Volume 38, No. 1, April 26, 2024

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

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CALENDAR OF EVENTS

May 27, 2024
Memorial Day Holiday
CWS Offices Closed

June 17, 2024
2nd Quarter 2024 Est.
Tax Payments Due

July 4, 2024
Independence Day Holiday
CWS Offices Closed

July 26, 2024
2nd Quarter 2024
Quarterly Reports &
Distributions Delivery

September 2, 2024
Labor Day Holiday
CWS Offices Closed

September 16, 2024
3rd Quarter 2024
Estimated Tax Payments Due

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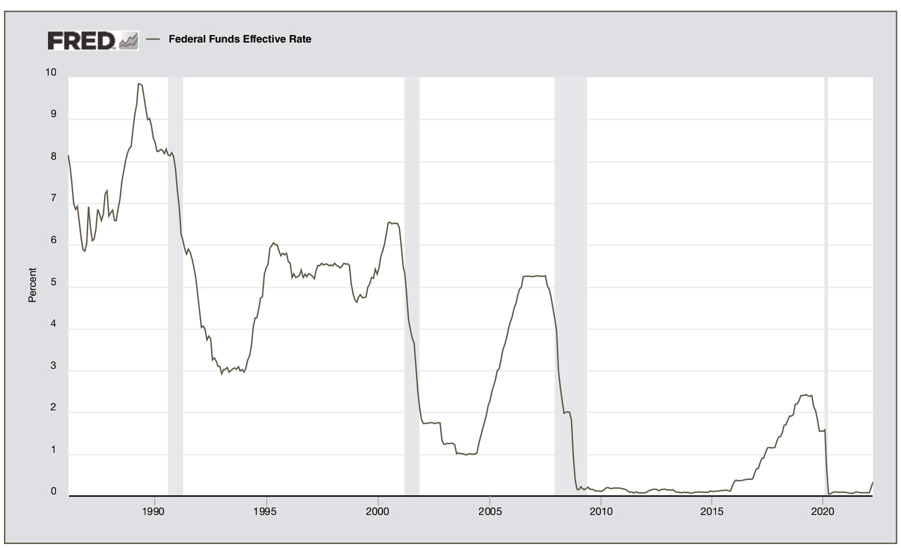
GOODBYE TO THE LONG EMERGENCY

By Gary Carmell

This article represents the salient points from my presentation at CWS' Annual Investor Meeting on April 2nd. Although I discussed the apartment market in some detail, space limitations will have me focus on the significant change in the Fed reaction function for this article.

From the mid-80s through early 2022 this chart shows how the Federal Funds Rate was on a continuous downtrend in which subsequent peak yields were lower than previous peaks and subsequent troughs were lower than previous troughs.



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This reflected a Fed reaction function operating from the perspective that the risk of disinflation leading to deflation due to a credit-centric economy was a greater concern than materially higher inflation. This focus became even more pronounced after the Great Financial Crisis in which both short- and long-term rates fell dramatically and stayed there for a long time until they began rising in 2016 through mid-2019. And after Covid hit, both short- and long-term rates fell off a cliff.

Covid unleashed not only lower rates but a bazooka of monetary stimulus and, more importantly, deficit spending that only had precedence during war time. The latter is what is the biggest change in my opinion and has ushered in the transition from what I have been calling "The Long Emergency" (late 2008 – March 2020) to the "Real Normal." The Real Normal is a play on the expression the New Normal and uses Real instead of New because it's predicated on the return of materially higher real (inflation-adjusted) interest rates akin to the 2001–2008 period which I think is more representative of the economic, financial, and Fed reaction function conditions to base one's decision-making on versus The Long Emergency.

These two tables are a great representation of the differences between the two policy regimes. The first one represents how inflation-adjusted yields on 3-month T-Bills were a negative 1.64% during The Long Emergency. In other words, investors were willing to accept short-term yields far below the rate of inflation because of the safety of T-Bills, a lack of concern about inflation, and liquidity value. This is far different than the 2001–2008 period which provided investors a short-term yield essentially equal to inflation, which I think is going to be more of the norm going forward.

