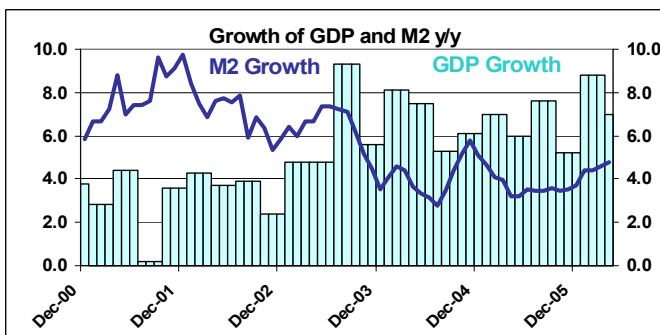




Cascade Investment Commentary

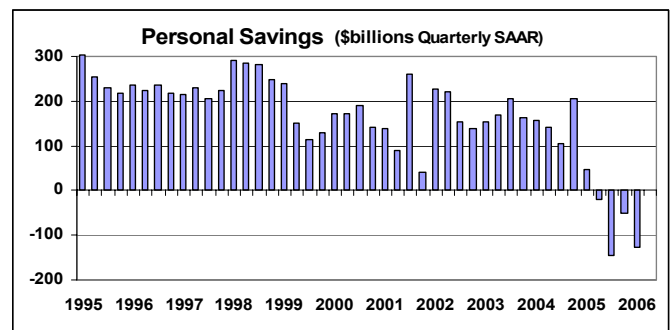
April was a critical turning point in world financial flows. The G7 and the IMF have sounded an alarm over the asset bubbles and US saving/consumption imbalances. As the quarter ended all nine major central banks were either raising borrowing costs or draining liquidity from the system and there was no mistaking the worldwide effect on stocks and bonds.

William McChesney Martin (a longtime Fed Chairman) liked to say that his job was to take away the punchbowl just as the party got interesting. It seems that over the past eighteen months the Federal Reserve has been raising the price of punch but not keeping it from the party. The anger in the analyst community about the Fed dropping M3 money supply statistics is that M3 was a very good gauge of the amount of punch at the party.



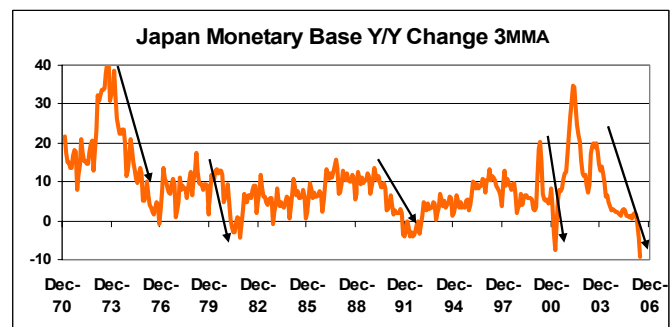
As can be seen above, the supply of punch as measured by M2 has been growing, but at a reduced speed from the shock of 9/11. Current monetary theory postulates that money supply should grow at about the same rate as nominal (actual non-inflation adjusted) GDP, so it would appear at first glance that the Fed has been slightly restrictive since 2003. At this writing, the nominal growth of Q1 2006 GDP was approximately 8.8% and the growth of M2 is 4.75%. It has been a mystery as to why 17 rate hikes by the Fed has been so ineffective at slowing down the economy. Part of the answer is the linkage between liquidity driven asset bubbles and global financial imbalances particularly in the US and in Japan.

We have commented on the US savings rate before, so in recap, our current account deficit soared to \$791 billion in 2005 and because we saved exactly zero as a nation we had to borrow all of it in the world markets absorbing about 70% of the world's savings. We do not know how far the world's central banks will take this rebalancing process. The adjustment has been felt most in emerging markets, commodities and high risk assets, yet at this writing the retreat has been orderly and still within the boundary of bull market corrections.

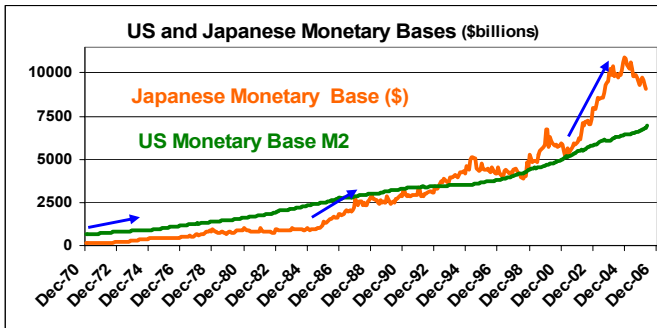


What caused this extraordinary concert of monetary policy? Perhaps after rate hike number 15 with gold above \$700 and the S&P Small Cap and Mid Cap Indexes at new all time highs the Fed realized that the external forces at work that have "sterilized" the Fed's policy had to be dealt with, and the first place to start was the biggest problem: i.e. Tokyo.

