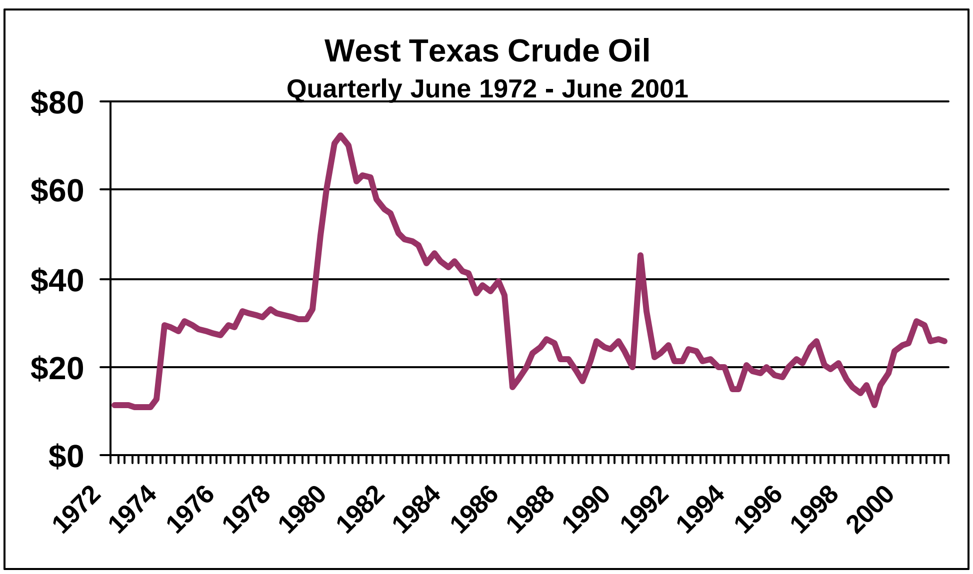
Cascade Investment Commentary

The slowdown that was accurately predicted six months ago in our Commentary is now here. Corporate profits are down so far this year, and are being called lower still by many analysts. Worldwide, the technology sector is being hit the hardest, followed by manufacturing. The great question of the day is will the American consumer, with his/her savings account currently flat, spend the $300-$600 Federal tax rebate check versus saving it, and if spent, will this be enough to keep the contagion of recession from the rest of the world's door?

It should now be obvious that the economy and the stock market are not going as hoped for. The Federal Reserve has just lowered short term interest rates for the sixth time this year, and according to Wall Street legend, the economy should be picking up after about six months of such monetary stimulus. It hasn't, and the stock market is now looking to 2002. While there are signs that the manufacturing sector of the economy is now flattening, corporate profits continue to fall, and may continue to do so for some time.

The market is enjoying both fiscal and monetary stimulus, and should be poised for a classic rebound in the Fourth Quarter. Early trading in July is suggestive that many market speculators expect just that. Our view is, however, that it is just possible ***that this time it will be different***. This view is based upon demographics, savings and leverage.

It is widely believed that the past three recessions (1973, 1980 and 1990) were caused by spikes in energy prices, and that the current slowdown has it's roots in the most recent energy spike which started in late 1998.



But as can be seen from the above graphic the recent rise is not dramatic enough to be the major cause for an historic number of corporations to warn of declining earnings.

