GOLD & ENERGY ADVISOR

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"2008 Will Be An Historic Year for US Investors!"

"Few have noticed—yet—but there's big trouble brewing in real estate. I think the changes in the national housing market will be one of the biggest investment stories this year.

"Here's what's going on, and how to profit from it!"

James DiGeorgia, Editor

- **Yale Economist Discovers US Homes Far Overvalued**
- **Federal Reserve Study: Home Prices Will "Fall Considerably" From Here**
- **Why This Crisis Will Last for Several Years, and What to Do About It**

2007 was a great year for *GEA*. Last year, our portfolio made 29.82 percent.

That's more than 2.5 times the performance of the Dow, and almost quadruple the performance of the S&P 500.

But that was last year. Now it's time to start looking at the coming trends for this year.

I believe that in December, we'll look back at 2008 and see that falling home prices were one of the biggest investment stories of the year. And that's what this issue is about!

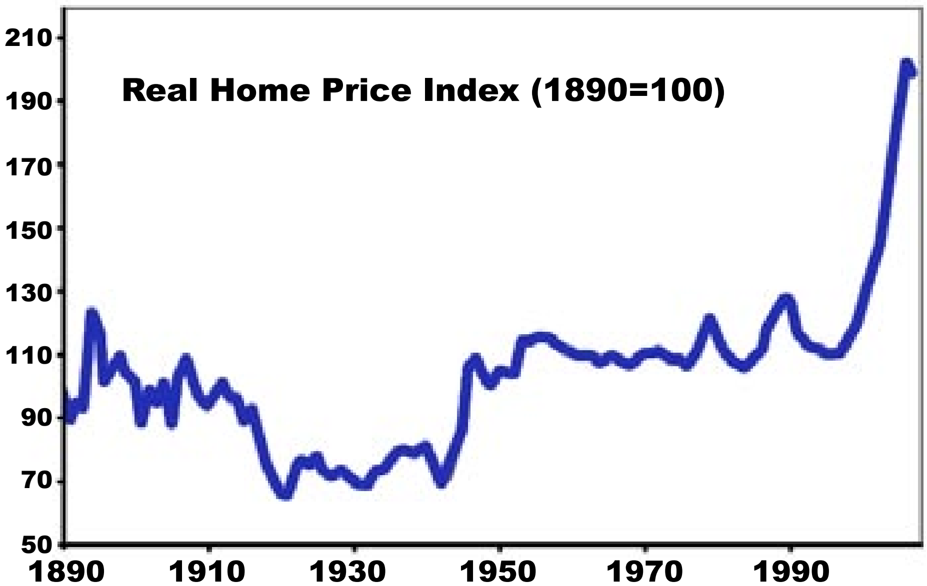
American Housing Market: Shockingly Overvalued

Robert Shiller is an economist at Yale University. He has quite a reputation in the investment community.

Among other things, his book "Irrational Exuberance," warning that the stock market was a bubble, was published in 2000—almost on the exact day that the bubble started to burst.

Shiller has continued his study of "exuberant" markets, and has now turned his attention to US housing. He doesn't like what he sees.

Shiller has researched national home prices going back to 1890, and adjusted all of them for inflation. He assigned the year 1890 to be a value of 100, and plotted the following years accordingly. The result was this chart:



Source: Robert J. Shiller, www.irrationalexuberance.com

Land availability. This objection is easily disposed of. Land prices didn't suddenly go ballistic in 1998. So the abundance or scarcity of land didn't drive home values up.

Population migrations. It's true that the US population has migrated in the past. From the country to the cities, then to the suburbs, now in some cases back to the cities, there have been large-scale migrations in US history.

This will raise prices in the 'receiving' areas, true. But it will also depress prices in the 'sending' areas. And we're talking about national averages here. So migrations are a wash, and they don't explain the current prices.

We see that national housing prices were fairly steady until World War I, which brought them down a bit. They came up again after World War II, and varied little for decades thereafter.

