

PATIENCE

By Steve Sherwood
Co-Founder, Chairman

Our theme this year is the same as it was in 2023 and many of the unique conditions that made forecasting in 2023 so difficult remain in place today. The Fed continues to implement economic tightening with a high Fed Funds rate of 5.25%, while also reducing its balance sheet. Major wars continue with no end in sight. The programs put in place during the pandemic, such as the Economic Recovery Act, Inflation Protection Act, and the Infrastructure Bill are all still pumping money into our economic system. This distortion has rendered economic forecasting tools that rely upon normal cycles to be somewhat unreliable.

There are also differences about what is happening in 2024 as compared to 2023. There's been a shift in the Fed's messaging to reflect the change from controlling inflation at all costs to controlling inflation while protecting jobs. This has resulted in an official Fed position of pausing rate hikes. The prospect of lower interest rates has heightened some optimistic views of the economy going forward.

The rapid rise of rental rates for apartments in the first half of 2023 has pulled back significantly and will likely remain subdued in 2024. The number of new construction starts of apartments has dropped off significantly from the starts in 2023 and other recent years, and will likely continue throughout this year and beyond.

There was a large number of apartment communities purchased at high prices with high leveraged short-term loans (3 years) created in 2021. These loans will come due in 2024, increasing the number of distressed sellers needing to take action.

Although 2024 is a lot like 2023, one way to describe the differences as we see it here at CWS would be to look at the themes for '23 and '24, which are the same in this manner. 2023 - PATIENCE in action; 2024 - patience in ACTION. Our patience will be present as we seize the opportunities created by the rapid unprecedented rise in interest rates.

The conditions are in place for distress transactions to occur in 2024 even if the Fed Fund rates are reduced significantly during the year. The reduction will not be sufficient enough to increase the amount of money that can be borrowed against an asset as compared to the amount of existing debt coming due.

It's likely the economy will slow this year, which may or may not result in a recession, but slowing, nonetheless. I am in the recession camp versus "the soft landing." In the apartment business, a slowing economy will have a significant effect on apartment rents as there is a large number of units in the pipeline that will be delivered throughout 2024. As mentioned before, the rate of new construction is significantly down, which will result in a void of apartment availability after the current sizable pipeline is absorbed.

As homeownership has become out of reach for many young people, it has increased the average age of renters from 37 years old to 41 years old in the last 20 years. This occurred before higher interest rates, which has resulted in the largest premium for homeownership over renting since it has been measured.

Many people will be renting for much longer based on the high premium for homeownership and the inability to qualify for a mortgage. The demand for rental properties will be very strong for a long time to come. The future of the apartment business is quite bright, even though there will be some challenges between now and the time our economy is back in a high growth mode.

Given the cost to construct apartments and the current rental rates, it's highly likely rental rates will have to move up dramatically before the next round of development occurs. We are already seeing signs that there will be sales of high-quality apartment communities in several of our markets at well below replacement cost. Our focus in 2024 will be to acquire these high-quality assets. It will take all our knowledge and resources to be able to buy these communities, as there is a significant number of well-capitalized smart buyers currently on the sidelines looking for the same opportunities. I am sure, as in past cycles, the CWS team will be able to successfully acquire some of these properties that will provide very significant returns for our investors for many years to come.