



Cascade Investment Commentary

October 6, 2008

There were more changes in the financial markets in the 30 days of September 2008 than in the prior 75 years. Friday the Congress with only a few hours of debate passed the first installment of what may prove to be the largest debasing of the U.S. currency ever. European bankers nationalized four banks last week and stated that they were "looking into the abyss". The Great Unwinding of the debt pyramid is collecting speed.

First a comment on the Paulson Plan adopted on Friday: It tries to move the solution past the election, it enriches a few chosen banks like Morgan Stanley and Goldman Sachs (and Mr. Paulson's foundation), it vests the Secretary of the Treasury with vast and uncharted power, it establishes the financial eugenics of survival of the politically fit, and it will not work in our opinion. As we write this Commentary the Dow Jones has lost over 700 points since the House vote Friday. Better minds and better plans will hopefully be forthcoming.

"Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate...It will purge the rottenness out of the system... values will be adjusted, and enterprising people will pick up the wrecks from less competent people..." These were the words of Andrew Mellon in 1928. His advice was ignored.

"We might have done nothing. That would have been utter ruin. Instead we met the situation with proposals...of the most gigantic program of economic defense and counterattack ever evolved in the history of the Republic...Some of the reactionary economists urged that we should allow the liquidation to take its course until we have found bottom...We determined that we would not follow the advice of the bitter-end liquidationists..." These are the words of Herbert Hoover. His first deeds in the crisis were to go on a gigantic public works spending programs such as Hoover Dam.

He tried to hold wages high by stopping immigration and by trying to get business not reduce paychecks. He gave in to Smoot-Hawley. He was defeated soundly by FDR who scolded his profligacy yet went on to spend vast sums to do the very same thing. The net result of all of this was a long Depression that was only ended by the spending of WWII instead of what might have been a deep recession the likes of 1920-1921.

We may plumb the depths of the debt abyss in October when the Credit Default Swaps for Fannie Mae, Freddy Mac, Lehman Brothers and Washington Mutual all settle. It is estimated that there are upwards of \$500 billion in contracts for FNM and FRE alone. This event was triggered by the government seizure of both firms, and while the underlying value of the debt is strengthened by government guarantee, those who bet on loss must now settle with those who bet on solvency. This was done by auction of the derivative contracts today October 6th; Lehman Brothers follows on October 10th and WAMU on October 23rd.

There will be winners and losers in the settlement and perhaps as the Senate Majority Leader Reid stated publically on Wednesday "One of the individuals in the caucus today talked about a major insurance company - one with a name that everyone knows that's on the verge of going bankrupt. That's what this is all about". For some clarity let's backup a step or two.

In the 1980's Lloyds of London faced a problem. The Americans were inventing "pension fund immunization", "portfolio insurance" and other clever packages which brought fat commissions. Lloyds responded by ramping up re-insurance. A typical "name" i.e. someone on the books at Lloyds who would bear the financial risk of a loss event would be approached to insure an event such as a tanker cargo from the Persian Gulf to Rotterdam. In return, the name received an up-front fee.

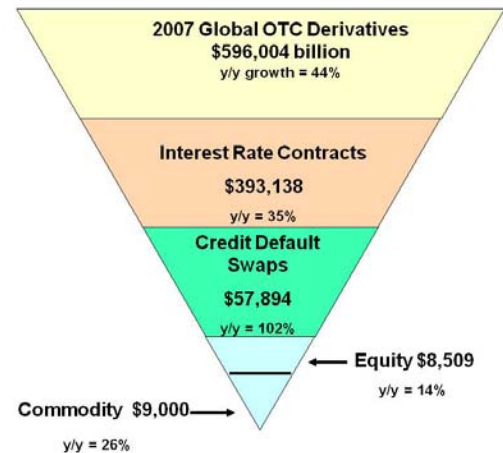
That name would then be advised to pass off ½ the risk of loss to another name. The hitch was that the salesman at Lloyds would get another commission on the re-insurance sale. That next name was solicited to do likewise and this went on until a complete daisy chain was formed and called the London Market Excess (LMX). This worked fine until there was in fact an event that required payment. The upfront fee was the reserve used to backstop a loss. However by this time all of the reserves had been paid out in commissions. When asbestos and pollution claims in the U.S went ballistic in the late 1980's and early 1990's there were no reserves and many English names lost everything they possessed. Lloyds lost several lawsuits had to reorganize in 2002.

