THE LINNEMAN LETTER

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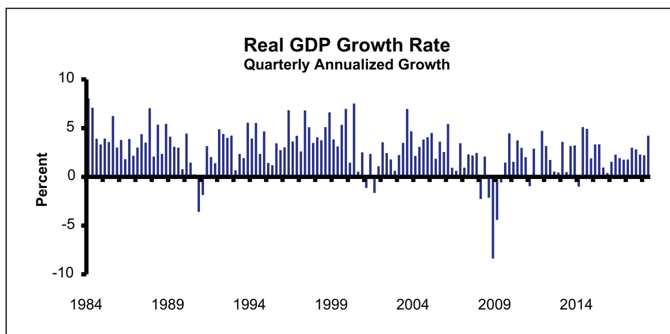
> *"When government fears the people, we have liberty. When the people fear the government, we have tyranny."*
> ~ Thomas Jefferson

Getting Better All The Time

The recovery has gained notable steam and is now 37 quarters long through the third quarter of 2018. We have achieved what you were told by most economists (but never by us) was impossible: growth in excess of 3%. But as we have written in the past, this is simply a return to historically normal growth. It is amazing what closer-to-market interest rates, lower taxes, and a reduced regulatory agenda can achieve!

The Keynesian model failed to predict: the Great Recession, the non-stimulative impacts of "shovel-ready stimulus" spending, the massive failure of federal deficits to stimulate growth, the extreme reductions in interest rates, and the unprecedented quantitative easing (QE) policy implemented by the Fed. So it is no surprise that the Keynesian model has failed just as miserably to forecast the strength of the economy over the past 21 months. Instead of dying, growth has taken off over this period, fueled by enabling people to keep more of their money, interest rates nearer to market rates, and reduced regulatory interventions. In the second quarter of 2018, the economy grew by an annualized 4.2% even as Keynesians declared that the days of U.S. growth in excess of 2.5% were long gone. In this regard, we are reminded of Mark Twain's comments about rumors of his death being grossly exaggerated. In the meantime, robust growth of about 4% per annum continues.

On a per capita basis over the past 20 months, real GDP growth has been 63% greater than during the Obama years, even though Obama-era growth came off of a cyclical low. The current growth not only helps individual households but also puts more tax revenue in government coffers. The CBO now forecasts that



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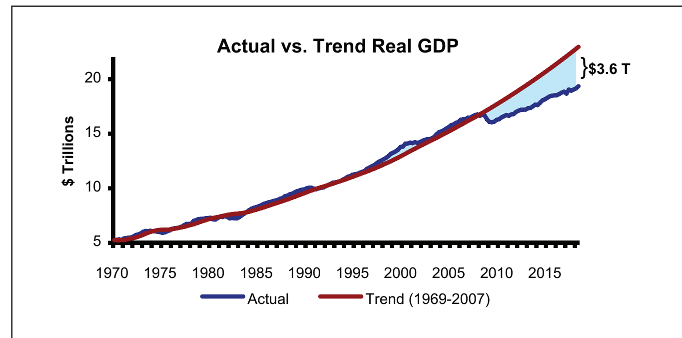
the additional growth-driven tax revenues will pay for 88% of their originally forecast "lost revenue" from the Trump tax cuts over the next decade. In contrast, the CBO estimates that during the low-growth Obama economy (2013-2016), the federal government lost more than $1 trillion a year in revenue. Our simple guesstimate of the lost federal tax revenue associated with the below-trend growth of the U.S. economy during the Obama era is that if 18% of the cumulative real GDP shortfall was collected as taxes, it would amount to $3.4 trillion over the period 2009-2016.

Those who favor greater government spending have always underestimated the impact of letting people and firms keep more of the money they earn. All too often, these observers have the luxury of non-incentivized jobs in government and universities, so they say that people do not do more if they are allowed to keep more of what they earn. But even if a 20% reduction in effective tax rates has no incentive effect on 90% of economic participants, if the remaining 10% are just 10% more productive, it boosts total economic activity by 100 bps annually. Hence, one could observe most people (especially government employees and university professors) doing nothing more, and yet, economic growth is surging.

Those who favor greater government spending have always underestimated the impact of letting people and firms keep more of the money they earn.

Government spending remains too high and continues to crowd out more productive private borrowing. Also, short-term interest rates that are still artificially too low are suppressing single-family housing starts, though this impact is dramatically less than 1-2 years ago. The 10-year cumulative real GDP shortfall is now in excess of $19.3 trillion ($59,021 per capita). That is, we have needlessly lost about a year of income over the past decade.

As short-term rates have risen, middle-income families are discovering they are being paid more interest on their 6-month to 2-year CDs and bank accounts. This higher interest income fuels their spending and boosts the economy until the real (inflation-adjusted) rate exceeds 3-4%. Higher short rates spur growth, particularly because single-family housing starts rise as the additional safe interest income enhances down payment capacity required for home buying.



