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Feb 05, 2007 - 12:45 AM
By: [Mike_Whitney](#)

The Fed should have tightened earlier to avoid a festering of the housing bubble early on. The Fed is facing a nightmare now: the recession will come and easing will not prevent it." Nouriel Roubini, "Fed Holds Interest Rates Steady as Slowdown Outweighs Inflation", Wall Street Journal



I'm really baffled by the e-mails I've been getting lately. A lot of people have been blasting my predictions that the housing bubble will burst in 2007 and trigger a deep and painful recession. They point to the Commerce Dept's recent report that "new home sales rose 4.8% in December after 7.4% increase in November."



The tone of these e-mails is always the same: "Neener, neener, neener...you goofed up, you numbskull. Admit you were wrong."

The implication appears to be that the housing bubble is some kind of left-wing conspiracy conjured up by paranoid loonies.

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[EWI's Market Watch: Can a Billion \(.3\) People Be Wrong?](#)

2/2/2007 5:51:03 PM

Source:Elliott Wave International
 People who say financial markets are not patterned need to go stand in the corner and face the wall. Really. And when their 'time out' is over, perhaps one of them can explain why China's stock market chart really doesn't look like charts of other exponential curves I've seen a hundred times before. Long-time followers of the Shanghai Composite Index will of course point out that this index has seen sizable fits and starts for a decade -- and they're right. But long story short, something happened in 2005... [Read More](#)

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2/1/2007 5:12:43 PM

Source:Elliott Wave International
 If you're like most Elliott Wave veterans, the first thing to pop out of this picture is a leafy green vegetable. No, I haven't fallen off the turnip truck. I'm referring to the three sets of five-wave formations that stand out in the chart -- a classic illustration of the FRACTAL nature of Elliott Waves.... [Read More](#)



While that does fit my Bio. to some extent, the housing bubble is not a conspiracy theory and there's overwhelming proof that the aftershocks will be excruciating. Don't forget, the "happy talk" in the real estate section of the newspaper is designed to soothe jittery nerves and help sales, not give the reader an accurate picture of a market which is sinking quickly.

In fact, the hoopla over the "rise in new homes sales" ignores the "real" story which appears in many of the same articles; that is, "In 2006 existing home sales declined by 8.4%, the biggest drop in 17 years, and new homes sales fell by a whopping 17.3%, the largest in 16 years". This is the real scoop although it is predictably hidden in the fine print. It signals the beginning of a long, downward spiral which will increase unemployment, shrink GDP, and send millions of homeowners into foreclosure and out onto the streets.

True, I don't have a crystal ball and I'm not proficient at reading the entrails of dead animals, but I have put together some of the relevant facts and I think they make the case more convincingly than the cheerleading realtors who appear in the Sunday newspapers. I should add, though, that all this misplaced joy about the Commerce Dept.'s numbers has convinced Wall Street that the housing bust is just about over and that the economy will continue to strengthen. That is a very bad sign because it means that the Federal Reserve probably won't lower rates when it meets later this week. The downside of the Fed's decision is that the 30 year mortgage rate is inching higher (6.33%) and is bound to put even more downward-pressure on new home sales.

Some of Wall Street's heavy-hitters know that trouble is brewing and are finally putting out the red flags. 2 weeks ago Goldman Sachs indicated that "the US Federal Reserve will need to slash rates 3 times this year as the housing slump goes from bad to worse and the American consumer begins to buckle". (Ambrose Evans-Pritchard "US Housing Bust getting worse")

"We believe that housing will soon become the 'straw that breaks the camels back', said David Kostin, the investment bank's strategist. Goldman Sachs said homeowners had treated windfall gains from rising house prices as if they were 'recurring income' using home equity withdrawals to subsidize over-stretched lifestyles. This artificial boost to spending has already dropped from 7% to 4% of GDP over the last year, and is likely to halve again in 2007. Mortgage equity withdrawal will fall from 13% of 'discretionary household cash flow' in 2006 to 7% this year, causing spending power to contract for the first time since the dotcom bust".

Clearly, the wiz-kids at G-Sachs are not taken in by the 4.8% jump in new homes sales in December. They see the dark clouds forming on the horizon and are anticipating the approaching recession.

The mainstream media are starting to be more forthright, too. CNN Money reported last week:

"Americans continue having difficulties paying their mortgage obligations, with December foreclosure rates above the 100,000 mark for the 5th straight month. The number of homeowners

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ReutersCRB	301.19	-0.14
US Dollar	85.09	+0.01
Bonds	110.31250	+0.21875
Gold	647.80	-0.10
S&P 500	1446.99	-1.40
Nasdaq	2470.60	-5.28

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entering some stage of foreclosure process in December was 109,000 ...up 35% from December 2005 according to Realty Trac". It sounds grim, but the worst is yet to come.

