Volume 26, No. 4, January 25, 2013

Quarterly Update

CWS Capital Partners LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

Friday, March 29, 2013
Good Friday
CWS Office Closed

April 10, 2013
CWS Annual Partners Meeting
Newport Beach Marriott Hotel
(Fashion Island)

April 15, 2013
2012 Tax Filing Deadline

April 15, 2013
1st Quarter 2013 Estimated Tax Payment Due

April 26, 2013
1st Quarter 2013 Quarterly Packages Mailed

May 2013
CWS Capital Partners
Semi-Annual Conference Call

Monday, May 27, 2013
Memorial Day
CWS Offices Closed

Thursday, July 4, 2013
Independence Day
CWS Offices Closed

July 15, 2013
2nd Quarter 2013 Estimated Tax Payment Due

July 26, 2013
2nd Quarter 2013 Quarterly Packages Mailed

www.cwscapital.com

Silver Linings Playbook

By Gary Carmell

I really enjoyed the movie Silver Linings Playbook. In fact, I saw it twice I liked it so much. Rather than discuss what the movie is about, I thought I would use the title to shed light on another silver linings playbook that was revealed towards the end of 2012. This was Ben Bernanke's announcement that interest rates won't be increased until the unemployment rate decreases to at least 6.5% and inflation remains below 2.50%. Bernanke has revealed his playbook, and from my perspective, the silver lining is that interest rates may remain lower for longer than most people are expecting, assuming he is not reappointed in 2014 and that his successor follows the same playbook.

