

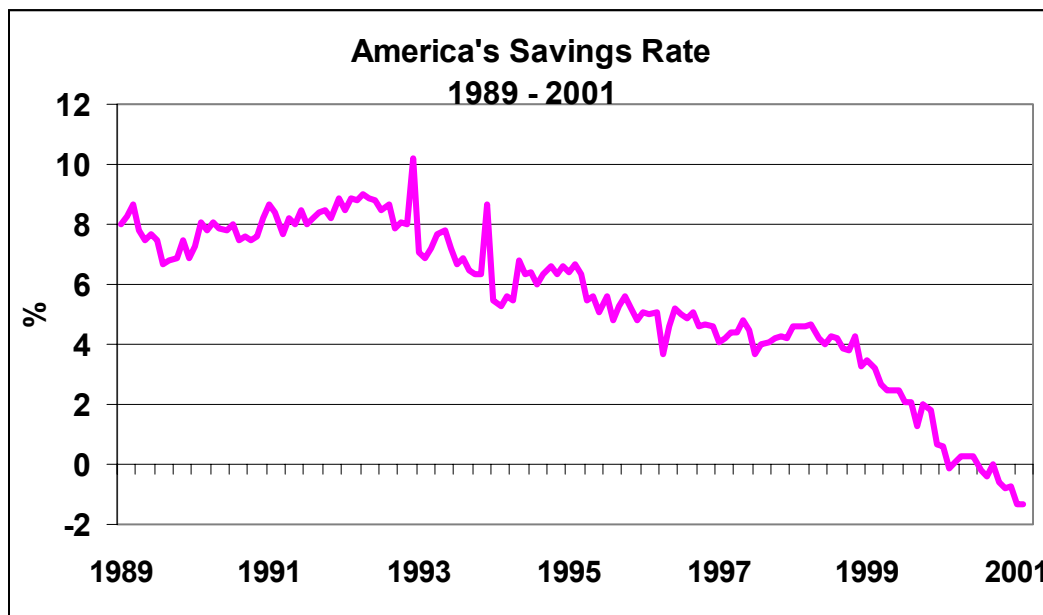


Cascade Investment Commentary

As the First Quarter of the New Millennium ended, the euphoria and expectations on Wall Street 365 days earlier seemed almost a thousand years past. For the amateur investors whose faith in unsound and unproven business models was rewarded with almost complete wipeout, it has become a time of disillusionment. For the professional investors who justified paying 100 times sales for what was thought to be excellent business models, it has become a time to realize that all companies, including Cisco Systems (briefly the most valuable company in mankind's history) are, in reality, cyclical. For the Federal Reserve Board, it has become a time to worry, and for Cascade Investment Counsel, it is a time to anticipate recovery.

We believe that the Fed is presently concerned about saving, spending and confidence.

On these pages we have cautioned about the consequence of America's declining savings rate for some time. Savings in January and February were both -1.3% annualized. Households are now cash flow negative by a \$325 billion annual rate. Coupled with the non-financial business sector, this is now 4.4% of GDP.

