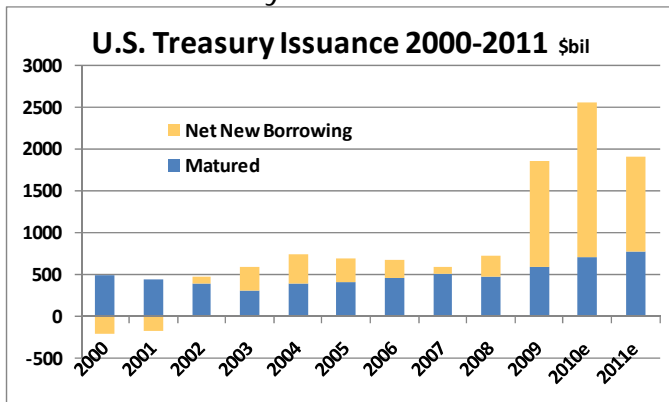


"I do not think it reasonable that public money -- taxpayer money -- be indirectly available to support risk-prone capital market activities, simply because they are housed within a commercial banking organization." Paul Volcker, Sep. 16, 2009

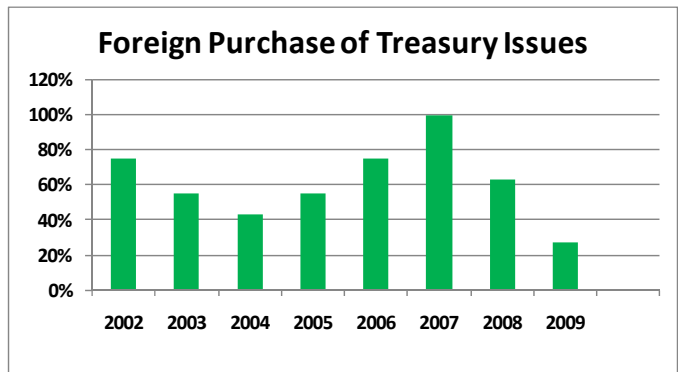
As the calendar gently rolled over to 2010 several nagging questions about the next two years seem softly unanswered: First, just who or whom is going to lend the necessary money to the U.S. Federal Government and to its various states? Second, how is it possible that a credit crisis caused by too much debt can be solved with yet more debt? Third, in a fractional reserve banking system is there any limit to the amount of money that can be created?

Let us answer the first question with a bit of review. How much money did the US government really borrow in 2009 and how much does it really need in 2010?



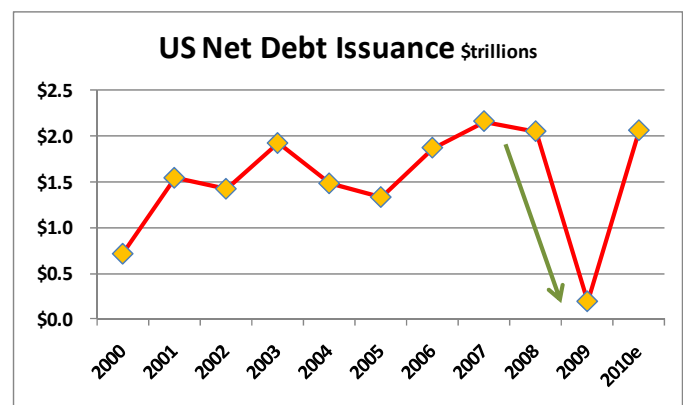
From the chart above we can see that the US Treasury issued \$1271 billion of new Notes, Bonds, TIPS etc. in 2009 and expects to issue \$1850 billion new debt in calendar 2010. With the rollover of \$702 in existing debt that makes a whopping \$2.5 trillion calendar. To guess who might be the lenders we should start with the usual suspects.

In the past decade foreign governments (principally Asian) have been the largest buyers. Treasury International Capital (TIC) data tells us that foreigners are still buying Treasuries but in declining amounts.



Foreigners purchased just 27% of the Treasury offerings through the 3rd Quarter in 2009, Households 45%. The Fed purchased 23% (\$293 billion) in "Quantitative Easing" (QE) or the direct printing of Federal Reserve Notes to officially purchase Treasury debt through September. Notwithstanding the reduced purchases of Treasury debt, foreigners were actually net sellers of Agency and Government Sponsored Enterprise (FNM/FRE) debt. Will they reverse course to support our borrowing needs in 2010? At near zero interest rates?

