



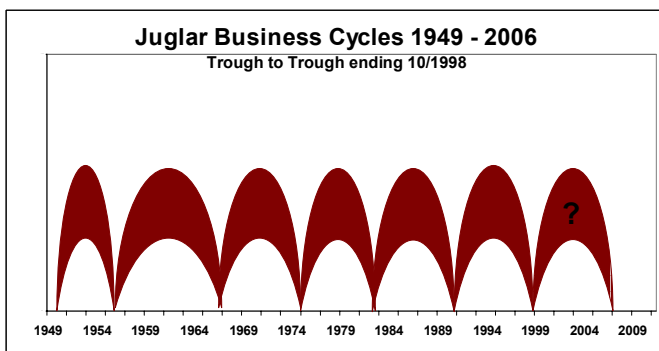
# Cascade Investment Commentary

**There are cycles in the investment world just as there are seasons on our planet. Although less exact in time, business cycle observation is no less important to investors. This Commentary tries to roughly locate our current position in the investment season.**

Analysts in the first half of 2006 seemed to be primarily focused on whether or not the economy would have a “hard” or a “soft” landing, the inverted yield curve and the end to Fed tightening. In the second half they seemed to celebrate the end of monetary tightening and record corporate profits. There is no commentary about a 2007 recession, only vague words about a “mid-cycle” slowdown led by housing. The big question that we at Cascade are now asking ourselves is whether or not the Federal Reserve has been able to eliminate the traditional cycles observed in the financial markets over the past 150 years, and if not where are we now?

The business cycle was first observed by a French economist named Clement Juglar (1819-1905). In 1862 he first wrote about an eight year (average) cycle based upon his observations of history’s boom-and-bust cycles of prosperity, crisis, liquidation and recession.

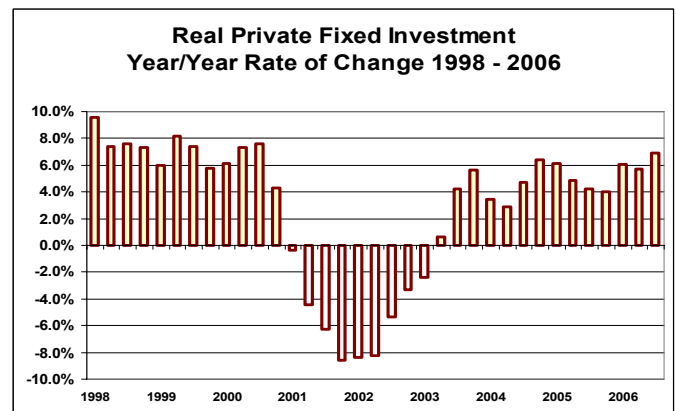
In the past 100 years there have been 13 observed business cycles despite the invention of the Federal Reserve, the Humphrey-Hawkins Full Employment Act, and massive transfers of wealth and endless fiddling of the tax codes by Congress.



The business cycle today is dominated more by private investment levels than inventory adjustments, and has changed over time to reflect an economy that is increasingly dominated by services rather than manufacturing. Thus it is becoming less sensitive to interest rate changes and more sensitive to federal fiscal policy.

Surprisingly, the eight year pattern observed 150 years ago continues until today. The longest post WWII cycle was from October of 1956 to the credit crisis of October 1966. The current cycle started in the aftermath of the Asian Credit Crisis on 1998 and the collapse of business information technology spending in 1999. Is now over seven years old and is of unknown further duration.

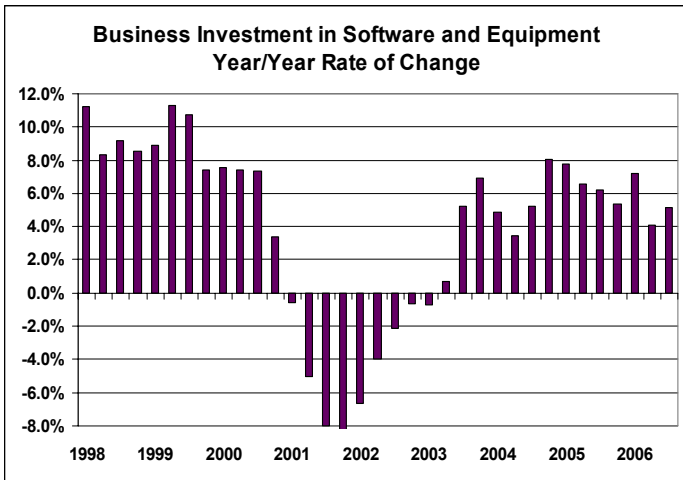
We can speculate about the further duration of the business cycle by observing the most volatile components that influence it such as business capital investment and real estate construction.



