



Cascade Investment Commentary

In addition to its statutory regulatory responsibilities the Federal Reserve currently finds itself in the dubious position of trying to juggle seven additional balls in the air at once: The value of the U.S. dollar, the credit market, inflation, employment, the economy, the housing market and the stock market. Each of these have deeply entrenched constituents that believe they should be protected above the others. The Greenspan Fed chose to solve the problems that each of these faced with the injection of massive new liquidity. Rising liquidity has now overwhelmed monetary policymakers worldwide and one or more of these balls is bound to fall. With the massive leverage built up within each ball over the past five years, the impact of one hitting the ground is profound but truly unknown.

The Panic of 1907 on Wall Street was caused by excessive lending (over 50% of bank deposits) to Trusts which speculated primarily in Railroad and Copper shares. In October the value of the collateral collapsed and the losses spelled ruin for many banks. Only J.P. Morgan was really solvent, and reluctantly stepped in to save the day. Afterwards Congress set up the National Monetary Commission (1909-1912) to study the problem, and after much debate the Federal Reserve (Fed) was created in 1913.

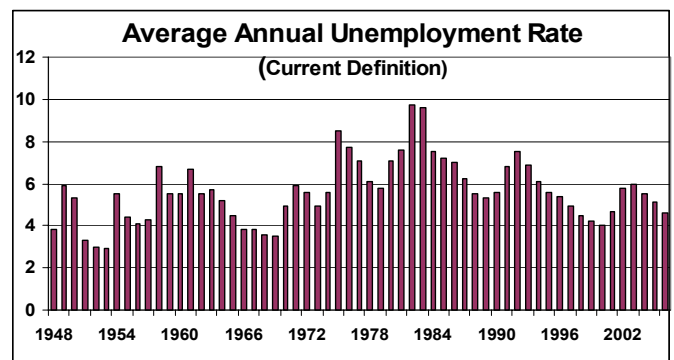
The original purpose of the Fed was to provide a ready reserve of liquid assets that could be lent to member banks in times of panics, and provide a national currency that would expand and contract with seasonal demands. Twelve Regional Banks were established with the private funds of banks in each District, and the HQ in Washington.

The Fed like all other Agencies, is a creature created by Congress (a fact that they are all periodically reminded of). The Act has been amended almost 200 times, notably the Employment Act of 1946 and the Full Employment and Balanced Growth Act (Humphrey Hawkins) of 1978.

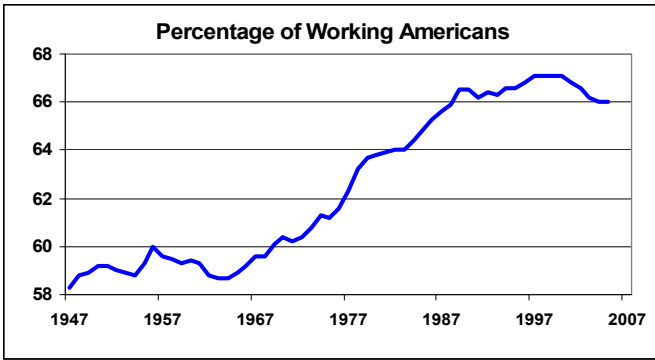
To get an idea of the burden placed on the Fed by Congress, we quote the official long title of the 1978 Act signed by Jimmy Carter:

“A bill to establish and translate into practical reality the right of all adult Americans able, willing and seeking to work to full opportunity for useful paid employment at fair rates of compensation; to combine full employment, production, and purchasing power goals with proper attention to balanced growth and national priorities; to mandate such national economic policies and programs as are necessary to achieve full employment, production, and purchasing power; to restrain inflation; and to provide explicit machinery for the development and implementation of such economic policies and programs.”

The Act explicitly instructs the nation to strive towards four simultaneous goals: full employment, production (GDP) growth, price stability and balance of trade and budget. We believe that the Fed now faces a zero sum game, and any policy shift will do harm to one of the mandated national goals. Rates go up unemployment rises and housing gets worse and. Rates go down the \$US falls etc.



