The Business Cycle:

Definition: A business cycle is the periods of growth and decline, booms and busts, expansion and contraction in an economy. There are four stages in the business cycle: and these stages are constantly repeating over a number of years.

1. Contraction – When the economy starts slowing down. Contraction is characterized by credit tightening. Banks decrease the number of loans. Mortgage lenders want higher down payments on homes, Regulations increase,

2. Trough – When the economy hits the bottom. The participants in the economy are not sure they have reached it until they pass it. The trough is the point at the end of the recession. Both the contraction and the recovery are times of preparation, and of education. It is important during the contraction and the trough you maintain this mindset. The longer the delay, the more I make it pay. If I can navigate the economy and identify the trough, I can move forward to build back equity during the Recovery.

3. Expansion – When the economy starts growing. It is characterized by confident expectations, credit expansion, wealth creation, bank deposits increase. The banks feel better about the economy. They start lending to businesses. The intelligent use of credit can flourish during an expansion. Day by day the economy is getting better in every way. The majority of the negotiations in the economy, work together, to prosper the economy.

4. Peak – This is the harvest period. It is when the economy reaches its highest state of expansion.

1. The business cycle is compared to the seasons of the year, the contraction is the fall, the trough is the winter, the Recovery is the spring, and the peak harvest is the summer.
Peak - Harvest Fall

Metaphorically speaking, and in a graph the business cycle is like a wave that measures the growth stages of the broad economy. The question is, how are we navigating this current wave?

Here is an analogy. The largest waves in the ocean are at a place called Cortes Bank. The waves go up to 80 feet or more where they meet a row of mountains beneath the sea. We were used to navigating six foot business cycle waves, and now we are forced to navigate a 100 foot tall business cycle wave, and the point of credit contraction that came with it.

In order to understand a business wave/ocean wave metaphor we will discuss Liquidity. Liquidity is the ability and speed in which an investment can be converted into cash. Stocks are very liquid because they can be converted to cash easily at the point of the exchange. Millions of shares of stock are bought and sold daily, and the speed and efficiency of the trades have increased. Real estate is not as liquid because the sales process takes a longer time. The average ownership time of a single family home is 14 years. The amount of time for stock ownership varies greatly which could be from one hour to an indefinite period of time. When long term investments (homes) were forced into short term investments (securitized) there were many more buyers than sellers in the marketplace which influenced the business cycle wave upward.

At the time of year when the weather conditions are right, the most experienced surfers in the world go to the Cortes Bank off of the California coast to surf the 80 foot waves. It takes a great deal of conscientious investigation into the right time of year for this area to be safe. Who can stay on their board when the crest is 90 feet? Who can stay on their feet with balance when the wave is overwhelming? No worthy surfer begins standing on one foot in two foot waves. The surfer must conquer the skills of balance and equilibrium. The principles of balance and equilibrium apply to economics in decisions on pricing. Profits of a corporation are maximized at the point where supply equals demand. This is called Price Equilibrium. In real estate, this is measured by comparative, or competitive sales in the marketplace.

It's the challenging waves that prove the skills of the best. You learn to navigate your way through the large business cycles through contrarianism. A surfer will paddle out to the wave with his surfboard pointed towards the wave, but at the point where the wave crests, the surfboard is reversed, the surfer stands on the board and with balance and equilibrium rides the wave to the shore.

The contrarian philosophy of the markets is this: when everyone is buying, you sell, and at the trough, at the bottom when everyone is selling, you buy. How do you know when to sell? It is the time where you watch your business TV commentary and everyone is an eternal optimist. When you get on the phone, and the person on the other line says; "the market is going up, and it's never going to stop, and this time, it's different." The time to buy is when the person on the other end of the phone says, "the market is going down, and the economy is permanently broken, it is never going to be like it was." These are two extremes of thought.

Seasonality is a type of Contrarian investment. Contrarian shopping is when you buy all your winter clothes during the summer, and buy all your summer clothes during the Winter. Rightly discerning and Navigating our way to future growth is the challenge, and we will meet that challenge together. George Santayana, a philosopher from Madrid, Spain said, "Those who cannot remember the past are condemned to repeat it."

It was Sir Winston Churchill who said, "The further backward you look the further forward you see". Let's use these quotes like a map that we will use to study the past, learn from, and apply to the future. This is why we need to investigate Bubble Theory in history.

BUBBLE THEORY:

Economic Bubble theory is this: That historically, it takes as much time for the market to correct out of an economic bubble as it did to get into the bubble, and prices return to the levels to which they started.

The first recorded economic forecast in Historical literature is the story of an Agricultural cycle in the Judeo Christian Bible. In Genesis 41, Joseph is called by the Pharaoh of Egypt to give an interpretation of a dream. Joseph told the Pharaoh, there would be an agricultural cycle of seven years of prosperity, and seven years of famine, save 40 percent of the crop every year of the first seven years of the agricultural cycle to feed the people through all 14 years. The grain became a type of national equity. This economic advice based on intuition, saved Egypt, and just like the economic bubble pattern, the time it took to enter the economic bubble is equal to the time it takes to get out of it. Save 40 percent of your equity. If Joseph was going to bring out a graph for the storage of the grain over the 14 year period, it would look like a pyramid. Learning from History, the concept of saving 40 percent of my income per year during the next growth cycle is a wise idea.