Until 1998.

This was the year the current housing bubble began. Notice how housing prices have shot straight up since then.

The magnitude and speed of the bubble has been breathtaking. Before adjusting for inflation, housing prices more than *doubled* in less than six years (from November 2000 to June 2006). Even *after* inflation, we've seen prices balloon by 85 percent since the end of the 1990s.

Although prices have fluctuated a bit over time, overall they've remained fairly constant since 1890. But now, in the last decade, they've almost doubled. If that's not a bubble, I don't know what is.

Now you might be thinking this evaluation is too simplistic. Surely there are good reasons for skyrocketing house prices.

Yes, there are. But they aren't the ones you think. Consider:

Population growth. Yes, the US population has grown. But it's grown at a slow, steady rate. Obviously, there was no big burst of new people in the late 1990s needing housing.

In fact, notice that housing prices averaged 104 until the late 1990s—only four percent higher than the initial 100 in 1890. This was despite the population quintupling during that time.

The population grew, and people needed homes. But at the same time, more land was developed and more houses were built, which kept prices steady. Which brings us to our next objection…

Stocks and other assets. When financial assets do well, people feel better about themselves and spend more freely. This impacts housing prices, but only slightly. For example, the Roaring 20s saw a major stock bubble, and housing did go up a little. But that little bump is nothing compared to the moonshot we see in the 1990s-2000s.

Construction costs. Yes, it's more expensive to build a house today than a few decades ago—but not when you consider inflation. After inflation, technological advances have made construction cheaper and easier now. Just compare the day or so needed to lathe-and-plaster a wall, compared to the couple of minutes needed to screw in a sheet of drywall. Or the time it used to take to string post-and-wire electrical wiring, compared to pulling a line of Romex. No, construction costs can't explain housing prices.

Interest rates. Now we're finally getting somewhere. When money is cheap, real estate prices go up. And we've seen historically low interest rates lately, starting with the Greenspan Fed and continuing through to the regime of Helicopter Ben Bernanke.

In fact, interest rates are one of…

The Real Reasons Why Housing Prices Have Soared

There are two main reasons home prices have become so bloated in the last decade: cheap money, and human psychology. Let's talk about each.

Cheap Money. In the last couple of decades, the Federal Reserve has been completely transformed. Back in 1981, the dollar was in a tailspin, and inflation was raging through the economy. So Fed Chairman Paul Volcker clamped down hard on the money supply.

The media shrieked about the damage he was doing. Politicians in Congress called for his head. Farmers blockaded the Fed building in Washington with their tractors.

But Volcker refused to submit. As a result, he accomplished the near-impossible. He got inflation back under control, and rescued the dollar from oblivion.

Only six years later, Alan Greenspan was put in charge of the Fed. And "Easy Al" never saw a problem that couldn't be solved by cranking the monetary spigots wide open. Just drown the economy in liquidity, and problems will go away… or so he seemed to think.

In reality, the immediate problem might be flushed away, but much bigger problems are created instead. When tidal waves of dollars are poured into the economy, they have to go somewhere. So asset bubbles form.

This explains both the tech-stock bubble in 2000 and the housing market bubble today. The only difference between them is that the first has already burst, while the second is just starting.

Anyway, that's the first reason for the housing bubble. And the first reason reinforced the second, which is human psychology.

Bubbles are self-reinforcing. As prices go up, investor confidence rises as well. Paradoxically, as investors should be getting more cautious, the opposite occurs. (Several studies have confirmed this to be true.)

As housing prices soared in the late 1990s and early 2000s, this just added strength to the mania.

Federal Reserve Study Says Housing Prices Will "Fall Considerably" From Here

The Fed just put a new study on its website. It was performed by three Fed economists (two currently on staff, and one who was on staff at the Fed until 2006).

This study examined the historical relationship between housing prices and average rents. Of course, the two are intertwined: when rents are high, more buyers enter the market to purchase a home, driving prices up. The opposite occurs when rents are low.