Japan has a history of very rapid movements in its bank's balance sheets. As Japan has the second largest world economy in GDP terms its actions influence world financial affairs more than most Americans realize.



Each major decline or deceleration of the Japanese money supply has been accompanied by a financial meltdown somewhere. Note above the years 1974, 1981, 1991, 2000 and now 2006. This cannot be mere coincidence.



Conversely each rapid expansion of their monetary base has caused a bubble somewhere (blue arrows). The monetary base has declined by \$US 200 billion between December and May (an annual rate of 17%).

In the chart above the last blue arrow highlights the \$5 trillion that was added to Japan's monetary base in the four years ending December 2005. This extraordinary move has taken place in a country with falling real estate prices, falling CPI and by all measures suffering economic depression. What gives?

Three official Japanese policies: First, Zero Interest Rate Policy (ZIRP). Since early 1999 the Bank of Japan (BoJ), in order to restore the balance sheets of its members has allowed them to borrow Yen for interest rates approaching zero with the clear intent of their re-lending that money for a profit offshore in US Treasuries, Gilts, Bunds etc. That lending level is about \$170 billion per year and has become a cumulative \$1 trillion.

Second, a policy known as Quantitative Easing (QE) was introduced in the spring of 2003 whereby the BOJ did not limit the amount of essentially free money that could be borrowed, and gave the banks a virtual guarantee that rates would be held ultra low for a very long time. Additionally this is a rather convenient way for Japanese exporters to finance their accounts receivable.

Finally, Japan has always managed its currency with a policy of Currency Intervention (CI) whereby the BoJ will intervene in the world markets to insure the stability of the Yen against its primary trading partners. Just imagine the possibilities of borrowing \$ US 5 trillion for free with no currency risk to invest in anything you wanted; and now envision the consequences.

The most easily observable consequence is that the Japanese monetary base has now grown larger than the American, despite an economy only one half its size! True, Japanese banks have improved their balance sheets as intended. Almost all Asian countries have a trade surplus with the US but a trade deficit with Japan. These countries have been able to borrow yen for free to import Japanese products, and their banks appear to hoarding yen in the memory of the last Asian crisis.

Another consequence is that American interest rates have been artificially low for an extended period allowing people to over-leverage their homes, and there are now large and small bubbles in various investments worldwide: Real estate all over Asia (ex Japan), the commodity sector, emerging market debt and equity come easily to mind.

With most of the developed world trying to cope with the commodity inflation caused by the huge infrastructure buildups in China and India at some point the third largest central bank had to get with the program. The rapid decline in Japan's monetary base sure looks like they are on board. George Soros made billions for himself and his hedge funds in early 1992 by shorting the British Pound and forcing a showdown with the Bank of England (which he won in August). That memory should be a concern as we now face a multi-trillion dollar hedge fund industry that can literally roam the world and roil markets at will.

We are not claiming that all of the financial imbalances in the world are the fault of the BOJ, nor are we claiming that a contraction in the balance sheet of the Japanese banking system will cause the world a "hard landing" economically.

What seems likely to us is that the concerto of nine central banks attempting to dampen inflationary expectations and to slow or stop highly leveraged speculative excesses will have an effect. There has never been a tightening cycle in which small and mid-cap stocks didn't perform poorly. To that list can be added emerging market securities of all kinds.

We have stated before that because finance has become the major industry in America we have left the normal business cycle and have entered a credit driven cycle. For that reason many feel that at the first sign of real slowdown in housing the Fed will "cut and run" in its inflation fight and once again flood the system with money. We are not sure yet. Housing is a long cycle industry driven by demographics as well as financial considerations.

At this juncture we feel that some adjustments in the world markets will be rather swift, and from our vantage point we expect that three issues (of importance to your portfolio) will likely be addressed by year end or early 2007: The quality of energy company earnings, the quality of financial company earnings and the risk premium across all asset classes.

Energy companies have for a long time been priced as "cyclicals", i.e. their earnings fluctuate widely and at the top of their earning power they command very low P/E ratios, and at the bottom of their earning power they command very high P/E's. The oil service companies have always been particularly sensitive to oil prices. The costs of drilling have been steadily climbing over many years (salaries and environmental protection) and as energy prices have fluctuated drilling becomes "cyclical".

