Volume 25, No. 4, January 27, 2012

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

Prior to March 1, 2012
K-1's Mailed

April 2, 2012
CWS Annual Partners Meeting
Newport Beach Marriott Hotel and Spa

April 6, 2012
Good Friday
CWS Offices Closed

April 15, 2012
Semi-Annual Conference Call

April 15, 2012
1st Quarter 2012 Estimated Tax Payment Due

April 27, 2012
1st Quarter 2011 Quarterly Packages Mailed

May 2012
CWS Capital Partners
Semi-Annual Conference Call

May 28, 2012
Memorial Day
CWS Offices Closed

July 4, 2012
Independence Day
CWS Offices Closed

July 15, 2012
2nd Quarter 2012 Estimated Tax Payment Due

July 15, 2012
2nd Quarter 2012 Quarterly Packages Mailed

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A POLITICAL CALCULATION

By Gary Carmell

"The economic system had pulled out of its sinking spell of 1929-33 only to become a chronic invalid, whose temperature was lower now in the mornings but showed no signs of returning quickly to normal. Americans were getting used to the fact that nine or ten million of their fellow-countrymen were out of work…The economic headquarters of the country had not only moved from Wall Street to Washington, but apparently had settled down there for an indefinite stay…No major decision could any longer be made in Wall Street without the question being asked, 'What will Washington say to this?"

"All this development of the Federal power the Republicans viewed with loud alarm; yet with such an air of inevitability did the growth take place that one wondered whether the Republicans, should they come to power, would be able to reverse the trend. It seemed likely that the difference between the two parties would be that one of them, in moving toward the concentration of power in Washington, would move with the throttle open; the other, with the brakes on…Surely, the visitor from

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Mars would would have said, these parties which so denounce each other are virtually as Tweedledum and Tweedledee…Bitterly the campaign progressed. Not since 1896, certainly, had public feeling run so high over an election. To hear angry Republicans and angry Democrats talking, one would have supposed the contest was between a tyrant determined to destroy private property, ambition, the Constitution, democracy, and civilization itself, and a dupe of Wall Street who would introduce a fascist dictatorship."

--Frederick Lewis Allen, Since Yesterday – The 1930s in America (1940)

All roads lead to Washington D.C. today as they did in the 1930s. With this being the case it's important to have a sense of where things are headed because most major industries will be impacted by decisions coming out of the Capitol, especially housing. This is especially true in an election year and few issues have taken on more prominence than the role and size of government and how to tackle our record post-war deficits. From a CWS perspective, decisions regarding how the deficit is handled will have an indirect impact on borrowing costs and the supply and demand for apartments.

I will work backwards and tell you how I think the story unfolds and then provide you with more details to support my assertions. Given,

1. The private sector is cutting its debt load, especially the financial sector;
2. Households need to rebuild their savings;
3. Housing remains oversupplied as foreclosures continue to take place in large numbers;
4. Monetary policy is nearly impotent with short-term interest rates at near 0%;
5. Inflation is very tame given global overcapacity, especially with regard to labor;
6. Tax rates are relatively moderate on a historical basis so there is less impact from cutting them than when they are higher; and
7. There are approximately 13.3 million people unemployed;

there is no choice but for the federal government to fill the hole created by the deleveraging (debt reduction) by issuing new Treasury securities (deficit spending) that will prop up demand in the economy and provide more savings (Treasury securities) to households.

I know this sounds heretical but we have to come to terms with the fact that blood is being drained from the U.S. economy by debt repayment and a desire for more savings (a leakage of spending out of the system) and that the last thing we need to do is apply leeches (tax increases) to the patient to drain more blood or reduce the flow of blood (cutting spending) when there is such demand deficiency. The only way out of our deficit problem is through growth and we cannot achieve growth through tax increases and

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spending cuts. Those can only occur down the road after U.S. households and consumers have rebuilt their balance sheets and have enough confidence to be able to spend and invest so that businesses can invest and hire so they can pass the growth baton from the public sector to the private sector. In the meantime, deficits help keep demand more elevated in the U.S. economy and provide additional savings (U.S. Treasuries) to a savings-deficient household sector mired in over-leveraged real estate, stagnant incomes, a weak job market, and tight credit. It will take many years to achieve the handoff to the private sector. If we worry about the deficit, we risk running into the same problem FDR faced when he sought to balance the budget in 1937 and precipitated a terrible recession which gave up approximately 67% of the growth in industrial production achieved from the bottom of the Great Depression in only nine months.