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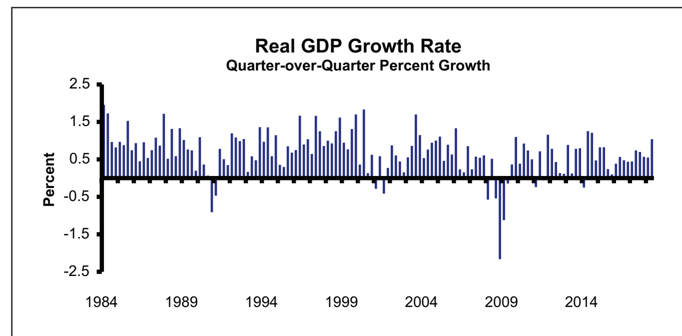

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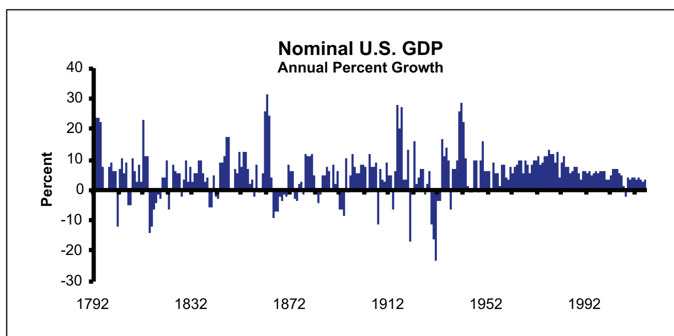

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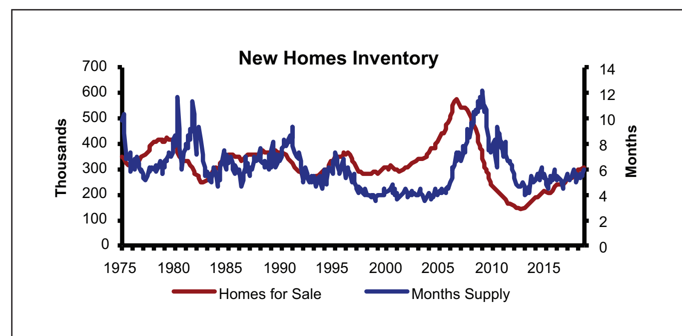

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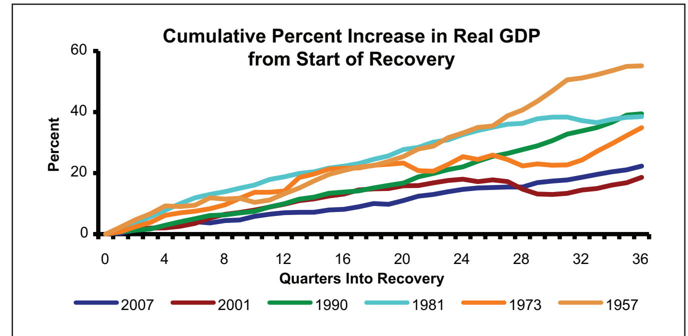
As the short rate increases toward market rates, capital will be better allocated, triggering greater growth.

The short-term rate is still at least 100 bps below the market rate. As the short rate increases toward market rates, capital will be better allocated, triggering greater growth. Only when the Fed in their infinite wisdom raises the short rate well above market level will the economy slow due to the misallocation of capital. High or low rates do not inherently inhibit growth; but rather, growth is harmed by large deviations (either above or below) from market rates.

Annualized GDP growth reached the long-elusive 3% threshold in the second quarter of 2017, dropping to 2.8%, 2.3%, and 2.2% in the subsequent three quarters, respectively, before jumping to 4.2% in the second quarter of 2018. We expect the current recovery to accelerate due to the absence of excesses in single-family housing, autos, and commercial construction. Consumer and business confidence remain solid. Also, a strong labor market exists with solid job growth, low unemployment rates, real wage increases, and weekly unemployment claims at 40-year lows. Year-to-date through mid-September 2018, new weekly unemployment claims averaged 222,000, with the latest standing at just 204,000. As a percent of the labor force, they are at an all-time low of 0.13% today versus the long-term average of 0.30% and the cyclical lows of 0.20% registered in 1968 and 0.18% in 2000.