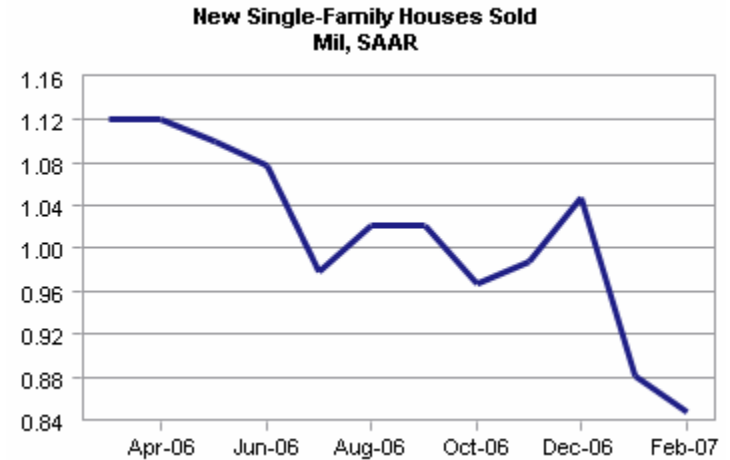
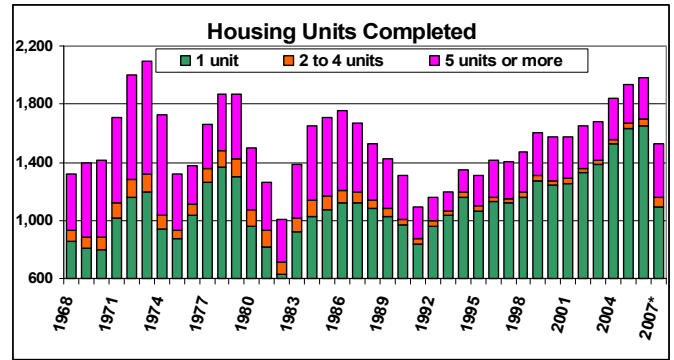
The chart above would indicate that the employment goal (most important priority of Congress) is being met. The latest report from the Bureau of Labor Statistics states that 144,427,000 persons (on average) were employed in 2006, and that represented 66% of the over 16, not in school, non-institutionalized population.



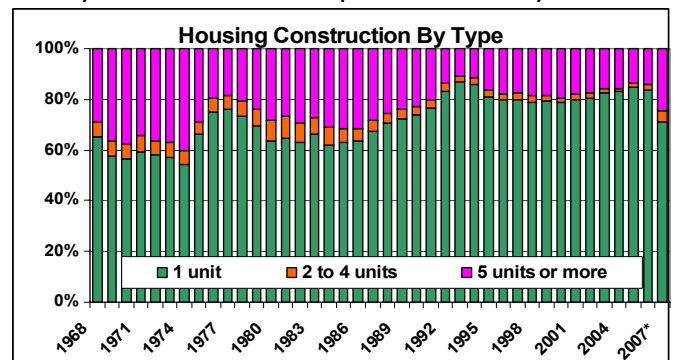
Of these 144,427,000 employed individuals 12,993,000 were involved in the construction or related trades. That is 9% of the total.

BLS Household Data Averages	Total Employed (000)
Construction Managers	1,010
Loan Counselors and officers	468
Architects, except naval	221
Real Estate Brokers and sales agents	1046
Loan interviewers and clerks	190
Supervisors, managers of construction trades	976
Brick masons, block masons and stonemasons	244
Carpenters	1843
Carpet, floor and tile installers	279
Cement masons and concrete finishers	107
Construction laborers	1693
Operating engineers and equipment operators	451
Drywall installers	295
Electricians	882
Painters, construction and maintenance	713
Pipe layers and plumbers	662
Roofers	242
Sheet metal workers	125
Structural iron and steel workers	59
Helpers, construction trades	132
Construction and building inspectors	102
Cabinetmakers and bench carpenters	113
Total	12,993

There has been a very steady ratio of employment to the number of home construction completions at about 6.5. That is each home under construction employs 6.5 workers for a year. As the employed tend to vote for incumbents these numbers are very important to Congress. The Sub-Prime issue is old news to them. The graph below tracks completed single and multi-family units completed, and their total times 6.5 is a good proxy for future employment. The latest Census Department New Homes Sales release shows new home sales are running at an annualized monthly rate of 848,000, or about 1.1 million per year.



Were this rate to continue through 2008 the "normalized" need of construction related jobs would drop by almost exactly 3 million to 9,958,000. The political outfall of this cannot be exaggerated and likewise the pressure on the Fed to accommodate directly or indirectly the continuing boom in housing. Note below the strong preference for single family units over multiple in recent years.

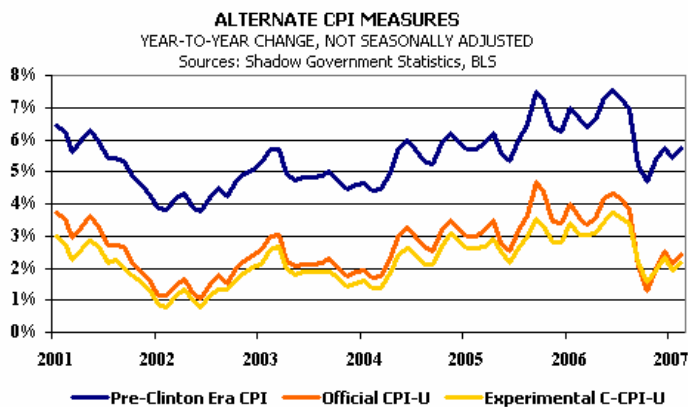


We all know that the housing boom lured borrowers without the genuine ability to repay the loans on a timely basis, so now what? For starters expect endless Congressional hearings. Since the Fed has the supervisory role over a shrinking percentage of institutions involved with making home loans will any lever of fiscal or monetary policy be used to "do something"?