In the graphic above we see the rate of change of investment in private fixed investment including housing. The very mild recession in the aftermath of the dot-com meltdown in 1999 started in late 2000 and accelerated into 9/11. After 9/11 spending resumed but the next graphic below shows the business investment portion of the total is an anemic recovery from the 1998 levels, and business spending has not rebounded by historical recovery norms.

We suspect that the weak economic numbers now being reported presage a further slowing of business investment in 2007.

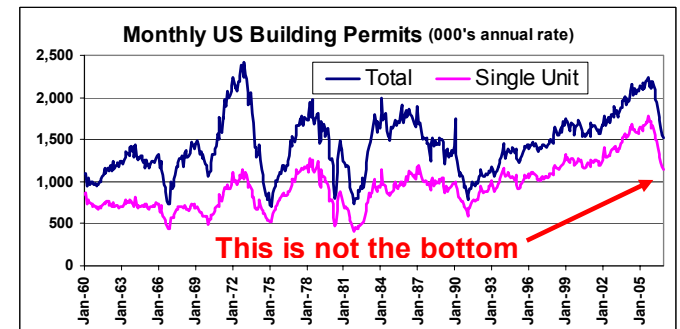
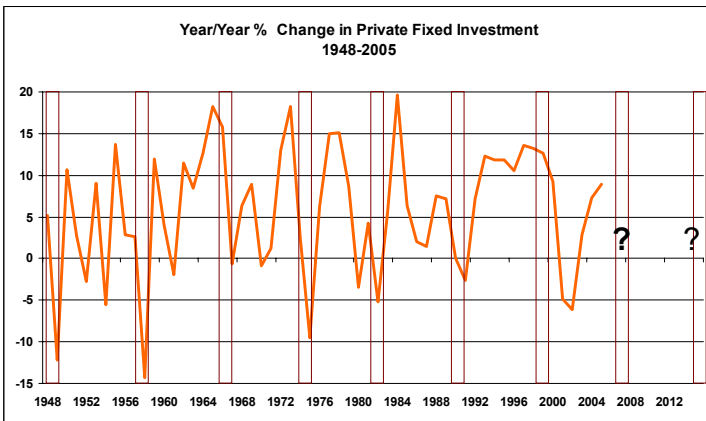
Our interest lies with the possible duration of the housing slowdown and how that may affect the business cycle. What we do know is that the construction cycle peaked in February 2006 and sales peaked in late 2005, with a resulting build in unsold inventory.



Peak	Trough	Duration (months)	% Decline in new starts
2/64	10/64	28	64
10/72	2/75	43	62
4/78	11/81	83	65
2/84	1/91	46	62
<b>Average</b>		<b>46</b>	<b>62</b>
2/06	?	?	36 so far

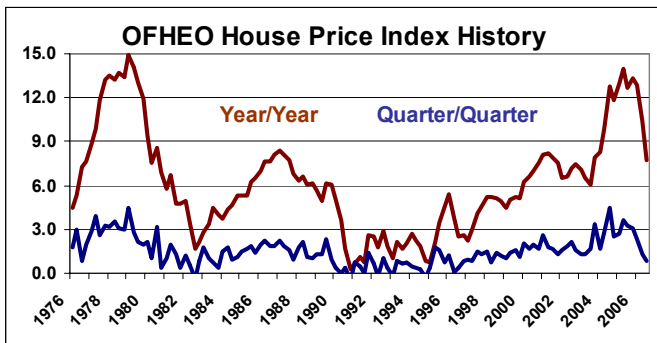
Below is the year over year change in private investment with the past troughs (from the schematic on page 1) shaded in pink. **Note how short and swift down-legs are.**

The historical evidence suggests that it will take much more time for real estate to come into equilibrium. We are only 10 months into a cycle that has averaged 46 months since accurate records are available. **Were this to be the shortest cycle in recent experience, we should expect a trough sometime in late 2007 into 2008 at the earliest.**

