



Cascade Investment Commentary

As the fifth year of the millennium passes the stark imbalances of the U.S. economy stand in even bolder relief than ever. Typically, there seems to be no public policy discussion of how these imbalances might unwind or the consequences. In this report we try to look out several years to address some possibilities.

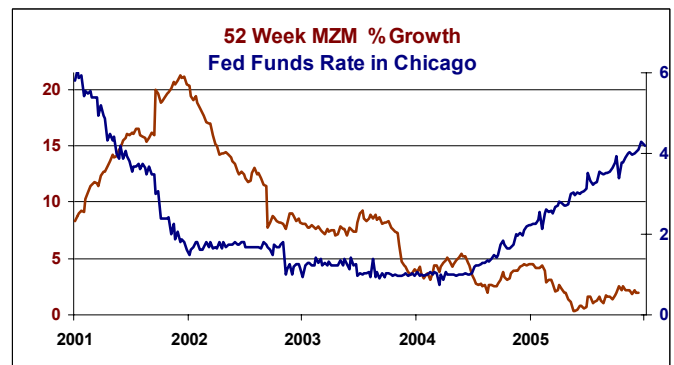
We have mentioned America's imbalances before: the trade and federal deficits, the structural inability of most states to live within their means, the growing inability of households to maintain their lifestyle without continuous new borrowing and most troubling, the deficit of productive assets to provide for future retirement.

We are writing this from Maui in one of the loveliest condominiums in the world (lent to us by very dear friends), and as we face west out to sea, we are reminded of the complexity of navigation in these waters faced by the captains of the square rigged sailing ships that hunted whales here 150 years ago. Those of you who have enjoyed any of Patrick O'Brian's stories appreciate the complexity of sailing such a vessel, where a single mistake can be lethal. One such mistake is getting "boxed".

Boxed refers to the situation where the ship cannot turn to the right or the left because of rocks or other impediments, cannot advance because the wind has shifted into the face of the sails, and the shore or other danger is immediately behind the ship. If the wind is sufficient, it will actually push the ship backwards. In America moving forward is called "growth" and it is the job of the Captain and the crew to provide more jobs, profits, wages, lifestyles, environmental protection, etc. We are reaching a situation in the U.S. where the major question for the coming years is whether the economic winds will shift and allow us to tack to safety and future growth, or whether the wind will stiffen in our face sending us backwards to the doom of deep recession.

Since we are at war (against terrorists) America's "ship" should appropriately be a Man-O-War. Boxing a warship was the ultimate act of poor seamanship and meant automatic court martial for the Captain. Our political environment has delivered many years of short term decisions made to avoid any economic pain to voters on the current incumbent's watch (two years for Congress and four years for the President). Those cumulative policy decisions are now boxing us with long term consequences. The ship is still moving forward, but the winds are changing. The winds in the face of the ship are the energy crisis first and the savings crisis second.

On the starboard (right side facing the bow) lies monetary and fiscal policy. After the Internet bubble burst the country went into recession and the Fed reduced interest rates to essentially free. This seemed good short term policy but longer term it had several negative consequences: First it fueled the "carry trade" super-liquefying the financial system. Second, it literally destroyed the incentive to save. Third, it started a housing investment bubble that has grown to near crisis proportions and last and worst it enticed households to borrow massively against their homes to fund an otherwise unearned lifestyle. All of these consequences must at some point be reversed by politically unpopular decisions.



Looking at money supply growth, the Fed appears to be taking the punchbowl away very slowly while raising the price of the punch.

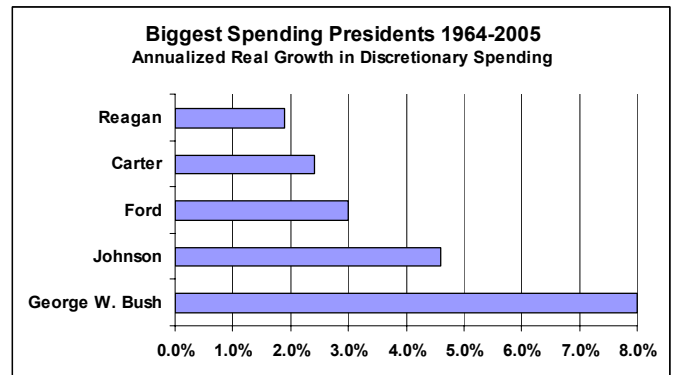
Historically the strategy of the Fed has been to raise rates high enough to stimulate savings and discourage speculation yet not stop the party altogether. The problem that the Fed faces now is that vast quantities of US dollars are owned and controlled overseas and its power to control the finances of this nation is greatly reduced from previous eras. It seems reduced to using only a gas pedal and a brake. Apparently using both at the same time, the Fed has added almost \$1 trillion of new liquidity since it started tightening in June 2004.