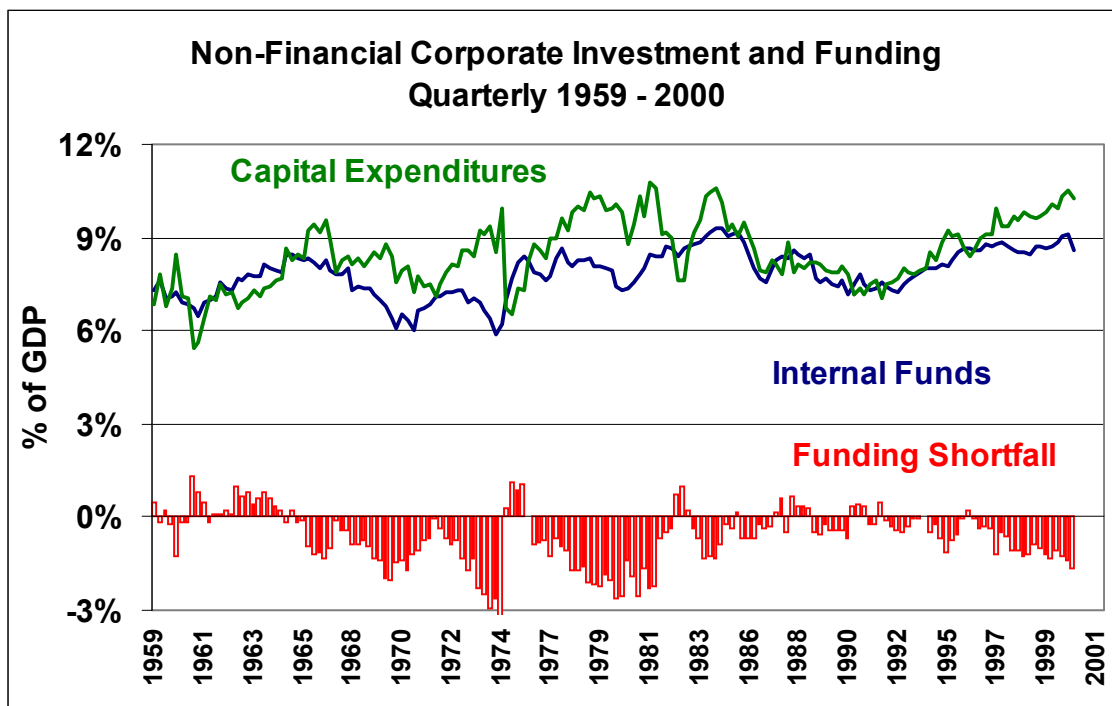


A year ago at the top of the boom, real (after inflation) disposable income was rising at the annual rate of 2.7% . Households however, cut their savings rate by 3.3% through the 12 months allowing real spending to rise by the annual rate of 6.3% . During the 12 months just ended, savings fell another 1.2% allowing spending to rise by 3.2% . It is important to understand the relationship between the savings rate and consumer spending. To maintain the current gap between income growth and spending growth, the household saving rate has to keep on falling, i.e. to become even more negative. If the savings rate merely stays at today's levels, consumer spending will slow. Were the

savings rate to rise, the deceleration in consumer spending would probably tip the country into recession. Going forward, it seems unlikely that spending can rise faster than incomes

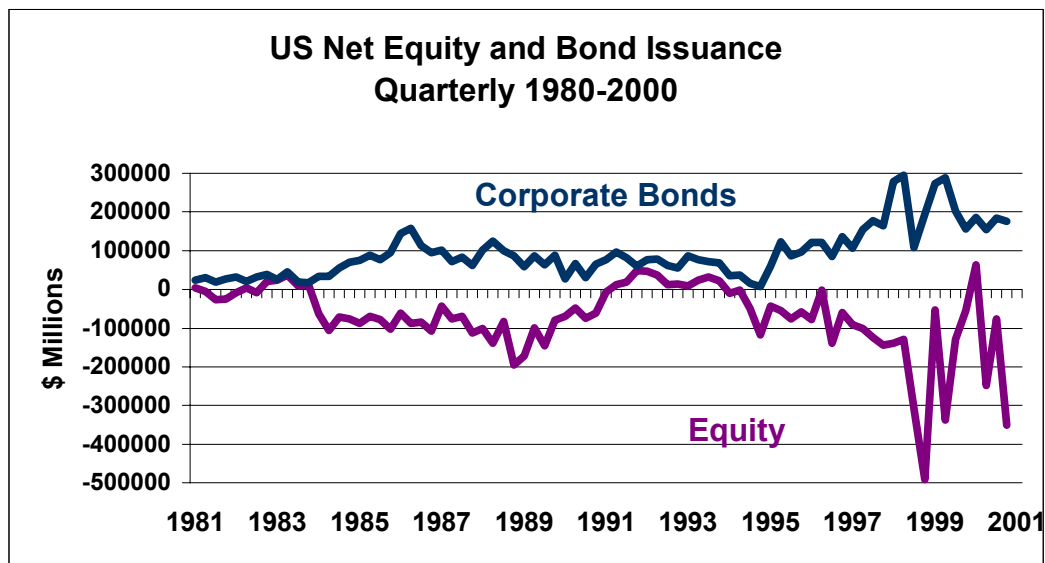
The nature of consumer spending, which now accounts for about 70% of GDP is also likely to change. During the past year, spending on durable items fell from a growth rate of 16.1% in February to only 2.3% by December. The stock market noticed immediately, and durable goods manufacturers, cyclicals and technology manufacturers all saw their shares pounded. While it appears that spending will rise about 2 ½% in the just ended quarter, spending on durables (notably autos) is increasing, which means that spending on services will finally start to feel the pinch.

