



Cascade Investment Commentary

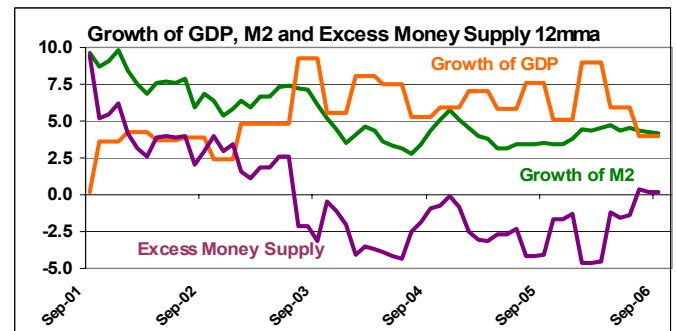
As we entered the fourth quarter of the year Wall Street was abuzz about the hedge fund Amaranth Advisors and how the 32 year old Brian Hunter was able to almost corner part of the natural gas market before losing \$6.2 billion. Washington is buzzing about the November election, and Main Street is buzzing about real estate. We grapple with a “hard” versus “soft” landing.

Moral Hazard is generally understood to be the risk that a party to a transaction has not entered into the contract in good faith, has provided misleading information about its assets, liabilities or credit capacity, or has an incentive to take unusual risks in a desperate attempt to earn a profit before the contract settles. Desperation is what apparently happened at Amaranth.

We have been stating for some time that the U.S. is not in a normal business cycle, but in the grips of a very unusual credit cycle whereby the country is functioning on rising credit rather than rising wealth creation in the “old economy” sense. The long term stability of an “Asset Based Economy” may get severely tested in the upcoming economic slowdown, and Amaranth may only be the “first cockroach”. How big is now “too big to fail”?

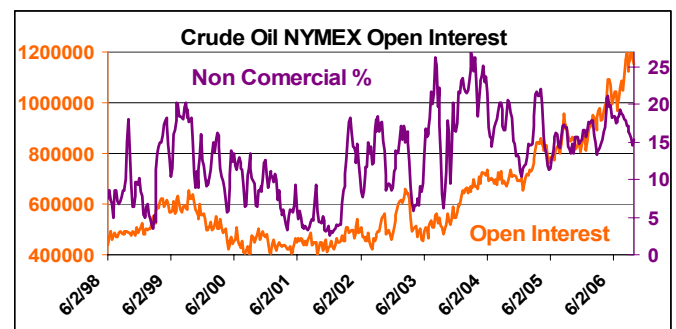
Financial blowups are nothing new to history but the Federal Reserve greatly changed the game in the wake of the 1998 collapse of Long Term Credit Management (a hedge fund that sported two Nobel Laureates in economics). Mr. Greenspan viewed the vast sums that LTCM owed to the banking system and decided that it was “too big to fail”. Chase Manhattan and J.P. Morgan were spared the embarrassment of admitting to shareholders that their due diligence was lacking, and the whole affair was literally “papered over” with a massive dose of new liquidity.

LTCM, the ensuing Russian debt crisis, the Y2K scare and the 9/11 attack led the Federal Reserve to add liquidity at a 10% annual rate.

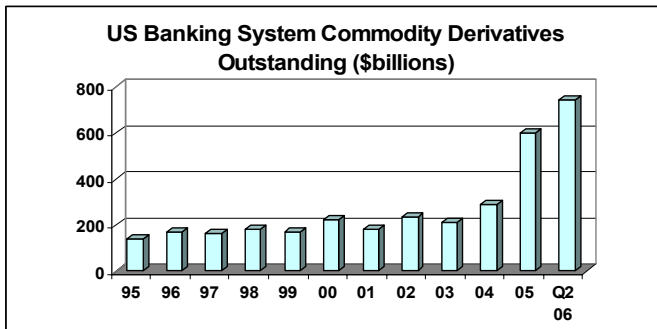


From October 1998 at the beginning of the LTCM crisis until July of 2004 when the Fed started raising interest rates, the M2 money supply grew from \$4311 billion to \$6295 billion or 46% and the M3 money supply grew from \$5953 billion to \$9282 billion or a rate of 56%. During the same period the GDP of the U.S. grew by \$3329 billion. The Fed created 86 cents in new money for every (computed) dollar of growth.

