IN THIS ISSUE

CHARTING THE COURSE

Fed Acknowledges Inflation Isn't "Transitory" After All (Even a Blind Squirrel Can Find an Acorn Once in a While)

By Mitch Siegler, Senior Managing Director

"I'm shocked – shocked – to find that gambling is going on here."
- Captain Renault, played by Claude Rains in "Casablanca"

We felt a bit like Captain Renault after hearing the Fed's Federal Open Market Committee (FOMC) statement on December 15. In part, that's because we've been writing about government fiscal and monetary stimulus and inflation on Main Street being much higher than official levels since before the pandemic began and steadily for the past 20 months. So, while it's gratifying to see a bit more transparency from the Fed, it's long overdue and sadly, a bit of too little, too late.

Since March 2020, the federal government and the Federal Reserve have teamed up to flood the economy with trillions of dollars. Mizuho Securities calculated that stimulus totaled $5.3 trillion from March 2020 through June 2021. During the same period, the Fed increased its holdings of U.S. Treasuries by $2.5 trillion. And that's before the recent trillion-dollar infrastructure bill and the $3 to $5 trillion "Build Back Better" bill – depending on whose calculations you believe. (BBB appears to be D.O.A. as of press-time though big spending bills sometimes have nine lives.)

Now, many economists and lawmakers feel the government has gone too far and a plurality of Americans surveyed seem to agree. Several recent polls conclude that, by a two-to-one margin Americans surveyed believe the past couple of years of government fiscal and monetary policy have increased inflation compared to those who believe it has reduced inflation. That's as plain as the nose on your face for those who've bought groceries or gas or paid rent lately. As we've said before, what you see at the grocery store is reality.

In November, U.S. inflation hit a 39-year high with prices 6.8% above those in November 2020, according to the Labor Department's consumer-price index. While the root causes of today's inflation differ from inflation from the 1970s and early 1980s, there are similarities. Then, the causes were energy spikes and political issues around oil production, which rippled through the economy through higher producer prices

and increased consumer inflation expectations. Now, inflation is a direct result of the pandemic and too much money chasing too few goods – largely the result of the flood of dollars coming out of Washington, D.C.

At first, the pandemic was deflationary – crimping both supply and demand – as Americans stayed home and boosted their savings, since there were so few things on which to spend money. Supply chain shocks and labor shortages impacted availability of goods and trillions in stimulus checks gave people more money to spend, stimulating tepid demand. Arguably, stimulus checks in March 2020 when millions of Americans were staying home to tamp down the spread of the virus made good sense. Since then, the combination of low supply and high demand for goods (enabled by continued Federal jobless supports and buckets of money sloshing around) has led to the price increases we're seeing just about everywhere we look.

To paraphrase the Fed's argument these many months, "don't worry, be happy; inflation is 'transitory'." This argument has been echoed, ad nauseum, by the Administration. Hope – as the old saw goes – is not a strategy.

Sure, it's entirely possible that the November 6.8% inflation rate will moderate this year as supply chain issues are resolved, labor shortages ease, semiconductor chips become more available for automobiles, electronics and other products and we put the pandemic in the rearview mirror and return to a more normal life.

But, reverting to the mean is a process and 6.8% will need to fall through 5.8%, 4.8%, 3.8% and 2.8% before it falls below 2%, the Fed's previous "target" inflation rate. At the risk of stating the obvious, serious moderation in the rate of inflation won't happen overnight, and many Americans will suffer the pain of higher prices for months – or years – along the way. That view is reinforced by a government report in mid-December showing that wholesale prices rose at a 9.6% clip for the year ending in November. That's the fastest pace in more than a decade. Since producer (wholesale) costs are the key input for consumer (retail) prices and the producer inflation rate is 41% above the consumer rate, hopes for a rapid plummet in the inflation rate are, shall we say, a tad optimistic, maybe even fantastical.

Now, the Fed does have some important tools at its disposal to cool the economy and tamp down inflation. Following the December 15 announcement, it's clear that the previous consensus about rates remaining lower for longer would need to be reexamined. And the idea that there wouldn't be any rate increases until 2023 was flat-out wrong. The Fed will be moving aggressively to reduce its purchases of U.S. Treasury bonds, which will likely come to a screeching halt by March. And the

majority of FOMC members and many economists and Wall Street analysts are now calling for three interest rate increases in 2022.

