Cracks Show in Housing, Bubble of Last Resort

by Richard Freeman

Reports appearing in the Oct. 3 *Wall Street Journal* from economic analysts began to confirm *EIR*'s much-denied warning of four months ago ("U.S. Real Estate Bubble Nears Its End," June 21), that the U.S. housing boom is a bubble which is popping. *EIR* had pointed, in particular, to the creation of a vulnerable mortgage-debt bubble by the two large national mortgage corporations—known by their nicknames Fannie Mae and Freddie Mac—as the trigger which could cause an explosion of unpayable mortgage debt to hit the economy as a whole.

In a page-one story, the *Wall Street Journal* worried that "cracks are spreading in the foundation of the U.S. housing boom, as evidence that the long run-up in housing prices can't be sustained." The *Journal* pointed to continuing job losses as undermining real estate markets. In a break from what has been consistent propaganda in the U.S. economic press about the enduring values of home-ownership at any price, it called the real estate market "speculative."

And the *Journal* reported a new study by economy.com, which determined (see **Table 1**), for 100 of America's large cities, (a) the percentage increase since 1998 of the median household income in that city; (b) the percentage increase of the median home price in the same period; and, thus, the percentage by which the increase in the median price required to buy a home, surpassed the increase in the median household income. In the case of San Diego, to take one example, the *median price* of a home has jumped to $362,000, out of the reach of the income of two-thirds of all American households.

The paper documented past examples of sudden fall of overinflated home prices: In Los Angeles, after home prices rose during the 1980s, they fell by 24% over a five-year period in the 1990s. But, after convincingly showing that there is insufficient real income behind the sky-high prices of homes in America, and the mortgages attached to them, the *Journal* then attempted to reassure its readers, that everything will turn out okay. Its primary argument was the fairy tale that unlike the "high-tech" stock market, the real estate market won't collapse "quickly" and cannot go through a depression, "because real estate is such a local phenomenon"; in other words, a collapse in some cities and local areas will be borne along by continued rise in housing valuations elsewhere. The argument ignores the housing bubble's predominant engine: the actions of the Fannie Mae and Freddie Mac national mortgage companies, which have created that bubble which is now ready to blow. As one financial newsletter put it in late September, "Fannie Mae is just a huge hedge fund, and its overextended."

TABLE 1

How Far the Median Home Price Increase Outstripped Household Income Increase Since 1998

Boston, Mass.	66.1%	Washington, D.C.	29.7%
Portland, Me.	61.3	Minneapolis, Minn.	28.3
San Diego, Calif.	59.8	Santa Fe, N.M.	21.1
Fort Myers, Fla.	59.4	Houston, Tex.	20.8
New York, N.Y.	51.3	Tucson, Ariz.	20.7
San Francisco, Calif.	39.8	Chicago, Ill.	20.1
Denver, Colo.	33.9		

Source: Economy.com for *Wall Street Journal.*

Fannie Mae's 'Duration Gap'

A Sept. 30 report by Fannie Mae—the Federal National Mortgage Corporation—showed that trillions of dollars of mortgage obligations are now at risk. The huge mortgage firm reported that its "duration gap" stood at negative ten months as of the end September; this is outside its "acceptable range." The duration gap is the difference between the average future maturity of all of an institution's assets, and the average maturity of its liabilities. This has major implications in the world of low interest rates that Federal Reserve Chairman Sir Alan Greenspan has created in an attempt to prop up the bankrupt financial system.

Fannie Mae's assets now come due ten months before its liabilities. Assume for a moment, that Fannie Mae issued its own bonds, at a 7% interest rate, in order to raise cash to buy home mortgages in the secondary housing market, which mortgages themselves bore an 8% interest rate. Assume also that the maturity of the bonds that Fannie Mae issued, and that of the home mortgages it bought, were the same. Fannie Mae then earned a net 1% spread.

But with Greenspan's Fed policy and the constant lowering of long-term as well as short-term interest rates, assume now that homeowner refinancing reduces the interest rate on those mortgages Fannie Mae is buying, from 8% to 6%. Since Fannie Mae still has its own bonds outstanding at 7%, now it is earning a *negative* 1% spread. If this is widespread enough, it will incur large, damaging losses. And the negative duration gap means that Fannie Mae must wait, on average, ten months, after its income-bearing mortgage paper is retired, before it can refinance them at a presumably lower interest rate.

In the $10.7 trillion U.S. housing market, Fannie Mae alone has over $2 trillion in highly risky obligations, including its own bonds and its responsibility for mortgage-backed securities (MBS). Add today's historically high mortgage default rates, due to job losses, and this huge "hedge fund's" blowout could remove the last prop from the financial system.