

Warning: Inflation Ahead

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During this recession, we have experienced massive asset price deflation. At the same time, we have also had consumer price deflation coming primarily through oil. However, falling oil prices provide increased purchasing power and leave more money in our pockets, and therefore act as net wealth increases for the U.S. The asset price deflation obviously has the opposite effect on wealth. Core inflation, net of food and energy, is still running in the range of 2-2.5%. Thus far, we have had assets declining dramatically in value, but overall, consumer goods pricing has been fairly stable primarily because the velocity of money has massively declined. Going forward, it may be a very different ballgame because as each dollar is spent more frequently (indicating greater demand), prices will rise.

From the beginning of September 2008 through the end of February 2009, the Fed increased the money supply (M1) by 11.8%, while the velocity of money fell by 7.8%. As a result, overall inflation has stayed steady even though significant asset price deflation has occurred. Absent this massive monetary expansion, we would have witnessed an enormous deflation due to the decline of velocity.

Fear – driven by enormous uncertainty and panic created by the abandonment of clear economic rules – caused the massive and precipitous decline in velocity. Given capricious and irrational government policy decisions, cash became the only safe haven. After Mr. Paulson declared that the world was coming to an end in early September 2008, sophisticates jammed their money into Treasuries to the point where they yielded negative real returns. Americans pulled their money out of hedge funds, stocks, bonds and real estate, and put it in banks, money markets, and shoe boxes as they became frightened about the soundness of the system. This occurred even as the Fed and Treasury officials could not figure out why these runs took place. Guys, you told them to panic, and they did!

It is breathtaking how the Obama administration has replaced the Bush administration's stunning arrogance of ignorance with an equally stunning arrogance of intelligence. Hardly a day goes by without a new "solution." Problems at Citi: give them more money. Sales are lagging at GM: replace the CEO. Hedge funds acting as fiduciaries for retiree money refuse to abrogate their senior claims on Chrysler: publicly renounce them as "speculators" (as opposed to debt holders acting in good faith to protect their legal rights). Tell them you will make sure they will fare even worse in bankruptcy and pressure the bankruptcy judge. Bonuses paid according to a contract and blessed by the governing

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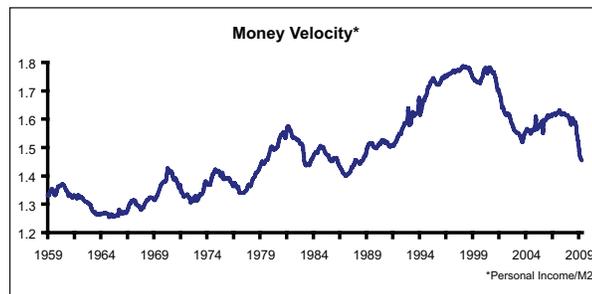
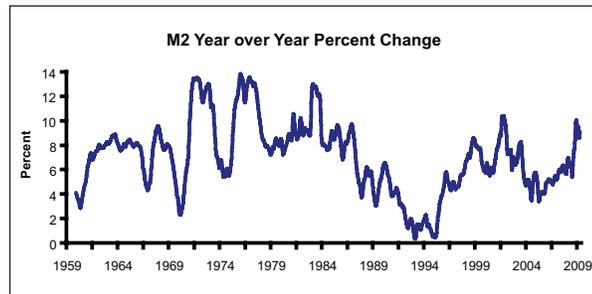
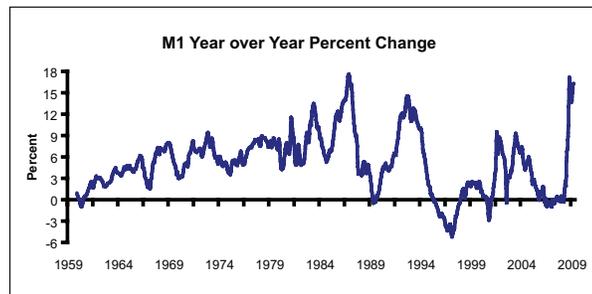
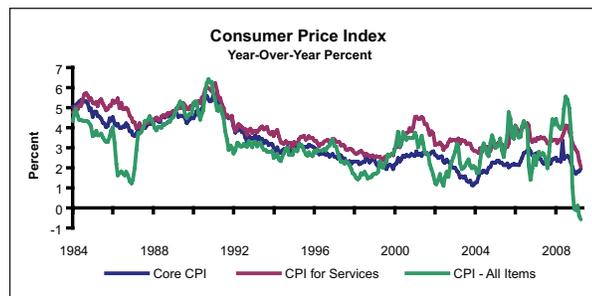
body (including government representatives): label them thieves and target tax them. Planning to attend a conference: chastise attendees for being profligate (even as the G20 representatives spend wildly on their own photo-op boondoggle). You desire that UAW members gain from bankruptcy and threaten secured senior debt holders. We had high hopes that the Obama administration would restore the rules and processes destroyed on both the economic and social front. Sadly, they have subjected us to perhaps even greater arbitrary over-reach. It boggles the mind that they are wantonly ignoring contractual rights even as they beg investors to accept subsidized government funds to restart capital markets. Do they not see the contradiction?

