PROPERTY WILL FALL UNTIL AT LEAST 2011

THEN US STOCKS WILL LEAD THE WAY

With that bold headline, ***Phil Anderson*** *had this essay printed in the UK's MoneyWeek magazine in October. Phil's a long-time member of Proz Oz and now spends much of his time in France with his French wife and family, but will be in Melbourne on March 17 for a speaking gig – see details on page 3.*

This financial crisis is a predictable cyclical downturn. How do we know where we are in it? The secret is in land prices.

Hardly anyone seems to know what is going on just now, let alone be able to explain it. Most believe the recent banking crisis was a random, unpredictable event. Far from it: the drama unfolding is just history repeating. Only the numbers get bigger. By studying the past, we can get a good idea of how the economy is going to unfold each year. And the most informative history to study is that of the US property market. Let me explain why.

Lessons from history

The US federal government began selling off its newly acquired real estate on May 10th, 1800. This marks a convenient starting point. It can be seen that property speculation in the US has consistently peaked around every 18 years, right up to the Second World War. Examining this phenomenon a little deeper, one can see an astounding repeat of economic and banking behaviour (see box below).

This 18-year property cycle is now going world-wide as more nations take up the US brand of economics. This process is underpinned by the enclosure of the economic rent, a concept first formalised by English economist, David Ricardo. Ricardo's Law of Rent states, simply, that the economic rent is not a cost of production.

Sellers of The Big Issue are quick to discover this law: sellers standing at busy street corners sell more of the magazine for the same hourly application of their labour than do sellers at quieter sites. This leads to behaviour that may include violence to defend the best site as 'theirs', or, more commonly in a civilised society a 'bid' for the best location. This bid is what Ricardo was first to identify as a 'surplus': the economic rent. Property investors know it today as locational value.

The banking crisis is nothing new In 1820, the US saw a marked downturn in economic activity. It began with a downturn in land prices after the bursting of the cotton price bubble in January, 1819: a price upon which banks had been creating vast amounts of credit. Most of the US banks of the time failed as land prices collapsed.

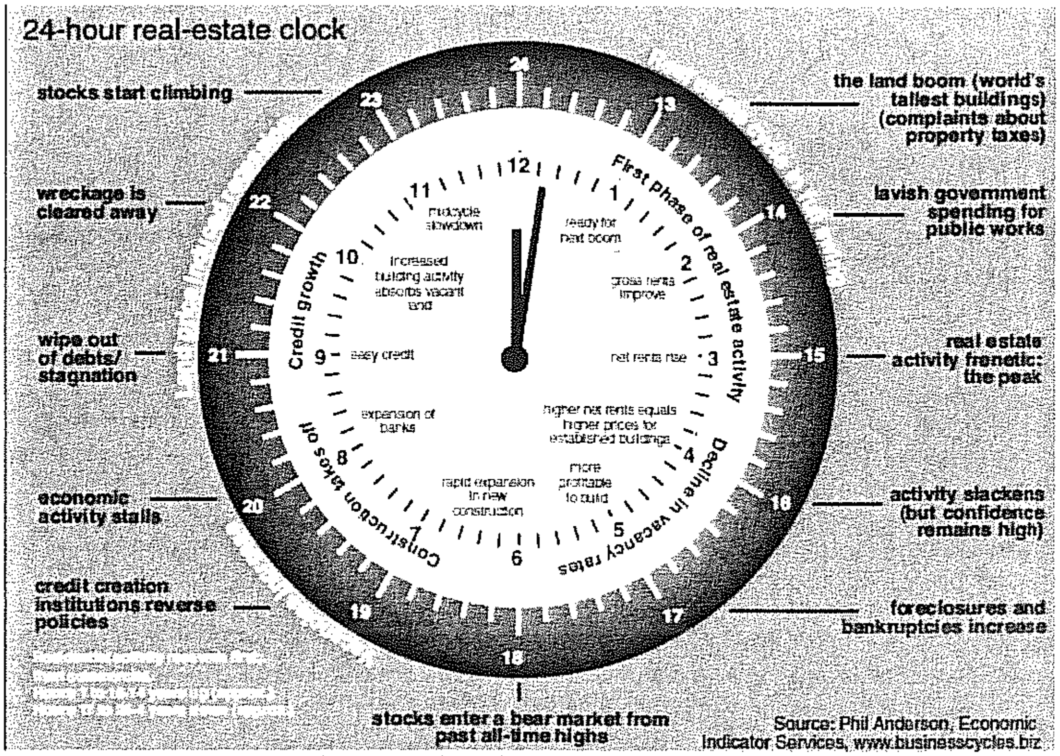
Into the 1830s, a revival in business led to a fresh bout of land speculation, funded on very liberal credit terms by the government. That came to an end when President Andrew Jackson's specie circular of July 11, 1836, decreed that, henceforth, payment for federal lands could be in silver or gold only. The circular coincided with the failure of several banks in London. Substantial land speculation had been taking place using the easy credit provided by the growing number of banks in the newly developing US territories. In New York, John Fleming, President of Merchants Bank fell dead from excessive anxiety with regards to the affairs of the bank May 4th, 1837, from which a run set in on all banks. The failures grew worse over the next two days, and United States Bank stock fell below its issue price for the first time. On May 9th there was a 'furious run on all the banks'; by May 10th, panic.