Our guess is that the Fed will maintain as much monetary ease as possible while pretending to be "vigilant" about inflation. 17 rate increases by the Fed have not slowed the growth in the credit markets or moved the official inflation needle.

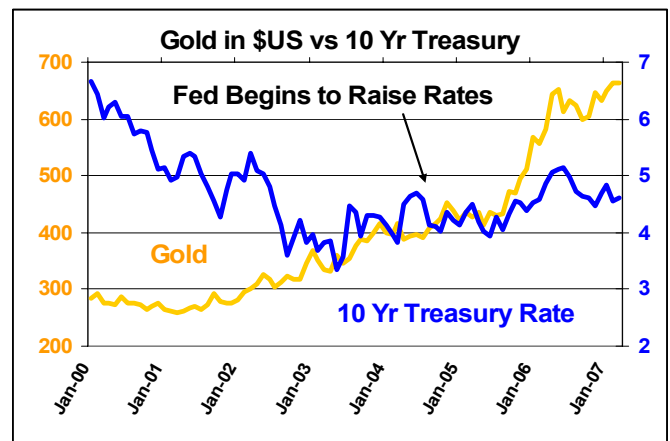
Select Measures of Fed Tightening	
52 weeks ending March 30	Increase
M2 Money Supply	6.1%
MZM Money Supply	8.8%
M3 Money Supply (SGS)*	10.9%
Money Market Funds	18.3%
Commercial Paper	20.1%
Collateralized Debt Obligations	32.0%
Fed Foreign Holdings of Treasury and Agency Debt	18.1%
International Reserve Assets (excluding gold)	19.1%

Shadow Government Statistics (SGS)* believes that the true rate of inflation is just shy of 6%. How price stability is to be maintained with financial metrics growing at present rates is a conundrum to us.

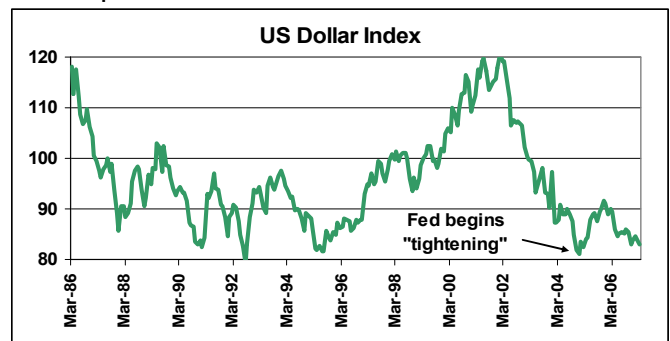


Fed Chairman Bernanke has testified that his inflation "comfort zone" as measured by the core Personal Consumption Expenditure Index is 1-2%. The upper end of that target has been exceeded for each of the past four years and we see only upward pressure in the immediate future. While Mr. Bernanke claimed last Wednesday that "inflation was a concern", it is clearly the real estate market that concerns Congress, and the only hope for many of their voters is continuing price rises in housing. That can only mean continued near or double digit monetary growth, and with it the resulting inflation.

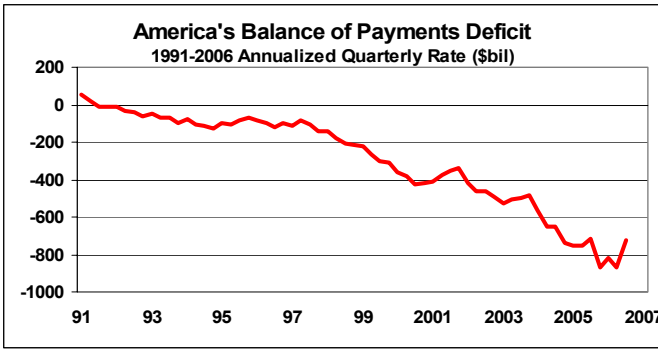
The perception of price stability can normally be found the price of gold in local currency terms, and in the interest rates demanded by lenders. Both have been rising in the U.S. for over three years.



