Will Market’s Boom/Bust Cycle Repeat?

Editor’s Note: This is the inaugural post for RealForecasts.com. For its first post, RealForecasts.com is re-publishing an article titled “Will Market’s Boom/Bust Cycle Repeat?”, which appeared in the June 17-June 30, 1998 edition of the Colorado Real Estate Journal. Today, we know the answer to the question posed by the article. The market’s boom/bust cycle did repeat – a mere 18 months later.

Will Market’s Boom/Bust Cycle Repeat?

By Jeffrey J. Peshut

June, 1998

Contrary to recent media reports, the pending sale of Miller Global Holdings’ eight-building metro Denver office building portfolio to Chicago-based Equity Office Properties LLC for $394 million will not be the largest commercial real estate transaction in Colorado history. That honor goes to a transaction completed in the early-1980s by Miller, Klutznick, Davis and Gray, another Miller-led organization.

Denver real estate veterans will recall that MKDG sold the 3-million square foot City Center complex to Prudential’s “PRISA” fund for $500 million in 1983-1984. Completed at the apex of an unprecedented economic and real estate boom, the sale included buildings known today as Johns Manville Plaza (f/k/a Petro Lewis Tower), MCI Tower (f/k/a ARCO Tower), First Interstate Tower North, 1801 California Street (f/k/a City Center IV) and the 615-room Marriott Hotel.

Within less than two years of MKDG’s sale to Prudential, however, Denver’s economy and real estate market descended into one of the worst bust cycle’s in the city’s history.

The question for market watchers today is whether Miller Global Holdings' sale to Equity Office Properties signals the top of this market cycle or whether the sale is the harbinger of a "new era" that is immune from the boom/bust cycles that have plagued the Denver economy and real estate market in the past.

A New Era

Those who believe we are entering a new era – where the old rules no longer apply – advance a number of arguments in favor of their view.

With respect to the national economy, they argue that the break up of the Soviet Union and the end of the Cold War freed up investment capital for productive uses, instead of being frozen in non-productive military uses. They say that this new capital has, in turn, been leveraged by advances in computer technology, creating unprecedented increases in productivity, low unemployment and low inflation.

Nowhere is this more apparent than in Colorado. Today, the state's unemployment hovers just above 3 percent, with moderate inflation of only 3.4 percent.

Further, most business leaders believe that the state's over-reliance on the energy industry caused the deep recession of the late 1980s. These leaders now point to a more diverse economy as the primary reason why a sharp economic downturn will not recur.

Real estate pundits also argue that the massive overbuilding of the 1980s was caused by a combination of the savings and loans – and other financial institutions – eager to make loans and passive tax laws that offered developers incentives for building. They point out that neither condition exists today.

They say that even though 1997 saw a sharp increase in the amount of speculative construction in both the office and industrial categories, it pales in comparison to the amount of build-to-suit construction. Industry insiders also argue that the emphasis on “modular” low-rise and mid-rise developments – as opposed to the high-rise developments of the 1980s – will help ensure that the supply of speculative office space will not significantly outpace tenant demand.

Sign of a Market Top

Those who view the Miller Global/Equity Office transaction as the sign of a market top argue that we are once again nearing the end of a “credit-fueled” economic expansion, similar to the credit-fueled expansion that ended during the mid-to-late 1980s. They believe that the Federal Reserve and commercial banks cause unending boom/bust cycles by artificially expanding – and later contracting – the supply of money and credit.

The Federal Reserve expands the supply of money and credit either by buying Treasury Bills in the open market or by lowering the discount rate as a means of lowering short-term interest rates.

As short-term interest rates fall, commercial banks tend to make more loans to both businesses and consumers. And when banks make more loans, they essentially create money that didn’t exist before. As businesses and consumers spend this borrowed money, the economy expands.

This scenario describes what occurred in the U.S. economy during the early-to-mid 1980s. Many argue that this also describes what happened in the U.S. economy during the past several years.

As with all good things, however, economic expansions too must come to an end. Like a fire, they either burn themselves out from lack of fuel or are put out by the Fed before the rage out of control.

During the mid-to-late 1980s, concerns about the rate of inflation for goods and services, and a weak dollar, led the Fed to drastically tighten credit and thus “put out” that economic expansion. It is too soon to tell whether concerns about the rate of inflation – for goods, services or financial assets – will lead the Fed to put out this expansion. Or whether the Fed will allow this expansion to “burn out” on its own.

Irrespective of how it will end, proponents of this view argue that the volume and profile of investment capital flowing into Denver real estate suggests that the current economic expansion and real estate boom will end in the near-to-mid term, especially if they look at how real estate marketing software can help to get agencies and realtors back on their feet. And what better way than to market yourselves to potential clients, buyers, and sellers. In the meantime though, consider the following points:

- **Money Supply**. First, in most business cycles, the growth in money accelerates as the business cycle matures. An accelerating growth in the money supply certainly explains the accelerating flow of investment capital into Denver real estate.
- **David and Goliath.** Further, despite outward appearances to the contrary, hordes of small “retail” investors are replacing a handful of “high net worth” investors as owners of a preponderance of Denver’s investment grade commercial real estate. Often, the arrival of the “little guy” signals the arrival of a market top.

This brings us back to the potential significance of the Miller Global/Equity Office sale. Just as Prudential’s “PRISA” fund acquired City Center from MKDG on behalf of the small pension fund investor in 1983-1984, Equity Office Properties is acquiring Miller Global Holdings’ portfolio on behalf of the small REIT investor in 1998. While the investment vehicle may be different, the profile of the ultimate investor remains the same.

Conclusion

It is human nature to forecast or project into the future in a linear fashion. Unfortunately, it is this propensity to project “linearly” that causes markets to behave “cyclically”.

Thus, the question of whether the boom/bust cycle will repeat becomes not “if?” but “when?” And once it does, for “how long?”