3-Month T-Bill Comparison

	2009 – March 2020	2001 - 2008
Avg. Yield	0.54%	2.62%
Avg. Median CPI	2.18%	2.70%
Real Yield	(1.64%)	(0.08%)

10-Year Treasury Note Comparison

	2009 – March 2020	2001 - 2008
Avg. Yield	2.46%	4.41%
Avg. Median CPI	2.18%	2.70%
Real Yield	0.28%	1.71%

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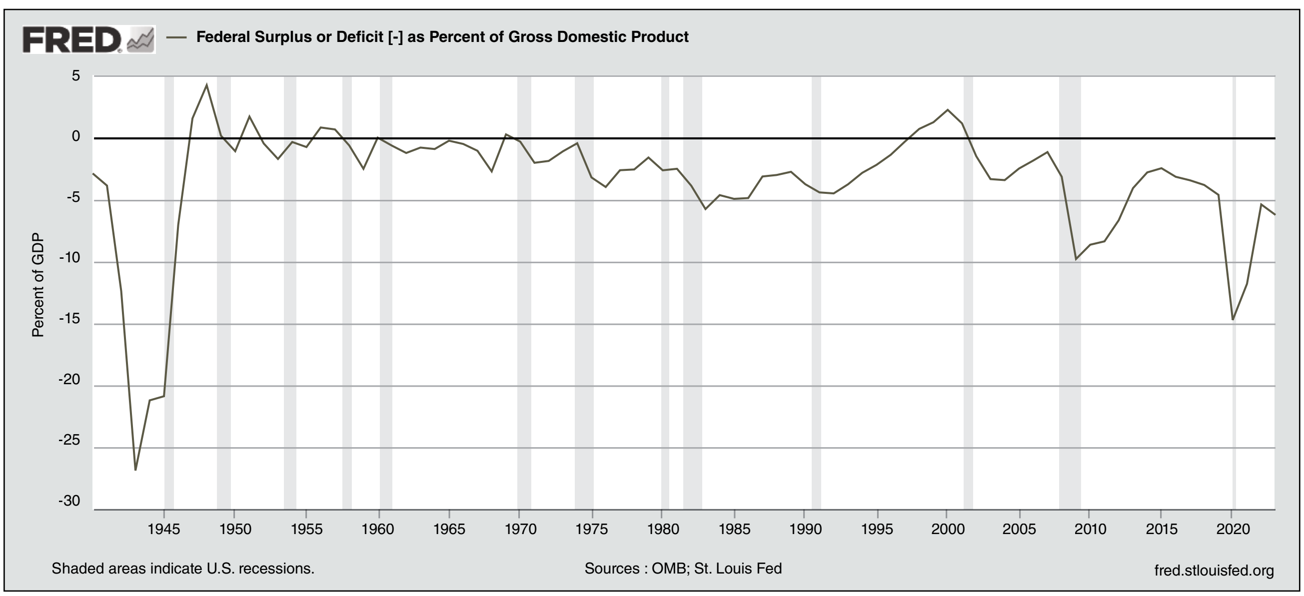
During The Long Emergency, the inflation-adjusted yield on 10-year Treasuries was approximately 0.25% above inflation, which does not seem like adequate compensation for having one's money invested for 10-years, albeit in instruments with no credit risk and tremendous liquidity. The 2001–2008 period is more akin to what I would expect investors would expect in terms of compensation, which is a real yield of 1.71%.

Before I discuss what this means for equilibrium short and long rates, I want to highlight the factors I think have contributed to the Fed policy regime change.

- Significant federal deficits even with healthy economic growth
- No loss of construction jobs
- Energy challenges due to A.I. and onshoring of manufacturing
- Healthy household balance sheets
- Greater global tensions.

In the wake of Covid the federal government unleashed extraordinary fiscal support. One can see from this chart that the deficit as a percentage of GDP was only exceeded by what transpired during World War II. Given the Covid shutdowns this is understandable to help avoid an economic depression.



