Volume 36, No. 3, October 28, 2022

QUARTERLY UPDATE
CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

November 24-25, 2022
Thanksgiving Holiday
CWS Offices Closed

December 26, 2022
Christmas Holiday (Observed)
CWS Offices Closed

January 2, 2023
New Year's Day Holiday (Observed)
CWS Offices Closed

January 17, 2023
4th Quarter 2022
Est. Tax Payment Due

January 27, 2023
4th Quarter 2022
Quarterly Distributions

March 15, 2023
Year 2022 K-1
Target Mail by Date

50 CWS Enhancing Lives Years

www.cwscapital.com

AN ANTI-CURIOUS JAY POWELL AND HIS KAMIKAZE FED

By Gary Carmell

I've been wrestling with the outlook for 2023 for our apartment portfolio because of the highly unusual global economy as we come out of Covid, overlayed with the geopolitical situation with the war in Ukraine, its impact on energy prices, and China's increasingly authoritarian governance and draconian economic and social policies. Inflation has obviously broken out in ways we haven't seen since the 1970s and it has caught the Fed flatfooted and now it is playing catch up in a big way. Short-term interest rates have gone up a tremendous amount as the following chart of 30-day average SOFR (one of the indices some of our loans are tied to) clearly depicts.

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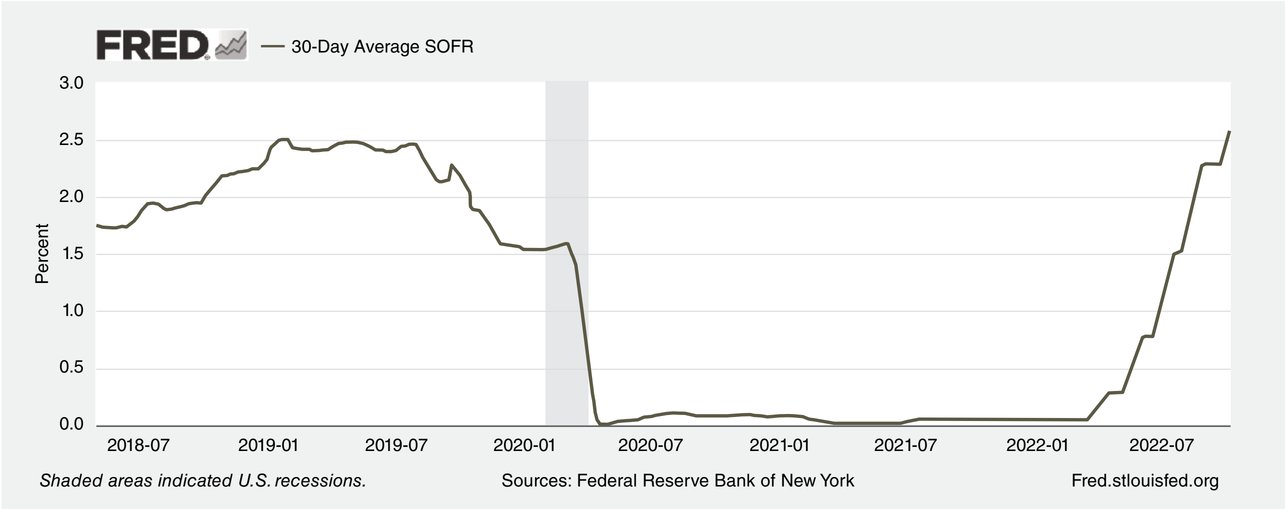

With over 80% of our debt being floating rate, we have seen our borrowing costs go up quite materially in concert with the trajectory of the chart above. The one mitigating factor, however, is that for a large percentage of these loans we purchased an interest rate cap that caps 30-day LIBOR (another index many of our loans are tied to) at 1.25% through the December mortgage payment. We bought that cap to cover approximately $1.7 billion of loans for $1 million in mid-2020. We are estimating that the cap will pay our properties over $6 million. This was clearly a great return on investment and something we feel fortunate to have put in place. Unfortunately, the cap expires after December so we will start to feel the sting of higher rates in 2023, which we expect will necessitate some distribution cuts.

Rather than getting into the weeds about the financial impact of higher interest rates, I think this is best done after we go through our budget reviews when we will have much better visibility as to what the impact may be on our distributions. What I do believe, however, is that 2023 will be the peak for short-term interest rates for this cycle and that the Fed will most likely need to start cutting rates some time in late 2023 or by early 2024. This does go against the message the Fed wants to convey which is that it is going to be very aggressive and vigilant in fighting inflation and it will not cut rates prematurely if it doesn't think the war has been won. And yet, I think they are fighting an enemy that is much more in the rearview mirror versus one that appears ahead through the windshield. And this will cause a lot of economic pain that will necessitate shifting from a very constrained monetary policy to one which will have to loosen up as we proceed through 2023.

My belief that the Fed will have to pivot in 2023 or early 2024 has to do with the mindset of Fed Chairman Jerome Powell who has proven himself to be what I would characterize as flexibly dogmatic. He has shown a willingness to change direction, even if it's contrary to previously stated guidance, and like a reformed smoker, he can be very dogmatic that the new course is unequivocally the right direction from which there should be no deviation.

I recently listened to Hollywood producer Brian Grazer's book *A Curious Mind* which I enjoyed very much. In it he espouses the benefits of curiosity to enlarging one's world and

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making life far more interesting and enjoyable. There is one chapter, however, in which he talks about the benefits of being anti-curious. This is the approach he takes when he has made up his mind to move forward with a project after what may have been a great deal of time and exhaustive research and he does not want to be talked out of it. If someone says no, he does not want to know why, and he'll give them a chance to reconsider, but he will then move on if they're still not swayed. The train has left the station and there's no turning back.

I bring this up because I believe that Federal Reserve Chairman Jerome Powell is now in this anti-curious frame of mind after concluding he was much too late in stopping the expansion of the Fed's balance sheet and took too long to start raising interest rates. He is dead set on reversing course, and he is intent on doing so very aggressively no matter the consequences and without seemingly being concerned with what other people have to say or how financial markets react. He will not be talked out of continuing to raise rates during the next two meetings regardless of knowing full well that monetary policy acts with a lag.

