Are You Buying, Selling, Building or Investing?
Our Take on the Housing Market

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Late spring brings not only blossoming gardens, but also for-sale signs. Americans are on the move and home prices are up. Yet last month, existing home sales dropped 2.5% from March levels and were down 1.4% from April 2017. Are rising prices a sign of continuing expansion of the housing market, or should we expect housing growth to peter out as prices and interest rates rise? With housing-related stocks up 343% since the end of the recession, we wouldn't want to overstay our welcome, so we spoke to several companies involved and did a check of the macro data. We came away convinced that the housing sector offers investors further opportunities for gains, and some companies offer among the best value plays in the market.

Whether they are retiring couples moving to smaller digs or millennials searching for their first homes, home buyers are running into two challenges: lack of inventory and rising prices. In the background lies a growing sense of urgency, as interest rates and housing prices march higher. While this leaves buyers in a pinch, it's good news for home builders.

Existing home sales account for about 90% of homes sold. Sales of single-family homes last month were running at an annual rate of 4.84 million homes sold, while the pace of new construction was running at 662 thousand. Inventories of existing homes on the market remain tight, as anyone looking for a home can testify. Inventories fell 6.2% year-over-year in April and have declined for 35 straight months. But even if more existing homes were to be listed, those owners would have to go elsewhere. And this is occurring even as April's 5.3% year-over-year increase in selling prices capped 74 consecutive months of home price appreciation, which sends a market signal to builders that the market would welcome more construction. The real problem remains the multiyear underinvestment in home construction, which still hasn't fully recovered.

Our recent discussions with home builders and materials suppliers reinforce our view that the housing market has at least a few more expansion years left in the current cycle (barring the occurrence of a global meltdown from another quarter). Builders report labor shortages as the primary factor slowing construction. While they would be willing to pay up for more skilled labor, skilled workers left the industry a decade ago and have since migrated to other forms of employment. And it seems that none of the builders is too interested in getting into bidding wars for labor with the other home builders. One company, which builds modular homes both on location and at its factory, reported that it was moving some construction back to the factory where more automation in construction reduces the need for labor. Expect to see more double-wides wrapped and rolling to delivery during your summer road trips this year.

Home builders are also grappling with pricier drywall, more expensive concrete, and higher lumber costs (U.S. tariffs are not helping), and are having mixed results passing those higher costs through to home buyers. Some report passing higher costs directly to buyers—and recent data shows a roughly $7,000 cost bump to the average home price—while others seem to be taking a hit to profit margins. Builders of more moderately priced homes (where supply is tightest) report passing through costs more readily than those at the higher end of the market.

When we combine the industry trends and company commentary with macro data on growing income, an expanding population, and rising household formation, we see a market unlikely to satisfy demand for housing for a few years more. And while housing-related stocks have risen substantially since the end of the recession, we are finding attractive opportunities trading well below the current average for the S&P 500 (at 16.4 times forward 12-month expected earnings). Some of our favorite holdings are trading as low as 7 times 2019 earnings and up to 16 times. Without any doubt, these stocks remain in the penalty box since the housing meltdown in 2007 despite the positive backdrop.

The recent drop in home sales and the further decline in inventories only serves to reinforce the strength in demand for new homes. Housing starts have been climbing, and the continued low inventory levels tell us that we are not yet nearing the end of this expansion.