

# The property cycle has turned

This chapter takes a closer look at the current trends in both the business cycle and the long property cycle. The forecast performances of the national non-residential property cycle and residential cycle are also analysed.

Historically, the South African long property cycle has a duration of around 17 years from trough to trough (or peak to peak), making it distinct from the much shorter business cycle. However, despite this distinction, the peaks and troughs of the property cycle naturally coincide with a business cycle peak or trough, albeit with a lag of one or two years. The duration of the lag depends on the degree of oversupply at the time of the business cycle trough.

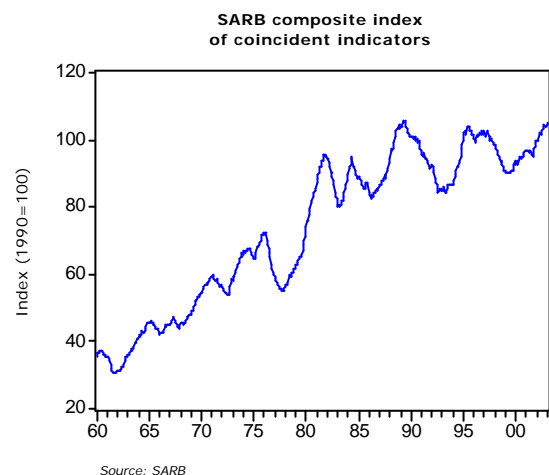
The property cycle can serve as an important investment tool for buyers, sellers and developers. Buyers should typically enter the market when the property cycle is still near its trough, simply because the probability is strong that at that point real rentals and prices are bound to rise. Sellers, on the other hand, should leave the market when the property cycle is near its peak. This is because real rentals and prices are expected to decline in the near future.

Developers normally enter the property market en masse during an upswing. This is because prices and real rentals rise, making new developments more viable. However, to enter into new developments close to the peak could be risky, especially on the down side of the peak and if the developments are done on a speculative basis.

## Business cycle

The business cycle, as represented by the South African Reserve Bank (SARB) composite index of coincident indicators, is still unmoved from its upward trend, in which it has been since the middle of 1999. Not-

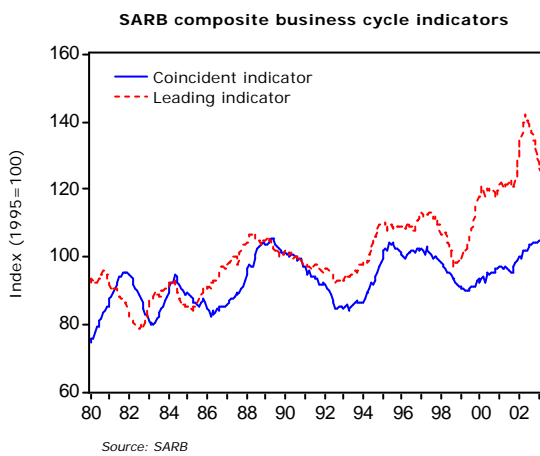
withstanding the slight slowdown in economic growth this year, it is expected that the upswing in the business cycle will continue to 2005/2006, making it the longest upturn since 1960. The upswing should be supported by a further easing in interest rates on the back of lower inflation, further possible income tax cuts as well as a recovery in the global economy. On the whole, the SA government has come a long way in ensuring greater macroeconomic stability in the country, which has laid the foundations for a better performance in the economy. The greatest risk to this scenario is the performance of the balance of payments in the face of declining interest rates, which will boost domestic consumption and imports.



The next graph compares the SARB's leading and coincident indicators. After the strong upturn in the leading indicator since the beginning of 2002, it dived sharply from mid-2002. According to the SARB, the sharp upswing was caused by an increase in many constituents of the indicator, with several of them benefiting from a weaker rand exchange rate. However, this gain was reversed shortly afterwards, following a strengthening in the rand again.

According to our calculations, the leading indicator leads the coincident indicator by

about five months on average. Thus, we can say the leading indicator points to the general direction the economy should follow over the next five months. Although the domestic economy did perform stronger in the last two quarters of 2002, the upsurge was not as sharp as hinted by the leading indicator. We certainly do not expect the coinciding indicator to show the same spike as the leading indicator, nor do we expect the economy to track the latter.