While the household savings rate is well known, the savings shortfall also affects the corporate sector. As value investors, we are keenly aware of free cash flow, because that is where capital expenditures (capex) and dividends come from. While investment spending hit new highs in 2000, internal funding lagged. This has been going on for some time, as the chart below demonstrates.



What is different now from the shortfalls seen in the 1970's is where the money is going. In the late 1960's and 1970's, we were building an infrastructure to support the digital economy. Businesses were building electric generators, transmission lines, telephone and microwave circuits, and mainframe computers. Today is very different.

In the past few years, business has indeed invested in plant and equipment, notably in Internet and telecom technology. Less seen is the amount of money being used to reduce the capital base of corporations through share repurchases and the funding of stock options. Such repurchases have been good in the short term for share prices, but has a long-term consequence that we fret over.



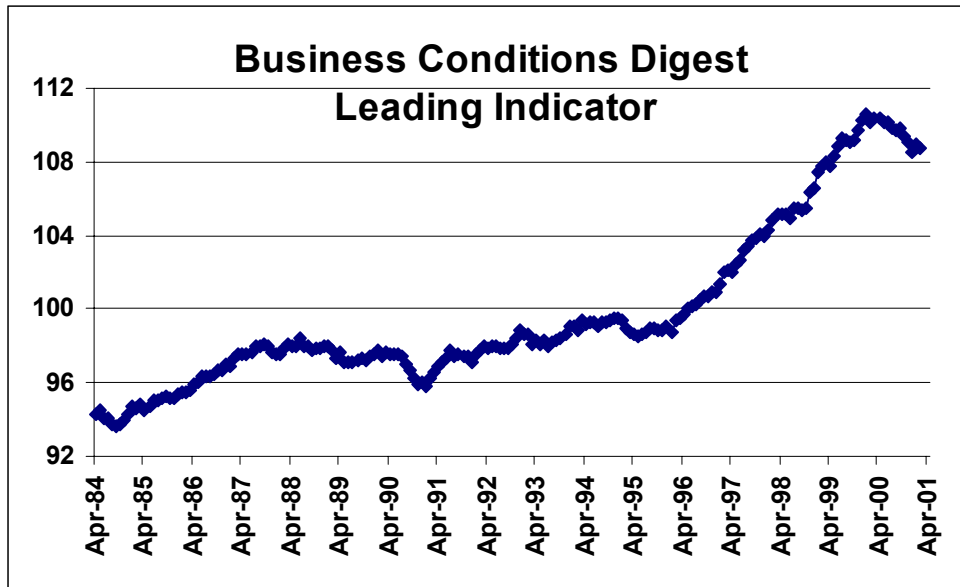
As the chart above reveals, during the last few years of economic boom corporations were net issuers of huge levels of debt. In past business cycles, such free cash flow was used to either increase dividends, reduce debt or fund capex. What we saw for the past three years is that with the exception of dot.com new issues, there has been a significant amount of corporate free cash flow buying in stock, at times with borrowed money. The result is that corporations are becoming increasingly leveraged.

Not co-incidentally, 2000 was a bad year for dividends. Dividends paid by the S&P 500 companies fell 2.5% in 2000, the first decline in 10 years, and the largest in 50 years. We forecast that corporations will meet with increased resistance from shareholders to excessively generous stock option schemes, and the huge share buybacks will go “bye bye”.

Thus the first dilemma for Mr. Greenspan: To keep the country out of recession the Fed must encourage the public to spend money at least as fast as they earn it, while continuing to borrow enough of the rest of the world’s savings to cover the ongoing depreciation and depletion on the nation’s factory’s, plants and physical production equipment. All this when the equity markets are weak, and employment growth is slowing. Ironically, if the Fed succeeds, it will only delay the pain of delayed gratification. Commonly known as “Savings”.