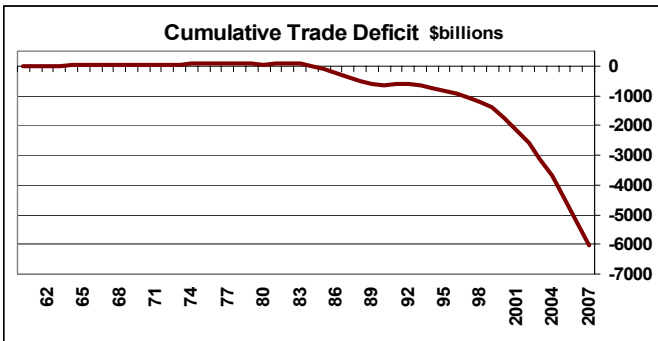
The possibility of rising inflation due to massive new liquidity is not lost on \$US holders. On March 15th China's Premier, Wen Jiabao explicitly characterized macro conditions (in China) as "unstable, unbalanced, uncoordinated and unsustainable." The following day the People Bank of China raised interest rates. China has recently announced plans to "diversify" its portfolio of reserve assets currently invested mostly in US Treasury and Agency debt. With interest rates rising in all of our major trading partner countries, how can the Fed cut rates at home and maintain \$US stability? If the \$US breaks down we will import inflation on a massive scale.



The balance of trade is a story often mentioned. Our concern is that we have outsourced so many manufacturing jobs that we will not have very much of value to sell to the rest of the world in order to stabilize this imbalance should the world choose not to fund our consumption with their savings.

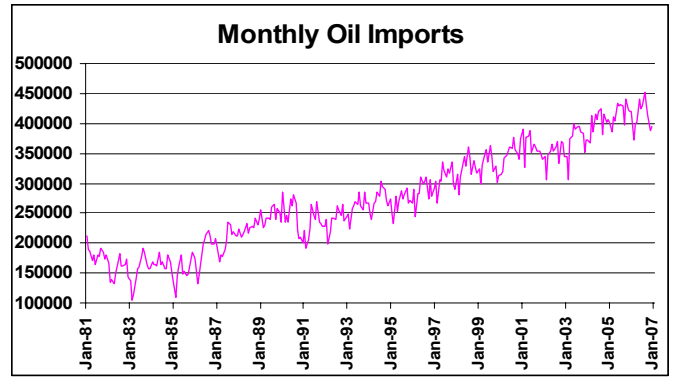


David Ricardo (1772 – 1823) first proposed the benefits of open trade. This was prior to the Internet’s ability to move intellectual property over phone lines or the outsourcing of professional services to developing countries. Bill Gates said famously that “the Internet changes everything”. We believe that it will fundamentally change the debate over the terms of “fair” and “open trade” in the immediate future. We estimate that the cumulative trade deficit since 1960 is just over \$6 trillion. Notice the change since the Internet became a worldwide commercial vehicle in 2001: policy makers sure have.

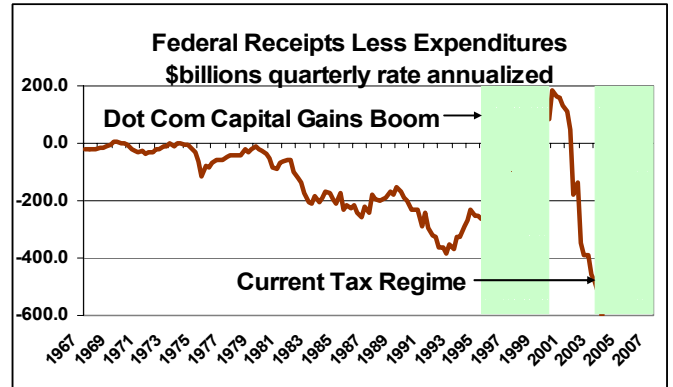


The “uphill flow of capital” is now the phrase describing poor nations’ financing the excess consumption in the US. Recently Nasser al-Shaali, chief executive of the Dubai International Financial Center Authority (DIFC) recently said “Reverse globalization – when you have emerging market players going out and acquiring developed institutions- is a tide that no matter how you try to swing against it, will be very very prevalent in the years to come”.

Although every President since Richard Nixon has stated that “we must reduce our dependence on foreign oil” we know of nothing that will immediately break the long term trend we see below.



Fiscal policy is in a box also. The current tax regime has boosted federal revenues substantially. Congress has only the election of 2008 on its mind and many seem mindless to the damage likely from a major tax increase. With an economy growing barely above the stall rate, the talk alone may very well push us into official recession contrary to stated policy.



If there is a massive liquidity response by the Fed to the falling real estate / Sub-prime mortgage problem, the most likely balls to hit the ground are the \$US and the official and perceived rate of inflation. If that occurs what do we suppose that Gulf States and Chinese policy makers will invest in given their recent public announcements? More inflation sensitive bonds or the productive assets that create the only tradable goods we can sell to the world with a competitive advantage? Your portfolio is invested in such companies: mostly insensitive to interest rates and which produce goods and services that are vital to America and the world.

March 30, 2007.

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