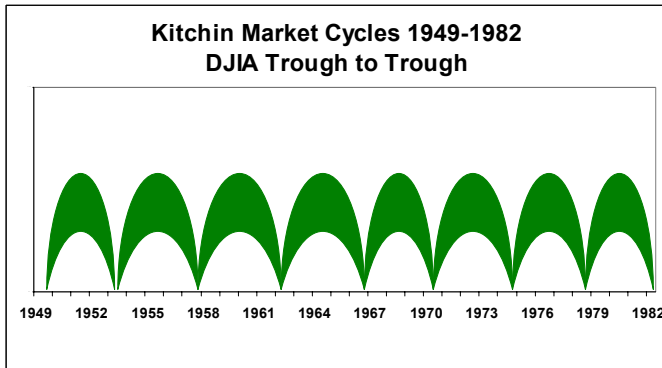


That leaves just housing to carry the cycle expansion into the future. That house prices are no longer rising is old news, what is not is the certain rise in construction, mortgage refinance and related industry unemployment.

There is a lesser known 8 year business cycle that includes major infrastructure investment such as government spending on highways, schools etc. as well as the real estate component of the Juglar business cycle. It was described by Simon Kuznets (1901-1985). Kuznets worked at the National Bureau of Economic research, and won the Nobel Prize in Economics in 1971 for inventing the National Income and Product Accounts (NIPA) which is the basis of determining GDP. This cycle bottomed in 1982, in 1998 and may again in 2007.



The cycle most often referred to by consultants is the 4 to 4<sup>1/2</sup> year stock market cycle first described by Joseph Kitchin in 1923. The “Kitchin Cycle” was originally a 40 month inventory cycle but due to federal spending patterns has now joined with the 48 month election cycle. We illustrate this cycle movement graphically below.



The Kitchin cycle is closely related to the eight year Juglar cycle but curiously not to GDP. The work of Simon Kuznets and the NBER has identified 33 recessions since 1854, all of which were preceded by a bear market in equities (to be fair, there have been bear markets which did not end in recession). The stock market is well known as a leading indicator and on average has led the business cycle by about six months.

Dow Jones Industrials - Bear Market History					
Begin	GDP	End	GDP	Months	% Change
Sep 1929	104	Jul 1932	59	34	(43)
Feb 1934	66	Jul 1934	66	5	0
Mar 1937	88	Mar 1938	89	12	1
Sep 1939	92	Apr 1942	126	31	37
Jun 1946	223	May 1947	240	11	8
May 1948	266	Jun 1949	266	13	0
Dec 1952	371	Sep 1953	381	9	3
Mar 1956	428	Dec 1957	462	21	8
Dec 1959	513	Oct 1960	528	10	3
Nov 1961	562	Jun 1962	583	7	4
Feb 1966	675	Oct 1966	793	8	17
Nov 1968	936	May 1970	1033	18	10
Dec 1972	1287	Nov 1974	1553	23	21
Jul 1976	1804	Feb 1978	2417	19	34
Oct 1979	2600	Apr 1980	2725	6	5
Apr 1981	3052	Aug 1982	3276	16	7
Nov 1983	3690	Aug 1984	3978	9	8
Aug 1987	4690	Oct 1987	4767	2	2
Jul 1990	5797	Oct 1990	5849	3	1
Jan 1994	6800	Apr 1994	6911	3	2
Jul 1998	8658	Sep 1998	8789	2	2
Jan 2000	9519	Oct 2002	10542	34	11

In the preceding chart notice that bear markets have little correlation to GDP except for 1929. The most recent bear markets (1983-1998) averaged only 3.8 months and the average gain in GDP was 3.0%. Viewing those bear markets for price decline severity is another matter. Pre WWII declines were more severe and lasted longer than post WWII; we really don't know why.

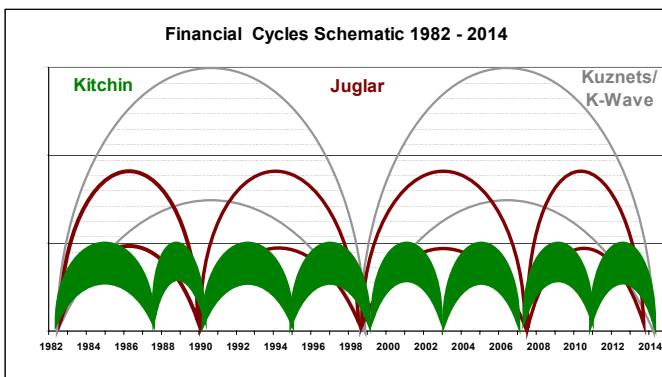
There were two secular (long term) bear markets in the 20<sup>th</sup> Century: 1906 – 1923 and 1966-1982 (outlined in pink) during which the Dow Jones gained virtually nothing.

