Real Estate Cycles Part 1: The financial cycle

10-18 year financial pricing cycles are long and often ignored. Understanding is crucial to avoiding catastrophic losses.

September 29, 2015 BY IAN IPPOLITO (Updated 7/2018)

Investing in real estate without understanding the real estate cycle **is like riding a canoe** in the ocean. You'll be perfectly happy as long as the weather's good. And when a storm hits, **you could experience a catastrophic disaster**. So, if you can forecast today's weather, you can know when it's safe to paddle out, and when you might want to stay home.

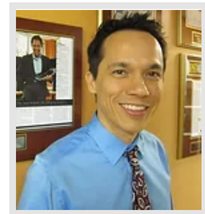
Just like the weather has recurring patterns (like El Niño), so does real estate. The **most important** are the **financial cycle** (which affects the price of your real estate) and the **physical cycle** (which affects the rental income).

This article series will talk about the **cycles that are important for commercial real estate**. (A future article will talk about residential real estate).

- Part 1: The long commercial real estate financial cycle that drives prices.
- Part 2: The shorter physical cycle that drives rental income via vacancies and rent prices.
- Part 3: Warning signs that a recession is about to hit.
- Part 4: Where are we in the local real estate cycle?

What is the financial cycle?

About Ian Ippolito



Ian Ippolito is an investor and serial entrepreneur. He has been interviewed by the Wall Street Journal, Business Week, Forbes, TIME, Fast Company, TechCrunch, CBS News, FOX News and more.

Ian was impressed by the potential of real estate crowdfunding, but frustrated by the lack of quality site reviews and investment analysis. He created The Real Estate Crowdfunding Review to fill that gap.

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The **financial cycle determines the price** of real estate. Local new construction determines the supply. Demand is driven by national factors that affect the desire for investors to hold commercial real estate (CRE). They include:

> 1) The desirability of CRE versus other asset classes (like stocks, bonds, etc.)
> 2) interest rates, lending standards and liquidity
> 3) Global capital flows

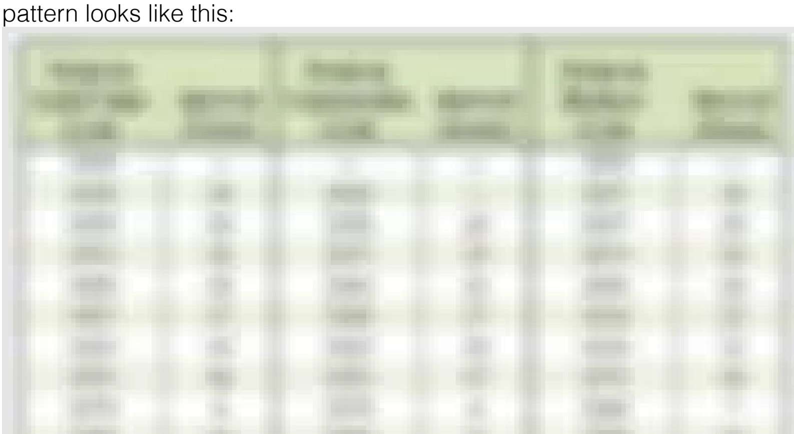
That sounds highly random, but **some claim the cycle has tended to be fairly regular**.

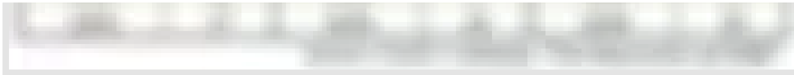
18 Years a Slave (to crashes)

2018-06-26 Editor's note: I personally no longer have confidence in the accuracy of the data in this section but am keeping this section here anyway, to preserve the historical reocord.

The data comes from the Harvard continuing education site and an author/economist named Fred Foldvary. However, in attempting to replicate/duplicate it for accuracy, I am running into problems. Some of the claimed peaks seem to be missing from the cited sources and some of the recorded peaks seem to be omitted. Specifically I have not been able to find the claimed land value peaks of 1973, 1979 (his source... Balance Sheets for the US Economy 1991...seems to show no peaks there) and the same with 1989 (couldn't find any references to land value in Statistical Abstract 1996). For construction cycle peaks, I was able to find two additional peaks from his data source (Statistical Abstract 1996) that appear not to be in the above chart: 1964 and 1994. I've reached out to him, and as of 2/9/2020 (2 years later) have received no response to these issues.

According to Fred Foldvary on the Harvard continuing education website, most people believe that the ups and downs of real estate pricing are completely unpredictable. However, back in 1930, Economist Homer Hoyt looked at the history of prices and found that real estate busts had **often** occurred at **intervals of about 18 years**. Today, almost 100 years later, that pattern looks like this:





Two notable exceptions to the 18-ish year rule were:

1. World War II. **Longer at 48 years**.
2. The 1979 mid-cycle recession caused by the Federal Reserve doubling interest rates. **Shorter at 6 and 10 years.**

Other times, the pattern has held. **Who knows** what will happen in the future. **But if** the **pattern repeats** itself at the average of 18 years then **2023-2024** might be another pricing peak, with a downturn shortly after.

On the other hand, someone might argue that there's **not enough data** here for **Foldvary** to **predict the answer with certainty**.

Either way, we know for sure a financial downturn **will occur eventually**, even if we **don't know exactly when.**

What happens in a financial cycle downturn?

The end of the financial cycle is generally **brutal**. Since at least 1969, a downturn in the financial cycle has always ended in a nasty crash. The **average price drop has been 45%**, and it's taken **5 to 8 years to recover** to the pre-crash state. These are conditions that can easily bankrupt an investor, or at the very least depress returns for years. If you were invested in real estate in 2008, then this sounds painfully familiar.

When's the next financial cycle downturn?

If the **18 year average holds, we might expect the next pricing bust around 2025-2026**. But **who knows and it could be sooner or later**. And a global war or exceptional event can extend or shorten the cycle (and as mentioned above, this has happened twice before).

What kind of things could **cause the end to come early**? Anything that affects the factors mentioned above that make up the financial cycle. Here's a list that unfortunately is by no means exhaustive:

- The Federal Reserve raises interest rates too quickly. (This was the root cause of the Savings and Loan Crisis, and the end of the physical cycle in the 1980s).
- A banking crisis causes lending standards to tighten rapidly. (This can be caused by many things, including an asset bubble held by banks. This is what caused the end of the physical cycle in 2007).
- A financial crisis causes loan liquidity to dry up.
- Capital inflows quickly dry up. For example, right now there's a lot of global capital flowing into U.S. real estate searching for safer yields. If anything causes that to change (global war, crippling black swan event) that will reverse, and cause prices to drop.

These sorts of events are **difficult to predict in advance**. On the other hand, none of these things are everyday occurrences, and many take time to create. This is why historically it's sometimes been multiple decades between crashes, an less often a shorter-term event.

So in my opinion, the **odds of the pricing crash occurring on any particular day in the immediate future are probably fairly low.** It's something I constantly keep an eye out for, because the consequences are so severe. But as of right now (2017) I don't expect it to happen tomorrow. Time will tell if my opinion is right or not.

What, me worry? Well..yes.

If you feel you are okay on the financial cycle, then you might be **thinking that you actually don't have to worry** about real estate cycles in your investing, right?

Unfortunately, no.

Understanding the long-term financial cycle isn't enough, because prices are only one part of real estate investments. The other part is income, which is affected by the physical cycle. The physical cycle is shorter-term and more volatile, and is what most people are referring to when they talk about "The Real Estate Cycle".

We'll talk about it in The real estate cycle – Part 2: The 4 phases of the physical cycle.

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