Insights on Investing

Analyst Q & A:

The Bullish Case for Housing

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Kevin Bennett is one of Davenport Asset Management's research analysts and has been in the industry for 10 years. He is primarily responsible for industrials, materials, and housing-related stocks. See below for his thoughts on the housing industry.

Q Could you provide a quick overview of the housing market?

A Sure. There are currently an estimated 136 million housing units in the United States, including single-family homes and rental units. Housing generally contributes 15% - 18% of GDP through both residential investment and consumption spending on housing services. Furthermore, total residential construction spending is roughly $475B annually. So you can see it's a very big and important piece of the U.S. economy. When we think about the industry, we break it down into three components: single-family, multi-family, and repair and remodel.

Q What different ways can you invest in the housing sector?

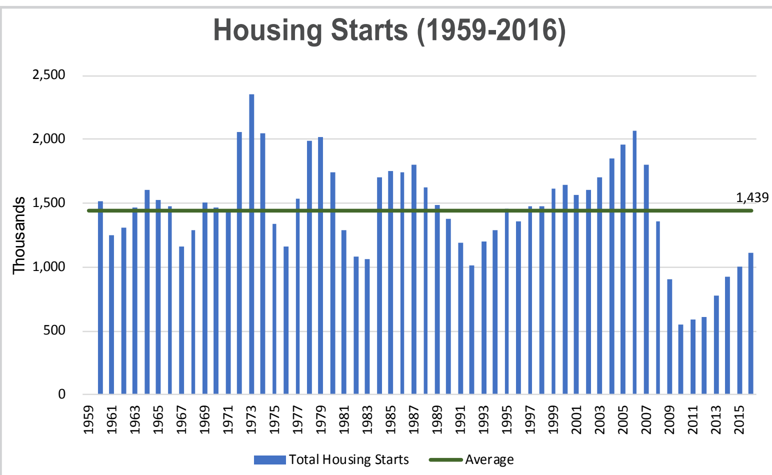
A There are a few different ways to invest in housing. The most obvious choice is homebuilders, but there are also building product companies, building materials, distributors, and some ancillary industries such as title insurance.

Q Do you foresee growth in this sector?

A We think the economic backdrop is bullish for the housing market. Starting at a very high level, we think the number one driver of housing demand is job growth. This makes sense given that someone without a job is less likely to be able to buy a house or spend money upgrading and remodeling. The U.S. economy has seen 75 straight months of job growth, which has helped drive housing demand. Additionally, consumer confidence is an important metric and hovers around a 15-year high.

Q Which part of the housing market has the best outlook?

A We believe the single-family, new construction subset is most poised for growth. The chart here shows housing starts going back to the 1950s, including the bubble and subsequent market crash in the mid-2000s. Housing starts peaked at over 2 million units in 2005 and declined for four straight years, bottoming out at 550,000 in 2009. Since then, the sector has been on a slow and steady recovery, but as you can see on the chart, total housing starts remain 17% below the long-term average. We are not assuming we will get back to the prior peak, but we see no reason why we would not at least get back to the long-term average, which indicates several years of growth ahead.



Source: US Census Bureau. Data shown from 1/1/1959-12/31/2016.

Q What gives you confidence that the recovery in housing starts will continue?

A A couple of things. First, the inventory of both new and existing homes for sale is currently well below a normal level, indicating very tight supply in the market. Secondly, an indicator measuring homebuilder confidence shows that builders are about as optimistic as they were back in the mid-2000s. With the supply of homes low, and builders feeling good about the environment, we think this supports the outlook for solid growth in single-family construction.

Q Why haven't housing starts grown faster?

A There are a couple of constraints in the market right now. First off is the availability of lots. Builders are having trouble finding land in areas where people want to live. Secondly, there is currently a lack of construction labor. This may lead to a lower overall growth rate in housing starts, but a longer recovery, which we think is a good thing for the stocks.

Q What about the existing home repair/remodeling industry?

A We also have a favorable view of the repair/remodeling market. The Leading Indicator of Remodeling Activity, published by the Joint Center for Housing Studies at Harvard University, projects solid high-single-digit growth in remodeling through 2017. In our view, the two biggest drivers of remodeling are home prices and home transactions. Home prices are steadily rising and have now surpassed the prior peak on a national level. Transactions, measured by existing home sales, also drive remodeling. Homeowners typically remodel and/or upgrade within three years of purchase. Existing home sales in November almost reached a 10-year high. We believe the continued increase in home prices as well as a solid rebound in existing home sales bode well for remodeling spending in the coming years.

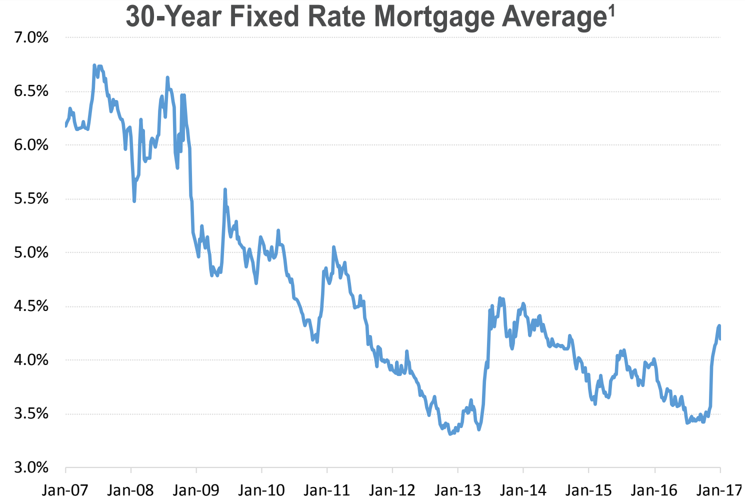
Q How about multi-family?

A This is the one area where we are not as optimistic. We believe this subset of housing has likely peaked and will probably decline in the coming years as supply continues to be robust. We also believe that more millennials will look to home ownership as a goal in coming years, as they start families of their own.

Q What concerns you about housing?

A Other than an economic downturn, our biggest worry concerning housing is the recent spike in mortgage rates. As shown in the chart below, the average 30-year fixed mortgage rate has increased 23% since October 2016. At just over 4%, we think mortgage rates remain very attractive, but there could be a temporary blip early in 2017 as buyers adjust to recent spike in rates.

30-Year Fixed Rate Mortgage Average[1]



Source: Freddie Mac as of Feb 1, 2017. Data shown for weekly periods 1/4/2007-1/5/2017.

As of February 1, 2017

[1]Freddie Mac, 30-Year Fixed Rate Mortgage Average in the United States© [MORTGAGE30US], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MORTGAGE30US, February 1, 2017.