Dow Jones Industrials - Bear Market History					
Begin	DJIA	End	DJIA	Months	% Change
Sep 1899	77	Sep 1900	53	12	- 32
Jun 1901	78	Oct 1903	42	28	- 46
Jan 1906	103	Nov 1907	53	23	- 48
Nov 1909	101	Sep 1911	73	22	- 27
Sep 1912	94	Dec 1914	53	27	- 44
Nov 1916	110	Dec 1917	66	13	- 40
Nov 1919	120	Aug 1921	64	21	- 47
Mar 1923	105	Oct 1923	86	7	- 19
Sep 1929 *	386	Jul 1932	41	34	- 89
Feb 1934	112	Jul 1934	85	5	- 24
Mar 1937	196	Mar 1938	97	12	- 50
Sep 1939	158	Apr 1942	94	31	- 40
Pre WWII Average				20	- 42
Jun 1946	210	May 1947	163	11	- 22
May 1948	193	Jun 1949	164	13	- 15
Dec 1952	292	Sep 1953	259	9	- 11
Mar 1956	521	Dec 1957	427	21	- 18
Dec 1959	679	Oct 1960	578	10	- 15
Nov 1961	733	Jun 1962	539	7	- 26
Feb 1966	989	Oct 1966	744	8	- 25
Nov 1968	985	May 1970	662	18	- 33
Dec 1972 *	1048	Nov 1974	578	23	- 45
Jul 1976	1009	Feb 1978	747	19	- 26
Oct 1979	910	Apr 1980	763	6	- 16
Apr 1981	1024	Aug 1982	770	16	- 25
Nov 1983	1297	Aug 1984	1079	9	- 17
Aug 1987 *	2747	Oct 1987	1616	2	- 41
Jul 1990	3024	Oct 1990	2344	3	- 22
Jan 1994	3986	Apr 1994	3544	3	- 11
Jul 1998	9368	Sep 1998	7400	2	- 21
Jan 2000 *	11750	Oct 2002	7198	34	- 39
Post WWII Average				12	- 24

A cyclic bull market with more than three distinct up-legs is very unusual. In the chart above we noted them with an asterisk. They have always been followed by corrections greater than average. **The bull market that started in November 2002 appears to have five up legs so far.**

**We** are entering the 50<sup>th</sup> month since the Kitchin cycle bottom of the US equity markets in November 2002. From that standpoint alone the markets are probably due for a short term bear phase. Historically, the longer the market advances without a down phase the larger the correction.

**Putting** all of the aforementioned cycles together we get a very interesting graphic. As can be seen the convergence of all three is uncommon. In the 20<sup>th</sup> Century it happened in 1907, 1921, 1932, 1949, 1966 1982 and 1998-1999. Against this historical background, we were particularly cautious in 2006 about the large financial imbalances that have developed in recent years and will continue so in 2007.



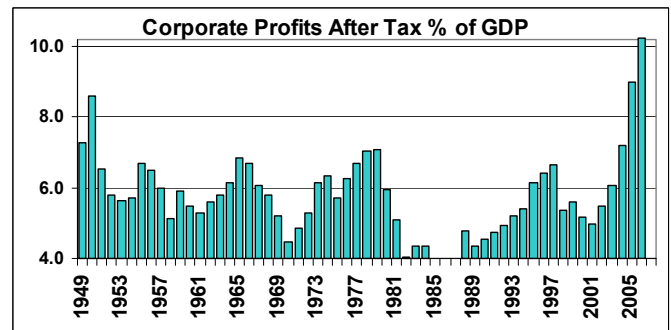
**Last**, there is the still possibly significant 64 year cycle described by Nikolai Kondratieff (1892-1938). Kondratieff was exiled to Siberia for predicting in the mid 1920's that there would be depression in the Western economies but Capitalism would survive. He thought that it was agriculture based cycle but modern scholars believe it is a long term inflation/deflation cycle.