It is laughable that the government's new TALF and PPIM programs rely on rating determinations by the same rating agencies who have been clearly discredited. It seems the old adage "close enough for government work" applies. Similarly, why do they continually say that PPIM will buy "toxic" assets, when they are strictly focused on AAA-rated instruments? After all, Simon Properties bonds are rated A-, so if the ratings mean anything, the debt to be purchased is far less "toxic" than Simon debt. If they really want to buy toxic assets, why not focus on the sub-AAA assets?

Some \$30 trillion was knocked off the peak market value of global equities, including \$7 trillion in the U.S. If you think this was because of subprime loans, you have to explain how \$1.3 trillion in total face value can destroy so much value in so many disparate places. It was the flight to cash in the face of arbitrary government decision making that crushed asset values. It is what has driven investors out of markets causing excess volatility and abnormal levels of illiquidity. This is seen in the fact that while over the last 50 years, only 1% of trading days saw increases/decreases of more than 3%; since the governmental madness began in September, 38% of trading days exceed 3% changes. Furthermore, half of the 50 most volatile trading days (in percentage terms) since 1950 have occurred since September 2008. We beg you, please stop helping us!

The result is that cash held at banks (the monetary base) doubled during the last two quarters of 2008 from \$832 billion in June to \$1.6 trillion in December. It increased nearly another \$120 billion in the first 5 months of 2009. Similarly, checkable deposits and currency, small time savings deposits, and money market fund shares increased by \$1.3 trillion or 13% on a combined basis over the second half of 2008 and into the first quarter of 2009, rising from 7.0% of total financial assets to 8.3%.

Meanwhile, bank excess reserves have soared from \$2 billion in August 2008, to \$844 billion in May 2009. As a percent of total reserves, they rose from 4.5% in August to 93.5% in May, while as a percent of required reserves, excess reserves rose to over 1,400%. In September 2008 alone, excess reserves rose by \$58 billion. They rose an additional \$208 billion in October, a further \$290 billion in November, and \$208 billion in December. All this occurred even as required bank reserves rose by a mere \$11 billion.



To grasp the magnitude of this, if we exclude the 9/11-induced panic in September 2001 (which drove excess reserves to 33% of total reserves), the 50-year average to August 2008 was 2.6%. Similarly, as a percent of required reserves, excess reserves have been between 1-5% over the last 50 years. Massive amounts of cash are sitting with the Fed and on company balance sheets. History tells us that banks do not operate with \$700-800 billion excess reserves for very long.

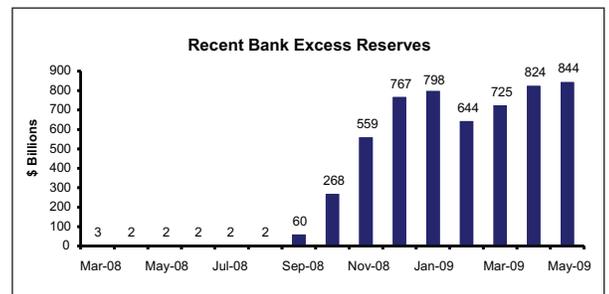
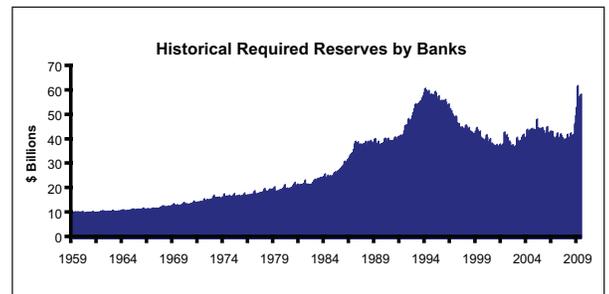
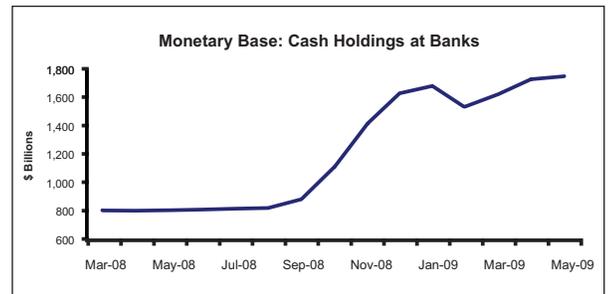
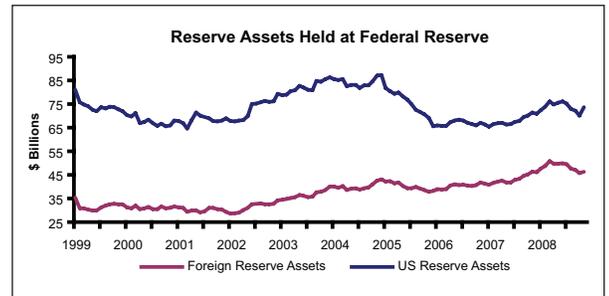
These unprecedented bank excess reserves, combined with the enormous increase in cash holdings, mean that as banks begin to lend their excess reserves and the velocity of money begins to rise, there will be a stunning surge of liquidity chasing goods, services, and assets. In theory, the Fed will perfectly foresee these changes in velocity and will perfectly take money out of the system by selling (instead of buying) bonds and by raising interest rates. This would sop up excess liquidity, thereby avoiding asset and consumer price inflation. But if you believe that the Fed is prescient, you have not been paying attention.