This wild increase in money had to flow somewhere, and the “carry trade” and real estate seemed good candidates. The “carry” in bonds has been written about extensively. You borrow short term and lend longer term. The Japanese have been borrowing in Japan for less than 1.00% for years re-lending in the U.S. for more than a decade. After the LTCM crisis, the Fed encouraged this behavior until mid 2004 when the Fed started a slow tightening. Banks borrowed at 1.00% which in turn was lent to the U.S. Treasury for two years at 2.50%. Hundreds of billions of dollars chased this trade. Bankers were a happy lot. As interest rates started to rise, the “carry trade” moved into commodities, principally oil.



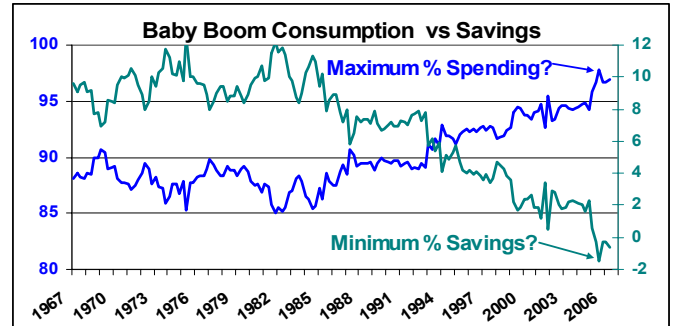
At the low point in short term interest rates non-commercial speculators amounted to over 25% of oil contract “long” positions versus 4% in Wheat and Sugar and 1% in Cattle.



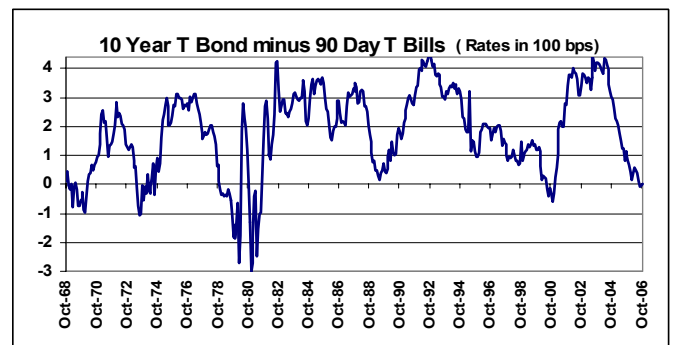
As pension funds and endowments cannot take physical possession of the commodities, they must “roll” them forward. This is very profitable when future prices are above current prices. Capturing the spread is very profitable; actually historically more profitable over the past 25 years than the S&P 500. As hedge funds have poured billions into commodity trades it has flattened the forward curve thus becoming increasingly less profitable. In fact, many commodities are higher in the spot market than in the futures market requiring the commodity to rise in value in the future just to break even. Because commodities pay no dividends, if the futures curve is flat it is effectively a negative yield. We believe that in the past quarter significant unwinding of such positions contributed to the weakness in oil and oil companies. And there were no hurricanes.

Elections are not our blood sport of choice. We believe that it has been a long run of bad policy by all parties that has put the Americans in the position we are in: A net debtor country with a declining infrastructure base from which to service a rising tide of debt to foreign nations. We see no change on the horizon. The nation has now experienced 16 consecutive months of negative savings, a record that dates to 1932. That is a policy discussion that is **not** occurring in this election cycle. The following chart illustrates an interesting possibility. The savings spikes of 1974-1976 and 1982 could have been WWII baby boomers and the Korean War boomers saving for their first home (remember when you had to have a down payment?).