If I were to give a label to Powell's Fed, it would be the Kamikaze Fed. They are hell bent on crashing planes into ships in a desperate attempt to reverse the tide against inflation. Unlike Japan in World War II, however, which had very little chance of succeeding in turning the tide of the war, the Fed is starting to win the inflation battle and, rather than taking a pause and seeing how the economy responds to its aggressive medicine before adding more, it's not taking any chances and it is carrying out an all out assault on demand by raising interest rates and tightening financial conditions with the ultimate goal of having it spill over to the job market.

Kamikaze pilots were only given enough fuel for their airplanes to get to the ships, but not to return home, so they were truly on suicide missions. The Fed is taking a lot of fuel away from the economy in the hopes that higher interest rates, wider credit spreads, a dramatically slowing housing market, a relentlessly strong dollar, and much higher short-term risk-free rates will dampen animal spirits, lead to less risk-taking, create a loss of wealth, all in the hopes of creating much greater slack in the labor market by catalyzing significant layoffs to crush inflation. Powell wants to make sure that he is using all the levers he has, along with his surrogates, to crash planes into the economic ship of the United States.

Before discussing the impact the Fed's actions have already had on the economy, I'll do a little detour to discuss our apartment portfolio. One of the culprits of the high measurements of inflation is the unrelenting increase in housing-related costs, particularly rent. At CWS we have been beneficiaries of this as our portfolio has seen quite significant rent increases over the last year. For example, in July through September the new leases we signed were approximately 13% higher than the amount paid by the previous resident. For those residents renewing, the average increase for this three-month period was approximately 14%.

The market has been so strong in some cases that there are examples of properties that have seen their revenues grow by an amount that has been able to cover much of the increase

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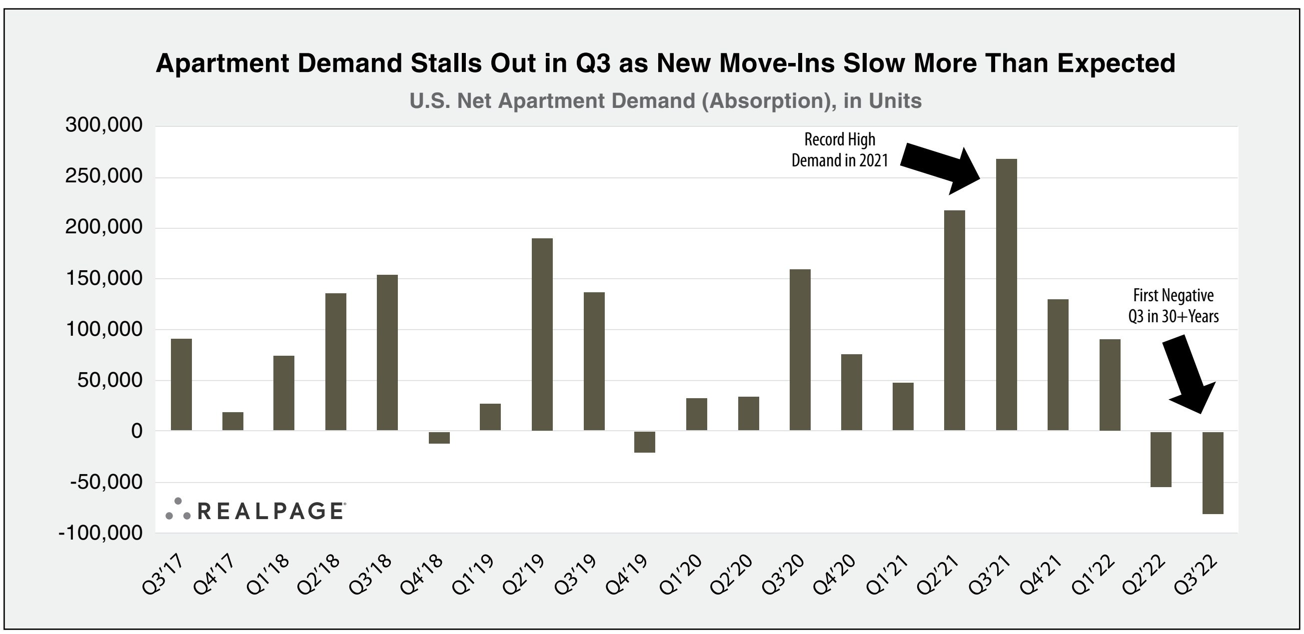
in debt service (so far). For example, we have a property which we are in the process of refinancing because its loan is coming due. And while its debt service has gone up by approximately $62,000 per month based on August versus January, its revenues have gone up by $58,000 per month based on the same two months.

This is one of the reasons we have had a bias toward variable-rate loans. Our experience has been that short-term interest rates often correlate with the performance of our portfolio since both are very sensitive economic indicators. When the economy is strong, rents should grow nicely which should translate to higher revenues. The same is true for interest rates. Thus, as our debt service goes up we would expect our revenues to grow as well. And probably more importantly, when the economy is weaker and our pricing power is not as strong, we should see interest rates drop and flow through to our debt service at a time when our revenues may be at risk of dropping or staying flat. Of course there are no perfect hedges and there can be wide variations between individual properties, but for this part of the cycle the theory is holding up reasonably well in practice. It sure was a huge winner during Covid and other downturns. The real question now is how much longer can this hold up with the Fed still aggressively raising rates and recession risks growing materially?

We are very much on the lookout for a slowdown. There do appear to be some cracks in the apartment armor. For example, as the chart below shows, the third quarter leasing activity for the nation was the weakest it's been in 30 years. And this is on the heels of a weak second quarter as well. Despite this, occupancy rates still remain quite healthy, and this is the case for our portfolio as it has hovered around 92% for the last five quarters. If we do go into a downturn, our initial conditions are fairly healthy.