The navigational risk is that when short term interest rates rise enough to stop the rampant speculation in the financial and housing markets, households may actually start saving again (due to attractive rates of return and lowered expectations of further profit in real estate). This will impact retail sales and sales taxes. Any slowdown by American consumers will have an affect on the Asian economies, and they in turn could slow their buying of our debt instruments, thus starting a viscous circle raising our rates and lowering the US dollar.

Just prior to Y2K, and again after 9/11 the Fed flooded the banking system with liquidity. Financial institutions flush with money to lend could not entice corporations to borrow but found willing customers to purchase real estate. The subsequent liquidity fed bull market has led to a bubble in certain types of housing that continues to this day. How close we are to the end of this bubble is unclear, but a major clue is that at this writing Toll Brothers, a Mid-Atlantic home builder has a market value greater than General Motors.

The inability to date of the Federal Reserve to slow down the drunken driver also known as the American Consumer is a major concern of ours. It has become national policy to encourage more consumption even though the long term effect on the average household is toxic. We believe that interest rates will have to rise to the point that over-consumption and speculative activity in housing slows. That rate could actually be higher than now thought. How over-leverage unwinds is always a mystery, but always painful for some.

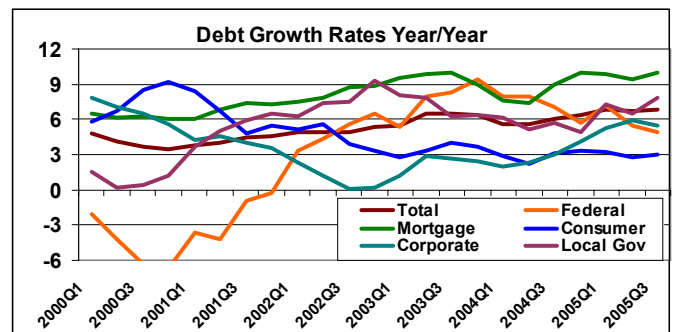
The other big rock to starboard is fiscal policy. The profligacy of the Republicans as a majority party is of such magnitude that the only appropriate word is “shocking”. Where’s Clinton? He faced a “Contract with America”.



Vice President Dick Cheney’s dictum that “Regan taught us that deficits don’t matter” is only meaningful if you think in Washington’s time frame (two/four years). Outside the Beltway this statement is on a par with a major oil company saying that oil reserves don’t matter or a construction company saying asbestos doesn’t matter. On Election Day 2000 gold was \$265. Today it is \$529.

On the port (left facing the bow) side of the ship lies the physical economy. While there is always water there, in places it is sometimes deep and sometimes shallow. The deepest part is personal consumption at 71% of GDP and the shallowest is the savings rate at -1%.

In past years, the consumer paid down debt and slowed spending in tough times. Not so recently. In the prior two recessions consumer spending has kept rising mostly due to household leveraging. In the past five years there has been almost \$1 trillion of “equity extraction” to bolster consumption.



Many find this equity extraction no problem. We disagree. While complex in the extreme, it is part of a riptide relationship we currently enjoy with Asian countries, principally China. Much has been written about our new “symbiotic” relationship with China: we buy their “stuff”, and they lend us the money. We don’t believe that this can last forever. First because China is making massive mal-investments in productive capacity that may fall into disuse, and second not all of the trade profits are being reinvested back into the US. Much is finding its way into China’s own real estate bubbles. China will have to revalue its currency upwards at some point, maybe not in 2006, but soon thereafter. This will upset apple carts on both side of the Pacific.

On the Chinese side, the now deteriorating US fiscal circumstances at the federal level will probably drive our savings rate down even further causing us to demand to borrow even more of the rest of the world’s savings surplus. The current account deficit is running 6.5% of GDP now and may go to 7.5%. This will place extreme pressure on China to invest when other prudent nations are unwilling to do so.