Jim Willie at the goldenjackass.com provided this bleak look at the current housing market:

"Beazer Homes stuck a hot poker in the heart of the dimwitted optimists who believe the housing market has stabilized. Their spokesman said, 'We have yet to see any meaningful evidence of a sustained recovery in the housing market'. To back that statement up, they reported new orders were down 55% from a year ago, and their cancellations are running at a horrendous 43% rate. People might sign contracts based on hearing the media news, and cancel those same contracts on a contrast with reality checks. The Dec. existing homes sales came in at minus0.8%, the largest decline in 24 years dating back to 1982. The official data contained a contraction which went overlooked on the shallow voices on CNBC. The data claims that inventory levels fell by 7.9% at the same time that sales fell in a big way. Well, perhaps the inventory levels do not factor in the cancellations. (They do not) Bear in mind that 3 large homebuilders in recent weeks announced a collective \$1.2 billion in land option losses. The pain has not nearly ended for housing."

The signs of a major economic downturn are everywhere for those who chose to look beyond the cheery predictions in the real estate section of the news.

Next year, an estimated \$1 trillion of ARMs (Adjustable Rate Mortgages) are due to "reset" which will cause stiff increases in monthly mortgage payments. We're bound to see a steady rise in defaults as well as a boost in new claims for personal bankruptcy.

This downward cycle is just beginning. In 2006, a mere \$300 billion in ARMs reset pushing overleveraged homeowners to the brink of insolvency. Imagine what will happen in 2007 when \$1 trillion of these explosive loans comes due. And, of course, as more people are unable to hang on and their homes go into foreclosure; inventory will continue to skyrocket. Peter Schiff of europac.net summarized the situation this way:

"The recent jump in bond rates suggests that things are about to get much worse for the housing market. Since January 5th interest rates have risen by over 30 basis points and gold has risen over \$40 per ounce...My guess is that rather than a bottom of the housing market, bond investors around the world are beginning to appreciate the inflationary implications of a real estate crisis.

A substantial decline in real estate prices will either produce a severe recession on its own or exacerbate one that arises from other factors. In either case the result will likely be the Fed coming to the "rescue" with inflationary monetary policy. Inflation will push long-term rates higher, causing more loans to default. With credit destroyed and home equity and jobs lost, foreign creditors will rush for the exits sending the dollar into a tailspin. The Fed will be forced to buy all of the paper foreign lenders no longer want and that savings-short Americans cannot afford. Domestic money supply will explode sending consumer prices

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soaring”.

Schiff's calculations are exactly right; a recession is just one effect of the deflating of housing bubble. The other effects are even more serious; the anticipated “flight” of foreign capital from US markets and an impending currency crisis which is liable to dethrone the greenback as the world's reserve currency.

The source of our current problem is complex; deriving mainly from artificially low interest rates, currency deregulation (which has helped to create the enormous account imbalances) and shoddy lending practices.

Presently, Rep. Barney Frank (D-Mass) who is the new chairman of the House Financial Services Committee is leading the charge to enact “nationwide lending standards to protect consumers from deceptive unfair and predatory mortgage practices.” Frank intends to pass legislation that will put more pressure on lenders to make sure that borrowers fully understand the requirements of their loans and ensure that they are financially capable of making regular payments when their loans reset. (increase)

But Frank's attempts at consumer protection through “suitability standards” are too, little too late. Mortgage debt has increased \$4.5 trillion in just 6 years. As interest rates rise and ARMs reset there's no chance of a “soft landing”. By the end of 2007 we should have a much better idea of the magnitude of the damage.

Frank is right, though, much of the dilemma stems from goofball loans cooked up by mortgage lenders trying to bulk up their commissions. For example:

In 2000, a mere 2% of borrowers took out “nontraditional mortgages”. (That is, mortgages that allow borrowers to pay only the loan interest or just a part of the interest each month without paying anything on the principal) In 2006, that number jumped to 35% of all new mortgages!

Also, Piggyback loans (which allow people to borrow the money for a down payment) currently represent 25% of all new mortgages. Think about that! The down-payment used to be proof that a loan-applicant was credit-worthy or financially responsible. Now, mortgage lenders have abandoned that standard in order to generate more loans.

Finally, sub-prime loans now represent 20% of all new mortgages, whereas, in 2000, sub-primes were only 5% of total loans. These are the loans which are made to people with bad credit who typically pay considerably higher rates of interest. According to the New York Times, nearly 20% of these sub-prime borrowers will default in the next few years pushing 2.2 million borrowers into foreclosure.

