



Cascade Investment Commentary

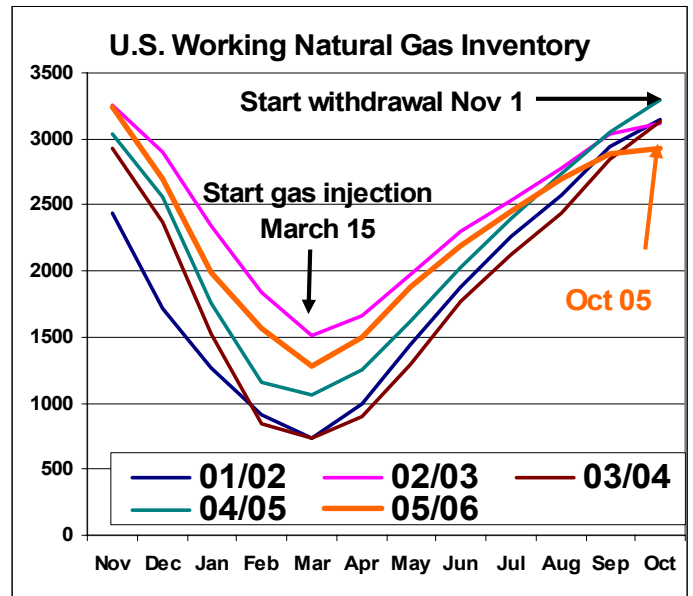
It is evident that the forces of Katrina/Rita are possibly a “tipping point”; a catalyst for many changes that might have happened slowly but are now vastly accelerated. These changes include the awareness of the natural gas crisis, the slowing of consumer spending, the tightening of lending standards, and the President acting more like L.B.J. than Ronald Reagan.

In a capitalist society, economic behavior is changed at the margin by price signals which in turn, allocate scarce resources. In the 3rd Quarter several price signals began flashing yellow, and post Katrina/Rita energy started flashing red.

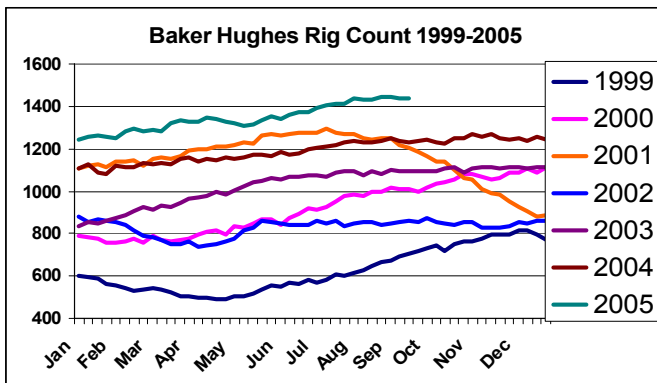
The immediate post-Katrina concern of the market has been the effect on energy, particularly natural gas. Natural gas has been a keen interest of ours for several years, and it should now be apparent even to the casual observer that there is a big supply problem (accelerated by the disruption of production). Last week the natural gas market was in near panic as late summer cooling needs put demands on winter stocks of heating oil, coal and natural gas.

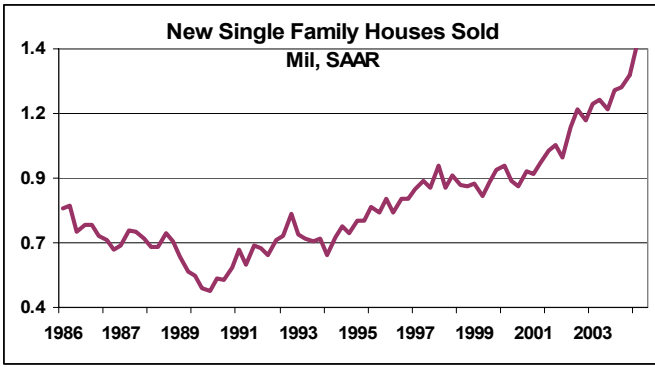
Prior to the hurricanes, a record number of rigs were drilling for gas onshore and offshore, yet the total volume of gas produced remains in decline.

It takes about 3.2 trillion cubic feet (Tcf) in storage on average for the heating season. The country enjoyed a warm winter in 04/05 and started the 05/06 season (orange line) with 1.28 Tcf in storage. On September 29 there was 2.885 Tcf in storage versus 3.056 Tcf this date last year, leaving 315 (billion cubic feet) to be stored in October. The record October monthly storage injection of gas was 250 bcf set in 2003, and with the damage to the gulf it is very improbable that we will even get to normal levels. The first week of October stored only 44 bcf of the 315 necessary. If winter is colder than the 5 year average at the margin there may not be enough gas or fuel oil.