Bridgewater Associates is the world's largest and most successful hedge fund manager. In a January 3, 2012 Wall Street Journal article about Bridgewater, the following points here conveyed reinforced the deleveraging thesis:

> Robert Prince, co-chief investment officer at Bridgewater, and his managers at the world's biggest hedge fund firm are preparing for at least a decade of slow growth and high unemployment for the big developed economies. Mr. Prince describes those economies—the U.S. and Europe, in particular—as "zombies" and says they will remain that way until they work through their mountains of debt.
>
> "What you have is a picture of broken economic systems that are operating on life support," Mr. Prince says. "We're in a secular deleveraging that will probably take 15 to 20 years to work through and we're just four years in."
>
> In Europe, "the debt crisis is [a] long ways from over," he says. The economic and financial morass will mean interest rates in the U.S. and Europe will essentially be locked at zero for years.

Yet, despite what I think is the solution, keeping the spigot open, I don't believe the political will exists to do this to the levels we need. Austerity and deficit reduction seem to be the publicly stated intentions of both political parties. If this truly comes to pass then I believe this will result in a more slowly growing economy than would otherwise be the case and continued low interest rates for many years to come. For this reason, a fair number of our recent financing decisions have been to select variable rate loans. This may seem odd given how attractive fixed rate loans are and that short-term interest rates have nowhere to go but higher. There are some distinct advantages with variable rate financing, however. They have much lower cost pre-payment penalties which provide us with greater flexibility in the event we want to sell the property or even refinance it. With fixed rate loans we would require buyers to assume the financing we have in place due to significant

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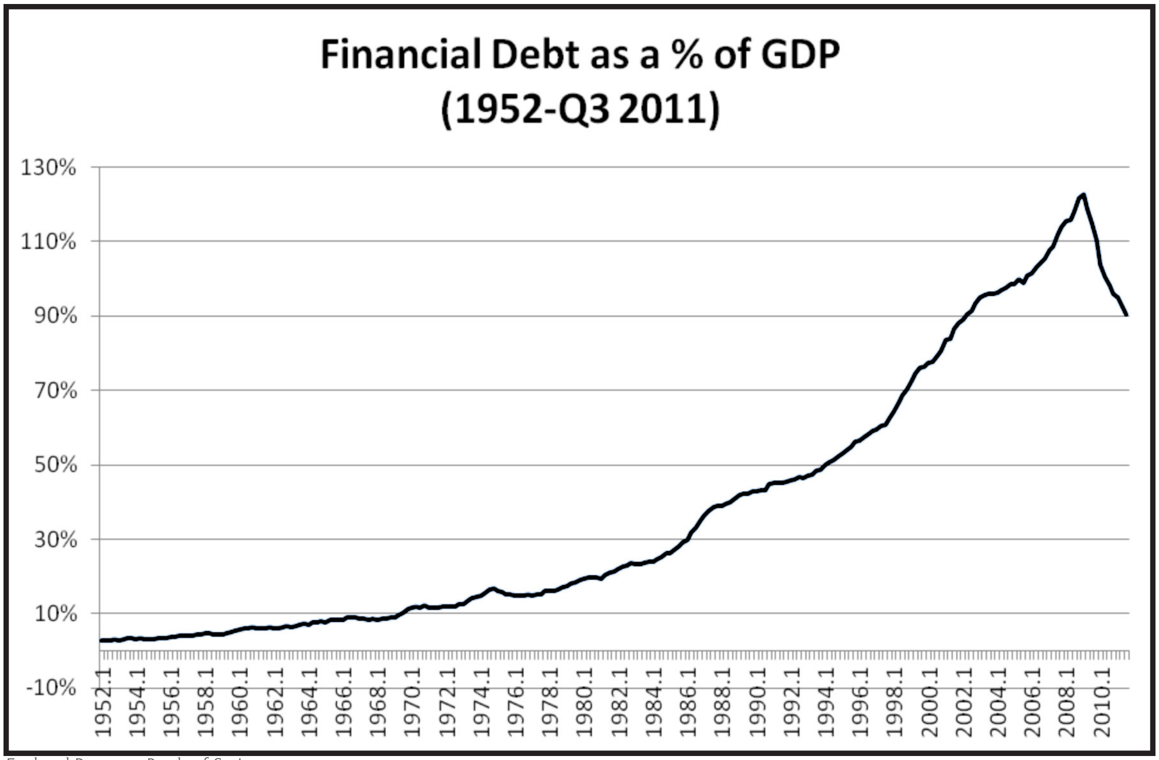