Lender's are also at risk from loans which don't require strict documentation of income. In fact, 62% of all mortgage originations go to people who simply state their earnings on the loan application without providing any proof from IRS records. That's why they are commonly referred to as “liar's loans”. A recent survey found that over half of mortgage-applicants (who don't produce verification of their income) exaggerate their

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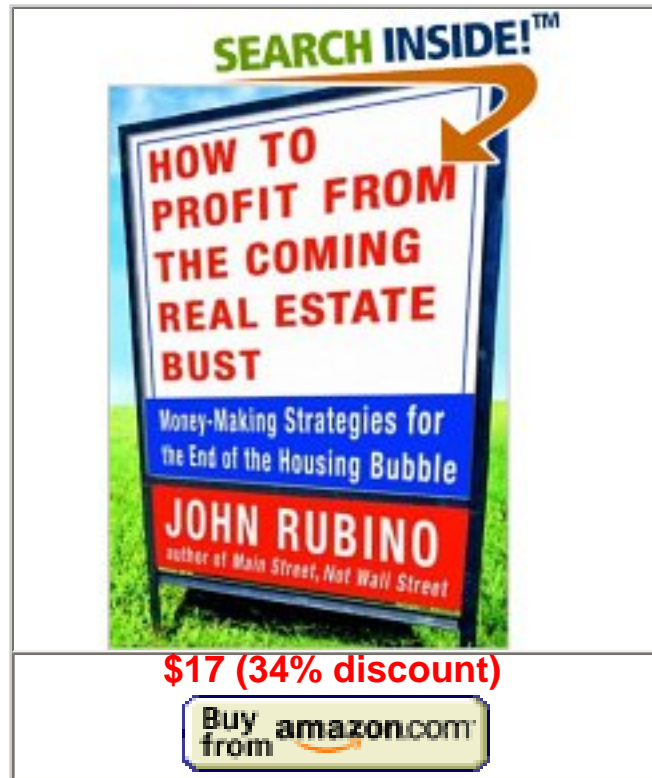
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earnings by more than 50%! It is expected that many of these borrowers have purchased homes that are way beyond their means and will have a difficult time avoiding foreclosure once their ARM reset. Liar's loans are just one of the many ticking time-bombs which now litter the entire mortgage industry.



In the last 7 years the total value of real estate in the US has increased by a mammoth \$11 trillion; the greatest expansion of personal debt in history. This monstrous new liability has continued to bloat despite nationwide wage stagnation and declines in real wealth (as per personal savings) It is purely the result of seductively-low interest rates and reckless lending practices.

As Bill Fleckenstein says in his article "Face it: The housing bust is here", most of the blame can be pinned on the Federal Reserve and their profligate monetary policies.

"Alan Greenspan managed to make folks lives ultimately even worse, in attempting to bail out his equity bubble with a real estate bubble," Fleckenstein avers. "Let's never forget who the un-indicted architect of this mess was: Alan Greenspan and the other merry pranksters at the Fed. Of course, these folks didn't learn anything from the equity mania, and who will turn out to have gotten themselves trapped in the housing mania, really have only themselves to blame. As I have been warning for at least a couple of years now, all of this was going to be wonderful until it wasn't. That moment in time is upon us."

But what's the point of recriminations and finger-pointing? The fact that we were all taken to the cleaners by the crafty bastards at the Federal Reserve won't help us now. The best plan is to figure out a way to get out of debt while preparing for the eventual crash. Sooner or later, we're all going to be forced by circumstances to live within our means.

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As for the notion that the housing bubble is a “left wing conspiracy”; here's a summary from the far-right “Weekly Standard” which draws many of the same conclusions:

“Just as cheerleaders of the high tech bubble of the late 1990s developed ever more creative explanations for why traditional metrics of valuing stocks no longer applied, the same has been true during the housing bubble. Housing bulls point to immigration, building restrictions, Baby Boomer demand for second homes, and other seemingly plausible justifications for skyrocketing home prices. But examining the value of housing using time tested and common sense metrics such as price-to-income and price-to-rent ratios suggest the gains in the bubble areas can't be explained by economic fundamentals....People are buying in the face of sky-high prices because they've seen many of their friends or relatives make a fortune in real estate; besides (they tell themselves) no one knows real estate prices never fall. As with the stock market during the tech bubble, many are basing purchasing decisions not on underlying value, but on what they think they can sell a property for in the future—the very definition of a speculative bubble...

Even flat home prices would therefore slow economic growth unless other parts of the economy rapidly accelerate. But a hard landing—meaning a recession—is a real risk. If home prices fall modestly, millions of homeowners will see their equity wiped out. Many of those with the least amount of equity, as we've already shown, are going to face significant increases in their monthly payments. So what has been a virtuous but unsustainable cycle for the economy—higher home prices, more borrowing against home equity, higher spending, increased job creation, even higher home prices—could easily reverse and become a vicious cycle—higher monthly payments, declining home prices, less spending, job losses, foreclosures, even lower home prices.” (“Housing Bubble Trouble: Have we been living beyond our means?” The Weekly Standard, April, 2006)


It's better to look beyond the Pollyanna prognostications of the Commerce Department and the National Association of Realtors. (NAR) Their judgment is no more reliable than Bush's promises of “democracy” in Iraq. Housing prices have completely disconnected from reality. And the “correction” ahead is bound to be ugly.

By Mike Whitney

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