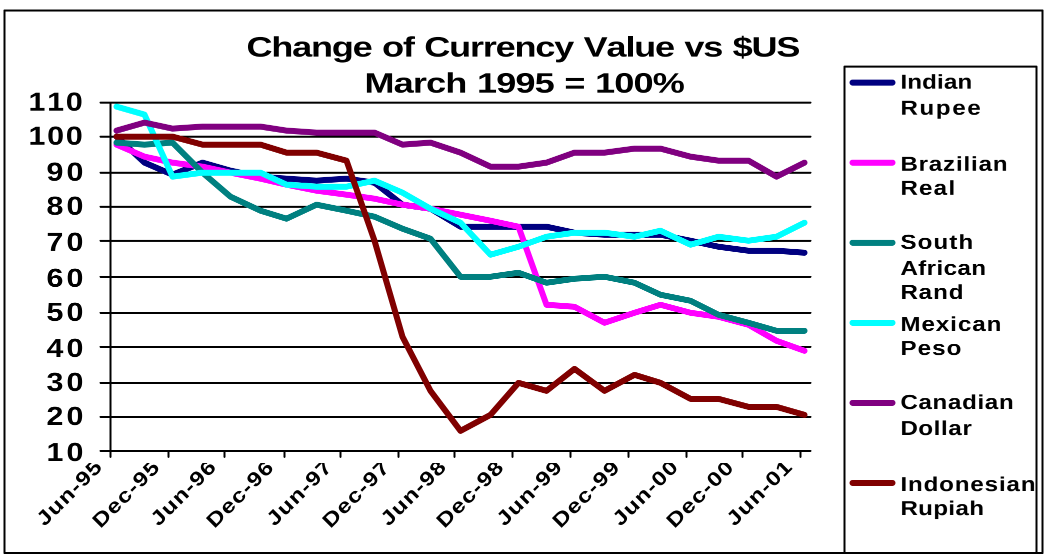
Demographics. America's population growth has slowed from about 1% per year to about .7% per year in the past few years. As a result, American corporations in increasing numbers have sought out business abroad for top line growth. The problem is that all of our traditional trading partners, i.e. NATO members, Japan, Australia, and those with strong currencies have either almost no growth or negative growth themselves.

Thus companies such as H.J. Heinz (which we own in our portfolios) is facing domestic U.S. food consumption growth of 1.5%, less than that in Europe, including absolute decline in many countries. Their answer, like so many others, has been to go to where the growth of population is, i.e. South America, Africa, and the Moslem countries.

Below is a list of some of our major trading partners, and their current population growth rates.

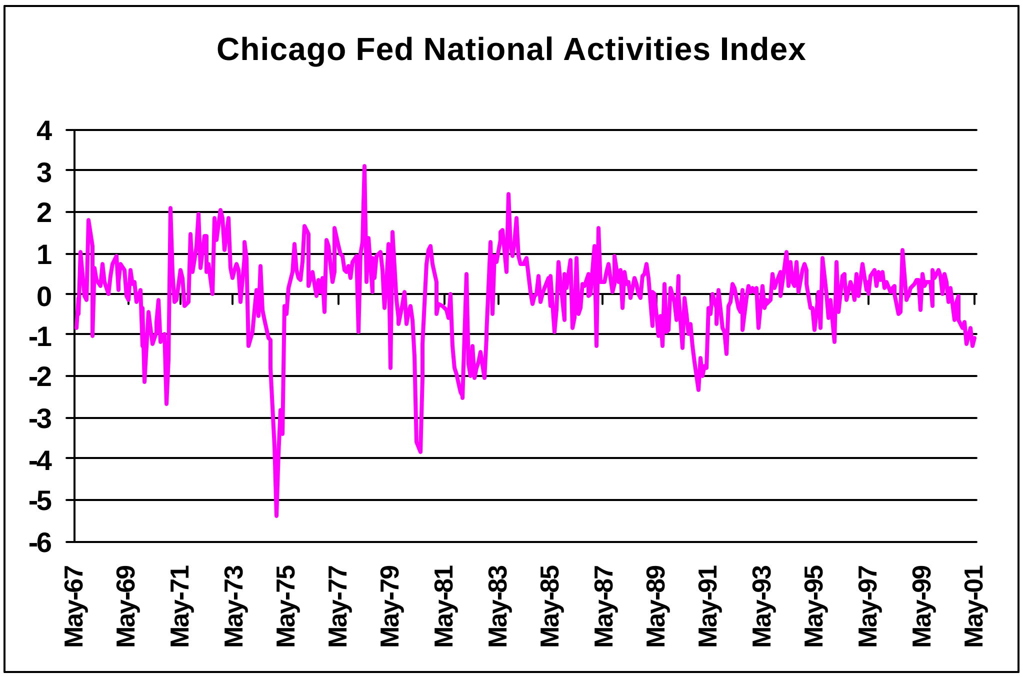
Population Growth	1980-1998	1998-on
Australia	1.4	0.2
Brazil	1.7	1.1
Canada	1.2	0.6
Germany	0.3	-0.2
Egypt	2.3	1.5
Italy	0.1	-0.3
India	2.0	1.3
Indonesia	1.8	1.2
Japan	0.4	-0.1
Korea	1.5	0.7
Mexico	1.9	1.4
United Kingdom	0.3	0
United Stated	1.0	0.7