The authors went so far as to say that rents are to home prices as dividends are to stock prices. Just as dividend yields are an inherent component of stock pricing formulas, so are rents when calculating proper housing values.

These economists gathered data back to 1960, and found that rents averaged between 5 percent and 5.25 percent of home prices. This was true up until 1995, when average rents were $6,636 ($553 per month), and housing averaged $134,000.

But then the bubble started to inflate. Just 11 years later, housing prices had more than doubled, to $282,000. However, rents had only increased 48 percent, up to $9,816 ($818 per month).

This means the rent/price ratio had fallen to only 3.48 percent.

THE GOLD AND ENERGY ADVISOR

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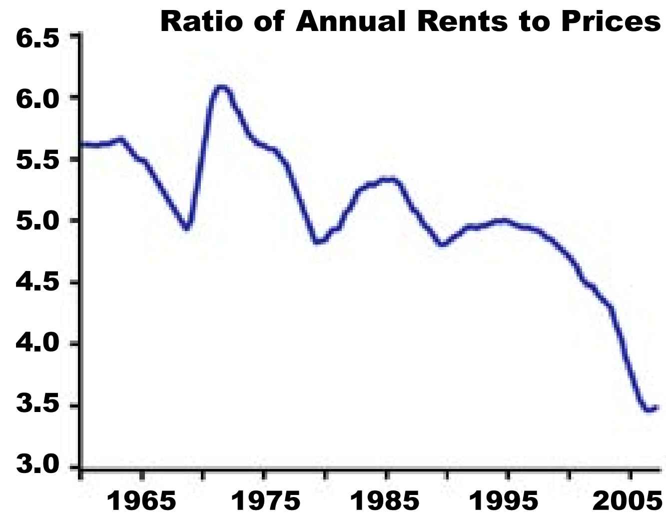
Latest prices as GEA goes to press—January 16, 2007

Comex spot contract: silver $16.21, gold $901
Nymex spot platinum: $1,586, palladium $380
Nymex Light Sweet Crude Oil $94.00

Silver coins			Dealer will buy at this price	Dealer will sell at this price
100 1 oz. silver American Eagles			$1,700	$1,796
100 1 oz. common rounds			$1,590	$1,675
$1,000 face value US pre-1965 coin bag (circulated)			$11,191	$11,449
$1,000 face value US circulated silver dollar bag (VG or better)			$11,000	$11,500
US Morgan silver dollars	PCGS	MS64	$46	$50
	PCGS	MS65	$120	$130
	PCGS	MS66	$225	$245
Platinum coins				
U.S. Platinum Eagle:	1 oz.		$1,560	$1,645
	1/2 oz.		$777	$843
	1/4 oz.		$386	$436
	1/10 oz.		$155	$187
Gold coins				
US Gold Eagle:	1 oz.		$906	$924
	1/2 oz.		$448	$473
	1/4 oz.		$222	$240
	1/10 oz.		$91	$97
US $20 double eagle:				
Liberty	Raw	MS60	$890	$910
	NGC	MS63	$1,350	$1,385
	NGC	MS64	$1,720	$1,770
	NGC	MS65	$4,680	$4,810
Saint Gaudens	Raw	MS60	$900	$920
	NGC	MS63	$1,080	$1,110
	NGC	MS64	$1,200	$1,230
	NGC	MS65	$1,455	$1,505

Prices provided by Finest Known



Source: Davis et. al, The Rent-Price Ratio for the Aggregate Stock of Owner-Occupied Housing

Put another way, it's now far cheaper to rent (compared to buying) than it used to be. Current rents can 'support' a certain level of home prices. But prices have bloated up far beyond that support.

How Far Will Home Prices Fall?

For balance to be restored between rents and prices, prices are going to fall for the next several years. As the authors put it, "For the rent-price ratio to return to its historical average… house prices likely would have to fall considerably."

