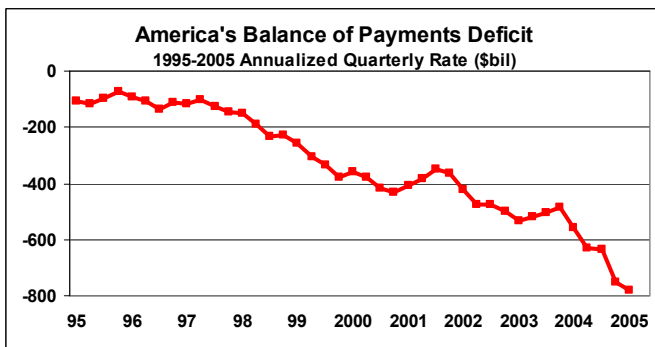
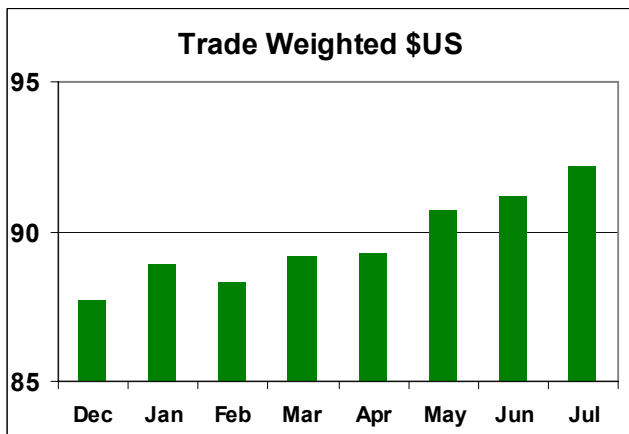




# Cascade Investment Commentary

**At the beginning of the year we, like many others thought that the sheer size and weight of our trade deficit would cause the \$US to decline against our major trading partner's currencies. Further, we believed that the action of the Federal Reserve to raise short term interest rates would cause longer dated bonds to fall slightly in price. Below, we reflect on why we have been wrong so far.**

**Why** are people bidding up the \$US against major trading partners currencies while the US trade deficit continues to swell? What are the buyer's motives?

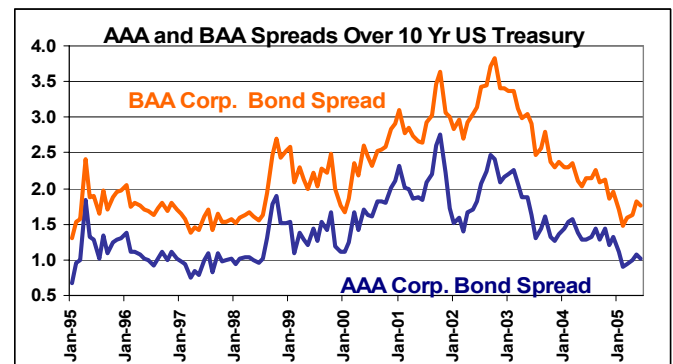


**Purchasing \$US to buy oil is a big reason, but possibly investors reaching for yield.** "Reaching for yield" refers to the practice of extending the maturity or lowering the quality of fixed income holdings to add more current income to investment portfolios. In a world that has become accustomed to 6% income for pensions, annuities, endowment payouts etc., low interest rates are causing great strain.

**It** hurts even more if you are European or Japanese. With 10% unemployment in Germany and Italy, and just shy of that in France, we can understand why they are taking a currency risk to earn more income.

<b>U.S.</b>	<b>4.02</b>	<b>Japan</b>	<b>1.78</b>
<b>Germany</b>	<b>3.66</b>	<b>France</b>	<b>3.14</b>
<b>England</b>	<b>4.27</b>	<b>Italy</b>	<b>3.90</b>

**Investors** have chased the premium over the "riskless rate" 10 Year US Treasury down to the levels seen just before Long Term Capital Management blew up in 1998 over leveraged "carry trades". When hedge fund mania started in 2002 and 2003 risk was amply rewarded. Today's interest rate environment has been described as "return free risk".

