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How to Protect Yourself from the Coming Real Estate Crash

'Soft Landing' Unlikely

If you have made a fortune from the bubble, count your blessings. But get out now, while you still can.

Whether the end is precipitated by a sudden interest rate spike, an increase in mortgage defaults, problems at Fannie Mae or some other factor, the burst of the housing bubble now appears to be approaching and is likely to occur within the next six to eight months.

Many real estate analysts are still hoping for a "soft landing" of the housing bubble through which prices would either stagnate or fall very slowly resulting in minimal impact on both homeowners and our economy as a whole. But, this is unlikely for several reasons:

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1. Much higher mortgage rates are just ahead.

Hundreds of thousand of new homeowners with ARMS and interest-only mortgages will face much higher interest rates in the next few years. The fact that interest rates on credit cards are also rising and inflation is picking up virtually guarantees that many will be unable to make their mortgage payments.

A mere 2% rise in interest rates means increases of up to 40% in monthly mortgage payments. And that will trigger a huge wave of defaults during the next few years, forcing housing prices down. Most at risk are those who have recently received creative mortgages in the biggest bubble areas.

In a recent edition of FIR, we noted that with Fed Fund rates at 3%, 30-year mortgage rates averaged 7.45%. But today, such rates hover at about 5.5%. When this anomaly of low long-term rates corrects itself, an event the market will most assuredly witness, then the real estate boom will be over.

2. The inventory of homes is rapidly increasing.

Weiss Research reports: "There are more new homes for sale now than at any other time in history," although "this abundant supply is not yet being dumped on the market."

The reality is that the recent boom in real estate speculation has funded a massive increase in the construction of expensive condos and new homes that are scheduled for completion in the next few years, flooding the market with inventory at precisely the wrong time. Many of these units could end up selling for a fraction of their current book value.

3. Speculators will flee the market when interest rates rise.

Speculators now account for up to 30% of all real estate purchases. If real estate prices show any sign of stagnating, speculators will start dumping their properties to avoid losses, flooding the market with inventory.

4. Massive consumer debt has set the state for massive defaults.

Americans are deeply in debt, and even small increases in interest on mortgage payments, credit card bills, car loans and other debt could trigger a wave of bankruptcies and mortgage defaults.

5. Many banks and savings and loans are now at risk.

Since they have huge portfolios of risky home loans, even a small increase in mortgage defaults could force cash-strapped banks to foreclose on properties, flooding the market with inventory.

What Could Burst the Housing Bubble?

Any one of the following events could burst the bubble:

- Rising mortgage rates, which will eventually follow rising interest rates
- Property speculators deciding to sell their properties rather than continuing to buy
- An increase in mortgage defaults, which we are already seeing this year
- Fannie Mae and Freddie Mac finally cutting back on or being forced by Congress to discontinue their increasingly liberal housing loans
- Withdrawal of foreign investment from the U.S. real estate market, which is also beginning to occur already
- The public finally waking up and realizing what real estate professionals have been saying for years: The enormous increases in housing prices cannot continue and could even reverse

Some 30% of the total U.S. economy is now directly or indirectly dependent upon real estate. That includes banks, insurance companies, construction firms, brokers, appliance manufacturers, contractors, lumber mills, steel companies, furniture manufacturers, carpet sales and the list goes on and on.

If the real estate market falls even a little, consumer spending could plummet and many banks might fail, plunging the already shaky U.S. economy into recession or worse. And thousands of businesses and millions of jobs would be lost along the way.

Nine Ways to Protect Yourself

1. **Don't assume you will have plenty of time to react when the bubble bursts.** In a matter of months, the housing market could go from "hot" to "dead," meaning you could end up stuck with overpriced investment properties, unable to sell your own home for a profit. So, whatever you do, don't delay in taking steps to protect yourself from the impending real estate bubble. With warnings now plastered on the front page of virtually every national magazine and newspaper, irrational investor exuberance could quickly turn into panic and the end could come at any time.
2. **Switch from an ARM or interest-only loan to a fixed-rate mortgage.** Fixed-rate mortgages are now at their lowest rate in 30 years. To avoid an unpleasant surprise should mortgage rates rise sharply, lock in those low rates immediately.
3. **Make sure you can afford to stay in your house.**
If you are happy where you are now living and have no reason to move in the near future, and you have no problem meeting expenses (including any upcoming increases in mortgage payments), don't worry about whether the value of your house goes up or down. After all, a home is much more than just an investment.
But if you are struggling to make your house payments (or you expect a hike in your mortgage rate soon) or expect to be transferred to another city soon, consider selling and moving now.

When the market boom is over, not only could prices fall – it will be difficult to sell your home, even in prime markets.

Another reason to sell might be your net-worth worries. If you took a hit during the '90s tech boom but have made back your losses – and even made gains – in real estate, it would be wise to sell your property and buy a smaller one, or rent and take some of your winnings off the table.

When the market boom is over, not only could prices fall – it will be difficult to sell your home, even in prime markets. For example, if you sell your house now for \$600,000, then rent for two years at \$1,500 a month and eventually repurchase a similar home for \$400,000, you would have a net gain of \$164,000, plus interest on your \$600,000.

For most people, the tax consequences of such a strategy will be minimal. Under new tax rules, a married couple can realize up to \$500,000 in profits from their home without having to pay any taxes on it. Check with a qualified tax adviser for details and restrictions.

4. Consider selling investment homes and condos now.

This makes a lot of sense – if housing prices go down soon. And wouldn't you rather sell your property now for \$500,000 and repurchase a few years from now for much less?

Even if you currently have a positive cash flow from rentals, ask yourself: Will it still be worth keeping the property if rents go down 10, 20 or even 30%?

Between 2001 and early 2004, apartment and house rents dropped by 15 to 30% in San Jose, California.

On the other hand, if you own property in a smaller city or rural area where property prices are still reasonable, there is no reason to sell now.

5. Make sure your savings are safe!

Financial institutions heavily invested in real estate will be at severe risk and could even fail when housing prices crash. Most at risk are banks and savings-and-loans.

To make sure your bank or S&L is safe, you can get an analysis of its rating from Weiss Research at www.weissratings.com for a small fee.

Weiss Research is an independent business that provides objective and honest ratings of banks, S&Ls, insurance companies, health care plans and many more concerns.

Unlike Standard and Poor's and Moody's ratings services – which are funded by the companies they rate – Weiss ratings are truly independent and much more accurate, since they are free to divulge the truth. In the 1980s, just before the S&L collapse, Weiss was rating many S&Ls at "D" (weak) or "E" (very weak), while Standard and Poor's and Moody's were classifying the same companies as "AAA" or "AA".

Amazingly, in some cases they even maintained these absurd ratings for days after the companies had closed their doors! So I recommend you play it safe. Get Weiss Ratings on your financial institutions before the crisis hits.

Also check out what percentage of their overall portfolio your bank, S&L and insurance company have invested in real estate. If you don't like what you see, change banks right away. Often, financial institutions right next door to each other have dramatically different portfolios and risk levels.

6. Get out of residential REITs (Real Estate Investment Trusts).

In the past, FIR recommended REITs that focused on commercial – not residential – properties. Since then, some of our recommendations have appreciated from 40 to 50% or more in a year. For example, one of our picks, Catellus Development Corporation, shot up 61%, while another, Tanger Factory Outlet Centers, rose 48%.

While we still believe commercial real estate will weather the housing storm that is brewing, at the moment, we would not recommend new investments in REITs.

7. Make conservative investments.

These include CDs, Treasury bills, precious metals and strong foreign currencies. See our June 2005 issue on Sector Investing and our April 2005 issue "The Inflation Lie" for specific recommendations.

8. Sell shares of companies most at risk in a real estate crash.

One way to profit from the coming real estate crash is by dumping stocks most likely to fall as a result of it ...

That includes many banks, S&Ls, mortgage lenders, brokerage firms, real estate companies and other businesses that are heavily dependent on the housing market. Again, such companies are excellent candidates for short options.

One way to profit from the coming real estate crash is by dumping stocks most likely to fall as a result of it – including overexposed banks, construction companies and financial services companies – both in the United States and throughout the world.

Another strategy is to buy options – called “puts” – on these stocks. Since it is unclear exactly when the crash will occur, we recommend buying options known as LEAPs (Long-term Equity Anticipation Securities). These are long-term options expiring at least a year from the day you purchase them – or further out.

Weiss Research lists the following companies as some of the best candidates for dumping or shorting. Weiss rates them financially at D+ (weak) or lower. If you own any shares of the stocks listed below, you should definitely consider selling them soon:

- Building Products
- Commercial Banks
- Construction
- Consumer Finance
- Diversified Financial Services
- Real Estate
- Thrifts & Mortgage Finance

9. Prepare now for a major downturn in the economy.

Pay off your credit cards, cut your expenses and save more. When real estate crashes, the economy will take a hit. At FIR, we may not have a crystal ball, but we know this much: Since the real estate boom will not be cooled by rising Fed rates, a soft-landing scenario is unlikely. And a hard landing could push the United States back into a recession.

This is why FIR continually recommends investing in sectors that will do well during a housing-induced recession. It is also why we encourage investors to look globally for opportunities.