Selling in emerging markets is the easy part. It's getting paid in a strong convertible that is the problem. As can be seen from the chart below, over the past five years, there has been extreme deterioration in the local currency value in most developing countries versus the US dollar. We chose this time period because it was the first quarter after the Mexican Peso bailout by the Federal Reserve/World Bank. Brazil, a major trading partner, has seen it's currency plummet more than 60% against the $US since 1995. This not only makes it very difficult for Heinz, Citicorp and others to report profits from their considerable enterprises in Brazil, it also highlights the mechanism whereby the U.S. is enjoying price stability.



A strong dollar policy has served us well, as the dollar has become the "least-worst" currency to own, and the world's desire to own a non-depreciating currency has fed our savings shortfall. The direct result of that is ***we are importing the deflation of the emerging world through their collapsing currencies, and exporting our domestic inflation through our "strong dollar" policy.***

These demographics aren't fresh news, and multinational corporations have been trying many methods of generating double-digit returns from low single digit top line growth over the past five years. The most recent was the headlong rush into "productivity" (read information technology). The thought has been that if costs could come down far enough, operating leverage would carry the day. The big buildup in technology in the past few years was supposed to be secular (always up) rather than cyclical. However, in early June John Roth, the CEO of Nortel Networks remarked that "the market for [Nortel's] products is contracting at an alarming rate".



The Chicago Fed National Activity Index (CFNAI) is a weighted average of 85 existing monthly indicators of national economic activity. It is constructed to have an average value of zero and a standard deviation of 1.0. This gives the natural growth of the economy over long periods an index value of zero, so a positive index reading corresponds to growth above that trend, and a negative index reading corresponds to growth below trend. The May 2001 reading was –1.06, indicating slowing from trend, but not the severe readings of the three previous energy shocks 73-74,80-81 and 90-91

The manufacturing recession has spread worldwide. OECD leading indicators are down 3.4% year over year, which is the worst since 1981. History is not very comforting on this issue. Generally when manufacturing goes into recession, it spreads widely. The 1998 Asian crisis was the post WWII exception. The service economies and the information technology economies avoided recession then because of the Y2K information technology build-out and because the savings rate was a healthy 4% and there was enough buffer to keep the economy going.

The Savings Buffer. Readers of our commentary are well familiar with our mantra on U.S. savings. Alan Greenspan has mentioned the wealth effect of the stock market and the resulting economic behavior on numerous occasions. At his request, the Federal Reserve Board sponsored a remarkable study of the wealth effect by Dean Maki and Michael Palumbo released in April titled *Disentangling The Wealth Effect: A Cohort Analysis of Household Savings In The 1990's*. It is the first comprehensive study of savings habits and patterns ever collected, and shows some startling data. The study compiled five groups of families based upon their income level and their level of education. Their spending and savings patterns were analyzed for the period 1992-2000.

Income Category	1992 Savings Rate	2000 Savings Rate	Difference
Top Quintile	8.5	-2.1	-10.6
Second Quintile	4.7	2.6	-2.1
Third Quintile	2.7	2.9	.2
Fourth Quintile	4.2	7.4	3.2
Bottom Quintile	3.8	7.1	3.3

Some startling data appeared. It had been speculated by economics that it would take "implausibly large" increases in spending by the richest Americans to generate the growth of aggregate spending seen by consumers from 1994 to 2000. Quoting their conclusion, "To the contrary, our direct investigation of savings rates across the income and education distributions, which properly accounts for the concentration of wealth, demonstrates that all of the consumption boom really can be attributed to the richest group of households. Between 1992 and 2000, the level of aggregate savings, as measured in our data, fell about $200 billion, reflecting a $240 billion drop in the level of saving by households in the uppermost 20 percent of the income distribution that was only partially offset by a $40 billion increase in saving among those in the lower 80 percent".