Source: Federal Reserve Bank of St. Louis

pre-payment penalties we would have to pay. This in effect lessens the buyer pool because most purchasers prefer to structure their own financing rather than having it forced on them. These variable rate loans also have conversion features which allow us to switch to a new fixed rate loan with a longer term if we think that makes sense at the time. Finally, there is typically close to a 1% starting rate advantage versus the prevailing fixed rate alternative at the time the loan is originated. We think this advantage should remain in place for at least two years based on stated Federal Reserve policy of holding rates where they are through at least mid-2013.

What will move short-term rates higher? Albert Einstein said, "Everything should be made as simple as possible, but not simpler." In the spirit of Einstein I think it simply comes down to the fact that jobs and job growth are very difficult to generate when the private sector is de-leveraging (cutting its debt burden). Let's look at a couple of charts. The first is the total debt outstanding of financial firms as a percentage of Gross Domestic Product (GDP):

The chart above clearly shows that as each decade passes, our economy has become much more "financialized". Whether we like it or not, we have been heavily dependent on Wall Street and I think this is one of the reasons behind the Occupy Wall Street movement. When humans feel powerless and perceived to be at the mercy of ignominious forces, they want to lash out and regain some sense of power, control, and dignity. The chart also shows a stunning and unprecedented drop in financial debt since 2008 as a result of the near cataclysmic collapse in the global financial system that started with the sub-prime mortgage debacle and spread to housing overall, the stock market, high yield debt, and now Europe. Why

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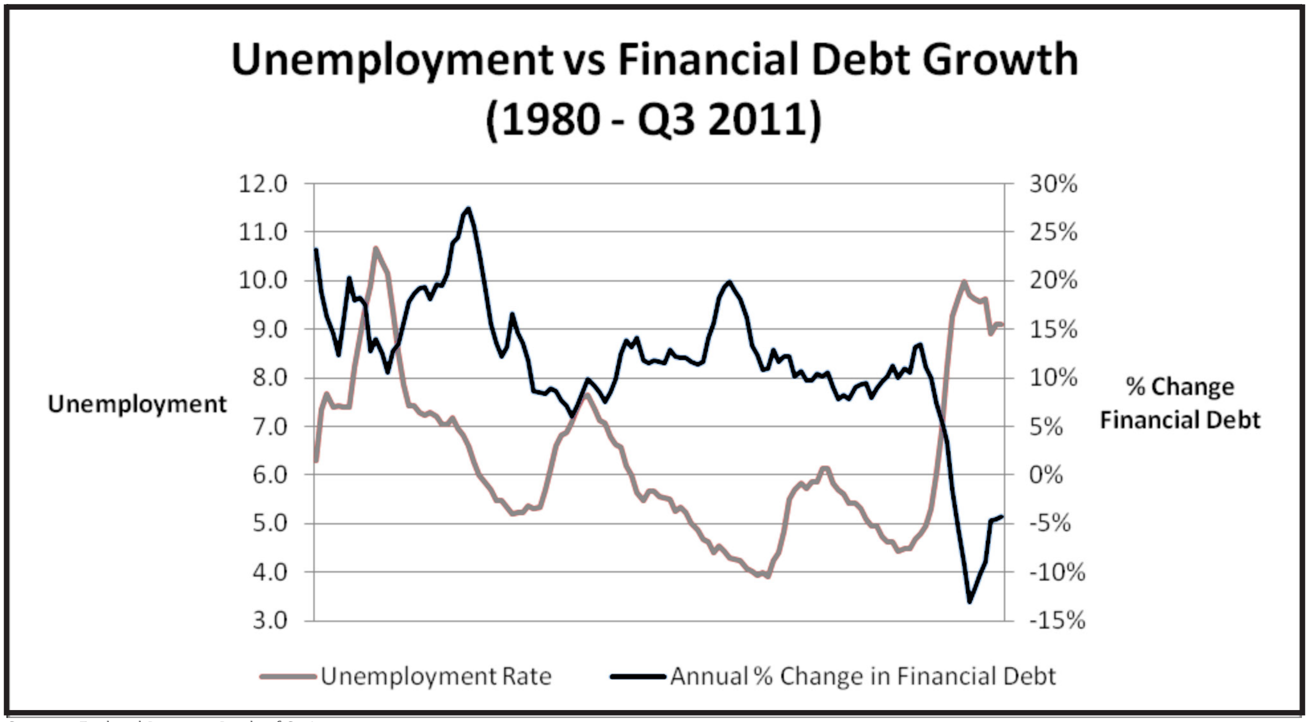

