This is an excerpt from the Winter 2012-13 issue of *The Linneman Letter*.

Volume 12 Issue 4

Economic Martial Law Is the Rule of the Land

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

> *"The democracy will cease to exist when you take away from those who are willing to work and give to those who would not."*
>
> *"My reading of history convinces me that most bad government results from too much government."*
>
> *~ both quotes attributed to Thomas Jefferson*

Martial law is the imposition of extreme government measures that severely limit normal activities. In free societies, these measures are usually brief and associated with emergencies such as 9/11, hurricanes, floods, and other far-reaching disasters. History is filled with "temporary emergencies" stretched out by tyrants for years, and even decades, to restrict individual liberties.

Late in the Bush administration and accelerating through today, a "temporary" economic crisis spurred government officials to implement measures to "impose order." These measures include: TARP; bailing out favored companies; regulations hurriedly passed with little if any definition of their substance (Dodd-Frank and ObamaCare spring to mind); interpreting the opening of non-union facilities in South Carolina as a violation of labor laws; unprecedented levels of government "stimulus" spending; unimaginable amounts of monetary intervention; and the imposition of an artificial interest rate environment. Even if these moves are economically correct (which we do not believe), it is democratically harmful for an unelected branch of the government, such as the Fed, to deviate so far from its contemplated role. These intrusions have seriously reduced economic liberties and undermined market forces. We are now almost five years on, and this economic martial law is increasingly looking like the "temporary" measures permanently imposed by despots. Enough is enough. It is time to return to normalcy by eliminating economic martial law, which distorts and erodes market forces. Only then will we get the predictability and signals that allow the "invisible hand" to create economic growth once again.

As a first step, the Fed must raise interest rates. No investor knows how to work in today's interest rate landscape, which discourages risk-taking and confiscates income from savers. Capital markets are filled with fear-driven safety seekers reacting to serial government

Table of Contents

Economic Martial Law Is The Rule Of The Land
The Weak Recovery Goes On And On, And On
But Deficit Spending and Uncertainty Continue
What Goes In Must Come Out Eventually
And The Winner Is...
Another Look At Income Inequality
Household Debt Drops Post-Recession
Will Office Use Per Employee Rebound?
Energy Sector Game Changers
Real Estate Capital Markets
Housing Market Update
The Euro Must Go
Look-Back To Summer 2009: Global Recession Threatens European Union
Look-Back To Spring 2003: Is The Euro Doomed?
Market Close-up: New York City Office
Market Close-up: Miami Industrial
Market Close-up: Phoenix Multifamily
Market Close-up: Las Vegas Hotel
Office Market Outlook
Industrial Market Outlook
Multifamily Market Outlook
Retail Market Outlook
Hotel Market Outlook
Seniors Housing And Care Market Outlook
Vacancy/Occupancy And Absorption Projections

NAI Global
Commercial Real Estate Services, Worldwide.

For more information about a subscription to *The Linneman Letter*, contact Doug Linneman at dlinneman@linnemanassociates.com.

LINNEMAN ASSOCIATES

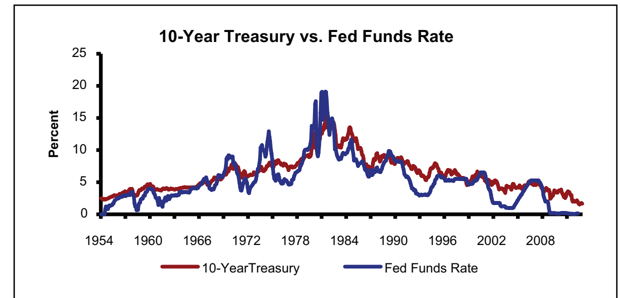
manipulation. We need risk takers, not economic martial law, to drive the economy forward.