After the severe downturn of 1837 to 1842, politicians decided that such a depression should never be allowed to happen again. Banks would only be allowed to create credit based upon a high level of gold and silver reserves, to be held at all times in the vaults of each bank. Ironically, in 1849, gold was discovered in California, leading to the largest migration of people the world had ever seen, into the new lands of America. Flush with gold, the banks started lending again to an eager bunch of gold and land speculators. The August 24th, 1857 failure of the Ohio Life Insurance and Trust Company of New York, a bank despite its name, caught the markets by surprise. Thirty days later, another leading financial institution, the Bank of Pennsylvania, in Philadelphia, closed its doors. Newspapers reported 'the wildest excitement', as queues of depositors formed at every single bank in the city, demanding their money back, only to find it wasn't there. There was a nationwide banking panic in October, followed by a severe downturn that lasted until the start of the Civil War in 1861.

Many would suggest that the 1873 US downturn, panic and then depression, was caused by the collapse of the railroads. These companies, however, were nothing more than enterprises formed to secure the give-away, at very low prices, of what the railways ran over - the land. The September 18th, 1873 announcement in New York of the failure of Jay Cooke and Company, a bank heavily involved in financing these newly developing railroads (via bond issues) startled investors. Disbelief soon gave way to panic, as the stock market collapsed and daily interest rates rose to 5% as the banks began to hoard their (now scarce) cash resources. There had been substantial land speculation prior to all these events, especially through the listed railroad companies. This speculation peaked several years before the bank failures, in 1869.

The 1893 depression in the US was again preceded by the massive buying and selling of real estate and land, not just in the US, but world-wide. Again, the economic turn was marked for all to see by a banking bust, this time in the UK, in November 1890, with the collapse of Barings Bank, the Queen's own banker. Two weeks before, the Bank of England had lifted its discount rate from 5% to 6%. These events are not unrelated. Credit difficulties were obvious in the US by February 1893 when the Philadelphia and Reading Railroad company had collapsed after struggling to meet its interest payments.

The 1893 worldwide crash was so severe that few individuals caught up in the subsequent depression ever speculated again. While the US did see renewed selling of the government lands into 1908, the First World War cut short any likely after effects. The events leading up to the 1929 stock market crash are well known. However, the common perception of the stock market collapse igniting the 1930s depression is wrong. It is easy to conclude that the inaction of the Fed, allowing the money supply to collapse, was the cause of so much of the 1930s trouble, as current Fed chairman Ben Bernanke would have us believe. On the contrary, the Great Depression was a direct result of the continued collapse of real estate (in reality land) prices, to a level below the outstanding worth of all the mortgages the entire US banking system had created. Sound familiar? The real estate speculation peaked first, prior to the downturn, in 1926, exactly 18 years after the previous peak in 1908. Throughout the 1930s, the lower house prices and farm land went, the more banks collapsed.



