THE LINNEMAN LETTER

This is an excerpt from the Winter 2013-14 issue of *The Linneman Letter*.

Volume 13 Issue 4

From Stifled To Stellar

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The government has made a practice over the past two years of taxation without legislation. Not only has the Fed's interest rate policy robbed savers of interest income, but arm-twisting of financial institutions, most recently JP Morgan and Bank of America/Merrill Lynch, has allowed the government to extract roughly $100 billion (relative to total annual tax revenues of roughly $2.5 trillion and a federal deficit of $600 billion) without taxing authority, trial, or admission of guilt. This practice of governmental pick-pocketing is par for the course for banana republics around the world, but is new for the U.S. It underscores the power of government and the difficulty of even the well-heeled to protect themselves from "The Prince." Some things have not changed since the Borgias.

About a third of this money will go to "consumer relief" programs, which are little more than directed subsidies, while another 40% flows to government agencies (primarily those "innocent babes in the woods" Freddie and Fannie). The remainder will go to various investors. While we opposed federal bailouts from the moment they were proposed, this is hardly the appropriate way that one "taketh away," and provides yet another example of the staggering increase in capricious government behavior and the erosion of predictable rules.

While the brunt of these extractions have been borne by "too big to fail" entities, the full burden of increased regulatory activity of the past five years has primarily fallen on small firms. Some 35 years ago, we investigated how mattress flammability standards failed to improve mattress safety but crushed small mattress manufacturers, many of whom went out of business as they struggled with the high fixed costs of regulatory compliance. Our research found that while regulations burden all firms, small firms see their viability eliminated as high fixed costs decimate their profits, while larger firms amortize such costs over large bases. When it is all said and done, innovation and employment are reduced, prices increase, and consumers reap no benefit.

The lesson that small firms suffer most when regulations explode is relevant to today's muted economic recovery. When the health care system, which impacts all firms big and small, is radically changed, the burden falls disproportionately on smaller firms, which lack compliance specialists. Similarly, the explosion of regulations

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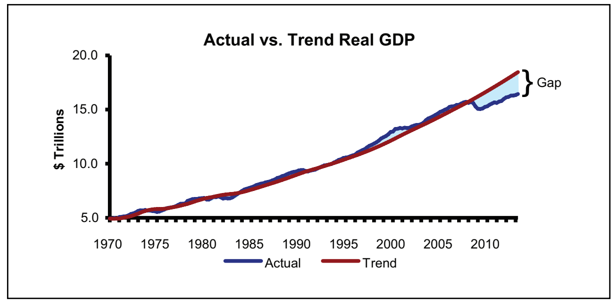
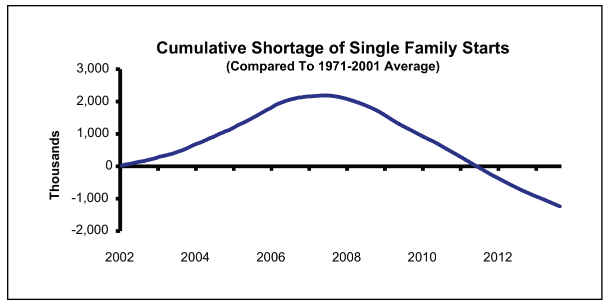
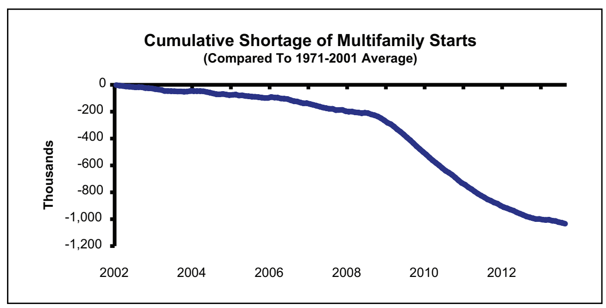
in the financial sector impacts almost every firm; but the burden falls disproportionately on the smallest ones. With only one-third of Obamacare and Dodd-Frank regulations written some three years after passage, small firms are being forced to spend valuable resources figuring out how to comply rather than how to grow, while large firms use their resources to lobby for favorable treatment rather than investing in growth. The result is that smaller firms, the lifeblood of job growth and innovation, have been handicapped and unable to grow, while large firms seek "political rents" rather than growth. Hence the muted recovery to date.



