facebook.com/thereinman

Follow @DonRCampbell

www.donrcampbell.com

The Reality Report

January 2012

2012: The Year of Confusion, Concern & Consternation

"The Perfect Environment for a Sophisticated Investor"

By Don Campbell

2012 is going to be a year of confusing economic signals, mixed real estate messages and fearful investors. In other words: the perfect environment for the sophisticated long-term real estate investor.

Over the last 20 years, my research team and I have been analyzing the Canadian real estate markets from a unique point of view – we don't look at the real estate numbers. This approach has allowed us and the sophisticated investors who understand this approach to move forward when real estate signals all seem to be showing "stop" – and stop when signals all seem to be green.

Using this approach is now more important than ever with the European debt crisis, turmoil continuing in the Middle East, a US government unable to solve their massive job loss problem and soaring world oil prices. In fact, never before have investors been faced with so many mixed signals.

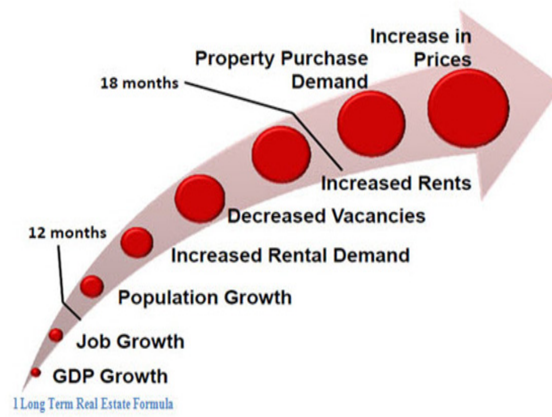
We call this the Long Term Sustainable Market Indicator approach, a long name with a long history of correctly predicting real estate market trends. Here are five insights to ensure you cut through a lot of the confusion and take the sophisticated approach in 2012 and beyond:

#1 Ignore Real Estate Statistics

If you are trying to predict what is coming in the real estate market, don't look at the real estate statistics - they only represent the past. That would be the equivalent of trying to drive across the city while only looking in the rear view mirror. A sophisticated investor understands that what is going to occur in the market is more important than what has already happened. Sounds simple, doesn't it? Yet, people still allow monthly headlines to dictate how they invest and how they feel about their portfolios.

To accurately predict where the market is going, an investor must understand the basic principle of "No economic growth = no sustainable real estate market". If you pay close attention to economic and population growth, you can accurately predict the direction of a real estate market 18 months in advance of its move. These are called the Key Drivers of a market.

The Sustainable Momentum Graph (below) shows the impact of economic activity on a real estate market.



In a nutshell this graphic states the following:

GDP growth = Job growth = Population growth = Job Growth = Population Growth = Increased rental demand (12 months later) = Increased rents = Property purchase demand (18 months later) which eventually leads to property price increases.

This cycle works in the opposite direction as well, over roughly the same time lines. Sustainable real estate price increases occur approximately 18 months after a region's economy begins to grow and they

■ 87 – 5855 Mt. Lehman Rd, Abbotsford, BC V4X 2P7 ■ 1-888-824-7346 ■ info@reincanada.com

drop approximately 18 months after the economy in a region begins to shrink.

As you can see, if you are only analyzing the real estate market using real estate numbers you are at least 18 months behind the sophisticated investor. Below is my most recent interview with BNN talking about these very points. Give it a watch to help you set up the rest of the article.

#2 Ignore National "Averages"

Using the Long Term Real Estate Formula is key; however, it is important to not try to predict your specific target region's market using national numbers. For instance, it is impossible to predict Ottawa's or Calgary's real estate market when only looking at GDP or job stats for Canada as a whole. This is especially true when analyzing markets in countries with a large geographic size such as Canada, the US and Australia.

Averages Don't Matter

Market averages are areas of confusion for most real estate investors. Real estate values are measured in various ways throughout the world, including averages, medians and other forms of indexes. Some of these measurements produce an inaccurate indication of what is actually happening to real estate values.

It is surprising how often less reliable data, such as averages or median sales prices, are quoted as a representation of what's happening in a real estate market. These figures often present a distorted view of a market's performance. For instance, when there is a disproportionately high level of sales activity of superior real estate in an area in a given period, it may appear that values in the whole region are increasing purely because the average and/or median price will look higher than it had previously. Prices as a whole may have actually decreased, but this may not be represented by the average or median figures.

