



Cascade Investment Commentary

The 1st Quarter of 2003 really ended symbolically when the statue of Saddam Hussein was toppled, and the whole world realized that the coalition forces would prevail. We like everyone else now must peer through the fog of war to anticipate the economic consequence. In our view, there are diverse trends, pushing the intermediate term positive, and the longer term neutral to negative.

Everyone likes good news, so we will begin there. If one surveys the history of American equity markets over the past 100 years, one finds good evidence for the well publicized “4 to 4 1/2 year market cycle”. The past century was characterized by long generally rising secular trends with two notable long term secular downtrends. Those downtrends occurred between the years 1929-1942, and 1966-1982. Some analysts suspect that we have entered a third such downtrend (Cascade Investment Counsel among them), so a scorecard could add perspective.

1929-1942

Length of secular decline: 13 years
 Number of cycles: 4
 Average bull market cycle: 19 months
 Average bear market cycle: 24 months
 Longest bear market cycle: 41 months
 Total 13 year decline: 51%
 Secular low: 1st bear bottom July 1932

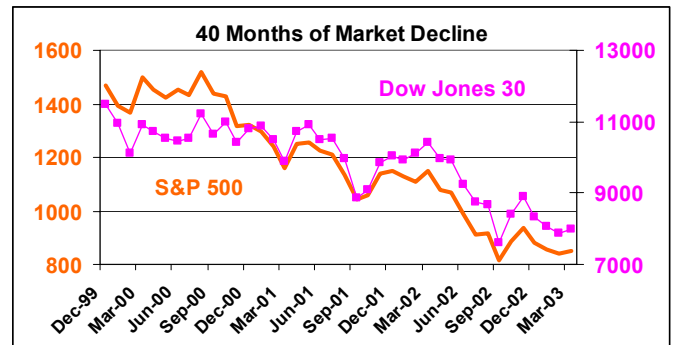
1966-1982

Length of secular decline: 16 years
 Number of cycles: 5
 Average bull market cycle: 19 months
 Average bear market cycle: 24 months
 Total 16 year decline: 29%
 Secular low: 3rd bear bottom Nov 1974

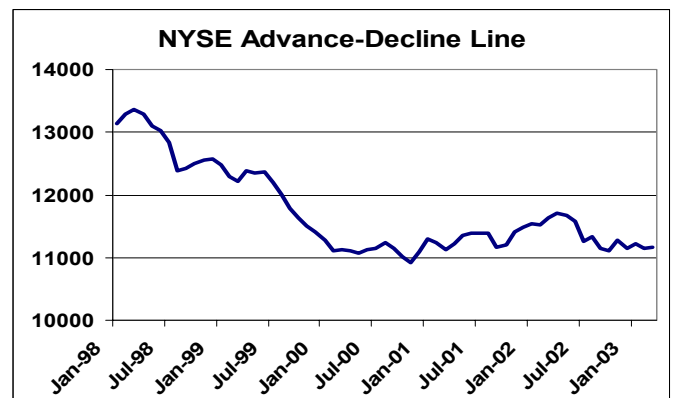
Note that in a secular decline the bear market cycles are longer than the bull cycles. This is a good clue as to our present circumstances.

2000-

Length of bear market cycle: 40 months so far
 Dow Jones Industrial decline: 30%
 S&P 500 decline: 42%

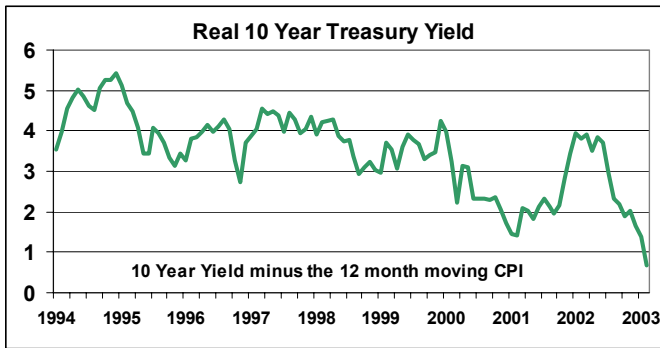


While the popular averages started declining in January 2000, many conservative portfolios started their declines as early as 1998. This was a contributing factor in the caution that many managers who lived through the 1966-1982 experience exercised prior to the peak.