Apartment investors have benefitted from the positive leverage that has been available on new acquisitions. What this means is that the yield at which properties can be purchased has been higher than the cost of debt to finance those acquisitions, thereby providing investors with very attractive yields on their equity. CWS has further increased the spread between the two by concentrating fairly significantly on lower cost,

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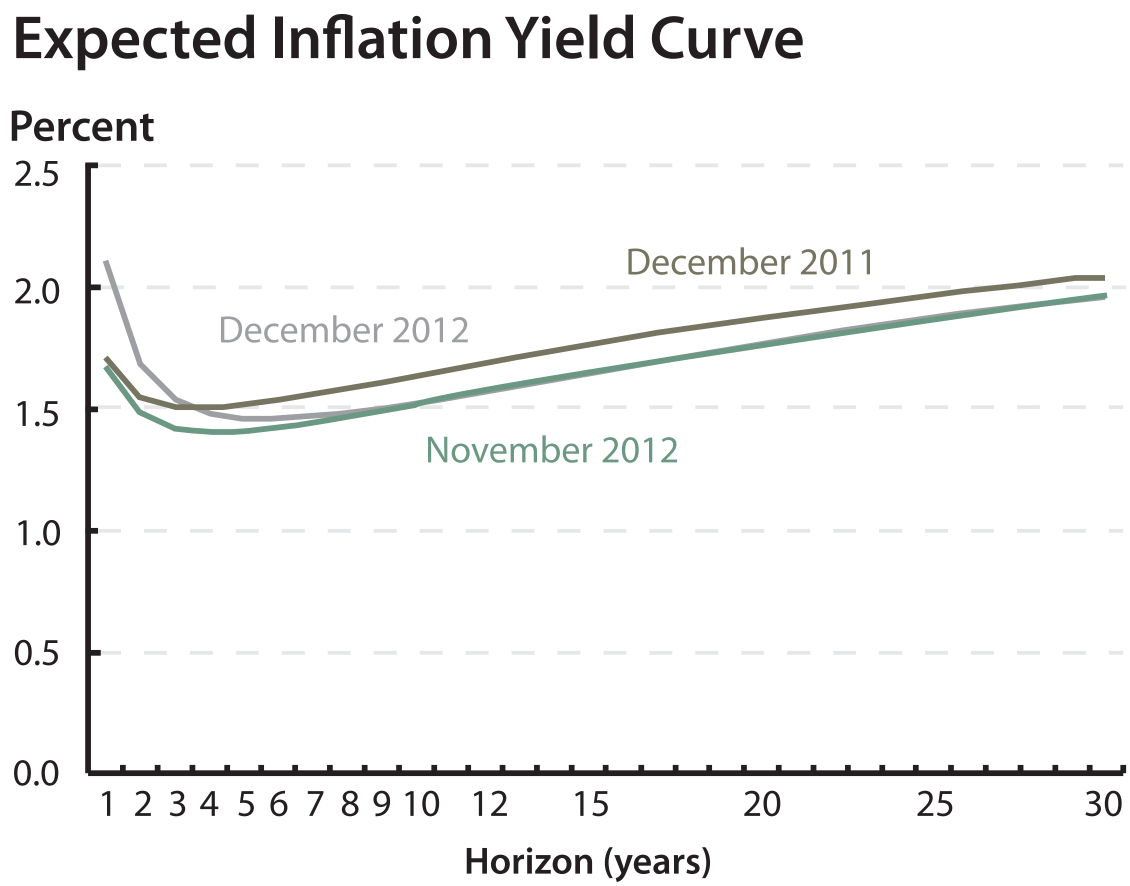
variable-rate debt. Reasons for choosing this strategy have been discussed previously. What is important for us is that when interest rates begin to rise, we can plan accordingly. Given the Bernanke playbook, the most important question is: When will the unemployment rate reach 6.50% provided that inflation one or two years out is projected to be below 2.50%? Even then, however, that doesn't necessarily mean rates will move higher. It just means that the conditions will be present for the Federal Reserve to consider doing so. For what it's worth, Japan's interest rates have been below 1% since 1995.