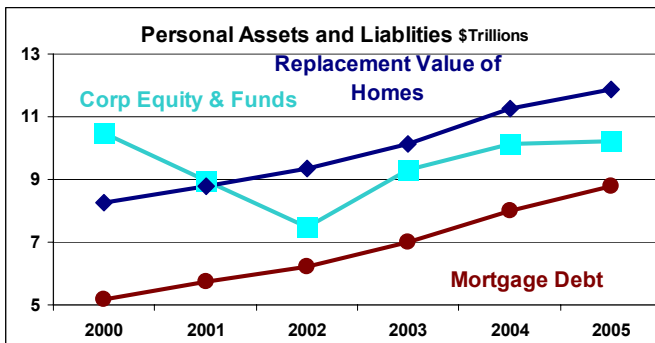
On the American side, the Asian purchasing of US Treasuries has kept interest rates artificially low, and the subsequent liquidity has helped fuel a housing bubble. Americans have taken equity out of their homes because the homes are going up in value. Perversely, many now consider the rise in home values to be a substitute for retirement assets, with absolutely no clue that ‘McMansion’ housing is not an investment, but conspicuous consumption. Many households now over invested in housing assets may not recover what they expect when they try to sell after retirement.

Home appreciation was not on the list when Moses descended Mt. Sinai, and there is no law that dictates that home prices trade at replacement cost. Prices will fluctuate both up and down but the mortgage will not. Any slowdown in home price appreciation will cause great trouble for those consumers protecting their lifestyle with equity extraction. Those believing that home equity is a suitable substitute for productive (income paying) retirement assets may come to great grief.

The composition of the Consumer Price Index also gives some clues about near term behavior. Again, rising energy cost is the wind against the mast.

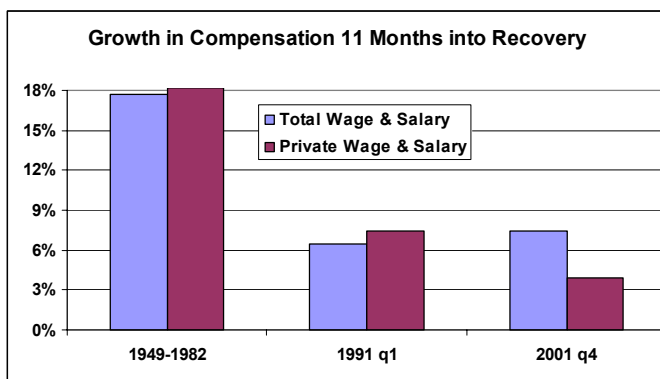
Consumer Price Index Expenditure Category:	% of CPI	% Change 11/04 - 10/05
Food at home	8.18	1.5
Food away from home	6.11	3.2
Rent of primary residence	6.13	3.2
Lodging away from home	3.00	2.7
Owners equivalent rent	23.15	2.4
Fuels and utilities	4.00	17.5
Household furnishings	4.35	0.2
Apparel	3.80	-1.2
New and used vehicles	16.38	5.0
Motor fuel	3.97	16.2
Public transportation	1.00	5.8
Medical care	6.13	4.5
Education	2.93	6.1
Communication	2.91	-1.4
All items	100	3.5

A few points to make on the CPI data: First, household furnishings have a greater weight than energy as a result of the housing boom (we expect this to change). Next, “Owners equivalent rent” is a guesstimate on the current rental value of homeownership, a fictional number. With a record number of citizens enjoying home ownership there has been extreme downside pressure on apartment rentals. As the largest component of the CPI it has helped keep the CPI much lower than is realistic. This will change as apartment building slows. Finally our outlook is for higher natural gas prices to work their way into the food chain via rising nitrogen fertilizer costs, so we look for the cost of foods to rise substantially in 2006.



The next big rock to port is wage income. It is surprising that after all of the fiscal and monetary stimulus of the past five years real (after inflation) wages are not rising. Corporations so far are keeping most of the recovery benefits. Recent labor unrest points to increasingly angry shipmates who will start asking for higher pay. In 2006 they will get it.