### The property cycle

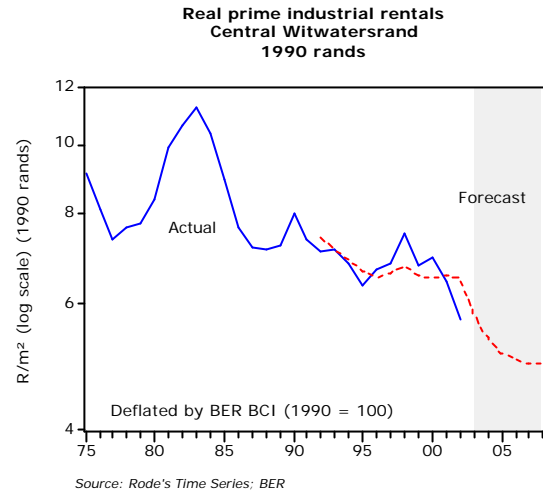
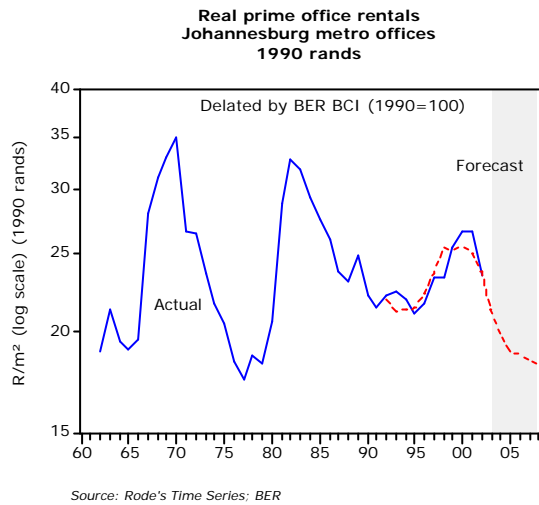
The forecast performances of *real* office rentals, *real* industrial rentals and *real* house prices in the accompanying graphs

are fair proxies for the non-residential and residential sectors of the property cycle.

First we analyse the property cycle as represented by *real* office rentals. For this purpose we use the Johannesburg metro office series, which comprises the historic performances of CBD offices before 1992, while rentals after 1992 are those of Johannesburg decentralized. The accompanying graph shows that the office sector of the property market dipped through its trough in 1995 and peaked in 2000/2001. This equates to a long property cycle of 18 to 19 years from the peak in 1982 to the peak in 2000/2001. Hence, the decline in real office rentals since 2002 is in line with the historic performance of the property cycle. The question, however, is how long the present downswing will last. If the previous downswing of 13 years (from 1983-1995) is to be repeated, then the present dip in real rentals could still have about 11 years to go before turning positive again. However, the downswing in the 1970s only lasted about seven years, which we think is the more likely scenario for the current downswing. If this is true, then real rentals should reach their nadir in 2008 or 2009. As a matter of fact, our forecast of real office rentals shows real rentals slowing down towards the end of the forecast period, indicating that a turnaround in 2008 and 2009 is possible.

It must be noted that the matching of supply and demand in the property market is a formidable task, for essentially two reasons. Firstly, building construction has a long gestation period. Secondly, property has a longer economic life than even durable consumer goods. This implies that, once an oversupply has developed in the property market, it will take many years to be rectified since the existing stock is consumed over decades, leaving only growth in demand to restore equilibrium.

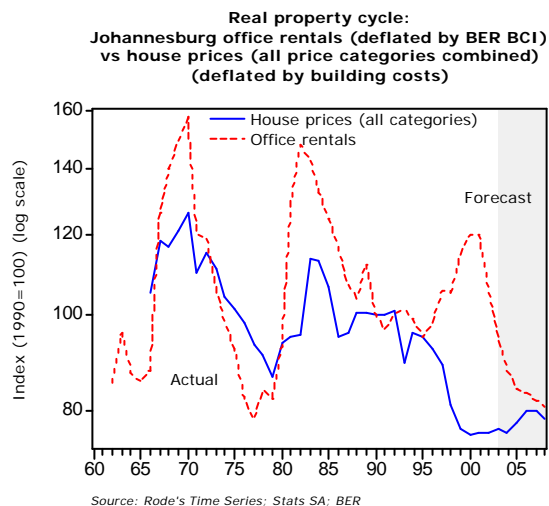
Non-durable goods	Semi-durable goods	Durable goods	Property
Few days to weeks	± 3 years	± 10 years	30 years plus
<b>Economic life in years</b>			