The study revealed that all other than the top quintile families continued to save and spend in the pattern typical of prior decades, a modest gain in saving and net worth growth.

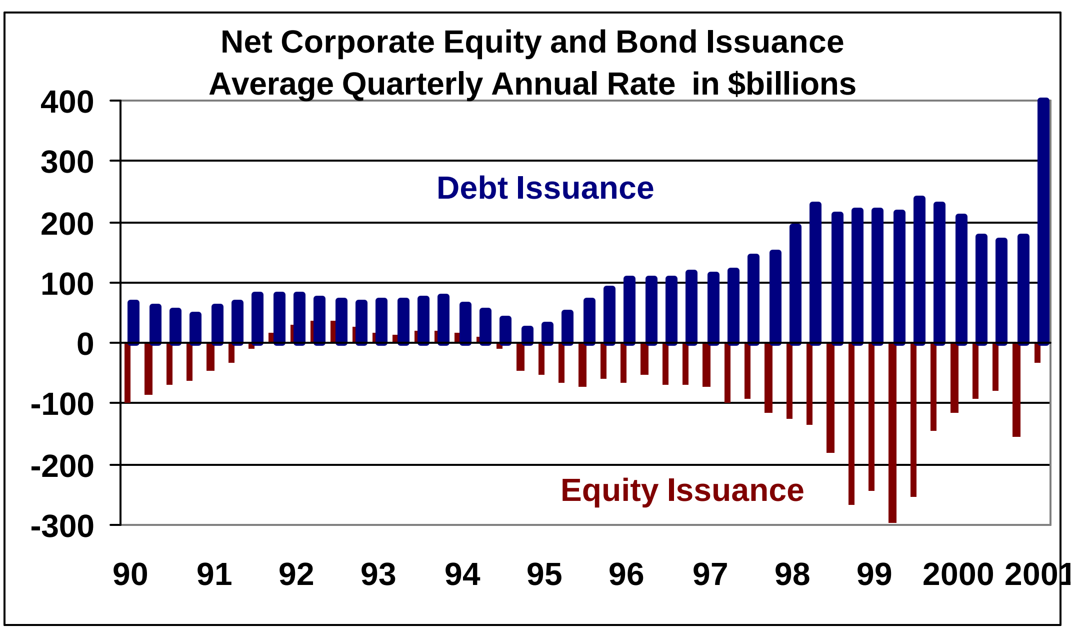
Our point is that with the burst of the NASDAQ 100 bubble, the savings rate and consumption patterns of the top quintile households will revert to their historical mean. This will necessarily slow the economic recovery. While we are not predicting recession, it is obvious that Safeway has a greater margin on prepared salads and designer coffee than on carrots and potatoes.

Percent of America's Assets Owned By The Top 20% Of Households By Income

Asset Category	1989	1998
Owner-occupied real estate	62	63
Consumer durable goods	51	47
Checking deposits	48	51
Money market mutual funds	81	76
U.S. Treasury and agency securities	84	76
Municipal securities	89	84
Corporate bonds	69	71
Publicly traded corporate equity	81	83
Closely held corporate equity	89	89
Mutual fund shares	82	74
Equity in non-corporate business	72	74
Defined contribution pension reserves	74	68
Total Assets	62	63

While the study only covered households, we would like to include the behavior of our corporations also.