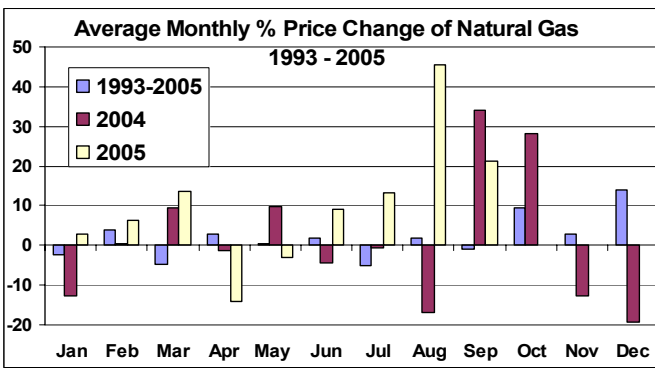


Side by side with the warm winter weather of the past four years, the nation has been building homes at a record pace, and in the past five years almost 9 million new housing units have been constructed. We can't even guess the commercial space built. Through zoning requirements and government regulations nearly all of this new space is heated directly by gas or by electricity generated by gas. It is possible that we have met the breaking point and \$14 natural gas may be the “tipping point” to prompt offshore drilling in “view protected” areas like Santa Barbara and Tampa Bay.

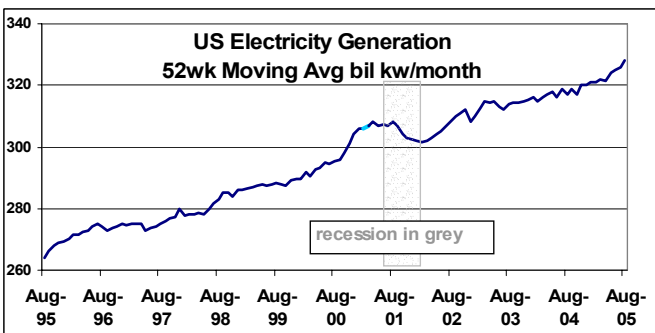




We are also now at a point where the historic patterns of gas trading and price flows have been disrupted, leading to violent swings in prices.



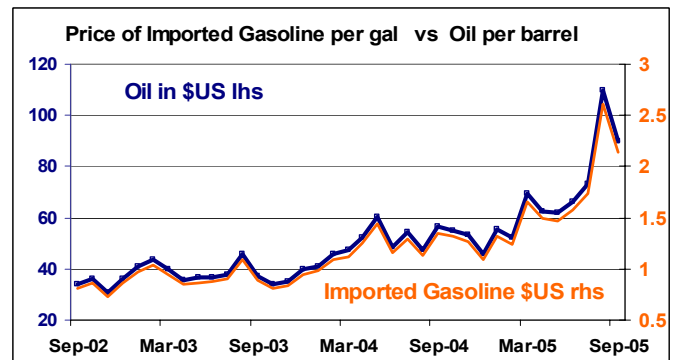
The chart above illustrates that the long historic pattern of natural gas prices falling in January, March, July and September and with only modest price rises in all other months save December has been broken. The price volatility of 2005 has never been seen before.



There has been a relentless rise in electricity demand both from new construction and the move to an information society. Although somewhat sensitive to economic slowdowns, electricity can be seen as a growth industry, and we continue a positive outlook.

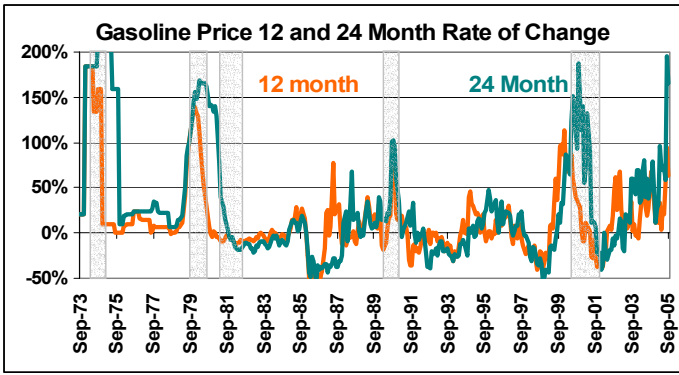
With a winter shortage of some fuels almost assured, some short term demand must be destroyed through the price mechanism and the choice is grim: who loses their job versus who goes without heat. The political decisions are in place and we expect emergency home heating assistance for low income people in case of a cold winter at the expense of manufacturing.

