Volume 32, No. 2, July 27, 2018

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

September 3, 2018
Labor Day Holiday
CWS Offices Closed

September 17, 2018
3rd Quarter 2018
Est. Tax Payments Due

October 15, 2018
2017 Personal Income Tax Return
Extensions Due

October 26, 2018
3rd Quarter 2018
Quarterly Packages Mailed

November 22, 2018
Thanksgiving Day Holiday
CWS Offices Closed

November 23, 2018
Day-after Thanksgiving Holiday
CWS Offices Closed

December 24, 2018
Christmas Eve Holiday
CWS Offices Closed

December 25, 2018
Christmas Holiday
CWS Offices Closed

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AIM 2018 Recap

By Gary Carmell

Normally I do a summary of my annual investor meeting presentation after the first quarter because we typically have the meeting in April. This year, however, the meeting was in May so I thought I would use this Quarterly Update article to summarize some of the key points that I tried to convey during my presentation at the meeting.

There has naturally been a lot of concern over rising interest rates as approximately 80% of our debt is variable-rate. Until this point we have been able to capitalize on this by having a lower cost of funds that has translated to interest savings of over $70 million since 2012. When we factor in the lower prepayment penalties from having repaid nearly $1 billion in floating-rate loans prior to their maturity

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versus either paying much higher penalties or selling our properties for less due to requiring the buyer to assume the fixed-rate debt, this would bring the total savings to over $100 million.

Currently, the average interest rate that we are paying is very close to the prevailing fixed-rate that was available at the time of origination of our variable-rate loans. And while interest rate increases from this point forward will generally be slightly negative relative to the prevailing fixed-rate that we could have put in place, new variable-rate loans are still about 75 basis points lower than current fixed-rate loans. In addition, we still retain the pre-payment flexibility in the event that we want to sell our properties, refinance them if interest rates drop, we want to extract equity, or use some of the equity we have built up to reinvest in the properties.

Currently there is very little difference between short-term interest rates and long-term rates. This means the yield curve is quite flat. Historically this has been a pretty good indicator of an economy that will be slowing down or potentially going into a recession, although this is more typically the case when short-term rates actually are higher than long-term rates. We are approaching this point if the Fed hikes one to two more times as there is a very good chance that the curve will be inverted.

I went and looked back over time at what happened to short-term interest rates one to two years later when the differential between the 10-year Treasury note yield and the 2-year Treasury yield was one-half percentage point (50 basis points) or less. You can see from the following table that there was a significant probability that short-term interest rates over the next year, and especially the next two years, would be lower when the yield curve compressed to 50 basis points or less.

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Probabilities of Short-Term Rates Being Lower 12 Months Later

	% Lower	% Higher	% Lower when 10Yr minus 2Yr <50 Bps	Median Increase When Rates Rose
Since 6/1/76	53.7%	46.3%	64.6%	1.41%
Since 1/1/84	58.4%	41.6%	72.4%	1.05%
Since 1/1/2000	57.2%	42.8%	70.8%	1.04%

Probabilities of Short-Term Rates Being Lower 24 Months Later

	% Lower	% Higher	% Lower when 10Yr minus 2Yr <50 Bps	Median Increase When Rates Rose
Since 6/1/76	56.1%	43.9%	71.4%	1.73%
Since 1/1/84	56.6%	43.4%	80.8%	0.75%
Since 1/1/2000	59.5%	40.5%	87.2%	1.31%

Of course past results are no guarantee for future outcomes but one can see that the probabilities increase materially that short-term rates will be lower one and two years ahead when the differential between the 10s and 2s is 50 basis points or less. And when rates do rise they typically rise about 1% over the first twelve months and between 0.75% and 1.73% two years later. Thus, even when they do rise, they typically do not increase significantly.

One can see how flat the curve has become via the following chart showing the differential between 10-year Treasury yields and 2-year yields.