Leverage. During the recession of 1990-1991 U.S. corporations used the extremely low valuations to purchase their own equity. When earnings and valuations rebounded, there was a net issuance of new equity into the marketplace. After 1995, however, as currency conversion from weak European and developing nations was straining bottom line growth, and productivity of workers was being improved as fast as possible through technology, a new way was found to boost earnings: buy in existing shares from the marketplace with free cash flow. With fewer shares outstanding, earnings per share can rise faster than top line growth. Just one problem: when you spend your free cash flow on financial investments instead of plant and equipment you can loose market share, or worse, you can become the high cost producer in your industry. The answer? Borrow money.

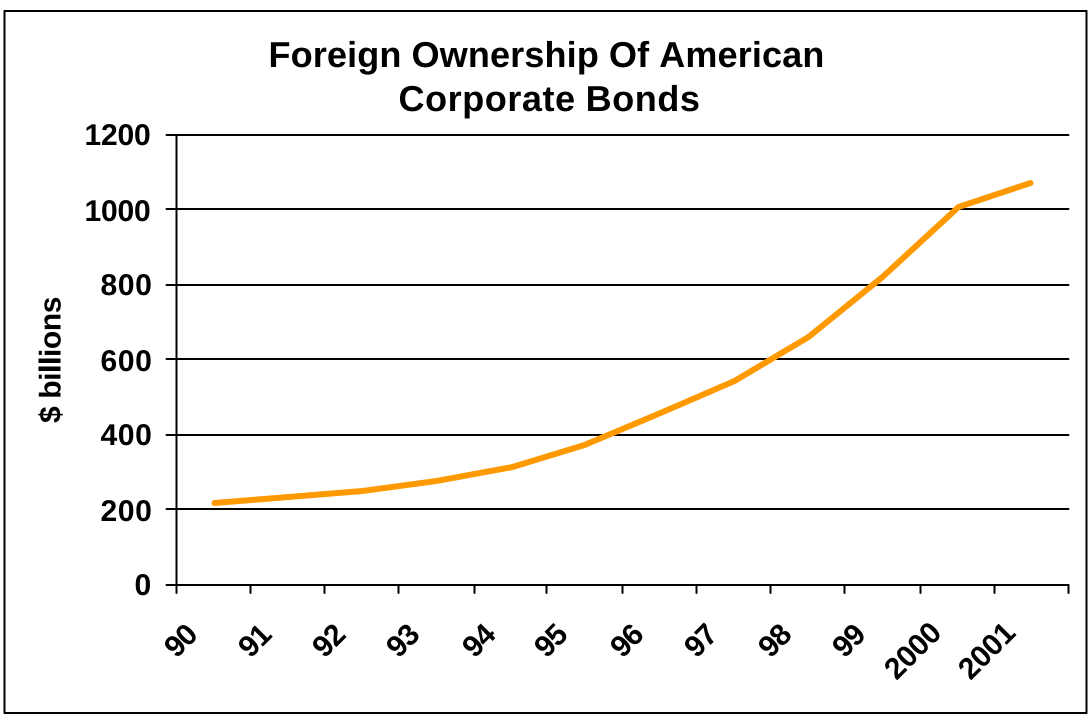


This graphic published by the Bank of England's Financial Stability Review illustrates their (and our) concern about the enormous leverage now built into the American corporate financial system. In the 4th Quarter of 1998 at the top of the market for old economy stocks, corporations purchased at the annual rate $491 billion of their own shares net of new IPO's (note that the graphic is average annual rate). In that same quarter $267 billion of corporate bonds (annual rate) were issued. That bond calendar was the second largest ever.

In the first quarter of 2001, the IPO calendar for technology, media and telecom stocks was very inactive, and yet despite the substantial re-pricing (read bear market) corporations bought back $33.9 billion, but issued an astounding $400 billion in new debt. Why it could be different this time is simply that many corporations do not have any free cash flow to purchase their own stock, and with greater leverage on their balance sheets and the subsequent higher interest rate expenses, will find recovery in bottom line earnings very hard to come by.

