Historic Financial Collapse Underway?

Porter Stansberry, July 20, 2008

I tend to be in hotel rooms when bubbles burst.

On January 6, 2000, I was on the 30th-something floor of the Marriott hotel across the street from the convention center in San Francisco. I was jet lagged and up working even though it was still dark outside, around 5:30 a.m. local time. Just then, Lucent Technologies announced earnings before the market opened. After beating expectations for 15 quarters in a row, Lucent missed its earnings forecast by 18¢. Much worse, it reported a $1 billion drop in revenue. You can't miss on revenues by $1 billion unless something is horribly wrong.

And something was horribly wrong. It wasn't clear until months later, but that was the morning the bull market in tech, telecom, and the Internet died. I vividly remember that morning. Believe it or not, I didn't have to look up the date or the details on the earnings miss. That morning is seared on my brain. It was the end.

I don't believe it was a coincidence I was in San Francisco that day. We financial scribblers follow the market. We cover what's hot. I visited tech capitals San Francisco, Boston, or Seattle nearly every month during the big bubble of 1998-2001. It was an incredible, exciting time. I'm glad I got to see it up close and personal.

This month, I got the same feeling I did back on January 6, 2000. It's over. And I was watching it all collapse, at the epicenter.

Recently, I was at the Four Seasons Hotel, looking down over the Las Vegas strip. Fannie Mae and Freddie Mac have finally cracked. While the stocks haven't gone to zero yet, it's clear the market woke up to the obvious fact equity holders of these companies are holding worthless pieces of paper. From my hotel room, I could see many of the reasons why...

Las Vegas may end up being the single-largest source of mortgage defaults. Upscale home prices here have fallen nearly 40%. The $2 billion Cosmopolitan hotel development is in default. The $6 billion Las Vegas Plaza is being delayed. Even Donald Trump has put his second tower on hold. It's a bloody mess.

Meanwhile, City Center, a $9.2 billion condominium/hotel development on the strip, is still going up.

Pre-construction sales began in February of last year – just before the financial markets shut out condo developers completely. I can see six huge cranes and the enormous steel infrastructure, half wrapped in glass. I cannot embellish on how big City Center is.

Each of its six main buildings seems bigger than any existing building in Las Vegas. This is the largest privately financed development in the history of the United States.

It sits in the middle of a desert, in a city whose economy is dominated by gambling. Those two facts alone would give most reasonable investors pause.

The entire complex is five-star. One-bedroom condos here sold for $700,000. And the complex includes literally thousands of them. What will they be worth in foreclosure? I'd bet less than $200,000. And who will absorb those losses? I can't help but think in another two years we will look at those buildings and wonder, "What were they thinking?"

On a smaller scale, the same problems and the same questions are being asked of real estate buyers all over the United States. And the answers are not pleasant. By a huge margin, the largest owners of residential mortgages in the world are Fannie Mae and Freddie Mac.

Whether we like to admit it or not, the entire market for housing in the United States has been corrupted by government involvement. By subsidizing the availability of credit and by granting huge tax incentives to home speculators, the government helped finance the biggest bubble of all – the biggest bubble in history. It won't be unwound without serious disruptions to our economy and, unfortunately, a tremendous amount of pain.

I was listening carefully this week to the congressional testimony of Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson. Both insisted Fannie and Freddie have enough capital to continue their operations. Paulson sounded just like a Latin American finance minister on the eve of devaluation.

Incredibly, they both insisted all that was needed was more regulation! I felt like I was watching a kind of financial Nuremberg trial, where the main perpetrators of the crime were utterly oblivious to the evil they'd created. I was aghast.

Consider: Only 20 years ago, the U.S.'s total outstanding mortgage debt made up roughly 30% of our GDP. Homeowners held large stakes in their houses – close to 70% of the equity on average. Today, mortgage debt equals nearly 80% of GDP. The average homeowner owns less than half the equity in his home. This seismic change in the nature of home ownership and debt financing occurred nearly overnight – in less than one generation.