The Fed economists assumed rents would rise at 4 percent per year, which is about their current average. If housing prices fall gently—say, over five years—then they'll have to fall an additional 15 percent from current levels.

Of course, they might not fall gently. They might fall quickly instead. In that case, they'll have to fall even further, to compensate for the shorter time that rents will be catching up.

For example, for balance to be restored by 2010, prices will have to fall more than 25 percent from current levels.

However, both of those figures assume rents will rise at 4 percent. As one of the economists admitted in a recent interview, rents might not grow by that much.

There's a huge overhang of unsold homes on the market today. Many of these could be converted into rentals. This might even *depress* rents rather than raise them. And that means housing prices would have to fall even further.

The Fed study seems to be grim news for home prices, and it is. However, it's actually the most optimistic prediction.

For what might be a more realistic view, let's look at that chart on page 2 again. Look at how steep that last rise is. And notice how far down it will have to come, to revert to typical levels again.

As I write this, the latest Housing Index is at 195 or so. Its long-term average is a little over 104.

For it to revert to its long-term average, housing prices will have to fall by *47 percent*.

Do I think this will happen? No. A plunge that deep would be politically unacceptable.

Whichever party is in power during a steep drop would get *thrashed* during the next elections. And both parties know it.

So I expect all sorts of political gyrations to prop up housing prices. More on this subject later. For now, let's ask…

What Damage is the Housing Bubble Doing to Us?

As the bubble bursts, what fallout can we expect?

Lots. First of all, we're already seeing carnage in the financial sector. Many billions in losses have been announced by banks, Wall Street houses, mortgage servicing firms, and others.

If this doesn't stop soon, our entire economy could be threatened. Japan experienced a banking crisis in the early 1990s when their huge property bubble burst. Over 15 years later, the Japanese economy *still* hasn't recovered. (Neither have their property values.)

And even if we manage to avoid a Japan-style morass, other effects are less avoidable. For example…

Jobs Are Evaporating

As home sales tumble, many real-estate related positions are going away.

I'm not only talking about real estate agents, mortgage brokers, and title insurance agents. Yes, those positions are disappearing, but so are many others.

About 10 percent of all US jobs are related to real estate. From landscapers to contractors to Home Depot workers to nursery owners… lots of people depend on healthy real estate for their livelihoods.

According to Mark Zandi, chief economist at Moody's Economy.com, "Every dollar change in housing wealth results in a change of five cents of consumer spending. And that adds up to hundreds of millions."

Thus, the private sector will get clobbered. And so will the public sector, because…

Local and State Governments are Bleeding

Many state and local governments are suddenly in serious financial trouble. They're getting hit from multiple fronts.

Property tax assessments. As American homes decline in value, their taxable assessments are falling as well. This means less tax revenue, obviously.

Nationwide, home prices have fallen by some 7.9 percent in the last 18 months. In many areas, they've plummeted a lot more than that. The tax base is shrinking fast.

Property tax collections. Homeowners who go into foreclosure rarely bother to pay their property taxes. The taxes might be recovered after a foreclosure sale, but in some states, that process can drag on for a year or more.

The *LA Times* recently ran an article about this problem. As an example, it described Fairfax County, Virginia—a state that didn't even experience a big property bubble, as California and Florida did. Nevertheless, "the number of foreclosures has exploded, from fewer than 200 two years ago to about 4,000 this year. The resulting $220-million budget shortfall has officials warning of significant cuts in services, including spending on public schools."

The article quoted a county executive, who said…

"Instead of having a soft landing, we've crashed."

Fee collections. Governments are losing money on building permits and other construction-related income. They're also collecting fewer transaction fees from real estate sales.

Fee collections are down by 20 percent or more in some states.

Sales taxes. When people buy new homes, they often buy new furniture and appliances. These purchases are drying up—and with them, the sales taxes that the tax authorities would normally collect.

A good gauge of this is durable goods orders. The most recent numbers are from November, when economists had been hopeful for a 2.2 percent increase. What number did they actually get? About 0.1 percent.

