



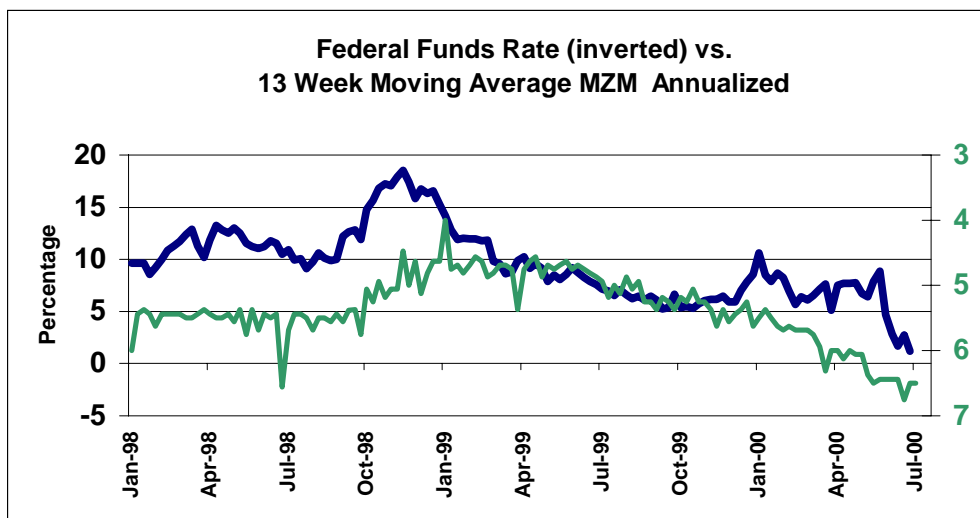
Cascade Investment Commentary

As we start the 3rd Quarter of 2000, nearly everyone in America has become a Fed watcher, and believes that the “soft landing” is a near certainty. In this quarterly review, we argue that there is some possibility that the landing could get harder than the market currently expects, and foreign, not domestic reasons may play a role.

Economically speaking, the first half of the year was picture perfect. Data presented at the end of the quarter show that after a booming first three months, the U.S. is slowing down to a more sustainable rate of growth. Europe is beginning to expand steadily, Japan is growing slowly in some sectors, and China is once again a positive factor. Popular wisdom here and abroad gives credit to our own Federal Reserve Bank.

Chairman Greenspan was almost canonized in his re-appointment. His name is now a household word unlike any prior Chairman. While Chairman Paul Volker was held in similar esteem on Wall Street, no one has come as close to Mr. Greenspan's approval rating with the general public. And no one has received the popular press of Mr. Greenspan. The rave reviews in the press are not limited to America. He is being featured prominently worldwide as the great engineer of America's long run of prosperity, and since we have become the importer of first and last resort to most of the world, by implication the engineer of world prosperity.

That said, it is obvious to most everyone that the great run of economic activity cannot last at the current pace, the second half of the year will be dominated by the hopes, wishes and dreams for a “soft landing”. This is to say that everyone, worldwide, is hoping that with the single lever of monetary policy, like the joystick of an ancient biplane, the Federal Reserve can glide the world's great locomotive engine to a safe and sustainable speed where no one feels any pain (i.e. loss of profit or employment). It should be remembered though, the Fed has only a single lever to pull, and that lever can only add money to the system or take it away.

