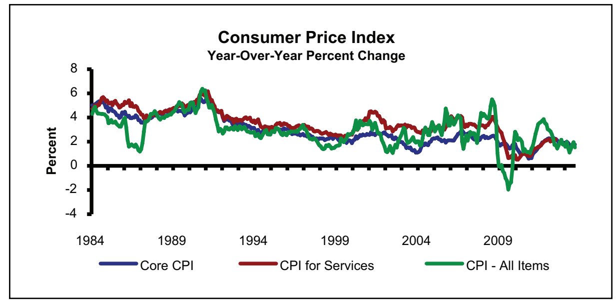
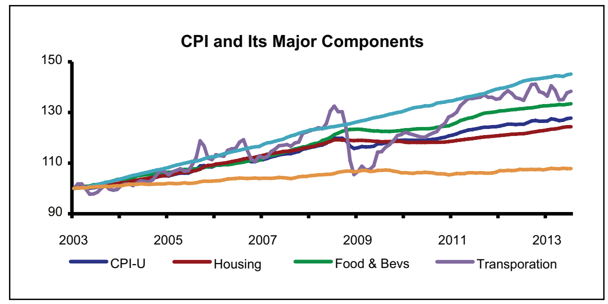
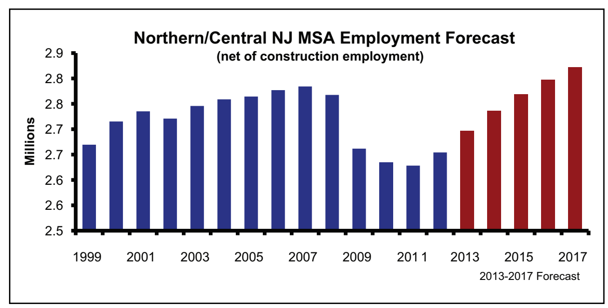
world, consumer price inflation is a reasonable proxy for economy-wide inflation (including asset prices). Such a view of neutral monetary injection was probably a reasonable model when the Fed injected money through many thousands of small, local depository banks. Remember that until about 40 years ago, most states did not even allow branch banking, and local banks only lent to local customers, while Glass-Steagall prohibited broader investment activities. In such a localized banking world, monetary injections may have not been literally neutral, but they were very much “grassroots.” Hence, using consumer prices to track the inflation of all prices was reasonable in the world of small local banks.

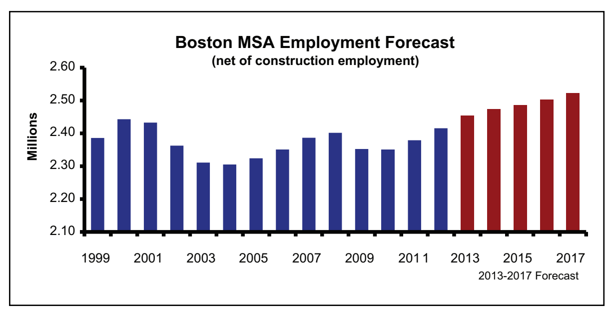
Over the past 40 years, the U.S. banking industry has morphed into a highly concentrated banking system, where banks both lend globally and conduct investment activities. As a result of this industrial transformation, money enters the economy not through a vast array of tiny lenders serving local customer bases, but rather through a few major money center banks that specialize in limited types of lending and trading activities. An unnoticed side effect of the increasing concentration of the banking industry is that money is now injected in a highly non-neutral manner. Newly injected money flows to the items financed by the money center banks. For example, if money center banks receive all of the monetary injections (which is close to true over the past five years), and these banks lend only to traders in U.S. government debt, U.S. government bond prices will be bid up while bread prices are little affected. Since today’s money center banks are disproportionately focused on asset lending and trading, one should expect the price inflation for assets in these niches to far exceed consumer price inflation. Thus, consumer price inflation remains low even as certain asset prices experience substantial inflation due to excessive money. That is, if money enters the system in a highly non-neutral manner, with most of the newly created money sent into assets rather than goods and services, consumer price inflation is no longer a useful proxy for the economy’s inflation.

This non-neutral monetary transmission mechanism has existed for at least the last decade. With the advantage of hindsight, it is abundantly clear that the run-up in home prices reflected the fact that the money center banks were channeling the newly created money (compliments of the Greenspan Fed) almost exclusively to this asset class. As a result, economy-wide inflation (based on the weighted average of consumer and asset prices) was rampant even as the Fed further expanded the money supply, fearing consumer price deflation. The mismeasurement of inflation caused highly destructive runaway inflation, primarily concentrated in housing prices. This resulted in a great reduction in the purchasing power of would-be homebuyers, causing them to rush in and buy before it was too late. It also caused, as invariably occurs with inflation, a misallocation of resources. In the case of the Greenspan Fed, it was a massive









transfer of wealth from buyers and their lenders to home sellers. The ensuing rapid monetary contraction led to a severe recession. And just as was the case with the high inflation in the 1970s (at that time, primarily of consumer prices), severe monetary policy was needed to tame inflation, causing a recession as deep as the inflation was severe. Not surprisingly, the two greatest post-WWII recessions followed the two greatest periods of inflation, though it was asset price inflation rather than consumer price inflation in the case of the latest recession.

