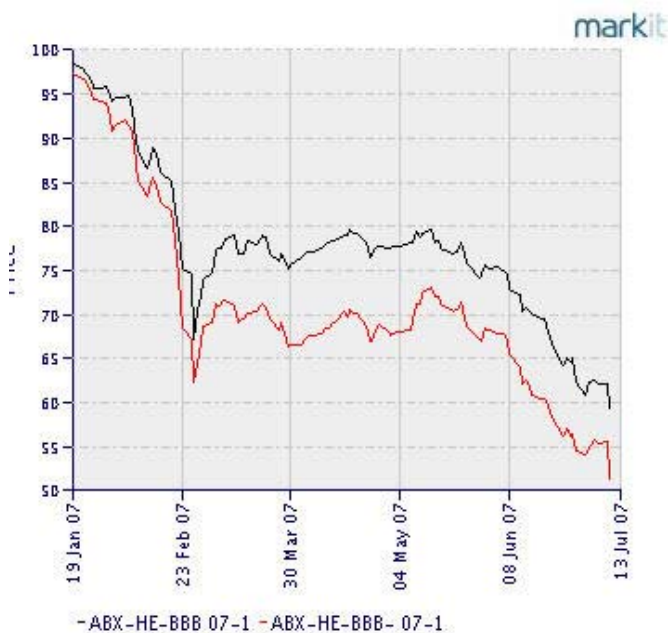




Cascade Investment Commentary

In the past three weeks many eyes have turned towards the sub prime home loan market and the implications of the Bear Stearns bailout of their "High-Grade Structured Credit Strategies Enhanced Leverage Fund". Immediate fears of a worldwide credit bubble added over 50 basis points to the yield curve in a single week, and the largest "junk" bond new issue calendar in years is now looking suspect.

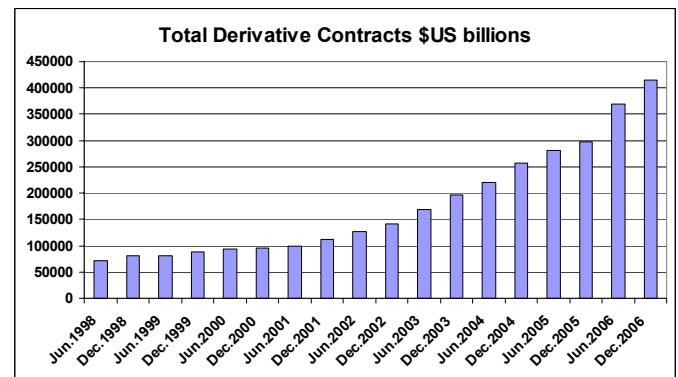
History suggests that the credit risk widening process has just begun and is far overdue. The chart below is the recent price action of BBB- rated Collateral Mortgage Obligations (CMO) as tracked by Markit.com.



CMO's are like sausages. They can have a variety of ingredients and are normally cut crosswise in small pieces which include everything. Many with the largest amount of ingredients are rated AAA. Many have sub prime mortgages (which are coming under increasing default rates as refi's become difficult) and some were originally rated as low as BBB-. The problem is no one knows for sure how much is where. Estimates of potential losses in investments backed by subprime mortgages range from \$52 billion to \$250 billion. Despite the prices on the graphic above, most are carried at par.

Cascade does not invest in subprime anything, but we care because our investments are sensitive to interest rates. The question now: Is this the beginning of a rational normalization of risk for lower quality investments, or is this the beginning of a full blown credit crunch that will deliver a full body slam to the economy and the markets and spill over to us?

To be honest, we have less a handle on world capital markets than at any time in our careers. The complexity of capital transactions has passed our observation capabilities. The Bank for International Settlements claims that there are more than \$400 trillion in outstanding Derivative Contracts. While full understand the meaning of these numbers is improbable, it would at least help to first review what we know of how the world got to July 2007.



Hyman Minsky developed a Nobel Prize winning Theory of Capitalist Development in the early 1990's which is built upon the premise that an economy is a complex, time-dependent system and that society is an "evolutionary beast" changing in response to endogenous factors, not an equilibrium seeking and sustaining system. He famously said that "capitalism comes in as many varieties as Heinz has pickles...Government action is an inescapable determinant of capitalist economic development. Its decisions shape the institutional framework that conditions economic activity."