Let's tackle inflation first to get that out of the way. Inflation does not appear to be a looming threat as the following graph shows. The Cleveland Fed has a model for estimating what the market believes future rates of inflation will be over the next one and thirty years. As the graph shows, inflation is expected to be in the 1.50% to 2.00% range, which is below the 2.50% threshold the Fed has set. Given this, then all we need to do is to focus on the unemployment rate.



Source: Federal Reserve Bank of Cleveland

Clearly the labor market is healing as the unemployment rate has come down from a peak of approximately 10% to 7.8%. The obvious question is when will it hit the magical 6.50%?

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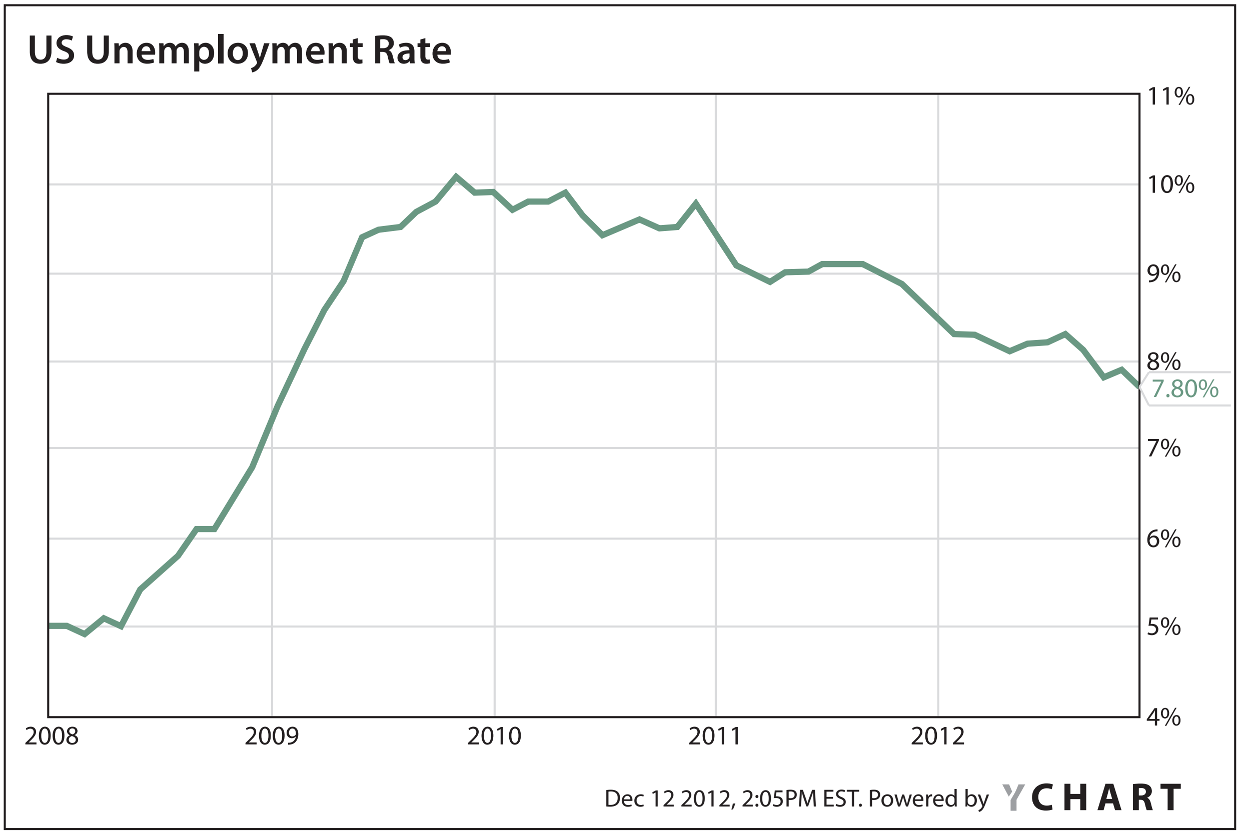