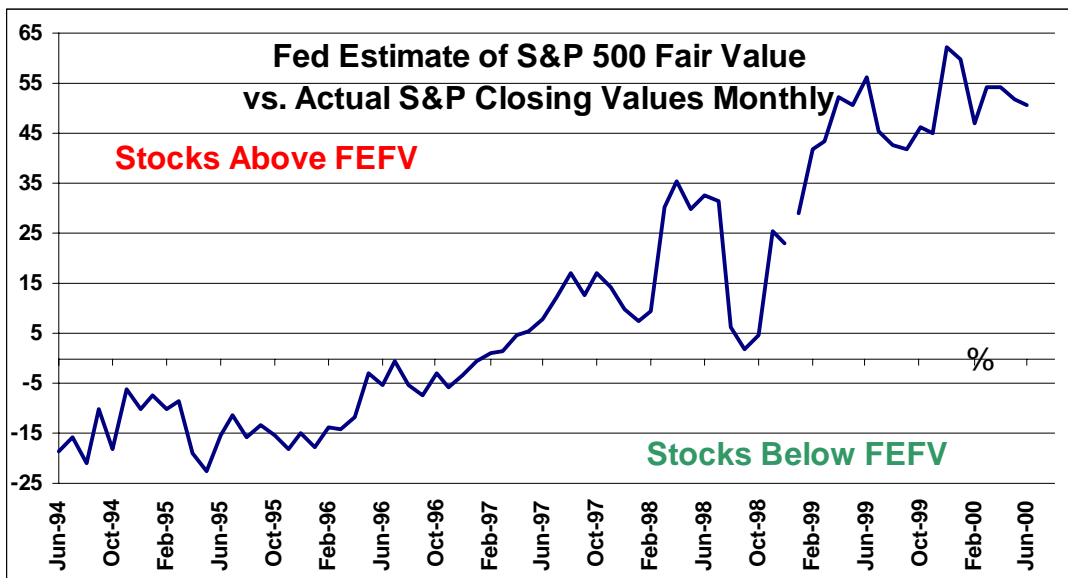


In the above chart we demonstrate that lever. The blue line (left hand scale) represents the growth of money that can be used to purchase goods, services or securities *immediately*. This definition of money supply is known as MZM, or funds with a zero maturity date. It includes currency, checking accounts, and all money market funds. Notice that the Fed pushed the rate of money creation to almost 20% in the fall of 1998 during the Asian crisis, followed by pulling back on the joystick to levels that were closer to the level of growth of GDP. Again in November and December of 1999 the Fed pushed the joystick forward prior to the millennium change, to be followed by pulling back on money growth. At this writing, MZM is growing at a paltry 1.6%, far below the rate of growth in the economy.

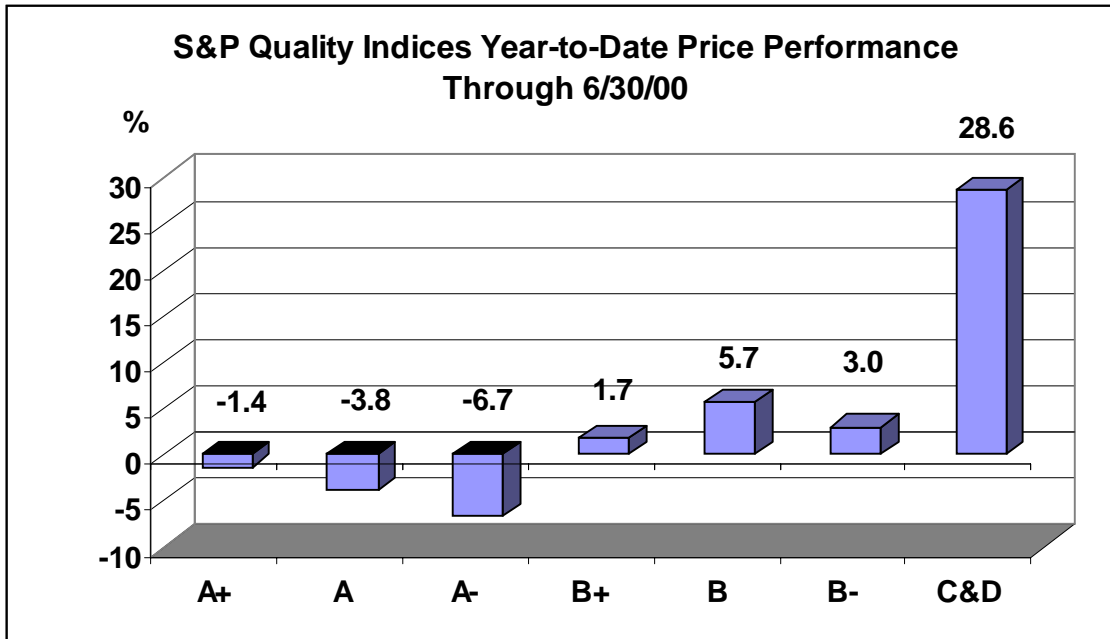
As the demand for money grows faster than the supply, the price goes up. The green line (right hand scale) is the Federal Funds Rate or the base cost of borrowing. While long term interest rates are the result of pure supply and demand by the public, the Fed Funds rate is the rate dictated solely by Federal Reserve activity. It accurately reflects the result of the Fed's recent desire to slow aggregate demand in the U.S. We have inverted the green line to show how correlated these activities are to each other.