Merchant capitalism established in the 1600's was characterized by owner-managed enterprises with few employees and few transactions.

Industrial capitalism was facilitated by the rise of financial organizations that could marshal the resources to organize capital intensive efforts such as factories, railroads, canal, etc. This was a very unstable form of economic organization, and booms and busts were common between 1866 and 1908.

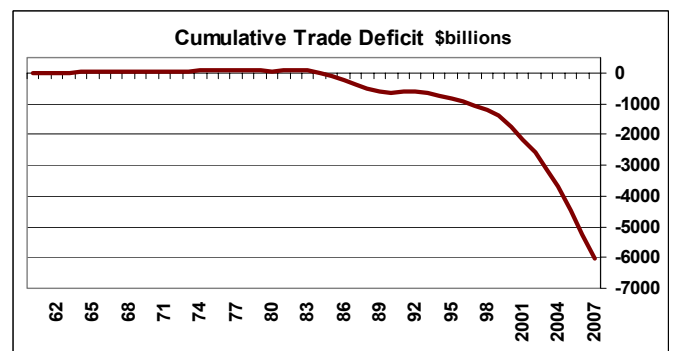
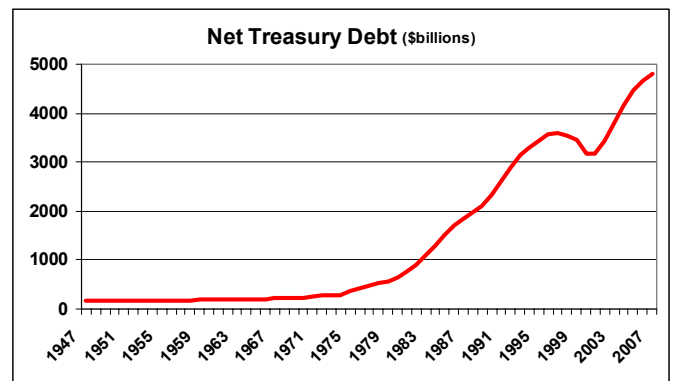
Banker capitalism arose from the establishment in the 1880's of very large cartels, trusts and corporations. People like JP Morgan sought to bring order to the chaos of industries with excess competition and little chance for long term profits. The financial panic of 1907-08 brought on by the speculation in the Great Northern Railroad was the catalyst that formed the Federal Reserve Board. Between 1908 and 1929 there were business cycles, but not the great booms and busts of the Industrial capitalism era. This era of stability also brought great numbers of investment banking houses whose speculative zeal collapsed in 1929.

Managerial capitalism followed almost immediately, where our major institutions such as the Federal Reserve, Federal Home Loan Bank and major fiscal actions by Congress directed how business would be conducted. This provided a nice cocoon for business: deposit insurance, labor regulations, oligopolies, generous farm policies all led to an unprecedented period of stability and prosperity after WWII. The flip side of this happy period was that many complacent managements neglected innovation and were not prepared for world wide competition. The oil shocks of the 1970's and the ensuing inflation sowed the seeds of where we are today.

Money-Manager capitalism grew out of the dissatisfaction in institutional investors in the results of many corporations in the 1970's and 1980's. The capital resources of our nation are now being concentrated into only a few global reaching hands, and much of it is outside the de facto control of any Central Bank authority.

Financial engineering is now the principle product of Wall Street firms. The U.S. Office of the Comptroller of the Currency commented last week that "U.S. bank revenues from trading derivatives and other contracts jumped 24% to a record \$7 billion in the first quarter as low yields from bond markets prompted more investors to turn to derivatives that can boost returns... Trading in derivatives contracts by banks including JP Morgan Chase & Co. and Citigroup Inc. rose 10% to over a record \$145 trillion in securities, up 31% from last year's first quarter". Just how did these firms evolve into the new "Masters of the Universe"?

We think the story really started when a beleaguered Richard Nixon closed the gold window at the U.S. Treasury in August 1971 and the entire basis of U.S. monetary authority became a "moral obligation". The only constraint on US deficit spending became the occasional (temporary) market reaction to an ever expanding level US Treasury note sales. With no restraints on its behavior, Congress began to spend without much regard to actual revenues. The cumulative amount of this past spending is now slightly under \$5 trillion.