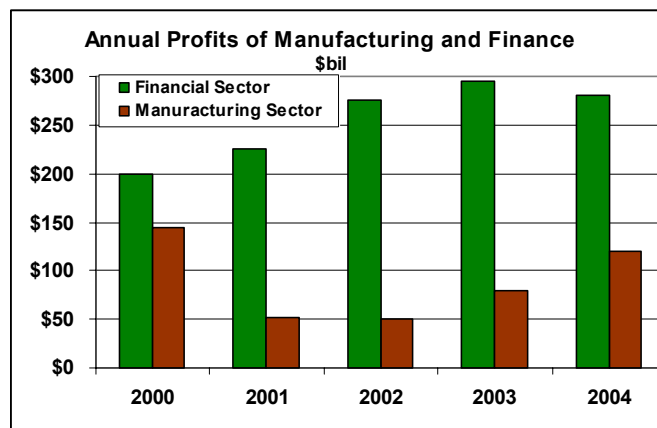
Between 1949 and 1982 total wage and salary income rose 19.1% and private wage and salary 17.7% respectively from recession lows. Eleven months after the q1 1991 low the recovery numbers dropped to 6.5% and 7.4%, and so far from the q4 2001 low total wage and salary has increased only 4.2% and private wage and salary 3.9%. These numbers are below the (official) collective rate of inflation.



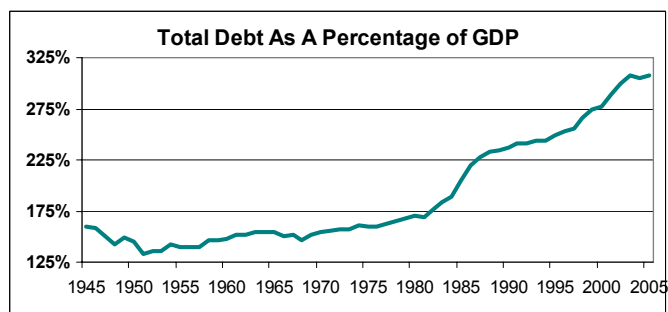
Two more gigantic rocks lie just below the surface: outsourcing and personal credit quality. America's willingness to outsource substantial portions of its industrial production, its food production and a growing percentage of its service economy to other nations should be watched with particular care. These trends have eroded by a considerable measure our long term ability as a nation to pay interest on the exploding household debt that we carry.

There are assets that a nation produces and assets that a nation trades. As we outsource the value added products of manufacturing to other countries our ability to sell products to creditor nations is marginally diminished. As our debtors become increasingly foreign that becomes increasingly important. Warren Buffett has referred to this process as becoming a "nation of sharecroppers" i.e. selling one acre at a time to maintain lifestyle.

We are also becoming a nation that increasingly trades abstract assets for a living. This only creates wealth for the traders. Re-financing a home creates no net wealth for the homeowner. It only creates service fees.

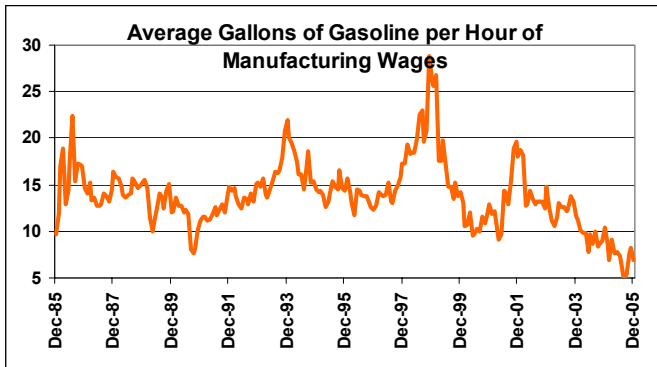


While it is true that sovereign nations do not ever intend to pay off their debt, loans to individuals are otherwise. Here the trade deficit comes into play. With \$800 billion a year trade deficit, money leaves "industrial" circulation where profits are reinvested in productive assets and returns in the "financial circulation" where it may drive prices of financial assets higher but does not in itself create wealth. Foreign profits return as our long term liabilities which ultimately beget financial servitude.