According to the Fed, they believe that the unemployment rate will reach 6.50% or below in 2015 as the following table shows.

Unemployment rate

Percent

Actual	4.8	6.9	9.9	9.6	`8.7	-	-	-	-	-
Upper End of Range	-	-	-	-	-	8.0	7.8	7.4	6.8	6.0
Upper End of Central Tendency	-	-	-	-	-	7.9	7.7	7.3	6.6	6.0
Lower End of Central Tendency	-	-	-	-	-	7.8	7.4	6.8	6.0	5.2
Lower End of Range	-	-	-	-	-	7.7	6.9	6.1	5.7	5.0

Source: http://www.federalreserve.gov/monetarypolicy/fomcprojtabl20121217.htm

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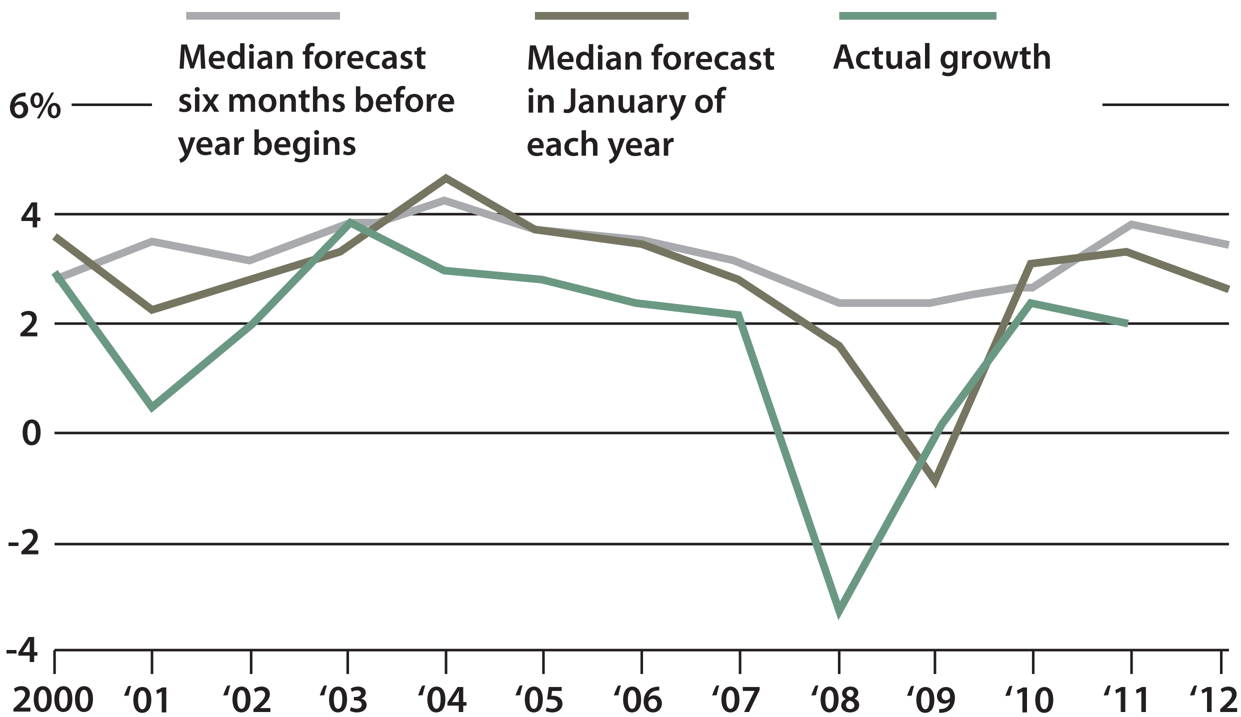
Unfortunately, if their projections regarding the growth rate of the economy are any indication of the Fed's forecasting track record, then it's quite conceivable that the Fed will be