Closer to home, housing costs, including apartment rents and the cost of homeownership, have been rising at a 5% annual pace these past few months, according to Goldman Sachs economists. We've been seeing apartment rent growth at double these levels in many of the markets where we operate since early fall. While we forecast cooling rent growth next year, this is unlikely to turn on a dime since many markets have had occupancy rates well above the 95% equilibrium level throughout the pandemic.

As we start the new year, we have much to be thankful for. Our health, our freedom, our families and our friends, for starters. We're also thankful that we didn't listen to the Fed these past two years because we might have halted apartment acquisitions and loaded up on floating rate debt. Instead, we acquired ten properties last year and financed nearly all of them with long-term, fixed rate loans. Those loans are going to be pretty sweet in the years ahead when rates could rise to much higher levels.

Warm wishes to all for a healthy and happy 2022.

Mitch Siegler is Senior Managing Director of Pathfinder Partners. Prior to co-founding Pathfinder in 2006, Mitch founded and served as CEO of several companies and was a partner with an investment banking and venture capital firm. He can be reached at msiegler@pathfinderfunds.com.

FINDING YOUR PATH

Reflections on an Interesting Year

By Lorne Polger, Senior Managing Director

It's hard to believe we're nearing the two-year anniversary of the onset of the pandemic. In some respects, 2021 feels like a second lost year. While we were buoyed with lots of good news along the way (vaccines and boosters, the end of lockdowns, the reopening of social gatherings, sporting events, concerts and live theatre and a robust market for apartments), we were whipsawed with many challenges, too (including Delta and Omicron variants, inflationary price increases, supply chain disruptions and employee shortages).

I got Covid this fall, after being vaccinated twice this spring. I was fortunate in that my case wasn't that bad, although losing my sense of smell for several months was unsettling. Many people asked me, "do you know how you got it?" Well, perhaps it was when I went for a walk. Or at the grocery store. Or when we went to dinner one night. Who knows?? This illness is everywhere these days, especially in its current Omicron variety. I suspect that at some point over the next year or two, virtually all of us will have had Covid. I no longer think that it's a question of if, only a question of when. At this point, those of us who are vaccinated and boosted and fortunate to not have underlying health conditions should be fine. I also suspect that boosters will become a regular part of our lives for the next few years, if not longer. A very small price to pay, in my opinion.

The three biggest surprises to me in the commercial real estate world over this year were the strength of the apartment market, the amount of capital in the marketplace, and the resiliency of the office sector, notwithstanding the massive changes that have occurred in how we work.

The Strength of the Apartment Market

When the pandemic first hit, we were concerned about the bottom falling out in the apartment market. Tens of millions were out of work, the stock market was in free fall and, notwithstanding occupancy rates of 95% or better in most of our markets, we wondered whether our tenants would be able to pay their rent. During the pandemic, occupancies at most of our properties rose to 97%-98%, collections exceeded 98% of scheduled rent, and demand for renovated units remained strong. Our leasing teams navigated the dynamic environment by closing clubhouses and gyms, then reopening and sometimes closing these facilities again. We leased scores of apartments via virtual tours with tenants signing leases sight unseen.

In many of our markets, we saw double-digit, year-over-year increases on new leases; in some markets, the average increases exceeded 20%. That's both good news and bad news. Certainly, it's good news for revenue (income) and value growth in our portfolio. The downside is twofold. First, it directly reflects the inflationary times that we find ourselves in (just in case you hadn't noticed the last time you filled up your car, went to the grocery store or went out to dinner). Second, it further stretches the wallets of our hard-working tenants across our portfolio

of workforce housing.

While we expected a robust recovery in 2021 following a challenging 2020, we were taken aback by the vibrancy of the recovery in occupancies and rents.

We certainly don't forecast the same increases for 2022. While we believe the apartment market will remain strong in 2022, and rent increases will likely exceed historical averages, we think most of the bounce has already occurred. From our perspective, it's healthier over the long-term for rent growth to be more moderate.

