



Cascade Investment Commentary

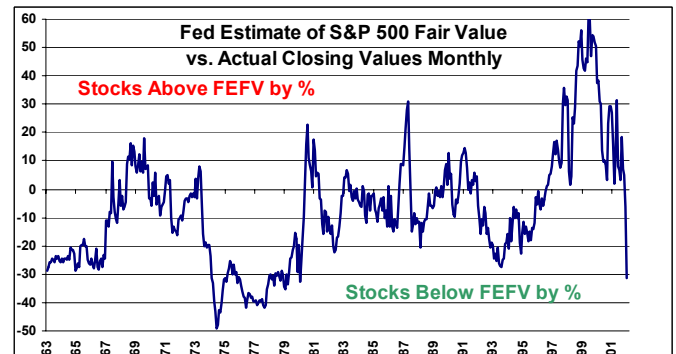
As July unfolded, investor sentiment turned about as sour as we have seen since 1974. It being an election year, every politician has put forth a plan to “punish evildoers” on Wall Street, and “return confidence” to the financial system. Allan Greenspan testified: “an infectious greed seemed to grip much of our business community”. We concur with the Chairman, but also do not believe that political statements will turn market sentiment. Only time will.

With the help of TV talking heads, almost all investors only want to know when this decline will end. We do not know, but having experienced every decline since 1962, we can observe that most investors now are losing sight of the important trees, as they think that the entire forest is on fire.

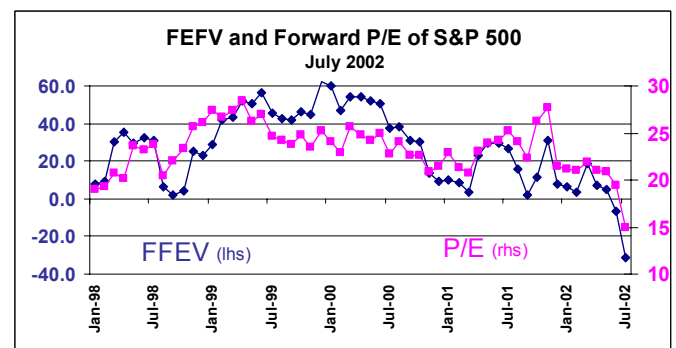
Almost daily we are asked when the market decline will end, mostly by people who have never experienced a real bear market. The short and easy answer is when there are more buyers than sellers, which historically is when prices are so compelling that the comfort of owning of short dated U.S. Treasury notes and money market funds is overwhelmed by the prospect of outsized returns. Also when the dividend yield exceeds most of the alternatives available to thoughtful investors. When will this be? We don't know, but we can see some measure of where we are now with general valuations.

In recent years we have made much ado over the Federal Reserve Estimate of Fair Value (FEFV). It measures the 10 year Treasury yield against the forward P/E of the S&P 500, for a broad view of overvalued and undervalued stock prices. As can be seen on the graphic following, the S&P looks to be trading at a considerable discount to the Fed Model.

What is important here, is that the current bear market has a good deal more information to work with than in past bear markets, although that in no way changes market psychology.

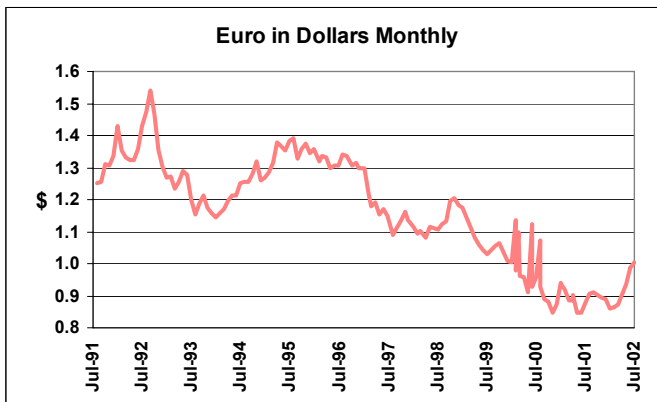


We should emphasize that rarely is the market correctly priced: It is either moving up or down towards some excess level. The forward P/E of the S&P500 now stands at 14.9x (We expect an 8% growth in 2003 S&P earnings from the street estimate \$51.00/share in 2002). It's low point P/E at the bottom of past grand bear markets was 11x to 12x, but in 1962 and in 1974 earnings were falling, not rising.