too optimistic. The following is a graphic from the Wall Street Journal showing how off the mark they've been so far.

I will give them credit, however, in that they projected that the unemployment rate for the fourth quarter of 2012 (January 2011 forecast) would be between 7.6% and 7.9% which has been accurate, although it has been revised slightly upward to 7.7% to 8.0% in their most recent forecast.

Wishful Thinking

Fed officials have consistently overestimated how fast the economy would grow in recent years.



Note: Based on median forecast of Federal Open Market Committee members
Source: Federal Reserve

The Wall Street Journal

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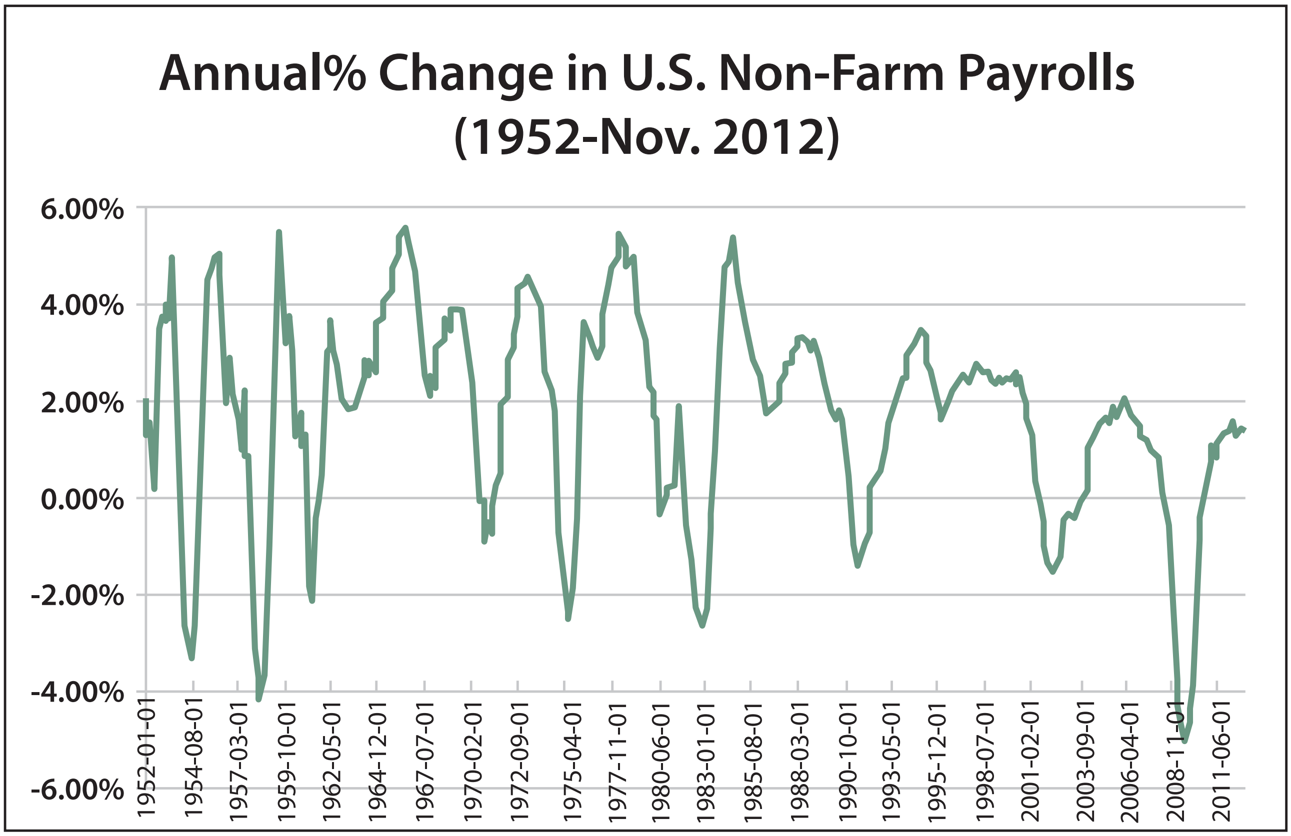
Where Do I Think We're Headed?