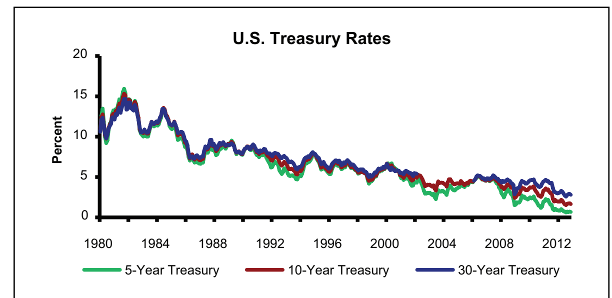
Investors cannot price risk when they do not understand it, rendering the efficient allocation of capital impossible. When negative real rates prevail for sustained periods of time for government debt, all other risk assessments become extremely challenged, as the benchmark for risk assessment has been eliminated. This forces investors to operate in an environment they have never before experienced, causing more uncertainty and less growth.

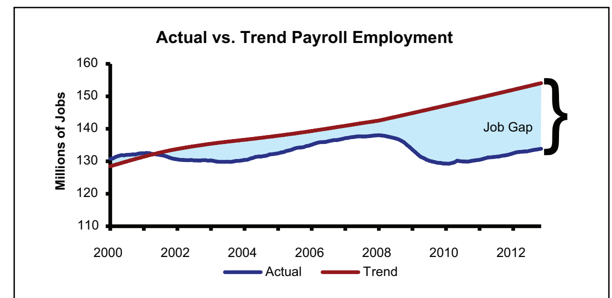
The imposition of economic martial law is why all economic forecasters, including us and those in government, have been so consistently wrong in their forecasts, and why crystal balls remain cloudy. All of these models assume basic market behavior within the context of a fairly stable set of rules. But with economic martial law and the constant changing of rules destroying market stability, all market-based predictions are undermined. Five years ago, we would never have dreamed that the money supply would have quadrupled, that interest rates would be so manipulated, that regulations in healthcare and the financial sector would be so far-reaching and ill-defined, that the Bush tax cuts would still be unsettled, and that a regulatory explosion would have occurred. And yet here we are.

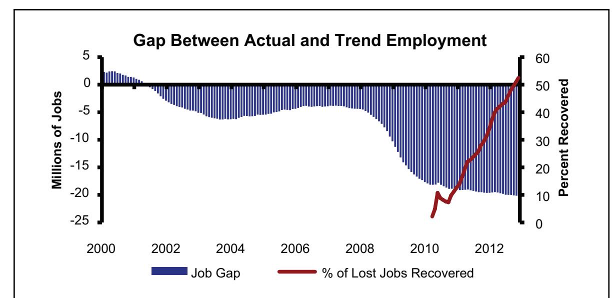
Real GDP growth remains 250-300 basis points (bps) below what would be expected following such a severe recession. Real GDP also continues to fall farther behind its long-term trend, and now stands $2.3 trillion or 1.04 standard deviations from where it should be. This represents about 14.7% of GDP. At an average of 8.5 million jobs for every $1 trillion of GDP, this implies a 19.6 million job shortfall for Americans. Alternatively, our employment trend analysis reveals that the U.S. remains 20.2 million jobs (1.03 standard deviations) below historical trend. We still have regained only 52.5% of the 8.9 million jobs lost during the recession. We have added just 416,000 jobs over the last three months (a mere 1.66 million annualized) and a tepid 1.9 million jobs over the past 12 months through November. At the current pace, we will not recover all lost jobs until 2015.

Commercial real estate remains hamstrung by the weakness of the nation's macroeconomic recovery. Of the key economic metrics displayed in Figure 5, only real after-tax profits, which have risen 2.2% year-over-year, have far surpassed pre-recessionary levels – though they are only 0.14 standard deviations above trend. Home prices are lagging due to excess (but rapidly declining) inventory. However, basic shortfalls have finally pushed single-family and multifamily housing upward. Other key indicators, including real GDP per capita, real retail sales, real median home prices, durable and non-durable industrial output, capacity utilization, payroll employment, multifamily starts, and median home prices, are more than 1 standard deviation below their respective historical norms.







