Volume 33, No. 2, July 26, 2019

Quarterly Update
CWS Capital Partners LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

September 2, 2019
Labor Day Holiday
CWS Offices Closed

September 16, 2019
3rd Quarter 2019
Est. Tax Payments Due

October 15, 2019
2018 Tax Return Extensions Due

October 25, 2019
3rd Quarter 2019
Quarterly Packages Mailed

November 28, 2019
Thanksgiving Day Holiday
CWS Offices Closed

November 29, 2019
Day-after Thanksgiving
CWS Offices Closed

December 24, 2019
Christmas Eve Holiday
CWS Offices Closed

December 25, 2019
Christmas Holiday
CWS Offices Closed

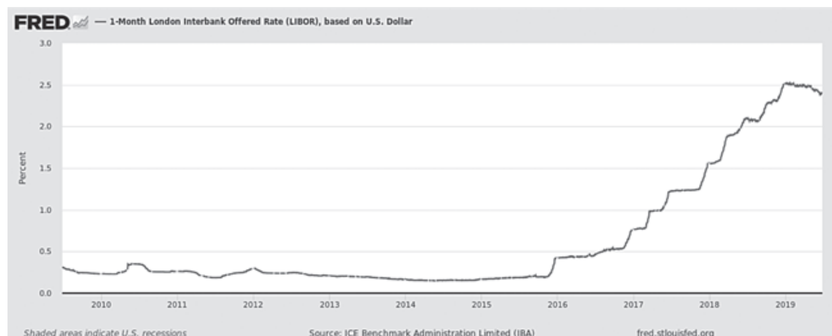
50 CWS Enhancing Lives Years

www.cwscapital.com

Capitalizing on a Slow Down

By Gary Carmell

With approximately 75% of our loans at CWS being floating rate, we have a strong interest (pun intended) in following the direction of short-term interest rates. As one can see from the following table, 30-day Libor, the index in which our loans are tied, was remarkably steady and at a very low rate between 2009 and 2016. We prospered handsomely as our cumulative interest savings, as compared to the prevailing fixed-rate equivalents at origination, exceeded $70 million. And this did not include the savings from not having to pay onerous prepayment penalties that come from having fixed-rate loans being repaid early.



Continued on Page 2

Continued from Page 1

Since 2016, however, Libor has been on a steady march upwards until very recently. This has resulted in us giving back some of our savings as our cost of funds in some instances is now higher than the fixed-rate equivalent available at origination. This did not surprise us as we did not expect Libor to stay at such low levels for as long as it did. We knew it would have to rise. We just didn't fear its rise because we did not think it would return to previous cycle highs and it would inevitably drop once the economy faced significant headwinds. In addition, because so much debt was created at such low rates, it would be far too harmful to the economy to raise them significantly because borrowers would have difficulty refinancing their debts when they came due in the event of a weaker economic environment. And these debt problems would in turn exacerbate the economic weakness.

For this reason, plus others which I will discuss below, we have been in the camp that rates would be much lower for longer than most people thought possible and that people need to accept that low rates are the new normal and that unconventional measures by the Federal Reserve are not going away. You may not agree with it and think it's doing more harm than good, but this is the reality. This was recently acknowledged by Fed Chairman Jerome Powell in a recent speech[1] in which he said the following ("ELB" stands for Effective Lower Bound or 0% rates):

The next time policy rates hit the ELB—and there will be a next time—it will not be a surprise. We are now well aware of the challenges the ELB presents, and we have the painful experience of the Global Financial Crisis[2] and its aftermath to guide us. Our obligation to the public we serve is to take those measures now that will put us in the best position to deal with our next encounter with the ELB. And with the economy growing, unemployment low, and inflation low and stable, this is the right time to engage the public broadly on these topics.