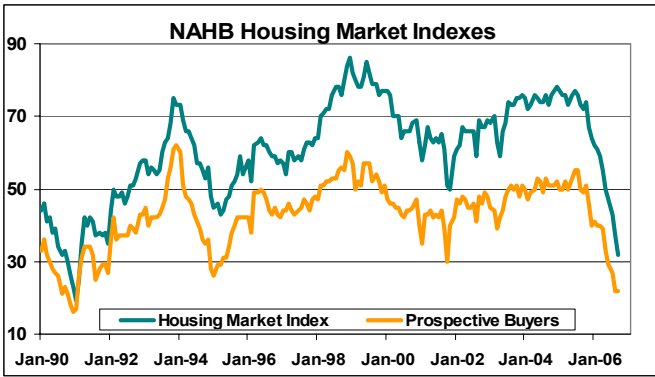
It is also possible that the spike in spending seen in 2005-2006 is the first sign that boomers’ spending could start to exhaust itself even before they face their retirement years. If this is indeed a bookend, we may expect to see many years of rising savings and reduced personal consumption.



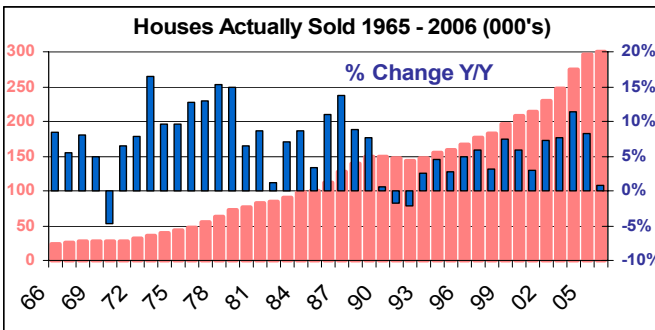
Hard landing or soft landing in real estate? Endless chatter in the press has been dedicated to housing prices and the creative means by which sellers and buyers are facing rising interest payments. The Office of the Comptroller of the Currency is concerned enough about “nontraditional mortgage products “ that they finalized revised rules on October 4th (after 11 months of public discussion) requiring the risks of a rising interest rate environment to be more fully explained to borrowers with Interest Only, Option ARM, negative-amortization, non-doc-low-doc and no down payment loans. More importantly, lending institutions must now “stress test” such mortgages to determine if they can with high probability be kept current in a rising interest rate environment, and must hold additional capital against those that are suspect.



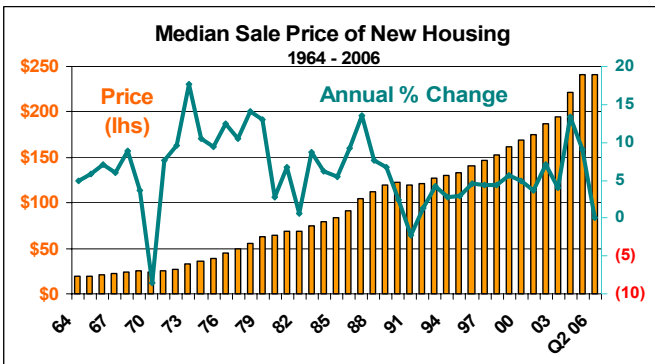
With short term rates below those of 10 Year rates, a growing number of ARM resets in 2007 may show signs of “stress”.