The reverse is also true. A high level of sales activity of inferior or lower-priced real estate in the same area may indicate that overall values in the area are decreasing purely because the average and median sales prices are lower. In reality, that period may have been characterized by a few sales of higher priced real estate, so while the average and median figures indicate that values are declining, they may actually be increasing.

In order to cut through the confusing signals, it is important to look at your target city's specific economics, rather than real estate market numbers. A great place to begin in 2012 would be to get answers to the following questions on your region:

1. Are long term jobs being brought into the region?
2. Is the unemployment rate dropping?
3. Is population growing with younger families?

Real estate investing involves a lot of variables, so minimizing your risk is imperative. The best offence is a good defence, and making sure you're informed and on top of the latest trends and research is going to keep you ahead of the curve. Be proactive – get out there and find as much information on your target region as possible. This is going to give you the confidence to make the right decision when you need to.

#3 Be Aware of Key Influencers

Key Influencers differ from key drivers in that they often prove to have a shorter term, yet dramatic, impact on specific markets. These key influencers can confuse a real estate investor as they make it look like a boom or bust is occurring when it really isn't. These influencers can be economic or government based.

For instance, the introduction of HST in BC and Ontario created mini-booms in new housing during the period between the announcement and the implementation as buyers tried to 'avoid' the new tax on their purchases. And now that BC has voted to remove the HST, the market is once again confused and there is a slow-down in new property purchases until the repeal.

A second influencer we are witnessing in some cities across the country is the 'Canada as a Safe Haven' trend. With world economic confusion occurring, investors large and small across the globe are parking their money in Canadian real estate and other assets. This influencer has pushed property demand beyond the true economic demand of the region, making it over-priced. How long this influencer will be in effect is more difficult to predict. However, as we have seen in the past, once the economic confusion begins to clear, a lot of this money will be repatriated to higher yield economies and when that happens, an increase in supply will hit these markets.

Remember: influencers push real estate markets outside of their predictable real estate cycles and can lead to a false sense of security to those investors who don't understand that they are temporary.

#4 ALWAYS Invest Based on Cash Flow

Ensuring that your portfolio and each property within it creates positive cash flow from the beginning is extremely important in economic times like these. There is no telling what can happen when an unidentified market influencer hits your target market or one that is currently pushing your market goes away. The only way to ensure that you can hang on during dips in the market is to ensure that you are focusing on creating positive cash flow.

Many speculators whose only profit model is one where markets go up in value call themselves investors, which unfortunately is just not true. Investors focus on buying positive cash-flowing properties in areas of strong economic and job growth while considering the increase in value to be a bonus.

With a positive cash flow portfolio you can weather any storm, you can get additional bank financing for future investments and you can begin to replace your job income. If, on the other hand, you can only profit if the market goes up at the right time for you, then you have just added a substantial level of risk to your portfolio and in today's market conditions, added risk is not a great choice to make.

#5 Invest Green – and I Don't Mean Eco!

There is a lot of talk about "Going Green" these days, but when I say that you should invest "Green" I don't mean buying a property and outfitting it with solar panels. What I am talking about is identifying how one specific green choice being made across Canada by your future tenants and buyers can dramatically increase the value of your property. If you want to own in an area that will increase in value, or increase in rents - upwards of 15% faster than similar properties in your region - then it must be in an area where major transportation changes are taking place. In fact, over the next 5 years, this demand trend will increase more quickly than it has in the last decade, providing you a unique opportunity.

Knowing this fact, we have completed an extensive analysis of transportation changes implemented in regions across North America and Europe. These peer-reviewed journal articles provide us with a snapshot of what we can expect in terms of the impact on real estate prices by major transportation improvements. The findings are quite remarkable for real estate investors.

As fuel prices continue to rise, commute times, commute costs and accessibility to job centres become key determinants for potential home buyers and renters. Residents now measure their commute distances in minutes, not kilometres, a process that leads to higher demand for properties that are located farther from their jobs in distance, yet closer in terms of commute time. Combine this fact with a larger cohort of people choosing to use transit for 'green' purposes and you have a dramatic increase in demand around rail and light rail stations.