Source: Phil Anderson, Economic Indicator Services, www.businesscycles.biz

Wherever this locational value of land is permitted to capitalise into a price, a property cycle will develop as speculators and companies chase land prices higher and higher, reducing the proportion of wealth being invested in creating jobs and improving businesses. This cycle is beyond the control of central banks. The enormous credit created by banks based upon this value now gives us the violence of the property boom, then bust. This cycle has so far manifest clearly in 14 years of rising prices, then four years declining (refer to winner's curse graph here?). From the 1955 land price low in most Western 'rent-enclosed' economies, the 18-year cycle has been exact: 1955 to 1973/4, to 1991/2 and now to what will most assuredly be another property low in 2010.

There are a number of very easy signposts which investors can look out for as the property cycle progresses through its 18-year run. Here are a few that warn of an impending cyclical peak. Tall buildings are a classic signal. Since 1837, there has never been a property peak without at least one building claiming the new 'world's tallest' title; often two or more are competing. Such buildings have in the past always opened to great fanfare, but in tough economic times. The Burj currently underway in the Middle East will not prove an exception in this cycle.

The price of copper is another tell-tale sign that the property cycle is about to peak. Since 1873, there has never been a property peak without the price of copper exploding into the final years of the 18-year property cycle. Copper is used extensively in the manufacturing process of course, and in the building of housing **(see graph below)**.

The yield curve also informs observant investors that a land price downturn is coming. An inversion of the curve is the thing to watch for. Higher interest rates equal lower asset prices and a contraction in credit.

The best indicator, though, is something most economists have no interest in studying: land prices. Contrary to popular belief, it is not house prices that go up, but the locational value upon which they are built. This value is the capitalised land rent, expressed as a price. Unfortunately, neither the US nor the UK bothers to collect this information in any precise form, but Australia does. And Australian economic cycles have a high correlation with US cycles.

Dividing a nation's land price by its GDP can help investors see where the money is flowing, either into the goods and services sector, or speculative assets like land price (see graph two). A strong rise in the barometer is a clear warning sign of too much land speculation taking place. A recession always follows this behaviour. It should be noted that it is not the recession that does all the damage to an economy. The damage arises from the precursor: an unsustainable rise in land price. Investors who learn to see things this way find it easy not to overbid for the locational value at precisely the wrong time.

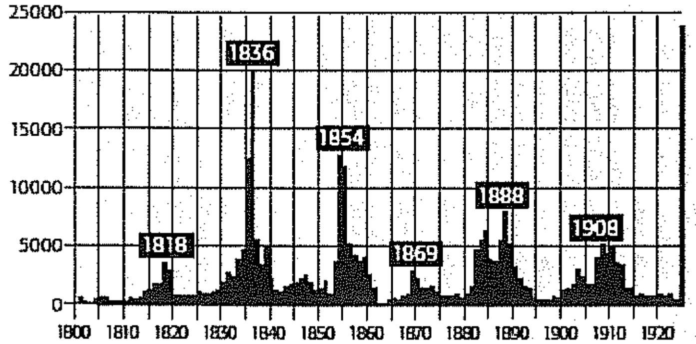
What history also teaches us is that the greatest speculation always takes place in the last years of the cycle. Fred Harrison neatly summarised this pattern with his "winner's curse" profile of the 18-year property cycle (see graph three). My research confirms the US has had a remarkable consistency with Harrison's "winner's curse" profile. US real estate, expressed in Real Estate Investment Trusts (Reits), underwent a mini-panic in 1962, seven years from the 1955 land price low after the second World War. Real estate values peaked in 1969, followed by an exact four-year decline after that. From the 1973/74 property low, seven years up saw the mid-cycle slowdown of 1981; seven further years of economic growth capped by massive real estate speculation into 1988; then a recession low by 1992. From this property low of 1992/3, seven years on saw the 2001 mid-cycle slowdown - and you know the story from there.