What is critical from my perspective is that politicians saw the true power of such spending for their constituencies that there is no political will to cut the deficit. And why is this such a seminal issue for me? It's because, on average the federal deficit is approximately 3% less than the unemployment rate. Thus, for example, if the unemployment rate is 5.5% then one would

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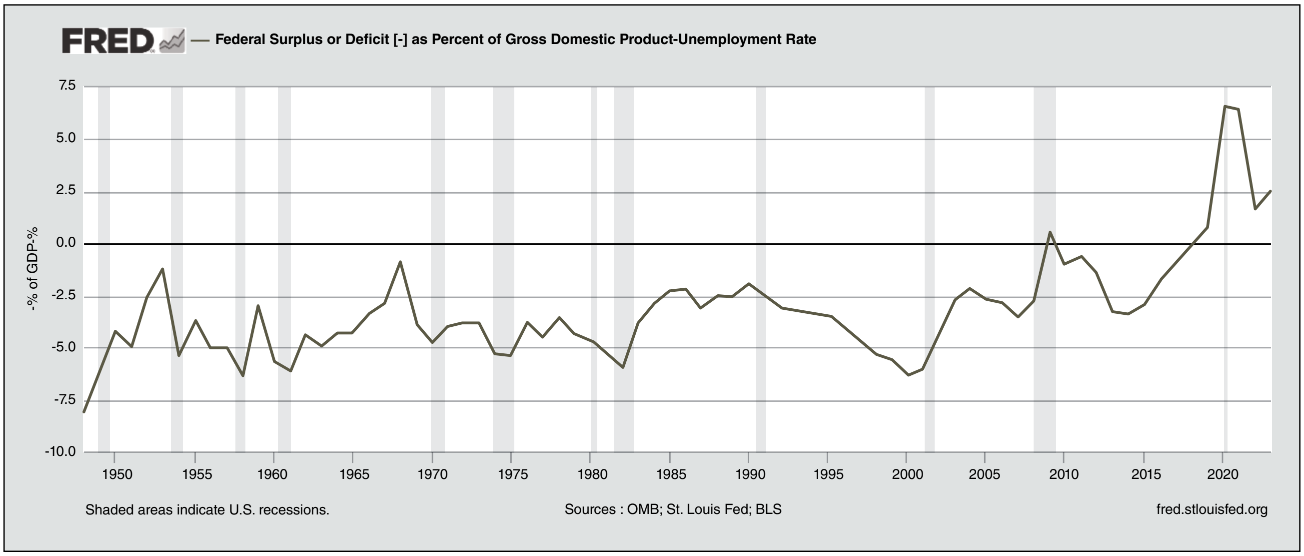
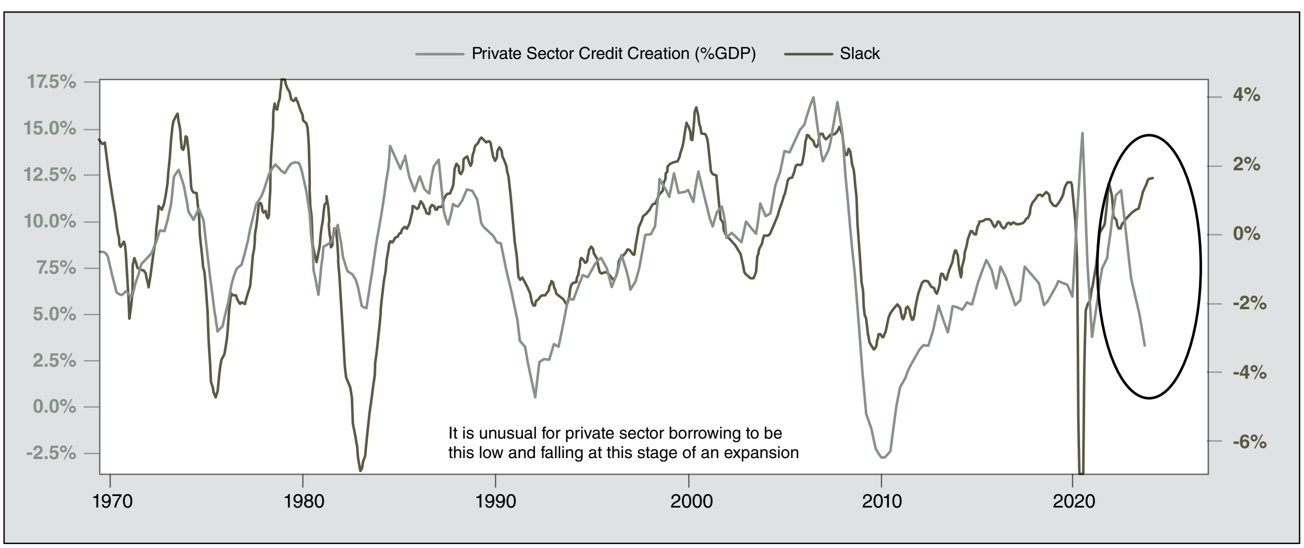
expect the deficit to be in the range of 2.5% of GDP. If you look at this chart going back to the 1950s virtually the entire time, up until Covid and now beyond, the deficit was less than the unemployment rate.