Let me start off with two graphs that lead me to believe that the Fed might be too optimistic in its unemployment forecast. The following chart shows that for about 32 years non-farm payroll growth would typically peak at around 5% on an annual basis. Since 1984, however, we have been experiencing lower highs in terms of employment growth peaks and lower lows relative to their bottoms. It looks like the growth rate is about to turn over and move lower. This would not be surprising given the payroll tax increase, the other taxes associated with Obamacare, phased-out deductions, and the prospect for spending cuts by the federal government offset by a strengthening housing market and improving incomes and manufacturing sector.



Source: Bureau of Labor Statistics

This decelerating trend reflects some sort of fundamental downshift in the economy's ability to produce jobs. Globalization, aging baby boomers, our financialized society (which requires more borrowing to generate growth) that is now cutting back on debt, and a relentless focus on corporate profitability come to mind as some of the structural reasons why we're going to have a challenging time growing much beyond 2% in terms of job growth. The following chart shows the incredible productivity gains that have taken place in our economy but how very little of that has been passed on to workers in the form of higher inflation-adjusted earnings since the mid-1970s.

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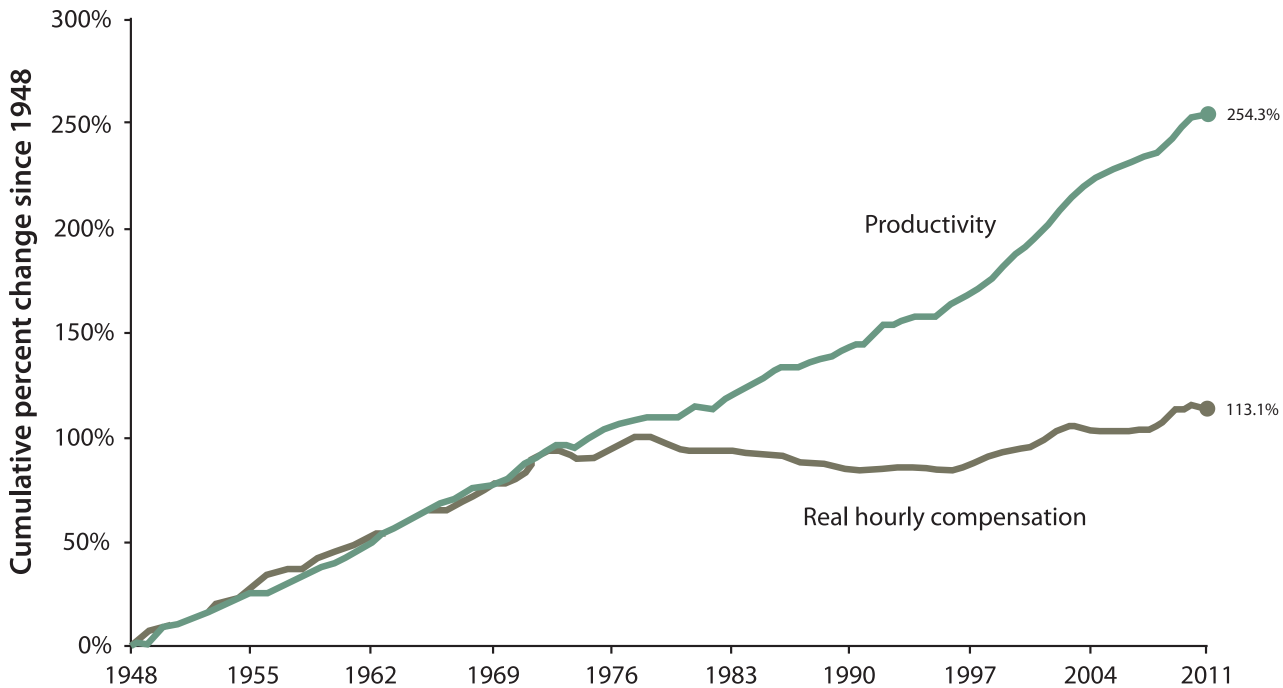
Figure 4U Cumulative change in total economy productivity and real hourly compensation of production/nonsupervisory workers, 1948-2011



Source: State of Working America

The U.S. economy has been able to grow by inflating asset bubbles like the leveraged buyout boom of the 1980s, the dotcom/telecom era from 1995-2000, and the housing bubble from 2003-2007 while also keeping a lid on hiring and wage growth. To me it looks like job growth may be peaking but let's assume I'm too pessimistic. To calculate the unemployment rate we need to know the size of the population and the labor force participation rate to determine how many people of working age want a job. This is highly influenced by one's age, race, gender, and educational attainment. Using the Bureau of Labor Statistics' forecast we can establish a baseline model. Interestingly, the participation rate has dropped about 1% more than projected and this is assumed to be attributable to the very weak economy in which many people have given up looking for jobs right now, particularly women. My numbers do not assume any catch up for this if the economy gets better which, paradoxically, could result in a higher unemployment rate if the labor market picks up more speed as more people come off the sidelines to look for a job.

I went back and correlated the last 26 months of positive job growth (yes, we've been growing for 26 months straight) with other 26 month periods to see if I could see any similar patterns. There were five different time frames in which the correlations were 0.91 or higher and they averaged approximately 23.4 months of additional job growth before turning negative year over year. I decided to be conservative and add another 40 months to