**The** 64 year K-Wave cycle (as it is commonly referred to) is broken into four 16 year seasons: Spring, the time of reflation; summer, the time of inflation, autumn the time of plateau or disinflation and winter the time of deflation. The end of the last winter cycle was 1949. From there 16 years of reflation lasted until 1965, inflation then started and lasted until 1981 whereupon disinflation started and lasted until 1998. According to the broad theory we then started a period of deflation that will last until about 2014.

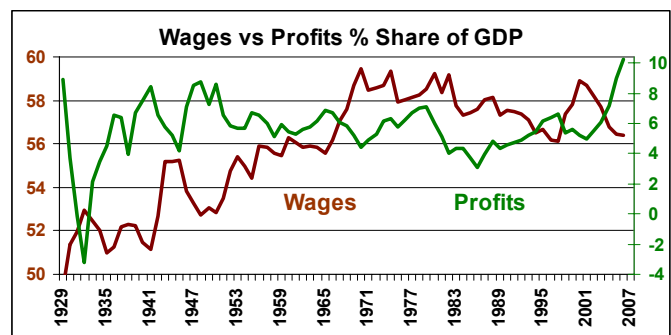
**Perhaps** our Dr. Ben Bernanke is a greater student of cycles than he lets on because he has certainly talked at great length in the past few years about deflation. The convergence of all four cycles somewhere near 2014 will be an event we will pay great attention to.

**Our** other immediate concern is the political cycle. Politics and profits are of course as old as governments and taxes. As we enter 2007, the effects of globalization are front and center to the agenda of organized labor in the industrial countries. Here in the US, the Congress will certainly confront China (labor has entered 27 bills since 2005 offering punitive measures).

**The** global arbitrage of labor has had the disquieting effect of pushing down the cost of business's largest expense component (in all advanced industrial countries), while at the same time raising profitability to levels not seen since modern records have been kept.

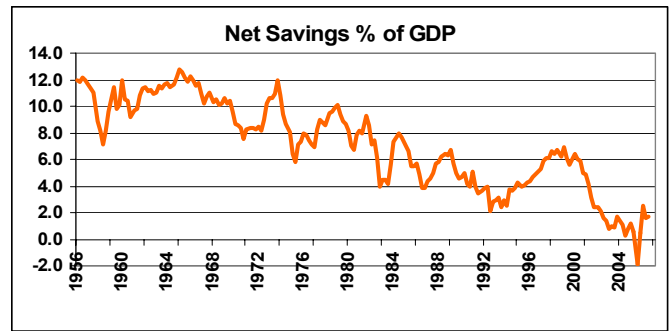


**The** recent rewards of owning capital assets have never been as pronounced vis-à-vis the rewards of labor, and despite the Fed's willingness to allow financial leverage to grow to the sky, will not continue forever.



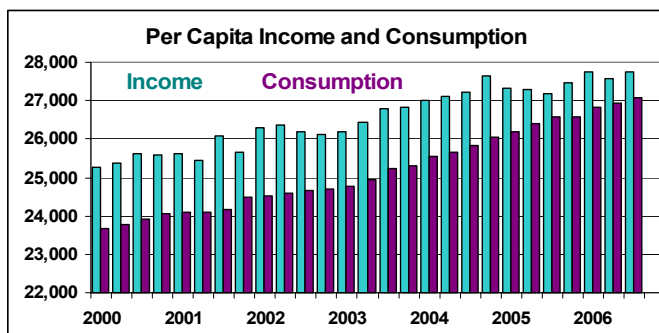
With labor's share of the pie virtually unchanged since the 1960's, it is very easy to believe that Nancy Pelosi-Harry Reid & Co. will fan a "worker backlash" going into the 2008 election cycle. In this regard the US is not alone. The political left has taken elections in Germany, Italy, Spain and Japan.

With the equity markets long overdue for correction, we reiterate our concern about financial leverage. The amount of money that has been placed by formerly conservative institutions such as large pension funds and foundations with hedge funds is truly staggering. Wall Streets net acquisition of financial assets grew at the annual rate of 26% up \$606 billion to almost \$3 trillion in the 3<sup>rd</sup> Quarter 06. This has in turn led to a snowballing of mergers & acquisitions, private equity and leveraged buy-out deals. We see great vulnerability in the now triple-layered leverage: Leveraged investors buying leveraged firms (or leveraging them after purchase) who are dependent on highly leveraged consumers. If consumer purchasing slows even slightly (we believe it will be considerable) there will be a significant rise in the possibility of a "negative event risk" that will roil the financial markets.