While we would be the last to doubt Mr. Greenspan's abilities to engineer the fabled "soft landing", we are somewhat concerned about the part where there is no pain. It certainly helps him now that inflation pressures are so muted at this late point in the economic cycle. There was ample evidence of his success (economic slowing) in June, including slowing housing starts, slower growth in job formation and notably a decline in the prices of copper, zinc, aluminum, etc. But there is also evidence of rising wage and benefit demands (particularly health care) that must be paid for by someone.

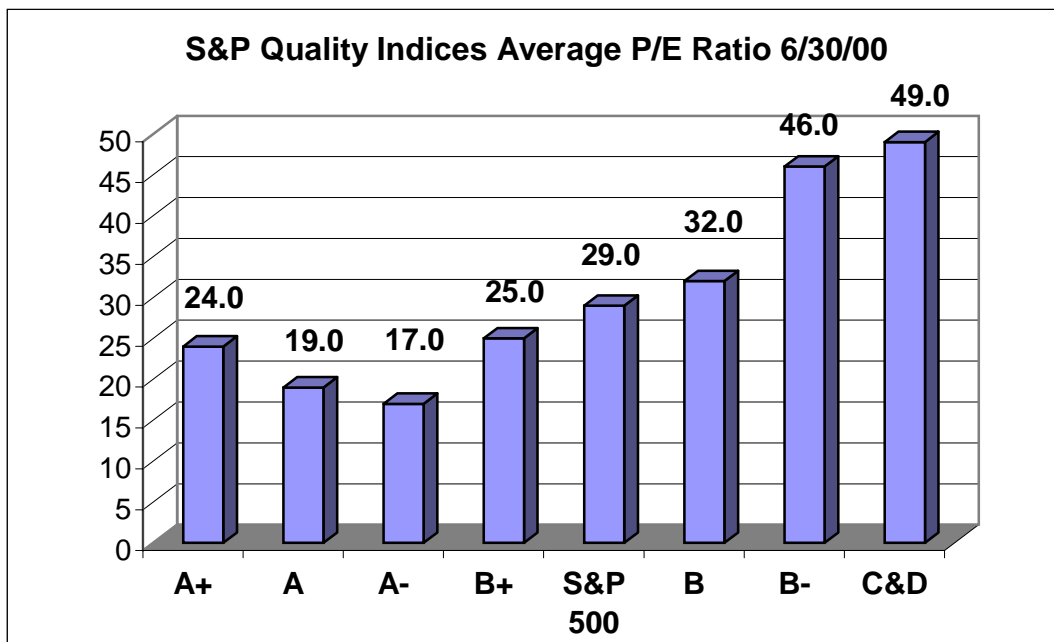
Earnings expectations on Wall Street are still exceptionally high, as are the multiples of those earnings being offered by new purchasers. The S&P 500 earnings are expected to grow over 17% this year with technology being up 27%.



Into this great run of corporate earnings, many investors have significantly downgraded the quality of their portfolios. We use the Standard & Poor's Quality Rankings as the benchmark. Cascade portfolios typically average A- overall, so we wanted to demonstrate the investing public's current appetite for risk. Below is a graphic of the equal weighted returns of all the stocks ranked by S&P according to quality.