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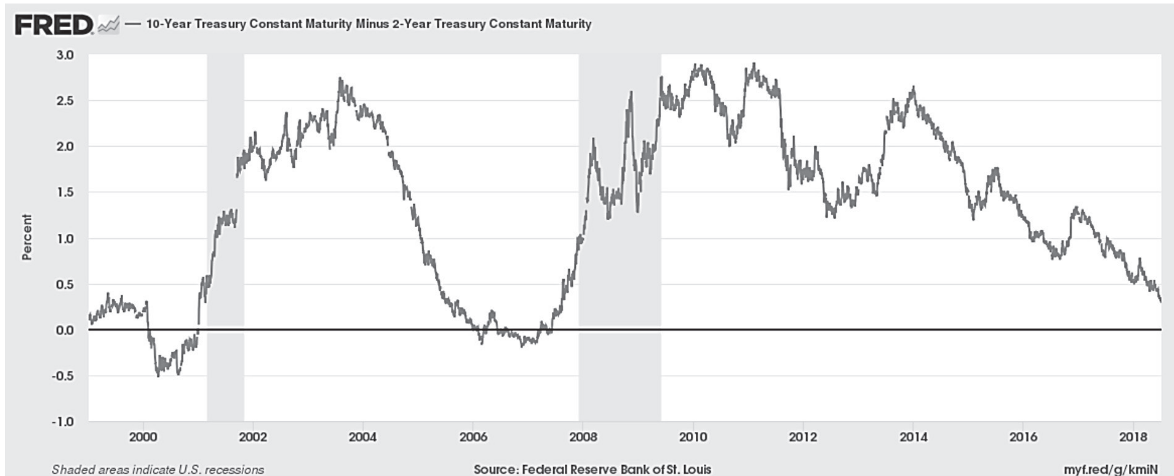
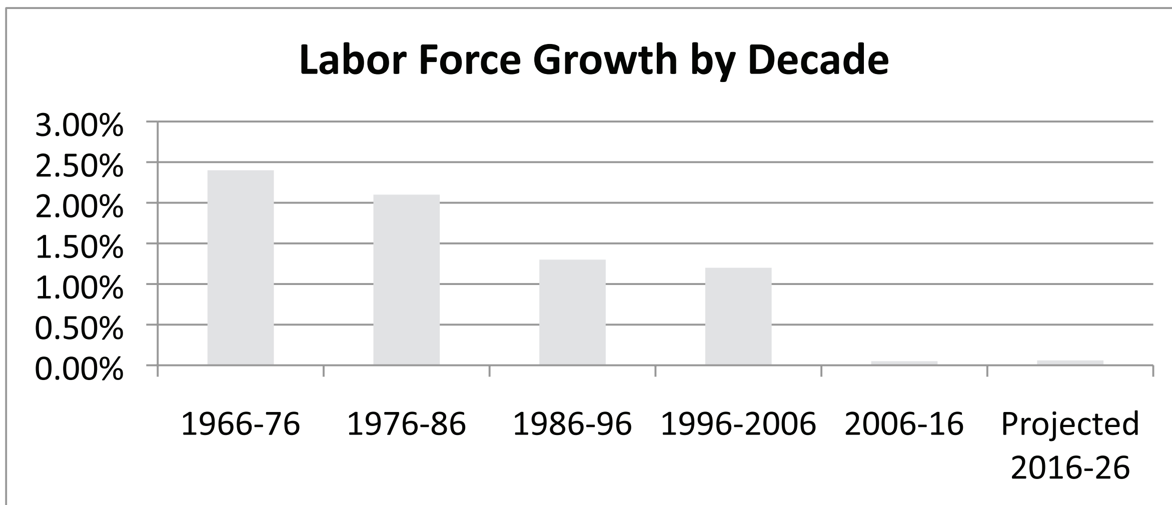


It's not surprising that a flat yield curve would lead to lower short-term rates in the future because our banking system is based on having a fairly steep yield curve where banks can gather deposits and pay relatively cheap short-term rates and then lend those dollars out at higher yields as a result of long-term interest rates being higher.

Besides the very narrow yield curve telegraphing a high probability of lower rates over the next 24 months, I still believe that we will see low rates for a long period of time due to the aging of western societies and correspondingly slower growing labor forces. The following table puts this in perspective and was presented at the meeting.



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Finally, the last key point presented was how strong our markets have been compared to the rest of the country. The following tables show population and job growth between 2000 and 2017 in the metropolitan areas that we are invested in and I compare them to the rest of the country (backing out our markets).

Population Growth

	2000	2017	% Growth	% of U.S.
CWS Markets	28.09 million	40.12 million	42.8%	9.95%→12.31%
U.S. w/o CWS Markets	254.16 million	285.72 million	12.4%	N/A
CWS Markets Growth/U.S. Growth			345%	

Job Growth

	2000	2017	% Growth	% of U.S.
CWS Markets	14.62 million	19.62 million	34.3%	10.97%→13.23%
U.S. w/o CWS Markets	118.61 million	128.74 million	8.5%	N/A
CWS Markets Growth/U.S. Growth			401%	

One can see that in aggregate the markets we have selected and invested in have dramatically outperformed the rest of the United States. Population has grown by almost 3.5 times the rest of the country while job growth has done even better with an outperformance of 4 times.

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The trade-off of course is more growth sometimes occurs because the cities and areas have more land available to create new supply of housing and offices and that allows for more affordable housing and brings more people in so it's sometimes a bit of a double-edged sword. This can lead to periods of over-supply as developers get ahead of the demand. The positive to this is that there is an ample supply of housing to accommodate growth until the market tightens up again which typically leads to higher rents and then ultimately more development to satisfy the demand.

Currently supply is somewhat ahead of demand resulting in newer product having a more challenging time. Although new communities are leasing up, they are having to do so by offering rent concessions. We think the next couple of years will be somewhat subdued in terms of rent growth. And while we are seeing positive rent growth in our portfolio we are contending with headwinds that make it more difficult to translate this rent growth into meaningfully higher Net Operating Income and distributions in the face of higher interest rates and a much more competitive labor market that's putting pressure on wages. We are also seeing rapidly rising construction costs and property taxes that are still a challenge that we are fighting aggressively.

We are still quite bullish on apartments as a solid, long-term investment due to favorable demographic and social trends, the perpetual need for housing in growing areas, and a more challenging environment for developers that may make it more difficult to deliver meaningfully higher supply after this wave crests in 2019.