



Cascade Investment Commentary

For decades after WWII America had a four year economic cycle that was centered around automobiles and the union contracts that surrounded their production and distribution. As we “morphed” into a service based economy politicians have created an economic cycle that is centered around the Federal election cycle. In this report we speculate that the economy has changed even further to reflect a “credit cycle” for the first time.

Recently we were at a gathering of all of the investment managers of one of our accounts. We were to report on our outlook for the future. We were the only bear in the room (and by several \$ billion the smallest manager). Below we try to summarize some our thoughts on what has changed in the financial landscape, and why that leads to our caution. Financial firms are leveraged as never before and counter-party risk is growing. Anemic household financial recovery will lead to consumer spending disappointment in 2006.

The stock market has been acting in an irregular fashion. Yes the market is still cyclical, and the election cycle pull is still evident, but this last cycle has been different.

In the “old days” Wall Street’s conventional wisdom was that the stock market bottomed about six months before a recession ended. Starting from the 1932 low of 41.22 on the Dow (7 months before recovery). A big job of an economic analyst in the past has been to figure out exactly when a recession started for bottom timing purposes. This conventional wisdom worked fine until this past recession.

Further, the stock market is supposed to be an efficient discounting mechanism, getting more efficient with each generation of laptop personal trade stations, number crunching spreadsheets and transparent Sarbanes-Oxley certifications. Everything about the past recession and the current recovery seem somewhat different. As the table above shows, the S&P bottomed 215 days **after** the end of the recession.

Curious minds at Cascade wonder if there is a larger disconnect with past stock market behavior that we should be paying attention to. After all, if “investment is the art of comparison”, we better have plenty of confidence in the data that comprises the answer to “compared to what?” So what gives?

Three things come to mind: Fiscal stimulus, monetary stimulus and leverage. The George W. Bush administration took office 90 days before the country was in recession. They came with a policy of lowering some taxes each year. We have enjoyed fiscal stimulus for 3 years in a row, plus we had the panic spending by Congress post 9/11, and in addition, the spending on two wars.

Asymmetric Stock Market Behavior

Recession Begins	Recession Ends	Length Months	S&P Bottom Date	Days Prior To End Of Recession
Aug-53	May-54	10	Aug-53	268
Sep-57	Apr-58	8	Oct-57	199
May-60	Feb-61	10	Oct-60	126
Feb-70	Nov-70	11	May-70	188
Dec-73	Mar-75	16	Dec-74	115
Feb-80	Jul-80	6	Apr-80	99
Aug-81	Nov-82	16	Aug-82	110
Aug-90	Mar-91	8	Oct-90	171
Average		10.6		160
Apr-01	Nov-01	8	Oct-02	-215

	Federal Revenue	Federal Expenditures	difference \$ billions
2000	2,025.20	1,789.10	86.3
2001	1,991.20	1,863.00	-32.5
2002	1,853.20	2,011.00	-317.5
2003	1,782.30	2,159.90	-538.4
2004	1,880.10	2,292.20	-567.4

In the panic that followed 9/11, the Federal Reserve put its foot on the money supply pedal all the way to the floor. Years 2001-2003 all showed money supply growing faster than GDP and thus adding to excess liquidity.

Money Supply Annual Growth Rates				
	M1	MZM	M2	M3
2001	3.03	15.8	8.71	11.4
2002	4.85	12.84	7.57	8.03
2003	6.04	7.31	6.83	6.32
2004	5.39	3.86	4.48	5.19

