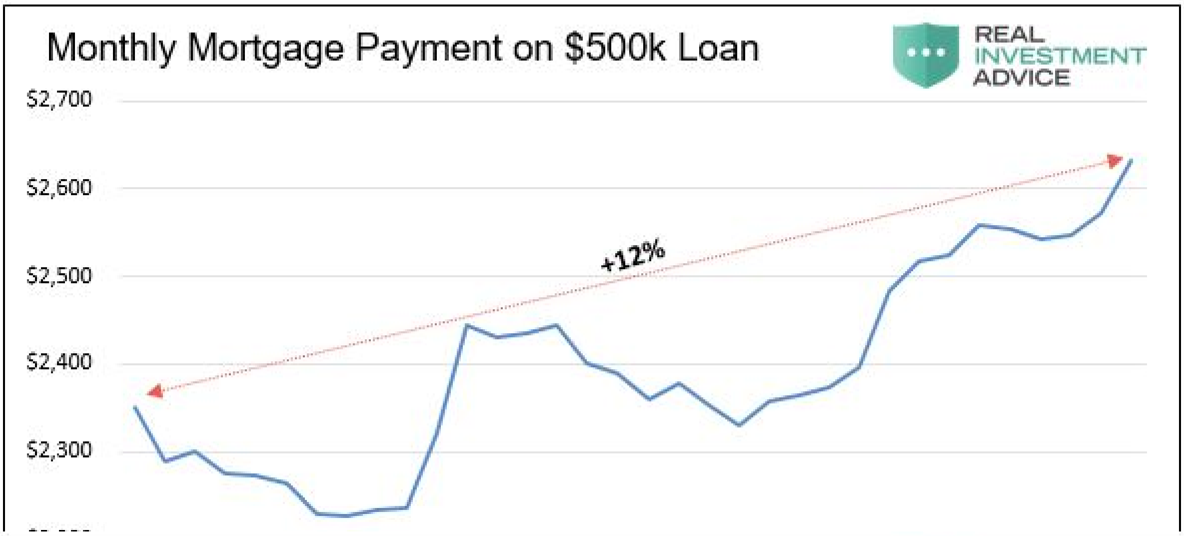
Please note this article will be distributed on our free site tomorrow but the Investment Implications section is only available for RIA Pro subscribers. Throughout modern financial history, the ability to borrow at a 5% rate on a 30-year mortgage was considered a great deal. Over the past ten years, mortgage rates falling to between 3% and 4% have warped perceptions. Evidence of this fact can be found by the sticker shock and home buyer consternation that the currently available 5% mortgage rate is causing. The rate shock is not limited to home buyers; the home building sector has fallen over 30% since it recorded a record high in January 2018. Notably, a month before hitting that record, the popular SPDR S&P Homebuilders ETF (XHB) surpassed the previous record high established at the peak of the housing bubble in 2006. Mortgage rates play a large role in housing affordability, which greatly affects housing sales and prices, economic growth and the profits or losses for those involved in the housing sector. We discussed and quantified housing affordability dynamics in our article, [The Headwind Facing Housing](). In this article, we consider whether the housing sector has fallen far enough to warrant investment consideration.