Property buyers within the winner's curse phase always end up with negative equity for years afterwards. And investors most highly leveraged in this phase do not survive the downturn.

In 2005, I created the 24-hour real estate clock (see picture on page xx) to help guide my own investments through the current cycle. Historically the property cycle has seen a very clear 14 years of rising prices, followed by four years of decline. Although this doesn't tell us how high the eventual boom may go, we can say that the higher land prices are permitted to rise, the greater the eventual bust will be.

There is no reason why this pattern will not continue, since the underlying structure of the economy will likely remain the same. Banks will continue to create the necessary credit to enable us to buy into rising land prices. Indeed, this is what the latest Congress bailout of the banks is designed exactly to do. In each new upturn, Wall Street finds new ways to avoid the rules and regulations expressly designed to stop the banking routs of earlier collapses.

US public land sales, acres '000, 1800-1923



So what happens next?

Investors can now expect four years of declining property prices, minimum. In the UK, this can be measured from the last quarter of 2007 - so prices will not stop falling until the end of 2011 at least. Certainly, at the end of every past 18-year cycle, prices have never recovered in a shorter time frame than this. The depth of the present banking problems ensure this current cycle will see at least the same time-frame. How far will property prices decline? History says 30% (minimum) can be expected from the peak, 50% or more for raw land. This will put even greater pressure on UK builders as the cycle turns further - in the 1991 downturn, some commercial property prices in Texas dropped by 90%.

Our current banking problems are certainly nothing new. It is amazing to witness, how quickly investors forget the previous banking panics at the end of the property cycle, as land prices begin to deflate. In October 1973, the collapse of the US National Bank of San Diego was the biggest in forty years. The bank collapsed because of the activities of its major shareholder, C. Arnholt Smith, chief fund-raiser for Richard Nixon and a major real estate speculator in southern California.

An even bigger bank failure, that of the Franklin National Bank of New York, followed exactly twelve months later, in October 1974, despite a rescue package from the Fed worth an unprecedented (at the time) $1.7bn. Property loans were a feature of this failure as well. The Fed chairman, Arthur Burns, when asked by a Newsday reporter what stopped the world financial system from imploding after the massive failure of Franklin bank, replied: "Luck, more than anything. We were sitting on a volcano. People were concerned in this country, but they were really scared abroad. We can't let it happen again, because we might not be so lucky the next time."

Yet we never seem to learn. The current US and UK property cycles will repeat in line with the 24-hour real estate clock. The UK is presently at 20.00 on the clock, the US at 21.00. Bad debts will have to be either paid off or wiped out (as Ben Bernanke and Hank Paulson at the Treasury are trying to get Congress to do, and Gordon Brown and Alistair Darling over here), and the wreckage cleared away, before the economy can move on. This is a process that takes years, not months.

So what will be the sign that the market is turning? Again drawing upon past behaviour, the US has led the world both into and out of each property cycle. For example, US land prices peaked in 2006, the UK a year later. So if we know what is happening in the US, we can see what is coming for the UK.

The US should hit its cyclical property low at some point in 2010. The best indicator that we are approaching that point will be the stock market (see 23 o'clock on the 24-hour real estate clock image). Over past property cycles, US stock markets have always made what might be called a 'generational low' – another reason why it is so useful to view history in 18-year segments. Usually by the time of the property low, the stock market will have surrendered 50% of the gains made in the 14 or so prior 'up' years. From 1992 to 2007 <GET EXACT FIGURES FOR THIS AND CHECK FOR FTSE 100 TOO>, that would put the Dow back to around 8,000 by the end of 2009, if not before. Given the size of the current banking problems and banks' totally inability to continue to create more credit until they have properly recapitalised, this is not at all an unreasonable forecast.

