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**Asset price bubbles and manias. How much was the property boom driven by collective psychology and herding behaviour?**

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**September 2005**

This report is submitted as part of the requirements for the award of the MA Property Valuation and Law degree 2004-05.

I hereby certify that this is my own unaided work.

Signed : \_\_\_\_\_

## **Acknowledgements**

Firstly I would like to thank my supervisor, Tony McGough, for his guidance and genuine enthusiasm for this topic, even though it attempts to put the value of a cash flow appraisal in perspective by focusing on the true market mover – social mood.

Robert Prechter, economist and founder of [elliottwave.com](http://elliottwave.com) who coined the term socionomics. His contrarian strategies predicted the boom and bust of the dotcom era, and he predicts a bust for property. His books and articles offer an insight into markets much deeper than most research.

## **Abstract**

This projects aim was to analyse the recent property boom and investigate whether it is consistent with an asset price bubble. Firstly the psychological mechanisms behind asset price bubbles were investigated; how does group psychology, herding behaviour and the madness of crowds contribute to manias, frenzies and price bubbles? Then the asset price bubbles from the past were investigated; in commodities, stock markets and also in property. From the Dutch tulipmania and the Florida real estate bubble to the 1980's property boom and the dotcom bubble.

With an understanding of the psychological mechanisms that build bubbles and given lessons from past bubbles; the recent property boom was then analysed to identify if there were similar psychological mechanisms at work, and if it displayed particular characteristics that would identify it as a bubble. On every analysis the boom was most definitely a bubble. The fundamentals were originally sound, speculative behaviour drove values to an all time high, the euphoria and optimism were extreme and widespread and encouraged by the media. People of average means made fortunes and schemes and scams were developed to exploit the optimism. At the peak most denied the bubbles existence and forecast only higher values. Human behaviour does not change through generations and no defined bubble has ever had a 'soft landing', they always burst, hence the prediction of 30% lower real values by 2010.

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## Hypothesis

The largest single business in the UK is the letting of property, it accounts for 7.9% of total GDP or nearly £100 billion annually. Over the last decade in particular the nation has been collectively gripped by property fever, from city investment funds chasing the latest hot commercial property assets, to lone investors hoping to get rich quick by buying up run down terraced houses in the North of England. The newspapers devote acres of coverage to the subject and the TV schedules are filled to bursting with the latest twist on how to make a fortune out of property. Accounts are legion of those who have already made a fortune from property, and those who hesitated in the face of ever increasing prices, scold themselves for missing 'such a sure thing' as the ranks of the Sunday Times 'rich list' are swelled by the latest property multi-millionaires.

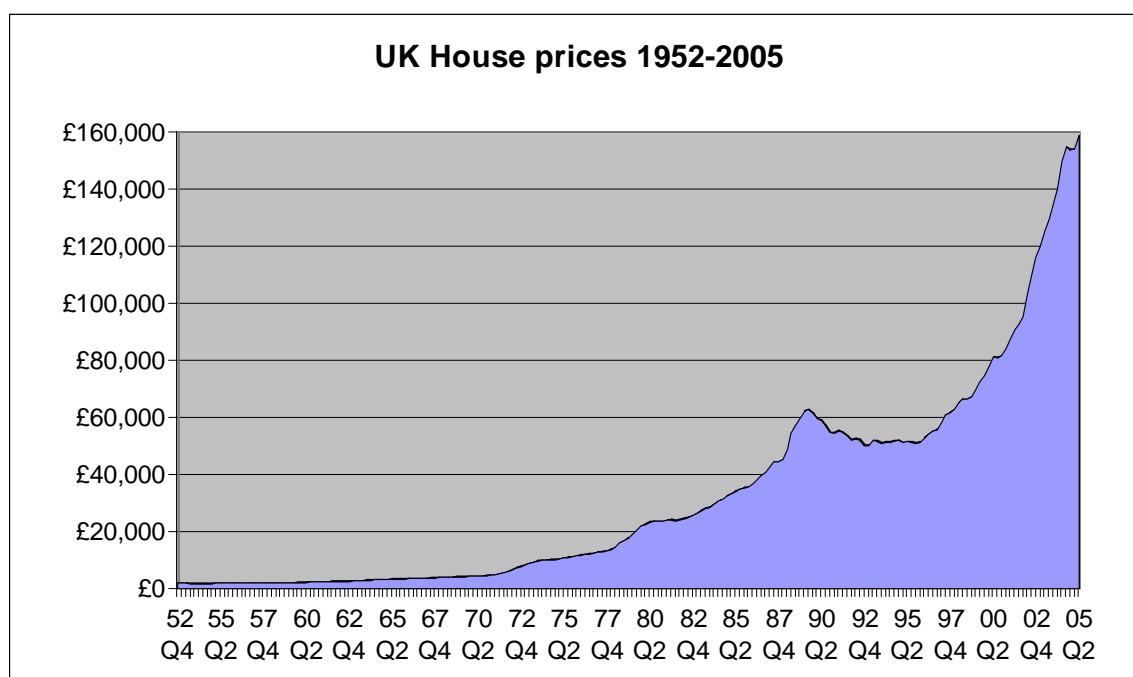
But has the market reached a turning point? After a decade of unprecedented growth, have values been driven to an extreme by an overwhelming positive collective psychology around property of virtually every type. Questions are beginning to be asked as prices stagnate or fall by small percentages, but still both professionals and amateurs alike seem overwhelmingly convinced that it is best not to try and time the market; they state that they are in it for the long haul whatever the consequences.

So, has property experienced an asset price bubble? And is it driven by the same psychological factors that create bubbles in other markets, as most recently evidenced in the dotcom bubble that eventually burst in 2000? Has the euphoria within the stock market and the dotcom boom merely transferred to property since the millennium, as Shiller has proposed, from one asset price bubble into another?

All markets are driven by greed and fear, fear being the stronger emotion, the property market as all others climbs 'a wall of worry' as prices rise investors are fearful that they may be buying at the peak, but clearly never know until after the event. As markets fall they slide down 'a slope of hope' investors hang on in there as they hope that the market has bottomed, often selling just as things turn around for the better. Their emotions and herding behaviour get the better of them and this is not confined to small investors, it is clear in large investment companies too, 'chasing performance' of the latest hot property

assets, driving capital values skyward as yields wither. The paradox within property and with many investment classes is that when assets are expensive and nearing a peak, demand surges as collective opinion dictates that 'the only way is up', conversely when assets are cheap and nearing a trough demand slumps, investors have had enough of this asset and want nothing to do with it, their recent experiences have a much greater effect on their behaviour.

Property in the UK and in many places around the world had never experienced a boom of such proportions, in parts of the UK and Ireland prices had risen 300% over the previous decade. By 2004 prices were higher in real and nominal terms than ever before and at 5.89 x average incomes, way above the long term average of 3 – 4. Can these levels be sustained, and are markets in for a large correction?



*Figure 1. Real UK average house prices 1952-2005 (source – Nationwide)*

The shape of figure 1. is consistent with other asset price bubbles throughout history, including the Dutch Tulipmania, the dotcom boom and the Dow Jones during the 1920's, with growth accelerating towards the end.

The recent enormous growth in property prices was fuelled by modestly rising earnings, falling interest rates and increasing demand due to sociological factors. However the biggest proportion of the increases is almost certainly bubble like in character. More relaxed lending criteria is the primary driver of higher valuations, and the easier availability of credit is itself symptomatic of a positive psychology towards property as an asset.

This is evidenced by mortgages at up to six times income, the 125% loan-to-value mortgage, self certification mortgages (where no proof of income is required) and the introduction of consumer friendly buy-to-let mortgages. In short the property asset price bubble was fuelled by an equally large credit bubble encouraged by a long period of positive group psychology. The credit feeding the boom; and the boom itself allowing credit to be released more freely.

Capital Economics among other forecasters predicts that prices could fall by up to 30% in many countries around the world and in particular in the UK, Ireland, Spain and the USA. But will anyone take any notice? There are still so many more market forecasters (often with vested interests) predicting a soft landing followed by ever rising prices. And there is still an overwhelming positive collective psychology towards property built up from a decade long boom. Cautious commentary is the exception to the rule.