The disappointing news is that the 'ever-lasting' downswing in *real* industrial rentals, as shown by the graph portraying real rentals on the Central Witwatersrand, is expected to continue for the greatest part of the forecast period, with indications of a levelling-off only surfacing around 2007. According to our forecast, real industrial rentals are expected to turn positive in 2008, albeit ever so slightly. If this forecast comes true, then real industrial rentals would have been in a downswing for 24 years. This poor prognosis is indicative of the pressure felt in the manufacturing sector. Postulated reasons for this are increasingly sophisticated production techniques which have enabled manufacturers to produce the same, or more, with less space. Another possibility could have been that manufacturers, as well as distribution and storage companies, have bettered their inventory-management processes, which again implies that less industrial space is needed. Hence, we can conclude that the steady decline in real rentals over the last 2½ decades has been rather a case of structural changes in the industrial property market than normal cyclical factors.

It is important to note the reason for using the Bureau for Economic Research's Building Cost Index (BER BCI) as the deflator in the graphs depicting *real* rentals. It represents the developer's perspective of the viability of new projects over time, assuming similarly growing land values and constant capitalization rates.

In the graphs depicting *real* house prices, building costs have been used as deflator — the BER BCI before 1980 and for the forecast period (2003-2008), and the Absa home-building cost index from 1980-2002. Using building costs as the deflator allows consumers (homeowners) to measure the viability of buying or building a new house. Hence, when *real* house prices trend upward, building rather than buying becomes more attractive due to house prices growing relatively faster than the cost of building a new house.



In the accompanying graph we compare the non-residential and residential sectors of the property cycle up to 2008. Johannesburg *real* office rentals, as used in the first graph above, and rational *real* house

prices (all price classes combined) are used as a fair proxy for the non-residential and residential sectors respectively. Furthermore, we also do a breakdown of the house market reflecting the historic performance of the different price classes, i.e. upper-, middle- and lower priced suburbs.

As mentioned above, *real* office rentals are expected to remain in their downswing to at least 2008/2009 before recovering.

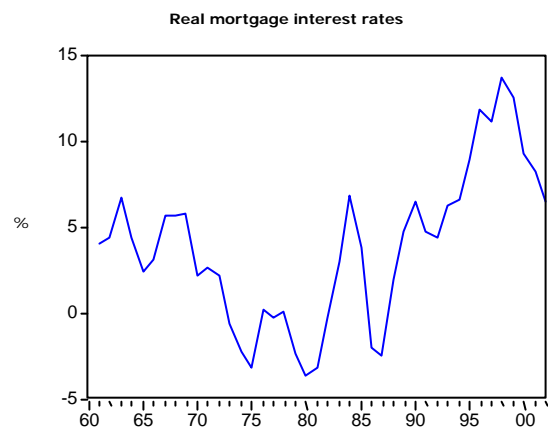
When comparing indices, one is looking at the levels relative to the base date (which has been set at 100) and not at the levels of the actual values recorded. In other words, the analysis in the accompanying graph, portraying real office rentals and real house prices, does not mean that real office rentals have been higher than real house prices since 1995, but that real rentals have grown faster from 1995 to 2000/2001.

Turning to the residential sector, the good performance of *real* house prices during the late 1960s and early 1970s, and again in the early 1980s, might stem from the inelastic supply of new residential erven during this era, aggravated by the baby boomers' demand for housing accommodation. The mismanaged gold boom of the early 1980s also pushed up demand.

As for the last few years' performance, *national real* house prices (all price classes combined) have been growing slowly since 2000, after losing ground since the gold-boom days of the early 1980s. On average, our forecast predicts this upturn to continue.