Among the many things not foreseen in the 1971 action was that the Americans would stop saving and become the A1 champion consumers of the planet. Americans have transferred an additional \$6 trillion to foreign owners primarily for energy and consumer goods. Warren Buffet says that we are becoming a nation of sharecroppers.

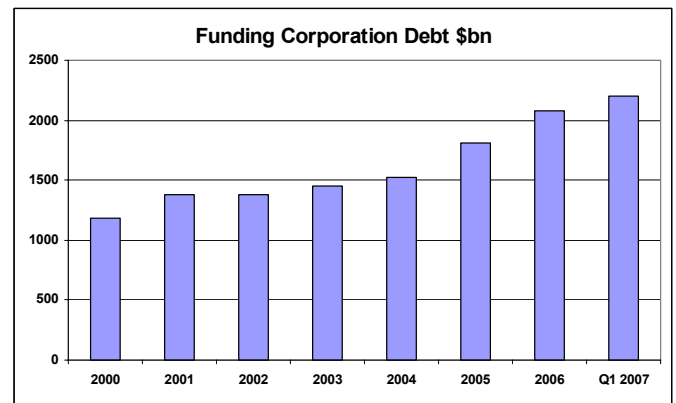
The "inconvenient truth" (to paraphrase a modern day Elmer Gantry) is that many nations in the world base their livelihood on selling goods to the U.S. and they take action to make sure that their currencies are always priced to give them a competitive advantage. They all attain that advantage the same way: they increase the amount of their own currency faster than ours.

Bank credit in the US ended the Quarter at a record \$8.6 trillion (tn). While the narrowly defined stock of money M2 only grew 6.5% over the past year, Money Market Fund assets grew to \$2.5 tn or 19.8% y/y, total Commercial Paper grew 20% y/y to \$2.2 tn. Asset Backed Securities issuance (the type that Bear Stearns is having trouble with) have slowed to only \$361 bn running about 3% behind last year, but Collateral Debt Obligations (CDO) is running 18% ahead of record 2006 sales. Foreign Holding of Treasury and Agency Debt are up over 20% y/y and all International Reserve Assets (excluding gold) are up 20.8% y/y to a record \$5.4 tn. This **is** financial inflation.

As with all past major inflations the people who can get their hands on the money first have a major competitive advantage. Thus real estate in the worlds biggest banking centers like New York, Hong Kong, London, Dubai etc. are still enjoying rising property values. The lifestyle of the "new capitalism" engineers is perfectly captured by the auction a fortnight ago of Claude Monet's painting of Waterloo Bridge in London for 17.9 million pounds, twice what Christies auction house had estimated.

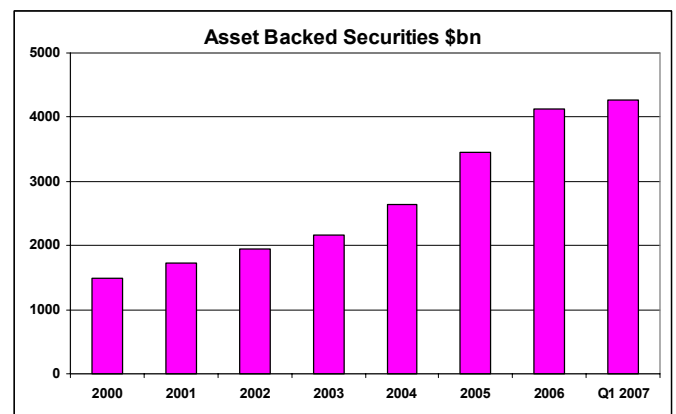
The world is now awash with Dollars, Euros Yen, Yuan, Franc's etc. These funds seek an income producing home: Enter Wall Street helpers with big ideas.

Historically the owners of this aforementioned \$11 trillion behaved as good world citizens, placing the money in their Central Banks which in turn dutifully purchased U.S. Treasury debt. In recent years that has branched out to Agencies and Corporate debt and equity as well. To "out-earn inflation" Wall Street has sold leverage and risk. Currently it is Funding Corporation (leveraged corporate buyout) loans.