## Part 1 – Theoretical framework

### How does herding behaviour and group psychology lead to mania for property and asset price bubbles?

#### 1.1 Efficient markets and the madness of crowds

*'Everybody was bearish and everybody was selling July cotton. You know how people are. I suppose it is the contagion of example that makes a man do something because everybody around him is doing the same thing. Perhaps it is some phase or variety of the herd instinct. In any case it was, in the opinion of hundreds of traders, the wise and proper thing to sell July cotton – and so safe too! You couldn't call that general selling reckless; the word is too conservative. The traders simply saw one side to the market and a great big profit. They certainly expected a collapse in prices.'*

#### **Edwin Lefevre, *Reminiscences of a Stock Operator* (1923)**

The efficient markets hypothesis as with many economic theories, proposes that man is a rational being. When operating in a market he will behave in a rational way and make rational decisions based on the facts presented to him.

However as with many economic theories, the observation of real world behaviour is often quite different. Individuals are influenced by the opinion and behaviour of others; for most it is psychologically traumatic to express an opinion in opposition to the general consensus let alone act upon it by making a contrarian investment decision. This consensus of opinion is what causes markets to trend in one direction or another, as the majority of participants act on the same opinion, so the market moves in that direction, their herding behaviour causing the market to move in a particular way. The individuals involved will then rationalise their investment decisions as being wise based on the results that they see, although their good fortune is usually the outcome of following the crowd.

This can be observed in the actions of financial fund managers; they are highly trained investment professionals, yet they consistently achieve merely average results and often



fail to match the market index. They benchmark their success against their peers in the industry and consequently follow many of the same investment decisions, leading to mediocre returns at best and comparable losses in a falling market.

The individual who might rationally evaluate that an asset is already too expensive will lose out as the majority weight of opinion within the market takes prices even higher. Professional investors understand this phenomenon and consequently attempt to ride with the direction of the prevailing trend, rather than making more 'rational' decisions about the true value of an asset.

It is this type of mechanism in extremis that culminates in market manias and asset price bubbles and it has been variously described as 'The madness of crowds', 'The herd mentality' and 'Group folly'. Its results have been observed throughout history from the South Sea bubble, the Dutch tulipmania, the roaring 20's and most recently in the dotcom boom leading up to the millennium.

So to what extent can the recent property boom be described as a mania leading to a bubble, it certainly has displayed many similar characteristics to previous price bubbles and is by no means the first such property bubble. The 1920's resulted in a property bubble, most extremely in the Florida real estate. The 1980's boom saw real estate bubbles around the developed world, most notably in Japan where prices are even today down on their peak in 1989, when Japanese investors purchased property with 100 year inheritable mortgages.

Today's property investors rationalise sky high capital values based on projected future capital growth, and ever increasing rents, and the almost universal opinion that you can never go wrong in property – the phrases have entered the language 'safe as houses' and 'as solid as bricks and mortar'.

Only time will tell if they invested at the height of the bubble; but one can assess how 'bubble like' the recent boom has been by analysing how bubbles have developed in the past and then comparing this with observed behaviour and particular activities such as the buy-to-let phenomenon during the recent boom.

## 1.2 How group psychology builds asset price bubbles

Speculative fever or mania for a particular asset, whether Dutch tulips in the 1600's, dotcom shares in the 1990's or property in the recent boom always follows the same pattern of development. The majority investor belief in a particular asset pushes prices beyond previous reasonable valuations, the price remains high for a considerable time period, and with property often for many months if not years, thereby reinforcing investor's confidence and sending prices higher still.

For those involved from the beginning this can be a heady experience, their apparent investment skill has been vindicated and the previous rules of valuation seem to have been left behind. They may have made a fortune that would have taken a lifetime of hard work. The boom seems everyone's topic of conversation and as stories spread of those who have already made fortunes, more and more investors pile into the market sending prices even higher.

The experts in the market are sucked in too, inventing new methods of valuation which are better suited to the 'new era', or the 'new economy'. Such was the case in 1999 at the height of the dotcom boom when market experts were predicting Dow 100,000 within 10 years (it had just passed 10,000), and similarly in London in 2002, as average property prices passed £250,000 many commentators predicted an average price of £1,000,000 by 2015; spuriously extrapolating past gains into the future. To those who had stood by and watched the message is clear, things are only going to get better. By now Investors have witnessed the wildest gambles turning into financial success and any voices of reason or moderation are drowned out by the clamour of speculation and the roar of the crowd as the market on mass inflates the bubble still further.

These observations of the frenzied crowd in the grip of a speculative fever are nothing new. Charles Mackay depicted just such behaviour in his classic book '*Extraordinary popular delusions and the madness of crowds*'; first published in 1841. The book is still widely referred to in the financial world as a warning from history of mans collective follies; and as a reminder of the powerful psychological forces at work within markets.

Mackay was fascinated by the collective behaviour of people swept up by popular ideas of all kinds from witchcraft and alchemy to the financial bubbles created by the South Sea Company and the Mississippi Scheme. The historian, Professor Norman Stone who wrote the introduction to the 1995 edition of Mackay's book draws the reader's attention to modern comparisons of the phenomena. For the South Sea Bubble we have the roaring twenties boom, for alchemy we have alternative therapies like acupuncture and homeopathy, and for Dutch Tulipmania we have the obsession of modern collectors who pay millions for works of modern art that have no intrinsic value save for the demand from other similar collectors.

Professor Stone writing just prior to the beginning of the dotcom boom and the recent property boom, would no doubt be fascinated to note that collective human behaviour has contributed in much the same way as in previous generations, to the building of asset price bubbles; although the objects of obsession are necessarily different for our times.

The psychology of crowds is best expressed by Charles Mackay himself all those years ago:

*In reading the history of nations, we find that, like individuals, they have their whims and their peculiarities; their seasons of excitement and recklessness, when they care not what they do. We find that whole communities suddenly fix their minds upon one object, and go mad in it's pursuit; that millions of people become similarly impressed with one delusion, and run after it, till their attention is caught by some new folly more captivating than the first. We see one nation suddenly seized from it's highest to it's lowest members, with a fierce desire of military glory; another as suddenly becoming crazed upon a religious scruple, and neither of them recovering their senses until it has shed rivers of blood and sowed a harvest of groans and tears, to be reaped by its posterity..... Money, again, has often been the cause of the delusion of multitudes. Sober nations have all at once become desperate gamblers, and risked almost their existence upon the turn of a piece of paper..... Men it has been well said think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one.*

**Charles Mackay, Extraordinary popular delusions and the madness of crowds. (1841)**

### 1.3 The Dutch Tulipmania

One of the earliest examples of market mania leading to an asset price bubble occurred in Holland from 1634-37. It is often quoted as an example of how a fad or fashion for a particular commodity can hype valuations to absurd levels and how speculators neither owning nor desiring the produce itself exacerbate market fluctuations.

The Dutch had a long history of trading in tulip bulbs, but in the early 17<sup>th</sup> century the rarer varieties became prized by aristocrats and wealthy merchants in Holland and other parts of Europe. Their fashionable allure arising precisely because of their beauty, fragility and difficulty in propagation, they became a status symbol for the wealthy; rather like a couture dress today that might sell for tens of thousands of pounds.