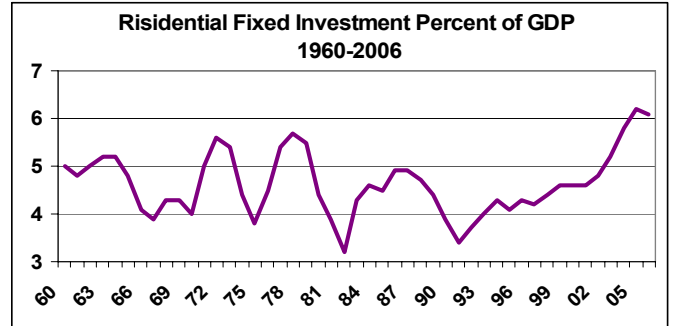
Clearly the new home market is softening and there is ample anecdotal evidence that the home builders are trying to reduce inventory. While everyone is hoping for a “soft landing” in real estate the NAHB chart above tells a pretty grim tale for new homes at least. What exactly would a soft or hard landing do to the economy? Will the current inventory liquidation of unsold new homes and condo’s turn into the first “inventory recession” since the 1960’s?



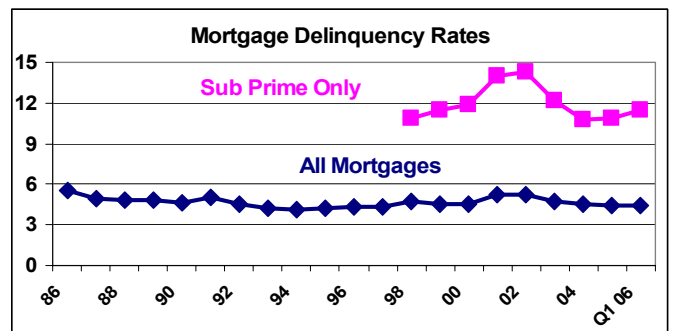
The nation has had an oversupply of new homes in the past. There have been three years in the past 40 in which new home sales fell in absolute terms year over year. We expect that 2007 will be the fourth. There have only been two years in which the median price of a home (nationwide) has fallen year over year: 1970 (-8.6%) and 1990 (-2.4%).



What is the probable economic impact of a real estate “inventory recession”? Probably reversion to the mean. Over the past 40 years Real Estate Investment has averaged 4.6% of GDP. The highest rate was 6.2% in 2005 and the lowest 3.2% in 1980 so let’s hypothesize that the hardest “soft” landing could include a drop to 3.2% of GDP for 2007.

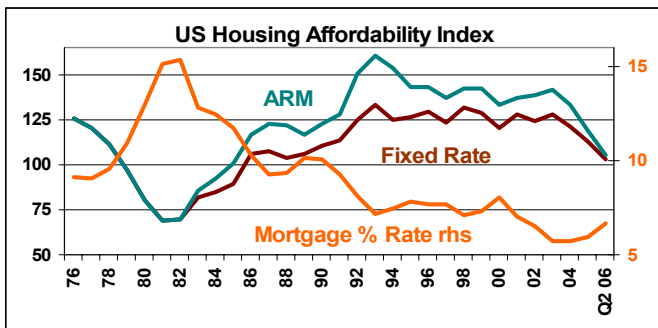


That would reduce nominal (actual dollar) GDP by 3% directly and another ½% for home furnishings. This assumes that none of the home construction people find work on commercial jobs. The US GDP grew on a nominal basis at 8.74% in the Q1 '06 and 5.69% in Q2. If we suppose that all other things remain the same, the GDP growth of 5.7% slows by 3% to 2.7% and then we subtract the core rate of inflation measured as Personal Consumption Expenditures (PCE) of 3.2% we could find a quarter or two in which we could have negative growth after inflation and thus a fair chance of an official recession.

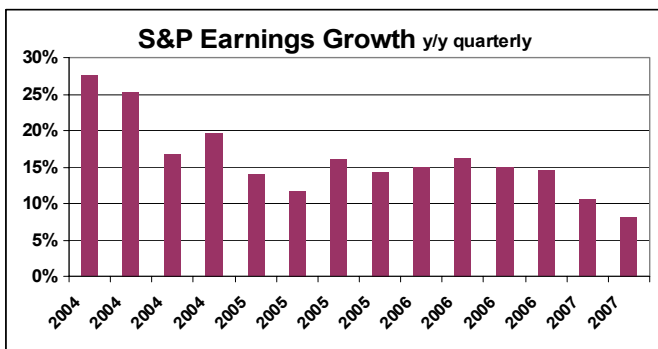


Most likely such an event would be telegraphed by a change in the sub-prime mortgage area. That is what the OCC must think by requiring more due diligence by lending institutions starting now. There is little data on sub prime loans but the All Mortgage Delinquency Rate is normal.