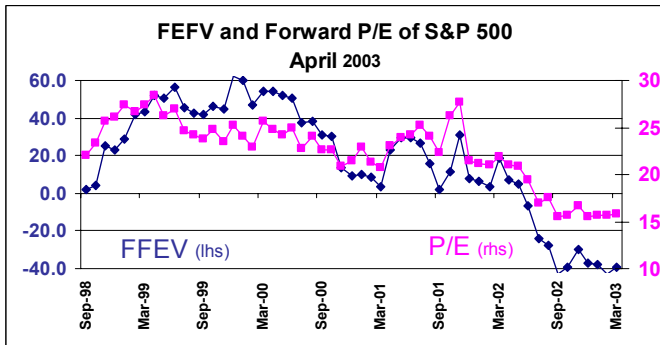
As can be seen from the NYSE Advance-Decline Line (a measure of the cumulative advances minus cumulative declines in individual stock prices), substantial erosion in the direction of prices began before January 2000, and while the magnitude of price changes is not revealed in this data series, it is noteworthy that the AD Line has now been going sideways for 40 months. This bear market is very long of tooth. Despite recent bad economic news, this is not the 1932 economy.

During this 40 month decline in equity prices, bond yields have fallen dramatically both in nominal and real terms.



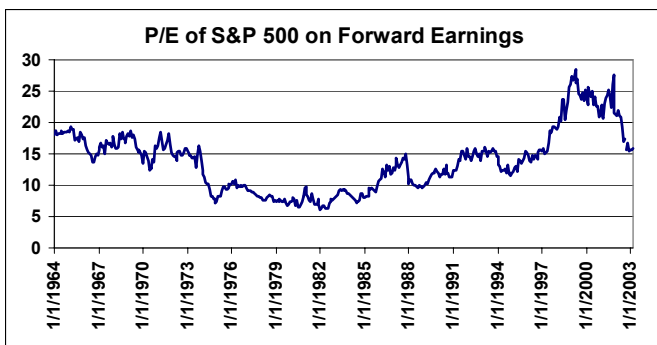
At this writing, the 10 year U.S. Treasury was offering only a .68% after inflation return. As past readers know, the 10 year Treasury is the mathematical anchor to more than mortgage rates. It acts as benchmark for risk/return analysis in many financial models.

One familiar analysis, the Fed Estimate of Fair Value has responded dramatically to low rates.



This model suggests that the S&P is quite undervalued (left hand scale). While at about 16 times forward earnings (right hand scale) the S&P 500 looks undervalued, price/earnings ratios are also very sensitive to interest rates.

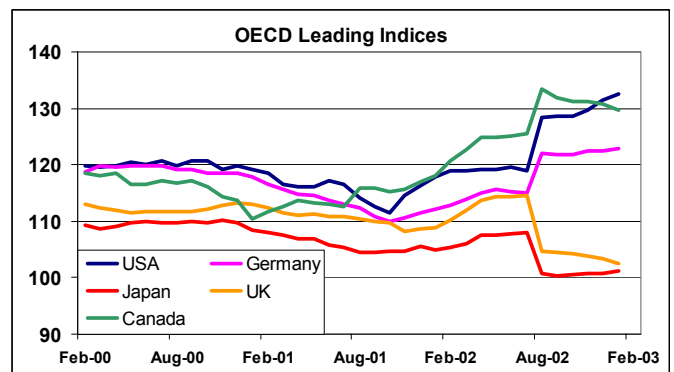
A longer history illustrates this point.



In the late stage of the last secular decline, equities did not compete well with bond yields in double digits. Price/Earnings ratios were compressed for many years.

Finally to cap the good news, there is the political cycle. Historically, stock markets have done well in election campaigns. The budget fight in Congress this week is based upon the firm belief that if the economy is flat 12 months hence, there will be different chairmanships in Washington. With the enormous fiscal stimulus from federal spending (we were running a \$300 billion deficit *before* the war), coupled with some form of tax relief, the equity markets should enjoy a strong but probably temporary wind at their backs. Remembering that typical bull cycles have been 19 months in secular declines, please note that we are only 20 months from the next election.

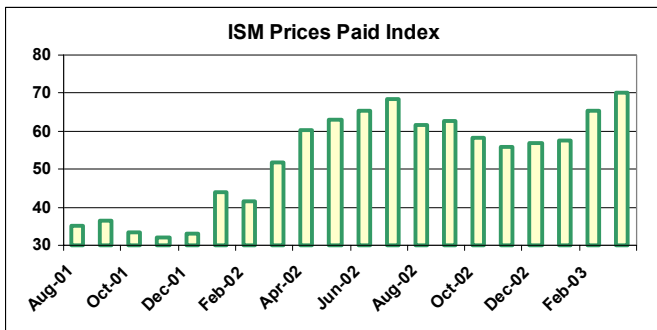
Post election is the longer term to us, and there we see some trends worth noting. First, Inauguration Day has become a frequent cyclic top. Second, we have long noted our concern over the trade deficit. 12 months ending February it was \$440 billion, and running at \$42 billion per month. Remember that we are borrowing this money, and interest must be paid even if the principal is postponed forever. While declining oil prices will help, that fact is that we must start to export products and services in significantly higher amounts to maintain the stability of the dollar and domestic interest rates. For that we need healthy trading partners.



