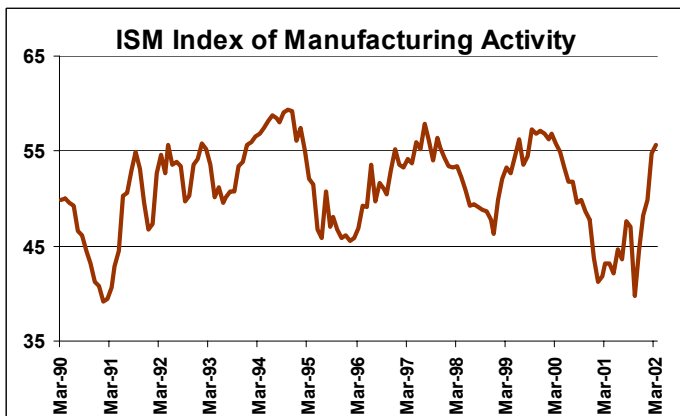




Cascade Investment Commentary

As we enter the second quarter of the year, there are signs that the economic recovery may be front end loaded, and that the optimistic outlook may fade somewhat in the second half. Because profits are now more leveraged to cost containment than sales growth, strong earnings are possible with even modest growth. The Federal Reserve may not raise short rates as fast or as high as is currently thought as profits are leveraged to very low short term rates. This may lead to higher stock prices in the 2nd half of the year.

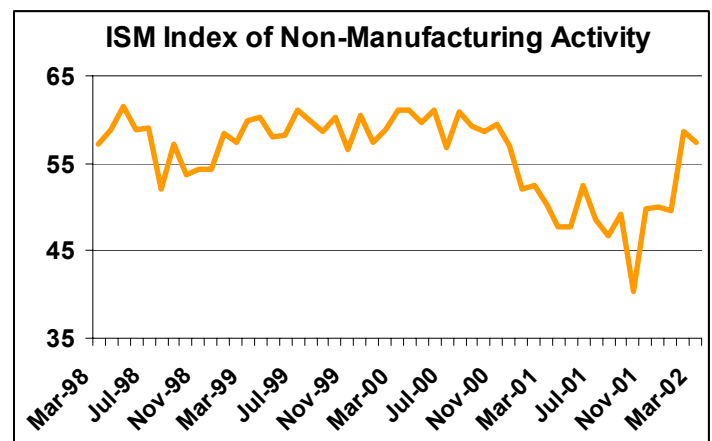
We suspect that the inventory rebuild of the first quarter may act as a “front loading” of the economic recovery, giving the strongest gains in the first half, followed by lackluster gains in the second half. Visible evidence is in the Institute for Supply Management (formerly the National Association of Purchasing Managers) Indices.



The jump in manufacturing activity since the October low has been quite dramatic (any number above 50 is expansion, below 50 is contraction). As we remarked last year, historically, the Fed has not raised interest rates until the index rose above 55. Today we are at 55.6, and there is now speculation on when rates will rise, not if. The rate of advance from the October lows to the current level of activity is just not sustainable, and after a six week period of surprising good economic data,

the last week of March and the first week of April brought some disappointing data, including falling new home permits, rapidly rising energy prices and sluggish retail sales.

The ISM Index of Non-Manufacturing Activity shows that when the capital goods recession began to hurt the service economy in 2001, jobs everywhere started to get scarce.



But with the inventory rebuild, confidence has returned, and service activity expanded rapidly, until the end of March. The question to be answered is whether the recovery has enough “legs” to get employment going again.

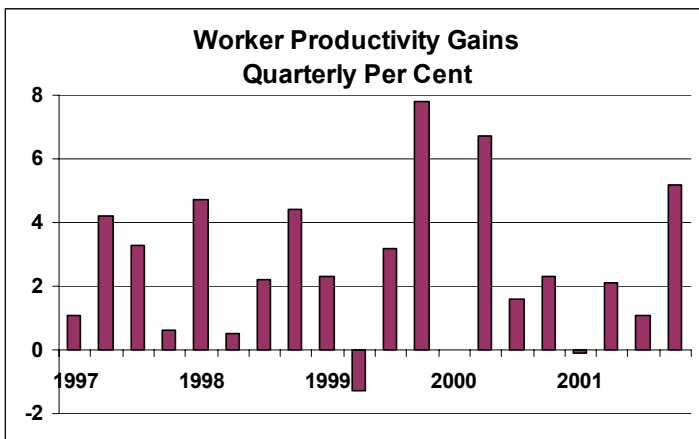


In the name of cost rationalization, hundreds of thousands of people were laid off in 2001, and with more coming this year, consumer confidence numbers should stabilize.