If we add the \$803 billion that the Federal Reserve purchased in the open market of Agency debt, coupled with the net decline in credit card debt, corporate debt and Asset Backed Securities, the total borrowing in 2009 was only about \$200 billion net! The green arrow below illustrates the Fed's QE effect on the totals. We believe that the lack of net supply kept longer term rates low in 2009.



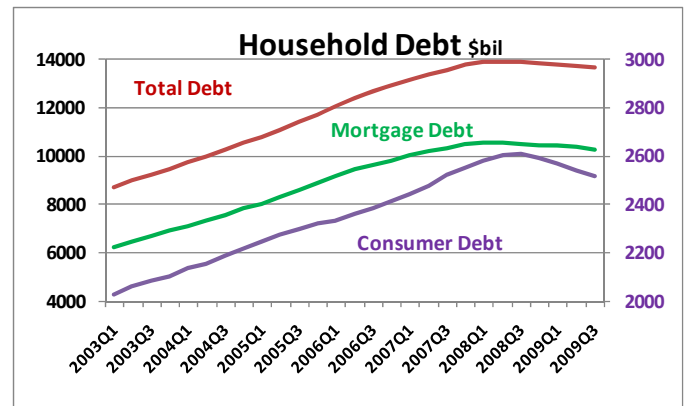
2010 will see the need for \$1850 billion net new federal borrowing. From where?

First, the Feds QE policy is set to end in March. At the beginning of the financial crisis in mid 2008 the Fed had about \$800 billion in US Treasuries on its balance sheet and little else. After Lehman blew up they quickly sold much of that total to bail out Wall Street firms. Congress then authorized \$1.75 trillion including \$300 billion for the purchase of long dated Treasury bonds (there being no real other buyers), \$155 billion to purchase Agency securities and \$1.25 trillion in mortgage backed securities (MBS). The Fed only has about \$200 billion more Treasuries to trade for bad loans without another authorization by Congress.

Second, the 3rd Quarter household savings ran at a \$489 billion annual rate or slightly over 4% of income. Household bond fund purchases were at a rate over \$300 billion. This easily covered the net \$200 billion net funding requirement in 2009 but will be wildly short of the 2010 needs. If we include all of personal savings and after dividend undistributed corporate profits we are still short.

Net Private Savings Annual Rate \$billions		After Tax and Dividends Undistributed Corporate Profits \$billions
2000	168.4	130.3
2001	132.3	132.9
2002	159.1	184.1
2003	110.7	244.3
2004	115.0	272.3
2005	127.7	670.5
2006	235.0	644.7
2007	178.9	555.1
2008	286.4	480.0
2009 Q3	489.9	673.4

Household deleveraging is quite apparent. Consumer debt declined at the rate of \$82 billion in Q3 (with growing bank charge-offs) and increased savings. We expect that Baby Boomers will continue to deleverage and that savings will slowly drift to up to the 6%+ level by 2011. But we will still be short.



Third, on the Christmas Eve voice vote in Congress to “temporarily” extend the debt ceiling FNM and FRE were quietly granted a release from the \$400 billion cap on government cash injections. So far FNM has received \$60 billion and FRE \$51 bn and it should be expected that mortgage defaults will continue to build and greater losses are in store. These losses are not budgeted so Fed actions have now become a stealth arm of fiscal policy; Congress gets deniability.

Fourth, stateline.org which follows state finances published a report in late December stating that despite \$145.6 billion of spending cuts since July 1 that 36 states remain in deficit to the tune of \$28 billion, and tax revenues are still falling. They must either borrow from the public debt markets or seek emergency funding from Congress.

Fifth, this does not include our trade deficit. Our trading partners have been offering us vendor financing for years and even a large portion of their domestic savings. Some of our trading partners are getting downright ornery. Over the holidays Mr. Zhu Min, deputy governor of the Peoples Bank of China made the following comments: “The United States cannot force foreign governments to increase their holdings of Treasuries...Double the holdings? It is definitely impossible.” He further added “The US current account deficit is falling as residents’ savings increase, so its trade turnover is falling, which means the US is supplying fewer dollars to the rest of the world. **The world does not have so much money to buy more US Treasuries.**”