Suddenly, consumer confidence has become a must-watch indicator. This is a result of Mr. Greenspan’s comments to Congress suggesting that what appeared to be an

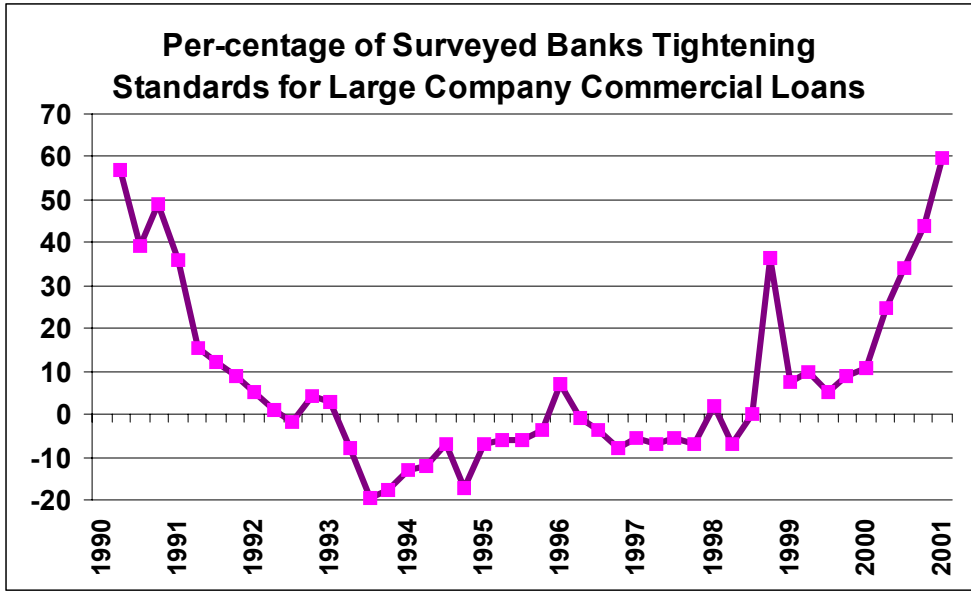
inventory correction in the 4th Quarter of last year could turn into a recession if consumer confidence falls. By implication, this infers that Fed policy is to prevent consumer confidence from falling sharply.



The second dilemma for the Fed is that the largest portion of consumer confidence is employment, and while lowering the discount rate will have a positive long-term effect on job creation, job security is not well correlated with the Fed Funds rate. Further, with households reducing the equity in personal residences through re-financing and second mortgages, it may take a considerable drop in long-term rates to de-leverage households and to rekindle the consumption pattern of the past five years.

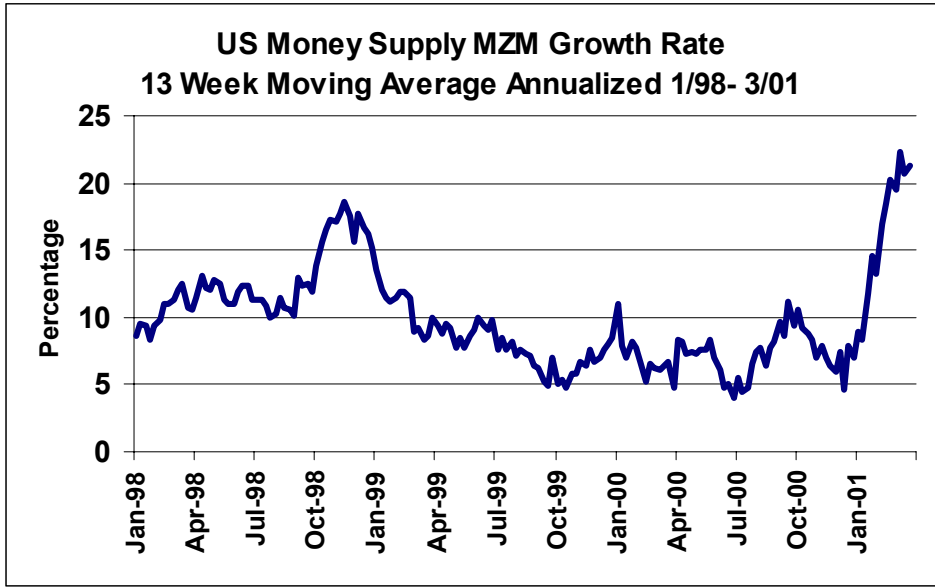
The recent leveraging of corporate balance sheets has not gone unnoticed by the banking community. Starting in 1990, the Fed began surveying both large and small banks in each Reserve District about their future lending plans, including whether they were tightening or loosening their standards for commercial and industrial lending. This survey has taken place following each quarter with two exceptions. The survey was taken in September 1998 (instead of October) during the crisis of Long Term Capital Management, and it was taken in mid March instead of early April 2000. The results are startling.