In short, the proximity of interest rates to the ELB has become the preeminent monetary policy challenge of our time, tainting all manner of issues with ELB risk and imbuing many old challenges with greater significance. For example, the behavior of inflation now draws much sharper focus. When nominal interest rates were around 4 or 5 percent, a low-side surprise of a few tenths on inflation did not raise the specter of the ELB. But the world has changed. Core inflation is currently running a bit below 2 percent on a trailing 12-month basis. In this setting, a similar low-side surprise, if it were to persist, would bring us uncomfortably closer to the ELB. My FOMC[3] colleagues and I must—and do—take seriously the risk that inflation shortfalls that persist even in a robust economy could precipitate a difficult-to-arrest downward drift in

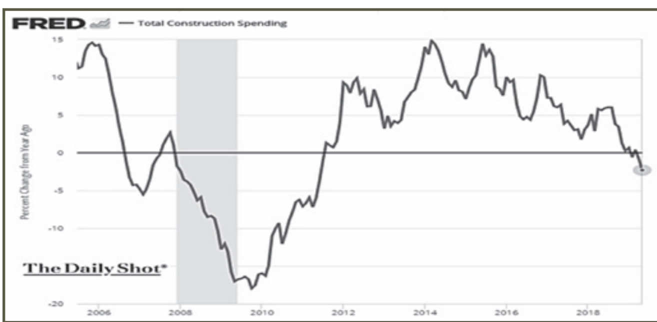
Continued on Page 3

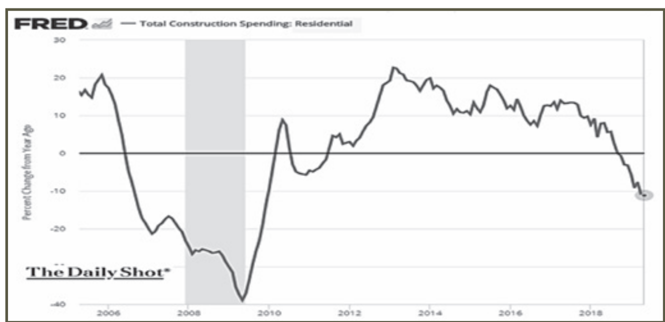
Continued from Page 2

inflation expectations. At the heart of the review is the evaluation of potential changes to our strategy designed to strengthen the credibility of our symmetric 2 percent inflation objective.

It appears that we may now be starting our descent towards the ELB with trade tensions impacting global economic growth and negative rates in Germany and Japan[4] keeping a lid on U.S. rates such that a reduction in short-term rates is on the horizon. The first chart shows how both global and U.S. manufacturing have slowed down considerably based on surveys of purchasing managers. No doubt the trade war is having a big impact on this.

In addition, private sector construction spending is contracting, particularly for residential and commercial construction.





