The Linneman Letter

Celebrating 25 Years

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The following is an excerpt from the Winter 2025-26 edition of The Linneman Letter.

Counter-Narrative: The Key Driver of Cap Rates

Another counter to the prevailing narrative is our research finding that real estate cap rates are driven primarily by the flow of funds. We have noted that the flow of funds is below normal based on the Linneman Real Estate index, depressed transaction volumes, and substantial private equity dry powder. This is in part due to the abnormally high short-term, low-risk real rate of return created by the Fed's too high interest rates. Some have countered that money flows in the economy must be loose today because stock market valuations are at record highs and this could only occur in a loose money regime. But stock valuations are not high for mid-cap value stocks or real estate. Rather, they are very high only for the 10-20 tech stocks whose lofty valuations are driven by the future of AI. Their stock prices appear to be a bet on AI being a "jump" technology in terms of productivity. For example, if U.S. productivity growth jumps from 1.5% a year to 3% a year, these companies will reap huge profits beyond any normal metric. If they harvest this additional 1.5% of GDP, it translates to $450 billion a year. Such a productivity jump will generate trillions in value for these companies. However, if (as we suspect) AI is simply the most recent variant of how the 1.5% annual productivity growth occurs (joining a long list of other life changing technological innovations including internal combustion engines, electricity, computers, etc.), today's valuations for these companies will be very disappointing as the profits to be garnered are not "jump" profits but rather continuation profits. In either case, the valuation of today's stock market is driven not by loose money but rather exuberance about AI.

Counter Narrative: Inflation Update and Forecasts

High inflation in the wake of the global economic shutdown during the COVID-19 pandemic was largely the result of demand for almost everything roaring back while supply lagged. The NY Fed's Global Supply Chain Pressure Index peaked at more than four standard deviations above normal in late 2022, but was basically back to normal in November 2025, indicating that there is once again a general balance of supply and demand across the world. Hence, inflation has receded.

There are two commonly used measures of consumer price inflation: the Consumer Price Index (CPI), which is published by the Bureau of Labor Statistics (BLS); and the Personal Consumption Expenditures Index (PCE), which is published by the Bureau of Economic Analysis (BEA). Each month, prices

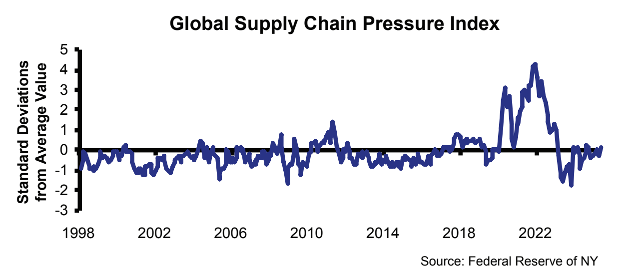

figure 1

A sample of articles available in the complete version of *The Linneman Letter*. To subscribe to *The Linneman Letter*, contact Doug Linneman at dlinneman@linnemanassociates.com.

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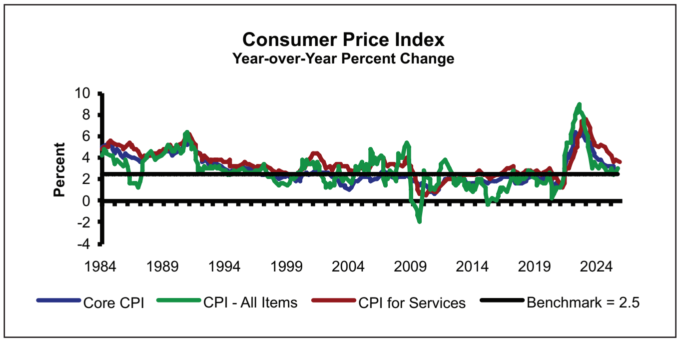

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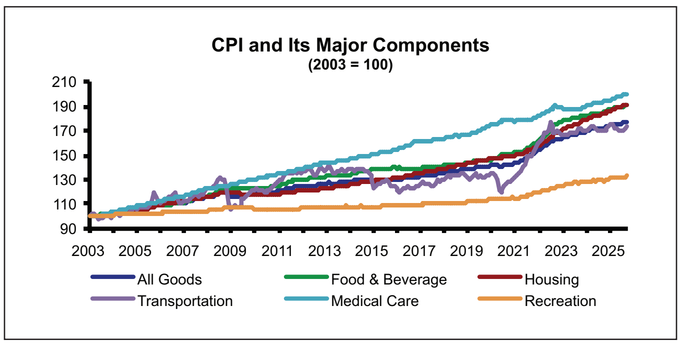

