The Linneman Letter

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QE3 And The Twist

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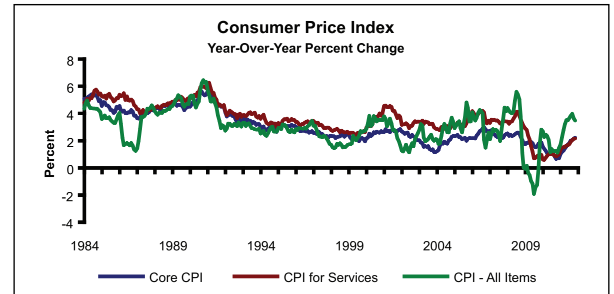
The Fed recently announced that it will buy up to $400 billion worth of long-term government bonds while selling U.S. government notes. This is yet another hard-line move in a decade of aggressive Fed interventions. While theory suggests that the Fed should temporarily intervene in capital markets in order to stimulate or dampen the economy, what we have witnessed over the last decade is hardly temporary.

For eight out of the last 10 years, the Fed has held short-term interest rates below current inflation, creating negative real short-term interest rates. When done briefly, this may stimulate the economy without excessively distorting capital markets. However, as demonstrated during the Greenspan administration, when done for prolonged periods, this creates enormous capital market distortions. What the Fed has done over the past decade is no different from the price setting done for most goods by the USSR. And as occurred in the USSR, every artificial price generates distortions that snowball over time. Hence the housing bubble, the subsequent crash, and current attempts to re-inflate the sector.

The Fed used quantitative easing (QE1) to create enormous liquidity in the face of a possible liquidity crisis. This was probably the right thing to do at the time, as a shortage of liquidity could have been catastrophic. Unfortunately QE1 did not achieve its intended goal, as the additional liquidity sat on bank balance sheets as excess reserves at the Fed, rather than rippling through the economy as loans. Hence, we witnessed the oddity of a lack of loans in the presence of the greatest liquidity in U.S. history.

The Fed cannot be blamed for failing to foresee that liquidity would go dollar-for-dollar to excess reserves rather than loans. This situation is historically unprecedented, leaving observers of all political stripes at a loss for a coherent explanation. The lack of rules meant that businesses were uncertain about the future and how the game of Old Maid would end, and chose to be very conservative. As a result, banks kept their capital in reserve. And when faced with an attack on “millionaires and billionaires,” the owners of small firms retrenched



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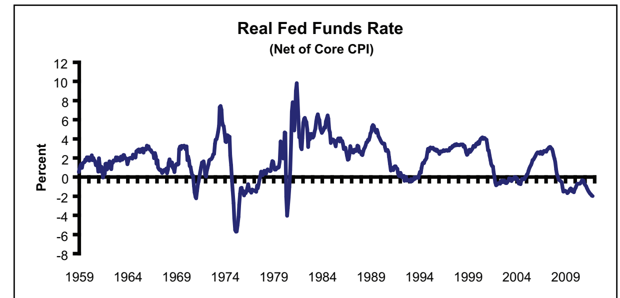
rather than borrowing to expand. The result has been a lack of lending and a lack of strong job growth.

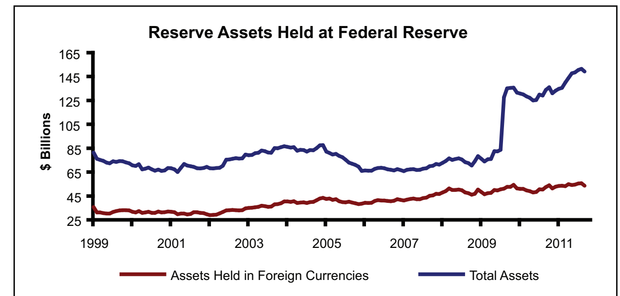
QE2 poured more liquidity into a system that already possessed stunning levels of excess liquidity. The issue was not that banks did not have sufficient reserves to lend, but rather that banks either refused to lend or could not find credit-worthy borrowers. Pouring more liquidity into the system further increased excess reserves with no impact on economic activity. QE2 was like throwing water on an already extinguished fire. The damaging part of QE2 was that it indicated that the Fed was going to "do something," anything, adding to economic uncertainty.