I detect no political will whatsoever to curtail the deficit which results in a non-economic consumer of goods, services, and labor having a significant impact on the economy and inflation pressures. This next chart is informative in that it shows how private sector borrowing has dropped in the wake of higher interest rates and tighter lending standards despite healthy economic growth (positive slack). If you analyze this further, it shows how private sector borrowing growth is now back down to levels that were more common in the aftermath of the Great Financial Crisis. Said differently, the large fiscal deficits are masking underlying private sector weakness. Perhaps some of this is related to firms having less need to borrow because they have healthier balance sheets, but I think it has more to do with credit costing more, challenging lender underwriting standards.



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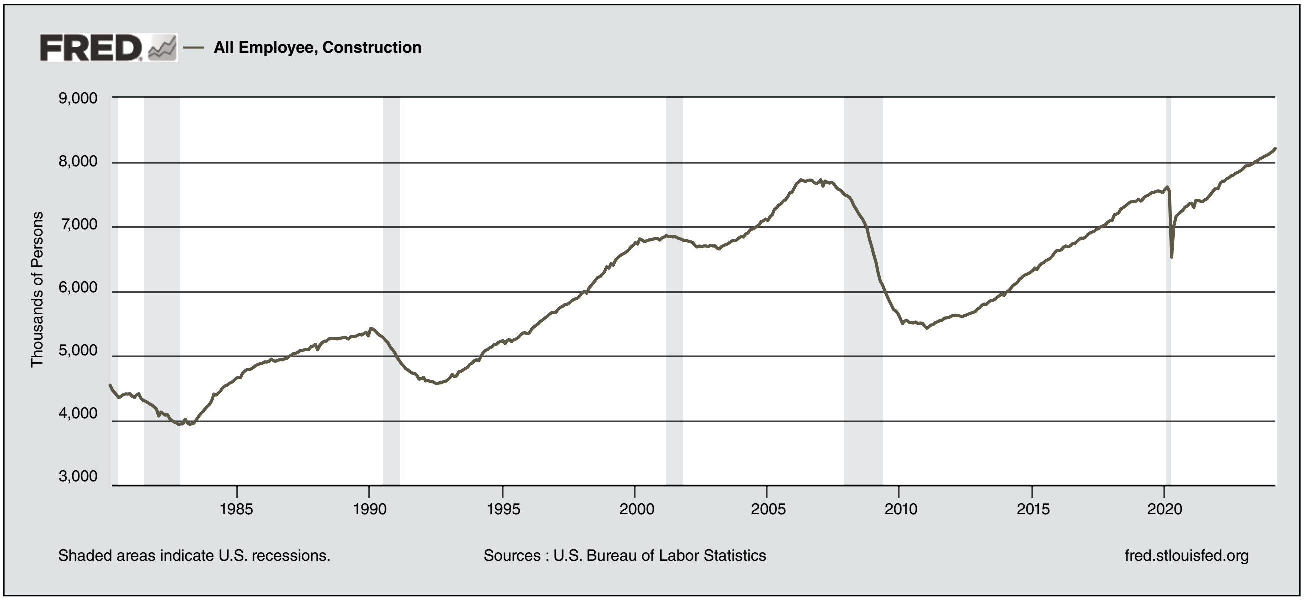
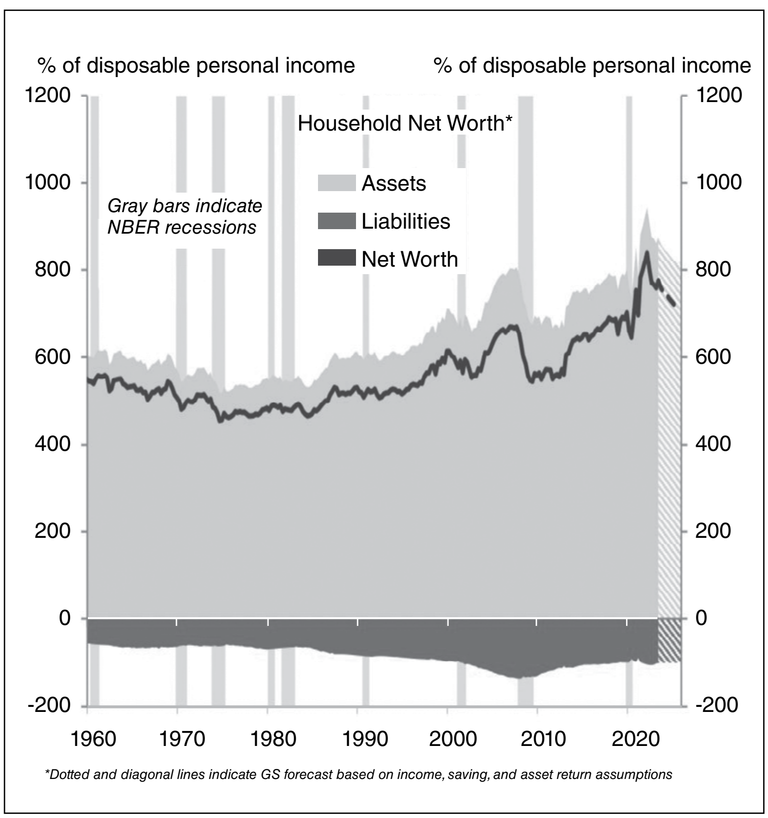
Given how high interest rates have gone it would have been reasonable to expect a material decrease in construction jobs, like what has happened in previous cycles. It's not unusual to see the construction sector lose 15% of its jobs during a downturn. This has not been the case as government spending on infrastructure, chip incentives, and green energy have kept the demand for construction labor high. In addition, much of this spending is still going to take place in the future so the outlook for construction activity is quite positive which should also cause more inflationary pressures.