To fill the void left by Gulf refinery outages through imports is very costly as the difference between the cost of oil and the value of distillates (the crack spread) is currently very wide. This represents a big profit windfall to foreign refiners. In the chart below the right hand scale is the price per gallon of imported gasoline. The left hand scale translates this into \$US per barrel of oil.



At the quarter's end, Houston was paying \$3.06 per gallon of gasoline or \$128 per barrel of oil equivalent (boe). Houston's gasoline comes primarily from the Caribbean. The conditions in New York Harbor were considerably better where they import gasoline from Europe. The spot price was only \$2.33, or \$90 per boe. Importing is an expensive solution to our chronic refining under-capacity.

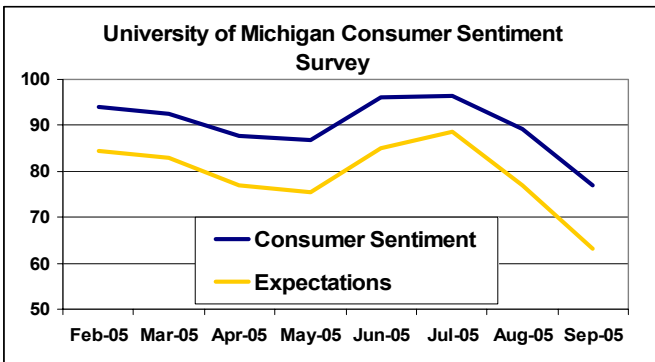
Economists often speak of "elasticity of demand", or the sensitivity of an activity to the change in price of that activity. Motorists did slow their consumption of gasoline by a few percent after Katrina, but we wonder if that was due to the jump in price or lack of availability. Below we chart the 12 and 24 month running per-cent change in gasoline prices. Recessions are shaded in grey.



Significantly, after prices have risen over 100% over the preceding 12 months, the country was in or near recession (marked in grey), and always in the five 24 month periods prior to this writing. We will have to see if the sixth 24 month event in the series follows true, as we are clearly at now 200% above 24 months ago.

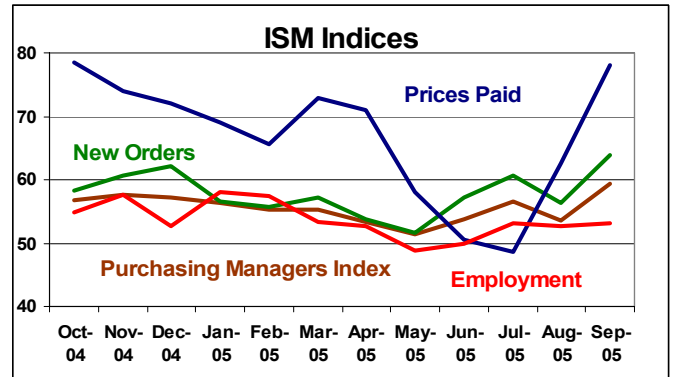
Economics is a behavioral science and often behavior modification takes time. We would not expect that the rapid change in gasoline prices in spring 2005 would change many long held summer vacation plans, for example. In the very short term people “deal with it”, they make substitutions elsewhere. If expensive energy endures, expect consumers to “trade down”, eating at restaurants less, drinking less expensive wine etc. Christmas sales will, in our opinion, be completely weather driven. A cold fall will equal a poor Xmas shopping season.

The market’s next concern is sentiment. With consumption 71% of GDP and 60% of corporate profits everyone is rightly concerned with the pulse of the nation. Sentiment appears to have peaked in July and was declining even before Katrina, but we were already calling for a consumer slowdown.



As the nations’ largest retailer, WalMart is the weathervane. They warned of slowing sales and earnings due to rising gasoline prices in July and again in early August. Immediately after Katrina we saw many other retail firms warn of slowing sales. WalMart has mentioned that more money spent on gasoline is less spent in their stores, and they measure that relationship in pennies per gallon. We are avoiding the entire retail sector.

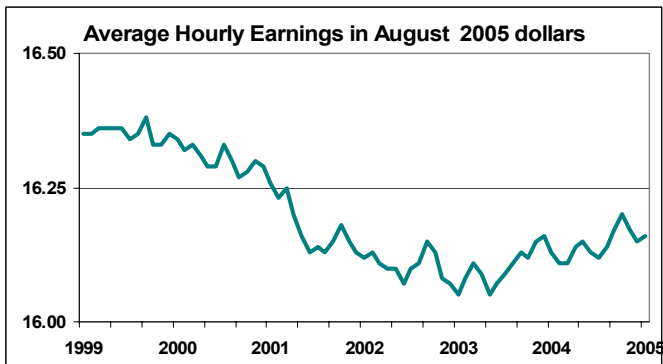
The ISM data issued today was very interesting. This is the first post-Katrina report of business community activity and we see that new employment is above 50 (expansion), but has been slightly positive but anemic for a number of months. New orders and prices paid really stand out.



