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The Big Picture: The Good, The Bad, And The Ugly

The onset of the conflict (dare we call it “war”) with Iran is of huge economic importance to the Middle East, Europe, and Asia. But because of the U.S. fracking revolution that began 14 years ago, the impact on the U.S. economy is relatively limited. In fact, the attendant increase in oil and natural gas prices benefits the U.S. (though it harms most consumers in the country), as we are the largest producer of both commodities in the world. This is a very different situation than 50 years ago, when the spike in these prices crushed the U.S. economy.

The Middle East holds about 48% of the world’s proven oil reserves and 30% of its production. And about 20% of world oil supply passes through the Strait of Hormuz, most of which is bound for Asia and Europe. The fact that the U.S. has enormous shale-based reserves and is about 21% of global production (versus about 11% for Saudi Arabia, 5% for Iran and 4% for UAE) means that our supply of oil and natural gas is largely unimpeded. In contrast, if it had not been for fracking, we would be a huge net importer, and the price of oil would have easily reached \$200 per barrel. Severe adverse economic fallout in the U.S. would have occurred not only because of the bombing of Iran but also the Russia-Ukraine war.

As we go to print, the price of oil stands at about \$105 per barrel, but we believe that it will revert to around \$65 per barrel by year-end 2026. Fracking is available at scale, with some degree of profitability at around \$45-\$50 per barrel. And this is a rare opportunity to expand output and make hay while the sun shines for Guyana and the tar sands in Canada, as they do not require usage of the Strait of Hormuz. This is similarly the case for the tar sands in Canada. Therefore, as the price increases above that threshold, oil producers will continue to profitably produce. As supply increases, oil prices will come down. But producers will see substantial windfall profits for a period. Therefore, we expect to see a broad-based call for the implementation of a windfall tax. That is, if only 10-15% of the economy benefits

from rising oil prices, then why not tax and redistribute to the other 85% who are paying higher prices at the pump? While we are not proponents of such a tax, we will not be surprised when it passes on Capitol Hill, especially in the run-up to the mid-term elections.

Looking back to 2025, significant events included the 9.5% drop in the federal work force, federal taxes remaining largely unchanged, the border being effectively closed, lower inflation, and events in the Middle East. None of these were easy. All were heralded by the media except the decline in the federal work force. And yet this decline is one of the most astounding economic phenomena we have seen in our life. After all, federal government employment rose by 2.6% during Trump’s first term and 3.8% during the Biden administration, before falling by 287,000 (a stunning

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9.5%) in 2025. It fell an additional 29,000 and 10,000 in January and February 2026, respectively. In fact, since federal employment peaked in January 2025, it has fallen by 10.8% (326,000 jobs) through February 2026. Interestingly, the decline began after Trump's election but before he took office. We view this decline as a short-term negative but a big, longer-term positive. It will move many workers from jobs focused on restraining growth and transferring wealth to jobs that create wealth.

Despite a weakening labor market, the economic outlook for 2026 is brighter than widely predicted. Greatly reduced regulatory burdens, fewer federal workers dedicated to restraining growth, lower interest rates (at least 50 bps this year), and less uncertainty around tariffs will fuel growth. For these reasons, we expect real annual GDP growth to be 1.5% in 2026 and 2027 and 1.8% in 2028.

While we have no opinion on the legal underpinnings of Trump's tariffs, it is a good thing that they are going to be reduced as a result of the Supreme Court's February ruling that they were not permitted under the 1977 International Emergency Economic Powers Act (IEEPA). And while it is highly unlikely that Congress will re-impose the original tariffs (as they have passed fewer bills than any Congress in recent memory), President Trump is using other legislative acts to temporarily impose 15% tariffs across the board (with exceptions). These too will be legally challenged, as they rely on a balance-of-payments (not a trade deficit) emergency — and there is no such emergency.

The net effect will be a reduction in the average effective tariff from around \$10 per \$100 of imports seen in 2025, to about \$5 per \$100. This is higher than the \$3 per \$100 average which prevailed for the seven years prior to 2025 but is massively lower than what registered in 2025. Tariffs are effectively taxes, which like direct taxes, slow the economy. So a lower tariff will reduce the economic drag in 2026. The average tariff will fall primarily because of enormous drops on goods from China, Vietnam, and Brazil.

Despite the slow-down due to the substantial tax increase on imports in 2025, the private sector has adjusted and moved the economy forward. And while tax revenue has roughly quadrupled, the amount of tax revenue raised is never a gauge of the economic effectiveness of a tax.

Getting To “The Right” Interest Rate

We are honestly perplexed by the rise in long-term interest rates as oil prices have risen. We expected the yield on 10-year treasuries to decline in a flight to safety as the Iran bombings ramped up. Instead, they have risen around 30 bps. The common explanation is that high oil prices will cause higher inflation as the impacts of higher oil prices work through the economy. But this is an unlikely scenario. Even a cursory inspection of the history of oil price spikes reveals that they are generally very short lived. The obvious exception was the 1970s. But at that time the U.S. was a relatively limited and high-cost producer. In addition, an array of ill-conceived regulations placed constrictions on U.S. oil production at that time. Further, the world economy was massively more oil dependent, and fewer supply alternatives existed.

As oil supply expands in the Americas and Russia over the coming months, oil prices will recede fairly rapidly. With the benefit of 20-20 hindsight, we expect this to be yet another temporary oil price spike. Further, for the 10-year yield to rise due to inflationary fears, oil prices would not only need to rise this year but also would need to rise notably year after year. This is because a one-time price spike would show up in inflation initially but thereafter have no inflationary impact.

As a result, we encourage those needing to borrow or refinance over the remainder of 2026 to be patient and let the long rate decline as this inflationary fear effect on long rates diminishes.