The graph also shows that the residential and non-residential property sectors followed similar broad trends up to 1995. However, since then they have moved in opposite directions. Real house prices continued to decline after 1995 up to 1999, buckling under the pressure of high *real* interest rates. Before 1995, house prices were not very sensitive to interest rates,

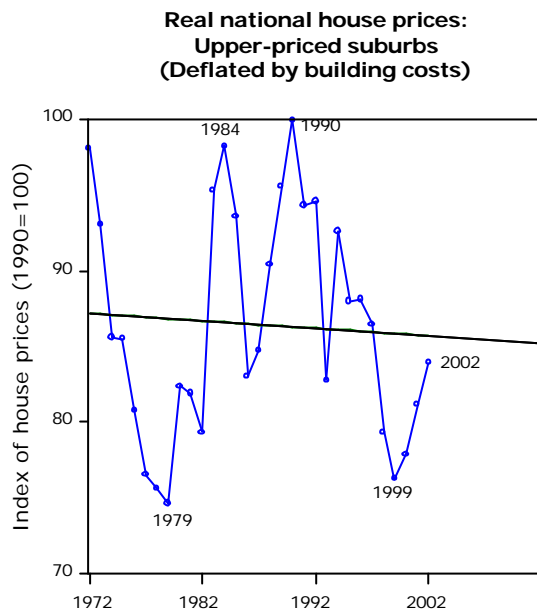
because an increase in interest rates normally coincided with an overheating economy. The resultant increase in money in homeowners' pockets normally exceeded the adverse effect of the higher interest rates, making home buying nevertheless more affordable. The big difference from 1995 was not so much the higher *nominal* interest rates, but the big jump in *real* interest rates (see accompanying graph), which rose way above historic levels, and for reasons not linked to an overheating economy but to external forces over which SA authorities had no direct control.



Source: Stats SA; SA Banks; panel of economists

In spite of the tough interest-rate regime, decentralized Johannesburg real office rentals excelled from 1995 in response to the increase in the demand for office space from especially financial and IT companies, who, in turn, were riding on the JSE boom. However, this led to overoptimistic building and, together with the demise of the financial and IT boom at the end of 1998, resulted in a huge oversupply of space, which ultimately led to the decline in real office rentals soon afterwards.

Next we discuss the historic performance of the different price classes within the house market. *Real* house prices in the upper-priced residential suburbs show far superior real growth than those in the lower-priced suburbs. Furthermore, upper-priced suburbs seem close to their long-term trend (portrayed by the regression line) after showing *real* growth from 1999.



Source: Rode's House Price Index; Absa; BER

But our annual house-price data for 2002 only covers the performance of house prices up to quarter 2002:3, implying that 2002's annual average actually only reflects what has happened up to mid-2002. Hence if we add to the 'mid-2002' figure *real* house-price growth of about 2% (derived from Absa's latest house price data for all price classes and home building costs) for the year to June 2003, then house prices in the upper-priced suburbs should currently be on their long-term trend. According to our calculations, this means that upper-priced houses should in *real* terms then be about 17% from their 1990 high. If we assume that the growth in Absa's home building cost-index will remain around the present level of  $\pm 15\%$  p.a., then upper-priced houses should in *nominal* terms be about 32% from their 1990 high. Thus, if we assume that the present annual *nominal* growth rate of around 15% in average house prices continues, it will take roughly two years for upper-priced houses to reach their dangerous peak of 1990.

However, the above calculations are based on the performance of all price classes, whilst upper-priced suburbs have, on average, put in a superior performance. Thus, if upper-priced suburbs continue performing

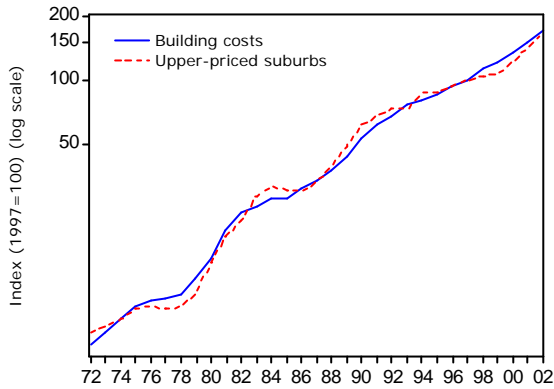
better than the average for all houses, it is more likely that the peak will be reached within the next year to 18 months. This scenario becomes even more likely when one takes into consideration the present favourable climate for growth in the house price market, i.e. lower predicted interest rates, possible further income tax rate cuts as well as healthy GDP forecasts. Another factor that can count in favour of real house prices continuing on their growth path is the likelihood that in many cities the manufacture of new stands cannot keep up with the booming demand for new housing as a result of bureaucratic incompetence and red tape.