Refining and marketing (R&M) is a different story, however. R&M companies are "cyclical" only to the extent that GDP quickens or slows. Our work shows that Exxon has been more sensitive to GDP changes than crude oil prices. For reasons that we do not understand it is almost universally forecast that R&M companies will see a downturn in their earnings in 2007, and thus their P/E's will rise.

As believers in the concept (if not the exact timing of) Peak Oil, we expect that there will be no new "elephant" oil fields that will come on stream in the future with enough extra crude to crash the world markets. US gasoline demand last week was at the daily rate of 9.6 million barrels. The same week last year was about the same and two years ago it was just under 9.2 mmbd. We think that the price of oil will stabilize for a while reflecting the equilibrium of supply and demand across the world, and that consumption will rationalize to a price based upon sweet crude in the mid \$60's to low \$70's. That said, the R&M companies should be viewed as consumer staples not cyclicals.

At this writing, the P/E of the S&P 500 is 14.5 based upon forecast 2006 earnings and the relative P/E of the energy stocks on our Approved List are displayed below. Note that they all have expected 5 year growth rates at or below their current P/E ratios, and that for the 10th year in a row Wall Street consensus earnings expect a decline in earnings next year in the R&M companies (COP, CVX, MRO, VLO and XOM).

Company	06		5 YR Est.	10 Yr Avg	Current
	P/E	PE	EPS Growth	P/E Relative to SPX	Relative P/E
APA	7.7	7.2	11.2	0.8	0.5
APC	7.8	7.1	9.9	1.1	0.5
BHI	18.7	14.8	21.7	1.8	1.3
COP	6.3	6.7	8.8	0.8	0.4
CVX	7.6	7.9	8.5	1.3	0.5
HAL	17.5	13.8	18.8	1.9	1.2
MRO	7.9	8.2	9.0	0.7	0.5
SLB	22.6	17.4	20.5	2.1	1.6
VLO	7.8	8.7	7.6	0.8	0.5
XOM	9.8	9.8	7.8	1.1	0.7

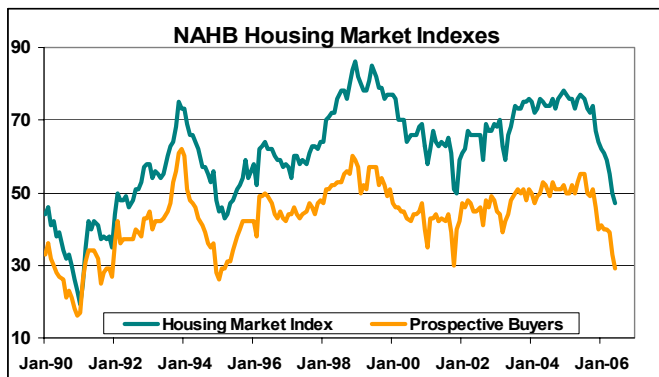
Despite a probable slowing of consumer spending, a probable decline in gasoline usage or at least decline in the growth rate of its use, we believe that the above companies represent the best long term value assets in our Approved List and we will continue to overweight them in your portfolio.

The next area to be re-rated will be many of the financials. As clients you are aware that we have not owned any lending institutions for over a year as we thought the intent of the Fed starting 18 months ago was actually to tighten.

We have been accused of being early in the past, and this time was no exception.



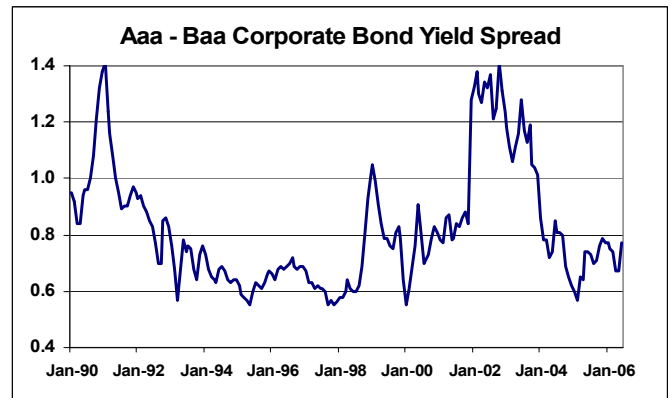
As we have stated before, the hedge fund community has put a “double dare you” on the Fed with respect to any actions that would seriously effect the politically supersensitive employment level. The Fed’s action so far has not hampered the profits of the nation’s largest industry i.e. finance. But since fees derived from housing has become such a big driver of financial sector profits how can a slowdown (let alone a hard landing) in the housing sector not hurt upcoming profits?