Now let's return to the economy and some of the indicators I'm looking at that lead me to believe that the Fed is going to be overtightening and materially increase the risks that we

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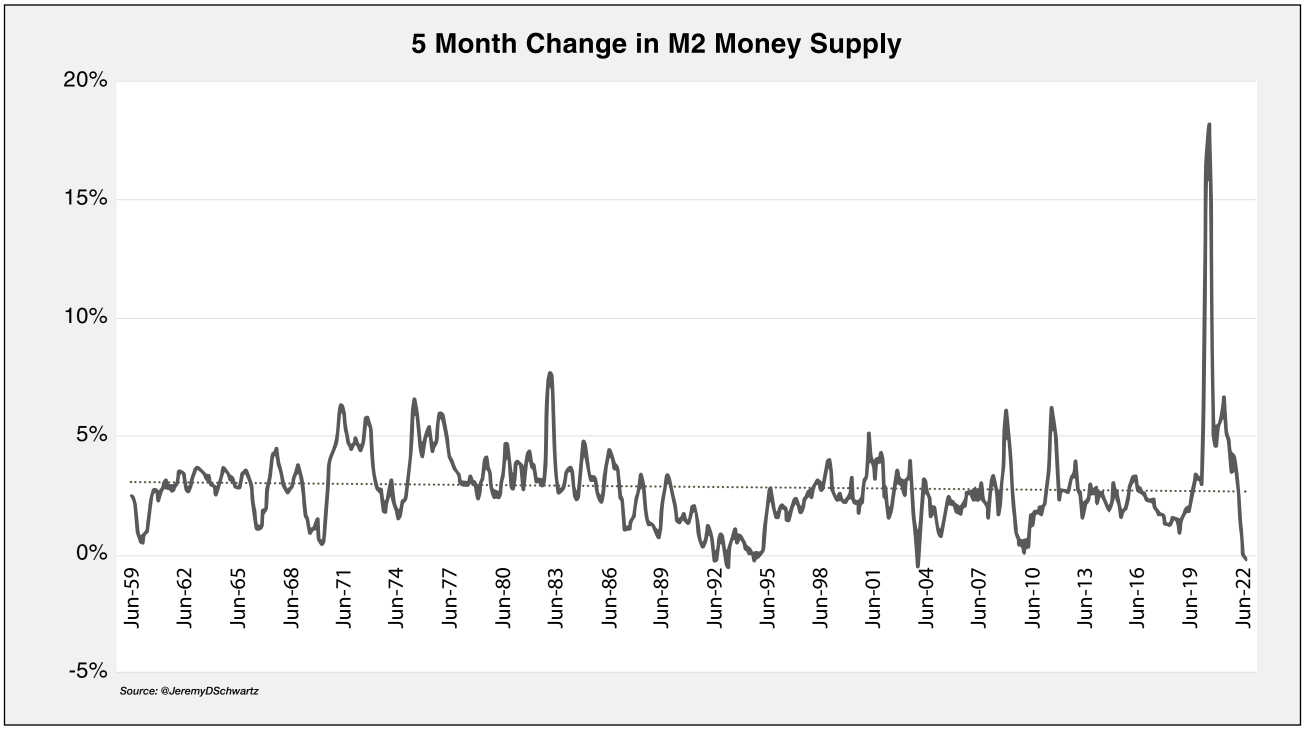
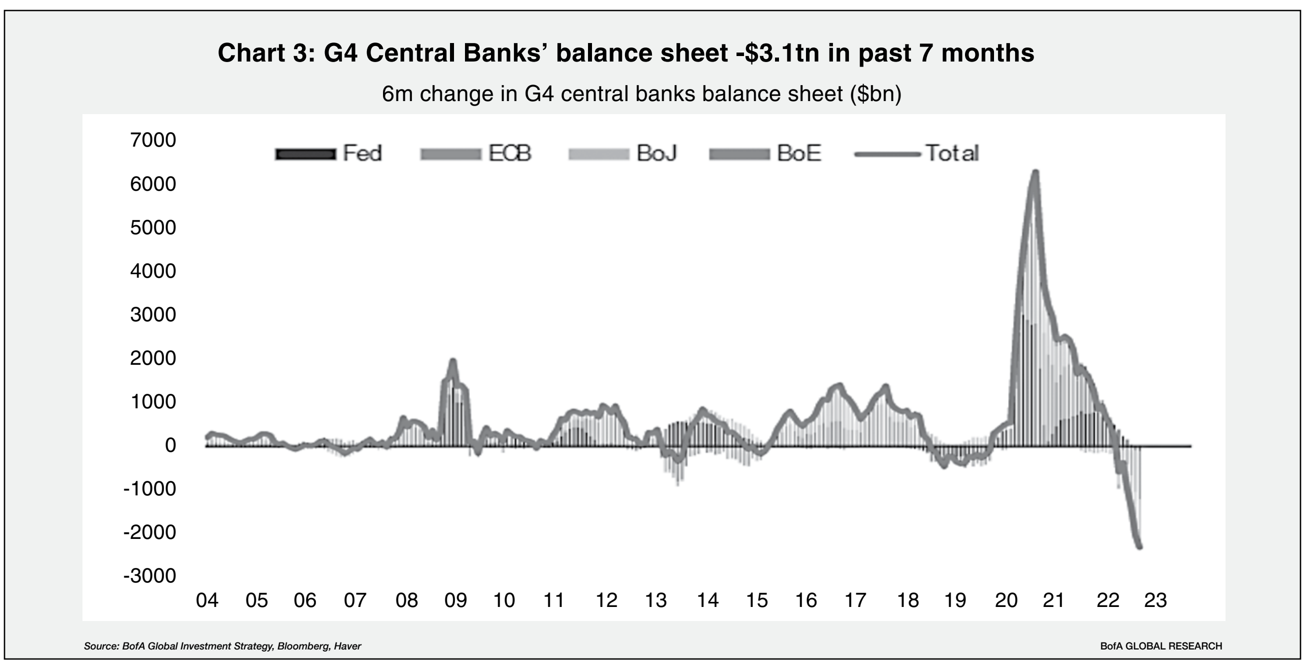
go into a recession. The first is money supply. What the Fed giveth, it can also taketh away. One can see how after growing at an unprecedented level during Covid, the Fed is now contracting the money supply quite rapidly.