After the Chrysler bailout in the 1980's Wall Street began selling bondholders a product to insure the payment of Corporate bonds (automobile and related corporations among others) should they default. Called a Credit Default Swap or CDS, it is effectively an insurance contract although not regulated by any State Insurance Commission.

The blog SAR describes it best. "Say you go to the racetrack and put a bet on a horse. Your bookie allows you (he knows that you got some cash) to take that ticket and use it as collateral for a bet on the next race, without knowing the outcome of the first. Rinse and repeat. You place a thousand bets. You're now in over your head, but your bookie doesn't realize that. Plus it works like a shine as long as your horses win, which is what they do for a while. So did Charles Ponzi. But...that's not the end of the story. Your buddies want in on the free manna from heaven deal. So you sell them risk on the risk on the risk on the risk of all your layered and leveraged bets (they, too, know you got some cash). They then take the tickets to the bookies' window as collateral for another bet. Again, rinse and repeat. And they too have friends who want in. Rinse and repeat."

It would seem that AIG had some losing horses in European banks and was quickly nationalized before the public could see the

level of reserves underpinned their derivative book. The whole scheme is unwinding and \$700 bn seems far too small to stop it. In December 2007 the notional value of such contracts was \$596,004 Billion, up 44% yoy.



When a company defaults on its bonds the bondholders form a protection committee which sues in a bankruptcy court to protect the assets of the corporation for the ultimate satisfaction of the liens on assets. The holders of CDS have a different procedure. Through the International Swaps and Derivatives Association (ISDA) a date is set and posted to <http://www.isda.org> to auction the losses through a protocol set in 1985 and well tested. The largest prior auction (to our knowledge) was the auction of \$25 bn of derivatives on Delphi (a car parts maker) in 2005.

The ISDA set a period of about a week (ending October 2) for all parties to derivative contracts in FNM and FRE to sort out their net positions. On Monday October 6 the London firm Creditex collected bids and offers for the bonds covered by the contracts. The lowest price for the FNM bonds was 91.5% and 99.9% of face value. Those insuring against loss and wishing to settle (650 firms signed up) must pay 8.5% to those who purchased it. FRE debt settled at 98% and 94%. If one party's cannot pay it is called "counter party risk", yet the auction results did not show any major failure, and indeed there were unsatisfied buyers. This may have been the cause of the late day rally in stocks.

The case of Lehman Brothers is much more bothersome because their bonds have been trading in the open market between 15 and 19 cents on the dollar. Lehman reportedly has \$660 bn of outstanding debt and the total CDS outstanding is unknown to us. The auction is set for October 10th and WAMU October 23rd. This is, in our opinion, one major reason for banks to freeze up their capital lending. Everyone wants to see who is still standing at the end of October.