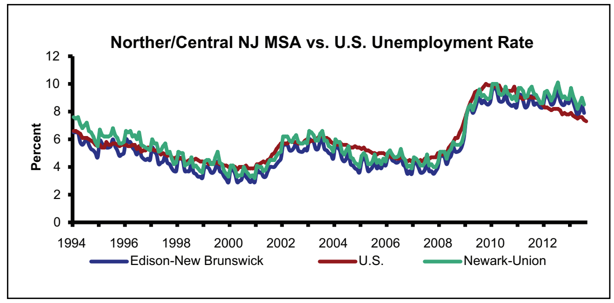
The Bernanke Fed cut rates to zero, manipulated long rates, and conducted staggering amounts of quantitative easing in an attempt to shock the economy out of the recession it created. It continues these interventionist policies at the expense of allowing capital markets to set rates, even as sluggish growth occurs. The Fed defends its actions by pointing to muted consumer price inflation, even as runaway inflation has occurred in bonds (particularly government bonds), stocks, and many other assets. Inflation is occurring in these assets' valuations, rather than consumer prices, because the Fed has focused its monetary injections primarily on a dozen money center banks.

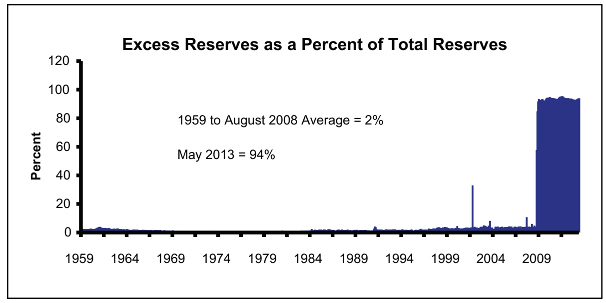
Banks lose if interest rates rise, as the long-term, fixed-interest assets on their balance sheets will fall in value. However, they win as interest rates rise in terms of their income statements, as the spread they earn will tend to rise. In fact, the value of these institutions has become a highly leveraged bet on government policies.

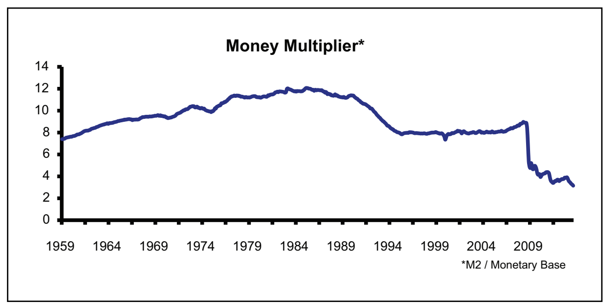
Money center banks have also channeled the newly created money to the federal government, purchasing 10% of newly issued net federal debt. And they have channeled funds into the recapitalization of high-quality borrowers, while largely ignoring loans to small local businesses and consumers.

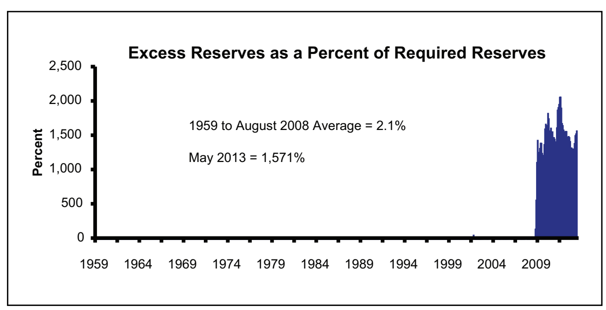
Commercial real estate price inflation has generally not occurred, as banks have reduced their lending to commercial real estate by $300 billion over the past five years. The current inflation has distorted capital allocations and transferred staggering amounts of wealth from lenders (primarily U.S. retirees and foreign sovereigns) to high-grade borrowers (particularly the U.S. government). This inflation tax has allowed the U.S. to maintain unsustainable budget deficits without the need to raise taxes or cut spending, as the newly created money has financed the revenue shortfalls. But the current inflation will end badly once the Fed finally raises rates. We already had a hint of the recessionary response associated with the shock of declining asset prices when Mr. Bernanke muttered something indecipherable about tapering. And the longer the Fed waits, the deeper the next recession will be.

In a normal recession, operating cash flows are cyclically reduced; but as the economy slows, long-term interest rates also decline modestly. The net effect is that asset prices are little affected, as the









drop in short-term cash flows is mostly offset by the temporary reduction in long rates. Consider a simple income-divided-by-cap rate valuation model. If NOI falls by 10% during the recession, and rates fall by about 8%, the value decline is only roughly 2%.

Some observers have applied this rationale to current asset pricing by suggesting that value will be a race between rising NOI and rising long rates. But given the fact that NOI fell for cyclical reasons (though somewhat deeper than the norm) while long rates fell primarily due to massive Fed manipulation, there will be no race. Or at least it will not be a very competitive race. This is because while cash flows declined 10-20%, the 10-year Treasury yield fell by about 65% (from roughly 4.5% to a low of roughly 1.5%). And there is simply no way that cash flows can grow more than 100% over a 5-year recovery period. We have already seen that this is the case for the first 100-bp (70%) increase in the 10-year yield, which occurred in a matter of days. And more is to come as the long-term yield moves back towards 4.5% (a further 80% increase).