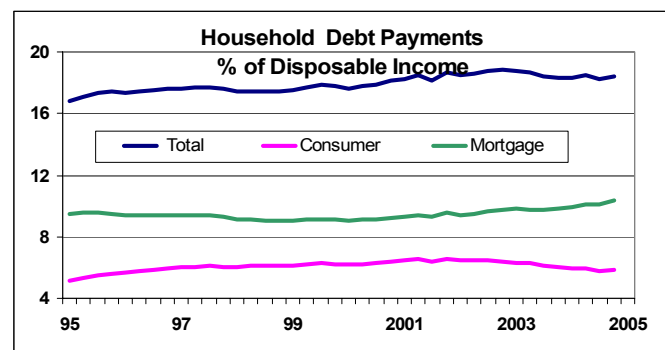


**For** the past several years the American consumer has been the economic engine of global demand. From 1997 to 2004 U.S. private consumption growth averaged 3.9% per annum, almost twice the growth rate of all other industrial countries (2.1%). While the U.S. generates 38% of the advanced world's GDP, we have been generating 53% of the consumption growth. Even in the post tech-bubble (since 2000), the U.S. GDP growth has averaged 3.2% compared to 1.25% in Euro zone and 0.8% in Japan. Consumption as a percentage of our GDP has risen steadily to the level now of 71%. A vested interest in our consumption binge has been acquired not only by many business interests but by state and local governments as well. The next slowdown, even shy of recession will cause great fiscal grief to states with high sales taxes.

The American consumer has been spending more money than current earnings for some time, and the source of the extra spending money is well known: home equity extraction and foreign lending. The home re-finance data is followed closely by Federal Authorities.

Year	Household Equity % of Residential Market Value	Year over Year Home Price Appreciation
1996	56.6%	2.6%
1997	56.3	4.6
1998	56.3	5.5
1999	56.6	5.2
2000	57.7	7.6
2001	57.7	7.5
2002	56.8	7.5
2003	56.0	8.1
2004	56.1	11.9
2005	56.3	12.5
<b>Cumulative Total</b>		<b>100.6%</b>

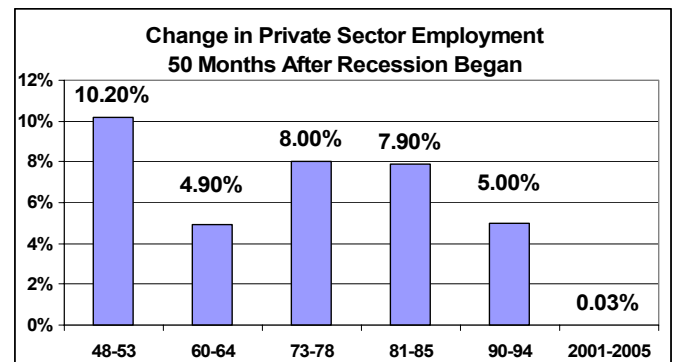
Americans have withdrawn almost 100% of the total 1996 value of their homes and replaced it with the almost exact amount of debt, and since debt and its interest service is a fixed number and the equity value of the home fluctuates (both up and down), we worry for (avoid) the lenders should real estate go down in value, and we worry for (avoid) those businesses dependent upon ever more consumption should real estate merely go sideways. So far not a critical problem.



Equity stripping has happened against the backdrop of the poorest jobs recovery from a recession in memory. The entire economic cycle since 2000 has been without precedent. Past recessions have been triggered by monetary tightening, which in turn led to rising

interest rates, slowing business investment, slowing home construction, slowing consumer expenditures, rising savings rates and contraction of consumer credit. At the beginning of the economic downturn of 2000-2001 the Fed raised rates in three rapid steps to 6.5%. GDP growth fell from 3.7% in 2000 to 0.8% in 2001, yet credit expansion rose sharply for the first time ever in a recession.

Business fixed investment was the real loser in the last recession. Over 3 million manufacturing jobs have been lost, and there is no recovery in sight. They have been largely replaced with government and service jobs that require no capital investment. It is true that private sector employment has recovered back to the 2000 level, but 803,000 of the 836,000 net total jobs are government/service related.



As public sector and service jobs replace manufacturing at lower hourly rates, readers should not be surprised that real average gross weekly earnings published by the Bureau of Labor Statistics are virtually unchanged since 2000. In March 2005 they were \$276.08 per week versus \$275.62 in 2000, yet they are now supporting substantially more debt. We grant that lower interest rates makes the monthly payments seem affordable, but over the four years 2000-2004 disposable income of private US households rose by \$1,452 billion. \$3.8 trillion was borrowed against housing, but only \$216.9 billion was spent on new housing. \$2.8 trillion was spent on consumption.