When you add up all these problems—property taxes, fees, and sales taxes—the shortfalls are huge. State, county, and city governments are all getting clobbered by the real estate crisis.

The most severe problems are occurring in California. State officials are facing a $14 billion deficit. Lawmakers have slashed funding for a broad variety of state services, including long-term nursing care for the indigent. They've even asked state law enforcement to have their uniforms cleaned less often.

But other states are in trouble too.

For example, in Nevada, the governor has ordered an across-the-board cut of 4.5 percent.

In Arizona, lawmakers are facing a 10 percent budget deficit. The chairperson of its Senate Appropriations Committee recently warned, "If we don't make some serious moves in '08 and '09, we'll be out of savings. And out of gimmicks."

In Kansas City, Missouri, officials are notifying state-funded agencies of severe cutbacks. For example, reStart Inc. is a ministry that offers shelter, meals, and other services to the homeless. With the steep rise in foreclosures, the ministry has a lot more 'customers' than it used to. But now the state is slashing the funding in half—the real estate sales fees used to fund reStart have plunged. The ministry's executive director told a reporter, "The cut's going to be just staggering. What will we do? I can't tell you."

As Corina Eckl, an analyst for the National Conference of State Legislatures, recently said, "We're at the early stage of a problem that's going to get worse."

She's not alone in this prediction. In fact, a very disturbing report was released by the nation's largest group of city leaders…

Portfolio Update

In Update #437, we recommended selling short a put on Weatherford International (WFT). We sold the January $60 puts (symbol WFTML) at $1.55.

In Update #438, we issued instructions for subscribers who wrote options on Encore Acquisition (EAC) and Pioneer Natural Resources (PXD).

For EAC, we rolled up our December $25 calls (EACLE) to the March $25 calls (EACCE). For PXD, we rolled up our December $45 calls (PXDLI) to the January $45 calls (PXDAI).

In Update #439, we closed out our spread position on Plains Exploration & Production Company (PXP). We made a return of 52 percent.

In Update #442, we covered our short position of our Weatherford January $60 put (WFTML). We made $135 per contract.

In Update #443, we issued instructions for subscribers who have positions in XECAG, DVNAO and PXDAI.

We rolled up our Cimarex Energy January $35 calls (XECAG) to the $35 March calls (XECCG). We also rolled up our Devon Energy January $75 calls (DVNAO), to the February $80 calls (DVNBP). Finally, we rolled up our Pioneer Natural Resources January $45 calls (PXDAI) to the March $45 calls (PXDCI). These actions reduced our cost bases in the stocks.

In Update #444, we recommended buying one May $55 call (WFTEK) on Weatherford International. We also recommended the July $25 call (GQIGE) on Gulf Island Fabrication.

In Update #447, we took profits on our Weatherford International options (WFTEK). We made a $210 profit and a 13.54% return.

United States Mayors Say the Real Crisis is Yet Ahead

The US Conference of Mayors is "the official nonpartisan group of cities with populations of 30,000 or more." It represents over 1,100 American cities.

The Conference recently released a grim report about the housing crisis, and its effect on city and state governments. It says that the worst of the crisis has yet to hit us.

The report predicts that in 2008, our national GDP will shed a full percentage point, going lower by $166 billion.

Also, about 524,000 fewer jobs will be created across the country.

American property values will lose $1.2 trillion during this year. Yes, that's trillion, with a "T." The declines will vary by state, but will be as high as 16 percent.

Also, another 1.4 million homes will go into foreclosure. That's $316 billion worth of property.

Governments at all levels will continue to be crushed, even down to individual cities:

- The New York metro area will lose an estimated $10 billion.
- Los Angeles will lose $8.3 billion.
- Dallas will lose $4.0 billion.
- Washington will lose $4.0 billion.
- Chicago will lose $3.9 billion.

Combined, the top ten cities alone will bleed by over $45 billion.