Since recoveries end either due to seriously flawed policy decisions or consumer and business excesses, we continue to monitor for signs of excess. After bottom-



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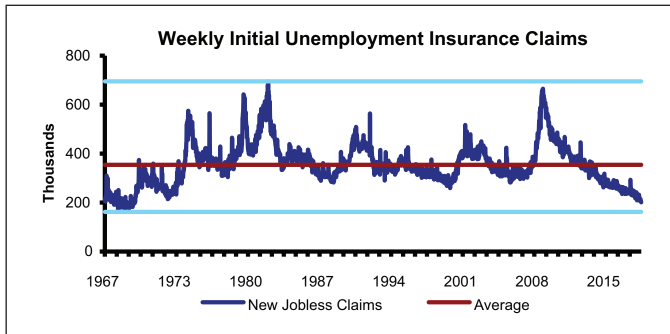

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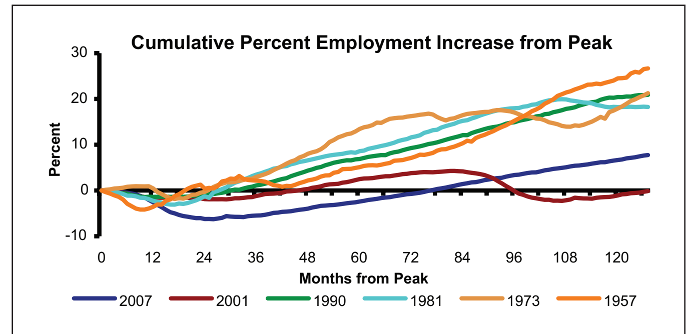

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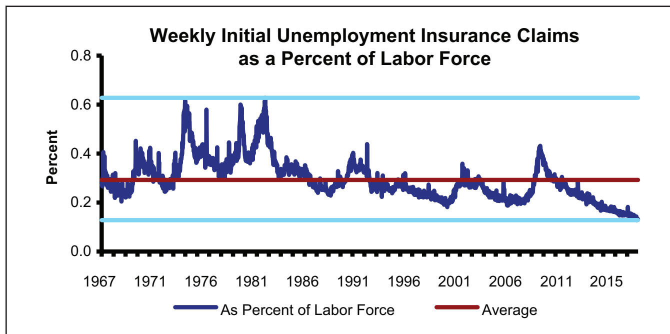

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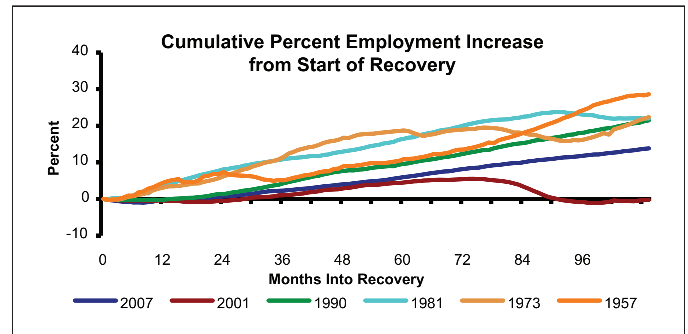

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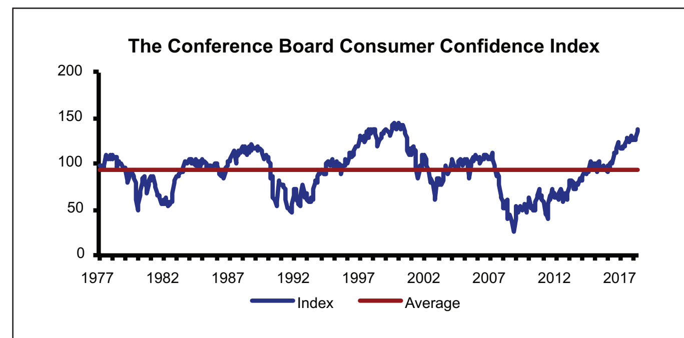
ing at 25.3 in 2009, the Conference Board Consumer Confidence Index stood at 133.4 as of August 2018. This is 4,050 bps above the 50-year average (1977-present), 1,300 bps higher than a year earlier, and 2,220 bps above the 2007 pre-recession level of 111.2. The University of Michigan Consumer Sentiment Index stood at 95.3 in August 2018, 930 bps above the 50-year average of 86.0 and 4,000 bps above the 2008 recessionary low of 55.3. Taken alone, consumer confidence appears to approach excessive levels, but viewed with the muted performance of other indicators, there is no need to sound the alarm.



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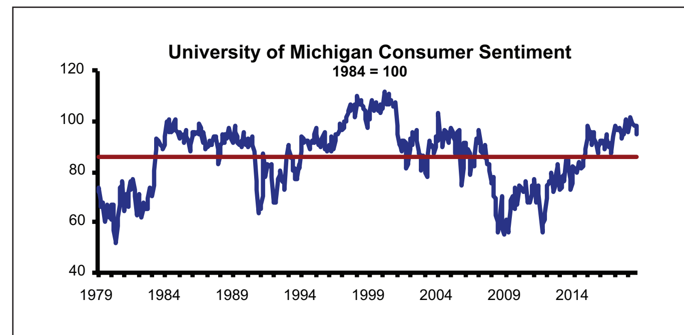

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About Dr. Peter Linneman

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 fourth 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, and was named among the top 30 "Most Influential People in Real Estate" by Commercial Property Executive in 2013.

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*.

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