# L&W SUPPLY MERCHANDISING UPDATE - Q4 2022

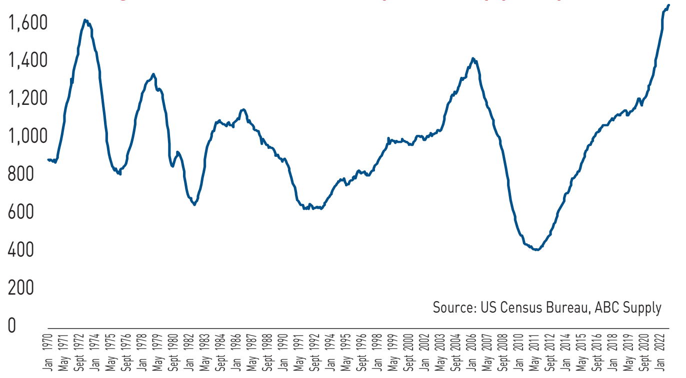
Demand (particularly for new construction) has softened and balance appears to be returning to the supply chain in many parts of the country, but if the past few years have taught us anything, it's that change could be right around the corner. Our Q4 update focuses on the latest info to keep you informed.

There is little doubt a slowdown is here, but in this quarterly update, Kevin Hocevar explains why there is optimism for a V-shaped recovery.

## DEMAND

- US Housing Starts (seasonally adjusted) were down 0.5% in November from October and 16.4% YOY, but historically high units under construction have softened impact in the short term.
- Non-Res Put in Place Construction was up 9% in Q32022 (vs. 2021).
- The Architectural Billings Index was below 50 in October and November for the first time since early 2021.

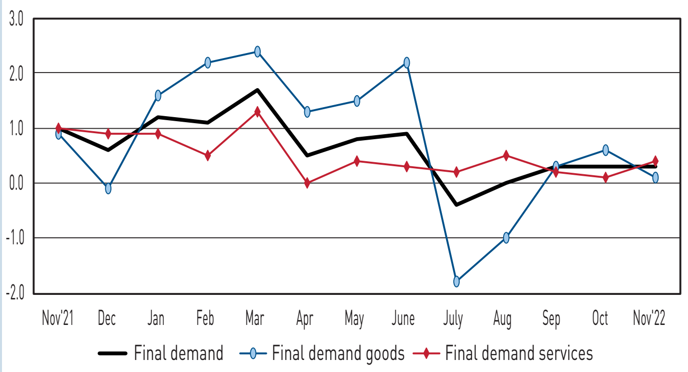
**Housing Units Under Construction (thousands) (SAAR)**




## INFLATION

- The price of a gallon of Diesel in December ($4.59) continues slow decline from summer peaks.
- National spot prices for natural gas continue to drop, but some regional prices (mainly west) remain high.
- The Consumer Price Index was up 7.1% YOY in November vs. the prior year and up 0.1% from October. The Producer Price Index for goods was up 7.4% YOY.

**One-month percent changes in selected PPI final demand price indexes, seasonally adjusted - Percent change**




# KEY PRODUCT UPDATES

## WALLBOARD

- Q3 manufacturer wallboard shipments were up 7.2%. YTD shipments are up 3.2% through 9 months.
- Wallboard availability has increased outside of the Northeast/Southeast which still remain tight.
- Glass mat production has improved slightly and expectations are for it to be slightly better in 2023.
- Cost pressure on synthetic gypsum, energy and labor continue to push up manufacturer costs.

## CEILINGS

- Several manufacturers have announced tile increases for early 2023 as inflation continues.
- ABI readings in October and November turned negative for the first time since early 2021.

## STEEL

- Q3 manufacturer steel shipments (reported by SFIA) were down 13.8% vs. 2021, YTD down 19.6%.
- After 7 straight months of declines, galvanized coil prices appear to have bottomed and have started to rise (even though domestic steel demand remains soft) which could soon impact metal framing pricing.

## OTHER PRODUCTS

- Fiberglass insulation availability is improving, but still challenging. Loose fill insulation supply remains tight.
- Rigid insulation production has improved significantly in the past few months.
- Joint compound availability has stabilized. Several manufacturers have announced January increases.

# MARKET HIGHLIGHTS FROM

# KEVIN HOCEVAR

Director of Research - ABC Supply

The waiting game continues. Since housing activity started sharply slowing earlier this year, the building materials industry has been waiting to feel the impact (front-end trades likely feeling it more than back end) however conditions have remained fairly resilient, in large part thanks to record homebuilder backlogs. Given weak net new home order activity the past few months amid worsening housing affordability, these backlogs will unwind and eventually a slowdown will be felt (probably sooner than later). None of this is new information and I'm sure everyone is sick of hearing about an inevitable downturn. Instead, we want to focus on the eventual recovery. Though the timing, magnitude, and duration of any soft patch is yet to be determined, there are events occurring in the economy that give us hope for a V-shaped recovery.

The underlying demand and need for housing are there as demographics and low existing home inventory, among other factors, are supportive of housing. The challenge is affordability as evidenced by the National Association of Realtors Housing Affordability Index hitting multi-decade lows in October. Key drivers of affordability include home prices, mortgage rates and household income. In this writeup we'll focus on mortgage rates.

Per Freddie Mac, 30-year mortgage rates hit 6.90% in October 2022, the highest level in 20 years. So what could cause this to come down? First, let's deconstruct the 30-year mortgage rate into 1) the 10-year treasury yield and 2) a spread. The 30-year mortgage rate and 10-year treasury yield are nearly perfectly correlated (0.9779 r-squared) with mortgage rates averaging a 1.71% premium to 10-year treasuries over the long run. During times of economic and interest rate uncertainty that spread widens as shown in the chart to the right. In November, the spread was 2.92%, tied with October 2022 for the widest spread since August 1986. Historically, when economic uncertainties subside spreads have normalized and assuming that history proves to be a guide, a full reversion to the mean could chop off ~1.20% from current mortgage rates alone. Hopefully this can occur as we move through whatever economic malaise/recession that occurs in 2023 and move into a stronger 2024.

On top of that, as inflation gets under control it could put downward pressure on 10-year treasury yields. This is evidenced by October CPI rising only 0.4% m/m which fell below consensus expectations of 0.6%. This spurred the biggest one-day drop the 10-year treasury yield has seen in 13 years. Specifically, yields dropped 30 bps from 4.12% to 3.82%. When November's CPI data was released, it also came in below consensus estimates resulting in a similar, but less pronounced, decline in rates (about 10 bps decline). Therefore, as inflation gets under control it's reasonable to believe interest rates will as well. To that point, economists (per Factset) forecast CPI inflation of 8.1% in 2022 followed by 3.7% in 2023 and 2.4% in 2024. Similarly, consensus expectations per Factset suggest the 10-year treasury yield, which currently sits at 3.49%, will drop to 3.35% in 2023 and 3.00% in 2024.

Summing it all up, if (big if) consensus forecasts come true and 10-year treasuries yield 3.0% in 2024 and the spread to mortgages reverts back to the mean of 1.71%, that would imply mortgage rates of ~4.7% in 2024. Consensus estimates aren't quite there as average industry association and broker estimates are currently looking for mortgage rates of 5.4% in 2024 (based on Fannie Mae, Mortgage Bankers Association, NAHB, and Wells Fargo average estimates). And there are many other factors at play including home prices, household income, macro economy, etc. However, we don't think it's unreasonable to believe mortgage rates can come down from current levels over the mid-term which goes a long way to improving housing affordability and supports a V-shaped recovery.