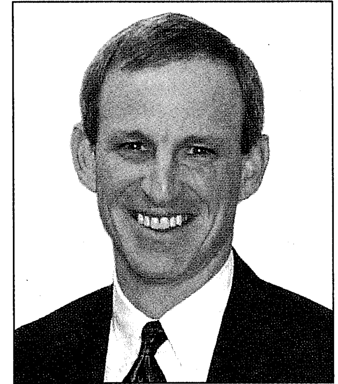
REAL ESTATE CYCLES: A LONG TERM PERSPECTIVE

By David M. Rosenthal



WE HEAR IT EVERY DAY: "REAL ESTATE IS IN A BUBBLE." WELL IS IT? What does our current real estate market look like in the context of history? Real estate markets, like all other markets, tend to be cyclical. We have been in an expansionary phase for what seems like a very long time. Unfortunately, many of us remember the painful end to the last expansion at the end of the 1980s and we are rightfully uncomfortable. Let's look at the fundamentals and history of real estate cycles to help us make some sense of our current situation.

Why are Real Estate Markets Cyclical?

According to Glenn Mueller, Ph.D., director of real estate research at Legg Mason, "Real estate markets are cyclical due to the lagged relationship between demand and supply for physical space." This view is also shared by Jack Harris, Ph.D., of the Real Estate Center at Texas A&M University. He says, "The cyclic pattern is caused by the market's tendency to self-correct. If new supply could be produced or withdrawn instantaneously, the market would always be in equilibrium and there would be no cycle. In reality, a considerable lag exists between before the need for more housing or office space is identified and the time new space becomes available. This lag creates the cycle."

What are the Phases of a Real Estate Market Cycle?

According to Dr. Mueller of Legg Mason and Peter Korpacz of PricewaterhouseCoopers, there are four phases to a real estate cycle.

Phase One—Recovery. During recovery, vacancy declines, there is no new construction, and rent growth is negative to mildly positive (below inflation). Cap rates are typically stable but high, and investment purchases are typically opportunistic.

Phase Two—Expansion. In the expansion phase, vacancy continues to decline and new construction begins. Rents rise rapidly as demand for space exceeds supply. Cap rates begin to decline as more investors enter the market, resulting in rising property values.

Phase Three—Hypersupply/ Contraction. This phase is characterized by significant new construction, which leads to an excess of property. This, coupled with declining demand, leads to rising vacancy and declining rent growth. Typically, investors react to the declining fundamentals by reducing their interest in new purchases and as a result cap rates begin to rise and values decline. If new supply continues to exceed demand after long-term occupancy rates are reached, then the market falls into a recession.

Phase Four—Recession. If the cycle slips into recession due to continuing oversupply, then vacancy will rise to new highs and rents will continue to fall. As a result, investors leave the marketplace, resulting in a further rise in cap rates and substantially declining property values. This phase continues until new construction ends and demand for space returns to the market.

How long is a typical real estate cycle? The chart shows a long-term history of the real estate market cycle in the US over the past 185 years. Each of these market peaks in property value was concurrent with a peak in real estate development and construction activity.

Year that land values peaked	Length of Cycle (years between peaks)
1818	- -
1836	18
1854	18
1872	18
1890	18
1907	17
1925	18
1973	48
1979	6
1989	10

Source: Fred Foldvary, Ph.D., Economist, Santa Clara University

Is the Marketplace Different This Time?

Legg Mason and PricewaterhouseCoopers contend that it is. Dr. Mueller observes: "The technology revolution has affected real estate in many of the same ways that it has affected our society. More information has made real estate markets more efficient." Korpacz agrees: "We believe that the explosion in the quality, quantity and timeliness of real estate information over the past 10 years has produced a more efficient real estate asset class. The natural result of the increase in timeliness of real estate information is a reduction in the lag between vacancy and rental rates to pricing and value."

Does this mean that we can accurately predict where the market will go tomorrow or next year? That question is answered every day in the marketplace, as we each make our bet on the future. Dr. Harris of Texas A&M says: "Those who understand cycles view market booms with caution and search for opportunities in down markets. They tend to resist excess optimism at the top of cycles and pessimism at the bottom of cycles. (They) view market change as normal rather than as a sign that something is wrong." We would be wise to pay attention, since change is one of the only things that is constant in our world.

The views expressed in this article are those of the author and not Real Estate Media or its publications.

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