The Property Cycle: Where Now?

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May 15, 2008. The denial phase is over. Now the pundits who tried to distract people from economic reality are grudgingly acknowledging that the property cycle has not only turned but will not recover in the second half of 2008. The "soft landing" soft-soap talk is behind us.

What happens now? Economists are still not offering investors the kind of detailed analysis that encourages confidence of the kind needed to put one's savings at risk in the markets. Diagnosis still relies on psychological explanations for boom/busts. A classic example is Charles Kindleberger's *Manias, Panics and Crashes* (1989). He lumped together *idiosyncratic* episodes of speculative activity with end-of-cycle boom/busts (*structural* episodes) which stem from the rules built into the capitalist economy.

- Historians delight in recalling the Dutch tulip fiasco, and the South Sea bubble of 1720, because colourful characters were behind what turned out to be one-off scams. These were random events, responses to either luck (such as the alleged discovery of gold) or invention (money-making schemes of fertile imaginations). They could not be predicted, using the tools of the economist.
- The financial crisis that broke in 2007 was pre-determined by the structure of the economy. By "reading" the logic of property rights and the way the state raises its revenue, we can anticipate trends with reasonable accuracy. The key tool is David Ricardo's law of rent.

Newspapers prefer the unscientific diagnoses because these produce colourful copy. Thus, when Mervyn King, Governor of the Bank of England, attributed chaos in the financial sector to the "greed" of bankers, he received a sympathetic hearing. Given the size of the bonuses received by bankers, greed is not an unfair epithet. But it has little to do with trends in the property market which would assert themselves even if bankers were self-denying acolytes of St. Benedict.

The Deterioration in Property Markets

Old hands in the property sector like Sir John Ritblat, the former head of British Land who lived through the two last property crises (1974, 1992), have begun to revise their forecasts. Sir John had previously predicted some recovery in the second half of this year. He has now revised his expectations, but still remains cautious. He talks about the UK remaining at its current depressed level "for at least the remainder of 2008".

The commercial property market in Britain will not recover for another five years. The same dismal prospect holds true for the commercial centres in the United States. The buoyancy to be observed in the cash hotspots, like the oil sheikhdoms of the Middle East, is an illusion: they are living on borrowed time. They are still speculating in land development which must end in tears. Within 18 months, expect to see a forest of ghostly skyscrapers haunting the landscape in places like Dubai.

Housing markets continue to weaken throughout the world. There is no end in sight to the US crash, and the UK's downturn has barely begun. Prices are stalling in Eastern Europe and all the way to South Korea. My 2005 prediction of a 20% decline in UK house prices was too cautious: they will overshoot the long-term trend price before bumping along at 30% below peak prices for more than five years.

Consumers are retrenching, which will result in a rise in unemployment. One indication of this is the reappearance of empty shops in the high streets. Retailers who mortgaged their homes to raise the capital to start their businesses are being squeezed at two ends – the high price of credit from banks, and the tightening grip on the credit cards of customers.

A Time for Heroics?

Can the cavalry ride to our rescue over the crest of the hill?

The pundits manage to sift crumbs of comfort from world trade. They assume that China and India are self-propelling engines of growth that are decoupled from their customers in Europe and North America. If they continue to power ahead, won't this provide sufficient momentum to prevent the downturn in the West from getting totally out of control?

China's Politburo is in a quandary. It has tried to curb inflation over the past several years through regulatory measures. An overheated real estate sector, in particular, has attracted the ire of Beijing. But China has to indulge in face-saving big-ticket spending projects related to this summer's Olympics. Once these are out of the way, watch for the brakes to be applied. China's manufacturers will find it increasingly difficult to turn out the goods at cheap enough prices for cash-strapped customers in the West.

So I expect the convergence of seriously bad news early in 2009.

From the West, America will be reconciled to a toboggan ride down to the trough of the business cycle.

From the East, the flow of cheap products will start to dry up as China's factories cut back to weather the disappearance of their markets around the globe.

As EIS subscribers know, I predict that 2010 will be the nadir of the cycle. But we are not there yet. Banks still have to come under heavy pressure, over the next 18 months, as the collateral value of securitised properties weakens further. The repossession rate of homes will exceed the levels achieved in the early 1990s, causing the financial sector to remain volatile for much longer than is now being predicted by central bankers. And one consequence of that will be a loss of revenue to government budgets. This, in turn, will trigger cut-backs in pubic spending, adding a further twist to the contraction.