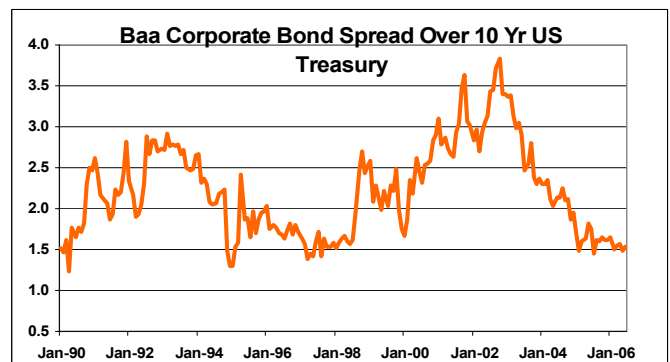
It seems to us that the question facing the markets for the next few months is how the Fed can simultaneously slow general inflationary expectations, slow the price rise in housing, slow the speculation in commodities, reverse the US savings rate from negative territory, maintain stability in the value of the \$US in the face of a Congress gone wild with earmark spending without something breaking?

Benjamin Graham (the 1930’s chronicler of ancient investment wisdom) famously wrote about a “margin of safety” when making investments. “Risk premium” is the “margin of safety” that investors demand to wander further and further from a “riskless rate of return”. That rate is often the 90 day US Treasury bill, but can be other benchmarks.

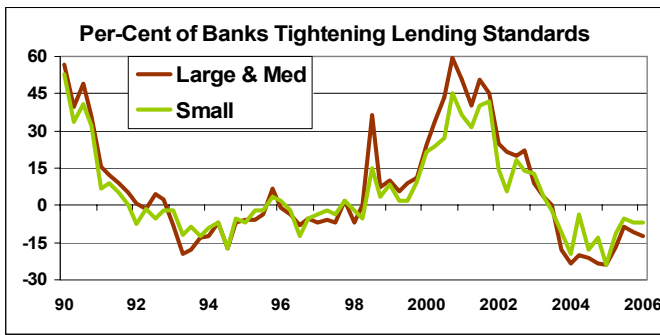
The oldest measure of investors’ current demand for a premium to take on risk is the Barron’s Confidence Index published since the early 1920’s. It is the difference between Aaa and Baa bond yields.



Today many decisions are made based upon the yield of the 10 year U.S. Treasury. As can be seen below, investors feel very confident in the quality of corporate earnings as the premium of Baa yields to 10 year Treasuries is near an all time low. Can it decline much further? We don’t think so.



The margin of safety being demanded by large and small banks when making new loans is near an all time low as well, and in fact despite 17 rises in the price of punch banks are actually lowering lending standards further.



One other measure of risk tolerance is the volatility index or VIX. This measures the risk appetite of the professional end of the market through the cost of hedging against volatility. As can be seen professionals are just now becoming only slightly more risk averse.



Another measure of the lack of a margin of safety being demanded by investors is their appetite for small and medium cap securities versus large cap issues. Below we see the S&P 500 Index divided by the Russell 2000 Index. The Russell 2000 outperformed the S&P 500 until the market bottom of 1994, then underperformed until the top of the “old economy” stock market in 1999, and has outperformed since then. The chart also demonstrates that this risk preference is a big macro whose trend is hard to reverse without substantial turbulence. Our view is that the continuing preference for high risk assets shows that along with hedge funds, banks and lending institutions the general public is also “double daring” the Fed to do what is really needed to unwind the major financial imbalances of our time and thus suffer the accompanying pain of unemployment.



When we started on Wall Street there was a saying “three steps and stumble”. It referred to the long time observation that after the Federal Reserve had raised interest three times, the stock market dutifully fell. As the financial world has become totally global and the Bank of Japan or the Peoples Bank of China have great influence on world markets that rule is probably no longer valid. However we think that the first ever harmonious and concerted effort of all nine major central banks to address unsustainable financial flows will now be a first step, the persistent high cost of energy will serve as a second step, and the long awaited decline in the growth of US consumer spending will be a third step. The stumble will be in high risk assets worldwide.

In many ways the job of Mr. Bernanke is more complex than that of his predecessors Greenspan and Volker. Globalization and the arbitrage of labor are now significant factors and the leverage in the world’s financial system is unprecedented. If the Fed is successful in the Herculean job before it, it will force a big change in attitude by many people. One way or another, the notion that asset appreciation is a responsible substitute for real savings (deferred consumption) must be discredited. The Fed cannot lose this dare. As we stated in January, the US is in a policy box canyon and there are no good options left.

July 5, 2006.

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