We were also extremely fortunate to catch an opportunity with three distressed deals that we purchased in 2021 for Pathfinder Opportunity Fund VIII. These relatively new, Class-A properties were 40%-60% leased when we found them and are all at or over 95% leased today. The properties leased back up quickly and have been ahead of budget in both revenue and occupancy.

Overall, we are very pleased with how our entire portfolio is performing going into 2022.

An Ocean of Capital

The second surprise was the continued huge amount of capital in the marketplace, which has contributed to driving up pricing to near nose-bleed levels. Perhaps we should not have been surprised. In a near-zero yield environment with inflation expectations running well above nominal interest rates, investments in rental housing have remained at or near the top of many savvy investors' wish lists. We don't see anything that would reduce the level of liquidity in the near- term. Accordingly, we will remain very disciplined with our purchases in 2022, and only invest in opportunities we feel offer solid value for our money.

Strong Demand for Office Space in a 'Work from Home' and Virtual Work Environment

Pathfinder shifted to a virtual office environment in March 2020, and we've remained in a virtual/hybrid office mode since then. Many of my business associates have taken similar paths, and of course, we've all read about how some of the large technology companies have led the charge in this area. As such, I'm scratching my head at how office landlords have maintained (and in some markets, even increased) their asking rents! It just doesn't make sense to me. Whatever space you're in today, you probably need less of it tomorrow. So

why would office lease rates rise? Office vacancies in many major markets remain at historically high levels, especially so in downtown submarkets. Return to work dates have been pushed back again and again. Whenever companies return to the office, it seems a safe bet that fewer people will work there each day, reducing overall demand for office space. Sure, distancing may necessitate more square feet per employee, but I wonder when the shoe drops with office.

I'm thankful for many things over this past year. The love of a great woman. The health of my family. The joy in seeing my adult children launched in their careers and in successful relationships. The ability to experience travel again. The continued success of our business. I hope that 2022 brings greater health, joy, and success to all of you.

Lorne Polger is Senior Managing Director of Pathfinder Partners. Prior to co-founding Pathfinder in 2006, Lorne was a partner with a leading San Diego law firm, where he headed the Real Estate, Land Use and Environmental Law group. He can be reached at lpolger@pathfinderfunds.com.

GUEST FEATURE

A Housing Crisis Q&A

By Matthew Quinn, Vice President

America has a housing crisis. The root cause is a shortage of homes and apartments, which has been exacerbated by land shortages, high construction costs and barriers to new supply – including entitlement delays, parking regulations and environmental regulations, among other factors. Below are a few commonly asked questions about the housing shortage and brief answers.

We hear a lot about the housing shortage in America – how big an issue is this? America is short on housing, although the estimates of the magnitude of the shortage vary widely. A recent study by the National Association of Realtors put the number of immediately needed housing units nationwide at 5,500,000 while a 2021 Freddie Mac study pegged it at 3,800,000. This "shortage" includes what is needed to sustain household growth (i.e. we need the kids to move out of the basement), replacements for units at the end of their useful life, second home demand and vacant units to maintain an efficient marketplace. Meanwhile, Americans are building about 1,500,000 units per year. So even if demand magically halted – which it won't – it would still take three years to build enough homes to meet today's need and by then we'll be further behind.

If demand for housing is through the roof, why don't developers just build more homes? For starters, home building is expensive. Land in desirable areas is scarce and prices are high. Material costs are at all-time highs and there is an historic labor shortage. It can take years to get the necessary government approvals and entitlements – especially in places where demand for housing is particularly strong – so a homebuilding venture is inherently speculative and margins for homebuilders can be razor thin. For many real estate investors, there are easier ways to make a profit, including buying and renovating existing homes.

Why doesn't the government step in and make it easier for developers to get housing permits? There are about 80,000,000 homeowners in the U.S. and a meaningful portion of them don't want more housing, especially affordable units, in their neighborhoods. This unofficial lobbying group known as NIMBY's (not in my backyard) is big and boisterous and rears its head at community planning hearings and city council meetings. And because of their numbers, they make it difficult for elected officials to create laws aimed at solving supply issues like increasing density, building government subsidized affordable housing projects and reducing environmental red tape.