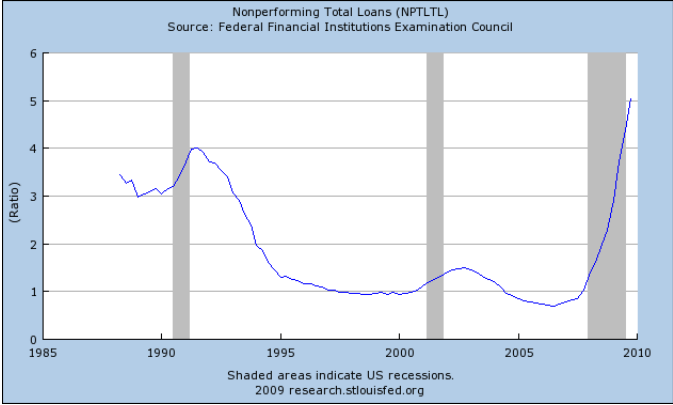
Growth of US Treasury Holdings by Major Foreign Owners			
\$billions			
	Oct-08	Oct-09	%Δ
China	604.1	790.9	30.9%
Japan	629.6	746.5	18.6%
UK	133	230.7	73.5%
OPEC	176.7	188.4	6.6%
Carib Bks	203.5	169.9	-16.5%
Brazil	141	156.2	10.8%
Hong Kong	69.8	142	103.4%
Russia	110	122	10.9%
Total	2980	3498	17.4%

China's 2008 trade surplus with the U.S. was \$268 bn and they purchased over \$600 billion of Treasuries. We estimate the 2009 surplus to be around \$235 billion, and through October their purchases have been \$791 billion. It is possible that they could continue to add to their Treasury holdings past their trade surplus but other recent statements cast some doubt.

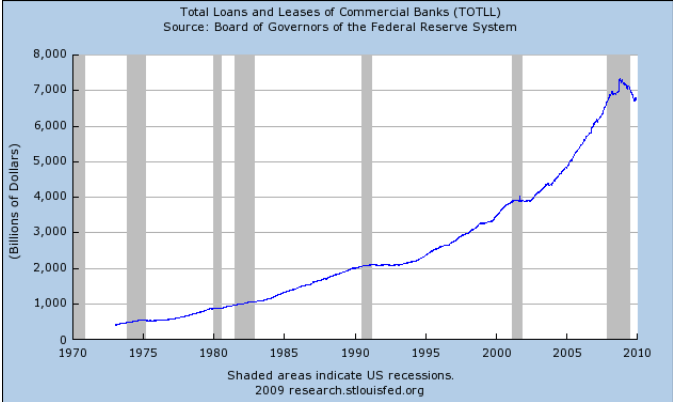
Next we turn to the question of the coming decade. How can the current crisis of too much debt be solved with even more debt? It was Richard Nixon who proclaimed that "we are all Keynesians' now". Keynesian philosophy has become the crack cocaine of western politicians. It holds that government can control and fine tune large economies with fiscal policy run by a very few of our "best and brightest"; running deficits in recessions and surpluses in boom times. Forgotten in post WWII America is the surpluses in good times. While this philosophy has been great for those who are elected to distribute the deficit spending, it will soon, in our opinion, to come to repudiation. We are in a debt death trap.

Let us explain further. It was during Ronald Regan's presidency that we switched from a "save and spend" to a "borrow and spend" nation. Capital markets became triumphant and Wall Street became "God's Work".

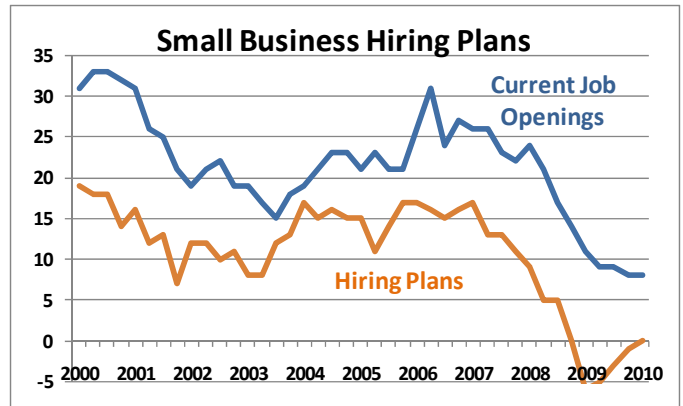
We at Cascade were great fans of Reagan but always took issue with his opinion that "deficits don't matter". The cumulative effect of this philosophy will haunt our nation for another decade. The banking system was able to move from a model of collecting savings to lend to business and credit worthy individuals to a model of finding the loans first and then finding funding in the capital markets; i.e. borrowing the reserves to fund the loans ex post facto. America became addicted to a constant growth model that required a geometric growth of debt. That model is now broken. At the end of the 3rd Quarter of 2009 the nation's gross credit market debt was \$52,617 billion and that was supported by about \$2,000 billion in base money or a ratio of about 3.8%. Nonperforming loans have risen to 5% of outstanding total loans and this certainly raises the issue of solvency.