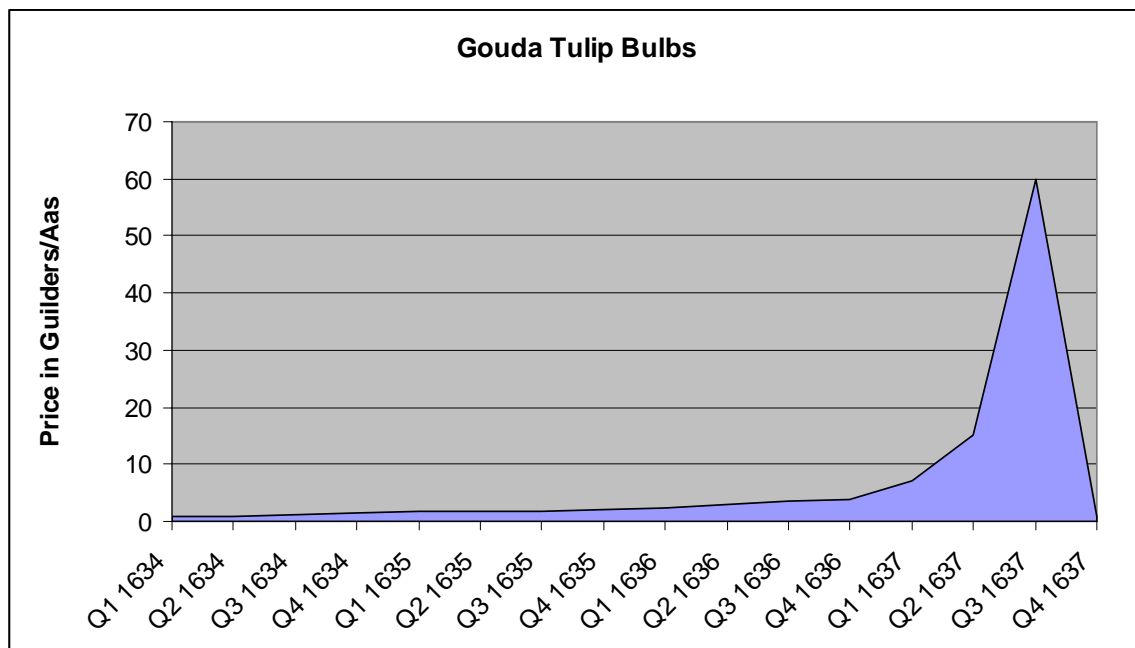


Figure 2. Gouda Tulip Bulbs prices 1634-1637 (source - Elliot wave international)

Rising prices through fashions demands attracted non-professionals into the tulip trade from 1634. The fact that the Dutch operated an early kind of futures market in bulbs, where trades could be made on bulbs still in the ground, encouraged speculative

investment - similar to what happens today in agricultural commodities like potatoes, wheat, oranges and coffee.

In the final stages of the mania foreign investment flooded Holland and people of all classes liquidated other assets in order to trade in tulip bulbs. True futures markets emerged in 1636 where buyers neither possessed the cash to purchase bulbs in the future nor did the sellers possess the bulbs to deliver. Futures contracts themselves were traded wildly in a frenzy of speculative gambling.

At the height of the mania a single Semper Augustus bulb was sold for 5500 guilders, equivalent at the time to the price of a substantial house, and hundreds of thousands of investors were gambling their entire fortunes on futures contracts or the bulbs themselves which had minimal real value. As always with manias; the frenzy died almost overnight in February 1637. The specific reason remains unknown, although it is likely that large traders simultaneously tried to cash in on their good fortune (aware of the folly of the crowd), flooding the market with tulip bulbs and causing prices to spiral downwards. Prices quickly fell by 90%, and Holland was mired in an economic slump as thousands of individuals apparent fortunes vanished.

#### **1.4 The Wall Street crash of 1929**

*'When Main Street talks, Wall Street walks.'*

***Well known saying on Wall Street, of unknown origin.***

The boom on Wall Street leading to the crash of October 1929 was characteristic of an asset price bubble. The origins of the boom were initially sound, but as stock prices gathered pace, more and more money and people were sucked into a speculative frenzy for stocks. The economists of the day declared a 'New Era' of ever rising prosperity and ever rising stock prices.

The generally psychologically positive feelings of the times encouraged many ordinary individuals who had never participated in the markets to become involved and 'invest'

(risk) their life savings on the latest radio, telephone, automobile or aero stocks, then the new boom industries of the day.

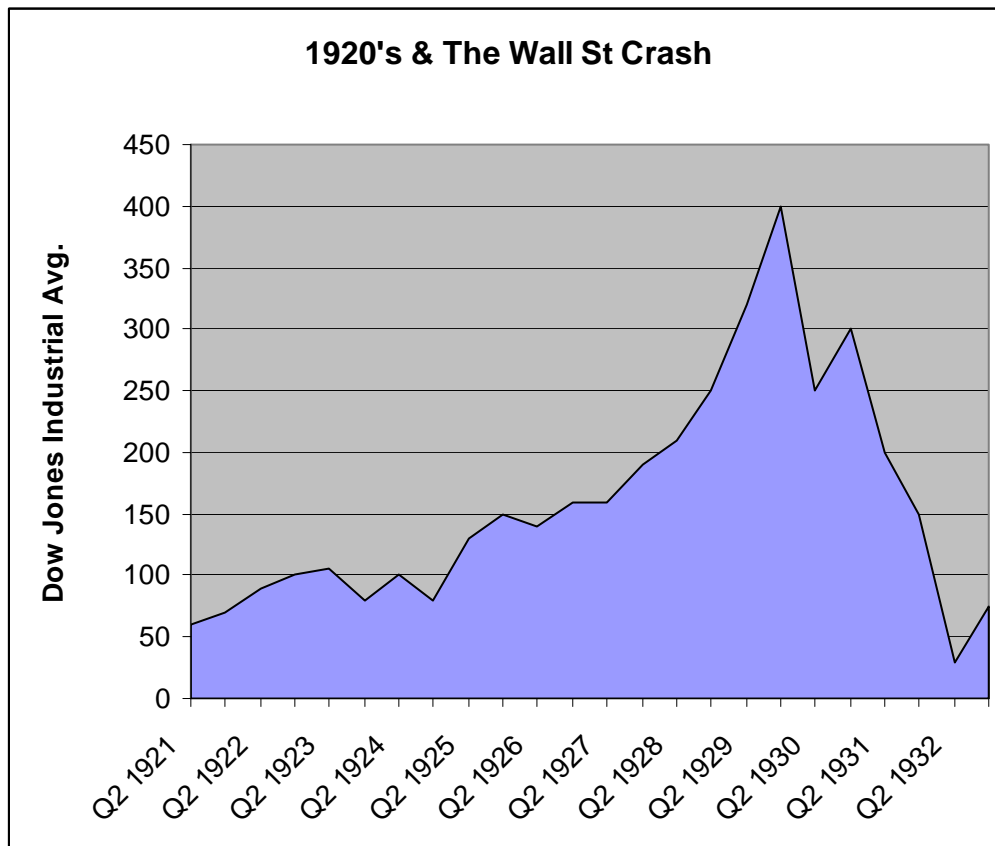


Figure 4. Dow Jones Industrial Average 1921-1932 (Elliot Wave international)

A popular legend of the times says that in early Oct 1929 the Wall Street financier Joseph Kennedy (father of JFK) was having his shoes polished by a shoe-shine boy somewhere in New York. The boy was obviously ambitious and followed the markets. He even suggested some hot tips to Mr Kennedy of new companies that he thought were going to make it big. On returning to his office, Kennedy figured that if even the shoe-shine boy was offering him stock tips that the end of the boom must be close; the positive feeling towards the market was obviously so widespread that virtually everyone from the highest to the lowest were hoping to make it big in the market; the last money was coming in and therefore there was little upside potential. In fact in such a position a major downturn looked inevitable as the smart money, in from the beginning would begin to cash in their winnings at the sky high valuations. Kennedy himself did just that, ordering his brokers to sell, and so rescuing his fortune from the ravages of the Wall Street Crash.

## 1.5 The Florida real estate bubble

During the roaring twenties many average Americans became wealthy, bought cars and enjoyed more travel. A popular destination was Florida, then relatively undeveloped. Visitors from the Northern states enjoyed the warm weather and while on holiday witnessed the beginnings of a building boom and heard of land values doubling and trebling.

The population of Florida was exploding and soon speculative money was flowing into Florida real estate as huge new golf communities and villas with swimming pools were built; the Miami Herald became the heaviest newspaper in the world due to all the real estate advertisements. Between 1922 and 1925 values boomed and increased four fold in one single year. Speculators were causing a frenzy of investment and began buying marginal swampland that would never be economically viable to develop.

Nonetheless values continued to spiral as speculators played 'pass the parcel' selling on quickly to other speculators seduced by the sight of fortunes being made. Prices became ludicrously high and new investors could no longer afford to buy. Earlier investors decided to exit the market in droves and those unfortunate enough to be left holding the baby when the Florida bubble imploded in 1925 found themselves with unwanted and often worthless land that lead to their own bankruptcies. To compound the crash a hurricane ravaged South Florida in 1926, and the market took until after WW II to recover.