Source: Federal Reserve Bank of St. Louis

is this important? Because the more "financialized" we have become, the more connected our job creation has been to the growth of debt in the financial sector as the chart above shows.

The chart above shows when financial debt grows, the unemployment rate drops, and when it contracts, unemployment expands until both exploded in the opposite direction with the global financial meltdown that commenced in late 2007. It appears that the bleeding has stopped…for now. If Prince of Bridgewater is correct, however, we still have another ten years or so to go before the deleveraging ends.

What Has Filled the Void?

With such drastic debt reduction occurring in the private sector, something had to fill the void, lest we spin into a deflationary vortex of depression. This is where the federal government stepped in with unprecedented post-World War II spending. It is for this reason that I started this article with excerpts from the extraordinary book, <u>Since Yesterday – 1930s in America</u>, as I believe there is no better parallel to today than what took place in the 1930s which was preceded by the boom of the 1920s, akin to our 2000-2007 period. I attempt to look at the world as realistically as I can, study history to find the best historical parallels, and do my best to assess how things will unfold and what we can do to best prosper from the circumstances or to avoid the risks that may materialize.

Earlier I stated that we need to continue to keep the spending spigot on to avoid spiraling downward economically and ultimately, socially. Why am I so adamant about this? Using the Einstein approach, the following chart sums it all up for me.

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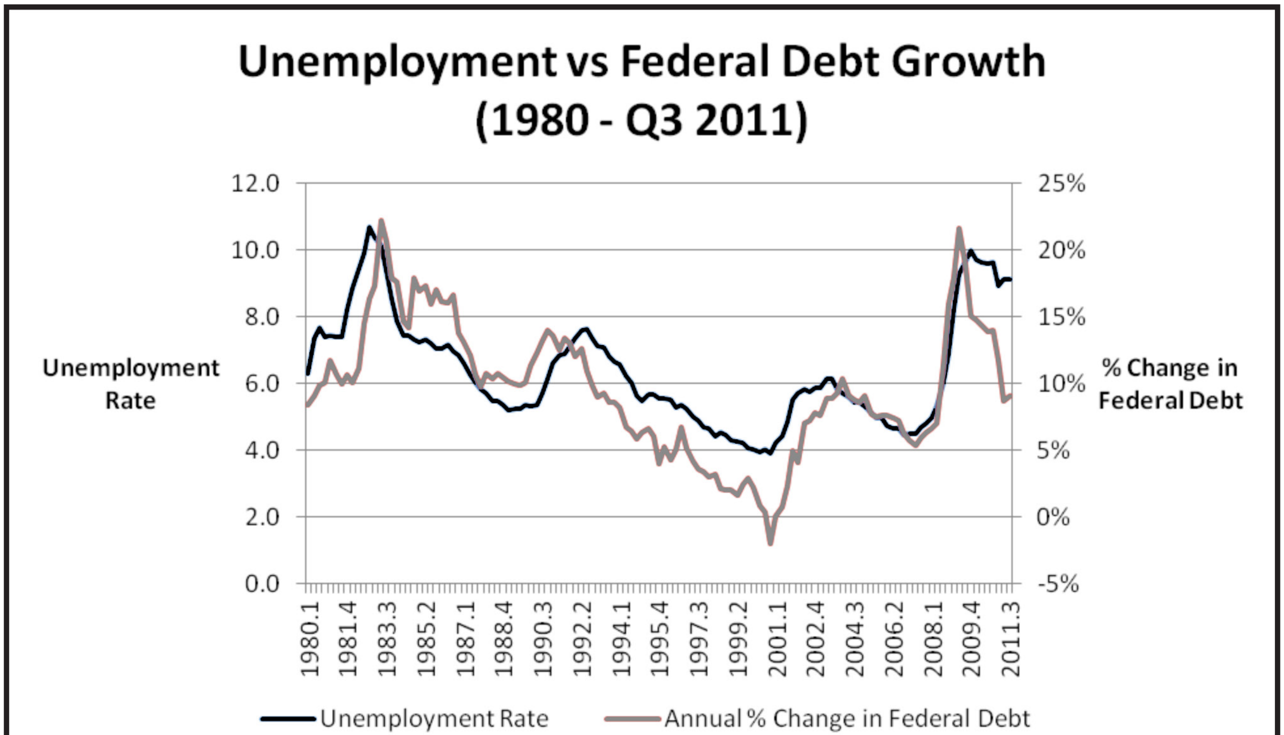