This is happening globally as well, as measured by the balance sheets of four of the largest central banks. One can see how the combined balance sheets exploded higher by nearly $6 trillion only to see 50% of this contract over the last seven months. There is much more to go.



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Jay Powell has been saying that the labor market is too strong and one of the indicators he looks at to have him draw this conclusion is the number of job openings. This can be a volatile and noisy indicator, but if August's report was any indication, then the job market could be cooling materially.

ECONOMY

Job openings plunged by more than 1.1 million in August

PUBLISHED TUE. OCT 4 2022 · 10:18 AM EDT | UPDATED 19 MIN AGO

Jeff Cox
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@JEFFCOXCNBCCOM

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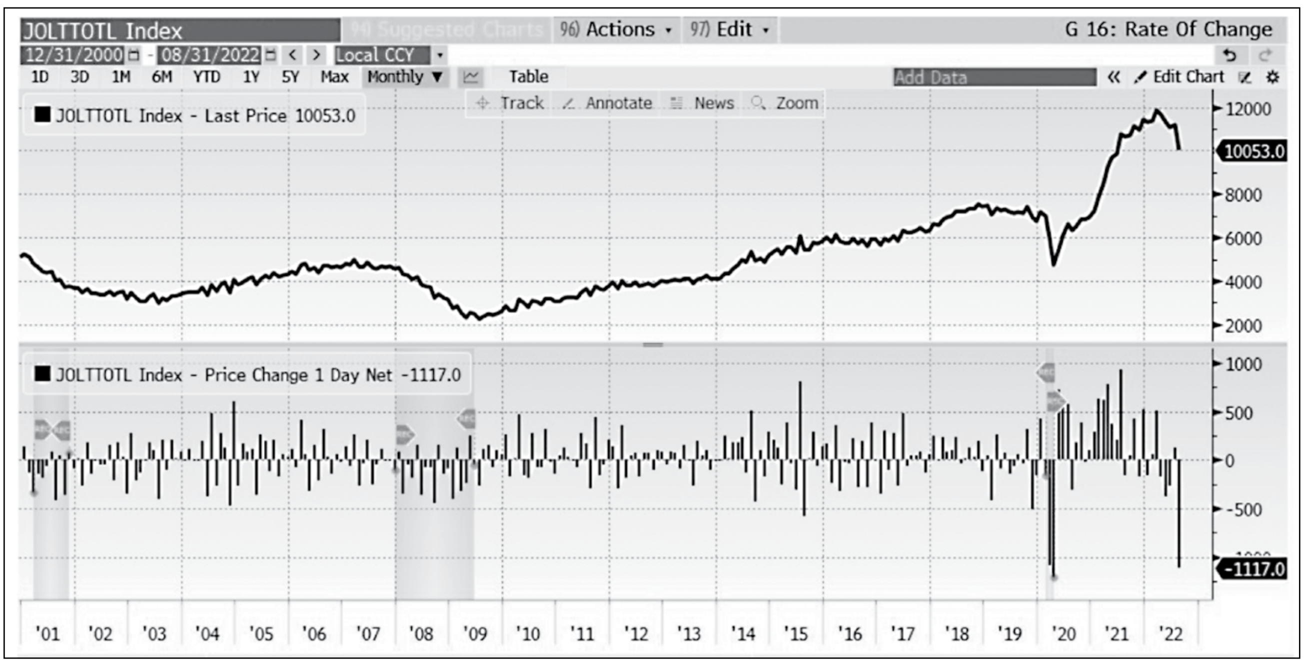
One can see from this chart that the trend has been quite negative over the last six months and is commensurate with a much slower economy.



I thought this chart was interesting in terms of potentially showing the future path of job openings. This chart would seem to suggest that the NASDAQ may be a leading indicator of future hiring. This makes intuitive sense because the NASDAQ is typically comprised of faster growing companies so when their stock prices are going higher then it's usually a sign of good business prospects and growth opportunities which would give these firms the incentive to hire aggressively to be positioned to capture more growth. Of course the converse is true as well when their stock prices drop. One can see from the following chart that the NASDAQ has had a material correction and with the IPO window essentially shut and the cost of capital rising, the prospects for growth are diminishing which is now leading firms to focus on more belt tightening which is not a great sign for strong future demand for labor.