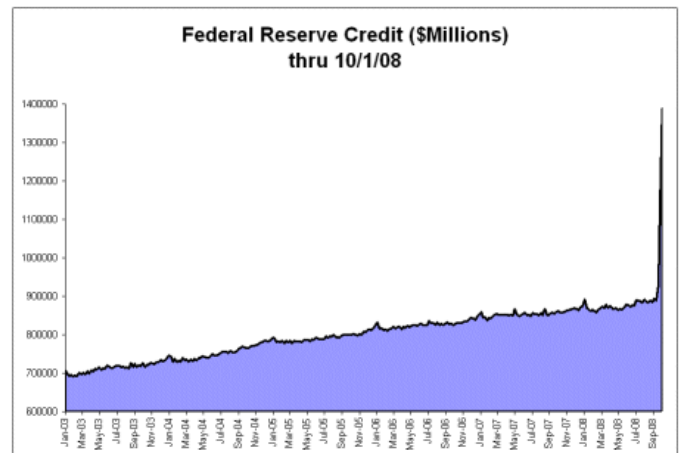
This unwinding has now crossed the Atlantic. Ten days ago German Finance Minister Peer Steinbrück claimed that the financial crisis was an "American problem", the fruit of Anglo-Saxon greed and inept regulation that would cost the United States its "Superpower status". Over the weekend Germany had to save Hypo Real Estate, the Dutch the 300 year old Fortis and the French Dexia.

The Daily Telegraph reported that French finance minister Christine Lagarde begged Mr. Paulson to save AIG because (according to the AIG annual report) "...Approximately \$379 billion (consisting of the corporate loans and prime residential mortgages) of the \$527 billion in notional exposure of AIGFP's super senior credit default swap portfolio as of December 31, 2007 represents derivatives written for financial institutions, principally in Europe, for the purpose of regulatory capital relief rather than risk mitigation..." Thus we now find that the European banks are more leveraged and at greater risk than the American banks and that had AIG failed and defaulted on its CDS, \$3+ TN would have to come off European bank balance sheets.

Mr. Paulson may have saved Europe for a few weeks only. Over the weekend Ireland shocked the EU with the announcement that all bank deposits would be guaranteed by the government. Willem Buiters writes: "The Irish guarantee is the most 'in-your-face' beggar-thy-neighbor provocation since medieval armies catapulted bubonic-plague-ridden corpses into the cities they were besieging." The Bank of England now must take measures to stop the flood of deposits from going to Ireland.

The Hypo deal failed on Saturday and Germany reversed itself Sunday and will insure all German deposits. The EU clearly does not have plans in place to deal with this crisis. The meltdown of LIBOR lending has forced the Fed to extend \$330 billion of dollars to the European Central Bank on top of the \$300 billion existing line as there is now a critical shortage of \$US in the European system. The Fed upped its line of credit to U.S. banks to \$900 bn today. Let us hope the euro survives this crisis.

Over the past three weeks the Fed has increased total credit by \$457 bn to a record \$1.389 TN. Federal Reserve Credit \$515 bn year to date and 61%yoy. If we add up all of the guarantees from Bear Stearns to AIG there is more than \$1.2 TN and we have no idea of how deep the AIG or WAMU mess is.



We have chronicled in the past that the US economy has a need for geometric levels of new debt to sustain each new \$1.00 growth of GDP. \$700 bn isn't going to cut it. The economy will need upwards of \$2 TN of new credit to avoid a fall in GDP going forward. In addition the Federal Debt closed on September 30th at \$10,024,724,896,912.49 which was a net increase of \$1,017.1 billion. With the recent decline in the price of oil our Balance of Payments Deficit was running just a hair under the annual rate of \$750 bn. Just who is going to loan our Treasury \$2.75 TN in 2009? Our creditors are speaking out.

On September 20 Prime Minister Vladimir Putin issued the following statement "We all need to think about changing the

architecture of international finances and diversifying risks. The whole world economy cannot depend on one money-printing machine... This is a very serious issue that should be addressed in a calm, attentive and working manner without haste together with our colleagues from Europe and America... This issue should be considered not in a confrontation-like way but very benevolently in order to find the most acceptable ways for the development of the world economy and world finances”.

On September 29 China’s premier Wen Jiabao said “the impact from the current financial crisis in the U.S. may affect the whole world... U.S. finance is closely connected with Chinese finance...If anything goes wrong in the U.S. financial sector, we are anxious about the safety and security of Chinese capital...”