Source: Federal Reserve Bank of St. Louis

This chart shows the annual percentage change in federal government debt outstanding and the unemployment rate. It doesn't take a real keen observer to see that when unemployment goes down so does federal government borrowing and when unemployment goes up so does federal government borrowing. This should convey to those worried about the deficit that the solution is simple: get people working again. More jobs mean more tax revenue, heightened economic activity, and less expenditure for unemployment insurance and other social safety nets and the collateral costs of people being out of work (crime, health problems, psychological issues, hunger, etc.). **We have a jobs problem which results in a deficit problem and not the other way around.**

The only way out of the problem is through economic growth and this is where the analysis comes back to our borrowing strategy articulated at the beginning of the article, low interest rates for a long period of time. Interest rates kept lower than the rate of economic growth will allow us to grow our economy much more rapidly than our rate of growth of our debt while still allowing us to rack up huge deficits over the next ten years or so to cushion the blow of private sector deleveraging. By suppressing interest rates, the Federal Reserve can do its share to keep the cost of borrowing low for the federal government so that it can carry out an orderly transition back to the private sector over the next decade to once again become the engine of growth.

What about inflation? Nothing to worry about given the tremendous excess capacity we have in the global economy, especially when it comes to labor. So what am I worried about? Austerity. If we cut back federal

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expenditures too much then interest rates will remain low but the damage it could do to the labor market could hurt demand for apartments if more people lose their jobs and move back home or double up with roommates. If you look closely at the last few data points on the last graph you can see the beginning, significant divergence between the growth rate in federal debt and the unemployment rate. Although the federal debt is still growing, it's increasing at a much slower rate while unemployment has barely budged. Considering the growth rate in the debt, one would have expected that the unemployment rate would be much lower, but it's not. I fear that austerity is beginning and we are on the verge of creating a lot more unnecessary pain to our economy and citizenry.

As apartment owners I would expect mild austerity to keep more people renting, allow for interest rates to remain low, and enable us to continue to increase rents provided there is not a meaningful increase in supply of new apartments built. Overall, I am hard pressed to think of an industry as well-positioned as ours to benefit from an environment of mild austerity. I will sign off with one more excerpt from Since Yesterday– The 1930s in America (1940) to draw a parallel from the past that I think is still relevant for today and why large deficits will be with us for many years to come whether we like it or not:

"Throughout these early years of the New Deal the levels of prices and wages and the structure of corporate and private debt were being artificially supported by government spending – or, to put it another way, by the failure of the government to levy high enough taxes to take care of the spending. If it had been possible for the law of supply and demand to work unhindered, prices and wages – and the volume of corporate and private debt – would theoretically have fallen to a "natural" level and activity could have been resumed again. But it was not possible for the law of supply and demand to work unhindered. In a complex twentieth-century economy, deflation was too painful to be endured. Hoover had set up the RFC because the banks couldn't take it; Roosevelt had set up the Federal relief system because human beings couldn't take it."