How do we overcome pushback on densification from existing homeowners? Since governments can't seem to convince these NIMBY's to accept higher density, they've started forcing their hands. In California, where owners of million-dollar homes are stepping over homeless people on the sidewalks, the state legislature has realized it's a humanitarian crisis and in September passed three statewide housing densification and permit streamlining statutes to boost construction. To no one's surprise, the rebellions began immediately and cities and neighborhood groups are pushing back with numerous lawsuits already filed.

Do other countries have this problem or is it unique to America? Unfortunately, this is a worldwide problem that has been exacerbated by a reduction in construction due to the Covid-19 pandemic. The problem exists in both democratic and authoritarian countries where low inventory and high demand have caused skyrocketing rents and home prices. Politicians in these countries have suggested a wide range of potential remedies including nationalizing private property, converting vacant office/retail into residential housing, banning foreign homebuyers, expanding tenants' rights, increasing density in suburban areas and rent control, to name a few.

Some solutions have been proposed – which of these fixes are good policy? Policies aimed at artificially controlling pricing like rent control and rent caps have been proven to make the problem worse by disincentivizing future development and further reducing supply. Given the choice, a developer will build apartments in an area without rent control so the areas with rent control see less development in the long run. Rent control can also create a mismatch between tenants and apartments (i.e. once a tenant secures a rent-controlled apartment, they may never leave even if they need less space/fewer bedrooms in the future) and a decay in the quality of rental housing as landlords become disincentivized to improve their properties or make necessary repairs.

The only real solution for America's housing crisis is increasing supply and the supply-side policies aimed at solving the problem – increasing density, building more affordable housing, speeding up approvals and removing environmental roadblocks – are among the best long-term solutions. The recent densification and permit streamlining laws passed in California are a big step in the right direction and policy makers around the U.S. should be taking notes.

Matt Quinn is Vice President at Pathfinder Partners, focusing on asset management activities. Prior to joining Pathfinder in 2009, Matt worked with a San Diego-based firm which consulted on mergers and acquisitions and with the Wealth Management division of a California regional bank. He can be reached at mquinn@pathfinderfunds.com.

ZEITGEIST – NEWS HIGHLIGHTS

The AirBnB Effect

Since the beginning of the rapid growth in short-term rental housing ("STRs") in the mid-1990's, AirBnB has emerged as the largest player in the market with over 7,000,000 listings in 220 countries. In comparison, the top ten hotel chains have about 5,500,000 rooms.

AirBnB markets itself as an easy way for homeowners to earn additional income by hosting short term guests. However, of the over 1,000,000 AirBnB listings in the U.S., more than 60% are owned by professional hosts which operate at least two other STR units. And as of 2018, nightly stays in apartment buildings represented 65% of the total rentals with 35% in single-family homes. The data suggests that the original concept behind AirBnB – for homeowners to supplement their income via short-term rentals of their primary homes – has morphed into something else.

STRs can have both positive and negative impacts on their communities. While they create additional income for "hosts" and bolster local businesses, they have a negative impact on nearby hotels, can lead to a shortage of neighborhood parking and reduce the availability of traditional rental housing. By converting a single-family home or apartment to an STR unit, investors are essentially removing much needed long-term housing for local residents while contributing to the increase in rents and home prices. And as STRs become more popular – they've increased 105% in the U.S. since 2017 – their impact is compounding the nation's already historic housing shortage.

The negative impacts have not gone unnoticed by policymakers, who are facing increasing pressure to boost the supply of affordable rental housing, especially in larger cities. In response to supply concerns, New York City has banned STRs in apartment buildings and implemented fines of up to $7,500 for rentals of less than 30 days. Denver limits STR's to owners' primary residences; violators can be fined up to $1,000 per day. Many other municipalities are following suit and adopting STR restrictions of their own. The future of the short-term rental industry, a growing powerhouse in overnight travel, is as uncertain as ever.

Package Delivery Overload!

U.S. retail sales were up 16% year-over-year in October 2021 according to recent Reuters report. This massive buying surge coupled with the explosive growth in e-commerce means more packages are being delivered to front doors and mailrooms. The drastic increase in packages over a short period of time – parcel delivery surged 70% during the Pandemic – has left apartment owners without efficient package delivery systems with a major strain on front office personnel and storage capabilities.