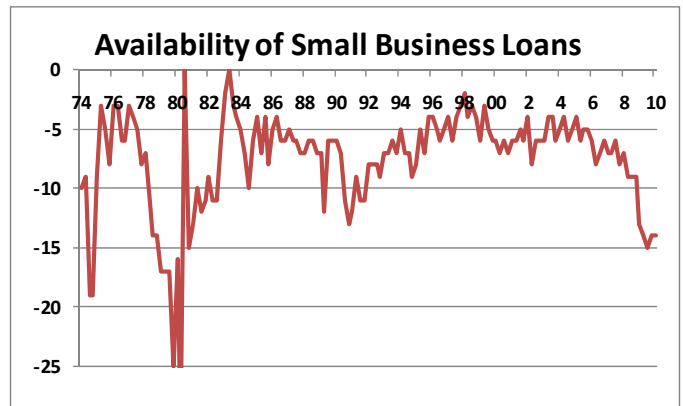
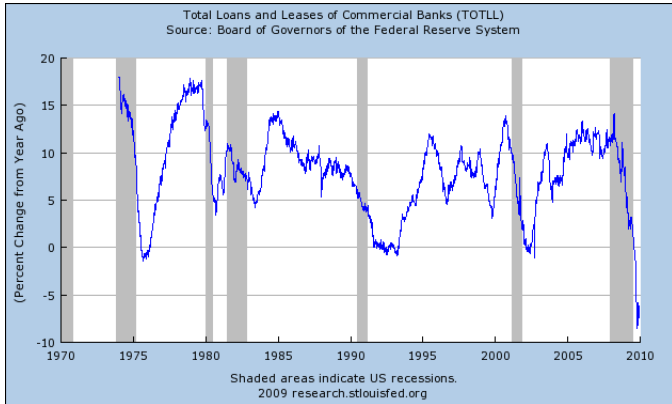
It is not an unrelated event that reporting rules (FASB 114) have been suspended so that banks can carry loans that are seriously delinquent at 100% of face value. In this environment total loans are shrinking and this is not enabling economic growth.



Given this reality banks are not lending because they have no marginal capacity to do so. There are no excess reserves to be borrowed only excess liquidity, and there is a big difference. In a fractional reserve system banks must have reserves to lend. The Fed can lend banks liquidity, but it cannot lend them capital. As a result bank lending continues to fall and all major and many smaller banks are issuing new equity.

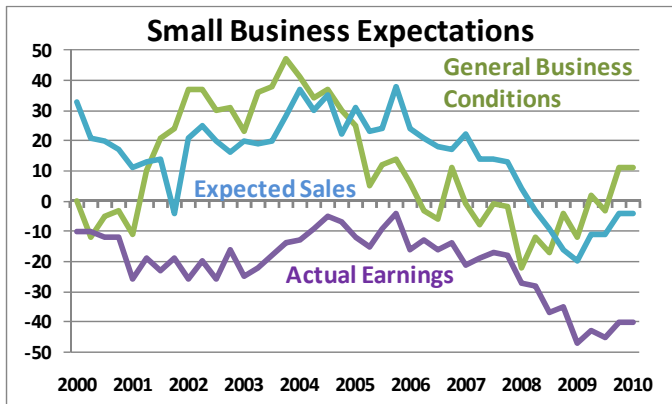


Loans are available to some businesses that are credit worthy and conditions are not as dire as the credit crisis of the 1980's. Then credit was available but prohibitively expensive; now it is inexpensive but not readily available.



The backbone of job creation in America is small business, and a look at their condition is important. The latest report from the National Federation of Independent Business reports that conditions are improving but expected sales are still falling and actual earnings expectations are still declining.

To conclude the issue of debt: to break the doom loop, the debt burden of past uneconomic projects, both commercial and individual must be written off, forgiven or both. The political clout of Wall Street has moved \$trillions of losses from their books to the public at large straining almost to the breaking point the viability of the public financial system. Wall Street saved itself and Main Street suffers. This must change.



In the early 1980's "crowding out" described the government's gathering all of the savings of the country for its own use. 2010 will be a repeat as the \$1850 billion of new debt needed by the Federal Government will suck most of the oxygen out of our economic system. We believe that the appropriate course of action with your investment funds is to concentrate on those firms with little leverage on their balance sheets and long term financing already in place.