Fannie Mae and Freddie Mac made it all possible. Released from capital-ratio requirements and backed with a line of credit at the Treasury, they were able to buy a nearly unlimited amount of mortgages. Today, Freddie or Fannie finance more than 80% of all new mortgages in the United States. Over the last several decades, their presence in the market greatly lowered interest rates, created an endless supply of credit, and pushed housing prices higher. Meanwhile, the cost of the government guarantee, which lay behind Fannie and Freddie's power, was invisible.

Now what?

The size of the bailout of Fannie Mae and Freddie Mac could easily surpass $1 trillion. But Congress has no understanding, at all, of what's about to happen.

In 2003, chairman of the Senate Banking Committee Chris Dodd refinanced his home mortgages with Countrywide Financial, receiving a below-market interest rate that allegedly saved him $75,000 a year. He never disclosed the benefit to the Senate and claimed he was in Countrywide's VIP program because he was "a good customer of Countrywide's" – which is as bald-faced a lie as has ever been told in Washington, D.C.

In any case, the bill Dodd is getting through Congress (which was written by Bank of America, by the way) will create a new tax on Freddie and Fannie – 4.2 basis points on all mortgages they buy. That would generate about $600 million annually.

And, the money won't go into the general fund. Most of the money (65%) will go directly to the secretary of Housing and Urban Development, who will pass out the loot in the form of block grants to states. The Treasury secretary will get the rest of the money. He's allowed to give it to any nonprofit entity he chooses. And that means, whoever wins the presidency will get another $600 million (or more) each year to kick back to political backers. All for "affordable" housing, of course...

If Congress had any idea how serious the problems with Freddie and Fannie were going to become, they wouldn't mess around with a new tax or allowing a rival to Fannie and Freddie (Bank of America) to draft the bailout. Clearly, Congress has no idea how much trouble Fannie and Freddie face. Here's my estimate:

Freddie and Fannie own or guarantee $5 trillion (yes, *trillion*) in U.S. residential mortgages. I'm convinced mortgage losses after recoveries will exceed 10% of the total outstanding and could exceed 20%. Thus, over the next 12 to 24 months, Fannie and Freddie will likely face losses of between $500 billion and $1 trillion. That's a huge amount of money, even for Congress.

There's simply no doubt Fannie Mae's and Freddie Mac's shareholders will be wiped out. Last month, I wrote the market value of the mortgages on their balance sheets has fallen by at least 5%, wiping out all of their equity. And when you factor in the off-balance-sheet guarantees these firms have sold, it was impossible to imagine they remained economically viable...

I'm embarrassed to admit my estimate of Fannie and Freddie's viability was hugely optimistic. Both firms seem unlikely to last through the end of July. Readers who followed my advice in June are up over 70% on their short positions in Fannie and Freddie.

I'm certain the government will do whatever it takes to ensure Fannie and Freddie continue to operate – but that doesn't mean bailing out the shareholders. All the government will do is guarantee Fannie and Freddie's debts. That means a huge amount of taxpayer money is about to go into troubled mortgages. A huge amount of money the government doesn't have and won't be able to increase taxes enough to afford. And that means inflation is going to get a lot worse. The government is going to pay for guns, butter, and housing. Look out.

The value of the dollar is going to go down, and the price of everything else is going to go up. I think this sets the stage for a true inflationary crisis – as the economy can't adjust to soaring commodity prices. I also find it hard to believe our foreign creditors will continue to hold U.S. Treasury bonds if the U.S. Treasury takes on all of the mortgage losses of Fannie Mae and Freddie Mac. I think they'll dump our bonds and that will literally be the end. No more world reserve currency. No more pegs to the dollar around the world. We'll be on our way to banana republic status, in terms of credit quality.

What's the best way to protect yourself and to make money on this looming crisis?

You must buy gold and silver as a hedge against a further collapse in the value of the U.S. dollar.

Most people don't spend any amount of time thinking about the value of the dollar. It has never occurred to nine out of 10 Americans that the last 35 years mark the first time in recorded history that every major financial power in the world operated with fiat (paper) money in the absence of a World War. No monetary backstop exists anywhere – no limit in any country to the amount of paper the government can create on a whim. Meanwhile, the track record of every experiment with fiat money is 100% perfect: In every case, the currency regime was eventually destroyed by an inflationary crisis.