The mechanisms behind the Florida real estate bubble seem remarkably familiar to situations today as UK investors buy in sunshine hotspots across the world. The starkest similarity, for scale and hubris, must be in Dubai.

## 1.6 The 1980's worldwide property boom

The Dutch Tulipmania occurred during the origins of modern capitalism, and the 1920's represented the zenith of unrestricted commerce. Modern markets are much better regulated, and so surely such collective folly couldn't happen in modern times? Mackay had observed the crowding behaviour before the Victorian era, yet since then there have been numerous instances of manias leading to asset price bubbles. Our own era is no exception; the psychological drivers behind crowd behaviour remain the same, they come from primal instincts developed in a distant epoch. Mans psychological evolution has not had time to catch up with our technological development, so consequently manias and bubbles are just as common in the modern world.

The 1980's saw a property boom which ended in tears and bankruptcy for many, and which was characteristic of a classic asset price bubble in its conception and growth. David Dreman best describes how the eighties boom took hold, the similarities to today are prescient, for 'third world loans' just substitute 'internet stocks'.

*'In The Graduate, a guest at Dustin Hoffman's graduation party takes him aside and whispers one word to him – plastics. That's where fortunes would be made in the 1960's. In the 1980's it was to be commercial real estate. The beginnings, as they often are, were sound enough. The remarkable boom in real estate was triggered by its impeccable performance in the past. Real estate had a solid record of appreciation since the war.....because it had only gone higher in the past 40 years, it was inevitable, the smart money believed (and all money thinks it is smart), that it would continue to soar.'*

*'Big bucks flowed into commercial real estate. Banks, after losing heavily on third world loans, eagerly poured money into real estate. With prices ratcheting up, savings and loans, insurance companies, and other financial institutions increased their commitments, while the nation's gargantuan pension funds entered this market, many for the first time.'*

**David Dreman, 'Contrarian Investment Strategies' (1998)**

In Japan after a tenfold increase in property values through the 80's, banks were agreeing to finance speculative projects at 100% of their proposed value; and at the same time they



launched the 100 year inheritable mortgage for desperate first time buyers. These practices were deemed wise as Japanese property as well as Japanese stocks, would of course 'never fall in value'. The reality proved rather different, both property and the Nikkei index are still well below their 1989 peaks in Japan some 16 years later.

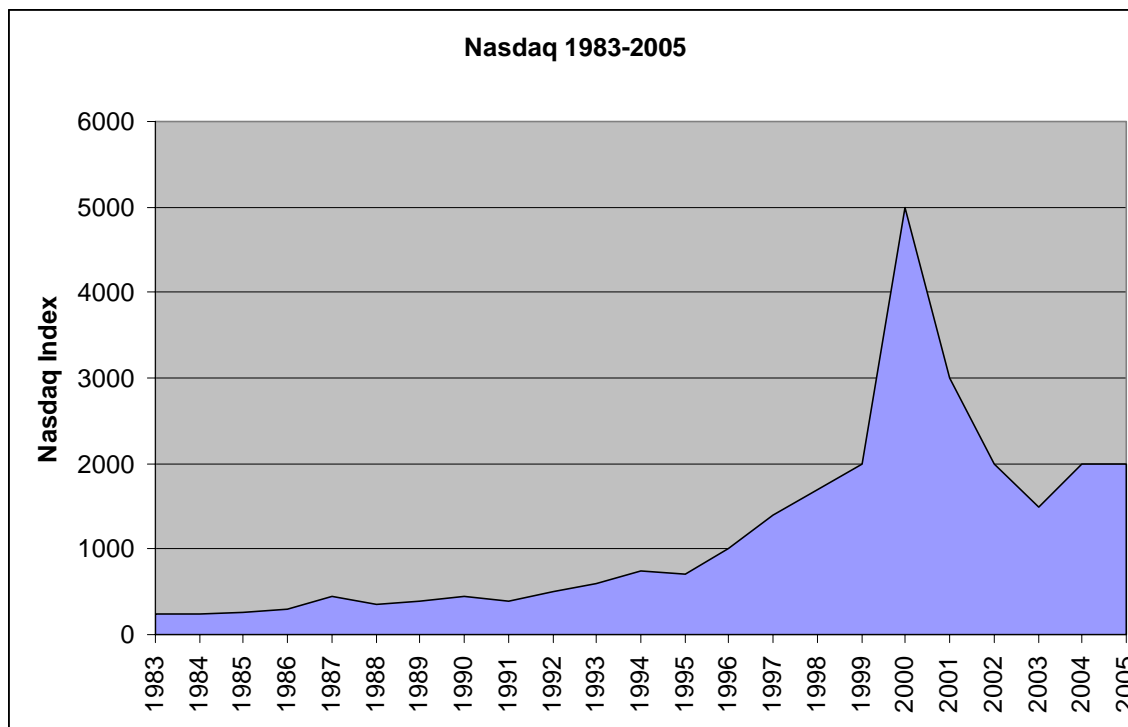
In the West the easy availability of finance fuelled a building boom leading to a huge increase in the amount of vacant office space. Paradoxically the same financial institutions providing the money for the development were cutting back on their own space requirements due to greater efficiencies. Between 1980 and 1992 office vacancy rates soared in New York from 2.9% to 17% and in London from 2% to 20%.

Because of the long time scale on large developments, just as many of these developments came to market in the early 90's, rents were falling and their highly geared developers were in trouble. The Reichmann brothers lost billions on London's Canary Wharf, and in the US Donald Trump filled for bankruptcy.

### **1.7 Modern mania – the dotcom bubble**

The late 1990's witnessed a market mania not seen since the excesses of the South Sea Bubble and the Dutch Tulipmania. It outstripped any modern stock market boom for excessive valuations and general hubris and excitement among investors. No doubt the new technology of the internet would generate some companies that would revolutionise the way business was done, some of which are still with us today like Amazon, Google and Ebay.

However, the momentum of money chasing the latest internet float on the stock market created many ludicrous businesses that defied logic in their inception and created bogus valuations which could never be justified through conventional accounting.



*Figure 3. Nasdaq composite index 1983-2005 (Elliot Wave International)*

Individual investors and stock market professionals alike were swept up in a frenzy of speculation and a thirst for easy money; this was the beginning of a technological revolution and all the so called 'smart money' wanted to be in at the beginning in order to reap the riches that would surely follow. The internet or technology label seemed to give a business a sheen of gold, and entire new markets were born to accommodate all the new businesses, like the Nasdaq and Techmark indices.

The dotcom boom itself was born out of the bull market of the 1990's. The traditional stock market had been doing so well that no less than the chairman of the US Federal Reserve – Alan Greenspan was urging caution as early as Dec 1996. 'Irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions.' Markets worldwide reacted with swift falls, but the setback was short lived. Greenspan was warning that a company's share price should at least bear some relation to its underlying earnings and by 1996 it was clear that many shares were trading at wildly optimistic price-earnings ratios; but at least these shares represented businesses that actually made some money in the first place unlike many dotcoms.

As the dotcom boom gathered pace investors scrambled to buy shares in companies that had no earnings at all and often when properly analysed no prospect of ever making a profit in the future. The list of new technology companies once valued at hundreds of million pounds and that eventually folded is lengthy and includes online dog food retailers, and the much hyped Boo.com an online designer clothes retailer, with the fundamental problem that people would not part with designer size money over the internet for clothes that they could not touch and feel or try on. Nevertheless J.P.Morgan, Goldman Sachs and Benetton financed the venture to the sum of \$185 million dollars, which was lavishly squandered by the businesses founders Kajsa Leander and Ernst Malmsten, photogenic Swedes in their twenties who managed to generate only \$1 million worth of sales and whose website took over a year to launch and even then was flawed and difficult to use. Lastminute.com, essentially just a travel agent soared in value on its floatation day to £733 million on a turnover of just £490,000; yet within three days the share price had halved.

The new economy and the revolution of the internet required new rules of valuation, professionals and amateur investors alike needed reassure (or delude) themselves that they were making sensible investment decisions.