While there are job openings available in small businesses, hiring plans are still below zero; small business is just not hiring due to the expectation of declining profits. This is a vicious circle: job losses beget credit card defaults and home mortgage delinquencies which leads to lowered home prices, bank profits and lower small business lending etc. This doom loop is destroying asset values faster than the Fed can print new money.

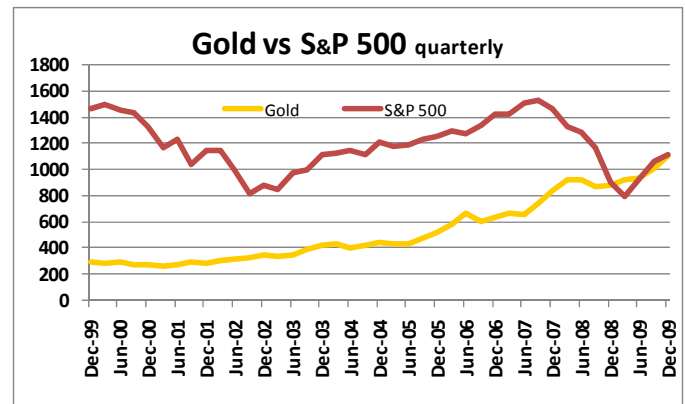
Below we highlight the largest holdings in our portfolios. We have always concentrated on free cash flow, but believe that in the next decade, low debt to equity ratios are going to be central to value investing.

Company Name	Debt/Equity Ratio
Barrick Gold Corp	-0.07
Johnson & Johnson	-0.05
Monsanto Co	-0.02
Goldcorp	0.01
Tidewater Inc	0.00
Noble Corp	0.00
Chevron Corp	0.04
Baker Hughes Inc	0.04
Schlumberger NV	0.07
Yamana Gold Inc	0.07
Agnico-Eagle Mines Ltd	0.17
Apache Corp	0.24
Marathon Oil Corp	0.33
Elin Lilly and Co	0.35
Newmont Mining Corp	0.36
Abbott Laboratories	0.33
Anadarko Petroleum Corp	0.48
ConocoPhillips	0.49
Potash Corp	0.64
TC PipeLines LP*	0.84
Enbridge Energy Partners LP*	1.14
Oneok Partners LP*	1.21
TransCanada Corp	1.25
Enterprise Products Partners LP*	1.45
Enbridge Inc	1.94

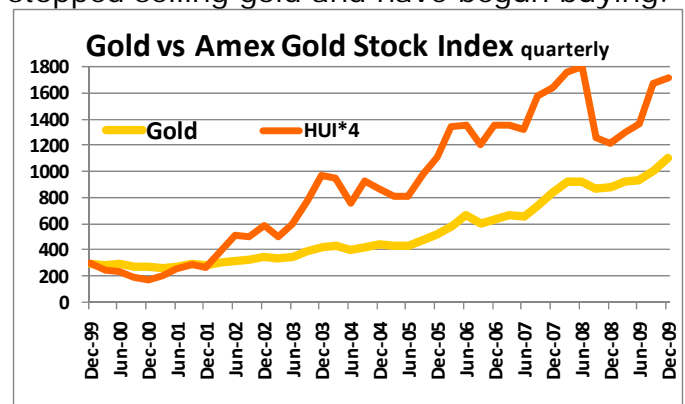
The issues highlighted in yellow are Master Limited Partnerships where the debt is short term bank loans which are periodically paid off through the sale of new partnership units. The number reflects the maximum bank line of credit not the actual leverage today. Bottom line: We are invested in companies with very low exposure to rising interest rates.

And now to the final question: Is there any limit to the amount of paper money that America can print without consequence? The broad money stock is about \$9550 billion and the total of QE at \$300 billion is a 3% dilution of the existing money stock.

We vote no on all corporate managements' request to give employees incentive options that dilute your equity position by more than 1% per year or a total over 5% in any long term program i.e. we oppose the efforts of companies to "water" their stock. Chairman Bernanke can wax poetic about high unemployment and low capacity utilization rates to prove there is no inflationary price pressure but he is in fact "watering" the monetary stock of the United States. The Central Banks of the world see this, and the stock and metals markets see this.



India bought \$200 billion of gold bullion from the IMF in November and Central Banks stopped selling gold and have begun buying.



Any post-March "exit strategy" from the madness of QE and the dilution of value of the \$US must include the sale of some of the toxic paper they now own. We do not know of any willing buyers of such size. We see no early "exit" only further monetary dilution.

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