We have mentioned in the past that while an inverted yield curve has not always predicted an economic recession in the formally recognized sense, it has always predicted a profit recession. We believe that a profit recession is very likely for 2007 and for the markets to rise from their current levels price/earnings multiples must expand in 2007 (we said this a year ago and we were wrong in spades), but any further expansion in consumption will have to come from higher wages. This will not happen quickly and we remain out of the retail sector.

The Government Accountability Office issued its report on the Financial Statements of the United States on December 15<sup>th</sup>. We quote from page 28: "...This new statement shows projected scheduled benefits exceeding earmarked revenues by approximately \$39 trillion [actually \$44 trillion if you include people under 15 years old] in present value terms for the next 75-year period. Considering this long-range projected funding gap in social insurance... the federal government's fiscal exposures totaled approximately \$50 trillion as of September 30, 2006, and increase of about \$4 trillion over September 30, 2005, and up from about \$20 trillion as of September 30, 2000. This translates into a current burden of about \$170,000 per American or approximately \$440,000 per American household."



Since the beginning of 2000 household income has risen by 9.8% but personal consumption expenditures have risen 14.3%. The difference has come at the expense of savings. When real estate was rising that was understandable. With real estate prices no longer rising home equity withdrawal becomes difficult. Home equity withdrawal peaked in Q3 2005 at the annual rate of \$730 billion, in Q3 2006 it is was down to an annual rate of \$214 billion and we expect it to fall further.

On page 152 the Comptroller states "While we are unable to express an opinion on the U.S. government's consolidated financial statements, (i.e. they won't certify the books) the following key items deserve emphasis .... Despite improvements in both the fiscal year 2006 reported net operating cost and the cash-based budget deficit, the U.S. government's total reported liabilities, net social insurance

commitments, and other fiscal exposures continue to grow and now total approximately \$50 trillion, representing approximately four times the Nation's total output (GDP) in fiscal year 2006, up from about \$20 trillion, or two times GDP in fiscal year 2000. As this long term fiscal imbalance continues to grow, the retirement of the "baby boom" generation is closer to becoming a reality with the first wave of boomers eligible for early retirement under Social Security in 2008. ***Given these and other factors, it seems clear that the nation's current fiscal path is unsustainable and that tough choices by the President and the Congress are necessary in order to address the nation's large and growing long-term fiscal imbalance***" (emphasis ours).

While we are unsure of the full implication of the Federal Government's admission that last year's deficit was really over \$4 trillion on an accrual basis, we hope you understand why your portfolio is over weighted in companies with tangible assets and non-weighted in those with highly leveraged balance sheets.

Returning to the nesting of cycles and the K-Wave possibly ending its deflationary cycle sometime around 2014, it becomes difficult not to believe that we are headed as a nation towards a financial train wreck when Social Security payments exceed receipts (currently forecast to be 2014-2016). Who among us really believes that the US Government will be able to fulfill all of the social promises made without resort to the use of the printing press?

Cascade is a Large Cap Value Manager and our primary focus is on the individual merits of the highest quality North American companies. We have always emphasized the quality of earnings, free cash flow and the ability of each company on our Approved List to maintain and raise their dividends. This is generally referred to as "Bottom Up Analysis".

We also believe that there is also a place for "Top Down Analysis" wherein we approach our portfolios from a macro economic view to determine desirable and undesirable industries to be currently invested in.

After almost 40 years of portfolio management, we acknowledge that there is a place for technical analysis also. Investments are made by people who have human emotions. Greed and fear are often talked about, but the current psychological environment should never be left out of a decision equation, particularly at major turning points. We have not forgotten the "madness of crowds" witnessed in our own professional careers.

It is our opinion that the next major market correction will determine if we are in a long term secular bear market such as 1906-1923 and 1966-1982, which started in 1999 for "Old Economy" stocks and in 2000 for the "New Economy" stocks or we remain in a continuing secular bull market that started in April 1994 and may hold until unknown possible events end it closer to 2014.

Against this historical background we expect rising volatility in 2007-2008 and possible extreme volatility in 2014-2015. We will know soon.

**"History tells us that every major economic and financial crisis has had two main causes. Excess credit is one, and excessive optimism is the other. Both exist in unusual abundance in the United States today." Dr. Kurt Richebacher 2006**

January 5, 2007.

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