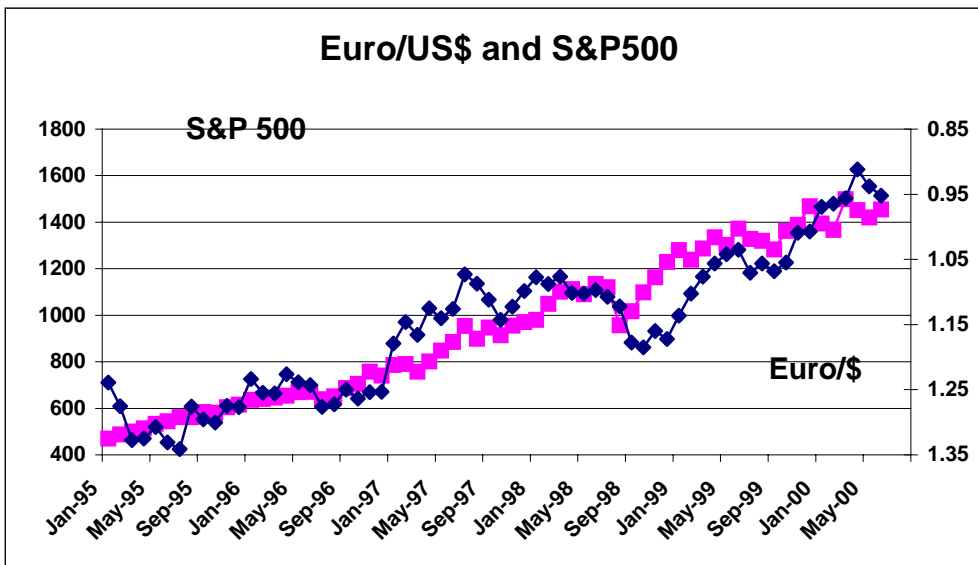
Accompanying the rise in risk tolerance has come the expansion of Price/Earnings Ratios, the price that must be paid for each dollar of current earnings. In the high quality area, (where we live) those firms rated A and A- in quality looked relatively "cheap" at mid year.



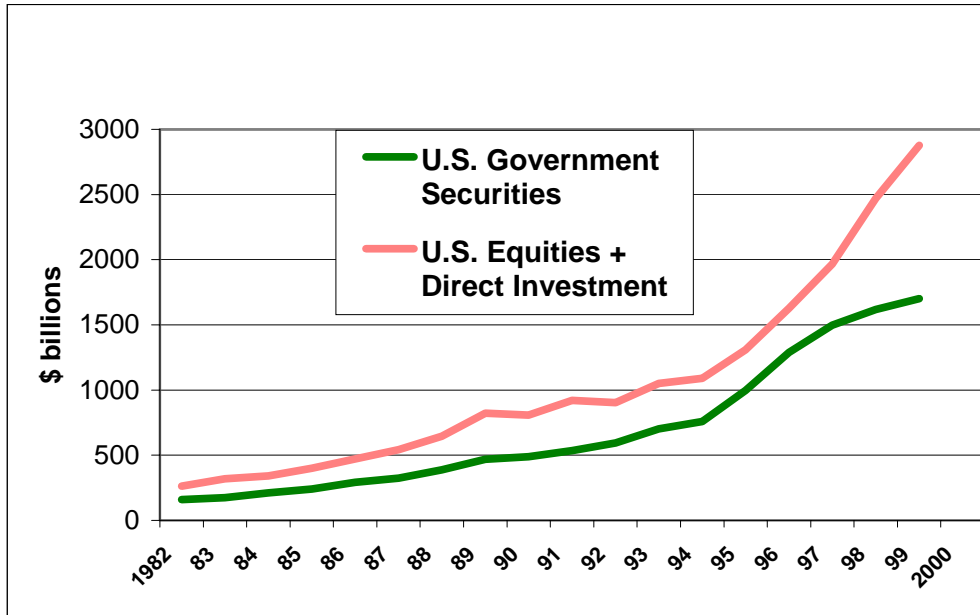
With market evaluations so high, and the damage being done to the value of any underachieving company's market values so great, we believe that it will be difficult for some sections of the market to maintain their lofty valuations. The most obvious area is technology, because it is the greatest current interest of foreign buyers. We cite foreign buyers in particular because of the current financial imbalances in place. In fact, it is financial imbalances that concern us most.

Not since the railroad boom of the 1890's has foreign capital flows into America been so important to our prosperity. As mentioned above, foreign investment has become an essential part of the "new economy" stock market, and the flywheel of a virtuous cycle that has created almost unfathomable wealth. As foreigners purchase the "new economy" stocks, they drive up the value of the dollar, thereby lowering the cost of importing (almost everything it seems), and releasing the Americans from the terrible burden of postponing consumption (formally known as saving).