Editorial note: We at Cascade are appalled by the actions of many U.S. corporations to "gin up" their stock prices in the above manner. We believe that the excess cash flow should have been returned to the shareholders in the form of dividends, or the total debt reduced. For consequence, we refer the reader to the sad tale of AT&T. We believe that American executives are over compensated with stock options and lust for capital gains has the potential of destroying more firms than Xerox and Lucent.

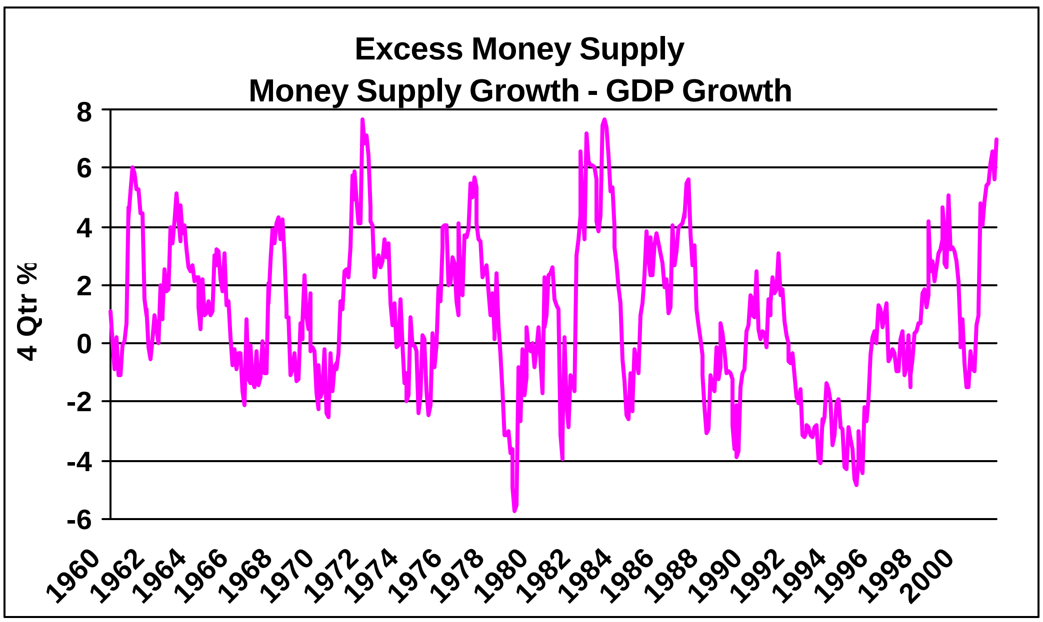
We are certainly curious as to who has been buying all of the corporate debt. A quick check of the ownership of American assets (above) shows that the Top Quintile of income earners added only slightly to their holdings. It must be someone else. If there is any trauma to the world financial system (Argentina defaulting on its debt for example), we may find out.



Looking Forward. We are not permanent bears. In our last *Commentary* we stated that we view the economy as cyclical, and it was time to anticipate recovery. In the past quarter, it has been revealed that finding earnings growth has been more challenging for corporations than previously anticipated despite accommodative fiscal and monetary policy. The public mood has stabilized, and consumer sentiment is up fractionally as energy prices have fallen. Tax policy has become somewhat friendlier, and your rebate check is in the mail.

Most importantly, there is excess money supply. The Fed is still providing liquidity far in excess of economic needs, and excess liquidity has always found its way into bank loans, car loans, real estate and stocks.

This liquidity can be pent up for some time, however. The technology, media and telecom companies are now on a "show me the earnings (money)" basis with investors. Old economy companies must show the discipline of capacity management. For multinationals, currency management is still a challenge, as a weaker dollar is mixed blessing. Our best guess is that the old economy company's earnings grows very slowly for a number of quarters because the American slowdown it is now being followed by world-wide slowdown.



Our best guess is that the surviving "new economy" stocks could see a good run, but only after it becomes apparent that our economy is turning up and their earnings are for real.

Fed Chairman Mariner Eccles was fond of saying that monetary policy was like pushing on a string. Chairman Greenspan is pushing very hard right now.

July 13, 2001