*'We have one general response to the word "valuation" these days: "Bull market". The internet has introduced a brave new world for valuation methodologies and it is a time of especially high risk/reward, in our view. When you overlay the high valuation of many start-ups with the relatively high valuation of the general market, well, we are where we are just trying to do our jobs and find some early stage great companies. If they execute, the valuations will take care of themselves. Again it's about monster markets, great management teams and good products.'*

**Mary Meeker, stock analyst, Morgan Stanley.**

The dotcom bubble burst in 2000 and most of the few companies that survived still cannot justify their bubble valuations based on earnings today. The German technology index folded completely and the Nasdaq was down 80% from its peak as the ensuing bear market engulfed both new economy and more traditional shares.

Greenspan's 'Irrational exuberance' finally vanished from the world's stock markets as speculators lost their entire stakes in internet companies and pension funds folded with the loss of people's life savings. The upward rise in share prices had lasted since 1980 with only brief setbacks along the way and so a prolonged bear market was beyond the bounds of most people's experience. Hadn't they always been told that the best returns were in equities? Amateurs and professionals alike had adopted a 'buy and hold' strategy, and any market weakness was an opportunity for bargain hunting, they were encouraged to 'buy on the dips'.

Unfortunately these strategies merely exacerbated their losses in the bear market, and investors both amateur and professional began to withdraw money from the markets and search for a safer home for their investments. During periods of economic expansion and bull markets, property generally does well although its growth tends to lag behind other more liquid markets like equities. As the bear market gripped the financial markets in 2001-2002; the property market was still in the early to middle stages of its boom. Investors, reassured by five years of solid performance and the supposed physical solidity and safety of property (just as they had been during the 80's boom), piled money into the market which has ultimately resulted in the highest property prices in history, both numerically and in real terms.

### **1.8 But property always goes up, right?**

In 2000-2001 the property market (in terms of the psychological construction of an asset price bubble) was at the stage where a small number of investors had made fortunes, and the evidence was reassuring more cautious investors who still had memories of the early 90's slump. Now, investors both amateur and professional, who were being burned in the stock market, began to transfer their investments into property and add fuel to the property boom.

Interest rates were falling and all the 'smart money' seemed to be going into property. The consensus opinion; that property always goes up and that it was the safest of investments was once again reborn, casually ignoring any evidence to the contrary. Riding off the back

of nearly ten years of bullish psychology now no one seemed to remember the dark days of the early 1990's, when repossessions soared and office developers went bankrupt. Or periods in the 1970's when property growth failed to keep pace with rampant inflation, thereby losing money in real terms.

During the depression of the 1930's property prices tumbled along with all other asset classes, and rents continued to fall throughout the 1940's. A property investment made in 1930 would have been disastrous to hold onto for the next 20 years, even if an investor could find tenants for it and avoided repossession.

However, as is ever the case during a boom period things were 'different this time'. Interest rates and inflation were low, and many market commentators declared that the beast of high inflation had been killed off entirely, and we could look forward to a future of only low interest rates. Of course, the details of the boom are always different, but the fundamental drivers behind it, group human psychology or herding behaviour are necessarily the same; people from generation to generation are affected by the same emotions of greed and fear that cause markets to move, only the objects of their obsession changes.

## **Part 2 – Contemporary mania, property and buy-to-let**

### **The 21<sup>st</sup> century property bubble, causes and symptoms**

#### **2.1 The origins of the boom and the influence of buy-to-let**

The residential private letting sector of the UK accounts for just 10% of all residential properties or about 2.5 million units. Successive governments have attempted to encourage greater institutional and private investment in the sector with largely limited success. This began with the abolition of rent controls in the 1980's and the introduction of Assured Shorthold Tenancies (AST's) in 1988.

Prior to these measures, private tenanted properties often traded at a huge discount to the wider market because of extensive security of tenure for sitting tenants and the possibility of inheritable tenancies. Landlords were also liable for extensive repairing obligations, despite low and often fixed rents. Consequently much of the sector was dominated by unscrupulous slum landlords like Rachmann and Van Hoogstratten who skimmed on repairs and often terrorised tenants into leaving in order to gain vacant possession of the properties.

The abolition of rent controls and the introduction of AST's has encouraged a new breed of individual private landlords, yet the percentage of private lets remains the same. It would seem that traditional landlords have sold out of the market, while new often more amateur operators have filled the gap, 75% owning less than five properties. The large institutions, until very recently, have largely ignored the private rented sector, despite the introduction of Business Expansion Schemes (BES) 1988-93 and Housing Investment Trusts (HITS). The professionals still regard the sector as management intensive and more risky than commercial properties which can be let on long full repairing and insuring (FRI) leases.

In the early nineties many properties became private lets by default as owner occupiers who had to move, yet could not sell or were in negative equity, rented out their previous homes. There was little straightforward investment in the sector, not least because of the difficulty of obtaining finance. The BTL mortgage as such simply did not exist. Properties

were financed on often expensive and difficult to obtain commercial loans. Investors required a proven track record in property, a large amount of equity to put down and often had to pay well in excess of the base rate in interest.

Experienced landlords of the time demanded large yields, to cover their financing costs and also because they understood the other significant costs characteristic to residential property. Short term tenancies result in frequent voids, repairs and refurbishments; and attract feckless tenants who think that the payment of rent is an optional obligation (despite glowing references and credit checks). There are also service charges and insurance to pay and the costs of acquisition and disposal are significant, particularly now with the huge rise in stamp duty.

Much of this seems to have been forgotten by today's generation of amateur landlords who think that a 6% return on their investment is great because it beats a bank deposit and more than covers their interest payments. If they did take the time to factor in all their other costs they would soon find that they were making a significant loss. Despite this they seem to persist with the belief that this does not matter because they are in it 'for the long haul' and they will make a fortune from the capital appreciation of their property. Such is the present belief in property generated by the positive psychology of the recent boom. But why should an asset appreciate in value, if it can't even pay for itself in the first place?

The most significant change to bring about the BTL boom began around 1995. As property stabilised and future growth looked likely, lenders relaxed their rules on who they would lend to for residential property investment. The BTL mortgage was born and was available to pretty much anyone who could provide a 15-20% deposit and proof of potential rental income, whether they had any experience in property or not.

The hard lessons learned by a previous generation of residential landlords, through years of experience, seemed to be casually forgotten by the new BTL investors caught up in the excitement of the times and the prospect of making easy money. Low yielding investments which would only have been viable for an owner occupier in the past, were suddenly also being chased by numerous BTL investors, driving prices much higher in spite of residential rents only growing slightly, as they do normally as a percentage of average incomes.

## **2.2 Chasing value, London, Brighton, Manchester, Liverpool, Hull**

As the BTL phenomenon took hold and prices exploded in core rental areas such as Inner London, investors began to look for better yields and the potential for growth elsewhere. Secondary areas of London, Brighton, student towns and cities like Manchester and Leeds now became the focus for investment.

Once again the volume of investment money along with local demand pushed prices up in these areas, and combined with now prevalent property investment schemes buying up entire blocks in some cities, the supply of newly available property to let soared; this had an adverse effect on rents and often resulted in long voids for new landlords. However, despite some difficulties, peoples enthusiasm for property as an investment would not be dampened just yet, there was still too great a head of steam behind the boom; investors would simply look to the next 'up and coming area' or the next tipped 'booming' city.

Liverpool became extremely popular, due to it being awarded European City of Culture status for 2008. Today Hull, recently voted the worst place to live in Britain and with some of the lowest prices in the country, is tipped as the next booming market, surely a sign that the end of the cycle is close and that all the positive energy must be running out in the market. Tony Dye, the fund manager and long term bear in both stocks and property, has dire predictions for the future of such markets - in particular Liverpool. He believes markets in such places are truly bubble like in nature.

## **2.3 Fly-to-let, France, Spain, Czech Republic, Latvia, Bulgaria.**

Inevitably investors began searching abroad for better value and better returns. Affluent Britons had for a long time bought second homes in France or Spain, but this time the motivations were investment based and relentlessly plugged in the property press and on television.

The surge in British people buying holiday properties to let, often with unrealistic ideas about their management and potential returns has resulted in a huge glut of such



properties available to let. Countries which have just entered the EU have also lured investors. Legal and tax systems can be difficult, and local economies often don't deliver the kind of tenants and yields that investors are promised; not to mention the difficulties of profitably managing a property in another country.

