



# Beware of Inflation

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No one deserves less forecasting credibility than the Fed. Over the last two decades, their macroeconomic forecasts have been among the poorest of any forecasters, despite the fact that they are the only forecasters who know macro policy decisions before they are announced. The Fed's abysmal forecasting record makes our record look extraordinary, as at least we forecasted a 2009 recession in early 2006. Even as the recession was well under way, the Fed was saying there was no recession. Yet the Fed's forecasts continue to gain respect.

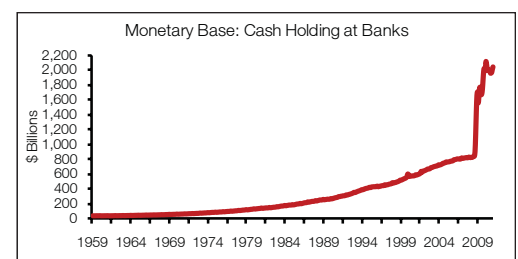
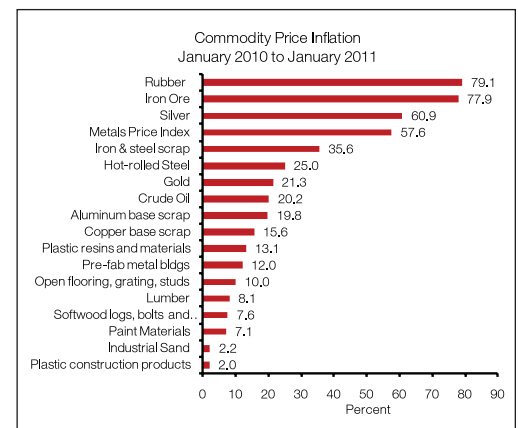
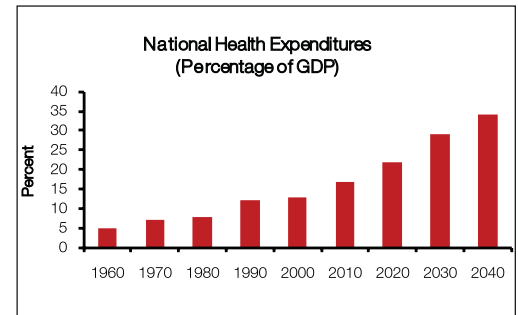
Most notable in this regard is the Fed's assurance that there is no danger of inflation. Bear in mind that this is the same Fed that worried about deflation a decade ago, subsequently flooding the market with liquidity that ultimately led to disastrous asset pricing bubbles (which they assured us did not exist), particularly for housing. Simply stated, the Fed's assurances about inflation ring hollow.

Let's look at some facts. We recently received notification from our healthcare insurer that healthcare costs for our company are rising by 24%. We were shocked, and discussed this increase with many other owners of small and mid-sized firms, only to find that their increases were even higher than ours. This raises a very simple question: How is it possible to have 25% increases in healthcare costs, which account for roughly 17% of GDP, and not have serious inflation? Even if all other prices in the economy remain unchanged, this healthcare increase alone would generate an aggregate inflation rate of 3.75%.

Also in the past year, education has risen by 4.4%, food prices have risen by 0.44%, and anyone in the business knows that apartment rents (supposedly 40% of CPI) have risen by at least 3% (and in some markets by as much as 8%). These basic truths suggest that there is already serious inflation in the U.S.

In the past year, commodity prices have risen significantly. For example, in the past 12 months, the Commodities Metals Price Index rose by 57.6%, while the Industrial Inputs Price Index saw an increase of 51.1%. And such commodities such as rubber, silver and iron ore have seen increases of 79.1%, 60.9% and 77.9%, respectively. Stock prices are up by about 20% over this time. And yet the Fed says that there is no serious inflation.

For over a decade, the Fed printed money and then waited for inflation to manifest in consumer prices. But instead, people poured the additional money into Dot-com stocks, then housing, and now commodities and assets. The Fed can print money, but they cannot control where it flows. Their continued focus on consumer prices is seriously misplaced.



Inflation is not only inevitable, it is already here! The Fed is pumping close to \$1 trillion in high-powered money into the system. Their claim is that this will not cause inflation, even though it is equal to approximately 8% of the economy because the marginal money multiplier has been zero over the past three years. But if they really believe that the marginal money multiplier is effectively zero, why do they not print \$10 trillion in high-powered money and repurchase all outstanding federal and GSE debt? The Fed's answer is, "Well, of course then there would be a money multiplier, and a lot of inflation." Our question is, "Since when is \$1 trillion not a lot of money?"