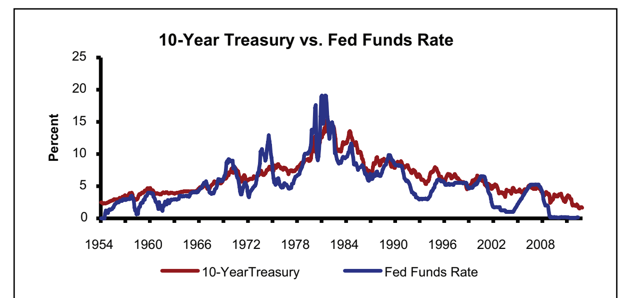


On the Road to Recovery

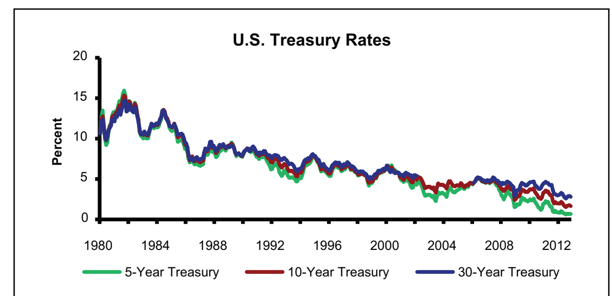
	Pre-Recession Best	Recessionary Worst	Current*	% of Loss Recovered	Predicted Trend**	Difference From Trend	% Growth Needed To Achieve Trend	Std. Dev. from Trend
Real GDP (2011 $ billions)	$15,350.8	$14,630.9	$15,726.9	152.2	$18,040.9	-$2,314.0	14.7	-1.04
Real Per Capita GDP	$50,735.3	$47,716.1	$50,072.2	78.0	$56,668.4	-$6,596.2	13.2	-1.03
Real Retail Sales (2011 $ millions)	$364,204.2	$310,919.3	$356,093.3	84.8	$417,776.4	-$61,683.0	17.3	-1.03
Real Median Home Price Index	225.2	179.9	187.9	17.6	284.7	-96.9	51.6	-1.07
Durable Industrial Output Index	102.3	74.5	98.2	85.3	117.6	-19.5	19.8	-1.39
Non-Durable Industrial Output Index	100.6	86.2	90.2	28.0	115.4	-25.2	27.9	-1.08
Real Per Capita HH Net Worth	$244,478.0	$177,383.5	$201,086.8	35.3	$235,569.6	-$34,482.8	17.1	-0.80
Payroll Employment (000s)	138,023.0	129,244.0	133,852.0	52.5	154,065.6	-20,213.6	15.1	-1.03
Unemployment Rate	4.4	10.0	7.7	41.1	5.1	2.6	-34.1	0.70
Conference Board Consumer Confidence Index	111.9	25.3	73.7	55.9	111.8	-38.1	51.7	-0.94
Median Weeks Unemployed	7.5	25.0	19.0	34.3	8.6	10.4	-54.8	0.92
Capacity Utilization	80.8	66.8	78.3	82.6	80.4	-2.0	2.6	-1.43
SA Auto & Light Truck Sales - Thousands	1,464.3	751.6	1,185.9	60.9	1,499.7	-313.8	26.5	-1.08
Median Home Price-to-Per Capita DPI	7.8	5.7	6.2	26.4	6.2	0.0	0.4	-0.86
Profits After-Tax (2011 $ billions)	$1,278.8	$783.4	$1,476.9	140.0	$1,468.9	$8.0	n/a	0.14
Percent of Industries Adding Workers (LTM Avg)	62.5	25.0	62.5	100.0	80.7	-18.2	29.1	-0.81
Multifamily Starts (SAAR 000s)***	378.0	53.0	281.0	70.2	334.4	-53.4	19.0	-5.85
Single Family Starts (SAAR 000s)***	1,823.0	353.0	589.0	16.1	1,101.2	-512.2	87.0	-0.66
Real Home Prices (2011 $)	$292,531.6	$210,269.2	$232,907.8	27.5	$268,343.1	-$35,435.3	15.2	-0.81

**Quarterly data through 3Q12; latest monthly varies, Octoberl or November 2012. SAAR indicates seasonally-adjusted annual rates.*
*** Trend data based on historical data through 2007.*
**** Housing start standard deviations compare actual to long-term averages. All other metrics are based on actual data versus the long-term trends.*

Real U.S. per capita net wealth has regained only 35% of the $68,000 loss suffered during the recession, remaining 0.8 standard deviations below its historical trend. Depressed consumer sentiment levels are restraining retail sales to a rebound of just 14.6% from the bottom, representing a recovery of only 85% of sales lost during the recession.