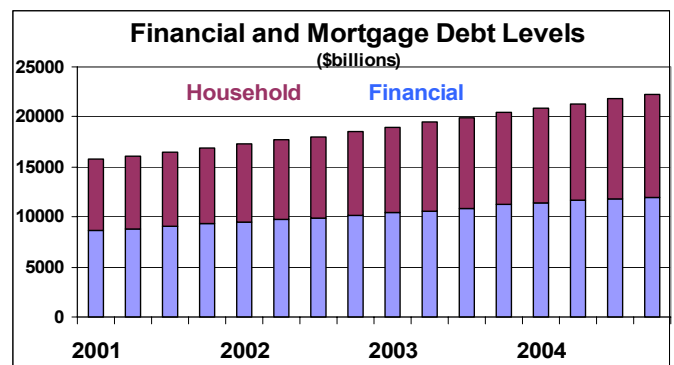
Cost of \$1 in GDP Recovery			
	Nominal	New	\$ New Debt
Recovery Period	Growth (\$bil)	Credit (\$bil)	For Each \$ GDP
2Q54 - 2Q57	84	105	1.25
1Q61 - 1Q64	126	183	1.45
2Q70 - 2Q73	355	546	1.54
2Q75 - 2Q78	706	1078	1.53
4Q82 - 4Q85	1046	3009	2.88
2Q91 - 2Q94	1143	2778	2.43
4Q01 - 4Q04	1854	8383	4.52

This recovery has taken an unprecedented level of debt to lift GDP. We suspect that much of this borrowed money has gone for purposes that did little to add to permanent US jobs.

Debt Growth	2004
Total Credit Market Debt	8.3 %
Government	9.0 %
Household Mortgage	13.5 %
Consumer Credit	4.9 %
Corporate Non-Financial Debt	4.9 %
Financial Sector	7.3 %
Gov't Sponsored Enterprises	3.8 %
Asset Backed Securities	15.7 %
2004 Nominal GDP Growth	6.4 %

While below inflation Fed Fund rates are not unheard of, the most recent length of time has been unprecedented. The Federal Reserve began lowering rates in January 2001, and from June 2003 to June 2004 kept the rate at 1.00%. A very long time to offer "free money".

Households during this period borrowed \$2615 billion raising their debt by 53%. Evidence points to consumption with this money. Financial institutions borrowed \$3426 billion raising their debt by 39.8%. Most evidence points to their re-investing this money in longer dated securities, also known as "the carry trade", making almost risk free profits. We think these significant profits are soon to end, and will harshly impact some financial firms.

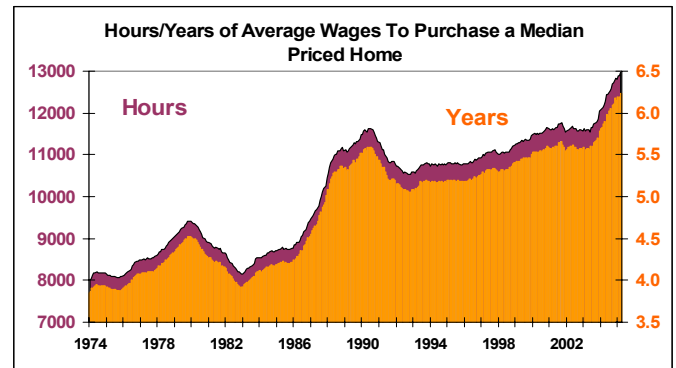


We have spoken before about Chairman Greenspan's warning to "the carry trade" participants. They are as frogs in a great liquidity pot currently sitting on a great burner in the Federal Reserve which has been heretofore raising the temperature 25 basis points per meeting. Many of these frogs will jump out of the pot, but many we fear will likely cook. Even for those smart enough to try to jump, the problem is now the sheer vastness of these numbers and how to unwind their trades. **At the end of the day it all comes down to liquidity, and who will buy in time of stress.**

In the daisy chain of credit one never knows exactly which is the weakest link. One link mentioned above is the growth of money supply, which is now down to levels more appropriate to GDP growth.

The largest link is the American Household. Now representing 71% of GDP, household behaviors are critical to watch. The big story in American households since 9/11 has been equity extraction, or the willingness of individuals to re-finance their house and extract cash leaving the monthly payment unchanged. All of the English speaking economies have been experiencing this same phenomenon.