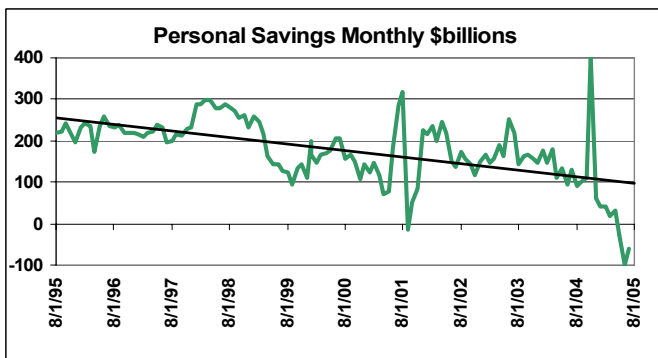
If new orders represented more than broken window replacement and short term relief effort supplies we would expect a pickup in hiring soon. We will see in the next quarter if the prices paid index is really a reflection of inflation or the temporary run-up in building products prices. We believe that the past decline in prices paid has been one reason the Fed has been officially not worried about inflation. Ongoing strength in this data would argue for more tightening of monetary policy.

Much is being made of the economic stimulus that will accompany a \$200+ billion effort to rebuild the Gulf Coast. Whether Congress has a rational debate on the merits of borrowing such a vast amount of money for what we at Cascade call (with tongue in cheek) “Operation Resurrect Atlantis” or not will be closely watched in the financial capitols of our creditors.

While the rebuilding of homes in the Gulf will help the income statement of some workers and firms, the hurricane damage acts as accelerated depreciation on the balance sheet of the nation. That balance sheet appears to us to be leveraged about as tightly as possible and the ability of the average family to take on any further financial burden is (to us) much in doubt. In August the average hourly earnings of American workers was \$16.16. In August 1999 adjusted for inflation it was \$16.35. People with declining real wages seem to be turning to any available means to cope.



We have mentioned the equity extraction story many times, and the personal savings rate has been heading for the zero line for several years. The saving rate finally went below zero in the quarter for the first time since the Great Depression, and not-so-coincidentally the credit card default rate hit an all time high of 4.8% up from 4.1%. These are pre-Katrina numbers, and we suspect that the post-Katrina late payment credit card numbers including mortgage defaults will be a real shockeroo.



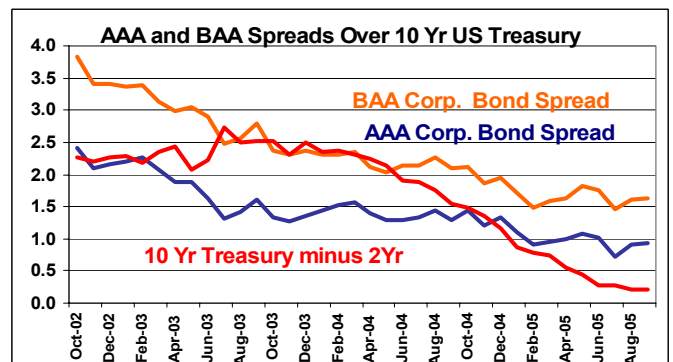
The bankruptcy law changes on October 17th, and then the minimum payment of 1/2% to 1% on credit card balances will rise to 3%.

It is estimated that this will be a reduction in spending power by the fully leveraged (maxed out) consumers of about \$46 billion per month. Just in time for Christmas.

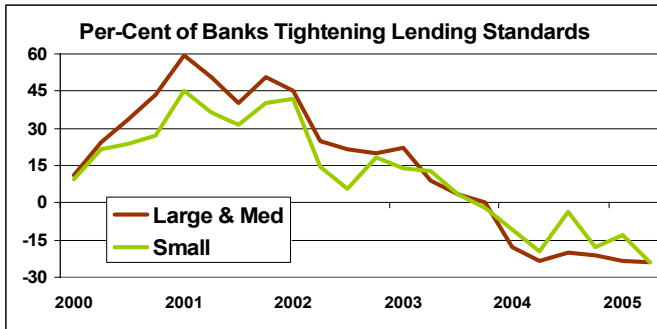
The unforeseen energy crisis has the Fed in a bind. Rising energy costs are **deflationary** in that they reduce the relative value of everything else. Because the Fed exists primarily to protect the banking system from itself it cannot allow a deflationary spiral to develop. This would deflate housing prices and cause a serious downturn in consumer spending and widespread default on consumer debt. At the same time, it cannot now lower interest rates because that would ignite even more demand for energy products. The Fed can influence the demand for energy products but not the supply. On the horns of this dilemma we look to see their deeds not their words. So far they have been raising interest rates at the front door, and flooding the system with money out the back door. This is a Faustian bargain, and will bring more inflation.

