CELEBRATING 25 YEARS

The Linneman Letter

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The following is an excerpt from the Spring 2025 edition of The Linneman Letter.

> *"Markets are constantly in a state of uncertainty and flux, and money is made by discounting the obvious and betting on the unexpected."* ~George Soros

The Fed's Bizarre Policy

The Fed uses interest rate policy as a very blunt tool, primarily to cool cyclically overheated housing, auto production, and manufacturing output. These three sectors are historically the sources of cyclical highs in the economy. The theory is that higher short rates raise the financing costs for these sectors, which rely on floating rate debt and dampen demand (particularly autos as 2/3rds of households borrow short term to purchase). But the pendent question is always whether these sectors need cooling in the first place, as over-cooling crashes the economy to below trend.

Even after long overdue cuts in late 2024, the monetary policy of the past two years has been bizarre. Shortly after stating that it was in no hurry to raise rates, the Fed rapidly raised rates by 500 bps in a frenzied attempt to "cool" the economy. The reality is that while real GDP is 12.2% above its pre-pandemic level, it is still 1% below the pre-pandemic trend and 9.6% below the long-term trend as of the fourth quarter of 2024. Thus, the Fed needlessly "cooled" an already cool economy.

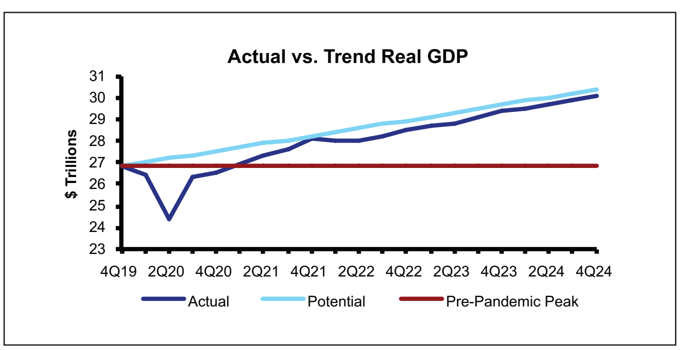

figure 1

Meanwhile, employment continues to lag the pre-COVID trend by about 4.2 million jobs (2.6%) through February 2025. Housing production, auto production and manufacturing remain under-heated due to the combined effects of the pandemic shutdown, supply shortfalls, and high short-term interest rates. There are nearly 3.6 million too few single-family units, 11.9 million autos under-consumed, and manufacturing remains below pre-pandemic levels and basically flat for the past eight quarters. Pent-up demand also remains elsewhere, most notably for travel and entertainment and healthcare. The Fed's policy of raising rates while the economy was still well below trend needlessly reduced real estate demand and constipated capital markets.

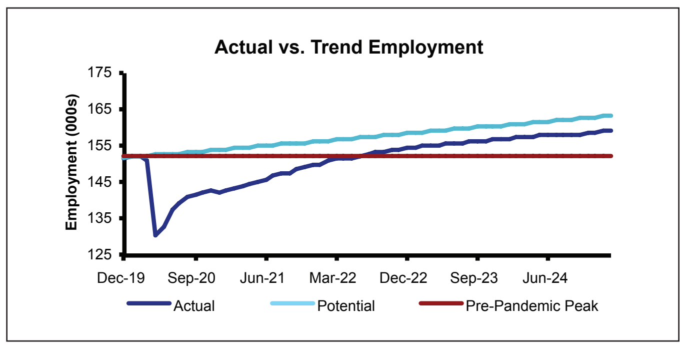

figure 2

The Fed (and most observers) saw high growth rates and rapidly rising prices as normal cyclical economic overheating. But these conditions were the results of a completely unique event: shutting down massive parts of the U.S. and world economies. Remember that five years ago, you could not go to theaters or sporting events; you could not fly to Europe or Asia; malls were closed; Vegas and Orlando venues were shuttered; unemployment soared; and bankruptcies skyrocketed. This was unprecedented. The rapid growth rates were a reflection of how low we had been, not how high we were. Rapidly rising prices reflected economy-wide supply shortages and supply chain struggles, not excessively high demand.

In addition, as we have repeatedly noted, short-term interest rates have little impact on vast swaths of the economy. State, local and federal activity, healthcare, education, and staples are all basically interest rate insensitive. Further, many borrowers locked in ultra-low rates debt in 2020-2021. Thus, about 80% of the economy has been largely untouched by the Fed's absurdly high short-term interest rates.

The Fed's (and the markets') laser focus on new economic data is ill-advised. Instead, the Fed should be focused on the broad picture. The most recent month is a tiny piece of the larger puzzle. As the Fed focuses on short-term data, the bond market follows suit to the point that it becomes like Kremlinology of yesteryear, where you are trying to interpret every comma and hand gesture. When the Fed Chairman speaks, people are guessing what they are really saying. This simply creates needless market noise. The Fed should speak and intervene far less.