This has been a pretty sweet deal for the European investors. In January 1996 the euro was valued at \$1.277. The S&P 500 Index stood at 615.93, and by simple division, with euros an investor could purchase the index for the equivalent of U.S.\$ 482.34. By July 2000 the Euro had fallen to \$.9523, and the S&P 500 Index had risen to 1454, creating a market value for the January 1996 investment of \$ 1526 (a gain of over 200%). These total return numbers have not been lost on the retail stockbrokers in Euroland.



This can go on for a long time, but not indefinitely. First, the euro has not been permitted to free fall into a third-world type currency, rather it has been bid up against the US\$ for investment purposes. Second, the competitive advantage now given to Euroland firms by this *de facto* devaluation is strengthening their corporate earnings at the expense of American firms, making their stocks relatively more valuable, and gaining attraction to domestic investors.

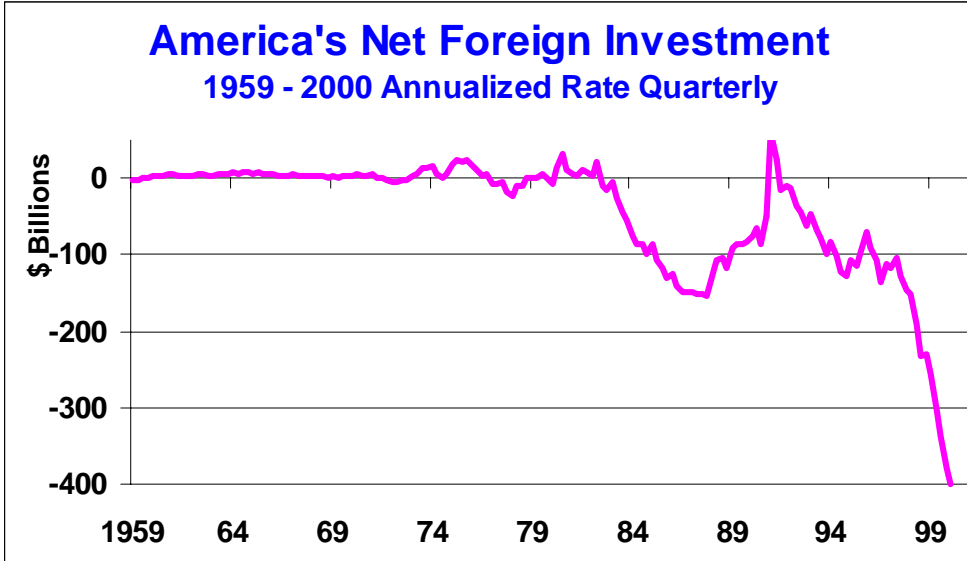


Figures released in June showed that foreign investors' spending to acquire or establish U.S. businesses increased 31 percent to a record \$282.9 billion in 1999 after tripling to \$215.3 billion in 1998. Prior to 1998, foreign investors' spending for new U.S. investments never exceeded \$80.0 billion.

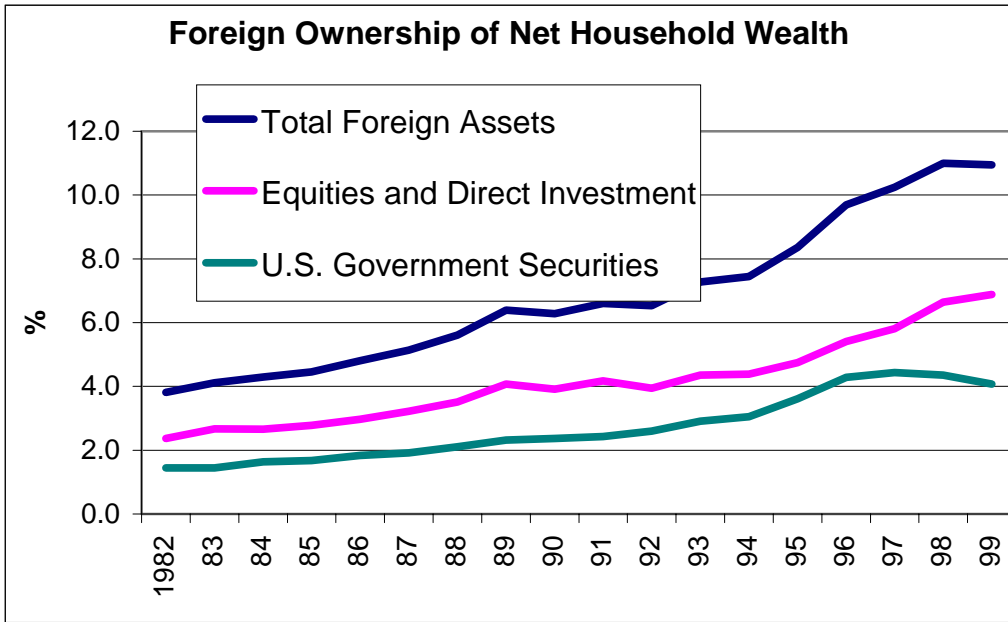
In March 2000 alone, foreign investors' purchased \$24 billion in equities, eight times more than they bought in March 1999. The March figure was just shy of the all-time high of \$27.7 billion set in February 2000. The 12 month running total ending March 2000 rose to \$159 billion. Of this, Europeans accounted for \$137.8 billion. In addition, net foreign purchases of U.S. corporate and other bonds were a record \$71.7 billion, up from \$57.9 billion.

