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Time to get out of rental property

The word on the street is that a lot of investors who bought property in Ireland over recent years are getting nervous. At least that's the word on the streets of Galway, but the same is almost certainly true in other places across the country.

With interest rates on the rise, it's little wonder that folks are getting anxious. For the first time in a long time, many investors have begun to talk openly about cashing in their chips by selling their property investments.

The question I most often hear is no longer "Is this a good time to buy an apartment to rent out?" but rather "Is this a good time to sell the apartment I bought a few years back?" Experience from other countries suggests that most investors here will get the timing wrong and will hold on to their investment properties for too long.

It is, alas, human nature to think that we can successfully predict the exact turning point of a housing cycle. By definition, very few investors get out at the peak, and most investors are left holding the baby as house prices drop.

The optimists, mostly from banks and real estate agents, will tell you that Ireland's housing market this year will pull off the long wished-for soft landing, with house prices stabilising but not falling. Unfortunately, the optimists don't have history on their side.

I can name no fewer than 30 episodes of house price booms that ended in busts in industrial countries since 1970 (I produced a study of these episode when I worked at the Fed—America's central bank).

Can anyone point to a single soft landing? In truth, a soft landing in the housing market is like the proverbial free lunch? There ain't no such thing. Housing markets just don't work that way.

The optimists will argue that house prices will be supported this year by continued strong growth in our economy and incomes. But this is a classic example of circular thinking. Forecasts of strong growth this year are based on the assumption that the housing market remains robust.

The reality is that growth in incomes is mainly coming from the property boom, and not the other way round. In turn, the buoyant economy is attracting floods of immigrants to our shores, mostly from Eastern Europe. Many of these people will leave when the housing market goes sour. Who will investors rent their properties to when that happens?

The optimists will protest that the increases in interest rates will not be large enough to damage our property market. Nice try, but no!

By the middle of this year, interest rates will probably have doubled from their level in late 2005. How high will interest rates go? The answer depends largely on how sustainable the nascent recovery in Germany's economy proves to be.

Most experts are very upbeat on Germany's economic prospects, and last week saw yet another slew of positive economic data from that part of the world. Good news for ze Germans, but bad news for Ireland's property market, because a resurgent German economy will make the European Central Bank more worried about inflation and therefore more inclined to hike interest rates. To be sure, interest rates in Europe will not go up by as much as they have done in the United States, where the housing market crashed last summer.

But try telling an investor here whose monthly mortgage payment is now greater than the rent he receives that higher interest rates don't hurt. That investor is now bleeding cash each month from owning investment property.

The scary thing is that he's not alone. Over recent years, one in every three new houses and apartments was bought by investors, often using interest-only loans. When interest rates were very low, rental income typically exceeded mortgage payments by a bit. However, as interest rates rose over the past year or so, that small margin disappeared and then turned negative.

Unless investors expect significant increases in house prices in the future, owning property-for-rent now looks like a losing bet. In the same way that a haemophiliac can bleed uncontrollably as a result of the slightest cut, even moderate interest rate increases can cause Ireland's investor-heavy housing market to bleed to death.

And there's the rub. Ireland's property market has only sentiment keeping it at the current dizzying heights. Nothing else.

It is pulling itself up by its own bootstraps. Investors are now in a game of second-guessing when other investors will decide to sell and bank the money they have made on property. Given the rising number of sweaty palms around, an early exit looks like the smart move.

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