A Normalized Economy

The 1% GDP gap versus the pre-COVIID trend equates to about $300 billion (about five months of normal growth) but is a huge improvement from five years ago when the economy was more than 10% ($2.8 trillion) below trend. It turns out that it took our economy about five years to basically recover from the economic shutdown. Given the magnitude of the restrictions imposed here and abroad, this is amazingly rapid.

2025 Predictions Snapshot

As we discussed in our webcast with Willy Walker in January, here are our predictions for some key indicators in 2025:

- **Interest rate cuts:** The Fed cuts at least 100 basis points
- **GDP growth:** Around 2.7%
- **Employment growth:** Around 1.8 million jobs
- **S&P growth:** A moderate increase of 7-9%
- **Crude oil prices:** Stabilizing near $68-$70 per barrel with increased U.S. production
- **Cap rates:** Fall 50-70 bps

Survey and Website Enhancements Coming Soon!

- We want to hear from you! The week of April 14th, look out for *The Linneman Letter* subscriber survey. Let us know what you like or do not like about *The Linneman Letter* and how we can improve your subscriber experience. All feedback is welcome and appreciated.
- Stay tuned for enhancements to Linneman Associates' website in the coming months. Not only will we have a new look, but we will be rolling out a data visualization dashboard that will be available to subscribers as an optional add-on. We will keep you posted!

A Growing Economy

	Pre-COVID Best	Current*	Difference from Trend	% Change Needed to Achieve Trend	Std. Dev. from Trend	Versus Trend
Real GDP ($ billions)	$26,856.5	$30,121.0	-$3,200.7	10.6	-0.72	lagging
Real Per Capita GDP	$81,655.0	$89,264.8	$2,598.3	0.0	0.22	**beating**
Real Retail Sales ($ millions)	$558,796.2	$615,297.0	$4,045.4	0.0	0.04	**beating**
Real Median Home Price Index (FHFA)	272.3	427.8	97.4	0.0	1.16	**beating**
Durable Industrial Output Index	100.4	100.9	-14.2	14.1	-0.53	lagging
Non-Durable Industrial Output Index	98.7	100.4	-7.3	7.3	-0.72	lagging
Real Per Capita HH Net Worth	$430,966.2	$491,491.5	$44,366.6	0.0	0.47	**beating**
Payroll Employment (000s)	152,292.0	159,218.0	-13,954.2	8.8	-0.65	lagging
Unemployment Rate (%)	3.5	4.1	-0.8	0.0	-0.43	**beating**
Conference Board Consumer Confidence Index	132.6	98.3	-1.8	1.8	-0.07	lagging
Median Weeks Unemployed	9.4	10.0	-3.3	0.0	-0.82	**beating**
Capacity Utilization Index	77.9	78.2	1.3	0.0	0.36	**beating**
SA Auto & Light Truck Sales (Thousands)	1,464.4	1,333.3	-26.7	2.0	-0.14	lagging
Median Home Price-to-Per Capita DPI	6.6	6.6	0.2	0.0	0.29	**beating**
Profits After-Tax ($ billions)	$2,673.1	$3,123.7	$227.8	0.0	0.29	**beating**
Percent of Industries Adding Workers (LTM Avg)	54.2	56.7	-9.8	17.2	-0.91	lagging
Multifamily Starts (SAAR 000s)	599.0	370.0	45.5	0.0	0.37	**beating**
Single-Family Starts (SAAR 000s)	1,004.0	1,108.0	202.9	0.0	0.66	**beating**
Real Home Prices ($) (Census)	$397,841.6	$438,474.0	$13,857.7	0.0	0.22	**beating**

**Quarterly data through 4Q24; latest monthly varies through Dec 2024-Feb 2025. SAAR = seasonally-adjusted annual rate.*
***GDP and employment trend lines based on 1969-2007. All others based on 1980-present. All dollars use 2024 base year.*

figure 3

At $30.1 trillion (2024 dollars) in the fourth quarter of 2024, real GDP remains 0.7 standard deviations below its long-term (1969-2007) trend, while real GDP per capita of $89,265 has been slightly above trend (0.2 standard deviations) for the last several quarters as the result of continued productivity growth. The U.S. economy is also benefitting from 40-60 bps of real GDP induced by the war in the Ukraine. This year will see growth boosted by the Trump administration's lower regulations and taxes, partially offset by tariff increases and immigration squeezes on lower skill labor. On net, despite the volatility of the stock market, we expect around 20-40 bps of real GDP growth above the historical norm of 2.5% per year.

About 78% of the long-term GDP gap relates to the massive under-production of single-family housing that began in 2008 and lasted over a decade. Production briefly hit about 1.1 million homes in 2021 before declining to around one million in 2022, 946,000 in 2023, and just over one million in both 2024 and year-to-date through February 2025. Most recently, annualized single-family starts stood at 1.1 million homes per year in February 2025, a welcome rise after the 995,000-unit run rate seen in January. However, February production represents a 2.3% year-over-year decrease versus February 2024, resulting in a cumulative (since 2002) shortfall (versus the historic norm) approaching 3.6 million units. The shortfall is about 4% of the relevant single-family housing stock and will take a decade or more to eliminate. This will remain a feature of the economy for at least the next decade.