Over the weekend Der Spiegel Online wrote “...The banking crisis is upending American dominance of the financial markets and world politics. The industrialized countries are sliding into recession, the era of turbo-capitalism is coming to an end and US military might is ebbing... This is no longer the muscular and arrogant United States the world knows, the superpower that sets the rules for everyone else and that considers its way of thinking and doing business to be the only road to success... A new America is on display, a country that no longer trusts its old values and its elites even less: the politicians, who failed to see the problems on the horizon, and the economic leaders, who tried to sell a fictitious world of prosperity to Americans... Also on display is the end of arrogance. The Americans are now paying the price for their pride”.

Although counterintuitive, these events have had a dramatic and negative effect on our portfolios during the past quarter.

The gold bugs have repeatedly pointed out that you can tell if there is going to be bad news issued by the US Government by watching the gold price at 8:00 AM in London. If gold goes down substantially either there will be a release of negative data or Mr. Paulson or Mr. Bernanke will be

speaking that day. Mr. Paulson (after Friday’s bailout arguably the most powerful man in America) has stated repeatedly “the Federal Reserve will continue to work closely with the Treasury as it undertakes these new initiatives. We will continue to use all of the powers at our disposal to mitigate credit market disruptions and to foster a strong, vibrant economy.” That power includes the use of the Exchange Stabilization Fund set up to manage the value of the \$US in world markets, the Presidents Working Group set up after the 1987 crash to manage stock market volatility, and now a revolving credit line to purchase any assets he chooses in his sole discretion.

In July with silver over \$18 per ounce the CFTC allowed a handful of New York banks to be short almost the entire year’s worth of world production. Funny thing; by September the price had fallen below \$11. We find it remarkable that in the greatest financial debacle since the 1930’s that precious metals would suffer significant declines as well as the producing companies. Here again the ghost of Lehman appears.

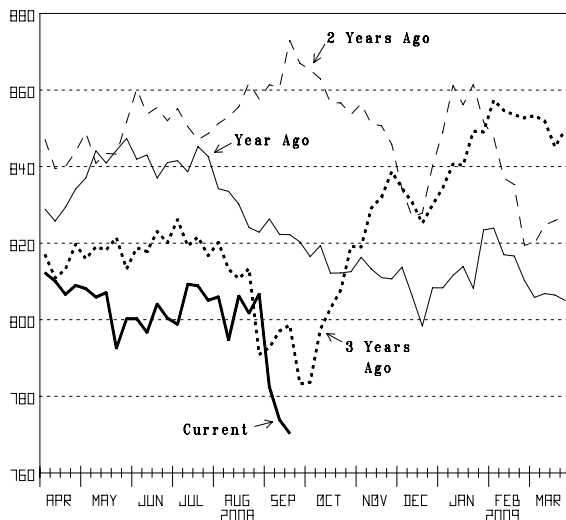
Lehman Brothers owned 20+% of Ospraie, a \$2.7 bn hedge fund that invested heavily in precious metals, oil, oil service companies and other related issues. We do not know how levered they were when they failed this summer, but it is almost certain that there was a major precious metal component. Lehman was a clearing agent for many hedge funds and momentum players, and many were invested in energy and commodities. Lehman’s frozen positions have caused havoc with much of the hedge fund community. Last Wednesday Goldman Sachs targeted 50 companies to sell short that were known to be long in many hedge funds that they suspect will have heavy redemptions. As Goldman and others rape and pillage their own community we expect that the volatility will be high between now and year end.

We are investors not short term traders however, and the underlying fundamentals for the securities in your portfolio are getting stronger not weaker.