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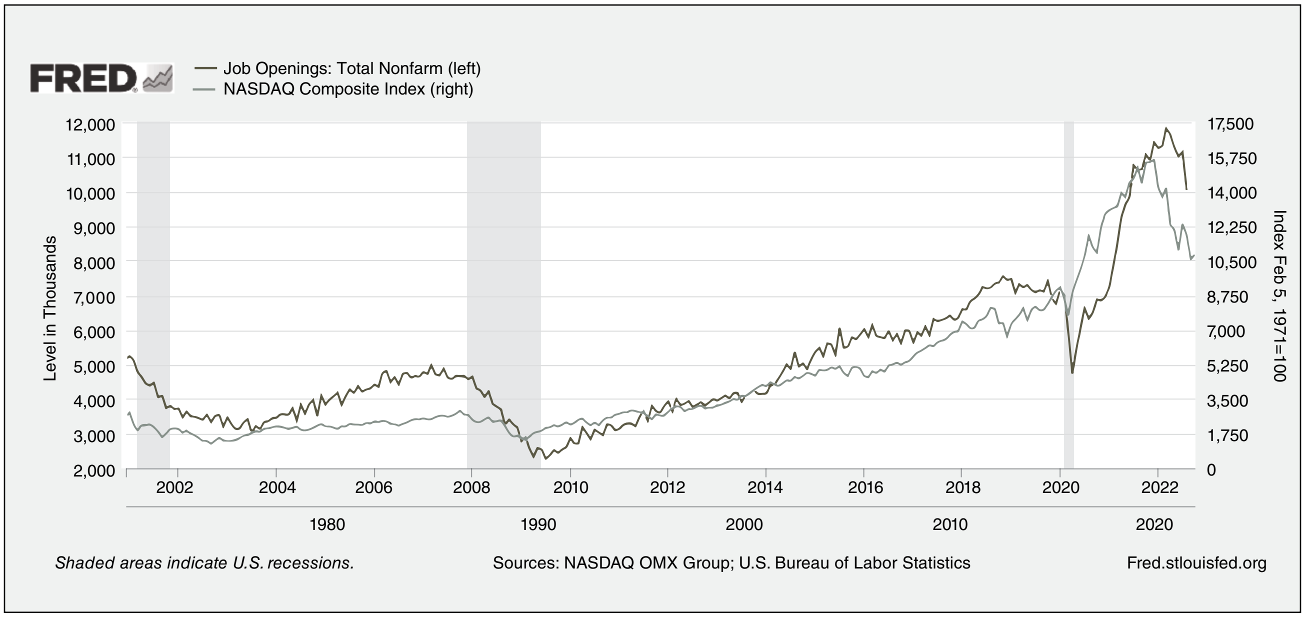
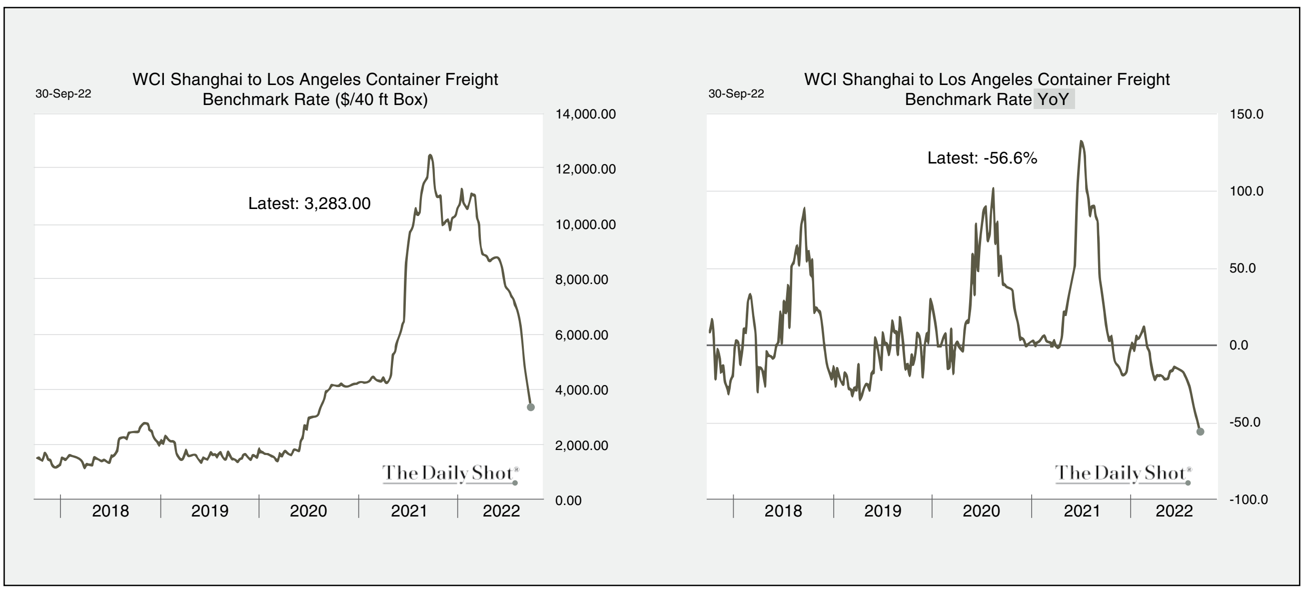


Supply chain issues have been a huge issue for the global economy and one of the major reasons as to why prices have shot up. The following charts, however, show the worst is far behind us and we are on a trend to get to shipping costs coming back down to pre-Covid levels.



What about the prospects for the manufacturing sector? One way of gauging the health of this sector is via the release of Purchasing Managers Indexes (PMI) from around the world. This chart plots global PMI values versus the percentage of central banks that are tightening monetary policy or loosening it. The central banks are the leading indicator so this graph is showing that it's look out below for global manufacturing as central bank tightening will stifle demand and lead to too much inventory which will necessitate manufacturers cutting back as orders get trimmed.

