Tortoise QuickTake Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide a timely update on trending topics in the market.

Welcome to this week's Tortoise credit podcast. I'm John Heitkemper, portfolio manager for high yield bonds and leveraged loans at Tortoise.

The dog days of summer are upon us as the calendar turns from July to August, and here in Southern California, that means plenty of beach and pool time to battle scorching temperature readings. The U.S. economy appears to be taking a cue from the weather these days, as last Friday's second quarter GDP release showed 4.1% quarter-over-quarter growth, the strongest reading since 2014. While the report highlighted broad-based strength in durable goods, nonresidential investment and exports, one notable area of weakness was residential investment, or housing, which declined 1.1% quarter-over-quarter, the second straight drop.

The quarterly GDP report isn't a surprise given some of the recent monthly housing data. Last week's existing home sales release for June showed a 0.6% month-over-month decline; while not a significant decrease, it was the third in a row. Existing sales are now down year-over-year in five of the six months reported thus far in 2018, and yesterday's pending sales report came in at -4% year-over-year. The trend in sales of new homes is similar, with the June reading down in excess of 5% month-over-month and the slowest pace in eight months. There are also signs of softness in pricing, with the average price of new home sales falling 2% year-over-year in June.

These developments in the macro housing data have some bond investors searching for explanations and wondering whether it's just seasonal or the sign of a peaking market. And for credit investors, what do these trends mean for homebuilders, many of which are high yield issuers?

The first place to look for answers behind the recently soft data is affordability, which has become more challenging due to both higher home prices and rising mortgage rates. According to the National Association of Realtors latest data, affordability is at its lowest level since August 2008, as the average 30-year mortgage rate jumped nearly a full percentage point from its September 2017 low of 3.67% to 4.56% in May of this year.

Another oft-cited potential reason for tepid sales is the low level of inventory, which had been at a 10-year trough until creeping up in the past few months. While low inventory might be capping transaction volume, it's probably putting upward pressure on prices as well. In fact, after accelerating from about 5% through most of last year, home price inflation appears to have topped out at around 6.5% in the past few month, according the S&P CoreLogic Case-Shiller 20-city index. As home price inflation continues to outpace income gains, affordability becomes a problem, particularly in expensive real estate markets. These same cities are also getting hit by a sharp drop off in demand from international buyers. According to the National Association of Realtors, foreign purchases of U.S. homes declined 21% in the year ending in March.

This brings us around to the final question, "What does it mean for homebuilders?" We think the answer is that while the macro data are not ideal, there are reasons for optimism as well. First, while somewhat soft of late, year-to-date new home sales are still the strongest they have been in 10 years. On a historical basis, new home sales – and starts – have remained at moderate levels since the last housing downturn during the financial crisis. In fact, new single-family home sales are still 50% below the 2005 peak, and by most accounts, the industry has not overbuilt. To the extent that sales slow, there should not be a large backlog of unsold units or unneeded lots.

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Furthermore, demographic trends actually appear to be improving. Household formations have accelerated to about 2% year-over-year for only the second time post-crisis, which has in turn helped push home ownership rates to just over 64%, low by historical standards but off the 2016 trough of less than 63%.

Lastly, recent earnings reports from the homebuilders themselves show that fundamentals remain solid despite divergent trends at the ground level. As you'd expect with a pick-up in household formation, new home demand is shifting toward entry-level homes. This mix shift explains part of the softness in macro price trends. For example, DR Horton, which sells new homes that have a lower price point on average, reported a 12% increase in new orders in the second quarter, demonstrating the strong demand from first-time buyers. Additionally, unlike prior cycles, homebuilders appear focused on profitability over volume. Across the industry, second quarter gross margins are up year-over-year despite significant headwinds from rising labor and materials costs.

For now, homebuilder earnings seem to be painting a different picture than the recent economic data. In coming months, we'll be watching the macro housing figures closely and continue to consider whether homebuilders can post favorable earnings should more clouds form at the macro level. Clouds might be good protection from the summer heat, but we're always looking to avoid a downpour.

Thanks for listening and please tune in for future Tortoise credit podcasts.

Narrator: Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

T**he S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index** seeks to measures the value of residential real estate in 20 major U.S. metropolitan areas: Atlanta, Boston, Charlotte, Chicago, Cleveland, Dallas, Denver, Detroit, Las Vegas, Los Angeles, Miami, Minneapolis, New York, Phoenix, Portland, San Diego, San Francisco, Seattle, Tampa and Washington, D.C.

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