[1] https://www.federalreserve.gov/newsevents/speech/powell20190604a.htm

[2] https://www.garycarmell.com/mortage-housing-crisis/

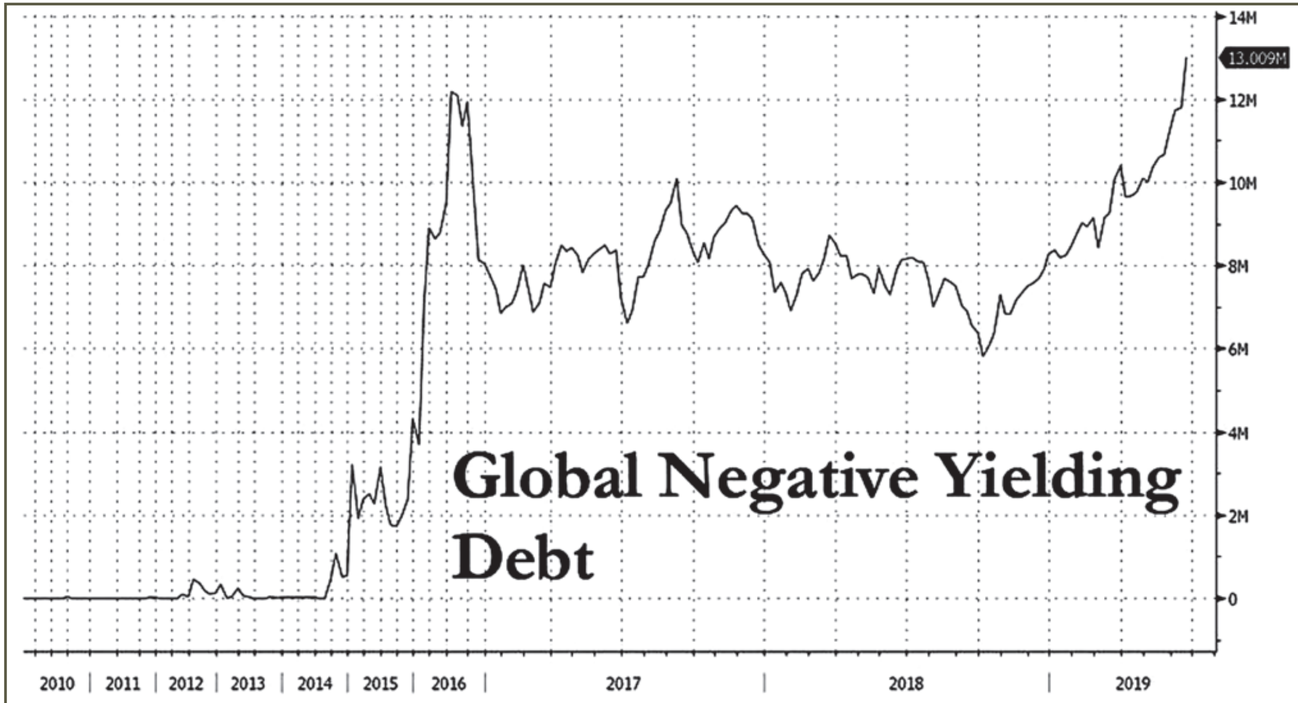
[3] https://www.garycarmell.com/bond-market-skepticism/

[4] https://www.garycarmell.com/japan-vs-b-i-s-global-interest-rate-increase/

Continued on Page 4

Continued from Page 3

The next chart shows another key factor that is pressuring the Fed to lower rates. The amount of debt globally with negative yields is now $13 trillion with France being the latest country going negative. A 2.05% 10-year Treasury note yield looks like a bargain to the rest of the world (not factoring in hedging costs).



Source: **Zero Hedge**

Continued on Page 5

Continued from Page 4

Finally, the following table shows how inflation expectations have been dropping, which is another factor that will support the Fed in cutting rates.

We are now at the point where rate cuts are inevitable and, based on the market's projections, should be very beneficial to our investments.

The following table shows that the market is factoring in rates cuts of approximately 0.75% over the next 9 months.

Cumulative Interest Rate Cut Probabilities Relative to Current Fed Funds Rate				
	-25bps	**-50bps**	**-75bps**	**-100bps**
July '19	100%	24%	0%	0%
September '19	100%	71%	15%	0%
October '19	100%	84%	39%	6%
December '19	100%	89%	55%	18%
April '20	100%	94%	72%	39%