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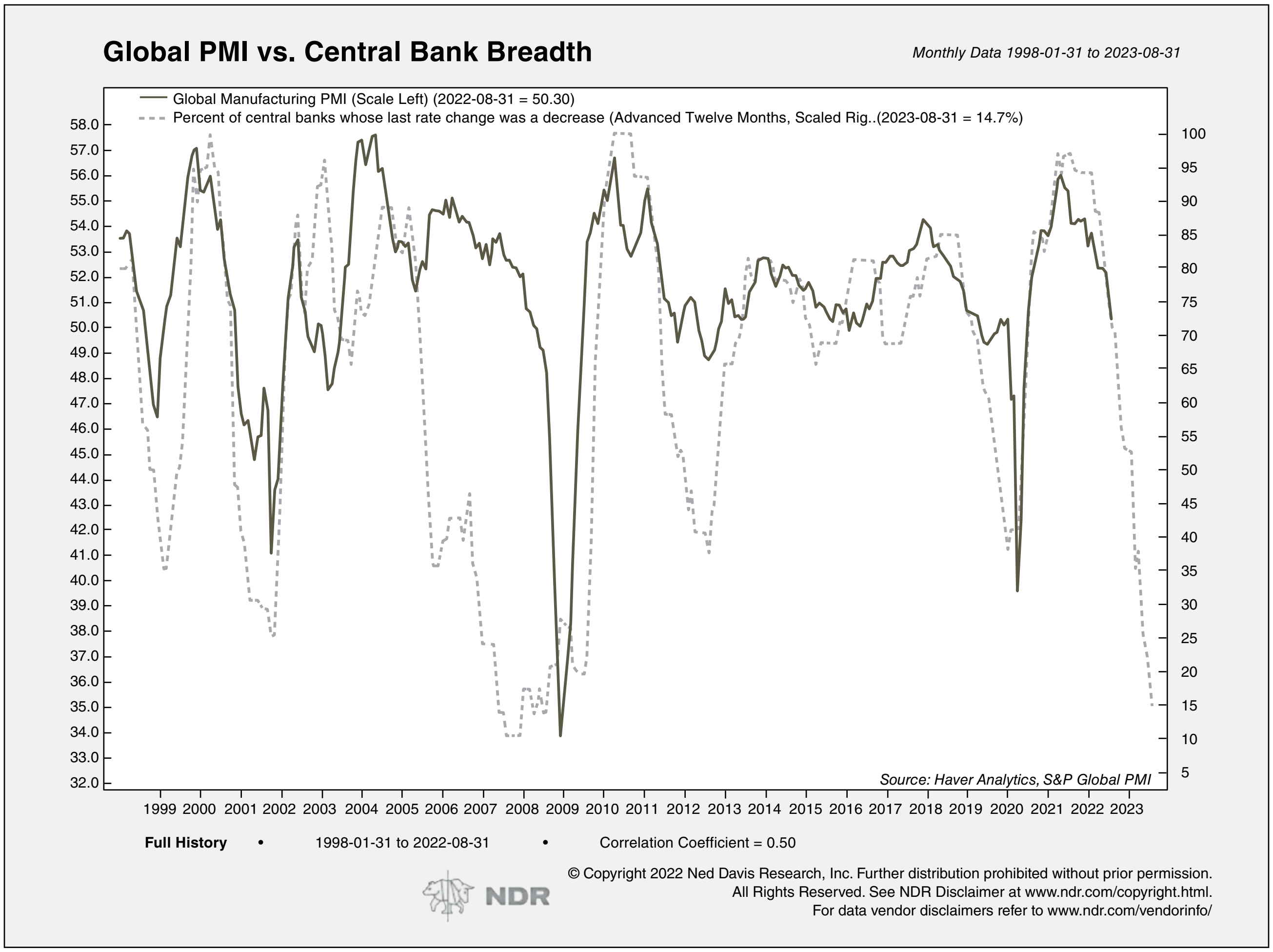

Even prior to the terrible third quarter, $9 trillion of stock market paper wealth vanished in the first half of the year. This is obviously not great for consumer confidence and makes people feel less wealthy and typically less inclined to spend.

WEALTY

Stock market losses wipe out $9 trillion from Americas' wealth

PUBLISHED TUE. SEP 27 2022·12:57 PM EDT | UPDATE TUE. SEP 27 2022 7:37 PM EDT

Robert Frank
@ROBTFRANK

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KEY POINTS

- American's holdings of corporate equities and mutual fund shares fell to $33 trillion at the end of the second quarter, down from $42 trillion at the start of the year
- With major market indexes falling further since July, experts say losses from financial markets could total $9.5 trillion to $10 trillion.
- Economists say the drops could add pressure to Americans' balance sheets and possibly hurting spending.

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One can see how the traditional 60% stock and 40% bond portfolio has had the second worst year with the exception of 1931. The year is not over so we'll see how it ends up. This just shows that bonds, which are typically a decent hedge against a declining stock market, have not provided its usual safe haven for investors.

60/40 Portfolio: S&P 500/US 10-Year Treasury (Total Returns, 1928-2022)

Year	Return	Year	Return	Year	Return	Year	Return	Year	Return
1928	26.6%	1947	3.5%	1966	-4.8%	1985	29.0%	2004	8.2%
1929	-3.3%	1948	4.2%	1967	13.6%	1986	20.8%	2005	4.0%
1930	-13.3%	1949	12.8%	1968	7.8%	1987	1.5%	2006	10.2%
1931	-27.3%	1950	18.7%	1969	-7.0%	1988	13.2%	2007	7.4%
1932	-1.7%	1951	14.1%	1970	8.8%	1989	26.0%	2008	-13.9%
1933	30.7%	1952	11.8%	1971	12.4%	1990	0.7%	2009	11.1%
1934	2.5%	1953	0.9%	1972	12.4%	1991	24.1%	2010	12.3%
1935	29.8%	1954	32.9%	1973	-7.1%	1992	8.2%	2011	7.7%
1936	21.2%	1955	19.0%	1974	-14.7%	1993	11.7%	2012	10.7%
1937	-20.7%	1956	3.6%	1975	23.6%	1994	-2.4%	2013	15.6%
1938	19.3%	1957	-3.6%	1976	20.7%	1995	31.7%	2014	12.4%
1939	1.1%	1958	25.4%	1977	-3.7%	1996	14.2%	2015	1.3%
1940	-4.2%	1959	6.2%	1978	3.6%	1997	23.8%	2016	7.3%
1941	-8.5%	1960	4.9%	1979	11.4%	1998	23.0%	2017	14.1%
1942	12.4%	1961	16.8%	1980	17.8%	1999	9.2%	2018	-2.5%
1943	16.0%	1962	-3.0%	1981	0.5%	2000	1.2%	2019	22.6%
1944	12.4%	1963	14.2%	1982	25.4%	2001	-4.9%	2020	15.3%
1945	23.0%	1964	11.3%	1983	14.7%	2002	-7.1%	2021	15.3%
1946	-3.8%	1965	7.7%	1984	9.2%	2003	17.2%	2022*	-21.0%

COMPOUND *As of 9/30/22 @CharlieBilello

I mentioned earlier about tightening credit conditions. Bank of America is very concerned that the Fed is on the verge of creating significant funding problems in various credit markets and the Fed needs to slow down before it creates significant damage to the economy.