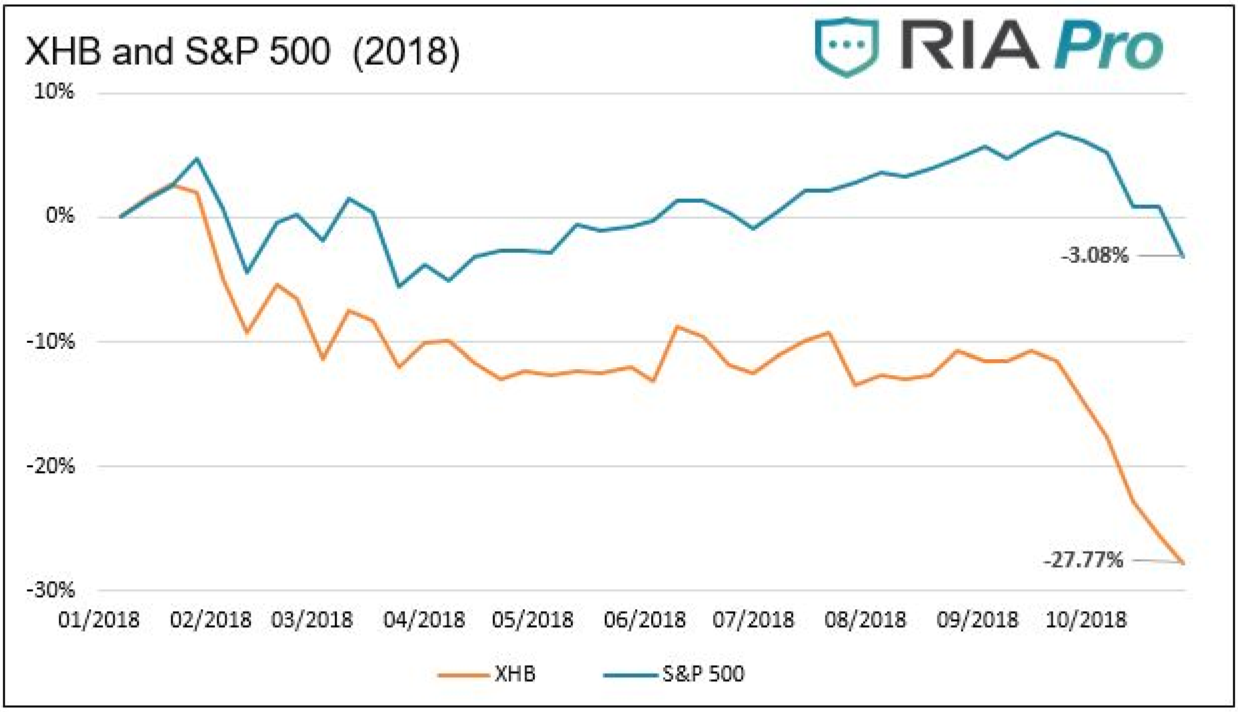
Headwinds Redux

In [The Headwind Facing Housing](), we produced two graphs that quantify the effect varying mortgage rates have on housing affordability. We modified those graphs, as shown below, to highlight how recent changes in 30-year mortgage rates have affected mortgage payments and housing affordability.



graph, the monthly mortgage payment (excluding taxes, insurance, and other fees) for a buyer purchasing a $500,000 house has risen 12% since 2016. The second graph illustrates the purchase price a buyer can afford for a fixed $2,500 mortgage payment. Since 2016, the purchase price has dropped from $530,000 to almost $470,000. The data in both graphs are based on 30-year mortgage rates rising from 3.87% in January 2016 to 4.83% as of the most recent data from the Federal Reserve. **Effectively, as the graphs show, a 1% rise in mortgage rates reduced affordability and increased monthly mortgage payments by about 10-12% in the current environment.** Higher mortgage rates dictate that buyers either take on larger mortgage payments or buy cheaper houses. The burden of higher rates does not solely fall on buyers; it also hurts sellers and those in the housing construction business.

Home Builders



tes and

Data

Courtesy Bloomberg Note that while XHB and the S&P 500 both fell in the first quarter, the S&P regained its footing and went on to new record highs before its recent stumble. Conversely, XHB drifted slightly lower following the first quarter decline. More recently, as interest rates rose, XHB fell precipitously. As shown, XHB is underperforming the S&P 500 by almost 25% year to date.