As quality conscious investors we are curious at who is lending this money to American households. In the next table note the absence of GSE's such as Fannie Mae.

Congress has reigned in the balance sheets of both Freddy Mac and Fannie Mae, and they have been recent net sellers of mortgages.

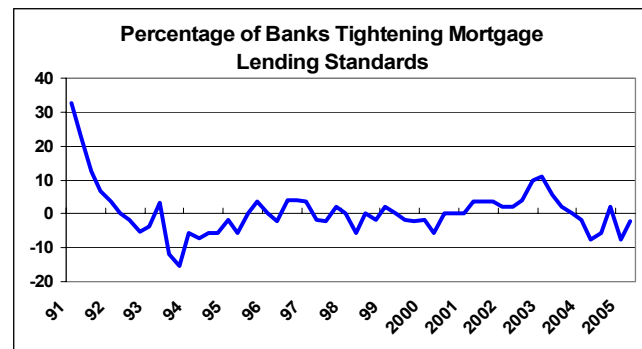
Mortgage Creation Sponsor	% of Total Q1 05
Banks	35.2%
S&L's	4.8
Credit Unions	2.8
ABS *	55.9

\* Asset Backed Securities

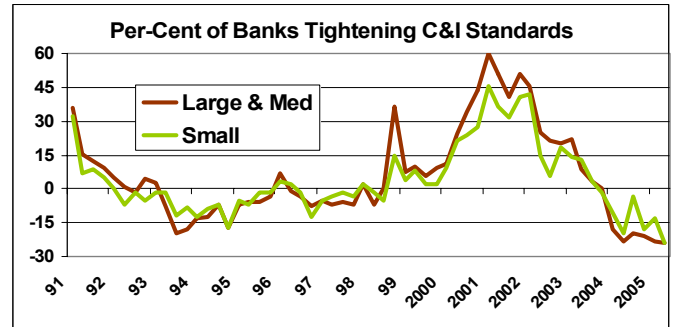
Asset Backed Securities have stepped in. They are bundles of home loans that are packaged just like GNMA (Government National Mortgage Association) pass through securities sold to institutions and individuals in lots as low as \$25,000. They are now the majority of the market, but the end buyer is still mysterious to us. These securities are purchased and sold in the unsupervised and unregulated markets. We are very curious about who holds the 0% down, interest only for 5 years, 11/2% spread (above US Treasury 10 year notes) that now comprises more than half of the new loans in California.

Home Equity Lender	% Total Q1 05
Banks	62.8%
S&L's	19.1
Credit Unions	4.3
ABS	6.1
Finance Co's	7.2

The home equity (2<sup>nd</sup> mortgage) business remains 94% with regulated lenders, but their current standards are historically very loose.



Perhaps one reason that we were wrong about the \$US and our prediction of rising interest rates was a convergence of factors that have lead to the collapse of risk premium across all lending markets. "Reaching for yield" has always been a strategy that leads to tears.



America's consumption dynamic now lives at the expense of an anemic national savings rate (that has fallen from 6% in 1997 to 1.5% of GDP today), and a current account deficit that has gone from 3% of GDP to 6.5% in the same period. The current account should have been adjusted via exchange rates, but the system has become very rigid as nations "manage" their currencies to keep "competitive".

Exchange rates have historically been the clutch plate of trade imbalances, but since we left the gold standard, that mechanism has created not rational balance, but mountains of paper money. As entire economies have been transformed into outsource centers for US consumption, we now face entrenched national interest in preserving the trade status quo.

Thus the world's economic scene appears terribly lopsided at the moment. At one extreme the Americans are consuming more than they can produce or can pay cash for.

At the other extreme the Chinese are producing more than they can consume themselves and continue to build the manufacturing capacity to produce "things" the world may not need and also may not be able to pay for. The Chinese have a growth mandate that is well known. Their attempt to lock in long term sources of energy supplies should not come as any surprise.