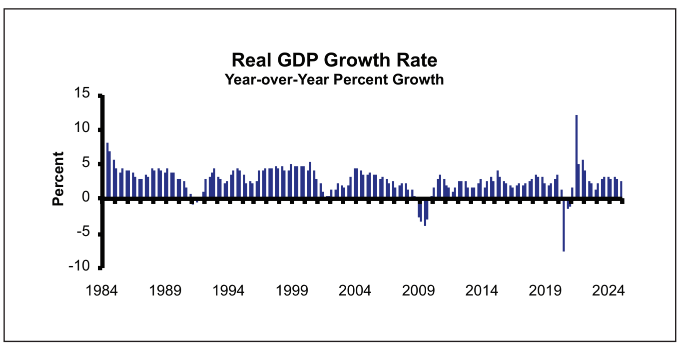

figure 4

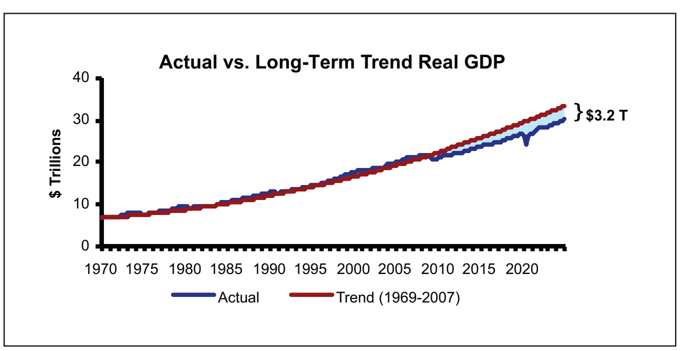

figure 5

Multifamily annualized housing starts rebounded from slow production in January, to 370,000 units in February 2025. This is well below the 614,000-unit peak seen in April 2022 but 36,000 units (11%) above the long-term average (1976-2001) of 334,000 units per year. As a result, the cumulative 21-year multifamily shortfall dropped slightly, to 346,000 units in February 2025, accounting for 3.6% of the GDP gap. The cumulative shortfall is about 0.7% of the rental housing inventory. This tightening suggests apartment rent spikes are coming in 2026-2027.

The cumulative housing sector shortfall amounts to $2.5 trillion of pent-up economic activity, while lagging auto production accounts for another $649 billion (21.2% of the GDP gap). Housing and autos combined represent the entire current real long-term GDP gap. The U.S. has produced about 11.9 million fewer cars and light trucks on a cumulative basis than the historic norm since 2019. Auto production rose by 330,000 units (2.1%) over the last year through February 2025 as short-term interest rates have come down modestly. In February 2025, auto and light truck production stood at 10.1 million vehicles on a seasonally adjusted annual basis, while coincident sales were on a 16-million-unit annual pace.

Real GDP per capita, real retail sales, real median home prices (from both the Federal Housing Finance Agency (FHFA) and the Census), real net wealth per household, the unemployment rate, median weeks unemployed, capacity utilization, median home price-to-per capita DPI, corporate profits, and single-family and multifamily housing starts are all above norm. Fourth-quarter 2024 Census-reported median home prices and the FHFA home price index beat trend by 0.2 and 1.2 standard deviations, respectively due to the underproduction of housing. Additionally, annualized single-family and multifamily home starts rose to 0.66 and 0.37 standard deviations above trend in February 2025. Meanwhile, real net worth per capita (4Q24), and median home price-to-per capita disposable personal income (January 2025) are above trend by

0.47 and 0.29 standard deviations, respectively. After-tax corporate profits were above trend by 0.29 standard deviations in the third quarter of 2024 (latest available).

Key metrics below their long-term norms as of February 2025 were employment (-0.65 standard deviations), the percent of major industries adding workers (-0.70 SD), consumer confidence (-0.07 SD), auto and light truck sales (-0.14 SD), and durable (-0.54 SD) and non-durable (-0.73 SD) output.

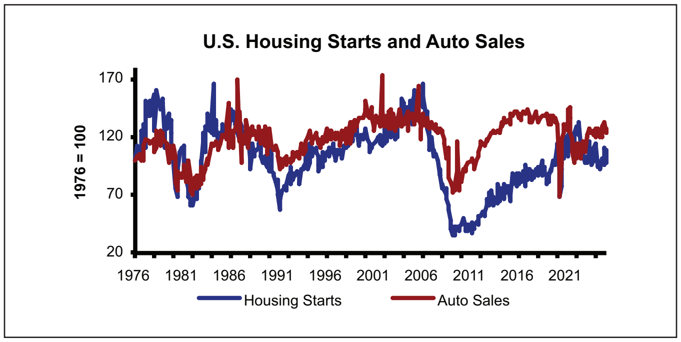

figure 6

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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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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