Previous generations of residential landlords understood these problems and usually kept their portfolio efficiently centralised in one local area and near to home. With many of the new breed of investors buying abroad, the heart seems to rule the head as they are seduced by the exotic and different, and there is inevitably a bit of one-upmanship going on. 'Just bought a flat to let in Prague' is bound to sound better than 'Just bought a flat to let in Penge.'

## **2.4 Auction mania and commercial property**

Property auctions had traditionally been the preserve of property developers and dealers. Most of the lots had defects that made them unmortgageable or they were building society repossessions. This combined with a 10% deposit and exchange of contracts on the hammer meant that most inexperienced people steered clear.

However, during the recent boom and encouraged by a rash of TV programmes, it seemed that everyone became an aspiring property developer, and sought an auction 'bargain'. More flexible financing enabled the uninitiated to take part and auction prices rose as amateur developers paid too much for potential projects. Any experienced developer who had performed a proper residual valuation, cash flow appraisal or indeed just a 'back of an envelope' estimate, with a suitable margin for profit, found themselves outbid by excitable new entrants hoping to make their first million in property.

The auctions also introduced the new BTL market to the possibilities of investing in commercial property. Many sales combined residential and commercial, and inexperienced investors were often seduced by apparently better yields and full repairing and insuring leases. Most prime commercial real estate is traded between the large firms of chartered surveyors, and often the properties sent to auction have complex leases and other problems which require expert management, that a novice investor would then have to buy in.

## 2.5 Voodoo economics and the credit boom

Property values in the UK at the peak of the cycle today are the highest they have ever been by any kind of measure; and naturally the market seeks to rationalise the high prices based on fundamental economics, near full employment, growth in earnings, low inflation and a steadily growing economy. There are also demand side pressures caused by more single person households and immigration. However as with the stock market boom of the late nineties, the fundamentals are used to justify high valuations after the fact rather than it's root cause.

The inflation of asset prices everywhere actually lags real economic expansion, and it happens primarily because of the expansion of credit following a period of above average economic expansion. Growth in GDP in the UK during the 1950's and 1960's was much greater than during the 1980's and 1990's yet it was the later period that saw the expansion of asset prices. The expansion of property prices at 15-20% per annum during the last boom, when economic growth was running at 2-4%, is symptomatic of overwhelming positive psychology leading to more relaxed lending criteria and a resultant expansion in mortgage lending and consumer credit.

Economists were apt to state that consumer and high street spending was keeping the economy growing when in reality consumption can never be regarded as creating real wealth, only production of goods and services can do so, and much of the consumption itself was funded from people re-mortgaging their homes to clear credit card debt, only so that they could take on even more consumer debt.

The success of the UK's retail sector and the financial services industry providing all the credit was in itself helping to fuel the property boom. This situation truly was a house of cards in more ways than one, and not much better than a ponzi scheme, where the merry-go-round of credit helped to perpetuate the boom. The proliferation of 6x salary interest only mortgages, 125% loan to value mortgages, and self certification deals with no proof of income are exactly the type of credit expansion that could only happen during a euphoric period of rising asset prices; as indeed these deals can only work if property prices continued to rise into the future.

Recent figures suggest that the consumer boom is over as many retailers report their worst sales figures for over a decade. As the property market slows and goes into reverse expect repossessions to soar as consumers with already overlarge mortgages and mountains of consumer debt, are unable to secure further finance and find themselves in negative equity.

## **2.6 A cultural and media frenzy for property**

The recent property boom has been accompanied by a widespread cultural and media fixation with property as an asset, and as a potential source of easy money. The British have long had an obsessive relationship with property, resulting in phrases such as 'An Englishman's home is his castle,' and the UK has much higher levels of home ownership than other European countries with about 70% owner occupiers. It is a widely held belief that owning is preferable to renting and successive governments have encouraged it, not least because it is a vote winner. The Conservatives introduced 'Right to Buy' for council tenants in the 1980's and maintained MIRAS (Mortgage Income Tax Relief at Source) until 1989. Gordon Brown pledged in his recent budget to increase owner occupation to 75%, and the government are now introducing SIPP's (Self Invested Personal Pensions) which will allow individuals to invest in property as part of their pension; a development which is certainly symptomatic of the bear market in stocks and the perception of property as a safe haven.

Today after a decade of increasing property values, pretty much everyone believes that you have to get on 'the property ladder' and there is genuine anger and indeed envy among the first time buyers, priced from their birthright of ownership by 'greedy' second home owners and buy-to-let investors. So called key workers, cannot afford to buy near where they work and there is general indignation from a generation that has been brought up to regard property ownership as a fundamental human right.

The reason for this state of affairs is both generated by and reflected in the media, indeed there is even a TV programme called 'Property Ladder', incidentally about how to make money from development and not aimed at owner occupiers. In 1995, when property was

cheap and pretty much anyone could have bought a one bed flat, there was almost zero coverage in the mainstream media of property issues, except for stories of those left homeless after struggling for years in negative equity and finally being repossessed.

Today every newspaper has a property section featuring the latest overpriced developments and articles and advertisements encouraging people with limited resources and no practical experience to 'invest' in buy-to-let in run down cities in the North where the boom is only beginning to peak, or even in countries they have barely heard of that have just joined the EU.

The TV schedules are now overflowing with property; what began with Changing Rooms, which was really just about fixing up your own house, has now developed into a speculative bubble of programmes. We have Location, Location, Location, A Place In The Sun, Grand Designs, Property Ladder, Homes Under The Hammer, The Million Pound Property Experiment and Call Yourself A Property Developer to name just a few; and the emphasis most recently, as is symptomatic of the mood towards property, is on people risking all to make it as property developers and speculators.

As with the market commentators in the roaring twenties, the journalists and the TV presenters feed off the prevailing positive mood and magnify its significance back to the public at large. If people are already invested they can smugly reassure themselves of their wise decisions and relax, and if not they can console themselves that they are still not too late to join the party; after all they can still afford to buy that house in Bulgaria and get 'on the ladder' there, despite the fact that they live in South London.

Given the prevailing mood right now and the relentless chatter about property from professionals and novices alike; I'm sure that if Joseph Kennedy were invested in property today he would be selling up right now.

## 2.7 Schemes, scams, and REITS.

*At length corruption, like a general flood,  
Did deluge all; and avarice creeping on,  
Spread, like a low-born mist, and hid the sun.  
Statesmen and patriots plied alike the stocks,  
Peeress and butler shared alike the box;  
And judges jobbed, and bishops bit the town.  
And mighty dukes packed cards for half-a-crown:  
Britain was sunk in lucre's sordid charms.*

### **Alexander Pope (on the South Sea Bubble of the 18<sup>th</sup> century)**

The developing stages of an asset price bubble always present the best opportunities for bold investors to make a lot of money, while the mainstream are still cautious, they are buying assets at still sensible prices and with the prospect of future growth. As prices grow and new fortunes are reported, and more and more investors become involved, the number of lucrative investment opportunities inevitably dwindles.

Paradoxically, it is precisely at this stage that demand for the asset soars; the mainstream now have the evidence they need to take the plunge and everyone seems to want a piece of the action. The market must now expand dramatically to meet this surge in demand and new companies, syndicates and all manner of imaginative and often dubious vehicles are devised so that everyone can have their bit.

Many are legitimate and launched with the best intentions, but anywhere where dreams are forged around potential fortunes will also be a magnet for the fraudster; he knows the seductive power of money to the average man, and often uses his actual or supposed success to lure investors into his next venture. This was ever the case in other asset price bubbles. As the South Sea Bubble took hold in the eighteenth century, the frenzied crowd eagerly poured their savings into the next great money making venture, such as:

*'For erecting loan-offices for the assistance and encouragement of the industrious. Capital, two millions.'*

*'For buying and selling lands and lending money at interest. Capital five millions.'*

*'For a wheel of perpetual motion. Capital, one million.'*

*'For trading in and improving certain commodities of the produce of this kingdom, &c. Capital, three millions.'*

*'A company for carrying on an undertaking of great advantage, but nobody to know what it is.'*

Once the subscribers had 'invested' their money in such schemes, the prices often doubled overnight and some speculators made fortunes, but inevitably over time real results or profits were non-existent; by which time another scheme would be captivating investors imaginations.