Fed Rate Hikes Are Pushing Credit Market Towards Dysfunction, Bank of America Says

- Credit stress is nearing 'critical zone,' stratagists say
- Fed needs to slow down hikes or face difficult fixes, they say

By Jill R Shah
September 30, 2022 at 9:14 AM PDT

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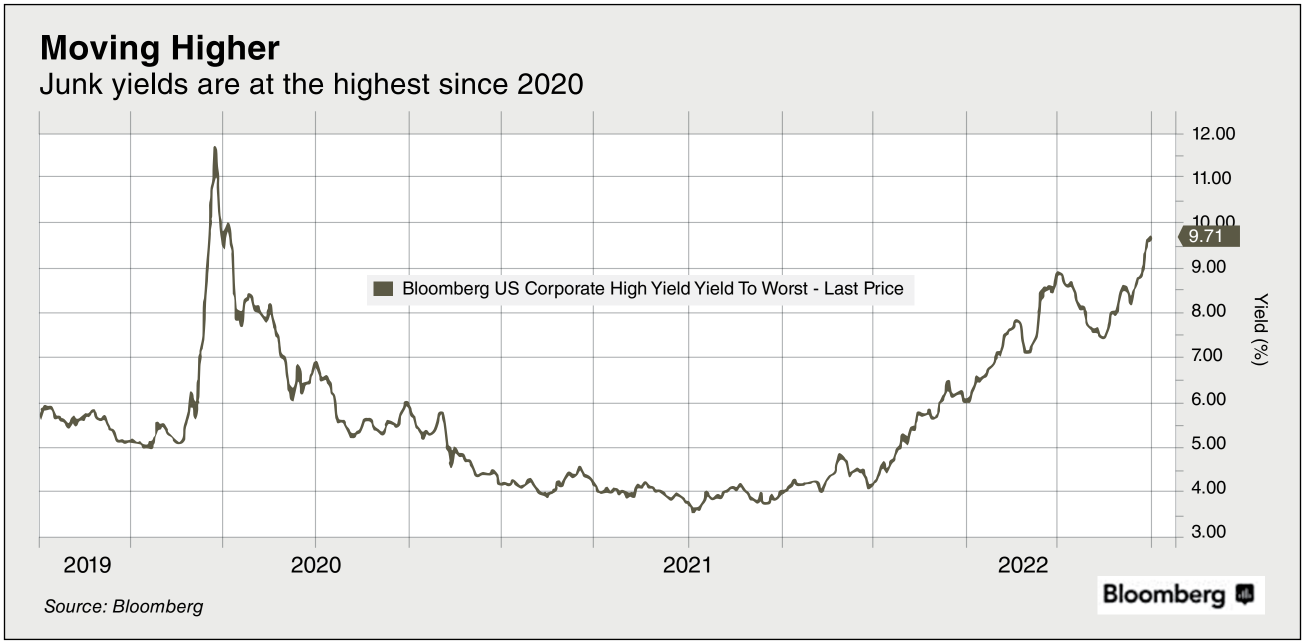
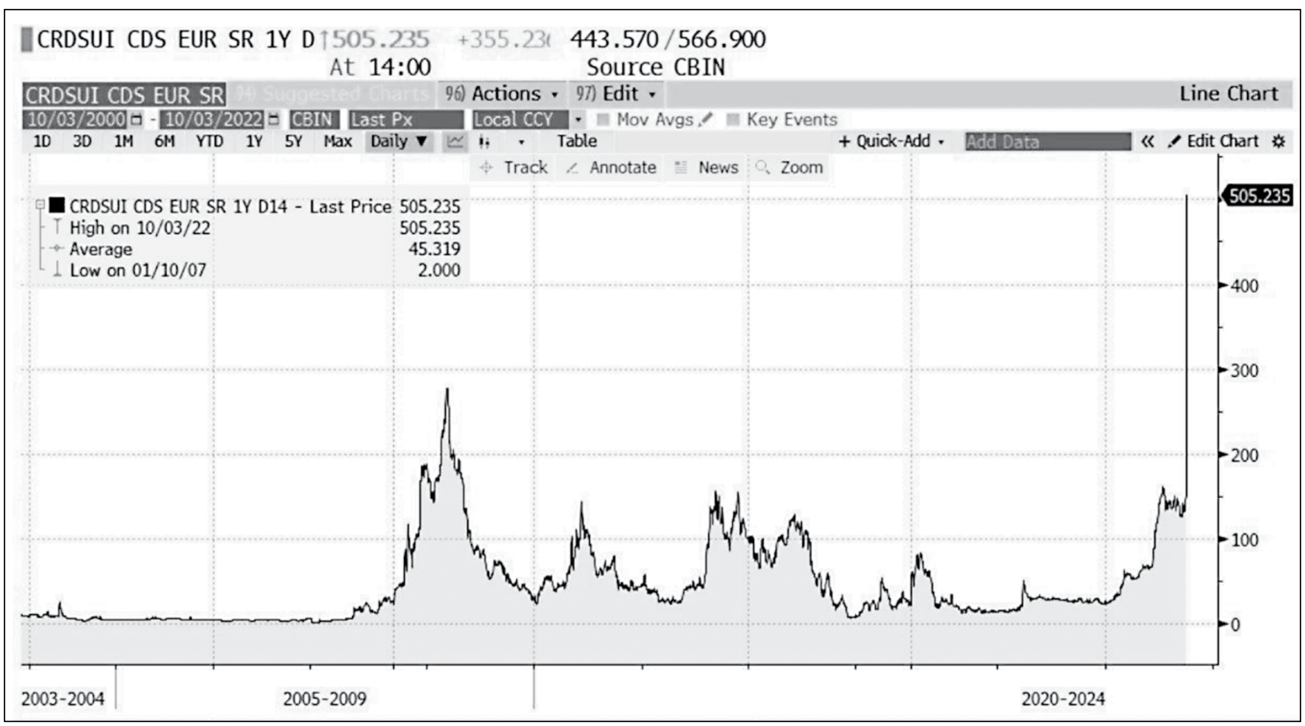
One can see that junk bond yields have shot up and they're approaching levels that were reached during the worst of the Covid economic contraction. This is a sign of credit conditions tightening for weaker companies. This will make it harder for them to raise new capital and refinance loans that are maturing.



