REAL-ITY

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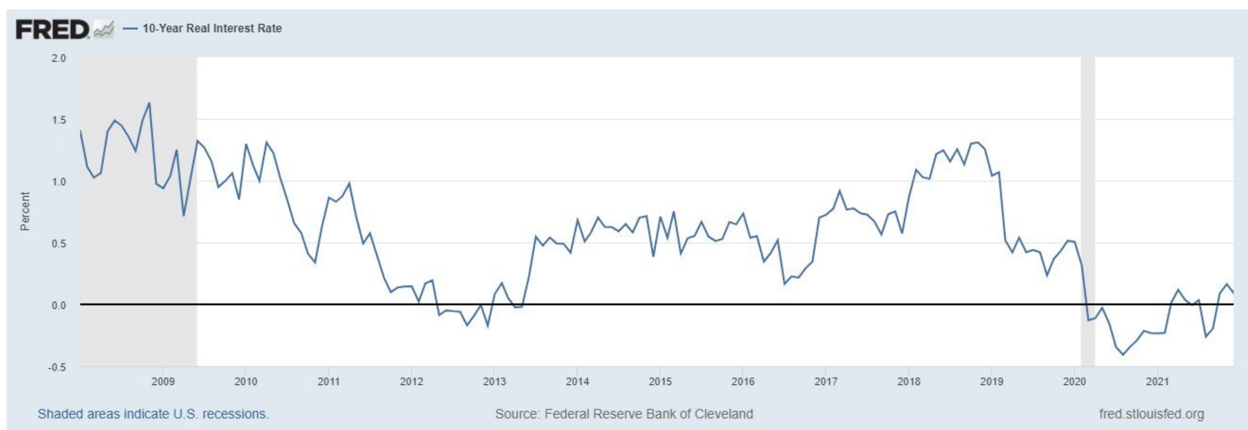
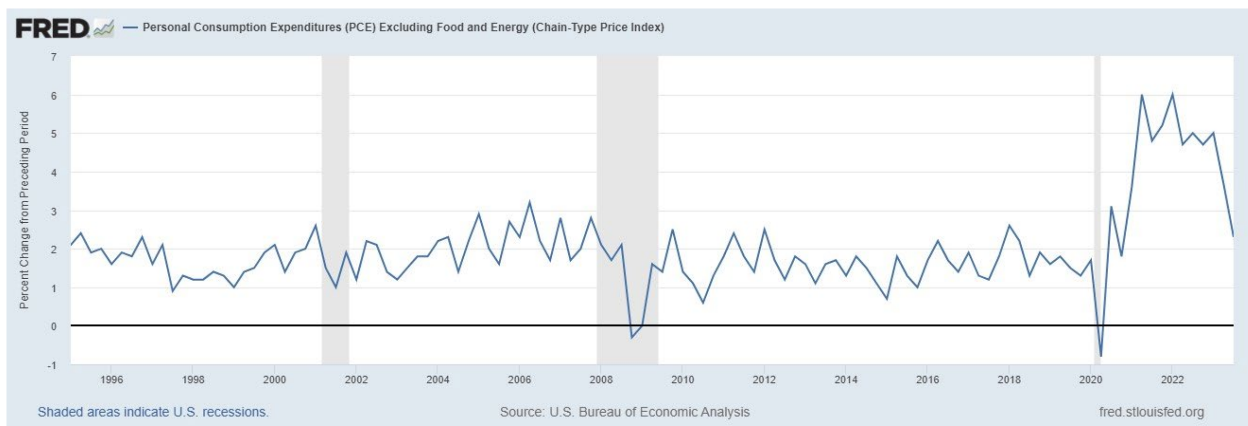
People often use the phrase “The New Normal” which is probably overused by now. We have called this report “The Real Normal” as it’s our belief that we have probably gotten out of the long emergency that took place between 2007 and 2021 encompassing the Great Financial Crisis, the sluggish recovery, and then Covid. This period was one in which the predominant risk was financial crises and correspondingly low inflation to potentially deflation. This led the Fed to keep rates under 2% for most of that time and for long periods of time less than 0%. Correspondingly, the real rate of return, which is the interest rate after backing out inflation hovered around 0% to even being negative at times for 10-year rates as this chart shows.