Banks are beginning to loosen lending standards, though from extremely tight levels. They are once again paying loan production bonuses, and 25 CMBS shops have been created almost overnight with an aggregate target of \$50 billion in loan production. Lending activity by commercial banks has increased by \$83.3 billion over the past two quarters. With the banking system sitting on nearly \$1 trillion in excess reserves, it possesses staggering lending capacity, as it can lend approximately 7.3 times this reserve position.

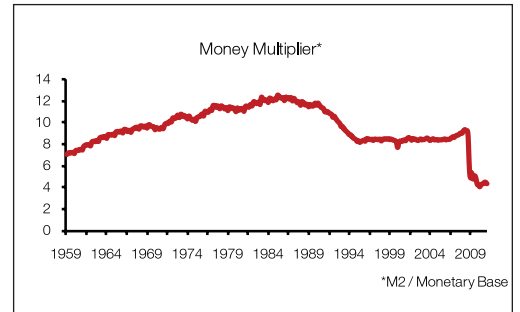
Regulators are not putting a lot of pressure on banks to sell assets. Only as banks record profits will they take the write-downs necessary to allow asset sales. You will not see fire sales because there is no regulatory pressure for them to clean their balance sheets.

As for "pretend and extend," it turns out that some of it was not pretending. That is, some of the pain was due to artificially depressed values, making it smart for everybody to wait a year or two while values recovered. Meanwhile, low interest rates have given a lot of cushion to investors as they find ways to roll debt. Since the short rate is going to stay low for another year or more, the day of reckoning can be pushed out, in the hope that cash flows improve and capital flows increase. So far, "pretend and extend" has probably turned out to be a pretty good policy, if you had to judge it to this moment.

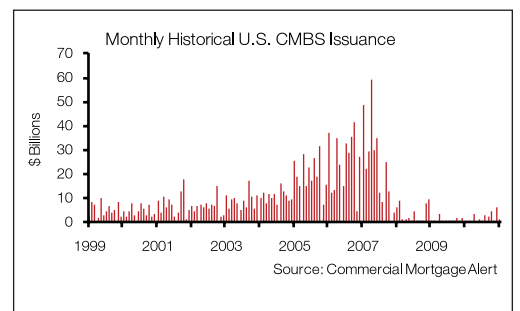
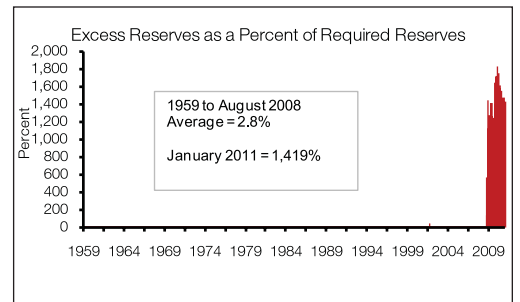
All of this occurs as the federal government is running a budget deficit of approximately 11% of GDP in the U.S., with comparable deficits around the world. The easiest way to pay for these deficits is to have the central bank buy new government debt with newly printed money (i.e., QE2). Our federal deficit problem is nowhere near being resolved, and remains a low priority for the Obama administration. More frightening is the fact that the Social Security/Medicare system becomes cash-flow negative in just eight years. This means that inflows will no longer be larger than payments to beneficiaries, requiring additional taxes to make up for the swing of these payments from positive to negative cash flow. The day of reckoning is only eight years away. And the problem becomes more serious by the day.

Meanwhile, the annual federal budget deficit is running \$13,000 per household (about \$5,200 for every man, woman, and child). This is on top of the roughly \$81,000 per household in outstanding federal debt that already exists. And as Boomers start collecting Medicare and Social Security, the problem becomes even more serious!

Medicare and Social Security spending outlays were 20% of federal spending in 1970, are 40% today and will be in excess of 50% by 2020. The federal deficit is growing by an amount equal to 10% of GDP annually, in an economy that grows at 3%. This is not pretty math, particularly as federal spending stands at 25% of GDP, the highest by far since WWII.



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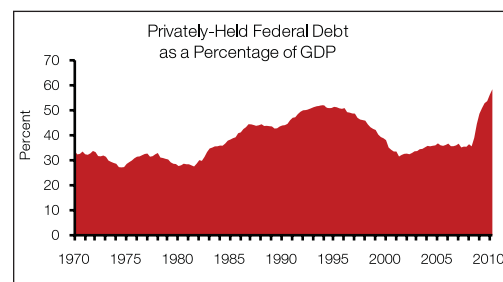
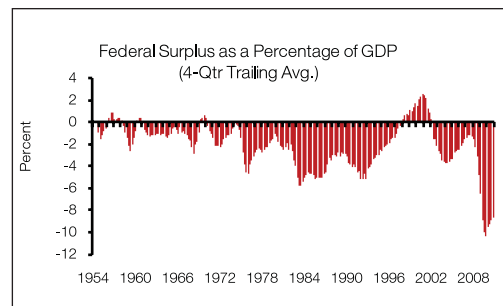