Europe is worried about its own potential Lehman Brothers implosion with Credit Suisse. This chart shows how the cost of insuring its bonds against default have gone vertical to record high levels that have far exceeded where they traded during the Great Financial Crisis. This is a very ominous sign for a firm that is much bigger than Lehman.



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Other European banks are not feeling the love from investors as evidenced by the very low price-to-book values of their stock prices. When investors pay such low values they don't believe the value of the assets are as high as they are stated on the books or their prospects are bleak in terms of future earning power. It's usually a combination of both.

G-SIB	Price to book
Credit Suisse	24.0%
Deutsche Bank	23.4%
Credit Agricole	33.8%
Unicredit	37.2%
Barclays	34.4%
Bank of China	38.7%
Societe Generale	27.0%
Standard Chartered	33.2%

Data source: Yahoo Finance 02-Oct E&OE

The explosive increase in the value of the dollar is causing problems for the rest of the world. While it helps with our battle against inflation, it does the opposite for other countries as key commodities are all priced in dollars. It also makes the cost of overall imports more expensive. It also makes it more expensive to service dollar-denominated debt. One can see from this chart how strong the dollar has been relative to some of our key trading partners.

China is not exempt from domestic currency weakness either as it is wrestling with a very weak economy resulting from its zero Covid policy, a crackdown on tech firms, and the cratering of its housing market.

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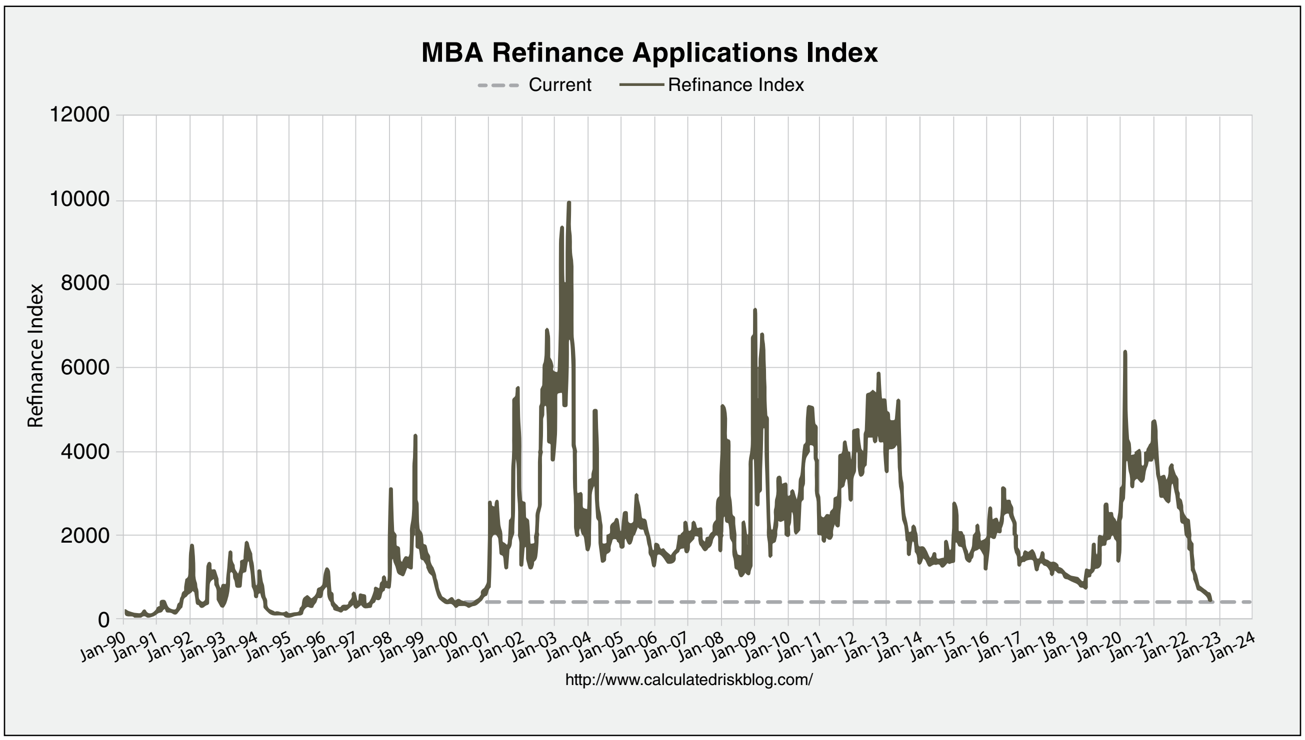
China tells state banks to prepare for a massive dollar dump and yuan buying spree as Beijing's prior interventions have failed to stem its currency's worst year since 1994

Phil Rosen Sep 29, 2022, 7:14 AM

Finally, we can see how the incentive to refinance has been obliterated with mortgage rates approaching 7%. Who would want to give up their 3% to 4% mortgage to refinance into one that has a rate of 6.50%? According to this chart virtually no one as we're back down to 2000 levels in terms of refinance activity.



To summarize, our apartments have performed very well. We benefitted greatly from stable performance and rapidly declining interest rates during Covid and through early 2022. Rates have risen quite rapidly as 2022 has unfolded and this is going to materially increase our debt service in 2023 after the interest rate cap we purchased in 2020 expires in December. Fortunately we have had strong revenue growth to offset some or all of the increase in debt service for many of our properties but the trend is not our friend. Rates will be raised two more times, which will increase our debt service even more, and we anticipate rent growth to slow as the Kamikazi Fed is hell bent on dramatically slowing the economy. I do think this will set the stage for rates to come down again in late 2023 or early 2024 which should help provide us with another hedge against revenues that may flatten out or even drop.

Buckle up, 2023 is going to be quite a ride!