Another tailwind for the economy is the strength of household balance sheets. The stock market is doing very well and home prices are still near their all-time highs as the combination of higher mortgage rates and many borrowers having locked in low rate, long-term mortgages has created a huge disincentive for people to list their homes because most people purchase another one and that would result in much higher payments. This should enable households to continue to spend.

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Power demand is another key area of the economy that could be facing pressure with onshoring of manufacturing and the huge energy needs of A.I. and the huge need for more data centers. This is another risk to inflation remaining moderate.

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> **Big Tech's Latest Obsession Is Finding Enough Energy**
>
> The AI boom is fueling an insatiable appetite for electricity, which is creating risks to the grid and the transition to cleaner energy sources
>
> *By Katherine Blunt* Follow *and Jennifer Hiller* Follow
> *March 24, 2024 7:00 am ET*

Finally, there is a much more contentious world with two axes competing that is raising tensions. These are the autocratic nations of China, Russia, Iran (and its proxies), and North Korea versus the West (United States, Europe, Asia, and some of Latin America). The former are using the tools of freedom to undermine freedom and social cohesion in the West while becoming much more assertive militarily. Examples include China becoming much more aggressive vis-a-vis Taiwan, Russia's invasion of Ukraine, disinformation campaigns, and bribing of European politicians, Iran using the Houthis to disrupt shipping in the Red Sea and Hamas and Hezbollah to engage Israel militarily, and the always present saber rattling by North Korea.

Given these factors, I am convinced that we're out of The Long Emergency from a Fed reaction function and from an investor return requirement perspective. We are now in the Real Normal. What does this mean for interest rates, both short and long?

If we believe that the 2001–2008 period is more indicative of the pricing of risk-free debt going forward, then this would mean that 3-month T-Bills should yield a rate very close to the inflation rate and 10-year Treasuries should yield approximately 1.70% more than inflation. Based on a few forward-looking market indicators, the projected future rate of inflation is anticipated to be in the 2.50% range. This would mean that 3-month T-Bills should yield close to that (currently 5.39%) and 10-year Treasuries 4.20% (currently 4.55%).