With regard to the short-term interest rate, many observers have reacted to dissenting votes at the Fed by suggesting that policy dissent is a bad thing. But nothing could be farther from the truth. Fed dissent is healthy, as it represents an escape from the groupthink that has been the norm at the Fed for far too long. Finally!

Rate decisions are complicated, particularly since the experience of the 2010s exhibited no relationship between interest rates and inflation. Specifically, the Fed kept rates near zero, yet instead of runaway consumer price inflation, we saw a decade of muted inflation. This result was exactly the opposite of what the Fed's model predicted. One would expect that this model failure would have created considerable disagreement over setting interest rates over the last five years.

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Instead, members have bowed in unison at the altar of an obviously flawed theory.

The linkage between short-term interest rates and inflation was always tenuous, as it depended on banks borrowing higher or lower amounts from the Fed to meet reserve requirements as the short rate fell or rose. This linkage disappeared after massive QE injections gave banks staggering excess reserves irrespective of where the interest rate stood. This was evident in the 2010s when the Fed kept the rates near zero, and yet there was only 1-2% consumer price inflation. In spite of this experience, the Fed acts as if a 25-bp rate decrease will create runaway inflation. We believe that the short-term interest rate should be 50-75 bps above inflation in order to properly allocate capital between long-term (risky) and short-term (safe) assets.

The short-term interest rate is artificially dictated by the Fed and impacts longer rates as well as the prices of risky assets. A short-term rate that is set too low generates an insufficient short-term real return, while one that is too high pulls investments from long and risky assets to short and safe assets. Such capital misallocations directly slow the economy, though with a lag.

For the past three years, the short-term real rate has been way too high, adversely impacting the economy and restraining capital flows into long/risky assets. Only as the Fed has belatedly lowered rates has the pricing of longer-term and risk assets improved. And even after the Fed's rate cuts in late 2025, short-term rates remain about 75 bps too high. This is because inflation excluding owner equivalent rent (which no one pays) has been 2.1% for the past two years, 10 bps below the 1989-2019 average. Since the effective short rate is 3.6%, it remains 150 bps, rather than 50-75 bps, over inflation. Thus, a full 75-bp cut is needed.

Not only is the Fed's monetary policy theory flawed, but a key metric (CPI) used to determine whether to adjust monetary policy is also flawed. The rate of actual consumer inflation (CPI less shelter) has fully normalized for the past two years at 2.1% annually. What no one (other than us) notes is that this is in line with the average of 2.2% per annum over the 30 years prior to the pandemic. That is, for the last two years, inflation has returned to its 30-year norm. Interestingly,

it was -0.5% from September 2025 through the end of the year.

The higher headline consumer inflation rates have been driven by seriously mismeasured housing inflation. The concept of owner equivalent rent is almost a quarter of the CPI calculation, yet it is a meaningless measure. It has run 3.3-6% over the past two years, seriously distorting measured consumer price inflation, as no consumer has ever paid this component. Another housing related distortion derives from the fact that CPI indicates that rent paid by renters has increased 3-5% over the past two years when all apartment data sources indicate basically no rent increases. This rent component, which is 12% of CPI, further distorts the inflation picture.

The key factors that caused the inflation spurt in 2022-2023 were the worldwide shortages of goods, services, and labor as the world opened back up and to a much lesser degree, notable monetary expansion. But these factors have been absent for the past two years, hence the normalization of inflation. And inflation will not return unless these factors return.

Another false narrative is that the rise in oil prices will create inflation that the Fed should counteract by raising rates. Putting aside the question of whether rate movements have much impact on inflation, this argument is seriously flawed. The Fed should be concerned about monetary inflation, not inflation caused by real phenomena such as wars and hurricanes. Nothing the Fed does can affect these factors, and as a result, they would merely be acting to show that they are acting.

Even worse is that an increase in interest rates in an attempt to reduce inflation (again, over which they have no control) simply means that those sectors which are sensitive to interest rate increases will be harmed. This will further damage parts of the economy associated with higher oil prices. This is a counterproductive policy unless the Fed changing interest rates magically opens the Strait of Hormuz or stops a hurricane from doing damage. But that is absurd. These real economic changes have nothing to do with the Fed.

Tinkering with the interest rate is simply needless interference in an already strained economy. Imagine the Fed saying that they are going to increase interest

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rates immediately after any major hurricane to offset the localized impacts of shortages created. Such a policy would be completely wasteful and have no impact on inflation. This is one of the basic tenets taught early in an economics course. If the Fed raises rates in an attempt to offset inflation created by increased oil prices, we recommend that they retake these basic courses. Such actions have never worked (and never will) to offset inflation but merely create economic distortions and slow the economy.

In the end, while we believe a 50-75-bp spread over inflation is the appropriate target, we expect that new Fed appointees during the Trump administration will advocate for an even lower 25-50-bp

spread. As such, they will push for cuts 25-50 bps larger than we would propose. If they cut rates even further than our target in 2026, the attractiveness of long-term risk assets like apartments will dramatically improve in 2026-2027. This will increase capital flows into real estate. Since our research shows that as capital flows increase, cap rates decline, there will be notable downward pressure on cap rates. This will occur as NOIs are rising due to reduced supply pipelines generating rent and occupancy improvements. For developers with capital and courage, now is the time to start development in order to harvest the benefits of this improved environment 2-4 years from now. While many developers have one, few have both!

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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*, edition 5.3. 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. Most recently, Dr. Linneman co-authored (with Dr. Michael Roizen and Albert Ratner) the best-selling book *The Great Age Reboot: Cracking The Longevity Code For A Younger Tomorrow*.

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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