In a more sophisticated age with greater regulation one would think that such chicanery would be impossible, but the psychological drivers behind the crowd which change little over time made similar happen during the dotcom boom. Eager investors who had missed the beginning built up huge demand for internet and technology stocks and inevitably the marketplace expanded to accommodate this and the floating of dubious new businesses exploded. The dotcom or tech badge on a business was flaunted by promoters and duplicitous accountants trumpeted outlandish forecasts of earnings, drawing in amateur and professional investors alike.

The recent property boom has been no exception, as real opportunities to make money became scarcer and mainstream demand boomed, all kinds of schemes emerged to channel investors money into property in ever more elaborate and imaginative ways. Encouraged by the sight of successful buy-to-let investors, thousands attend 'property investment seminars' where charismatic speakers tell of their rags to riches stories and promise to reveal their property investment techniques and secrets in forthcoming sessions costing thousands of pounds. People are seduced and sign up, yet this same information could be accessed freely on the internet, and the only secret is that their speaker got into the market many years previous when real money could be made. Of

course he is now making most of his money from the vast amounts that people pay to attend his investment classes.

The more sophisticated schemes also contain a more long term commitment from their investors. As well as paying thousands to attend the seminars, they are invited to join the investment club for thousands of pounds more where many people's deposits are pooled in order to buy properties off-plan from developers at a supposed discount to the market price.

One such company is 'Inside Track', which incredibly was effectively endorsed by none other than the Estates Gazette featuring it's operation in a gushing 4 page report in June 2005. Most of the investors come from London and the South East, but Inside Track and other investment clubs like Summertime Properties are now mainly investing in new developments in Northern cities like Manchester, Leeds and Liverpool.

They do indeed secure discounts from developers, but often the list prices are outlandish in the first place. Also, their projections of rental returns are often wildly optimistic in cities where there is already a surplus of new property to let and there are few wealthy tenants willing to pay more than £1000 per month in rent. Most disturbingly, the activities of the investment clubs, because of their volume buying, may even be affecting the market itself. Developers are securing finance for marginal sites based on the fact that they have 60% of the flats pre-sold to these investment clubs, sites which would otherwise remain undeveloped.

The results of this are already becoming apparent; in London's Docklands where the practice began a few years ago, some modern blocks have 30% vacant buy-to-let flats where investors desperately try to find tenants who will pay enough to cover their interest only mortgages. Capital values are also falling as amateur landlords try to sell their properties in direct competition with developers who are slashing the prices on their brand new flats just next door.

The Department for Trade and Industry are now in the process of investigating the practices of many of these property investment clubs, including that of Spencer Michael

Consultancy Ltd. which failed to deliver the promised properties to hundreds of hopeful investors.

These schemes described, may be on the fringe of respectability, but they certainly reflect the mood so in favour of property that people of all kinds in great numbers were so easily duped into following them. Yet even at the core of government and in the City itself, the property investment scheme is being reborn, in the form of REITs (Real Estate Investment Trusts), PIFFs (Property Investment Funds) and SIPPS (Self Invested Personal Pensions) which can be invested directly in property.

The City and Property Professionals alike have long been obsessed with the possibilities of the securitisation of property; dividing it into more manageable liquid units which can be traded more freely. All those investors who seemed to be missing the action in property, through lack of resources, can then buy what they can afford in someone else's managed property vehicle, such as a REIT.

These are new to the UK, but they have been commonplace in other parts of the world such as the USA for some time. It is indeed prescient that as the property cycle turns with values at an all time high that REIT's are once again being trumpeted as the convenient way to 'profit' from the property market. It is only when bullish psychology towards property is at a peak that REIT's are championed by financial institutions and demanded by investors.

The commercial property boom in the USA in the 1980's was accompanied by a growth in REIT's. With yields withering and management and administration cost taking their toll even during the good times, returns were at best modest; especially given the inherent risks involved in holding REIT's, where the underlying property investments are highly leveraged. When the market bombed in the early 1990's REIT's proved disastrous for their investors, the gearing magnifying their losses on the way down. There seems little doubt that the current enthusiasm from investors both large and small to trust their savings and often their pensions to new kinds of property investment vehicles including REIT's is entirely symptomatic of a peak in psychological affection for property investment. As values return to more realistic levels, these investments will once again prove disastrous.



## 2.8 'Money Illusion', are low interest rates really so great?

The Bank of England has recently cut interest rates by a quarter of one percent, in an attempt to stimulate the slowing economy and housing market and to stimulate consumer spending.

Conventionally wisdom dictates that low rates are good for property, and at face value this would appear to be the case. If one is to finance at 80% LTV, then the interest rate is important as it largely determines the monthly payments. However, focusing purely on the rate as a measure of affordability gives a false picture as it fails to take account of the property and interest rate cycles, and the real capital value of the property.

Recent low rates and low inflation have combined with a more lax attitude to the issuing of credit to lead to the highest property prices in history. Investors are encouraged to invest in property when rates are low, because they believe repayments will be too. However it is a merely a perception that they are paying less; 4% on £1,000,000 property will result in the same monthly payments as 8% on a £500,000 property before the bubble. Crucially the capital gain on the property is already in the price, the 'investor' although making 'low' monthly payments is paying for the seller's capital gain over the previous years.

The interest rate cycle may be bottoming out, and we have seen the classic examples of extreme bullish psychology on interest rates at work in the press, proclaiming that each resurgence in the rate was resulting in a 'lower high' of the new rate, and 'confirmed' by the recent decision to cut, and that we are now in a 'new era' of consistently low interest rates, exactly the kind of psychology exhibited during the dotcom boom, when the 'new economy' was lauded as providing the potential for unlimited future growth, (Dow 100,000 by 2010 as predicted in 1999, precisely before the beginning of a still continuing bear market). During the height of the property boom in 2003-2004, there were regular reports of London's average house price being £1,000,000 by 2020, based on current extrapolations of growth (not a wise predictor of the future) but picked up in the general fever of speculation as being true.

So, could investing in property at low interest rates be counter-productive? The market, although it professes not to be, is short sighted. The repayments are what everyone

focuses on, but the majority of profit from property comes from capital growth, and why would your fully priced investment grow in value, when yields are at record lows and the interest rate cycle turns around? As future investors enter the market at higher rates (if they can be persuaded), wouldn't they value your existing investment downwards to account for the higher payments they will initially need to make? Thus creating a capital loss on the investment bought at low rates at the height of the bullish psychology.

Money invested when interest rates are low is shouldering the burden of a huge amount of debt secured against sky high capital values – a liability that must be paid some day, and normally paid off over the term of say 25 years with a portion of the income generated from the investment.

In a high interest rate, high inflation, low capital value environment the real value of the debt is quickly eroded; it was smaller to begin with, inflation causes it to diminish in real terms and as incomes and rents rise in line with inflation the burden of the monthly payments becomes significantly less. In the meantime the interest rate cycle may have turned to lower rates, lowering monthly payments further, and causing the investors capital value to grow. Indeed in this environment an investor could find themselves paying off the entire capital much earlier than term as the capital borrowed diminishes and rates fall.

In a low interest rate, low inflation and high capital value environment the converse would be true. Investors investing at the top of the property cycle and the bottom of the interest rate cycle, face a huge capital debt that has to be repaid, and one which is barely eroded by the effects of low inflation. Low inflation also causes rents to stagnate, meaning that monthly payments which are generally high at the beginning of the term remain significantly high for a much longer period, leaving much less spare to pay back an already huge capital debt.

Having bought at the top of the property cycle and the bottom of the interest rate cycle investors can expect interest rates to rise rather than fall during their term, leaving them paying out more and more just to service the debt, and as rents are stagnant they may find their outgoings exceed their income. Also as interest rates rise future investors downgrade capital values to reflect the increased amount they will have to make in repayments, resulting in existing investors going into negative equity at the same time as they cannot

meet their own repayments. The effects of higher inflation will have a tempering effect on this process, but as property had risen way beyond the rate of inflation for many years during the boom, it is not unreasonable to suggest that it would devalue backwards for many years well below the rate of inflation in order to meet a more sensible equilibrium.