From the above we can thus conclude that upper-priced houses are presently (June 2003) moving into territory (above the trend line) where building a new house is becoming more and more attractive relative to buying a newish existing house. We can also say that upper-priced houses have, at the most, two years' *real* growth left before they reach their fatal 1990 level.

The next graph compares the *nominal* prices of upper-priced suburbs with that of home-building costs. As with the previous graph portraying *real* upper-priced houses, this graph also shows that in 2002 upper-priced houses were almost on the same level as replacement (building) costs. Hence, for the same reasons as mentioned above, upper-priced houses were in June 2003 moving into territory above the trend line (replacements costs), making it progressively cheaper to build than to buy.

In the long term, *nominal* house prices should oscillate around the building-cost line (trend line). The trend line can be viewed as the equilibrium point between house prices and building costs. Thus at times an overheated market will lead to house prices being higher than replacement costs (above the trend line), only to be followed by a period during which the opposite applies (below the trend line).

National nominal house prices versus building costs  
Upper-priced suburbs  
(Indexed to 1997=100)

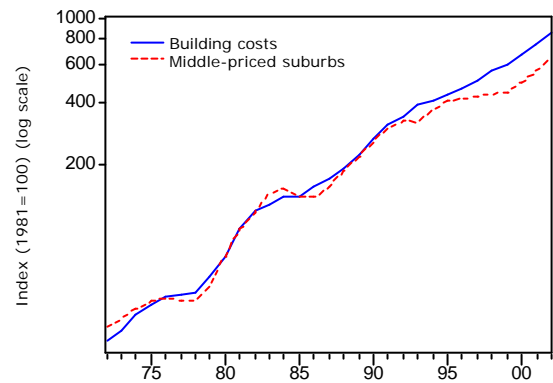


Source: Rode's House Price Index; BER; Absa

As for middle-priced suburbs, *real* house prices have also been on the up since 1999. Still, *real* prices in middle-priced suburbs are a long way off from the levels seen in 1988, not to mention the glory days of the early 1980s. On closer inspection, the first graph portraying *real* prices of middle-priced suburbs shows a sharp decline from 1995, the same time that *real* interest rates shot up sharply. This was the first time since at least the early 1960s that real interest rates moved above their historic band of -4% to 7%.

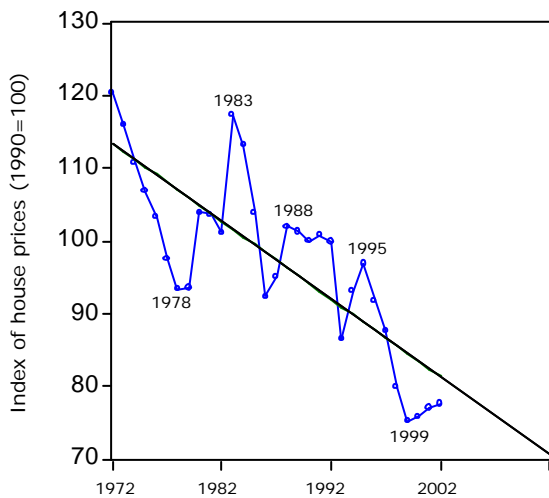
From the second graph, comparing *nominal* prices of middle-priced suburbs with home-building costs, we see that the growth in middle-priced suburbs started falling behind the growth in home-building costs from ±1989. This means that since then it has been relatively cheaper to buy a newish existing house than to build. This trend will continue until the demand for newish existing houses starts outstripping supply. Already middle-priced suburbs have started showing *real* growth, reflecting the steady increase in demand. However, it will still be some time before middle-priced suburbs reach levels where building becomes a lucrative option again.

