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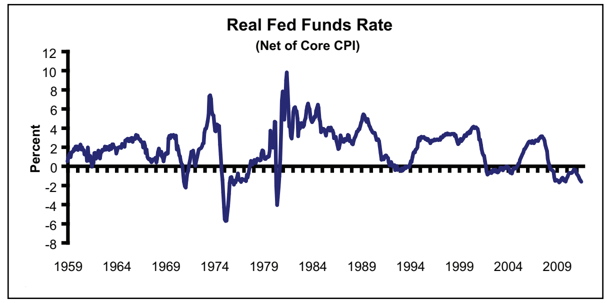
The Fed Believes It Is God

By Dr. Peter Linneman, PhD
Chief Economist, NAI Global
Principal, Linneman Associates

For the past three years, and for at least 80% of the past decade, the Fed, rather than the market, has set short-term interest rates. It has now kept rates at an unnaturally low rate of approximately zero for 19 months, in an environment fraught with inflationary risk. This extraordinary distortion of short-term returns not only punishes those who have the good sense to maintain cash reserves for safety, but also punishes investors choosing relatively short-term safe investments. This includes retirees as well as low-income households, most of whom maintain their meager savings in checking accounts and money market funds. The Fed has robbed these people of several hundred basis points of return on their money.



These people have watched their incomes fall by government dictate, forcing them to deplete their savings to replace the income they deserve on these investments. This gap is a de facto tax. This was done, to disastrous effect, by the Greenspan Fed from 2002-2006. And now, to pay for the imprudent investments created by that environment, the Bernanke Fed is doing it again, but on steroids (though, thus far, only for half as long). It is not only distorting short-term, low-risk rates, but also massively and directly intervening in the longer-term markets via QE2, robbing risk-averse, long-term investors of their incomes. These are the people who are currently "not getting their money" and paying for the losses.

It is not surprising that a growing cadre of citizens and legislators is unusually irate at the Fed, as the Fed is de facto imposing a massive tax to facilitate the federal deficit without any legislative process. The Fed officials imposing this tax are not elected, and are playing the role that people expect of legislators, whom they can lobby. Instead, the tax imposed by the Fed is decided in private chambers by people who are not answerable to the citizenry. We seriously doubt that a 95% tax rate on all cash holdings could ever achieve legislative approval. But this is effectively what the Fed's interest rate policy has done, without a channel for the public to voice opposition. In addition, just as happened in the early part of the last decade, the Fed's extraordinarily low short-term rates, and now also its massive purchases of Treasury bonds, are distorting investor incentives, causing investors to seek higher-risk and longer-term investments. As a result, the market for investments no longer reflects a "free market." Instead, as has been the case for most of the past decade, investment decisions are the result of actions by mandarins rather than private investors. Is it any wonder that we have

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had such gyration in our investment markets over the past decade, when we steadfastly refuse to allow market forces to work?

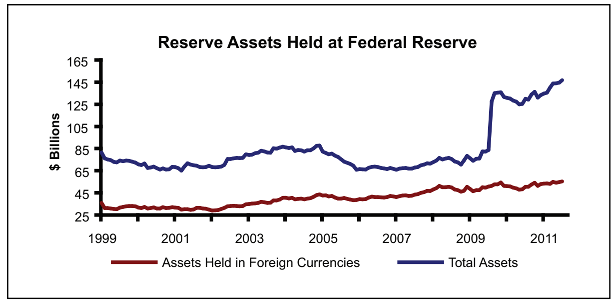
As was the case when Greenspan's Fed held rates artificially low for nearly four years, we are again witnessing an unnatural level of risk-taking. This has spilled over into real estate, as investors once again are being forced to "seek yield." While "empty space" is still notably less valuable than "full space," it is only a matter of time until the Fed's intervention changes this, by forcing investors farther out on the risk spectrum. The problem is even worse today than it was during the Greenspan Fed interventions, because the Fed has also directly distorted the long bond market via quantitative easing.