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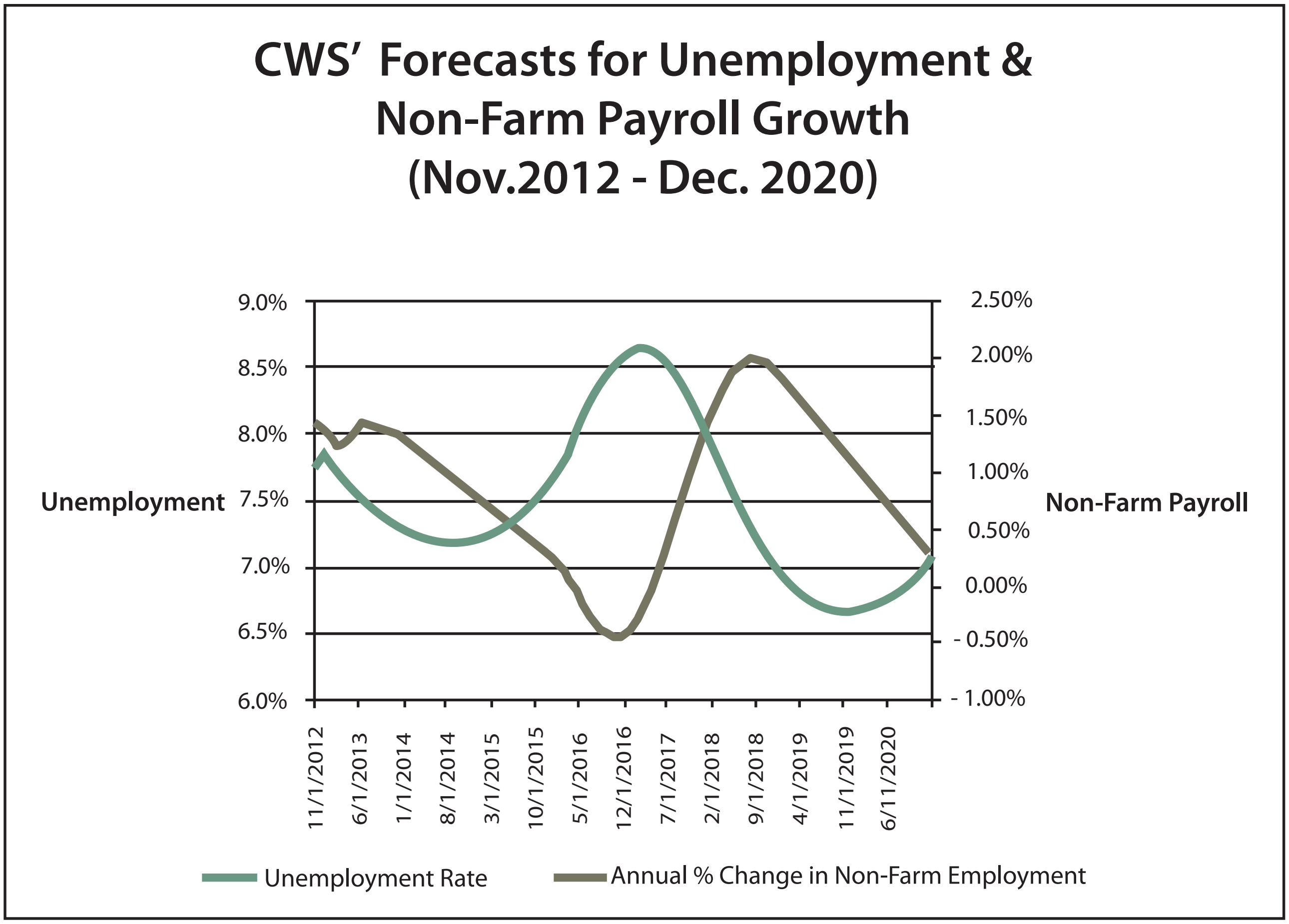
make job growth positive on a decelerating basis through March 2016 until it reaches zero and then drops by 0.4% (far shallower than any other recession) and stays negative for 12 months through March 2017 and starts growing again until it reaches 2% in September 2018 and then decelerates back to 0% by December 2020. The following chart shows the trajectory of unemployment and non-farm job growth based on these assumptions.



Source: Proprietary graph produced by CWS using CWS assumptions.

As you can see, based on these assumptions, the unemployment rate doesn't come close to 6.50% until 2019, far later than the Fed's forecast and this doesn't even contemplate a material downturn or any increase in the labor force participation rate.

So there you have it. Now that the Fed has revealed its playbook, I thought I should reveal mine as well. My eyes will be all over the employment report each month so I can update my spreadsheet to see who is more on track, Ben Bernanke or CWS. Based on my crystal ball, I am in the camp that short-term interest rates will remain at less than 1% beyond 2015.