National nominal house prices versus building costs  
Middle-priced suburbs  
(Indexed to 1981=100)



Source: Rode's House Price Index; BER; Absa

Real national house prices:  
Middle-priced suburbs  
(Deflated by building costs)

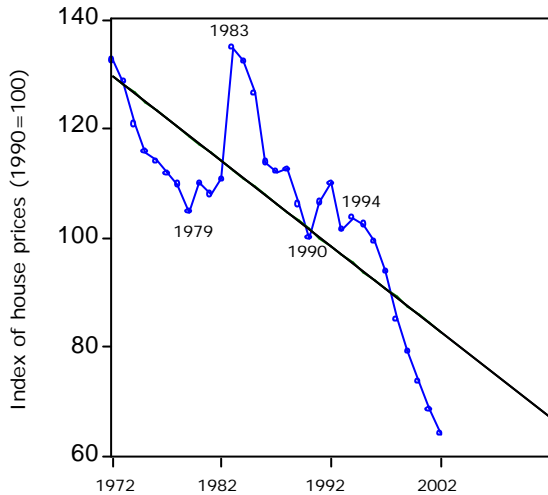


Source: Rode's House Price Index; Absa; BER

Lastly, we analyse the lower-priced house market. The first graph clearly shows how *real* house prices in this category have suffered, with few signs of a reprieve in sight. It seems as if this house-price class has been the hardest hit by the high real-interest rate environment of the last 7 years. Added to the misfortunes of this price class, have been the worldwide trend of the rich getting richer and the poor getting poorer.

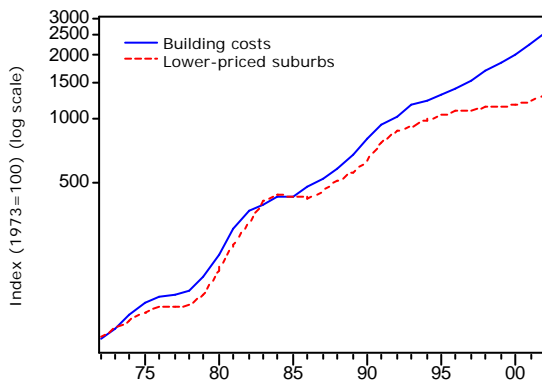
The second graph, comparing *nominal* prices of lower-priced suburbs with home-building costs, shows that it would be far cheaper today to buy an existing lower-priced house than to build one.

**Real national house prices:  
Lower-priced suburbs  
(Deflated by building costs)**



Source: Rode's House Price Index; Absa; BER

**National nominal house prices versus building costs  
Lower-priced suburbs  
(Indexed to 1973=100)**



Source: Rode's House Price Index; BER; Absa

From the above analyses of the different house-price classes, it is clear that the higher income groups were not affected as badly by the higher real interest rate climate as the income groups further down the ladder. Also, it seems the further one

moves down the income-group ladder, the higher the sensitivity to high real interest rates becomes. This can be explained by the higher income groups' average lower debt-to-income ratios relative to those of the lower income groups, meaning that higher earners can better absorb an increase in real interest rates than their compatriots lower down the food chain.

**In sum...**

To conclude, the non-residential property market is expected to remain in a downswing for the length of the forecast period, reaching its nadir not before 2008/2009. However, it seems, on average, as if the residential market is settled in its upward trend, which is expected to continue for at least the remainder of the forecast period. Also, upper-priced suburbs have been less sensitive to the higher real-interest rate climate since 1995 than the middle- and lower-priced suburbs, which have struggled in this environment. In addition, upper-priced suburbs are moving into territory where building a new house is starting to become a more viable option than buying. Still, going by past house-price performances, upper-priced houses have got between 12 and 18 months' growth left before the previous real-terms peak of 1990 is reached. Lower-priced suburbs have been in the doldrums for quite some time, with no sign of any light at the end of the tunnel.

Factors contributing to the expected continued rise in average *real* house prices are a further easing in nominal interest rates in the wake of lower inflation, more income tax brakes, as well as encouraging economic growth. ■