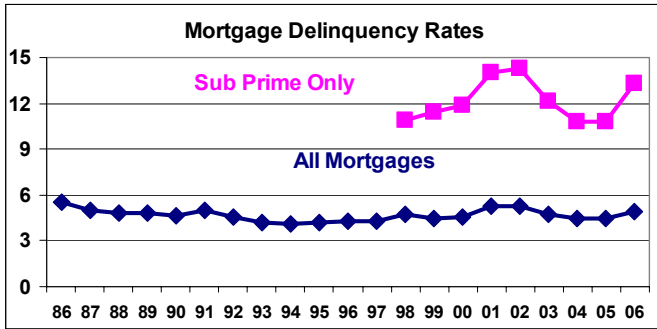


Central Banks have rules and impose them on their lending institutions through a treaty like agreement called The Basel Accords which sets the level of fractional reserves required behind bank lending (the imposition of these rules ended the bank lending dominance of Japan in the 1980's).

The new "Masters of the Universe" at Goldman Sachs, Citicorp, JP Morgan etc. have found that if they can entice these dollars out of the banking system and into higher yielding instruments, the fractional reserve requirement can be skirted, and each new dollar can be lent over and over again into virtual infinity (conveniently collecting a new commission each time).

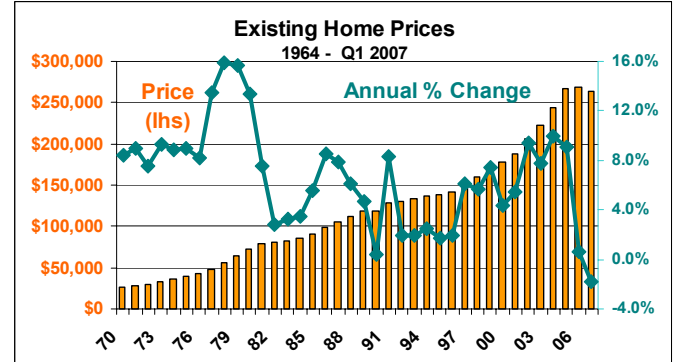
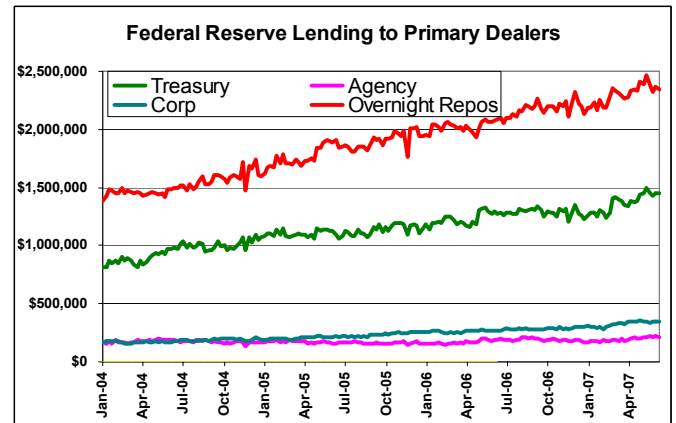


As more money left the rigors of fractional reserves, the spread (risk premium) narrowed and loans to almost anyone who would pay even a slight premium to Treasury yields became very popular. By 2005 the people who would pay the most were the subprime borrowers mentioned above.



The chart above illustrates the recent history of mortgage delinquency. What is different this time is the leverage used by Wall Street firms and Hedge Funds. When Long Term Capital Management failed in 1998, their \$3.6 billion was leveraged to \$125 bn in assets much like Bear Stearns. How big is the leverage now we are not sure of but we know that there are about 6 million subprime mortgages outstanding, and that probably represents a market value of \$900 bn. Every 1% drop in home values is thus a \$9 billion haircut to the collateral, and with 2 million mortgage ARMs to be reset within the next few months (\$50 billion in October) there is growing risk to the system. With many funds levered 10:1 in these mortgages there is plenty of dry kindling around.