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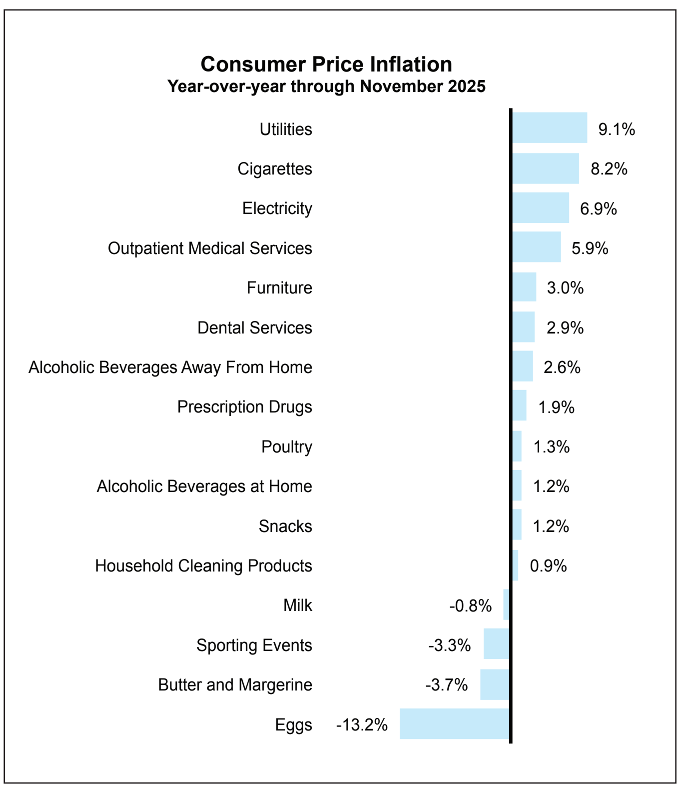


figure 4

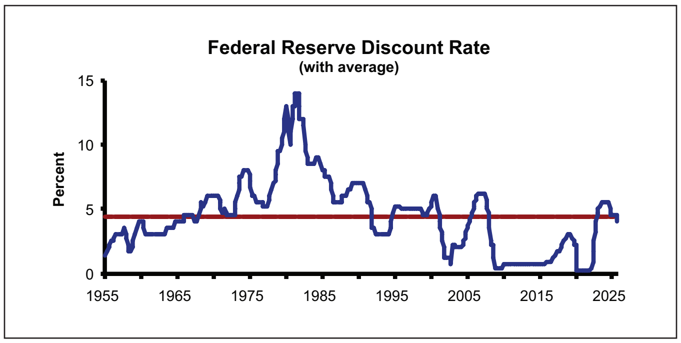
of almost 80,000 goods and services in 75 urban areas are collected. These indexes have weights crudely equal to the average share allocations (with the exception of housing) in a typical consumer budget. Of course, no one consumes this exact consumption basket. Notably, both indexes include owner equivalent rent even though no one pays it.

Due to the government shutdown, there was no CPI reported for October 2025. Year-over-year CPI inflation was 2.7% through November 2025 for "all goods" and 1.9% for Core CPI (which excludes food and energy). Year-over-year PCE inflation as of October 2025 (latest available) was 2%. But true consumer price inflation was far less due to how "shelter" inflation is incorporated into the indexes.

"Shelter" inflation has weightings of about 37% and 17% in the CPI and PCE, respectively. Therefore, housing increases PCE by about half as much compared to CPI. It is incredible that in an index with nearly 80,000 items, a single item raises the inflation rate by 100 bps (PCE) to 170 bps (CPI).

Due to the housing shortage, shelter inflation was 3.3% annually from 2015-2019, or 120 bps greater than general CPI of 2.1%. Taking an even longer perspective, from December 1990 through December 2019, the annual rate of CPI inflation excluding shelter was just over 2%. From August 2023 through November 2025, the annualized rate of inflation excluding shelter was 2.3%. This means that about half the items had inflation less than 2.3%, while the other half had inflation above 2.3%, with some prices changing a lot more or less than average. Thus, far from being high, inflation less shelter is only 20 bps higher than the average over the three decades prior to the pandemic. This underscores needlessly high short-term rates, as the Fed kept near zero rates throughout the 2010s even though non-shelter inflation was far higher than today. In fact, one would think that the 2010s would generate some humility about the Fed's inflation model, as consumer inflation stayed below 2% even as the Fed kept short rates near zero. Given that history, their concern that reducing short-term rates to 3% will create runaway consumer price inflation seems unfounded.

The "Shelter" category is made up of three components: rent, owner equivalent rent, and stays away from home. It is important to remember that shelter inflation in the price indexes is not capturing home price changes, as rising home (asset) prices benefit 65% of the population. Rather, it measures rent for renters and "equivalent rent" for homeowners. Owner equivalent rent is the theoretical rent that owners supposedly pay to rent their homes from themselves. And although owners pay no rent, 24% of CPI and 12% of PCE are driven by this item which no one buys. In fact, it is the only item in these indexes which no one buys.