In Canada, we have just surpassed a record number of people riding public transit and this positive trend has increased at an even faster rate than first expected. This increase in demand is beginning to provide property owners who own within 800 metres of a rail based transportation station an increase in value of 15% more than similar properties outside of this zone. This is also proving to be true with rents, as 2-bedroom apartments are shown to be renting for over 16% above similar units in the same city.

This is a trend that will continue no matter what the economic conditions are. To conclude, buying near a transit hub is the equivalent to playing both offence and defence with your real estate portfolio. You can have free access to our research on the effects of transportation changes on housing values for many major centers across Canada at the following link:

http://myreinspace.com/downloads/research_reports/m/research_reports/default.aspx

Conclusion

As I have emphasized many times over the last 20 years, it is great being a strategic investor during boom times, but it is critical to be a strategic investor during confusing economic times.

As we enter 2012 it is important to remember the 5 Insights above but to also remember that strategic investors always think and plan long term. For the long term investor, there are no other real estate markets in the world with the resilience of key Canadian real estate markets. It will not be a straight line - we will be influenced by what goes on elsewhere in the world. The position in which we sit as a country is quite remarkable.

Currently, during the economic turmoil, we are a safe haven for capital and investment which supports our economy. When the economic turmoil begins to disappear over the next decade, we will then step in to being the safe and secure supplier of the 4 key commodities the world will need during its recovery. Each of these commodities will bring strong job growth to specific regions of our country and, as you read in Insight #1 above, these jobs will further fuel demand for rentals and property purchases.

Markets are very specific (regional), and the fundamentals must be heeded exclusively to each individual area.

The 4 F's the world is going to need (and we are going to provide) are:

Food:

Higher food prices are coming, with some saying they're already here. As a matter of fact, the key food items around the world (i.e. rice, corn, wheat, soy) are already bouncing off of record prices and this is during an economic downturn. The world's population just surpassed 7 billion and it is not shrinking, so food demand is going to increase. Canada, as a major food producer, will benefit from this trend: on one hand you will have to pay more for food, but the Canadian economy will also benefit from higher prices.

Fuel:

There is no hiding from it. Petroleum based products are becoming increasingly more expensive, solar power is still very expensive, coal demand is through the roof as China tries to keep up with power demand and nuclear power is still increasing despite the Japanese disaster. What you'll notice about all of these sources of fuel is that Canada produces all of the main components for these. In fact, we have quietly become a safe and secure source of these critical commodities and our influence will continue to grow as demand outstrips supply around the world.

Fertilizer:

The three primary macronutrients of fertilizer are: nitrogen (N), phosphorus (P), and potassium (K); large reserves of potassium are found in Canada and the other components are created by our petroleum industry. More than 150 countries use potash, but only 12 countries produce significant amounts. As a result, about 80 percent of the potash produced moves across borders.

Canada is one of the world's largest exporters, accounting for about 40 percent of the total world potash trade. It is a world priced commodity, so as demand in other parts of the globe increase, the price we receive also increases.

The largest markets that Canada exports to include: US, China, India, Latin America (primarily Brazil), and other Asian countries (Malaysia, Indonesia, Vietnam, Thailand, Philippines, Taiwan, Korea and Japan).

With food shortages throughout the world, countries will try to get a higher yield out of their food production, while trying to improve the quality of the food. Fertilizer will be required to support the global food demand and Canada is poised to grow, based upon this trend.

Forestry:

The images coming from the Japanese earthquake and resulting Tsunami were horrific but, as things starting to settle down, the task of rebuilding will begin. Japan is a large importer of high-quality lumber and will be importing this from Canada. In October of 2011, China imported a new record amount of Canadian forest products with no end in sight for this demand.

Couple those two facts with the forecasted recovery of the U.S. residential construction industry in 2014, the Canadian forest industry is soon to be entering a super-cycle. You are going to see lumber markets spike in the next few years, translating into more Canadian jobs.

So at the end of the day, what do these facts mean to you? Simply, 2012 – 2015 will be the years that the strategic, long-term thinking investor will come out on top. In times of confusion the more sophisticated investor digs deeper for the hidden trends behind the monthly headlines in order to position themselves best for what is coming... rather than continually looking in the rear view mirror.