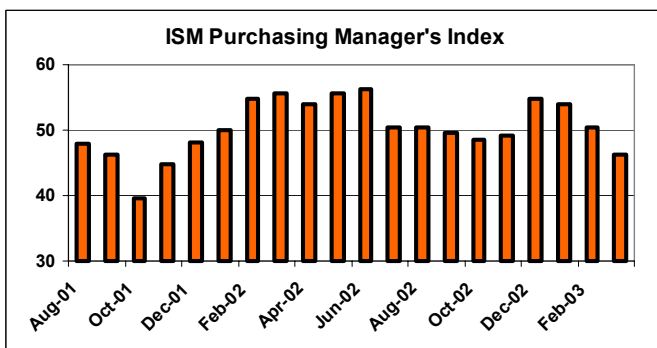
The OECD keeps an index of the trend of economic activity in the major industrial countries. As you can see Japan and the UK

have suffered substantial slowdowns in the past six months, Canada is starting to fall, and Germany is flat. Should Japan not recover and Euroland fall back into very slow growth, the effect on the U.S. will be much slower corporate profits from multinational companies, and rising trade deficits. These deficits will only be funded by investors secure in the belief that all is well in America, and that the \$US is a stable asset. If not, interest rates will rise.

Two other cautionary notes: First, cost push inflation is starting to be noticed in the manufacturing sector. This will, in our opinion, be reflected eventually in overall inflation rates. The ISM Prices Paid Index is surprising.

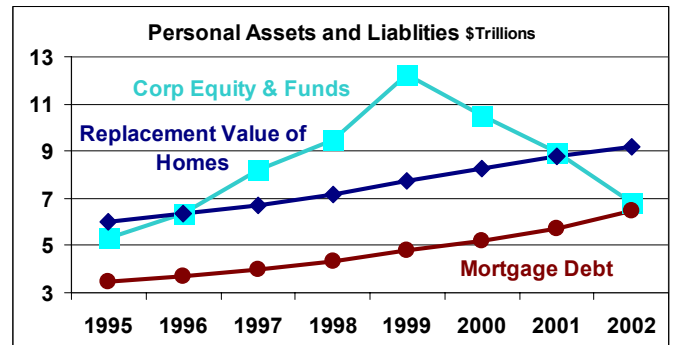


Prices were falling prior to 9/11, along with general business activity. But note that within the past four months, prices are rising despite falling business activity (reading less than 50).

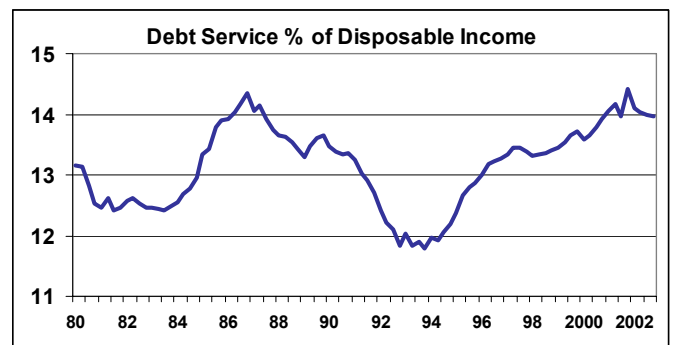


Secondly, households have maintained their consumption patterns through record mortgage re-financings. While rising home values have offset equity losses, there are limits. The first limit is leverage. In 1995 household home equity was 42% of replacement cost. Today it is 29%. In March 2001 home mortgage debt was \$5.3 trillion. Today it is \$6.4 trillion.

Lenders will become increasingly unwilling to loan to ever more leveraged households, and that will place a cap on borrowing and directly influence consumer spending. The level of that cap is unknown to us, but we are certainly closer to it than we were seven years ago. With government at all levels borrowing, interest rates cannot fall much further.



In any event, the consumer looks pretty stretched to us. Debt service as a percentage of disposable income is very close to the previously known sustainable limits. With the growing fear of insufficient retirement assets, household savings rates are climbing. We believe that households will begin to re-liquefy themselves. Besides, we are informed by some power shoppers that "there are no must have fashions". Consumer spending must slow.



In the "stagflation" market environment of 1966-1982, the most successful investment strategy was to find companies that could pass their marginal costs on to their consumers. Cascade portfolios are currently so constructed.

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