On the state level, California will again be the hardest hit, facing an additional loss of $2.96 billion in property taxes alone this year. Declining sales tax revenue will be another $994 billion, and transfer taxes yet another $39 million. Other states will hemorrhage red ink too.

The report examined 10 states in detail. (See table on next page.) These ten states alone will lose an estimated $6.6 billion in 2008. Small wonder that the Conference of Mayors has warned…

	Housing Starts 2005	Housing Starts 2008	Projected Property Tax Losses ($ millions)	Projected Sales Tax Losses ($ millions)	Projected Transfer Tax Losses ($ millions)
Arizona	93.5	35.3	$158	$69	-
California	194.0	94.3	$2,955	$994	$39
Florida	272.8	90.7	$589	$148	$99
Georgia	108.4	58.5	$134	$28	$3
Illinois	63.5	34.8	$329	$22	$6
Massachusetts	24.5	10.6	$223	$21	$34
Michigan	47.2	11.5	$111	$12	$1
Minnesota	38.8	17.0	$20	$3	$13
Nevada	43.6	16.8	$49	$19	$8
New York	48.1	29.3	$686	$97	$47

Source: The United States Conference of Mayors, *US Metro Economies: The Mortgage Crisis*.

"The foreclosure crisis has the potential to break the back of our economy."

Earlier, I discussed the Fed economists' study about housing prices and rents. You might remember it expressed uncertainty about how far, and how fast, prices will fall.

It seems obvious by this point that prices can fall farther than most people want to admit. How much time will the process take?

Well, there are several signs that the process hasn't really begun yet. First of all, consumer confidence has hardly budged. Capital expenditures have fallen a little, but not much. Ditto for business hiring.

People are in massive denial. This tells us we're still at the beginning of this crisis. That's why you see homes sitting with "for sale" signs in their driveways for 10 months or more. Sellers are still hoping to get prices from two years ago, and aren't dropping them significantly yet.

Once they do start dropping prices, that's when the correction can start in earnest…

Five Reasons Why Heavy Losses Will Continue For At Least Several More Years

#1: The easy money is gone. Subprime loans are history. Just a year ago, these were up to 20 percent of all mortgages. That means one of every five buyers are out of the market today. For that matter, even prime loans have tightened considerably.

#2: Declining prices discourage purchases. Nobody wants to buy a house and have it go down in price. Although many people are required to buy new homes—because their jobs were relocated, for example—many people will be sitting on the sidelines of the market. They'll wait for prices to turn around before re-entering as buyers. In the interim, this reduces the number of buyers, and adds more downward pressure to prices.

#3: The biggest wave of foreclosures is still coming. An estimated $512 billion of adjustable-rate mortgages will reset this year. 2009 will have large numbers of resets too. Many, perhaps most, of these loans will eventually end in foreclosure.

Nor will Federal legislation help here. The recent jawboning about preventing subprime mortgage resets resulted in a very limited number of people that would actually be eligible. Plus, $152 billion of the resetting loans aren't even subprimes anyway.

Foreclosures can cause a vicious circle. A foreclosed home usually sells at a 20-25 percent discount to an owner-occupied home. (The bank who owns it is desperate to sell, and the house has usually been neglected, sometimes even trashed, by its former occupant.) Too many foreclosures in a neighborhood drive down property values, which puts owners underwater on their mortgages, which means they can't refinance, which can lead to defaults and more foreclosures.

#4: Homeowner behaviors and attitudes are changing. In the past, struggling homeowners made their mortgage payments first, and then paid other bills. That's no longer true.

A large part of the problem is that people have been treating their homes like ATMs. They've extracted much of the equity from their properties, using it to pay other debts or just to spend on travel and other forms of consumption. Now that housing prices are turning down, many homeowners have no equity in their properties. Many now owe more than the home is worth.

Also, the easy money of the last few years has meant many people bought homes with little or no down payment. Again, they now have no equity.