The Dow image illustrating the 1974 cycle is typical of what will have happened by 2010. Stock market lows at the end of a property cycle are lows that are long remembered in markets. Attitudes change for a few years when they happen. For some investors, they become life-defining moments.

US stock markets have done this for as far back as there is stock market data available. Both 1877 and 1896 saw major stock markets lows, at the time of each respective property cycle downturn (see graph below). They are caused by the massive and unavoidable contraction in credit that affects every single individual and business. Cash will once again be king in 2009; a resource few will have in abundance.

Yet the stock market always turns up before the property market does. In 1991, as more and more grim news came out about the US property market and bank collapses – and it was indeed grim – the US stock market held its ground (see image five). And as 1991 progressed, the market saw higher lows. By 1995, as the US stock market broke into all-time new highs, the property downturn was history.

This will again eventually repeat for the US, but not before well into 2009 or even 2010. Until then, it is completely pointless investing in property since one would be buying into a declining market. And the best property gains come only as the property cycle gets fully underway, something which is most unlikely until several years after 2010. This does not require guesswork. The US stock market will lead the way.

Phil Anderson is director and founder of economic forecasting service, Economic Indicator Services (www.businesscycles.biz). His book, The Secret Life of Real Estate is to be published this month in the UK by Shepheard Walwyn.

Box out: The banking crisis is nothing new 830 words

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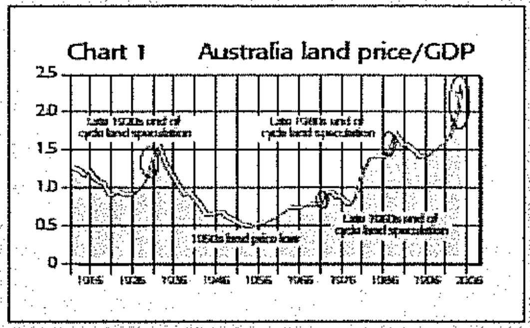

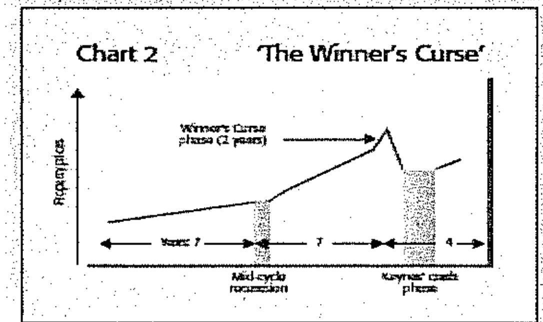

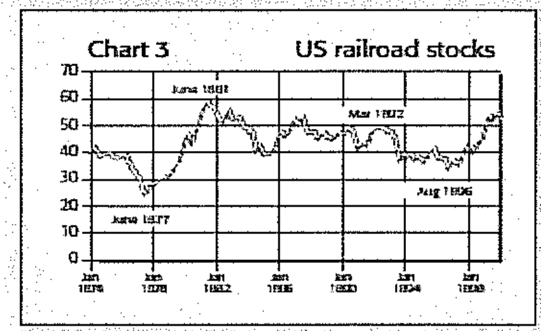

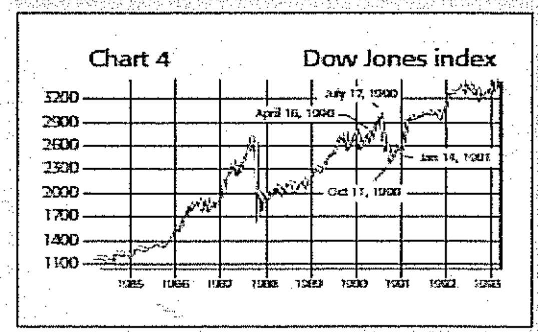

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