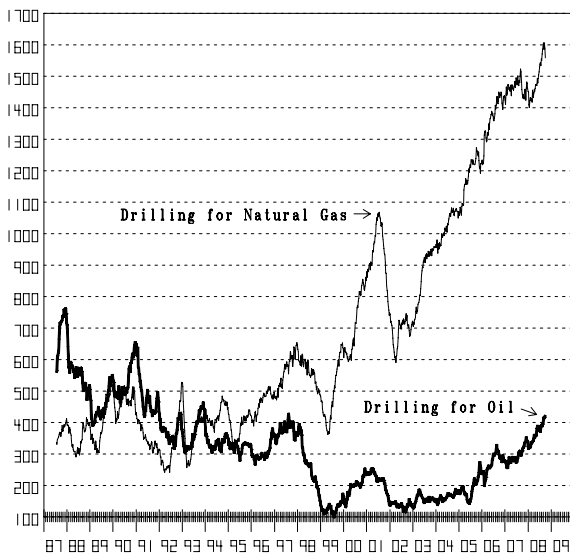
The almost unimaginable growth in government guarantees and credit advances added to the debasement of the major paper currencies of the world during the steep decline in world production of precious metals speaks for itself.

We have a genuine concern that as the world falls into recession the "demand destruction" so highly touted to force down energy prices will actually meet the reality of lower worldwide production of liquid hydrocarbon transportation fuels.

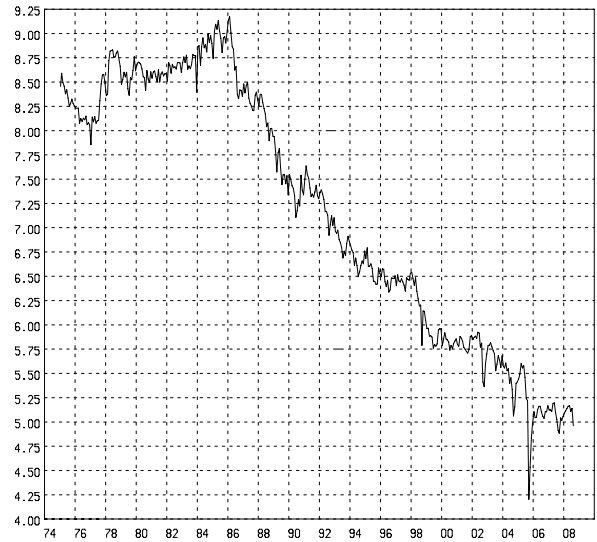
Total Oil Inventory: Diesel, Gasoline, Kerosene, etc.



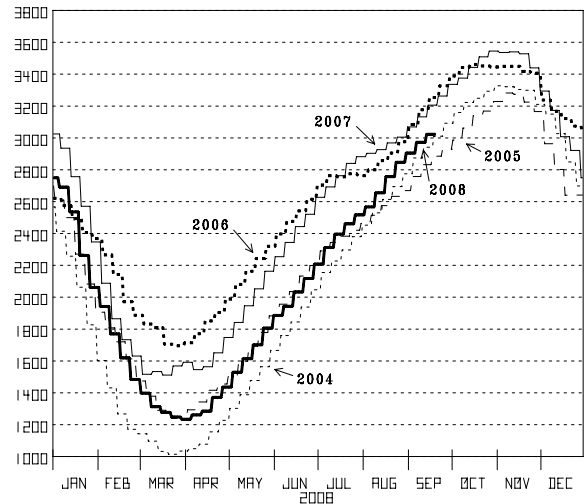
Number of Drilling Rigs Running in North America



The Oil Production of Those Rigs (million barrels/day annual rate)



Natural Gas Storage (billion cubic feet)



Longer term, the "break even" price to cover the social costs by Persian Gulf governments is reportedly \$70+/bbl this year and headed for \$80 next year. That Mexico's oil production is crashing and their exports to the U.S. are down 16% y/y has received scant attention; likewise the decline in Russian, North Sea and Kuwaiti production. Energy security will come to the front pages when the credit crisis finds solutions. Be patient.

Cascade Investment Counsel, LLC
 827 Alder Creek Drive, Medford, OR 97504
 541.857.8551
www.cascadeinvestment.com