March of

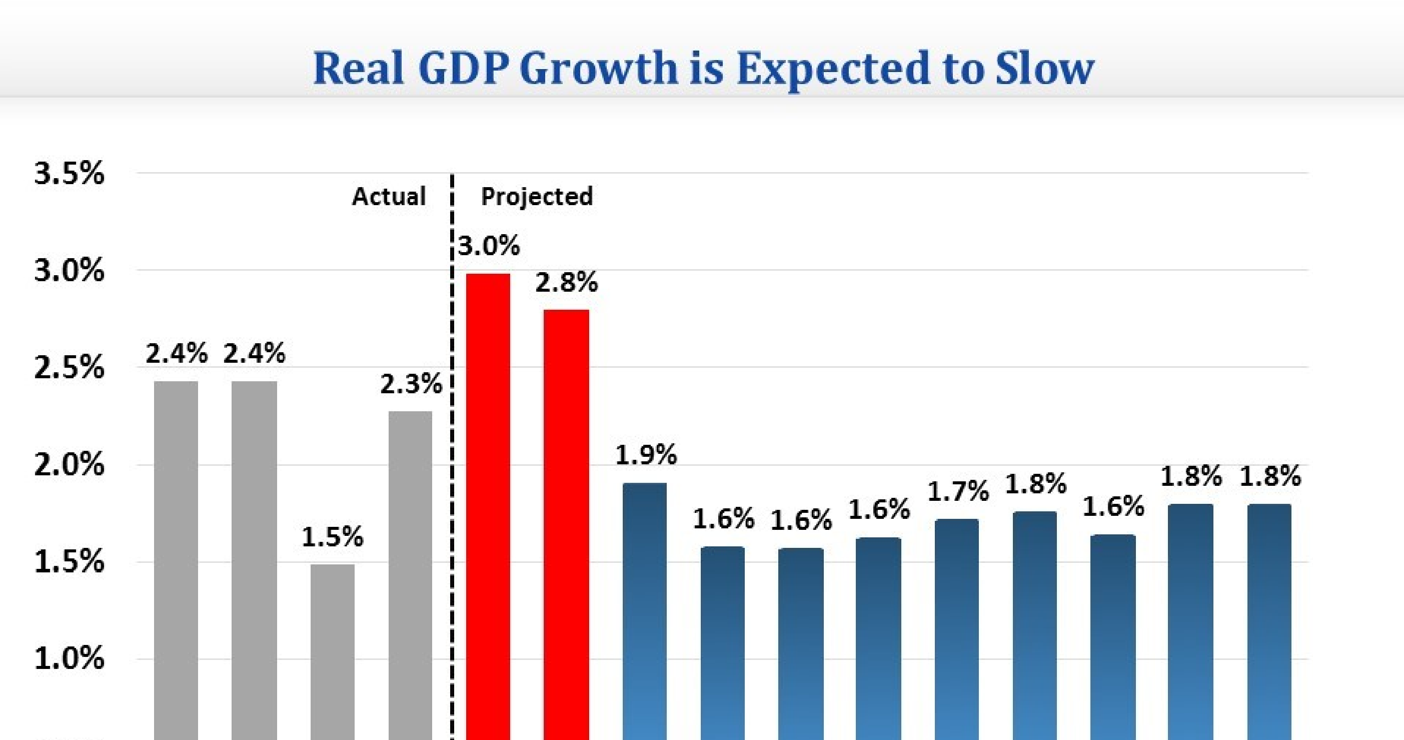
3 had

apsed

Courtesy Bloomberg Statistically, XHB and the S&P have had a strong long-term correlation (2006-present) of +.71, meaning that 71% of XHB?s price can be explained by changes in the price of the S&P 500. Interestingly, XHB has a +.21 correlation with ten-year U.S. Treasury yields over the same period. The positive relationship is not what one should expect as it implies that yields and XHB have risen and fallen together. Keep in mind, the relationship is not strong but the positive relationship is notable. Recently, however, as bond yields broke out of ten-year ranges, reached five-year highs and brushed up against key long-term technical levels, XHB investors became concerned. Since September 2018, the correlation between XHB and ten-year Treasury yields has been -.58 and greatly reflects the lagged effects of rising interest rates on housing activity. We suspect this statistically relevant negative correlation will persist and perhaps strengthen as long as rates keep rising.

Investment Implications

Despite its label of ?Homebuilder ETF,? XHB holds many companies that are not homebuilders. For instance, Whirlpool, Williams Sonoma and the Home Depot represent three of the ETF?s top six holdings. These non-home builders, many of which are categorized as cyclicals, have helped buffet the recent decline. On average, the top five homebuilders in the ETF are down 34% year to date or about 7% more than the ETF. While it is tempting to buy XHB given its sharp decline, the risks are onerous. The biggest risk is that yields keep rising. This will continue to be a headwind for home builders as housing affordability declines and mortgage payments rise. It will also further pressure the stock market and the economy in general which bodes poorly for the cyclical stocks in the ETF. Higher mortgage rates will also make it less tempting for consumers to perform cash-out mortgage refinancings or take out home equity loans. Both have translated into a sizable source of revenue for Home Depot, Lowes and other companies in the ETF that profit from home remodeling and furnishing. Those sources of funding for consumer purchases is quickly drying up. Per the Mortgage Bankers Association (MBA): ?*MBA's Weekly Applications Survey refinance index averaged 1,013 in June, the lowest monthly average since December 2000. The weekly index value dropped below 1,000 in three of the past six weeks, a level that it has not gone below since December 2000 as well.*? Even if yields peak at current levels and begin to trend lower, we are concerned that the reason for such a reversal in yields would be economic weakness. Heavy stimulus in the form of tax cuts and fiscal spending have boosted GDP by 0.8% so far this year. As the benefits of the stimulus fade, as is widely expected, economic growth should slow and have adverse effects on consumers. The recent takeover of the House of Representatives by the Democrats make new stimulus much less likely to counteract economic weakness.



Despite being in the midst of the second longest economic expansion in modern U.S. economic history, the Congressional Budget Office (CBO) is not currently forecasting a recession for the next ten years as shown above. We, on the other hand, realize that such a forecast is idiotic and, even more concerning, believe the probability of a recession within the next year is significant. A recession would likely result in lower mortgage rates, but the benefits to homebuilders and buyers will likely be offset by job losses, weaker consumer activity and declining consumer sentiment(home buyers). **Despite the recent decline versus the S&P 500 and other sectors, we currently recommend selling or reducing exposure to the homebuilders and the XHB ETF. We believe it is best to wait until the interest rate and economic environment becomes more clear. In our opinion, it's too early to catch the proverbial falling knife.** To stay abreast of the situation, we recommend following the weekly MBA purchase and refinance surveys as well as 30-year mortgage rates furnished by the St. Louis Federal Reserve (LINK). Other housing data, such as housing starts and new homes sales are helpful, but the data lags significantly, so caution is advised when using that data to infer something about the demand for housing.