This means that 10-year Treasuries are in the range of what I think the equilibrium value is (3.75% – 4.75%) and T-Bills have some room to drop. As the chart at the top of page 7 shows, the Fed, as represented by the circles, shows future short-term rates bottoming out at approximately 2.50% whereas the market is closer to 3.50%. The market either thinks that inflation will be higher, or that real rates need to be higher to either compensate for inflation risk or to offset many of the years of negative short-term rates, or some combination thereof.

And while in some ways it is a bitter pill to swallow that the environment has changed such that being exposed to variable-rate loans has been a net detriment after a decade of it

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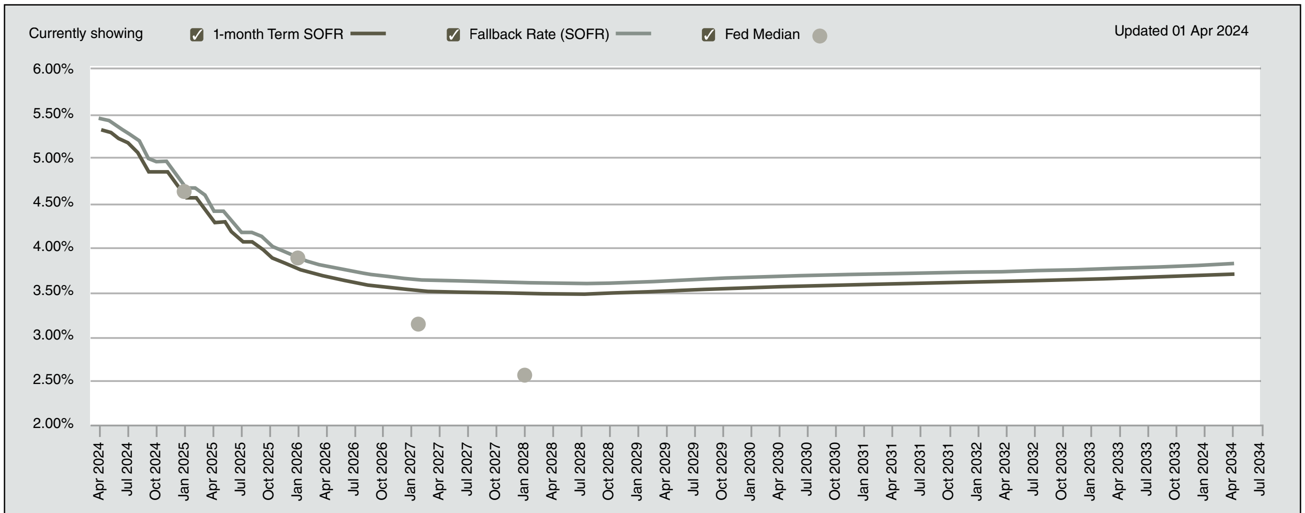

Each FOMC member indicates their view of the midpoint of the appropriate target range of the federal funds rate at the end of each of the next three years and over the longer run assuming a normalization of momentary policy. The FOMC has updated this "Fed Dot Plot" quarterly since January 2012.

Fed Governor Projections for Long Term
• 2.5625% - Fed Median

being so beneficial, it is important to look at the world as realistically as possible versus how I would like it to be. I feel a bit like John Maynard Keynes, when confronted with changing his mind about something, he supposedly said "When the facts change, I change my mind. What do you do sir?"

Do you want to know the irony of me using this quote to end my article? The first search result that showed up when researching the Keynes quote was from a speech given by Fed governor John Williams in 2019 talking about how the world has changed and policymakers and investors should take this into consideration. This is what he said:

"Shifting demographic trends and a slowdown in productivity are driving slower trend growth and historically low levels of real interest rates across the globe. This new set of facts requires us to rethink what we once knew, reassess how to best foster strong and stable economies, and ready ourselves for the future."

And then Covid hit and everything changed from the low growth, low inflation, low rate world to a very different environment. I wonder if Williams, like me, is now looking at the world with a new set of eyes and saying goodbye to The Long Emergency as well?

If he follows the same advice he offered at the end of his speech then he very well may be.

"The facts have changed, and so it is time to change our minds also. It is often said that change is hard. But experience teaches us that it is better to prepare for the future than wait too long. Ultimately, failure to prepare often means preparation for failure."