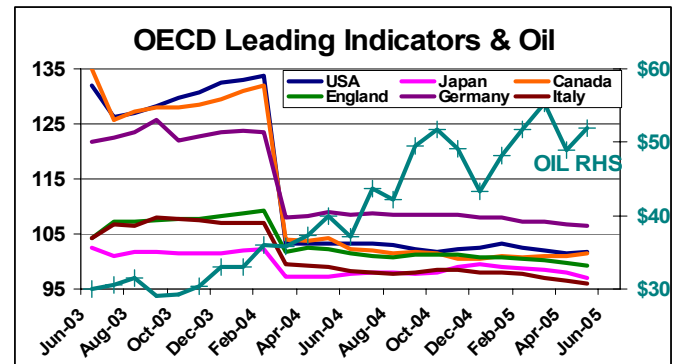
The current attempt of the China National Offshore Oil Company to secure hydrocarbon assets in Asia via Unocal fits a logical strategic pattern. Looking forward, the political row between CNOOC and Unocal is but the first demonstration of what international relations will be like in the post-Hubbert's Peak era.

The hot air in Washington about the acquisition masks a bigger issue, namely that China and the US currently have conflicting cyclical economic interests. In the late stages of a normal business recovery the business cycle runs into the headwinds of rising labor costs and rising capital costs. Not so this time. US companies are "arbitraging" rising labor costs by importing services as well as materials.

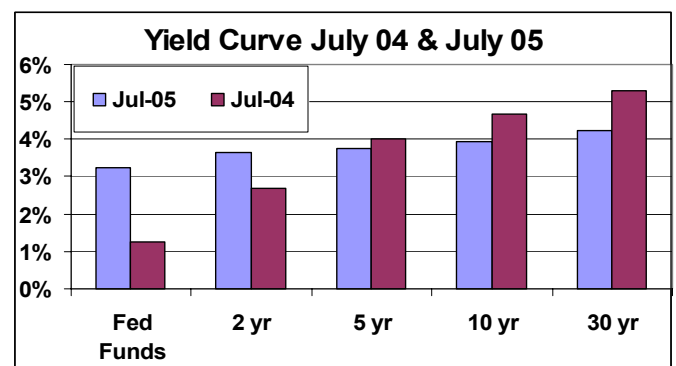
To the extent that China is competing for materials, especially oil, America as the world's largest importer of energy faces a rising trade deficit with each rise in energy costs. Thus it is in our interest that China cool down from their overheating in the building of manufacturing capacity, thus reducing the pressure on world commodity prices. Conversely, it is in China's best interest that US interest rates rise, slowing our growth and putting downward pressure on the commodities they need, and reducing the capital flowing into their manufacturing capacity, and incidentally fueling a real estate boom that may end as badly as did Japan's. The threat by Congress to impose trade sanctions to solve this problem is just not credible, as millions of US workers are involved with China trade and an estimated 15% of S&P500 profits are reported to come from the markup on Chinese goods.

Despite the mounting rhetoric on both sides, our countries work well together and the macro forces from energy costs are likely to serve up economic pain to both sides. For in between the two lopsided extremes is the rest of the world. "Emerging" economies are struggling under both bad government and high fuel prices. Their GDP's are flat, their wage income is flat and the governments are running big budget deficits. Because oil is denominated in \$US a \$0.20 rise in gasoline prices is but an inconvenience to the American motorist.

To those living in Mexico, India, Philippines or any other emerging country where the nominal wages are 1/10<sup>th</sup> of ours, this is a major blow to a family income. This affects our exports as well as "Old Europe's". Export sensitive Europe is growing on a flat line of 1%. Note that all industrial countries' leading indicators dropped when oil approached \$40 in April '04.



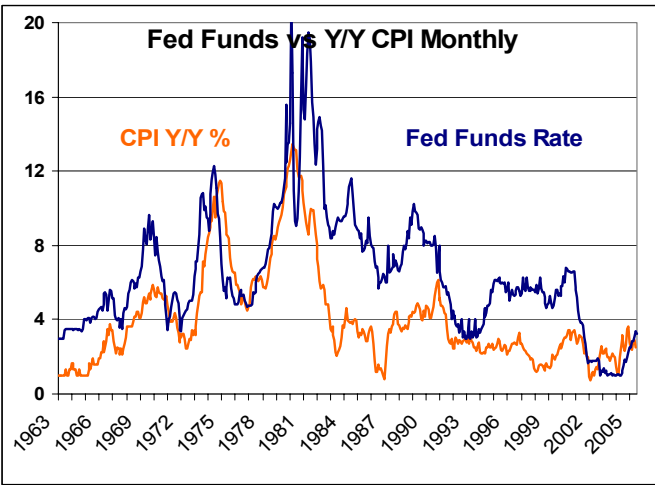
It is counter-intuitive to traditional economic thought that oil would be rising in such a flat economic circumstance unless the crisis in hydrocarbons is really greater than assumed. The results so far this year in your portfolio already beg the correct answer, as the capital discipline being enforced by the major refineries and integrated oil companies point to real trouble in the coming years. Rising oil is not inflationary. The energy crisis of the 21st century is in fact a **deflationary** story.