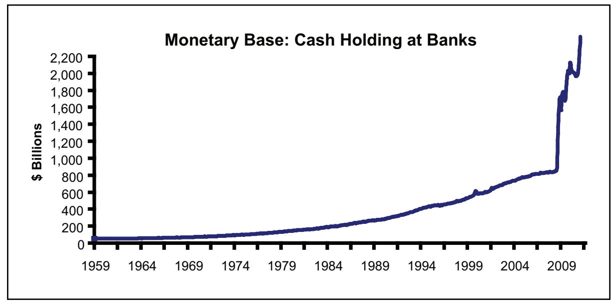
Compounding the problem is that this is not only occurring in the U.S., but in almost every major country around the world. For the past two years, there has been no market-determined price for long-term government bonds. Instead, we have one branch of the federal government (the Treasury) selling to another branch of the federal government (the Fed) as the primary determinant of long bond prices. This is hardly a case of a disinterested seller transacting with a disinterested buyer to set a market price.

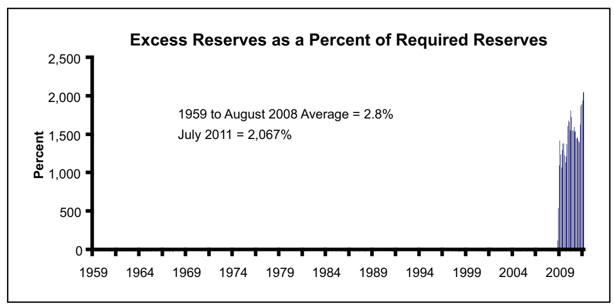
There are clearly canaries in the coal mine: famed bond buyer Bill Gross of PIMCO says that he is completely out of U.S. Treasuries; almost all net U.S. bond sales are to government entities (the Fed, foreign sovereign wealth funds, and foreign central banks); and fantasy investments are being sought. Thus, for the first time in our career, we can no longer interpret long-term U.S. Treasury yields as market-determined, risk-free rates. Previously, you could reasonably price real estate by saying, "I need (for example) 250 bps more in expected unlevered return to own a garden complex in Phoenix than Bill Gross (a smart, profit-motivated, disinterested bond buyer) requires on a 10-year Treasury bond." But this is no longer a valid way to price real estate, as Bill Gross and others are refusing to buy Treasuries because yields are artificially low.

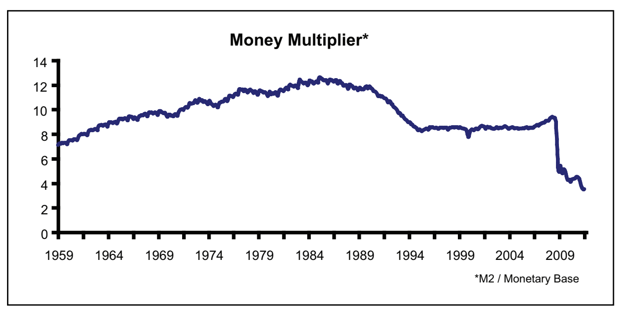
This has long been the case in Japan, where the Japanese government keeps rates absurdly low despite a soaring government debt burden. They are supported in this effort by foreign central banks and sovereign wealth funds, which are subjected to heavy political pressure by the U.S. government.

The net result of government manipulation of the Treasury bond market is that government debt yields no longer reflect risk free rates, but rather politically set "pay rates." These pay rates are far below the rates that a market of disinterested buyers and sellers would establish. We suspect that 10-year rates would need to be to be at least 4.5% to attract a sufficient number of profit-motivated buyers in a world where the return of greed has driven astronomical values for fantasy companies like Facebook and LinkedIn. And this figure may even go above 5%. Remember that the Treasury has to float roughly





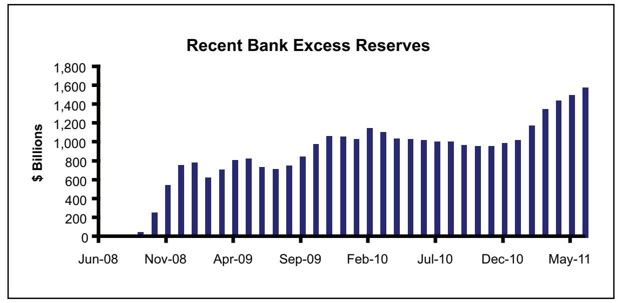




$150 billion in new debt each month for as far as the eye can see, of which the Fed has been buying nearly 60%, with foreign government entities purchasing the remainder.