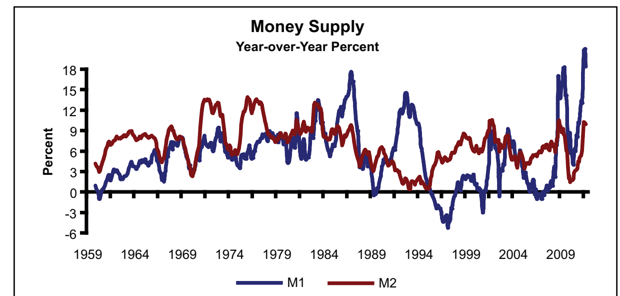
Now we come to QE3 and the Twist. QE3 is clearly unnecessary, as banks already have $1.5 trillion of excess reserves, enough to create nearly $10 trillion of loans. The buying of long-dated government bonds while selling short-dated government notes (the Twist) is nothing new, and was attempted in the 1960s, with research indicating that at most, it reduced long rates by 10 bps. So even if it is as effective this time, it will merely reduce long rates from 2% to 1.9%. Such a reduction will have no notable impact. After all, the decline in long bond yields from 3.5% to 2% did nothing to trigger economic activity. While it may lower mortgage rates by a couple of basis points, this will achieve nothing. Too many borrowers have negative equity or zero-balance mortgages. And as our research with Susan Wachter indicated nearly 20 years ago, interest rates are of little importance in terms of borrowing for homes, which is driven by equity cushions and down payment constraints.

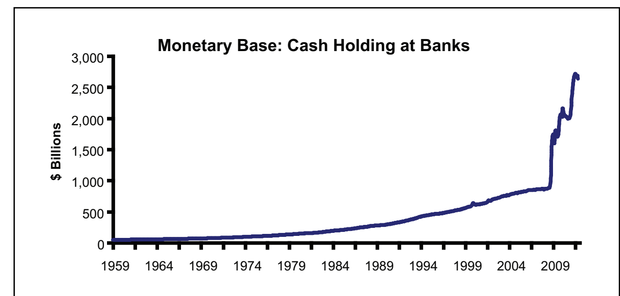
Now that 20% down is again the norm, people must save for several years in order to attain the necessary down payment. This is difficult given the high unemployment rate for younger and less educated households. Reducing the long-term interest rate by 10 bps will have no meaningful impact on mortgage decisions.

The Twist is dangerous in that it shortens the duration of U.S. debt maturi-ties at a time when the government should be financing as long as possible due to historically low long-term rates. Every time the Fed buys a long-term government bond, paying for it by selling a short-term government note, the outstanding maturity of debt held by the public shortens. This amplifies the rollover risk facing U.S. government debt, and accelerates the vulnerability to rapid increases in interest rates. Given the uncertainty about inflation and the willingness of China and other foreign buyers to continue to buy our long bonds at 2%, shortening the term structure of U.S. debt simply adds to the uncertainty over the U.S. economy.









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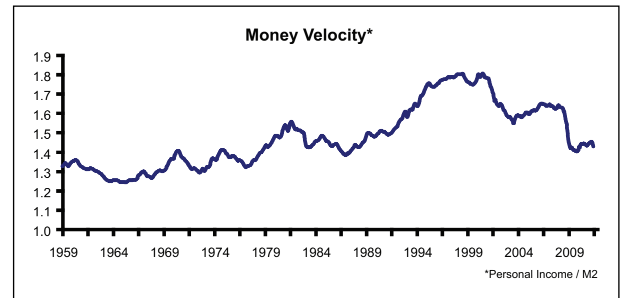
Adding to the challenge of interpreting capital markets today is that sovereign debt markets are primarily driven by governments purchasing debt from themselves (central bank purchases) and each other. Well over 50% of all purchases of U.S. Treasuries during the past year have been by the U.S. government and other sovereigns – hardly arm's length transactions. As a result, it is not a free market that is establishing the price of sovereign bonds, but rather government interventions.

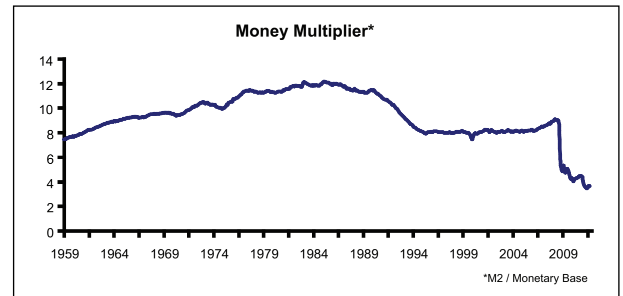
We are 60 years old and have never before seen 2% 10-year Treasuries, even though we have seen budget deficits and surpluses, high unemployment and low unemployment, inflation and deflation, Republicans and Democrats, and every imaginable combination thereof. We are unwilling to believe that a 2% yield on 10-year Treasuries is a sustainable long-term interest rate, particularly when U.S. inflation is running somewhere between 2% and 5%, large government deficits exist around the world, and stunning amounts of liquidity make higher inflation far more likely than deflation.