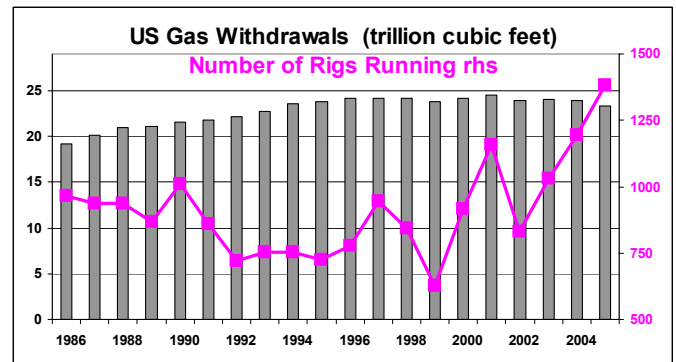
And so we are enjoying an artificial boom of consumption driven for the first time since the 1920's by a financial cycle not a business cycle. With about \$ 3.00 of existing debt for every \$1.00 of GDP it now takes about \$4.00 of new debt to produce \$1.00 of new GDP. The only way to grow is to keep the credit cycle in an expansion mode. Failing that, GDP slows. Despite the declining credit quality of the nation resulting from this behavior, we see no demand yet to change it from our creditors.

Looking forward to 2006 we expect that energy costs and financial leverage will be the big stories. Some oil analysts argue that the true cost of finding new oil (previously unknown fields) today exceeds \$200 per barrel. That roughly translates into \$6.00 gasoline or 2.75 gallons of gasoline per hour worked in manufacturing versus 6.8 at year end 2005.

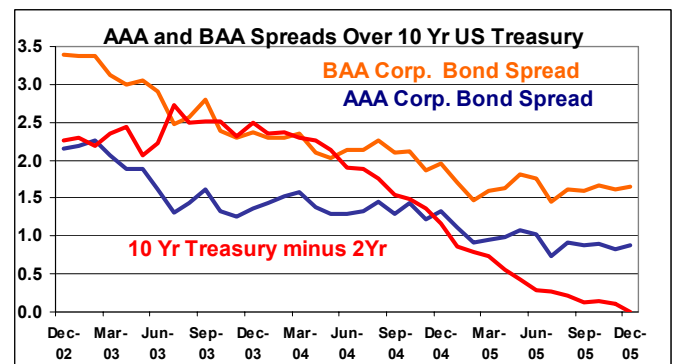


While we do not expect \$200 oil or \$6.00 gasoline immediately, the price paid must have some resemblance to the marginal cost of finding and production, and the era of cheap oil is now over. Our experience with oil in 2005 is pretty conclusive. The marginal ability of producers to add volume in light sweet crude is limited and the ability of refiners to process sour grades is limited (but growing slowly).

The immediate response to the 2004-2005 energy price signals will be additional drilling in the currently permitted areas of the US. In 2006 Offshore Weekly expects 837 new GoM wells to be drilled, up 13% from 2005. Of those 672 or 80% will be in less than 1500 feet of water, but only 29 wells will be for exploration. In shallow water that has been mostly done. Energy companies will be exploring in deeper water, and 111 wells or 67% of the 2006 deepwater activity will be for exploration. Chevron recently announced the Knotty Head discovery (Anadarko holds 25%) which is a well 170 miles south east of New Orleans which is down a record 32,681 feet (between 30% and 50% of the earth's crust). These wells will not be inexpensive, and the huge investments are not meant to lose money. The breakeven cost of new gas is rising. Also note that it takes more rigs to produce a declining amount of US gas.



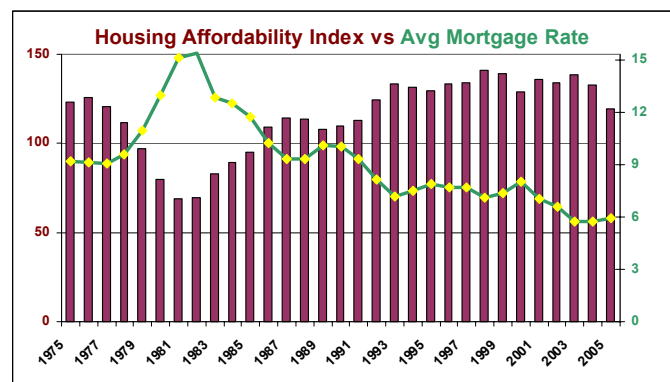
Turning to leverage, markets are so convinced that whenever there is a problem the Fed will flood the system with even more credit availability that risk premiums have collapsed. The ascendancy of Dr. Bernanke seems to insure a continuation of that policy. Ironically, in Mr. Greenspan's last testimony he stated "history has not dealt kindly with the aftermath of protracted periods of low risk premiums".