Unless we reduce the federal budget deficit to 2-3% of GDP (versus 11% today), the day will come when yields rise surprisingly quickly, because eventually we will be forced to sell to profit-motivated buyers like PIMCO. The vast amounts of money created by the Fed's government bond acquisition spree are already causing higher inflation, which debases our debt. As this occurs, foreign governments will demand higher yields. The recent shortening of U.S. debt maturities suggests that foreign government buyers are already moving in this direction, agreeing to buy U.S. government debt with relatively near-term interest rate re-strikes.

Bank excess reserves at the Fed remain at $1.6 *trillion* today versus just $1.6 *billion* (note the change from a "b" to a "t") three years ago. Staggering amounts of liquidity have been injected into the banking system and are largely "waiting to get out." Banks are increasing their lending, with commercial and industrial loans up by about 4% ($50 billion) year-over-year. That said, there is sufficient liquidity to push 10-year yields to 2%, even as inflation runs 4-5%, in a panic-driven flight to (seeming) safety.



In a search for yield, capital that would have gone into money market funds has flowed into higher-risk assets like stocks, junk bonds, and commercial real estate, due to the Fed's effort to encourage risk-taking via low rates. Unfortunately, while the Fed attempts to encourage financial risk-taking, the actions of the Obama Administration and Congress are discouraging businesses from taking risk. The result is a run-up in asset prices with little recovery in economic activity, and a return of financial (rather than economic) engineering.

It is high time for the government to return to regulating, rather than driving, financial markets. Even the most active monetarist believes that monetary interventions should be brief and infrequent. Instead, we have morphed into a situation in which Fed interventions are constant and deep.

The Fed has always been the protector of the banking industry, creating long periods of artificially low interest rates and steep yield curves. These hyper-extended yield curves create bank profits, the expansion of dominant banks, and ultimately the increase in leverage that invariably follows a run of ever-increasing bank profits. But this profitability inevitably comes screeching to a halt when the Fed allows the yield curve to flatten, as the bank carry trade disappears. This was demonstrated all too vividly when the yield curve flattened in 2006; shortly thereafter, banks came tumbling down. And it will happen again and again until banks lose their insured depository status.

It is time to get rid of federally insured banks. The FDIC was created to provide a safe place for risk-free investors to put their money. The thought was that by federally insuring bank deposits, retail investors would be more likely to put their money in banks, increasing capital market liquidity. But this was done at a time when the U.S. government had no outstanding debt, so the only way that an investor could obtain a federal government guarantee was via deposits in a federally insured bank.

In marked contrast, today there is nearly $14 trillion (including GSE debt) of federally guaranteed debt available for those desiring U.S. government guarantees. This amounts to nearly $125,000 per household, with the amount of outstanding federal debt rising by $1.6 trillion a year ($14,200 per household).

The result is that any household desiring the full faith and confidence of the U.S. government does not have to put its money in a bank to achieve this guarantee. Instead, this guarantee is easily achieved by investing in U.S. government bond funds. This would result in government bonds, and only these bonds, carrying the guarantee of the U.S. government. FDIC insurance is no longer needed, as more than enough federal debt exists to satisfy this demand for safety. Absent the FDIC, people depositing their money in banks would no longer obtain deposit guarantees, and banks would simply evolve into unregulated investment companies.

By eliminating FDIC insurance, we would strengthen our financial system, improve our capital allocation, and direct funds to the investment firms most capable of generating profits throughout the cycle.

Someone will have to bear the burden of past imprudent lending and investing and excessive government spending. We have decided, much to our chagrin, that it will not be the major financial institutions (a.k.a., too-big-to-fail banks) that lost on their heavily leveraged carry trade. Instead, federal transfers saved these institutions, as they were deemed too big to fail and allowed to become even bigger.

So who will pay? With private debt, the historic answer in the U.S. has been that the borrowers and lenders split the losses. But as the debt burden has shifted from a private to a federal government liability, the answer, increasingly, is that most people will be paid in full with debased currency created by the inflation associated with printing money. But taxes will be imposed and government spending will be cut, transferring the burden to particular citizens. And until it is known who pays, economic activity will be hindered as economic players tread carefully, lest they be blindsided by this burden.

Over the longer term, the people "not getting paid" will be government bond holders, who will be repaid with inflated dollars. This day of reckoning will come when the Fed stops being the primary purchaser of government debt.