By industry, outlays increased sharply in information, particularly in telecommunications. Within manufacturing, outlays in 1999 were substantial in computers and electronic products, particularly semiconductors and other electronic components, and communications equipment.

The U.S. current-account deficit (the combined balances on trade in goods and services, income, and net unilateral transfers) increased to \$102.3 billion in the first quarter. This demonstrates the desire of the whole world to earn and keep dollars. It also demonstrates that the appetite for ownership of equity in lieu of debt is manifest by foreign purchase of American companies.



These massive shifts in currency explain why the US dollar has remained so strong in the face of massive current account deficit widening, and why Americans are not feeling the pinch of a collapsed savings rate. It also explains the continued weakness of the euro against the dollar.



Then there is the debt problem. Statistics released by the Federal Reserve Board show that the growth of total non-financial debt in the U.S. slowed to a 5.5% annual growth rate in the first quarter. This slowing was due in large part to the decline in the rise of Federal Debt as the country runs a budget surplus. As we have noted before, much of the Federal surplus is due to Roth IRA rollover taxes and capital gains taxes, both of which may disappear in 2001.

Meanwhile, household and business borrowing remained brisk. In the first quarter household debt rose at an annual rate of 7.8% and business debt at 10.6%. We believe that it is important to note that for quite some time debt has been growing faster than GDP, and as our general theme reminds us, much of that debt is being borrowed from foreign sources.

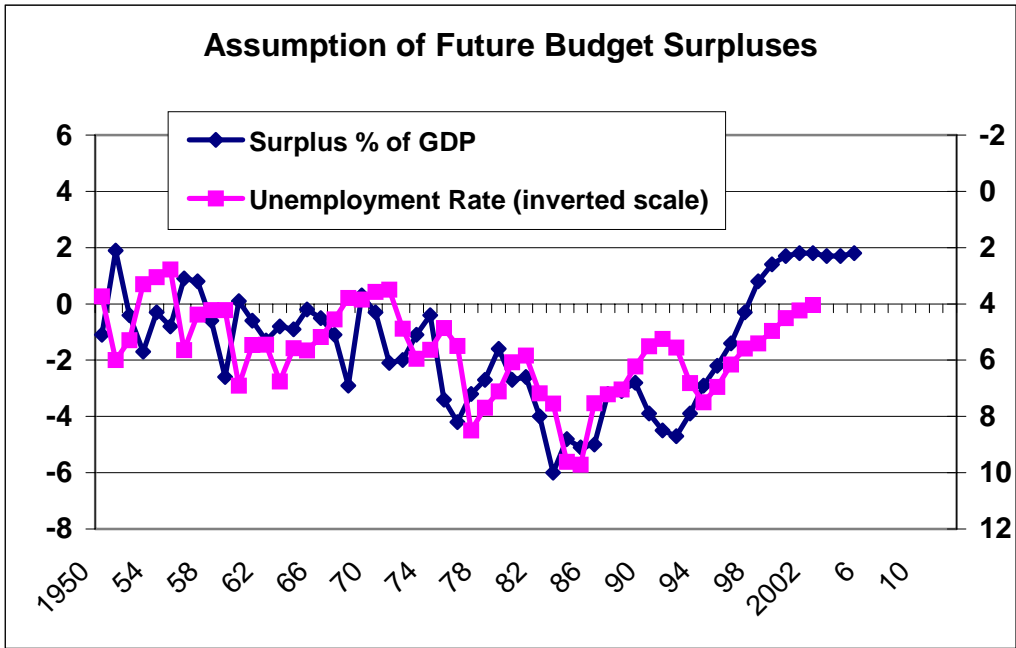
Percent Growth of Domestic Non-financial Debt						
	<u>U.S. Total</u>	<u>Federal</u>	<u>Household</u>	<u>Business</u>	<u>S&L Govt.</u>	<u>Total non-Federal</u>
1993	4.9	8.3	5.3	1.4	6.0	3.7
1994	4.6	4.7	7.6	3.8	-4.0	4.5
1995	5.5	4.1	7.9	6.8	-4.6	6.0
1996	5.3	4.0	7.3	5.8	-0.6	5.8
1997	5.6	0.6	6.5	8.7	5.3	7.3
1998	6.8	-1.4	8.8	10.9	7.2	9.5
1999	6.9	-1.9	9.2	11.0	4.4	9.5
Q1 2000	5.5	-5.5	7.8	10.6	1.2	8.4