This muted recovery has occurred even as energy discoveries and innovations have unexpectedly spurred growth by 50 bps annually. Until this uncertainty recedes growth will remain muted, much as it was in the 1970s, a period of activist monetary policy, activist regulatory activity, and high political uncertainty. But the uncanny resemblance of today's economic environment to the 1970s also provides a ray of hope – great hope, in fact.



As the 1980s began, the economy was operating far below its potential; it appeared that stagflation was destiny. Meanwhile, the White House, Congress, and Fed credited their activist policies with "saving America" from even slower growth. Major cities were near bankruptcy and pension plans were hopelessly underfunded. The future of the U.S. was bleak, as Germany and Japan were widely presumed to be in ascendance to global superiority via their socialized economic policies. U.S. real GDP had fallen almost 5% below its long-term trend, with this gap widely expected to increase "in spite of" valiant efforts to mitigate it through activist government policies. And yet it turns out that this gloom and doom was the darkness before the light. In fact, what few saw was that we were about to experience one of the greatest periods of growth in U.S. history. And all it took was a government that did less rather than more.



Today real GDP is more than 10% below its long-term trend, employment growth languishes, cities are near bankruptcy, and pensions are hopelessly underfunded. All of this supposedly despite salvation via activist government policies. Could the message be clearer? Less is more – far more.

In fact, the seeds of an enormous recovery are already sown, because we have done so much less economically in the face of activist government policies over the past six years. A dramatic example is that over the past decade, starting from a position of normalcy, we have produced 1.3 million fewer single-family homes than in a normal decade. That is, we have under-produced single-family homes by about 10% over the past decade. This represents roughly $400 billion in pent-up economic activity. We also have under-produced multifamily housing by about 1 million units over the past decade, representing an additional pent-up demand of roughly $250 billion. Add to this another $200 billion in forestalled home repair and renovation, plus $200 billion in forestalled auto purchases, and one quickly arrives at more than $1 trillion in pent-up economic activity. That is, about half of today's GDP shortfall is attributable to the housing and auto sectors alone. All it will take is a bit of certainty to unleash this pent-up demand.

When will certainty return and trigger out-sized growth? We honestly do not know. But we believe it will occur; and when it does, very good things will happen. That is, we may well be on the cusp of a new era of extraordinary growth, fueled by long pent-up demand, when we least expect it. The best evidence we can offer to persuade you is that just as in 1980, none of you believe it is possible.

What about the destructive political atmosphere in D.C.? It is awful and a national disgrace. But is it more toxic than when it appeared a foregone conclusion that Dewey would handily defeat Truman, or when Richard Nixon resigned in disgrace, or just 15 years ago when Congress was attempting to impeach President Clinton? We doubt it. Petty hatred in D.C. is sadly the norm rather than the exception. Remember that in five years, we will (probably) know when tapering will end and what will happen when it does. We will know what the Dodd-Frank regulations are and how they work. We will know how Obamacare works. We will even perhaps know if and when interest rates will rise, and how we will deal with the budget deficit. Eventually, much of today's extraordinary uncertainty will be clarified. And who knows, we may finally get a government that believes that less is more. A little clarity could go a very long way. If over the next decade pent-up demand is released, it will trigger a Golden Economic Era.

The interesting thing is that you do not have to pay for this potential upside, as it is viewed as so unlikely that no one is pricing assets in anticipation of such growth. However, it does sug-gest a conservative approach to leverage, as things could get still worse (remember the Carter years that came after the Nixon/Ford disaster and the Volcker interest rate dislocation, which was necessary to reset capital markets) before they get better. Thus, you need to be able to outlast the uncertainty in order to benefit from the very good times to come. In short, it is a great time to be a long-term value investor, but a bad time to be a highly levered short-term trader.