It is difficult to make the case that housing is slowing because of rising interest rates. As the graph below shows, rates are still low by historic comparison. Affordability has dropped significantly since 2003 as land prices have risen much faster than nominal incomes.

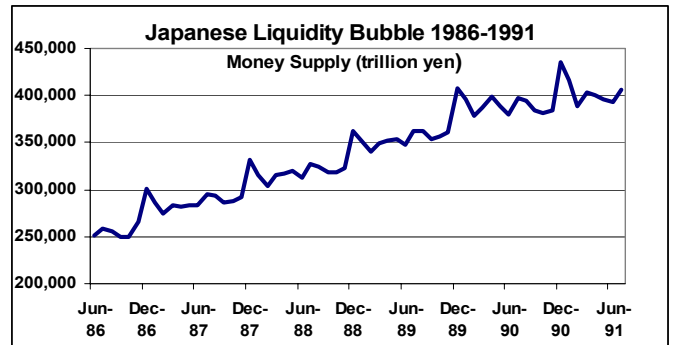


Whether construction reverts to the mean slowly or quickly we know that it *is* slowing and that the US faces an inverted yield curve. At this writing the 10 year Treasury is 56 basis points lower than Fed Funds and the 2 year is 49. Almost always when this happens we have a deceleration in corporate earnings. Below is Merrill's outlook for S&P 500 earnings. We think that most analysts will revise these estimates lower after the November election.

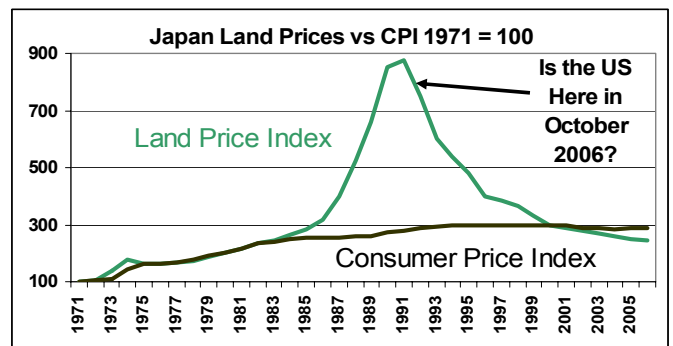


“Demography is Destiny” is the only concept that would underpin a very “hard landing” in real estate, and the most recent example is Japan. Japan went on a territorial conquest in Asia that reached a pre WWII territorial zenith in the mid 1930’s. Returning soldiers started their baby boom also in the mid 1930’s. That generation was force fed a liquidity bubble between 1986 and 1991 (front end boomers were 50 at the time) where the money supply grew 60% in 5 years. This led to a bubble first in Japanese stocks, then into real estate.

Young first time buyers of real estate found prices rising faster than wage growth and got completely discouraged. Entry level buyers dried up as young people changed their lifestyle to not include home ownership.



This liquidity also drove Japanese banks into aggressive lending worldwide which was ended by the Basel Accords which required all banks to keep at least 8% of their balance sheets in real capital. Bank loans, stocks and real estate fell as over leveraged banks and house holds were forced to unwind positions.



Our point here is this: Japanese households continued to de-leverage even as interest rates approached zero because they had been burned badly by too much debt. Will the new OCC rules have the same effect in America on highly leveraged ARM, I/O, no-down real estate buyers with negative savings rates?

Affordable housing is a US national priority and prices will either fall to the level of incomes or vise versa. Sub prime lenders: Caveat Emptor.

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