Around the world, inflation metrics are reaching their highest levels in a generation. According to Barclays, the following are inflation rates for some of the emerging markets. In 2010, China had 3.3% inflation, with growing prices beginning to erode China's exports. In 2011, China is expected to see 4.3% inflation. India suffered from 8.3% inflation in 2010 and this year is projected at 8.8%. Indonesia ended 2010 with 7.0% inflation and in 2011 is expecting 6.5%. Korea had 3% inflation in 2010 and is now projecting 2.7%. Vietnam more than doubled in 2010 from the previous year to 12.5%, and in 2011 is expecting a rate of 10%. Brazil had a 5.9% inflation rate for 2010 and now projects an increase to 6.3%. And inflation is clearly occurring in the U.S. in ways that are not being captured by CPI, as reflected by the cost of our company's healthcare insurance plan.

As inflation takes hold, generations that have never witnessed inflation will experience its destructive power. It will take wealth from fixed-rate long-term lenders and transfer it to fixed-rate long-term borrowers. It will crush those who have invested their life savings in nominal assets like bonds, particularly those who have bought U.S. government bonds in recent years at record-low yields. It will favor spendthrifts over savers. It will favor those with the foresight to index their contracts with inflation pass-throughs versus those who find such contracts too annoying. It will favor those with short-term leases relative to those with long-term fixed-rate leases.

It is essential that you are aware of the damage that inflation can wreak on your net investment position. Now is the time to lock in long-term debt, and do so for as long as you possibly can. In fact, the greatest window of opportunity has already passed, as 10-year Treasury yields have risen from a low of 2.5% in October 2010 to 3.5% today. Those who locked their rates three quarters ago, when we implored you to lock long, have created an asset out of their liabilities. And this will only grow over time.

Playing the yield curve is a fool's game for real estate owners. People invariably believe that they will be able to switch perfectly from short-rate debt to long-rate debt, benefiting from artificially low interest rates in the meantime. But by the time short-term rates rise, the long-term rate will have also risen. In fact, the reason the short-term rate will increase from its artificial level is because of a strengthening recovery and looming inflation. The only reason to play the yield curve today is if your cash flow is insufficient to cover a long-term interest rate. In this case you are dead if you lock long, while you at least have the chance to stay alive if you mismatch at today's low short-term rates. But anyone who can cover based on long rates today is wise to lock long. This not only takes advantage of today's low rates but also avoids the risk of capital market disarray when short-term loans mature.



Global Inflation Rates							
	2005	2006	2007	2008	2009	2010	2011
U.S.	3.3	3.3	3.4	2.2	0.9	1.6	2.2
China	3.9	3.8	7.6	7.8	-0.6	3.3	4.3
India	4.7	5.6	5.3	7.2	3.8	8.3	8.8
Indonesia	14.3	14.1	11.3	18.2	8.4	7.0	6.5
Korea	0.7	-0.1	2.1	2.9	3.4	3.0	2.7
Vietnam	8.2	7.3	8.2	22.1	6.0	12.5	10.0
Brazil	7.2	6.2	5.9	7.4	4.8	5.9	6.3

Sources: worldbank.org (2005-2009); Barclays Research (2011).

There are two threats of future capital market disarray: the market's inability to adjust smoothly to rapidly rising inflation, and the maturity of the large pool of CMBS and corporate loans put in place in 2005-2007. Capital markets can struggle with phenomena that theoretically should be easily handled. This is the case for both rapidly rising inflation and the large class of loans maturing around 2014-2015. Just remember, playing the yield curve works wonderfully, right until the moment it doesn't.

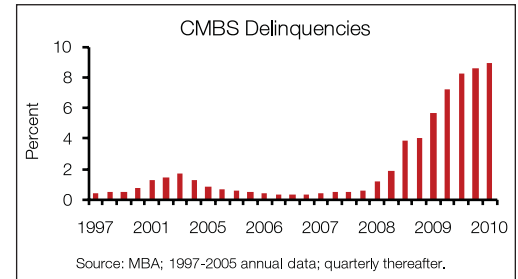
## Hedging Inflation with Real Estate

We are frequently asked if real estate is an effective hedge against inflation. Research from the last 25 years shows that statistically, real estate has effectively hedged inflation. That is to say, when inflation has risen, the return on real estate has not necessarily risen commensurately, if at all. But the reason for this result is that in the U.S. over the last 25 years, inflation has only varied about 2-3% per year. And there is no way the returns on real estate, which have been dramatically up and down, closely correlate with something that has varied by only about 100 basis points over 25 years. You simply are not going to find any meaningful statistical correlation.

