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HOW THE PROPERTY MARKET WORKS.

by Paul Osborne

In order to understand why the market rises and falls, we need to explore deeper into the functions of the market.

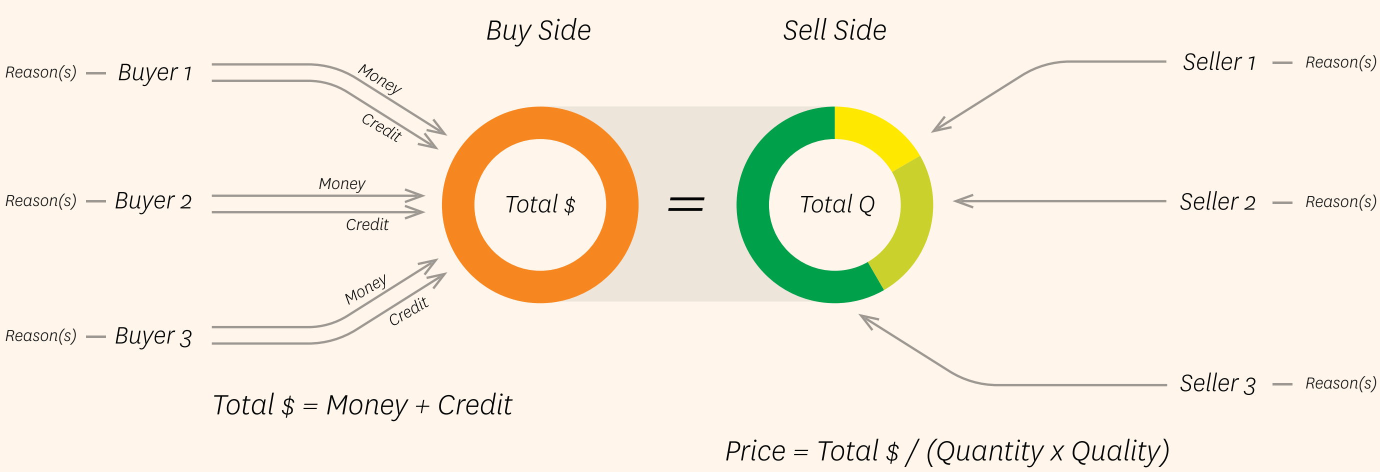
This is my viewpoint. This may differ from conventional economic theories of today.

The property market is made up of many transactions occurring at one time, each of these transactions adds up to form what we call the 'the market'. Forgive me if this sounds simple, however it's important to think about the very basic structure of a single real estate transaction, to understand the market as a whole.

Real Estate is either purchased wholly owned (money), or leveraged (credit). In todays environment, few properties are purchased whole (without credit). A purchaser will rely on credit by taking a loan from the banking sector. The higher the loan to value ratio is, the more important interest rates are to the purchaser, as extra money will need to be repaid to service the interest component of the loan.

If a purchaser commits to a $1 Million purchase price and pays $100,000 (10%) as a deposit (plus costs), then $900,000 (90%) is to be borrowed (credit) to complete the transaction. We can see that in this instance, actual 'real money' is $100,000 (10%) while $900,000 (90%) is credit. By observing this very simple calculation, we can see the importance of credit (leverage) in maintaining, decreasing or pushing up real estate values over time. In this case alone, 9/10th of the total price paid was credit, rather than 'real' earned money.

Multiply the above situation by thousands of different combinations, and we start to get an idea on the current demand for real estate assets.



LEVERAGE

The amount of 'real' money (deposit) will affect the amount of leverage (credit), so wages and employment are also important. The confidence of the borrower must also be considered, this is where perception of job security and the broader economic environment also play a role.

The banking sector is an important facilitator within the property market. Its ability or inability to supply credit to borrowers will restrict or increase demand for assets. A credit squeeze, such as what occurred in 2008, often happens independent of interest rates. In these times credit rationing and tight lending standards cut credit from the market, having an enormous affect on property pricing.

We will discuss more about credit shortly, but for now its important to remember the importance of credit as to whether the market might move up or down in the future.

As we move to the sell side of the property market equation, we encounter the land owners. The sell side is made up of a total quantity of property, each offering is differentiated by its overall quality. Quality takes into account location, build, design, craftsmanship, return, and the suitability of that asset to the purchaser at a given time.

Now it's important to remember that both the buying side of the market and selling side of the market influence each other. However, buyer activity tends to be the most important signal out of this two party relationship. A spark of strong buying interest will encourage owners to sell, pursuing favorable prices. While low buyer interest will subdue potential sellers from listing their property on the market, unless forced economically to do so. The flip side of this, is that more property for sale isn't necessarily rewarded with more buyer interest. Buying is often mimetic, that is people often buy when others are buying, while they hold back when others are not. This is a principle of human nature. Perceived desirable assets are self fulfilling. Sellers are less influenced by other sellers, except when setting reserve prices based on precedent performance.

Each transaction in the market has a 'reason' behind it, both on the buying side and the selling side. Reasons are important because of the zero sum agreements that bind both buyer and seller. While it might be strange to think of transactions as zero sum, most transactions (not all) will have a party that benefits most favorably within the agreement, at the expense of the other party. A real world example would be a cafe that buys its juicing oranges from the market on a weekly basis. If the seller at the market offered the cafe a 12 month supply of oranges, on a fixed contract with a 10% discount, it might be a perfectly fair agreement. However if the seller knows that within a number of months the price will plummet by 50% due to a glut of oranges being produced, then the seller of the oranges receives the favorable arrangement, at the buyers expense.