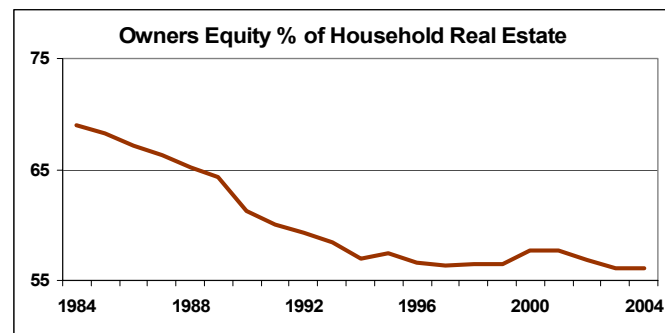
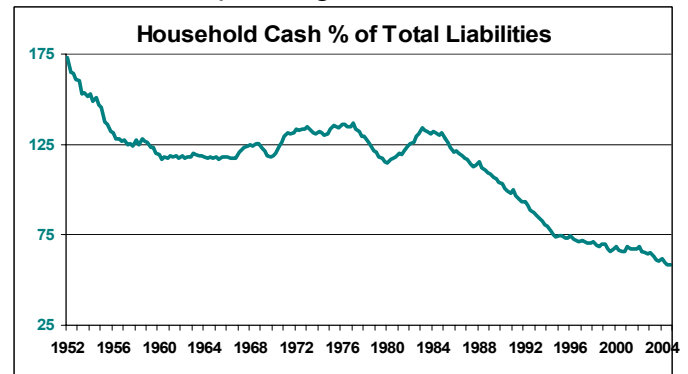
The UK and Australia now find that the flattening of their real estate markets have literally stopped home equity lift-out. This has lowered recent retail sales, and 2005 profit estimates are being lowered. In 2004 equity withdrawal in the US was about 51/2% of disposable income. This only works when interest rates are falling and home prices are rising. If equity withdrawal slows, 71% will be immediately felt in lower consumption, and thus lower earnings growth in many industries. Since 1998 almost all of the gain in US home equity has been lifted out, and the equity ratio is holding at about 56% of market value This credit link now appears to us to be weak.



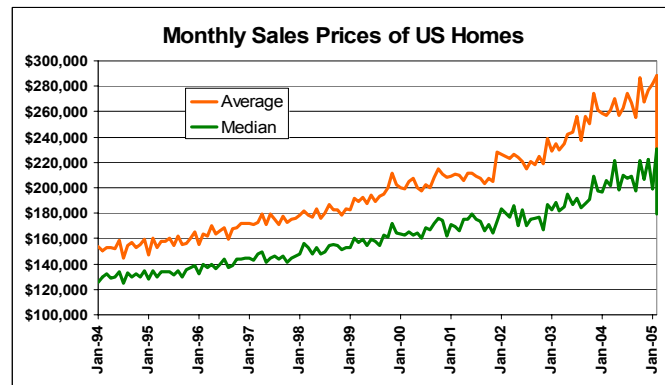
Today, despite improved labor productivity, technological advances, and the substitution of cheaper building materials, that price has risen to 12,974 hours or 6.2 years of labor. The cost of housing has been rising faster than the wage base beneath it, and at some point (soon) something must give: household consumption, home prices or wages. Our view of soon is the next 18 months.

We are now 40 months into recovery. In only 10 of those months did we have a positive surprise in job creation. While the average of the past seven post recession's growth in jobs is 6%, there has been no net growth yet. Wage growth is currently below inflation. It would be ominous if we have "outsourced" the labor component of GDP recovery. As the Fed raises interest rates, the end demand for the 29% of new homes purchased by speculators will wane considerably if household income does not improve by more than the rapidly rising household energy costs.

Household cash (checking accounts, savings deposits money market funds) is approaching \$6 trillion. Many analysts base their optimism on consumer spending on this. Not us.



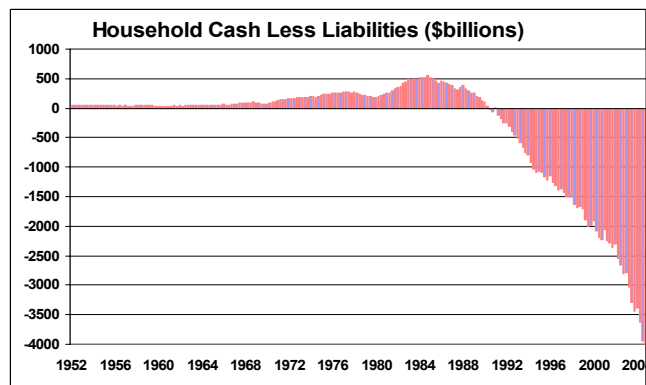
By most metrics the housing market appears robust. The median new home sold in February 2005 was \$230,700, and the average price was \$288,400, both are all time highs.