At best, Fed efforts will lag by 6-24 months, leaving the potential for a rapid, double-digit spurt of inflation. Realistically, we expect to get a spurt of inflation as high as 10%, even as the Fed tries to shrink the monetary base.

Faced with red hot government printing presses, "gold-bugs" (such as Steve Forbes) cry for a return to the gold standard, which was abandoned by the U.S. in 1971. Their claim is that since nothing backs paper money, there will be excess money creation and inflationary debasement of the fiat. However, the gold standard has experienced numerous instances of high inflation following new gold discoveries. For example, hyperinflation, not booming prosperity, occurred in Spain following the Spanish gold discoveries in the New World. And deflation and crashes occurred when the production of gold lagged economic growth potential, as the linkage between extraction and potential growth is extremely tentative at best (and indefensible at worst).

Gold standard monetary systems also experienced high inflation whenever the government changed the paper-to-gold exchange ratio, or simply decided to go "off gold" and print paper money to cover rapidly rising government spending. The crux of the matter is not gold-backed paper, as governments have frequently repudiated this policy overnight. The real issue is disciplined government spending and balanced budgets. Money printing rampages are always completely about a deep lack of spending restraint by government (such as today), not about whether gold-backed or fiat paper is being debased. The "gold-bugs" fail to grasp this fundamental truth.

The U.S. has historically been among the most disciplined nations in terms of government spending (though we will see whether that will continue). This may be sad, but it is nonetheless true. In recent history, the U.S. government spends 18-21% of GDP, versus



40-60% for most of the world. In the extreme, if a country's government only spends 1% of GDP, it can pay for this spending by printing paper equal to at most 1% of GDP. But as government spending rises, so too does the temptation to print money rather than tax. Runaway government spending (relative to the willingness to pay taxes) is a necessary precedent to rapid currency debase-ment. Hence, there is the fear of inflation in the current environment. Federal spending will rise by 8-12% of GDP in a year, as the tempta-tion to "run the presses" to pay for this spending will be very difficult to resist. This is equally the case with or without a gold standard.

How will commercial real estate fare in the face of an inflationary spurt? If higher inflation is limited to a 100-200 basis point increase which lasts for a year or so, the effects will be of secondary order on both property cash flows and values. However, it will crush highly levered floating rate borrowers who are barely above water at near-zero short-term rates. If the inflationary surge is larger, it will favor those with short-term leases (like hotels and multifamily rental) and properties with large near-term rental rollovers. It will also favor those with long-term fixed-rate debt, as they will be able to repay their debt obligations with unexpectedly debased currency. For example, 2% of unexpected inflation reduces your real debt liability by 15% over seven years. The hardest hit will be owners who mismatched long-term leased properties with loads of short-term debt, as their incomes will not rise in spite of rising inflation, even as their debt service soars.

Real estate would be a favored asset if that spurt occurred, especially if you have shorter leases, such as with multifamily, and if you have long-term fixed-rate debt. If you get a spike of inflation, it is always good to have the ability to increase revenues, while keeping interest costs fixed. So right now, we are bullish on multifamily in strong markets financed with long-term debt. It is the best positioned asset to cope with a spurt of inflation, in that you can renew your leases to reflect inflation, but your cost of capital will not immediately be re-priced.

When the inflationary spurt will happen is difficult to predict, as economic analysis is poor at predicting timing. Further, the roles of psychological forces and government policy far outweigh economics in this instance.

The magnitude of the current liquidity situation is unprecedented, rendering historic comparisons of little use. Our intuition is that the inflation of assets and consumer prices will be well underway by mid-2010. To the extent that the inflation spurt hits asset prices, it will reverse much of the \$9.5 trillion (16.2%) decline in real household wealth which occurred in the past year through the first quarter of 2009.