Package Concierge, a leading provider of automated locker and package room solutions, estimates that package handling time for apartment communities can

cost owners up to $25,000 per year. Those who work in apartment offices can attest to the mayhem associated with package deliveries – especially in dense, urban communities. They struggle with a panoply of issues, including package storage, resident communication surrounding pick-ups and theft.

Automated package lockers (also known as "smart lockers") are a godsend for frustrated residents and overworked front office staff. Today's smart lockers feature package security, instant delivery notifications and 24/7 contact-free pick-up and are quickly become ubiquitous in apartment communities.

Over the past several years, the industry has rapidly evolved and lockers now come equipped for indoor and outdoor use along with refrigerated compartments for medicine and perishable items. Property managers can utilize the lockers to provide new residents with keys to their apartments and to distribute important documents. As the e-commerce industry continues to boom and packages continue to flow, we expect the automated package industry to see lockstep growth.

(Editor's Note: Pathfinder has been investing in package delivery systems for several years. Check out the customized locker at our Bull Mountain Heights property in Vancouver, Washington.)

TRAILBLAZING: THE MADDOX, MESA (PHOENIX), AZ

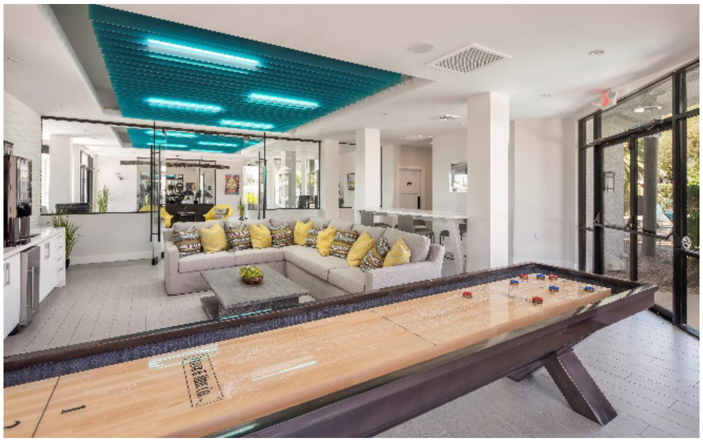
"Making the Grade on Livability"

Rankings have become an important metric in comparing quality of life for cities. High rankings not only make newspaper headlines, but also inform us of trends, influence economic growth and help cities attract new residents.

In January 2020, Pathfinder Income Fund acquired The Maddox, a 224-unit apartment community in Mesa, Arizona from Pathfinders Opportunity Fund V. The property is located on the border of Mesa and Gilbert, a rapidly growing area ranked highly for livability and economic prosperity.

Over the past decade, residents have been attracted to the Gilbert submarket for its award-winning schools and family-friendly ambiance. In recent years, the area has been recognized as one of the "Best Places to Live in America" by 24/7 Wall St., one of the "Best Places to Raise a Family" by WalletHub and one of the "Safest Cities in Arizona" by SafeWise. These factors have contributed to the area's robust housing demand pushing Gilbert's median home price up 31% year-over-year to $538,000 in November 2021.

The Maddox – Pool Area



The Maddox – Clubhouse Lounge

Mesa/Gilbert also has a dynamic economy supported by healthcare, education, aerospace, tourism and technology. In 2017, Gilbert was ranked by the Economic Innovation Group as the "Most Prosperous City in the Country" attributable to the area's emerging industries and world-class amenities. This notoriety has enticed Northrop Grumman, GoDaddy and Isagenix to open or expand operations in the area. In 2021, Gilbert was ranked the "Best U.S. City for Small Business Recovery Since the Pandemic" by Quickbooks; Mesa was ranked fourth.

The Mesa/Gilbert submarket is further supported by the robust economic growth of the greater Phoenix area. Phoenix grew faster than any other major city over the last decade, expanding its population by 11.2% with the addition of more than 160,000 residents from 2010 to 2020, making it the nation's fifth largest city. Phoenix has recouped all jobs lost during the pandemic and is projected to add 90,000 new jobs in 2021. These factors have contributed to Phoenix's recent recognition as the second "Best Labor Market in the Nation" by ThinkWhy.