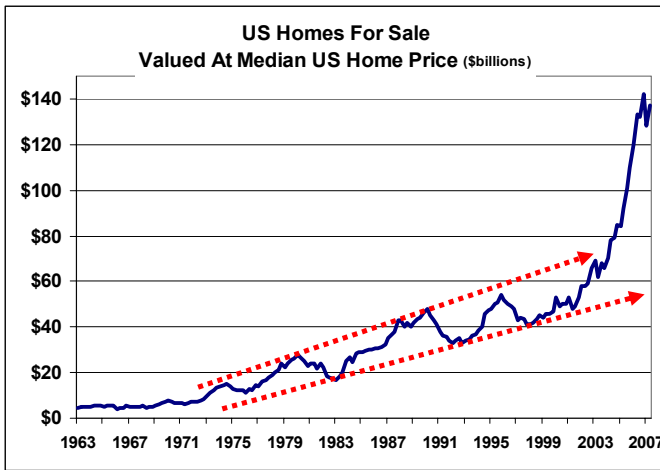
This week Moody's downgraded \$5 bn of CMO's with subprime components to below investment grade, and S&P is threatening to downgrade \$12 bn more. Insurers and pension funds will be required to sell these damaged assets into a market that was very thinly traded in the first place. Much of the leverage is through the Overnight Repo mechanism where Hedge Funds borrow money for a single day using the ABS and CMO's as collateral with an agreement to "repurchase" the property the next day. Overnight means overnight, and there is no absolute guarantee of a loan tomorrow.



All of this comes at an inconvenient time for everyone. Existing home prices are falling in absolute terms for the first time since the depression, the \$US is falling as the rest of the world begins to see the policy "box canyon" that the Federal Reserve is in, and interest rates are slowly rising to reflect the endemic inflation brought about by a long period of double digit expansion of money and credit.

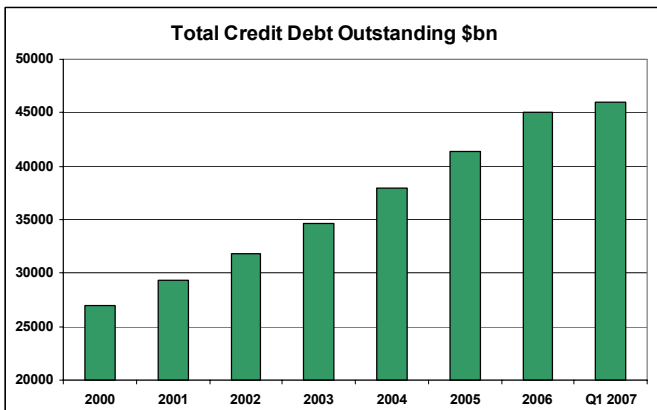


Home loans are typically priced off the 10 year Treasury yield. If the trend has changed there could be considerable pain still ahead.



By next January the bulk of the “liar loan” mortgages will have been either refinanced, or will be in some stage of foreclosure. Reportedly 8.9 months supply of homes is for sale representing a staggering \$140 bn. Historically this has only happened in recessions. How far could this correct?

The talking heads on TV keep hoping that the real estate market has “hit bottom”, but we remain agnostic. We only know that we are not comfortable owning any lending institutions in our portfolios, which is a tough call as they are 22% of the S&P 500 and a much greater weight in the Russell 200 Value benchmarks.



Americans have now an outstanding debt load of \$46 tn. The debt load is unwavering, yet the asset value fluctuates. The Bureau of Labor Statistics reports that the median wage – inflation adjusted weekly pay for the worker in the middle of the wage distribution has risen a cumulative total of just 0.9% over the seven years ending Q1 2007. Recession will only exacerbate the subprime problem.

Should the Federal Reserve cut interest rates between now and January to save the housing industry (and the median household), we would expect the selling pressure on the \$US to intensify, and we will respond by adding to our positions in companies doing business outside the US as well as our position in gold producers. Should the Federal Reserve raise interest rates to acknowledge that inflation is a growing problem we will lighten our position in gold producers and may return to owning some regulated utilities. Even if we believed for a second or two that inflation was only 2.5% y/y, the credit bubble is reaching a possible “tipping point” that may very well lead to a worldwide hiccup.

Statements in recent weeks by worldwide central bankers indicate that the Federal Reserve, the European Monetary Authority, the Peoples Bank of China and The Bank of England have all washed their hands of responsibility for the financial bubbles that now encompass the entire globe. How could anything worth \$400 trillion growing over 20% compounded for years be characterized as “well contained”?

We have been commenting on the runaway credit expansion for some time and now others are beginning to also. The Bank for International Settlements (BIS) stated last week that “The credibility of central banks around the world may hinge on their response to surging money and credit growth, which is helping fuel asset bubbles...’The current rapid expansion of these aggregates in various parts of the world may lead some central banks to ask soul-searching questions about the appropriate response,’ the BIS said...’Ultimately, the credibility of central banks lies in the balance.”

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