The big interest rate story continues to be the flattening of the yield curve. Eleven rate hikes ago in the summer of 2003 the 10 year Treasury yield was 280 basis points (bps) higher than the 2 year note (red line). At this writing, that has shrunk to 15 bps.

One reason to worry is that nobody else seems worried. Chairman Greenspan testified that the curve might become negative, but not to worry, this time such an occurrence might not bring recession. We think that there is plenty of cause to worry (that's what we're paid to do).



The “measured pace” of action on the part of the Fed has encouraged risk taking on the long end of the curve as many players are “reaching for yield” and keeping long rates low. We have mentioned before that the risk premium in almost every investment category has collapsed. Mr. Greenspan testified **“history has not dealt kindly with the aftermath of protracted periods of low risk premiums”**.



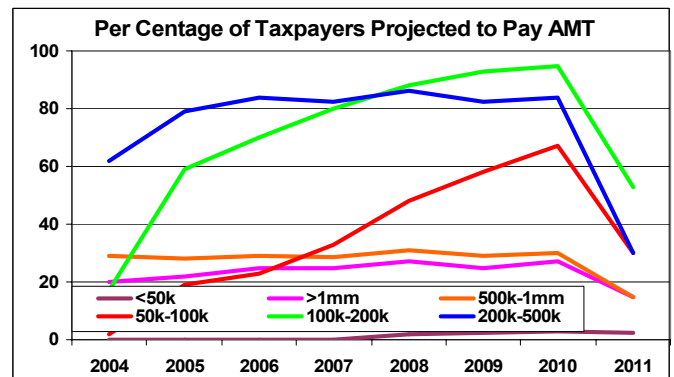
Now just suppose the Fed raises the Fed Funds rate to 4% in November and stops there waiting to review the post Katrina/Rita data further. How might markets react? Uncertainty would creep into the market for the first time in the tightening cycle, and we believe this will raise the risk premium in all investment categories. The asset bubble is now too big to ignore, and while no one wants to pop it, we all know it can not endure forever.

As Mr. Greenspan prepares to leave office he has inherited via Katrina/Rita a rather bitter legacy. The Deficit will rise above 3.5% next year, the American savings rate has fallen below zero and the current account deficit has passed 5% of GDP, widely believed to be the tipping point for currency revaluation. The \$US facing massive new external debt and a deteriorating domestic balance sheet is poised for a tectonic plate shift. But when?

Politicians are naturally trying to spend their way out of the voter’s ire about the war and the Gulf Coast mess, all of which puts Mr. Greenspan’s successor in the awkward position of having to reassure our foreign creditors that it is safe to pick up the tab not only for the reconstruction of the war, the Gulf Coast reconstruction, but for the continuing consumption binge in an America that cannot say no to the next “you pay our price” sale.

We are rapidly becoming a nation which privatizes corporate profits and nationalizes private losses. Northwest and Delta Airlines entered bankruptcy together on the same day last quarter holding hands with the Federal Pension Benefit Guarantee Corp (PBGC) to guarantee the various union pensions. We wonder aloud about American Airlines, Delphi, Visteon and other vendors to GM and Ford who will probably try to socialize their pension liabilities in PBGC as well. Louisiana has long had the most underfunded pension systems in America. Who are the tax payers in New Orleans that are guaranteeing the pensions of the firefighters, policeman, teachers etc. Who are the taxpayers in the Pelican State who will pay the state employee pensions?

With the usual suspects in Washington whining about rolling back the tax breaks that brought us only a feeble recovery since 2001, the President is sounding like LBJ (guns and butter and rebuild the gulf and...). The majority, the party of fiscal restraint says (with straight face) that there is no fat at all in our budget, so we thought you might be interested in what happens if Congress does absolutely nothing.



Notice the green line. The Congressional Budget Office forecasts that households with earnings of \$100 - \$200k paying the Alternate Minimum Tax are scheduled to rise from less than 20% in 2004 to 60% this year! By 2010 almost every tax return with \$100,000 will pay the AMT. LBJ would be pleased.

October 6, 2005.

Cascade Investment Counsel, LLC
 827 Alder Creek, Suite B
 Medford, Oregon 97504
 541.857.8551 541.857.8553 fax