During the 1970's property values slumped by up to 40% in real terms, yet hardly anyone noticed. Nominal values edged up slightly over the period as very high inflation disguised the real fall in value. This 'money illusion' largely prevented panic selling as investors didn't perceive their investments to be falling. Today in 2005 we are beginning to see the first real falls in value, but this time inflation is much much lower. There will be no money illusion this time unless inflation rises significantly; real falls in value will be reflected in nominal falls that people can easily understand. This makes the potential for a classic bubble burst much greater today, as a downward trend takes hold, the crowd may scramble for the exit, causing the market to collapse.

## **2.9 The physical manifestation of boom psychology**

### **(i) The Skyscraper Index**

The most defiant symbols of capitalism, and it's manifestation in the physical world has to be the skyscraper. Since the late nineteenth and early twentieth centuries powerful industrialists and corporations have sought to out-do each other, by building the tallest. The economic momentum and positive psychology required to begin such an undertaking only occurs towards the latter euphoric stages of a boom when caution has been discarded and finance is still readily available, as identified in Lehman Brothers 'Skyscraper Index'.

As these projects begin, the economic mood is generally turning for the worse. They end up being completed during the depths of the ensuing recession, vacant monuments for many years to the 'irrational exuberance' of the previous boom, and often bankrupting their developers in the process.

From the Woolworth Building in New York (completed 1916) to the Chrysler Building (1930), Empire State Building (1931) both symbols of the roaring twenties completed at

the beginning of the great depression. The Sears Tower in Chicago (1972) and the World Trade Centre, New York (1973) just in time for the depths of the 70's recession. The UK has Tower 42, formerly the Natwest Tower (1979), just in time for the early eighties recession, and Canary Wharf Tower (1989) just in time for the recession of the early nineties which had much vacant space until the current upswing in fortunes from 1996; in the process bankrupting it's Canadian developers the Reichmann Brothers. The Petronas Towers in Kuala Lumpur and the Bank of China building in Hong Kong were both completed in time for the Asian financial crises in 1998.

As I write many gargantuan projects are coming off the drawing boards or under construction around the world. London has the proposed 1016ft London Bridge Tower, designed by Enzo Piano, better known as the 'Shard of Glass'. This will be the tallest building in Britain and Europe when completed. There are also many other towers under construction in The City that would have been inconceivable ten years ago when memories were fresh of the debacle of Canary Wharf.

### **(ii) Dubai megaprojects**

The desert kingdom of Dubai in the Middle East, is right now home to the largest construction projects on the planet as it attempts to build a new economy based on real estate in an attempt to substitute it's dwindling oil supplies. On the premise of 'build it and they will come' Dubai is building tens of thousands of apartments and villas, hotels, shopping complexes and offices in vast developments. These include the Jumeriah Palm, a man made residential island in the shape of a palm tree and The World, similarly man made islands mapping out the entire globe, both of which are visible from space. The Burj Dubai tower is also under construction, which will be the tallest building in the world by some margin at 2313ft. Much of the development money is coming from their oil wealth, but many of the property investors are foreigners who have benefited from property booms already in their own countries.

Given the scale of the projects and as markets turn, it remains to be seen whether there is sufficient demand to hold values up. If, as in the past has held true, that the construction of the biggest, tallest, most expensive skyscrapers has always heralded an economic and

property slump, then the completion of the 'Shard of Glass' and the Burj Dubai Tower in 2008 will come at a time of depressed values and high vacancy rates.

## Conclusions and forecasts

*'He who ignores the mistakes of the past, is condemned to repeat them.'*

So is the recent property boom consistent with an asset price bubble, and most importantly will it burst, and how big a bust is likely to occur?

The characteristics of asset price bubbles throughout history and in the modern era have always followed the same pattern. Their graphical projections are always very similar as momentum builds, and also as they go bust and head downwards.

Sound fundamental reasons for an increase in values are eventually overtaken by a speculative frenzy, caused by herding behaviour driving prices to unsustainable levels. During the boom phase no one wants to miss out on the gains, and even professionals who understand the phenomenon ride the wave towards ever higher valuations, justifying their valuations because 'things are different this time' that the 'new era' means that prices can only ever go up. These phrases have been around since markets began, and both are simply a denial of reality.

Only the object of obsession changes in each new asset price bubble. The participants from generation to generation don't change their behaviour, they do not learn from the mistakes of their ancestors (although they may be aware of them). In every bubble, ordinary people appear to make fortunes through little or no effort, but these fortunes are an illusion. They will lose them on the way down, because they refuse to suspend their belief in the boom until it is too late.

In every case the media is also complicit in the frenzy, they follow and reflect the social mood back to the public, and magnify the boom through the spread of rumour, hope and

reported success, and they are always focusing on the next big thing within the boom. As the bubble reaches its climax, their coverage is always at maximum tilt; they are in fact one of the best contrarian indicators. As the bubble begins to deflate, they will consistently call for a 'soft landing' declaring the fundamentals to be sound, and say that the return of the good times is just around the corner.

In almost every respect the recent property boom is entirely consistent with an asset price bubble, but only with hindsight will most people believe that it was such. Although the tide of opinion seems to be turning, there are still far too many vested interests still talking up prices, calling for that soft landing, or declaring a new upward trend. There are also far too many individuals, who would not only lose face, but also fortune having literally 'bet the house' on the boom.

But property is different isn't it? It's a real asset, solid as 'bricks and mortar', a safe haven, and of course it always goes up in value. These are the beliefs that have fuelled this boom; people are fooled by the 'myth of ownership'. Just as they bought dotcom shares on margin, so they borrow to buy their investment property, convinced of its ever upward rise in price. They ignore the falls of the early 90's, and didn't notice those in the 70's (disguised by high inflation), they don't remember the 30's and have never heard of the Florida real estate bubble - those buying in Dubai today should take note.

The property boom has been bubble like in almost every characteristic, including its graphical shape. Sound fundamental reasons for growth have been overtaken by speculation. This growth has been fuelled by a vast expansion of credit; and the media and culture as a whole has been frenzied in its enthusiasm for property. Cautious commentary has been dismissed as the talk of doomsayers, and professionals have justified ever higher valuations, by declaring that the old rules (such as income multiples) are no longer relevant. The boom has fed off itself; the income multiples growing precisely because of the expansion of credit. In an apparently virtuous circle the consumer boom and financial services being driven by re-mortgaging and equity release. As the bubble has developed, investors have sought other markets and sectors both here and abroad, and products both legitimate and fraudulent have emerged to capitalise on the enthusiasm for property, allowing everyone to have their piece of the action. In common with other property bubbles, just as things turn a massive building boom is underway. Ambitious

projects are attempting to build the biggest and most expensive, the tallest building in London, and the tallest in the world in Dubai.

Before this project I suspected that current property prices were unsustainable; the boom certainly felt like a bubble, but it was difficult to find anyone who would agree that this was the case, and no-one would agree that prices might collapse. After examining past bubbles and previous property bubbles there seems little doubt that the recent boom was a bubble in both scale and character. Indeed the denial of the bubble itself and the denial of the possibility of a bust is entirely consistent with the group psychology generated by other bubbles. There has never been a bubble that didn't burst, bricks and mortar or not; these things don't have soft landings, in fact they usually overshoot valuations on the downside too.

There are commentators around predicting price falls of up to 45% over the next few years, but they are still the minority. Given a rise of 200% since 1995, even a fall of 45% doesn't seem much, but it would be disastrous for the economy given the level of debt, yet it is possible with an overshoot to the downside.

A fall of about 30% over the next five years would return values to the long term average, and restore a more reasonable ratio of house prices to income, given a moderate growth in earnings. So there's my prediction for the future, the property bubble should deflate until 2009-2011. Investments held today could still be sold at still high prices as the majority don't yet believe that prices will fall. Come 2010 brave investors will be able to pick and choose at bargain valuations as most will by then not want anything to do with property; such is the group psychology that creates bubbles and busts.

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## **Appendix 1**

### **UK Interest rates 1970-2005**





## **Appendix 2**

### **Historical UK interest rates 1878-1972**















## **Appendix 3**

**Andrew Farlow, The UK housing market: bubbles and buyers – extracts**





























**Appendix 4**

**Office of the Deputy Prime Minister, House price index July 2005-09-22**









**Appendix 5**

**Nationwide House Price Index, Sept 2005**











## **Appendix 6**

### **Halifax House Price Index, Aug 2005**