Wisdom

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Now is not the time to be making bold predictions about the future of the U.S. economy. There are too many one-time events that have occurred during the last two years to allow one to use history as a prediction of the economic future over the next couple of years. Neil Kashkari, president of the Minneapolis Fed, said recently in an essay, “Models seem ill-equipped to handle a fundamentally different source of inflation.”

The government injected $1.8 trillion of stimulus funds into the economy over a two-year period and the total stimulus will be in excess of $2.5 trillion. As this has never occurred so rapidly or to this magnitude, it is no wonder the expert economists are forecasting a range of near-term outcomes from a soft landing to a severe recession. Knowing that modeling the near-term future of economic growth is very difficult, CWS has adopted an attitude of **patience in action** as we process opportunities to purchase Class A apartments in our existing markets. By processing every transaction that occurs in our markets, we are able to keep a pulse on the pricing while only acting when our opinion of value matches the seller's needs. We are very comfortable being outbid by others who have a different perspective on value.

Although it is difficult to predict the near-term future because of so many one-time events, there are several significant data points that guide us in forming our opinions about supply and demand in our markets going forward. Having insights about the long-term supply and demand has led to many successful investments. There are a few things we do know. Post the Great Recession and for over 10 years, the amount of new construction for single family homes plus multifamily housing has been far below levels required to meet the household formation based on demographics. Up until 2020, the total deficit was growing every year based on low new construction levels. For that reason, a shortage of available housing is present across the U.S. and is particularly acute in the growing markets where we operate.

Secondly, home prices have more than doubled in many of our markets in the last 10 years, including Phoenix, Atlanta, and Austin. With interest rates doubling in the last two years, the cost to own a home has essentially doubled as well for those buyers requiring a mortgage. Since there are twice as many homeowners as there are renters, if 2% of the prospective homeowners become renters, the renter population will increase by 4%.

Thirdly, we know what the Fed is saying—higher for longer. We also know what the Fed says they will do is not necessarily what they will do. What they have done to date though can be counted as fact. In 2022, the Fed increased the overnight interest rate at an extremely rapid pace going from 1/4 of 1% to 4 1/2% in less than a year. This size and pace of increase will surely slow the economy significantly. The

effect on the economy will not be known for six to 12 months because there is a lag time from the time of increase to the ultimate impact on the economy. It is clear that single family housing construction starts will be reduced significantly as higher mortgage costs adversely affect the first-time home buyer.

Since the Great Recession, lenders providing financing for apartments have been very conservative in the amount of debt they would provide for a project purchase. Typically, it is approximately 60% of the total purchase price. More recently, it has dropped to about 50% of the purchase price. The discipline of the financing sources for apartment acquisitions over the last 10 years has resulted in most of the apartment owners having enough equity to refinance their properties comfortably as the loans come due. In 2020 and through 2021, capital sources created a way for apartment purchasers to increase their leverage in the form of debt funds. These funds are relatively expensive capital and short term in nature —typically three years. As those loans mature, it will be difficult to obtain a new loan because it is hard to replace a 75% of purchase price loan when market loan-to-value is closer to 50%. Some of these owners will have to sell under pressure and that is the time we would like to be a buyer. We don't expect this to be widespread, but we do expect it to occur in some cases.

In 2023 we expect apartment deliveries to be quite robust as construction delays have resulted in new units ready for lease reaching multi-decade highs. After this, however, we expect the level of multifamily construction to be reduced as the cost of construction and the cost of capital have both increased significantly during this transition. This has changed the economics of building and made it much more difficult for developers to access equity to fund new projects.

While the prospects for new supply look favorable starting in 2024, the demand side is not as predictable. The rate of household formation typically slows in a recession. If we have a recession, young people will stay at home longer and some who have been renting a unit by themselves will double-up, reducing demand for apartments. If this does occur, these young people do not go away, they just delay when they form a new household. There will be a bulge to offset any earlier reduction in household formation sometime over the next several years.

Over the past 50+ years, these times of uncertainty have provided CWS with some of the most successful opportunities for our investors. As we are in real estate investing for the long term, I am comfortable with the CWS approach to managing this market disruption with patience in action, which should result in outstanding returns.