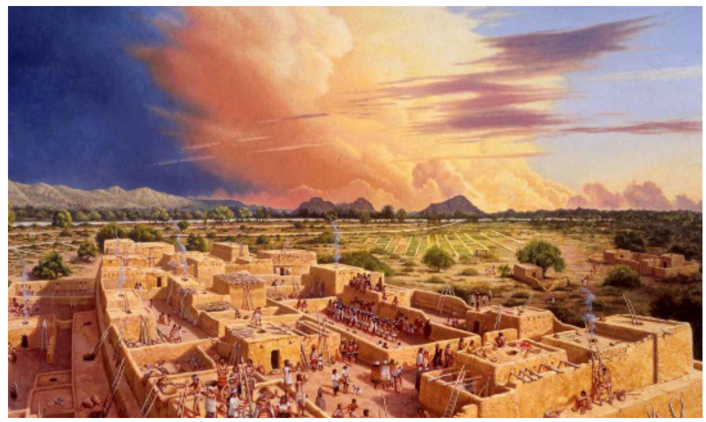
Maddox, built in 1986, is situated on an 11.8-acre parcel and includes a mix of one- and two -bedroom apartments averaging 836 square feet. Maddox is on the corner of Gilbert Road and Inverness Avenue, a highly visible location with exposure to 250,000 cars per day. The property boasts a very low density of just 19 units/acre and is well parked at two parking spaces/unit with half the spaces being covered.

Pathfinder Fund V acquired Maddox in 2016 and completed substantial renovations including constructing a new clubhouse, leasing office and fitness center, upgrading the pool area (gas BBQ, TV-lounge, shade structure and new furniture), repainting the exterior, upgrading signage, adding a package locker and renovating 87 apartments (37%). Since the 2020 transaction, we have recommenced interior apartment renovations, improved the dog park and turned a non-functioning pond into a park area with hammocks.

Maddox is four blocks north of the Gilbert Heritage District, a popular shopping and dining destination home to numerous restaurants, bars and boutique retail. Residents have the convenience of 12 employment centers within a ten-mile radius and under a a 30-minute commute to downtown Phoenix. The neighborhood is great and getting better.

Mesa, Arizona: Did you know?

The Hohokam Canal Systems: The history of Mesa dates back over 2,000 years ago with the arrival of the Hohokam people. These natives built the largest and most sophisticated canal system in the prehistoric New World. Some canals were up to 90´ wide and 10´ deep extending up to 16 miles. By 1100 A.D. the canals were delivering water to over 4,000,000 acres, transforming the area into an agricultural oasis. By 1450 A.D., The Hohokam had constructed hundred of miles of canals, many of which are still used today.



Rendering of a Hohokam Village

Photo Credit: National Science Foundation

NOTABLES AND QUOTABLES

A Fresh Start

"When the winds of change blow, some people build walls and others build windmills."

- Chinese proverb

"The first step toward getting somewhere is to decide you're not going to stay where you are."

- J.P. Morgan, *American Businessman*

"You may have a fresh start any moment you choose, for this thing that we call 'failure' is not the falling down, but the staying down."

- Mary Pickford, *Canadian Actress*

"Every new beginning comes from some other beginning's end."

- Seneca, *Roman Philosopher*

"I have always been delighted at the prospect of a new day, a fresh try, one more start, with perhaps a bit of magic waiting somewhere behind the morning."

- J.B. Priestly, *English Writer*

"The most important thing to remember is this: To be ready at any moment to give up what you are for what you might become."

- W.E.B. Du Bois, *American Author*

"Isn't it nice to think that tomorrow is a new day with no mistakes in it yet?"

- L.M. Montgomery, *Canadian Author*

"Although no one can go back and make a brand-new start, anyone can start from now and make a brand-new ending."

- Carl Sandburg, *American Poet*

"Never feel guilty for starting again."

- Rupi Kaur, *Canadian Poet*

"The beginning is the most important part of the work."

- Plato, *Ancient Philosopher*

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