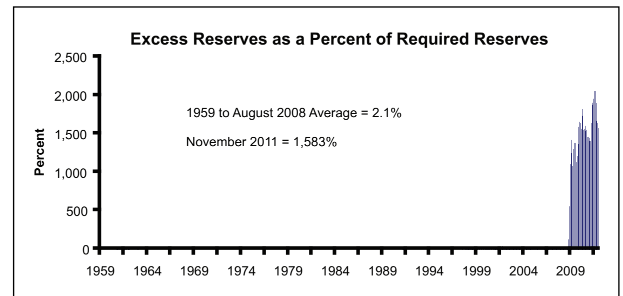
Some argue that we are now like Japan, with near 0% short-term rates and sustainable 2% long-term rates. But Japan's rates have been supported over the past 20 years by the Japanese Postal system, which covers sustained government budget deficits by a de facto tax, with Postal deposits and life insurance premiums from mom-and-pop Japan used to purchase government bonds at artificially low rates. Of course, the U.S. could require U.S. citizens to buy government bonds for their retirement accounts. In fact, such capital market manipulations are historically common when governments want to maintain artificially low interest rates. But we simply do not see how, for a sustained period of time, long-term interest rates can stay as low as they are today.

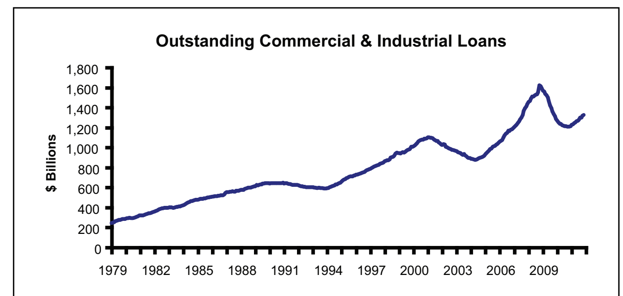
The purchase of real estate is a de facto synthetic purchase of a long-term Treasury bond plus a real estate spread. If you are not comfortable with the long-term Treasury rate, you are not comfortable with the purchase of real estate unless the spread is abnormally high. As the CMBS market evaporated after the July S&P debacle, spreads have risen even on high-quality "gateway properties," once again creating an opportunity in both public and private markets to acquire real estate with some room for error. But you cannot say that trying to assess the right 10-year Treasury yield is "above your pay grade" and only focus on real estate spreads in an environment where 10-year Treasuries are artificially low.

While long-term U.S. Treasuries are the accepted benchmark for the risk-free rate, ever increasing federal debt levels and deficits

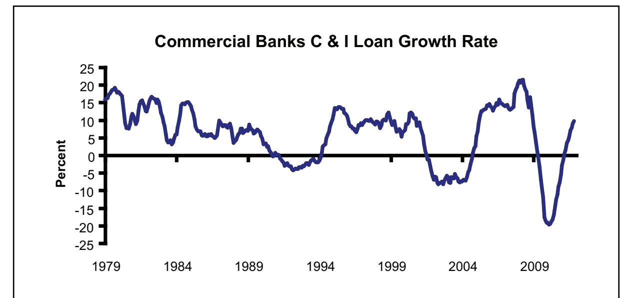


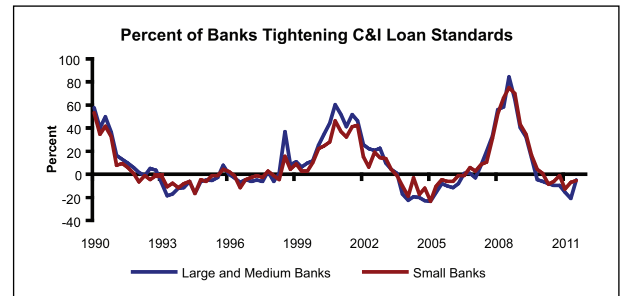


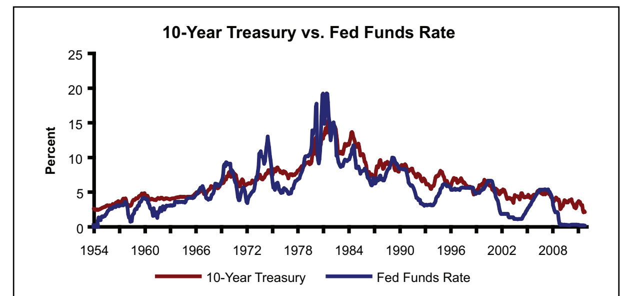




mean that these instruments are not as "safe" as they were even just a year or two ago. While the S&P downgrade of the U.S. government is silly, particularly in view of the fact that many other countries are still rated AAA despite equally untenable fiscal positions, it is true that risk has increased. A former student told us recently that in the face of weakened U.S. government credit fundamentals, his family was moving its money back to Columbia. This brought to mind the fact that high-quality real estate tends to be the flight-to-safety asset in societies where sovereign debt is not riskless. We learned this lesson in Latin America 20 years ago, when we saw real estate prices rise even as the economy faltered, because capital flowed into the relative safety of real estate. While the U.S. is not as weak as Latin American economies were in the 1980s and 1990s, it is fair to say that it is also not as safe as the U.S. prior to 2008. This is all to say that as the U.S. government bond has become less safe, high-quality real estate spreads should narrow.







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