The biggest problem for non telecom firms last year was the blow-out in both labor and non-labor costs. This year may see a slight reverse.

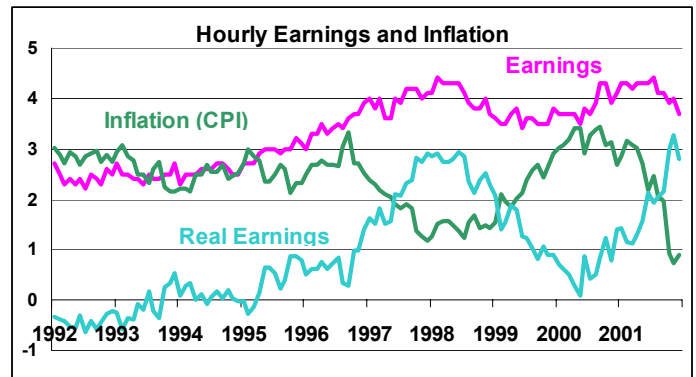
Manufacturing has been the epicenter of our current recession. This has reflected not only in our own inventory run down, but that of the rest of the world also. This has been the first time that all major industrial countries slowed at the same time, and it happened when the \$US has been particularly strong, giving American consumers relative bargains on hard goods they couldn't pass up. This is in part why the savings rate remains near zero: Too many genuine bargains.

Business sector unit labor costs fell at the annual rate of 2.7% in the 4th Quarter, and may have fallen even faster in the 1st Quarter of 2002. We believe that profits can rise significantly if unit costs fall, even if volume recovery is lackluster.



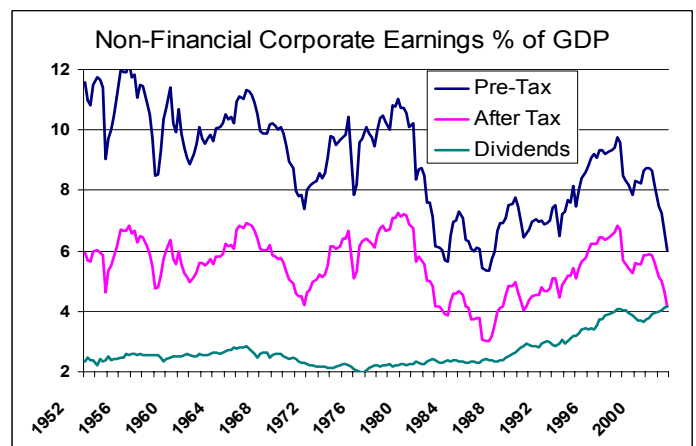
Surprisingly, the recent rise in productivity did not have much effect of the profits cycle. A fair question to ask is: if productivity is so important, then why did we just have the worst profits recession in the post war era? One possible answer is that the consumer, rather than corporate profits, has garnered the lion's share of productivity improvements.

Recent years have shown strong economic growth with little or no inflation, and almost all retailers have moved to the "WalMart model" of extreme pressure on end user prices.



We suspect that the good fortunes of consumers may change slightly. Above we illustrate y/y gross earnings growth (pink), the stated y/y inflation rate- Consumer Price Index (green) and the net or real y/y percentage growth in hourly manufacturing wages (teal). The consumer has had a very nice ride in the past few years at the expense of someone. That someone is corporate profits.