Despite three rounds of rate cuts, zero percent of responding banks indicated a loosening of standards, and almost 60% responded that standards had tightened so far this year.



We remind our readers that the tools of monetary policy are few and blunt. The Fed can create money or destroy money, and it can ease or tighten credit standards and prices.

It is instructive, therefore to see what tools the Fed has been using. Below is a chart of the broadest measure of money supply, MZM. MZM is Money with Zero Maturity, or deposits that can be withdrawn on immediate notice to purchase goods, services or securities. It includes cash, checking accounts, money market funds, credit union deposits, and other funds that can be utilized on immediate notice.

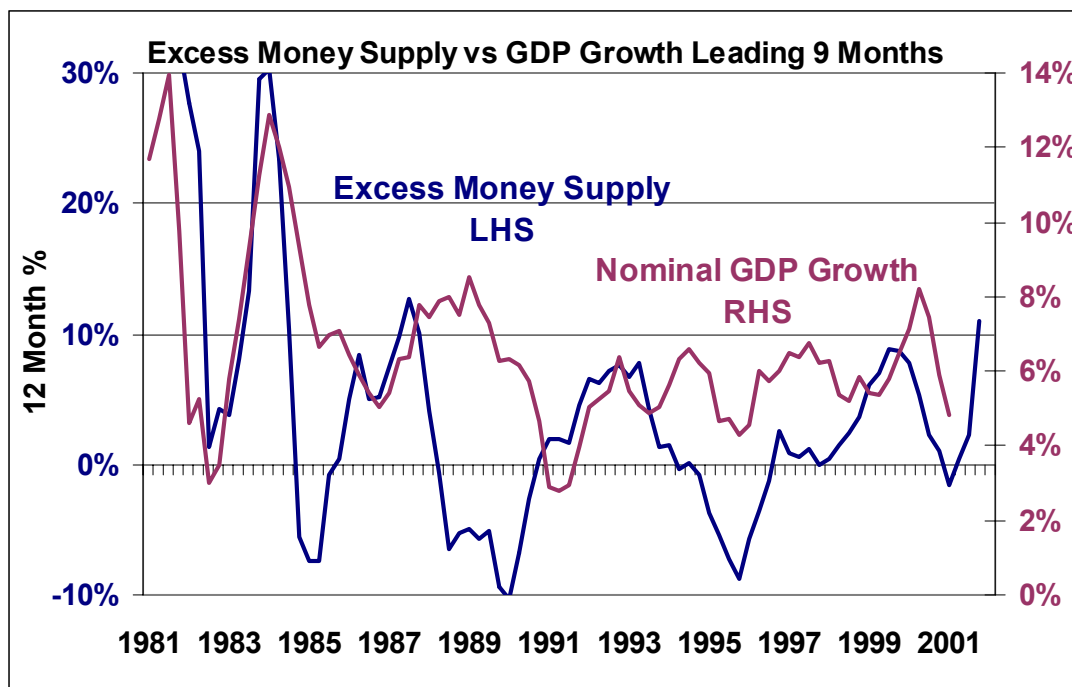


To see how extraordinary the current Fed behavior is, we must go back to 1983 in our database to find a three month period of money supply growth rate above 20% per year.

Not during the Russian / Long Term Credit Management crisis of 1998, not during the commercial real estate crisis in 1990-91, and not during the Savings & Loan crisis in 1986 has the Fed pumped so much liquidity into the market so fast.

There is consequence to this action. We hope, as we assume the Fed hopes that this vast injection of liquidity will bring renewed confidence to the financial markets, and subsequently to the economy in general. There is evidence that this has worked before.

In our final chart, we follow the growth of the money supply M2 (cash, checking, and certain retail money market funds) against the nominal (actual not adjusted for inflation) growth of the GNP, with M2 leading by 9 months. Our theory is that a certain amount of money growth is needed to facilitate GDP growth, and when there is excess money it will go into financial assets, and when there is not enough money to fund demand, it will be taken out of financial assets.



Excess money supply (blue left hand scale) is now growing above 10% as GDP growth (plum right hand scale) heads for zero. Not since the aftermath of the stock market “crash” in 1987 has liquidity risen so fast. This is extremely bullish for stocks.

The final dilemma for the Fed is to add enough liquidity to the system to keep overall financial stability without creating so much excess liquidity that roaring inflation ensues.

April 3, 2001