Reasons are important to understand, as they often hold hidden information about true motivations. Sometimes information that the buyer or seller knows, will add substantial value to their own positions. In this case, the party more informed is known as the sophisticated side. In society, we call this 'smart money'. Information is often asymmetrical by nature.

To get an overview of the market its important to understand who is buying, who is selling - and why? One party will often have an information advantage in the transaction.

If you want to know how the market is performing: then you need to ask - how much money and how much credit is available? What is the quantity and quality of property on offer? Establish what the reasons are for buyers and sellers - and you gain a clearer picture of the market.

CYCLES

The property market is influenced by debt cycles. Firstly, a short term debt cycle which is commonly called the business cycle. The acceleration of wage and credit growth within the private sector grow swiftly compared to the supply of property. Construction responds after this surge in demand and many new dwellings are built. A short term cycle typically ends when strict monetary policy increases interest rates to fight off inflation. Credit tightens and debt servicing becomes difficult on loans, this stops prices rising and a softening in values usually begins. These moments can bring a downturn, with a tight household cutting expenses and reducing money spent elsewhere within the economy. The construction industry is usually caught, with developers and builders locked into contracts to produce property within an oversupplied market place. We typically see bankruptcies within this sector. The commencement of interest rate cuts have a habit of being lowered prior to an incoming recession*. Its not until further aggressive interest rate reductions, that the household sector becomes re-stimulated. Investment into assets starts to look attractive again.

The constant underlying cycle is the long term debt cycle. These can last for 50 - 75 years. These typically end when debt levels become excessive compared to incomes within the private sector, and interest rates cannot be dropped any further to stimulate the economy. This time low interest rates are unable to expand credit again, the individual household instead starts to pay down debts rapidly and seeks to pay down the principal of the loan as fast as possible. This is completed on mass throughout regions, this is called a deleveraging. As credit growth is self reinforcing on the way up, deleveraging is self reinforcing on the way down. With a limited amount of people taking out new credit, the majority of the population are paying down debts and restricting money and credit to further assets. This causes property to fall in value. The further the falls, the greater the deleveraging is. Deleveraging can end in severe downturns (depressions) which cannot be rectified through monetary intervention, as interest rates cannot be reduced any further.

The best way to think of the long term debt cycle is to think of blowing up a balloon. You take one breath and the balloon expands while still remaining stable. You can ease air in and out at this point, the state of the balloon is robust. These short term fluctuations can be compared to the short term debt cycle. After a number of breaths however, the balloon becomes unstable and reaches a point of either popping, or air has to be let out. This can be either in a controlled or uncontrolled manner. Deleveraging is the point from the maximum air pressure of the balloon, back to its initial state of just a flaccid piece of rubber.

STAGES OF INVESTMENT

Like riding a bike, property investment typically moves through three gears of financing influenced by the borrower of credit. The market can ride in a particular gear for decades, however if you look closely, you will see individual investments at any time fit within any of these three gears.

The first gear is the hedge borrower. The hedge borrower makes an investment which receives sufficient cash-flow to pay both the the interest and principal of a loan. In todays environment, this is hard to achieve with most residential property investments.

The second gear is the speculative borrower. This is when the return on investment is sufficient to service only the interest repayments on the loan. Potential capital gains become the motivation for the borrower, however its not assured - its a bet.

The third gear is the loss leader borrower. Return on investment doesn't cover the interest component of the loan, so the loss leader borrower needs to find surplus money to repay the bank. The aim of this part of the investment stage is to find somebody else further down the line who is willing to buy the property at a price that will cover all losses incurred, plus profits.

Interest rate movements can also help a particular investment change gears. Low interest rates at the moment help make return on investment easier, however rates will eventually rise, leaving those who made their investment decisions based on current interest rates in short positions.

If majority of investments made in the market are using the third gear approach, then a downturn is likely to eventuate. Typically these investments are made towards the end of the debt cycle before credit becomes scarce, or interest rates increase.

SUMMARY

Markets are constantly evolving, however certain things don't change. Buyers and sellers always have motivations to trade and debt is the most common vehicle for funding assets acquisitions.

Importantly, we live in present times that are influenced by past events, even many decades ago. Looking at the property market from a birds eye view, including from historical narrative, will assist greatly in improving our understanding. As they say, history doesn't repeat, but it does rhyme.

If you want to know current market conditions, and want to glimpse into the future. Then you need to ask, how much money and how much credit is available and what is the quantity and quality of property on offer. Then establish what the reasons and motivations are for buyers and sellers. By monitoring the debt cycle, and the three different gears of investment, you will have a tremendous advantage in the market.

** Hyman Minsky's landmark paper 'The Financial Instability Hypothesis' has influenced my way of thinking regarding debt. The three gears of borrowing has largely borrowed from his theory.*
** The market is influenced by many other factors that I intend to write about in future. These include the growth of equities, foreign capital, household formation, markets within markets, housing preferences, demographic changes and human nature. Information asymmetry deals with the study of decisions in transactions where one party has more or better information than the other. Sellers of a property will generally have better information about their asset than a potential buyer will, however this is not always the case.*
** A case can be made that all money is Credit. For the purposes of this essay, 'real money' is defined as current holdings by a market participant while 'credit' relates to what is being borrowed.*
** 'Reasons' on why market participants buy and sell are constantly changing. Establishing all reasons is impossible, efforts must be made to gather as much data as possible.*

Please note: This paper is an opinion. This is not financial advice.