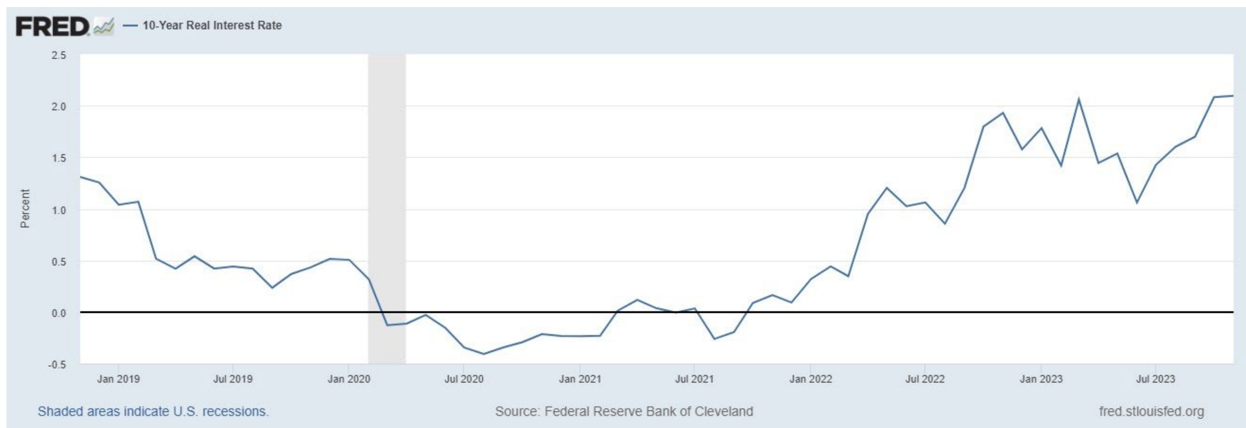


During this time the 10-year real rate averaged approximately 0.56%. With the fiscal and monetary bazooka that was unleashed, escape velocity was reached and the Fed and Congress finally took the actions necessary to break inflation out of its 2% holding pattern that it had been in for a very long time as the following chart shows.



Inflation is clearly on the downtrend and appears to be heading back to 2% but because of the fact that the federal government finally showed that it has the will and ability to flood the economy with money to get us out of a low inflation, low credit risk environment to an environment with solid income growth

and higher inflation, investors now have to price in greater risk of losing their future purchasing power. As a result, real rates have gone up materially since 2022 as this chart shows.



This adjustment to higher real rates has had a big impact on the cost of capital and, correspondingly, the valuation of all leveraged asset classes, including apartments. We expect that compelling opportunities will arise as far too many loans were originated between 2021 and 2022 using high leverage levels with high spread, variable-rate structures that were predicated on rents continuing to rise rapidly and were dependent upon rates staying low so they could exit these loans either with a profit or not need additional capital when they would come due in three years. Said differently, a lot had to go right, and all those variables couldn't fall short since there was very little margin of safety. These loan terms were short, the prices paid were very high, and the cost of debt was quite high but serviceable if rates stayed very low. Of course, rates didn't stay low. The Covid boom in rents did not hold as more supply came online and more people had to return to the office. Interest rate cap costs also exploded which put additional pressure on these borrowers.

The shift to a much higher required real rate of return will put a lot of pressure on developers with construction loans coming due in 2024 as well as those who purchased properties in 2021 and 2022 utilizing high leverage loans with three year maturities. We expect that CWS will be well positioned to take advantage of some of these opportunities in 2024.

**Disclosures: Past performance is not necessarily indicative of future results. There can be no assurance that any investment opportunity with CWS will be able to implement its investment strategy, achieve its investment objectives, or avoid substantial losses. All investments carry some degree of risk.*