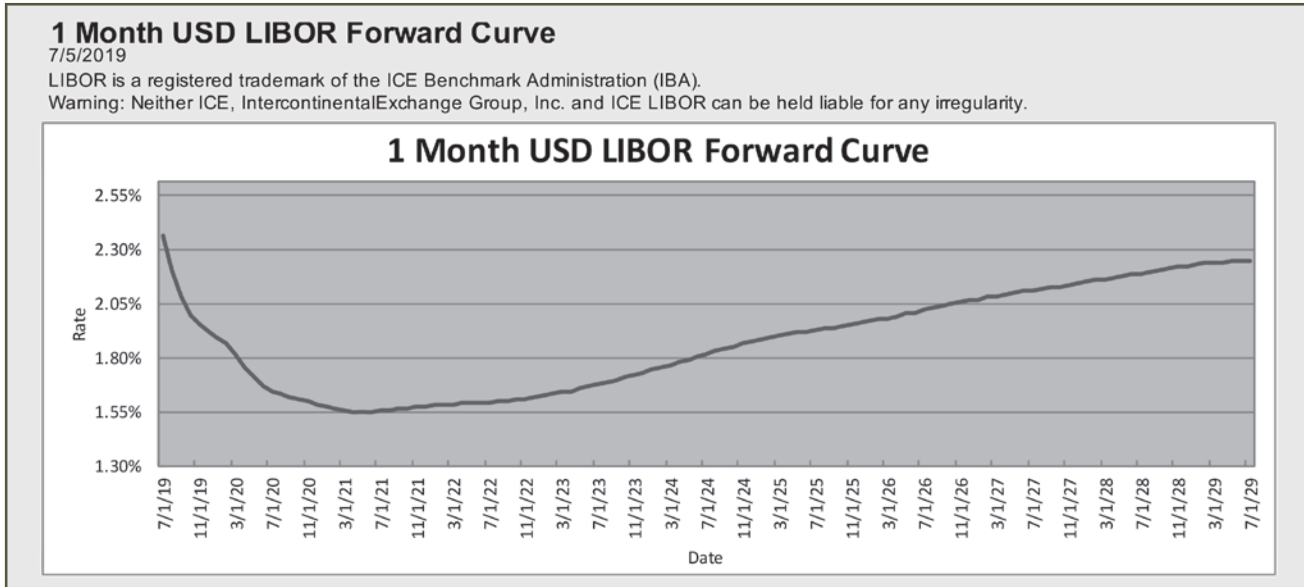
Source: **https://blog.knowledgeleaderscapital.com/?p=16530**

The market has priced in a 100% chance of the Fed lowering rates at the end of July by at least 0.25%, an 71% chance of another 0.25% in September (and 15% for 0.50%). The probabilities are such that there will be no movement in October but if they do move it will be by an additional 0.25% lower. Ultimately by 2020 the market is pricing in a greater than even chance that the Fed will have lowered rates by 0.75%.

Continued on Page 6

Continued from Page 5

The following chart shows the forward curve for Libor. It bottoms out at 1.55%, which is approximately 0.82% lower than where it is today.



Source: **Chatham Financial**

From a CWS perspective, the financial impact is quite significant. If rates were to drop by 75 basis points then this would translate into approximately $18 million in annual interest savings in one year compared to our annualized payments as of today. This would lower our average interest rate to approximately 3.42% for our floating-rate portfolio. And if rates stay that low then those savings will grow as they represent annual savings and not just a one-time benefit.

To put this benefit into further perspective and why we like the flexibility that floating-rate loans provide due to manageable prepayment penalties, I will use some data from a refinance we did of 11 properties that took place in December 2018. The average floating rate at closing was 3.75% while the fixed-rate equivalent was estimated to be 4.14%. We started off with a minor 39 basis point advantage. Unlike fixed-rate loans, however, our floaters allow us to capture future reductions in Libor (which we thought were far more likely than increases) while retaining prepayment flexibility. Thus, if rates do drop by 75 basis points then our cost advantage over the fixed rate equivalent loans will increase to 114 basis points, which is quite sizeable and gives us a strong financial cushion in the event of an economic slowdown and a more challenging apartment market.

Over the last couple of years we have had to contend with headwinds with a rising Libor and muted growth in our Net Operating Income due to more new supply of apartments, aggressive property tax increases by local counties, and cost pressures for labor and materials.

Continued on Page 7

Continued from Page 6

Now we are experiencing the opposite set of conditions as Libor will be dropping, thereby lowering our debt service, and a much improved operating environment as demand has outstripped supply and pricing power has returned. The following chart shows how apartment leasing activity has been quite robust after being pretty weak in the previous quarters.

For the three months ending June 30th, we signed 4,081 new leases with an average increase of 6.3% and we renewed 3,602 leases with an average increase of 4.8%. In addition, the rents achieved were approximately 10% higher for new leases signed than the average rents currently in place and approximately 5% higher for renewals.

The point of all of this is that we may be in the enviable position of having our cash flow increase fairly significantly due to lower interest rates and improving operating performance despite a weaker economic environment. And this should be a good thing for investors.