

June 2, 2017

Dear clients and colleagues,

Although choppy on a month-to-month basis, US new home sales numbers remain above GDP growth levels, driven by consumer confidence, improved household balance sheets and pent-up demand in the aftermath of the Great Recession. In addition, new homes are easier to buy than existing homes since there is 5.2 months' worth of new homes on the market versus the severe shortage of 3.8 months' worth of existing homes. In March, the median price of a new home was \$315,100, just slightly below the record high of \$332,700 posted in December 2016.

Of course, growth in new home sales continues to support building activity. The NAHB home builder confidence index was strong at 70 points in May, only 1 point below the 12-year high of 71 posted in March 2017. April housing starts fell by 2.6% to 1.172 million units, but were not far below the 9 and 3/4 year high of 1.328 million units posted in October 2016.

In the medium to long term, it's difficult to predict when new home sales will once again reach their peak. The perceived steady-state level of the housing market is 1.5M house starts. The current run rate of 1.2M is within the peak-to-trough range of 2.2M - 0.6M housing starts, as it has been since the early 1970s. With the current low inventory levels, the market appears to be in good shape, especially as we also expect consistent strength in new family formation numbers.

In his recent quarterly call, the president of Lennar Corp. (a homebuilding leader) stated: *"The economic realities of a constrained supply of housing options and the economic realities of rental rates are beginning to have a rational impact on decision-making for the first-time buyer as millennials are coming to market. Interestingly, the front page of USA Today reports today that 60% of millennials ages 18 to 35 are living with parents, relatives and roommates and that is a 115-year high".*

Additionally, the building recovery that began in 2010 has been led mainly by the multi-family segment (apartment/condo) with the single-family sector lagging. As certain materials, such as lumber, are used in much larger quantities in the construction of single-family dwellings, the demand for these materials could increase as this segment starts to accelerate.

Recent Trump policies on NAFTA lumber tariffs could affect homebuilders' margins, slowing Millennials' entry into the housing market. Moody's calculates that the proposed average 20% in countervailing duties on softwood lumber could add more than \$2,000 to the cost of an average home. Thirty-three percent of the lumber used last year in the US was imported, 95% from Canada. Lumber prices have risen 30% since February in anticipation of tariff implementation.

Housing: The epicentre of the US economy?

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Historically, residential investment (building and remodeling) has averaged roughly 5% of GDP, though its share dipped to 2.5% in 2010. Meanwhile, housing services (eg: rents and utilities) have averaged between 12.5% and 17.5% of GDP.

Thirty-five percent of the homebuilding industry is dominated by large cap companies with strong operational and financial advantages over their small cap peers. Their low double-digit EBITDA margins are indicative of the heightened level of competition in the industry. With technology and specialty market access, small caps operating in the supply segment of the homebuilding industry offer Global Alpha opportunities to invest in quality companies.

Global Alpha owns multiple companies that offer exposure to the US housing construction industry.

Rayonier is one of the largest private landowners in the US. It owns, leases or manages approximately 2.7 million acres of highly productive timberlands in the US and New Zealand to supply a wide variety of markets including pulp, paper, lumber and other wood products.

Caesarstone manufactures engineered quartz, primarily used as kitchen countertops in the renovation, remodeling and residential construction end markets. The other applications for its product include vanity tops, wall panels, backsplashes, floor tiles, stairs and other interior surfaces that are used in a range of residential and non-residential applications.

Limoneira is an agribusiness and real estate development company based in California. The Company's main operation is the production, sales and marketing of citrus fruit and avocados. The company holds 1,800 parcels of land designated for real estate development projects and high value land with large untapped value set for development.

Have a great weekend.

The Global Alpha team

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