Kenneth Lewis, the CEO of Bank of America, was interviewed on this subject by the *Wall Street Journal*. He said...

"We're seeing people who are current on their credit cards but are defaulting on their mortgages. I'm astonished that people would walk away from their homes."

With little or no equity, people are abandoning their properties. What was once unthinkable is now common. Again, more downward pressure on prices.

#5: Government policies. The House of Representatives recently passed the Mortgage Reform and Anti-Predatory Lending Act. Similar legislation is pending in the Senate.

This bill would punish banks for "steering consumers to a loan that the consumer lacks a reasonable ability to repay, does not provide a net tangible benefit, or has predatory characteristics."

This sounds nice in theory, but in practice it will be a disaster. Who will decide if a consumer has a "reasonable ability" to repay? Seems that once somebody gets behind on his mortgage, all he has to do is claim that his financial trouble is *prima facie* evidence that he didn't have the ability, and so the loan was predatory. For that matter, what is a "predatory" loan anyway? The lawyers will have a field day with this one.

The Consumer Mortgage Coalition has commissioned a legal analysis of this bill. The conclusion was that it "will likely generate significant litigation," and lenders will "rarely, if ever, be able to dispose of even frivolous lawsuits."

Of course, banks aren't stupid. They see all the landmines in this bill. If it becomes law, banks will just refuse to lend to anybody who actually needs the money.

Nor is this the first time such legislation has been tried. Several states have passed similar laws, with disastrous results. For example, the Illinois "Fairness in Lending Act" tried to protect poor people in "at risk" communities. The regulations were so Byzantine, and the penalties so stiff, that over 30 mortgage providers refused to make any loans at all to borrowers in those communities.

As a result, home sales plummeted by 45 percent in those zip codes! Unsurprisingly, home prices crashed too.

How to Invest During This Time

Obviously, it's far too early to tell how long the housing slump will last, or how far prices will fall.

My prediction is this. The underlying imbalances in the housing market will start to correct, and national prices will fall sharply in real terms, approaching their historical averages again.

But, paradoxically, nominal prices won't fall very far. Not for long, anyway.

How can I say this? Because it's easy to predict how the government will react. Along with stupid ideas like the so-called "consumer protection" law I just described, I'm sure Washington will pressure the Fed to apply its usual one-size-fits-all solution to financial problems.

In other words, they'll drown the economy in liquidity.

This will prop up housing prices, but only because the dollar will be massively inflated into near-worthlessness. Thus, in real (inflation-adjusted) terms, prices will fall. But in nominal (non-adjusted) terms, prices won't seem to fall very far, because the dollar used to measure prices will itself have depreciated so much.

Of course, there will be other consequences for the economy—too numerous to list here. Most of them are bad. But since we see this coming, we might as well profit from it.

And the best way to do that is with gold.

We might easily see inflation that will dwarf the huge dollar-depreciation in the late 1970s and early 1980s. Along with all the other reasons gold is going up, the housing market alone could drive gold to $2,500.

If I'm right about the housing crisis, we're going to see something new in American history. There will be *a deliberate attempt by the government to rescue a plunging multi-trillion-dollar market by massively inflating the dollar*.

The implications are breathtaking.

And here's why I love gold so much in this situation. Let's say I'm wrong, and even though housing prices correct themselves, the government doesn't drown the economy in dollars.

Gold will *still* profit from this situation anyway.

Why? Because real estate is one of the few "hard" assets left, and a fall in this market will shake people's confidence in it. Many people have been burned badly in stocks (in the bubble six years ago), and don't trust debt instruments either (thanks to the credit-market chaos this summer).

Real estate is now perceived as one of the few remaining stable assets—one that's immune to the ups and downs of other markets.

Once that myth is dispelled, people will want an alternative "hard" asset. But what will they buy? Artwork? Diamonds? Baseball cards?

No! They'll buy precious metals and rare coins.

Seems to me we're positioned to profit no matter which way this situation turns out. This is a *great* time to be a gold investor!