The tulip bubble in Holland was a different type of agricultural cycle combined with a free trade market. It emanated from the genetic colorization of tulips in the early 1600's. The newly colorized tulip was rare, sold at auction and bid to the point where each individual tulip was the same value as a two year salary. Luxury houses could be purchased for a bouquet. They were so valuable, that people thought mass cultivation would make them billionaires. It took about two years of exponential cross pollination and compounding of seeds to harvest millions of tulips. The supply became abundant and the prices came down. The mass cultivation of tulips in the 1600's permanently impacted the economy of Holland because they have the largest floral distribution network in the world.

The South Sea Company Bubble occurred in 1720 – International trade was evolving in the early 1700's, several reports came out exaggerating and boasting about the import and export contracts of the South Sea Company. The stock price of the South Sea company went up 1000 percent in one year. When the reports turned out to be exaggerated rumors, the stock lost its value. Sir Isaac Newton, the inventor of Calculus invested and lost 20000 pounds in the South Sea Company Bubble of 1720. He was quoted as saying, I can measure the stars but I can't measure the madness of people.

The railroad bubble of 1893: A series of banking mistakes occurred in railroad lending. Railroads invested in the real estate where the rail lines run, and the railway network became 17 percent overbuilt in 1893. The recovery occurred in 1897 after a period of four years.

During the late 1800's Henry Flagler, the business partner of John D. Rockefeller brought a number of railroad lines into Florida, and the eventual result was investment in Florida land which led to the 1920's Florida Land boom. The price of Florida real estate doubled several times over from 1920 – 1925 as the result of too many buyers in the market. Seasonality was a factor in the Florida land boom. There was a great amount of advertising in the Midwest and Northeast United States. During the winter periods, a trip to Florida seemed like paradise, and there were several people who wanted in. One property in Miami sold 10 times in one day.

The Savings and Loan Crisis of the 80s and nineties is a more recent study of bubbles in lending and property. In 1989, 1/5th of the 3300 banks in the United States were bankrupt, and many of the remaining banks were riddled with foreclosures. L. William Seidman, former chairman of the FDIC Banks stated, "The banking problems of the '80s and '90s came primarily, but not exclusively, from unsound real estate lending. Banks loaned more money than was manageable. The Resolution Trust Corporation was formed by the US government in 1989 to sell the assets of the Savings and Loan banks. Properties were being sold for 50 – 70 percent of their original value. Some office buildings sold for 20 percent of their value in the early 90's by the remaining banks that were required to sell their foreclosed properties.

Due to my work, I have access to past real estate sales data. Owners of property who bought in 1995 and sold in 2007 made from 78 to 480 percent on their initial investments during this 12 year period. Investors who leased their properties to tenants made an average additional 10 percent higher rate of return on their money every year. The investors that buy properties from 2007 – 2016 will receive greater returns during the next real estate peak. The goal, the ambition, the purpose, the motive, the secret to all business and investment is to buy low, and sell high, revenues minus expenses equal net income. It was my accounting teacher, Noel McKeon who repeated this equation in several different ways the first day of accounting class. Total Revenues minus Total Expenses Equals Net Profit. This is the core of the business equation. Great moments in good timing can occur when we correctly navigate the next Real Estate cycle.

In 1971, the nobel peace prize winner for Economics was Simon Kuznets. He theorized in 1940 that Real Estate cycles take about 18 years. This measurement is now referred to as the Kuznets cycle. From the early 1800's every 18 years real estate markets maximize volume, pricing, development and lending. The last peak in real estate pricing in valuation was in 1989, and that is when the peak ended, the contraction started and then peaked again, 18 years later in 2007. It was noticed that The Rockefellers real estate investments have fit comfortably within the 18 year rule. Current Applied Economics Professor at the Johns Hopkins University Steve Hanke has an article written for the Cato Institute titled The Great 18 Year Real Estate Cycle.

The 18 year cycle skipped from 1925 to 1973. This was due to the rise of the suburban residential core from the fifties. The 1970's and 80's saw the beginning of the commercial suburban development of office and retail. The market peaked in 1973, peaked again in 1979 based on the high double digit interest rates of mortgages. The peak from 1973 to 1989 was 16 years. The assets of the S&Ls took four years to sell from 1990 to 1994. The markets improve again as the real estate cycle of growth begins for a period of 14 years, the average time of residential home ownership. Further research into the algorythms of the 18 year real estate cycle are discussed in the books of Fred Harrison, British author and economic commentator who correctly predicted the real estate peak of 2006 and 2007.

We must proceed with a sense of due diligence to adhere to the economic principles at the foundation of business. Expansion Commercial, Inc endorses the standards of understanding the real estate cycle as a rational way of improving property, plant, equipment, and equity decisions.