Looking forward to the election season, we will undoubtedly hear volumes of hot air about spending the Federal surpluses and “retiring the Federal Debt”. The Office of Management and Budget has forecast that there will be no outstanding Federal Debt in public hands after the year 2012. An excerpt of their forecast follows:

Federal Government Financing & Debt (\$bil)													
Year	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Total Federal Debt	5657	5711	5774	5834	5885	5943	6003	6060	6113	6165	6208	6259	6543
Owned by Govt Accounts	2208	2487	2760	3042	3335	3651	3985	4334	4708	5113	5561	6038	6543
Owned by Social Security	1005	1165	1341	1532	1737	1963	2201	2457	2729	3014	3318	3692	4090
Federal Employee Retirement	681	718	756	792	828	864	899	932	965	997	1027	1056	1085
Owned by Other	552	604	663	718	770	823	885	944	1014	1102	1216	1290	1368
Forecast Surplus	211	228	224	236	255	268	286	304	332	364	416	500	547
Owned by the public	3449	3224	3014	2792	2550	2293	2018	1726	1405	1052	646	220	0

The underlying assumption is that the economy will continue to grow indefinitely at a pace near 4%, and that the surplus will always be 1.8% of GDP. No recession is forecast. Even with all of these rosy assumptions, the Federal debt would remain \$6.5 trillion. We suspect that there might be some political pressure to spend if the unemployment rate rises.

We thought we would graph the post WWII history of unemployment (annual average) against the budget deficits and surpluses. We have only extended the surplus years out to 2006, but the plan envisioned by the White House is to run a budget surplus of 1.8% of GDP until all of the publicly held debt is removed from the market. We are personally curious as to what the lever of monetary policy will be to a Federal Reserve with no public debt to buy or sell.



Once the US\$ begins to weaken against the euro, US equities will begin to lose their relative attractiveness (primarily against European issues). The virtuous circle could turn into a vicious circle where less capital is willing to come to America just at the time then the current account deficit is widening. The result would be a weaker dollar and rising interest rates concurrent with a slowing economy. Year 2001 could disappoint investors greatly.

Just as the Fed has only a single lever to pull (add or subtract money), the Congress also has a single lever: tax and spend. At the moment it is spending less than it is taxing which acts in itself to slow the economy (known as fiscal drag). As we enter the 3rd Quarter, corporate profits face hostile monetary, hostile fiscal and hostile currency policies simultaneously. It is for this reason that we think that the risks to US growth and corporate earnings starting in the 2nd half of 2000 going forward are skewed to the downside.

During the next quarter, American consumers face rising interest rates, slowing money creation, rising energy costs, and a government taking in more money than it is spending. A pretty strong headwind by our reckoning, and one that just might lead to a "harder landing" for some than expected.

July 7, 2000