This may be part of the long term "conundrum" of why long term U.S. rates are falling as the Federal Reserve is tightening at the short end. In the near term, however, talk that the Fed was in the "9th inning" of rate hikes seems overly pessimistic about the short term outlook. We at Cascade think that there may be quite a few "extra innings" before its over.

For some historical perspective on our “extra innings” thought, we present a picture of Fed Funds Futures (traded in Chicago) and the year over year change of the Consumer Price Index (CPI). This picture gives us some important information. Notice that the Fed Funds rate (blue) is consistently higher than the CPI rate of change (orange). If you subtract the Fed Funds rate from the Consumer Price Index change you get a very good proxy for the real rate of interest. Until 2004 negative rates were brief and rare.

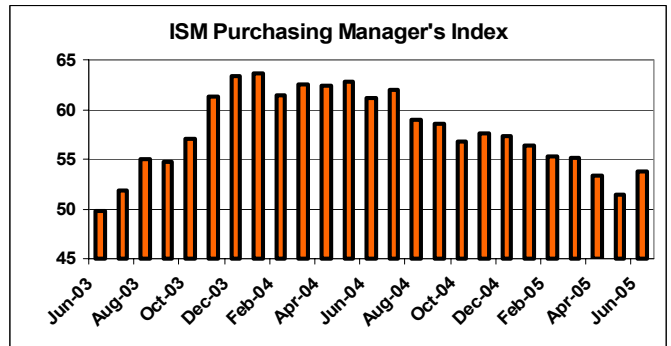
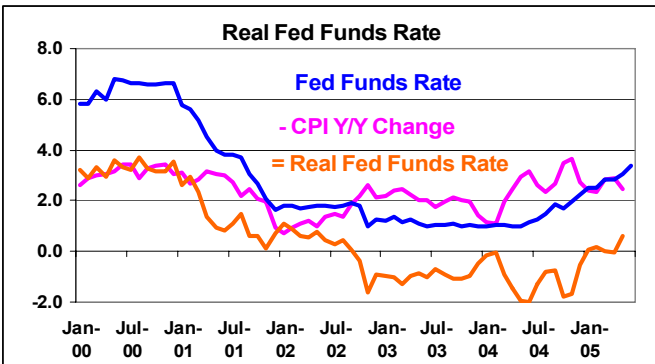
Since October 2002 we have had 27 months in a row of negative real Fed Funds rates. This is unprecedented, and has been concurrent with the greatest fiscal stimulus since WWII. Below we offer the dates of the final tightening in previous cycles, and the Real Fed Funds rate at the time. At this writing, rates are positive by only ½%.



Peak Date of Fed Tightening	Fed Funds less CPI Y/Y Change
Nov-59	2.5%
Nov-66	2.2
May-68	1.9
Aug-69	3.8
Jul-71	1.4
Apr-80	3.0
Jun-81	9.4
Aug-84	7.3
May-89	5.0
Apr-95	2.9
Jul-00	2.9
Jul-05	0.5

In terms of decades, the 1960's and the 1990's look similar, and it so happens that during those periods the average monthly difference between the two numbers was about 2%. While the 1970's were characterized by a Fed that was trying to play catch up to raging inflation (and gyrating the Fed Funds rate significantly), that decade ended with both numbers almost exactly even. And while this decade is almost half over and inflation seems tame, the record is much like the 1970's, i.e. the Fed Funds rate less the CPI change is 0.2.

Should the Fed stop after even three more moves of 25 basis points, it would signal the weakest post WWII recovery, and bolster the deflationary story of the current Energy Crisis. We note that the Fed has never tightened when the ISM Index was below 50, and in June it turned up to 53.8 from 51.4 in May.



**The US trade deficit cannot expand exponentially forever, and given the political rigidity of the exchange rate system, commodity prices probably will react to monetary imbalances more than currency values.**

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