I believe we have begun the monetary crisis that will end the dollar standard that has governed world trade since World War II.

I can promise you, the same way I promised readers that GM, Freddie Mac, and Fannie Mae were "zeros" – the U.S. dollar's strength will continue to fade.

Slowly, bit by bit, Americans will realize this. Our foreign creditors will realize it, too. The result will be a flight from the U.S. dollar into other assets – at any price. Please set up your affairs now, so you can profit from the coming panic, not be a victim of it.

Writing the most recent issue of my investment advisory – my third strong endorsement of precious metals in as many years – I can't help but feel like Chicken Little. Are things really this bad? Well, let me ask you which do you think is more likely?

Scenario one: The U.S. government recognizes its severe financial mismanagement. It allows Fannie and Freddie to collapse completely and does not assume their liabilities. Mortgage investors take huge losses. Mortgage rates soar to more than 10%. Housing prices fall 75% – which makes housing affordable for millions of Americans previously priced out of the market.

In the meantime, the government cuts spending by 30% and reduces taxes radically to encourage economic growth (which, ironically, increases tax receipts, leading to a balanced budget). It restructures Social Security, moving the age of retirement to 75. And most importantly, the government gets out of health care completely, renouncing all of its Medicare obligations. Hospitals and doctors immediately drop their fees to meet the affordability requirements of a free market.

Scenario two: The U.S. government refuses to take responsibility for causing a bubble in mortgage finance. Rather than allow the bubble to deflate quickly, it bails out Fannie and Freddie. Mortgage losses build for five years, reaching more than $1 trillion. Housing prices stabilize in good neighborhoods, but risk-averse lending practices result in widespread vacancy across broad swaths of America.

Refusing to substantially raise taxes, annual deficits surpass $1 trillion in 2010. Total government debt begins to spiral out of control as our interest costs mount. Our foreign creditors lose confidence in the dollar and begin dumping it on the world market. Inflation surpasses 20% annually and prices for energy soar. Oil reaches $250 per barrel. The president alleges an international conspiracy to destroy America and threatens to attack China if it continues to sell the dollar. Price controls are instituted.

No paper currency regime has ever lasted. No government in history has ever repaid debts as large as those already assumed by our government (in terms of GDP). A default is not likely – it is inevitable.

The answer seems obvious and urgent. Make sure you own a substantial amount of gold and silver. I prefer to own plain bullion. Buy gold and silver bullion and bury it somewhere safe. The gold won't rust. Silver is more difficult to manage, but the best way to own it is to take physical possession.

That's what I strongly recommend you do. Right now. Seriously. I wouldn't be surprised to see prices of these metals soar if Fannie and Freddie are taken over by the Feds, which is what I expect will happen.

Is there a chance I'm wrong about all of this? Is there a chance the death of Fannie and Freddie will mark the end of the crisis? That financial stocks will rise from here and gold and silver will fall?

Yes, absolutely. At some point all of the bad news will be in the market, and prices will turn before the fundamentals improve. So, yes, I might be Chicken Little. I might be dead wrong. But I don't think we are anywhere near the end of the real estate bubble collapse, and I know we haven't even begun to deal with the fiscal imbalances of our profligate politicians.

One more thing... I wish I were wrong about all of this. But I don't believe the debts of our government and many of our neighbors will ever be repaid. As a nation, we've essentially bankrupted ourselves over the last 20 years. And the consequences of those actions will be felt by several generations of Americans, at least.

I worry about the middle class, people who generally lack the financial knowledge and resources to protect their savings. They will probably believe the lies they're told by the mainstream press about "greedy" speculators and evil oil companies. They will almost surely support the policies and the politicians who are actually responsible for their increasing poverty.

I also worry about people who are retired and depending on the government to support them. They will surely see their standard of living decline substantially.

And finally, I worry most of all about my infant son. Will he grow up in a vastly different kind of America than I did? He could. And that makes me saddest of all.