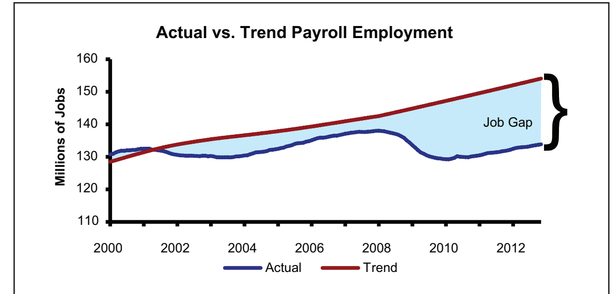
What would a full recovery to long-term trends look like for the U.S.? The $2.3 trillion GDP gap is equal to the GDP of Russia, Brazil, the U.K., or France. From a domestic perspective based on population shares, 15% of U.S. GDP is roughly equivalent to the combined economies of California and New Jersey, or of Texas and New York State. So a full recovery would mean the appearance of the entire economy of France or of two of our largest states. If the employment gap of roughly 19.6 million jobs were filled, this would require an additional 990 million square feet of office space (at an average of 50 square feet per worker), 1.5 billion square feet of occupied retail space, (at an average of 75 square feet per worker), and an increase in hotel occupancy rates of approximately 1,260 bps (at 0.03 room nights per job). In short, closing the economic gaps would generate a lot of additional real estate demand.



In addition, these 19.6 million jobs would impact the roughly 2.6 million pent-up households currently sitting in their parents' homes. An additional 1.3 million multifamily units would be occupied, which would drive the multifamily vacancy rate to 5.6% (versus 8.8% today). It would also create an additional 1.3 million single-family home buyers, creating a net shortage of 762,000 single-family vacant units, versus a net excess of 538,000 homes today. In order to keep up with these demand surges, single-family production would need to rise by roughly 1.2 million units over the next year, to 1.7 million units.

If the U.S. economy were at its full potential, the short-term interest rate would be approximately 50 bps above inflation at approximately 3%, while the 10-year Treasury yield would be 4.5-5%. At such

interest rates, cap rates would be approximately 100 bps higher, pushing cap rate spreads over Treasuries to traditional levels. However, these rate increases would not decrease property values, because the surging demand associated with an additional 19.6 million jobs and $2.3 trillion of GDP in the face of relatively fixed real estate supply would increase property cash flows more than enough to offset higher cap rates.



The argument that the economic gap is permanent because the U.S. has lost its competitiveness does not hold water, as it suggests that competitiveness was lost instantly in late 2008 and early 2009. While the U.S. labor force remains seriously challenged and our education system is disappointing (at best) at all levels, these are not sudden developments that caused the U.S. to lose competitiveness like a light switch going off. We believe that this gap is a result of the extreme uncertainty created by economic martial law and the associated market distortions.

We hope and believe that the "missing" 19.6 million jobs, $2.3 trillion of GDP, and 2.6 million households are not permanent. We believe that these gaps will self-correct, though in ways that we cannot predict. When they do, it will trigger a powerful surge of economic activity, like the Reagan recovery from the Ford-Carter era of economic malaise. However, this will only occur when economic martial law is lifted. Until then the gaps will grow.

As empiricists, we are struck by the fact that every time we have deviated from the long-term trend, the system has always somehow found its way back, much as an organism heals given enough time. Unless we have permanently devolved into Western Europe, this reversionary potential is an enormous economic tailwind, which would cover any errors you may have made in the underwriting of your real estate. Stated differently, closing the gaps will generate so much real estate demand beyond expectation, in the presence of a fixed supply, that cash flow improvements will swamp everything. Since we do not know when this occurs, real estate investors should: borrow less, in order to ensure that they are around to experience this tailwind; and borrow longer than normal, in order to take advantage of the low rates created by economic martial law.

Follow us on Twitter: