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The Coming Real Estate Crash

For over a year now, FIR has been warning that soaring increases in U.S. real estate prices were unsustainable and that a collapse could occur.

Now scores of major U.S. and international newspapers and magazines – including *The New York Times*, *Fortune* and *The Economist* – are echoing those same sentiments in their page-one stories.

“The current boom in real estate prices is the biggest bubble in history.”

In fact, *The Economist* magazine bluntly declared that the current worldwide boom in residential real estate prices is “the biggest bubble in history.” The magazine also noted that real estate is the single most important sector of the U.S. economy today and has fueled the country’s growth during the past four years.

Consumer spending and residential construction have accounted for 90% of the total growth in the American GDP over the last four years, and more than 40% of all private-sector jobs created since 2001 have been in housing-related sectors, including construction and mortgage brokering.

Clearly, millions of workers from various fields are dependent on its success. And countless banks, savings-and-loans, insurance companies, pension plans (which are heavily invested in real estate), appliance companies and painting, plumbing and electrical businesses all rely on real estate’s continued prosperity. And the list of interests goes on and on.

So it becomes apparent that a potential real estate price collapse could easily drag much of the consumer economy right down with it, plunging America into a major recession. Hopefully that won’t happen, but the danger grows every day as more and more Americans take out adjustable-rate mortgages, interest-only loans and second mortgages to cash in on their equity.

A punctured housing bubble in the United States would be bad enough, but the current bubble is in fact international, covering much of the developed world. That raises the daunting possibility of a global recession beginning in the next few years.

According to estimates from *The Economist*, “the total value of residential property in developed economies rose by more than \$30 trillion over the past five years to over \$70 trillion, an increase equivalent to 100% of those countries’ combined GDP.”

“Not only does this dwarf any previous house-price boom – it is larger than the global stock market bubble in the late 1990s or America’s stock market bubble in the late 1920s. In other words, it looks like the biggest bubble in history.”

Here are some examples of the incredible increases in house-price indices between 1997 and 2005:

Netherlands +76%	Spain +145%	Ireland +192%
New Zealand +66%	Sweden +84%	South Africa +244%
United States +73%		

Though FIR warned of the housing bubble, we never pressed the panic button with our readers. We assumed the Fed’s slow rise in short-term rates would lead to a very gradual increase in mortgage rates. The effect should have resulted in a soft landing for American real estate. But several developments indicate the soft landing may not happen and that a catastrophe awaits the U.S. residential real estate market.

“The prudent can make decisions today that will protect their wealth.”

Among the biggest risk-takers: those living on the financial edge, financial institutions heavily invested in residential real estate and people who own condos, vacation residences and luxury homes. These people will fall fastest and farthest during the housing crash – particularly those with properties situated in the hottest housing markets.

But no one is immune. Anyone involved in the U.S. economy will suffer from a housing crash. But the prudent can make decisions today that will protect their wealth and insulate them from any shockwaves the crash might produce.

Growing Reason for Concern

A recent article in Capitalism Magazine (www.capmag.com) shows just how crazy real estate market has become: “In 2004, existing home prices rose faster than in any year since the 1970s. Some markets are going bonkers. Alexandria, Virginia up 31% in 12 months; San Bruno, California 25%; and parts of Manhattan more than 50%. A front-page New York Times story featured a Florida couple who had bought and sold four properties – two condos and two houses – in the space of six months, clearing \$500,000. And none of the homes had yet been built!”

In many of the “hottest” real estate markets, over 70% of the properties sold are being bought not by prospective residents but by speculators, who “flip” them as quickly as possible for fast profits. Some of these investment properties are being sold for three to five times what they would have cost just a few years ago, doubling and even quadrupling in “book value” before they are ever even built.

But now speculators are becoming concerned. As a recent article in Fortune magazine pointed out, one speculator started questioning how long the boom could continue after he noticed that he was seeing the same investors again and again as he traveled the country bidding on properties that hadn’t yet been constructed.

Every day in every way, the frenzied real estate market is exhibiting more and more features mirroring those that came just before the disastrous Dot-Com bust and Holland’s infamous 17-century “tulip mania.”

FIR also believes in following wisdom, not hysteria. One wise man we consulted was Sir John Templeton, one of the greatest investors of our time.

As you will recall from FIR publisher Christopher Ruddy’s interview with Sir John Templeton in our February 2005 edition of FIR (Sir John Templeton Reveals the Future of the Stock Market, Real Estate and Life), Templeton warned of a U.S. housing crisis where values in some markets could fall by 50% - and Sir John is not a man given to hysteria.

Then there is the very sober Warren Buffett, who recently warned that liberal lending, artificially low interest rates and a herd mentality are “coming together in the real-estate market in a way that would lead me to believe that – certainly at the high end – people who buy houses today may have some periods when they regret it.”

And of course there is the sage analysis of former Fed chief Paul Volcker. Recently, The Wall Street Journal candidly reported that “Mr. Volcker thinks a crisis is likely” in the U.S. economy. Volcker believes that falsely low interest rates here, which have fueled the real estate bubble, are closely linked to foreign investment in U.S. debt. He foresees that investor confidence could fade “at some point” with “damaging volatility in both exchange markets and interest rates.”

It’s important to note that Sir John, Buffett and Volcker all warned in the late 90’s that the Dot-Com boom was dangerous and unsustainable.

Back then, none of the three were given much coverage in papers like The Wall Street Journal, not did they get any significant airtime on channels like CNBC. But their predictions turned out to be dead-on. And we fear they may be right again.

What Created the Real Estate Bubble?

Historically, home prices rise at about the same rate as inflation. As we have previously explained, the real rate of U.S. inflation is *much higher* than the official number. While the government claims it to be 2.4%, the actual rate is easily 5% a year.

Meanwhile, real estate prices have been rising much faster – 20% or more a year in the hottest markets. Most real estate experts acknowledge that this is unsustainable. If for no other

reason, that's because with rates rising so fast, fewer and fewer people can afford to buy a house.

So what has kept the real estate boom going for so long? There are five major factors:

1. Following the Dot-Com and Telecom crashes of 2000 and 2001, investors scrambled for solid investments. Real estate became the fad investment. Stock investment clubs perished and real estate clubs sprang up. This new money flowing into real estate caused prices to rise.

2. Artificially low interest rates maintained by the Fed help to keep mortgage rates at historically low levels, enabling purchasers to afford high-priced homes, creating a spike in prices.

3. With equity in their homes rapidly rising, many home owners either upgraded to larger homes, bought second homes or used their newfound equity for expensive consumer purchases, such as luxury vacations, SUVs, remodeling and home additions. Again there was a housing price hike.

4. Creative mortgages (ARMs, interest-only, zero down, negative amortization, etc.) pioneered by two huge quasi-government agencies – Fannie Mae and Freddie Mac – have enabled millions of previously unqualified Americans to buy homes.

5. As real estate prices have shot up, more and more speculations are entering the market, bidding prices even further – to astronomical levels in some markets.

Unfortunately, this massive growth can't go on forever, and there is mounting evidence the end of the bubble is near.

Real Estate Crash Imminent

In the late 1980s, housing prices dropped over 70% in some parts of Northern California. And during the Great Depression, *nationwide* real estate prices fell by at least that much.

Take Japan's recent real estate collapse as an example of just how bad it could get.

Similar to the sentiment in the United States today, in the 1980s Japanese real estate investors argued that prices couldn't possibly fall seeing as land was scarce and demand was soaring. But just ten years later, Japan suffered the worst property collapse in its history.

After reaching astronomical heights in the 1980s, nationwide real estate prices in Japan fell by 60% in the 1990s and by over 80% in large cities like Tokyo. Homes that sold for \$2 million in the late 1980s were going for under \$400,000 just ten years later.

"Prices will likely drop by 20 to 30%."

Although there is no way to pinpoint exactly when the U.S. real estate prices will stop rising and begin their descent, it seems most likely to occur sometime in 2006 and almost certainly no later than mid-2007. (But of course the decline *could* begin tomorrow.)

So how sharply will prices fall?

At best, in major bubble markets – including New York City, Las Vegas, Washington D.C., much of Florida and California, and many other large U.S. cities – prices will likely drop by 20% to 30%. At worst, we could see an 80% plummet in these markets, and a nationwide plunge of 20% with huge local variations.

At FIR, we do not see a worst-case scenario in the United States reaching the same depth and breadth of the price recession that Japan has witnessed. Several factors still make America a good bet:

- A growing population
- The fact that this country will remain a capital destination for global investors AND
- Low national tax rates compared to most other Western countries

Even if real estate prices were to fall by 20% during a crash, we believe that in 10 years you would still likely recoup that entire sum and more. But as any savvy investor knows, sector investing is crucial to continual investment success. If you see a trend underway, take steps to

either avoid its negative consequences or use them to gain a profit. The real estate sector – and its likely price recession – is no different.

The Bubble Surrounds Us

While more and more experts are expressing concern about a U.S. housing bubble, many real estate analysts and most government officials seems to still be in denial. Yet evidence of a bubble has become overwhelming.

Real estate expert Richard Benson notes: “The size of the housing bubble should not be underestimated. In middle America, prices are up 44% over the past five years. In momentum markets such as Las Vegas and Southern California, annual ‘price pops’ of 20 to 40% have commonly been recorded until just recently.”

Real estate prices have been increasing far faster than people’s income and therefore their ability to buy real estate is due largely to artificially low interest rates and creative financing.

Many wonder how you actually define a financial bubble. The best definition we’ve seen comes from iTulip.com: **“A market is in a bubble when participants foresee ever-rising prices even though prices are well above historic peak levels, while at the same time foreseeing either minimal or declining risk even though risk is exploding.”**

The following requirements for a bubble are now being met in spades in the U.S. real estate market: In the past, mortgages averaged 25% of income – today they are about half of income.

Historically, real estate prices have risen at about the rate of inflation. But for the last ten years, prices have escalated by at least *two or three times* the real rate of inflation and no less than five times the “official” rate of inflation.

Plus, the risks of buying property are exploding thanks to:

1. Greatly inflated and unsustainable increases in housing prices
2. Creative financing (ARMS, interest-only loans, etc.) which enable marginal and previously unqualified purchasers to buy property – or, more precisely, incur enormous debt
3. Soaring mortgage defaults (which put both banks and mortgage insurers at increasing risk)
4. Rapidly rising interest rates, which must eventually be reflected in mortgage rates
5. The hidden role of America’s primary mortgage purchasers and insurers, Fannie Mae and Freddie Mac, who have been the prime movers behind ARMs and other creative mortgages.

Culprits: Fannie Mae and Freddie Mac

Fannie Mae – the Federal National Mortgage Association (NYSE: FNM) – and Freddie Mac – the Federal Home Mortgage Corporation (NYSE: FRE) – are huge government-sponsored enterprises that function largely independent of the market and public scrutiny.

These two institutions have played a major part in creating over \$10 trillion housing bubble – but their role has been virtually ignored by the popular media.

Fannie Mae was created in 1938 after the Great Depression as part of Roosevelt’s New Deal. Initially its role was to provide local banks with low-interest mortgage funds in an attempt to revitalize the U.S. housing market.

Fannie Mae is exempt from state and local taxes as well as regulation by the Securities and Exchange Commission – despite the fact that the agency issues more securities than any other company in the United States!

Freddie Mac is a similar quasi-government agency created in 1970 so that Fannie Mae would have some competition. But both operate under the same rules and largely out of public view, making them less like competitors than they are co-conspirators. Together they control over 90% of the secondary market for mortgages in America.

Today Fannie and Freddie buy loans from mortgage lenders and then resell them to U.S. and foreign investors.

That means if a lender loans out \$300,000, they can then sell the loan to one of the two agencies and get another \$300,000 to lend. And this process plays out over and over again.

Without Fannie and Freddie, mortgage lenders would be limited to lending whatever cash they had on hand. But using these institutions provides lenders with virtually unlimited funds, which allows them to provide loans to just about anyone and everyone. Subsequently home prices are driven higher and higher.

The predictable result has been the astronomical housing prices we are now seeing. Together, Freddie and Fannie now have over \$1.5 trillion in assets plus over \$2 trillion in derivatives, making them by far the largest financial institution in the United States. Comparatively, banking giant Citibank – the next largest financial institution – as \$1.1 trillion in assets.

Given the pivotal role that Freddie and Fannie play in our economy, it's important to verify that they are making money and remain financially sound. Shockingly, it appears that they are not.

Both agencies are now embroiled in a massive financial scandal that MSN calls “an Enron waiting to happen.” A report issued in October 2004 by the Office of Federal Housing Enterprise Oversight found that Fannie Mae had engaged in a “pervasive” misapplication of accounting standards and poor internal controls while doling out enormous salaries to executives. Further, their accounting system was found to be so complex that no one could figure out whether they were making money or losing it.

For now, Fannie Mae shares are still touted by many Wall Street analysts, even as the agency continues to “pioneer” new and ever-riskier mortgage instruments, such as “negative amortization loans.”

These new mortgages allow borrowers to pay less than the interest on their loans, which is instead added to their principal each month. In a ridiculous twist, that puts the least-qualified borrowers deeper and deeper in debt, adding to the danger of a catastrophic real estate collapse in the near future.

The political champions of easy money and creative mortgages extol the virtues of making property ownership available to everyone. But in reality, more and more families are really taking ownership of nothing more than a massive debt. *Be sure to read part two next month: How to Protect Yourself from the Coming Real Estate Crash!*