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Home builders could get pinched when mortgage rates fall enough to lead owners of existing homes to sell. DAVID PAUL MORRIS/ BLOOMBERG NEWS

Cheap Mortgages Aren't All Good for Builders

HEARD ON THE STREET

Very little feels normal in today's housing market, including how home builders' stocks have been on a tear during a period of sky-high interest rates. Things could be equally weird as mortgage costs come down.

Home-building stocks surged within months of the Federal Reserve's first interest-rate increase in spring 2022. Costlier debt should be bad news for these businesses, damping demand by making homes less affordable for buyers and making it more expensive to finance land purchases and development. Instead, the share prices of some of America's biggest home builders— **D.R. Horton**, **Lennar** and **Pulte-Group**—

have more than doubled through this hiking cycle.

Thank the lock-in effect—the golden handcuffs of ultracheap mortgages taken out when rates were at rock-bottom lows that are discouraging owners from selling. The number of existing homes available for sale is still around one-fifth below prepandemic levels nationally.

Home builders have been making hay while the resale market has been on pause. The gap between months of inventory of new homes and existing homes hasn't been as wide since the 1980s. There are currently 7.6 months of sales inventory for newly built houses, Census Bureau data shows. Normally, builders would tap the brakes at around 6.5 months to avoid oversupply, according to Robert Dietz, chief economist at the National Association of Home Builders. But they have continued to churn out new units to fill in the void left by the resale market.

New-home sales rose 6% in September compared with a year ago, mainly because there has been so little else available to buy. Sales of existing homes this year are expected to be at their lowest level since 1995.

To keep new homes affordable, home builders have shrunk the size of the houses they construct by around 5%. They also offer incentives to prospective buyers, primarily mortgage-rate buy downs. Thanks to the run-up in home prices and healthy profits, the big publicly traded companies can offer buyers a mortgage rate of around 4.5% or 5%, even though the market rate is significantly higher.

This has kept sales volumes up, but it is costly. America's biggest house builder, D.R. Horton, said on Tuesday that its gross profit margin fell in its latest quarter because it needed to buy down mortgage rates to nudge people to buy homes. For every 1 percentage point a home builder buys down a mortgage, there is a hit of 3 to 4 percentage points to gross margins, says UBS analyst John Lovallo. D.R. Horton thinks extra incentives may be needed to keep people buying in the crucial spring selling season next year as affordability remains so stretched. The builder says volatile mortgage rates, which have risen since the Fed cut in September, have spooked home hunters.

When mortgage rates do eventually come down, these incentives won't be as necessary. But there will be new risks to consider around supply. The big question is what is the magic mortgage rate that will unlock the supply of existing homes.

Around 60% of outstanding U.S. mortgage holders have a rate below 4%. There is pent-up demand to sell homes, and equity as a share of total real-estate value has hit 73%, the highest level since the 1950s. This may make homeowners willing to take the hit on a more-expensive mortgage sooner than people think. Home builders are finding that buying down mortgage rates to 5% or 5.5% gets buyers off the fence, but the number that will motivate sellers is murkier.

In some pockets of the country, there is already a pickup in inventory as homeowners decide they can't wait any longer to sell. In Florida and Texas, listings of homes for sale are now 9% and 10% above prepandemic levels, respectively, based on data from the Federal Reserve Bank of St. Louis. In these markets, it is getting tougher to unload newly built properties.

Home builders have some advantages as new builds look more attractively priced relative to existing homes than they usually are. The median newly built single-family home was 4% more expensive than an existing home in September, according to UBS analysis. Historically, the price gap has averaged 18%.

The premium has shrunk because new homes are becoming smaller, but also because choked supply has pushed the price of existing homes to records. With buyers more focused on energy efficiency and stability of insurance costs, especially in stormier parts of the country, new builds might appeal to more buyers.

But home-builder stocks aren't cheap after their recent runup. D.R. Horton, Lennar and PulteGroup are currently trading at anywhere from 1.7 to 2 times book value, which is above the 10-year average for all three names. And the lower rates go, the more supply will unlock from regular sellers. In this strange housing market, cheaper mortgages seem more likely to mark the end of a boom for house builders than the start of a new one.— *Carol Ryan*

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September Home Sales Improved With Drop In Rates

BY JOSHUA KIRBY

The number of homes going under contract in the U.S. rose again in September as mortgage rates eased.

The report released Wednesday by the National Association of Realtors found that the pending home sales index, a leading indicator of house sales based on contract signings, rose 7.4% to 75.8 in September, reaching the highest level in six months.

The index nevertheless remains well below 100, representing the level of contract activity in 2001.

Compared with a year earlier, pending sales were 2.6% higher.

Rising sales reflect lower borrowing costs for mortgages and should continue if the economy keeps proving robust, said NAR Chief Economist Lawrence Yun. "Further gains are expected if the economy continues to add jobs, inventory levels grow and mortgage rates hold steady," Yun said.

All four regions of the U.S. saw increasing sales over the month, led by the West, where they were nearly 10% higher.