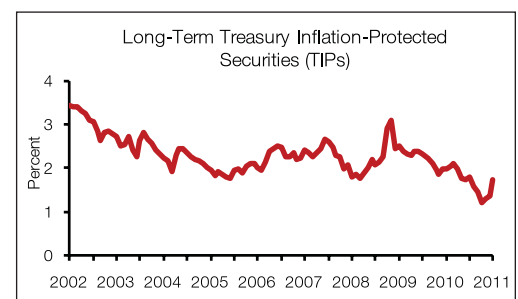
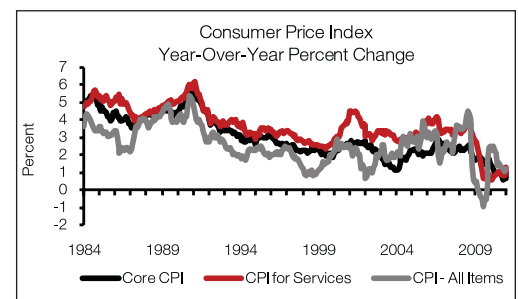
No one believes that if inflation changed from 2.6% to 2.8%, real estate returns would rise by 20 basis points. Twenty basis points is a rounding error. The real question is, "What happens if inflation goes from 2.5% to 5% or to 7%?" In such cases, real estate's track record is much clearer. This is not based on the last 25 years in the U.S., because that is not the kind of inflation we have experienced. Rather, global history indicates that in the face of substantial inflation, real estate does a good job of hedging inflation – not perfect, but good.

What kind of real estate would you prefer in the face of substantial inflation? The preference would be toward assets with short leases, which constantly re-strike new rents as inflation occurs. This favors the multifamily and hotel sectors; it favors assets with three to five-year leases over assets with 20-year leases; and it favors assets with long-term fixed-rate debt. One of the most attractive characteristics of the multifamily sector today is that it is an inflation hedge, as it has a short lease stream which is easy to finance in the long term. It is the one sector where you can get 10-year debt at low fixed interest rates almost without exception. So if inflation occurs, this sector allows investors to re-strike rents and lock in a fixed liability that can be repaid with inflated money. For hotels, investors still get the re-structured leases, but it is hard to obtain long-term fixed-rate debt. As a result, hotel sector borrowing costs will go up significantly if inflation occurs. Hence, the one property type that will fare best if we experience substantial inflation is multifamily.

However, even though we may have identified the most attractive property types to hedge against a high-inflation environment, we still need to get the pricing right, which is a whole other game of darts. Ten-year Treasury yields at 2% made no sense. We have subsequently had an almost 200-basis point increase in 10-year yields without any adverse impact on cap rates. This is because the cap rate spread was far too wide. That is, real estate was priced as if Treasury yields were closer to 4%. In other words, real estate debt spreads have narrowed, not because interest rates have come down but because Treasury yields have risen. We had very wide spreads on real estate debt, and by extension real estate cap rate spreads, until the recent upward movement in



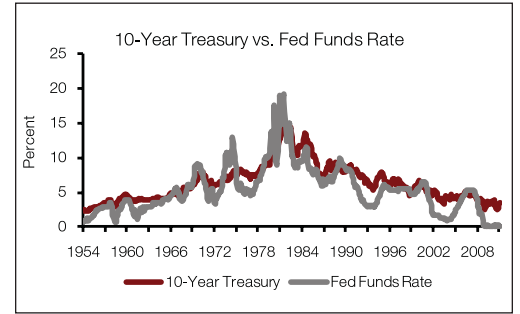
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Treasury yields. As Treasury rates have risen by about 100 basis points, the debt spread has narrowed by about 100 basis points. This is because many lenders had rate floors. We think that a 3.5% 10-year Treasury yield is at least 100 basis points too low.

When you buy a piece of real estate, you are buying a synthetic product, combining the long-term Treasury yield, a risk spread, and an expected income growth.

For example, if you buy an apartment complex at a 5% yield, you are buying a 10-year Treasury at a 3.5% yield plus a 150-basis point risk spread and the expectation that cash flow will increase by 20% to generate a 6% yield. Today, for this investment to succeed in the best assets in the darling markets (Boston, New York, Washington, DC, San Francisco and Los Angeles), you have to be right about the 10-year Treasury not changing, as well as about the correct risk spread being 150 basis points, and income growth being 20%. This is because for the best assets in the darling markets, properties are priced to perfection. By that, we mean that if 10-year Treasury yields rise, or if you are wrong about either the risk spread or the cash flow growth (or both), you are going to be disappointed in your return on investment. As you get away from the best assets in the darling markets, things are not priced to perfection (yet), leaving some margin for error. However, in the most competitive markets, only if you are right about all three factors will you be satisfied with your returns. And we have learned that we are rarely right about three important things at the same time.




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