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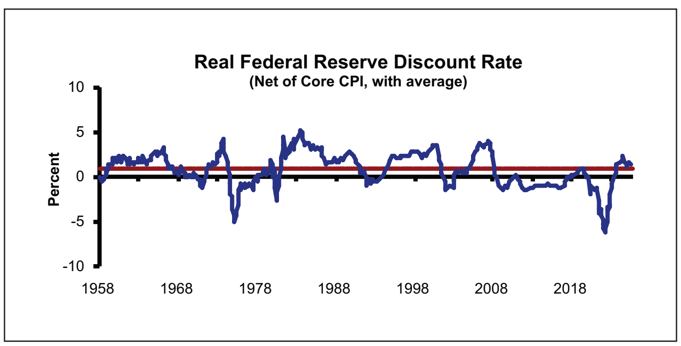

figure 6

Owner equivalent rent has increased by about 3.4% year-over-year. It is noteworthy that Europe excludes owner equivalent rent from their consumer price indexes. The simple reason is that owner-occupied housing is an asset, not a consumer good. As is the case with gold, stocks, commercial real estate, private equity, etc., owner-occupied housing should be tracked for asset inflation rather than as consumer price inflation. Owner equivalent rent is the primary source for year-over-year inflation in excess of the Fed's (arbitrary) 2% inflation target.

CPI inflation exclusive of owner equivalent rent is 2% year-over-year and a mere 1.8% annualized from April 2024 through November 2025, putting it below the Fed's 2% target. The Fed has been unable to realize this fact.

In the last four months of 2024, the Fed reduced rates by 100 bps and another 25 bps both in September and October 2025. This is too little and way too late because inflation has fallen by more than rates have been cut. The short-term rate should be about 75-100 bps above basic inflation, while the 10-year yield should be 150-200 bps above inflation. This means there remains substantial room for further rate cuts.

From August 2023 to November 2025, the CPI indicates that rents paid by actual renters rose about 3.1%. But landlords know that this is absurd. If any landlords reading this have actually increased rent by this much since August 2023, please let us know! The true range was -2% to 2%, with the average near zero. CPI absent shelter was roughly 1-2% over the past 18 months.

Inflation Forecasts. The reality is that we have had minor inflation since late 2023, as the supply caught

U.S. Inflation Outlook - Annualized Month-over-Month Percent Change of CPI

	CPI YOY Percent Change	CPI 12-Mo. Rolling Average	CPI All Items	CPI All Items Less Shelter	Core CPI	Core CPI Less Shelter	Food	Energy	Housing
Oct-24	2.57	2.58	2.75	1.59	3.24	2.95	2.57	-2.64	4.79
Nov-24	2.71	2.72	3.42	3.00	3.53	3.01	3.95	1.03	4.14
Dec-24	2.87	2.88	4.46	5.13	2.55	2.88	3.52	33.17	3.33
Jan-25	3.00	3.01	5.75	6.22	5.49	2.77	4.45	13.80	4.58
Feb-25	2.81	2.83	2.62	2.18	2.75	2.77	1.99	2.38	3.45
Mar-25	2.41	2.42	-0.60	-2.36	0.68	0.20	5.35	-25.18	2.70
Apr-25	2.33	2.35	2.68	1.92	2.88	2.33	-0.93	8.31	4.09
May-25	2.38	2.39	0.97	-0.18	1.57	1.14	3.48	-11.09	3.10
Jun-25	2.67	2.68	3.50	3.26	2.77	2.63	4.02	11.96	2.13
Jul-25	2.73	2.74	2.38	2.13	3.94	2.95	0.55	-12.08	2.84
Aug-25	2.94	2.95	4.69	4.32	4.23	3.10	5.64	8.57	5.37
Sep-25	3.02	3.04	3.79	2.51	2.76	1.90	3.02	19.71	2.50
Nov-25	2.71	2.98	2.48	4.51	1.93	3.90	0.73	13.81	2.20
Dec-25	2.89	2.99	3.65	1.80	2.97	2.81	3.13	14.03	3.36
Jan-26	2.88	3.00	3.31	1.30	2.55	1.71	2.29	15.85	2.68
Feb-26	2.83	2.99	3.15	1.30	2.48	1.21	2.05	14.57	2.74

*Forecasts Beginning December 2025 averaging prior 3 months. No data in October 2025 due to government shutdown.

figure 7

up with demand, causing price increases to largely cease. It is important to remember that inflation is not about high prices but rising prices. When supply, on average, caught up with demand, prices stop rising, but they did not fall back to previous levels.

To predict headline CPI inflation, we make simple forecasts for the next three months of CPI and Core inflation by taking the average annualized percent change over the previous three months. This method predicts that December will see CPI rise by 3.7%, followed by increases of 3.3% and 3.2% in January and February, respectively. Using the same methodology, we predict that Core CPI will increase by 3% in December, followed by 2.6% in January and February, respectively. For comparison, we forecasted what inflation would be if housing inflation was flat (which, in reality, it is). Using this method, we forecast that actual inflation for all items will increase by just 1.8% in December, followed by increases of 1.3% in January and February.

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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