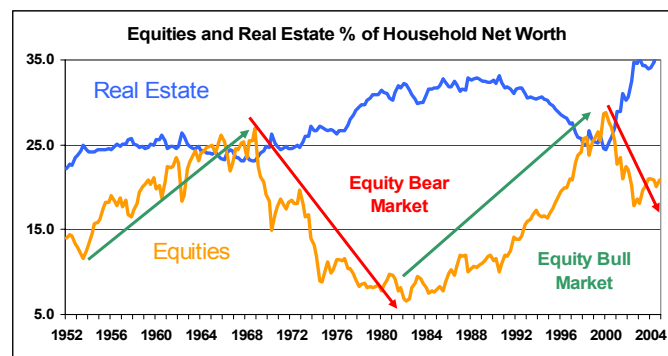
Being contrarians, we see an end to this parabolic sweep. The simple reason is that the average family cannot spend their entire paycheck on housing costs. In 1974 the average worker in manufacturing (highest paid category) earned an average of \$3.85 per hour and could purchase the average priced new home for 8000 hours (4 years) of gross salary.

While cash assets have been building, the chart above illustrates that liabilities have been building faster.

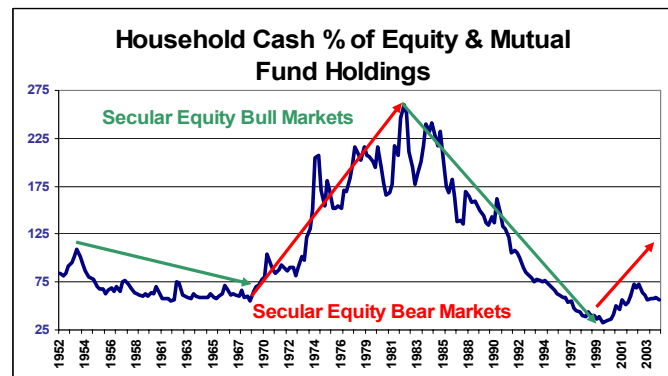
Households have two primary assets: their home and their equity and fixed income portfolio. Over time, households show preferences for overweighting one asset class over another, and these preferences are secular in nature. As the current secular bear market in equities takes its toll on portfolios, we expect the allocation of household portfolio assets to more resemble 1969-1982.



As for the final link in the chain, we look to a big source of real estate liquidity: Fannie Mae. Its balance sheet has exploded in recent years, adding \$ 1.2 trillion in liquidity to the home loan market. Chairman Greenspan suggested limiting further debt expansion in his March remarks. Federal Reserve Bank of St. Louis president William Poole stated “The accounting problems that surfaced a both Fannie and Freddie would surely have been assigned a very low probability two years ago... It may be that the highly volatile interest rate environment of the early 1980’s is extremely unlikely to recur, but I would like to see F-F maintain capital positions that would enable the firms to withstand such an environment anyway. **One thing I think for sure is this: An investor who ignores the risks faced by Fannie Mae and Freddie Mac under the assumption that a federal bailout is certain should there be a problem is making a mistake.**” Who will be the interest-only-nothing-down lender without Fannie Mae in the picture?



During secular bear equity markets, the household preference for cash assets rises. We expect that pattern to be repeated.



Household behavior has been driven by liquidity, and the belief that lending will be readily available against all portfolio assets. History suggests extreme caution. Every time the Fed has raised rates for a prolonged period there has been a liquidity crisis somewhere. Since the Long Term Capital Management collapse, derivative arrangements are up more than 500% to almost \$60 trillion. Someone somewhere has too much risk, and will suffer.

In summary: We find the probability of further fiscal stimulus, monetary stimulus, and increasing household leverage very low. We regard the future earnings of companies that depend upon such events as problematic. Our gravest concern is that we have become a finance based economy, and whether it is the trade deficit or instant access to equity in our homes, at the margin everything now revolves around borrowing. This cycle has an end.

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