Deceleration in the rate of GDP growth in 2006 will probably bring some unintended consequences. Here monetary policy is "boxed". Any reduction in US interest rates will lessen the value of the dollar sparking rising import costs and thus more inflation in food, home furnishings and energy in particular.

Alternatively, maintaining high rates at a time of decelerating GDP will aggravate the problems with over leveraged housing speculators. With real estate loans including home equity lines of credit now comprising 60% of commercial bank portfolios, shrinking margins of safety must be of critical concern to policy makers at the Fed and the Office of the Controller of the Currency (OCC oversees Fannie Mae and Freddy Mac).

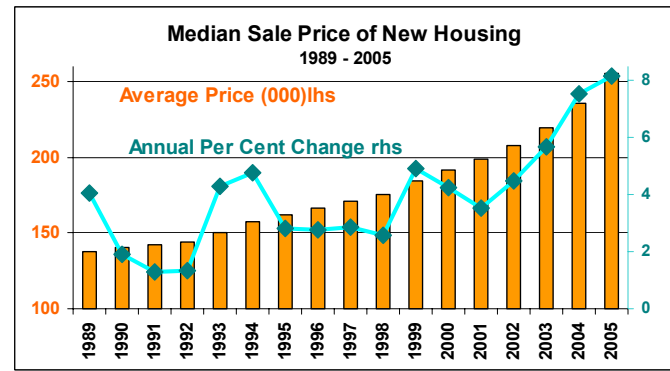
Our outlook over five years gets naturally cloudier. The financial cycle (formerly the business cycle) will probably turn when lenders fear for the return of their capital, and risk premiums return to normal. Slowing in the housing boom may trigger such an event, and with a large number of ARM's resetting this year and many interest-only loans starting to actually require payments in 2007 and 2008, we expect to see some growth in listings of spec properties, particularly coastal condominiums. Almost certainly in the next five years Asian central banks will lose their appetite for ever increasing amounts of US debt. Our trade deficit today is only 6.4% of GDP but if you take out the 23.15% non cash "Owners equivalent rent" from GDP that number jumps to 8.25%. This increasing debt load versus our productive capacity increases the uncertainty of political "event risks".



We mentioned earlier that housing for domestic consumption has supplanted much of the manufacturing of goods that could be exported for earned income. With housing affordability at a 14 year low, prices have little upside in our opinion. At a level of 100, the average household can officially afford a median value home. Rising energy and utility costs will lower the margin of safety in 2006.

The production of housing, its sale and the subsequent financing/re-financing, appraisal, redecorating, cite planning, street paving etc. has become a major industry employing millions. Any threat to the cycle of either home building or home refinancing is now a major threat to the fiscal soundness of many state and local governments, and to the Affordability Index itself due to multiple incomes per family.

Over the past 60 years, starting with the pent up demand for housing after WWII, America has made a breathtakingly large investment in suburban living. Home ownership has been the capstone definition of the American dream and today the greatest percentage of Americans are living it. No politician in America would tolerate the breaking of that dream which may account for the Fed's extraordinary accommodation in recent years. Any meaningful decline in house prices would cause considerable financial strain on bank balance sheets. We remind readers that 40% of homes in America are paid for; only a minority are leveraged into a danger zone. The plight of a vocal minority is always an opportunity for political decision makers.



Looking forward out 20 years, US suburban sprawl may be the greatest misallocation of funds in the history of man. The loss of \$1 trillion in the internet bubble may pale in comparison to the losses on housing and strip malls built in the previously sparsely or uninhabited zones of the Southwest and Southeast should the price of petroleum continue a relentless rise. When the cost of living in the southern climates of the US west and east become unaffordable due to the cost of heating, air conditioning and commuting to work the whole multi-trillion dollar structure of organized American life will come into question. With the first new nuclear reactor now 10 years away (from the next election), unsolved energy crises are the rocks on the shoreline for our "boxed" Man-O-War.

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