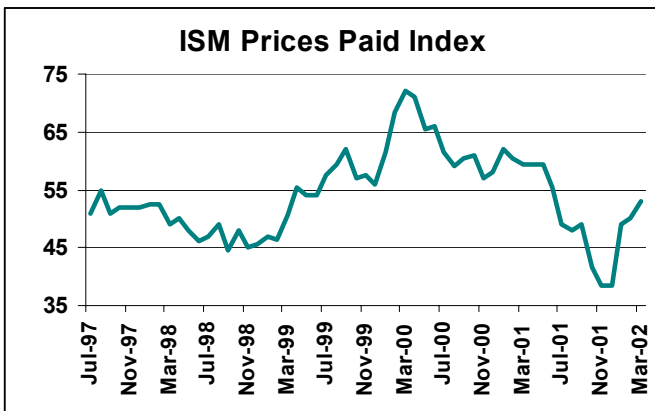
Old economy profits have been pummeled in the past three years, and the after tax profit margins of non-financial companies now stands near their post WWII lows. The profit of manufacturing has been in a secular decline since the 1950's, and previous cyclical U.S. recessions reflected not only the secular profit contraction, but also reflected a higher concentration of manufacturing to service jobs.



We feel that the next direction of corporate profits is up, as considerable consolidation is taking place in oil, forest products, metals, chemicals, and even in specialty retailing (especially new automobiles).

In 1952 manufacturing represented about 35% of private sector output. Today it stands at 15%, so its overall importance is diminishing. These are the “family wage” jobs, however, and government at all levels is sensitive to them. The current administration’s fawning over steelworker jobs is but one example.

The industrial sector is now seeing some small increases in prices paid for their goods. The ISM Prices Paid series measures manufacturers input costs, and is very highly correlated to the intermediate PPI (Producer Price Index). With prices paid turning up in the past few months, it’s a sure bet that final costs of goods, and in turn the CPI will also soon turn higher. This is not altogether bad news, as it is margins that have hurt corporate profits most.

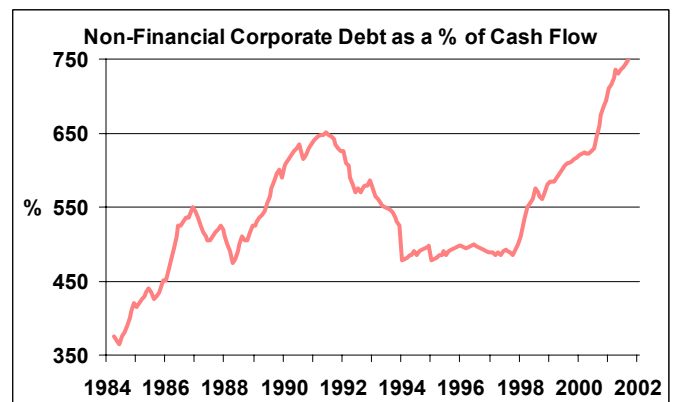


This quarter should show some modest gains in earnings, with more to follow in the second half. The main reason for our enthusiasm is productivity.

We cannot end our Commentary without a mention of the end of the quarter spat between Bill Gross (the world’s largest and most influential bond buyer) and General Electric. Bill mentioned on a CNBC interview that he would not hold any GE commercial paper because GE was overly dependent upon short term financing. As Bill cannot be ignored, Jeff Immelt (GE’s CEO) stated in a subsequent interview that GE had sold \$11 billion of longer dated bonds to retire some of the commercial paper. He further stated that the cost of doing so was “de minimus”, as it was GE’s practice to “swap into matching funds”.

\$11 billion of 6.5% notes costs about \$500 million per year more in interest than 1.75% commercial paper. That is not “de minimus” in Southern Oregon.

This double underlines a larger problem. In the roughly 15 year history of “interest rate swaps”, corporations have been able to issue long term debt, but pay only short term debt rates for the money. These transactions are often very complex, but in the end, they transfer the risk of rising short term rates back to the corporation. As short term interest rates have fallen, corporations have leveraged their balance sheets to short rates.



Many companies have (foolishly to us) used free cash flow to retire shares. This makes the earnings per share look good, but it adds leverage risk to the enterprise. Moody’s downgraded the credit of 159 companies last year and raised only 34. The worst ratio since ’92.

With corporate debt now very high compared to cash flow, a slight increase by the Fed will have a very harsh effect on earnings. For this reason alone we suspect the Fed will tighten less and later than the market expects.

If the Fed holds rates down longer than necessary, it will be providing excess liquidity to the system. That will lead to both increased inflation and a weaker \$US. But that is the 2003 story.

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