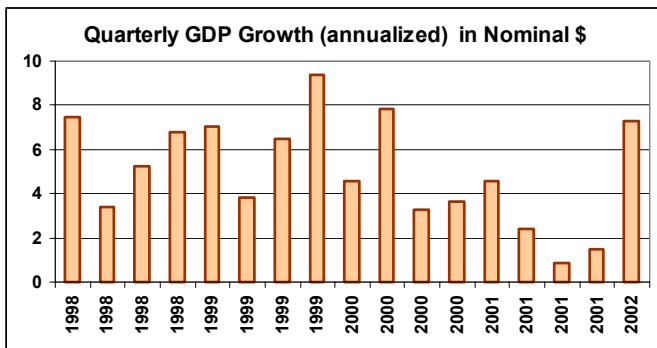


All of the drama around Enron and WorldCom hasn't gone unnoticed by European Investors, who have been doing their share of selling into this market decline to repatriate what profits they can into what appears to be rising profit prospects on the Continent. While the three-month rise in the Euro from .83 to 1.01 seems

like a wild ride in the scheme of things, parity is probably still too expensive a price for the \$US.



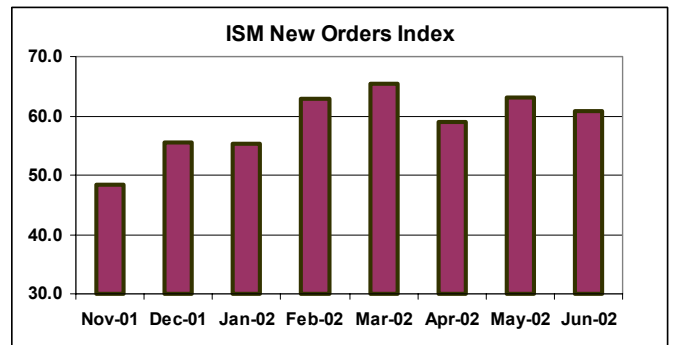
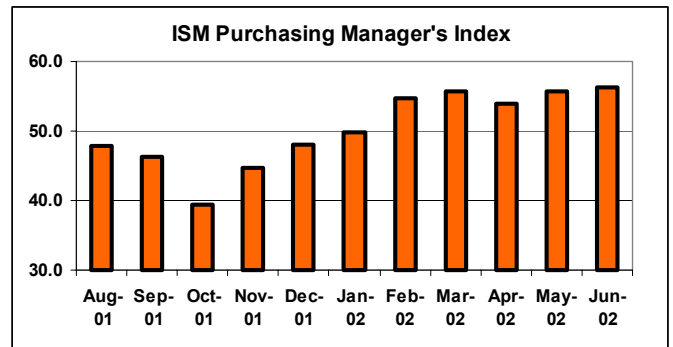
In our last Commentary, we speculated that the recovery could end up being front end loaded, leading the Federal Reserve to put future interest rate hikes on hold. Recent data supports this notion.



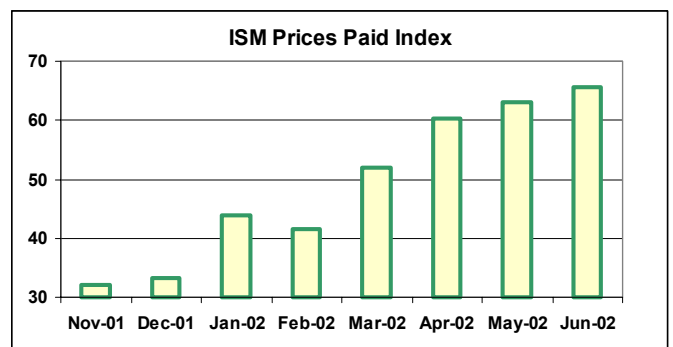
The 1st Quarter GDP growth number was just revised upwards to slightly over 6% (net of inflation), and almost 7.5% on a nominal (before inflation adjustment) basis. This is an unsustainable rate, and more subdued but positive quarters lie ahead. This is good news.

Actually, the “recession” of 2001 was so mild that on a nominal basis, we didn’t even suffer a single quarter of actual decline. This is very different from past bear markets.

The Purchasing Manager’s Index is showing steady expansion in recent months, after expanding quickly to the massive fiscal stimulus post 9/11.

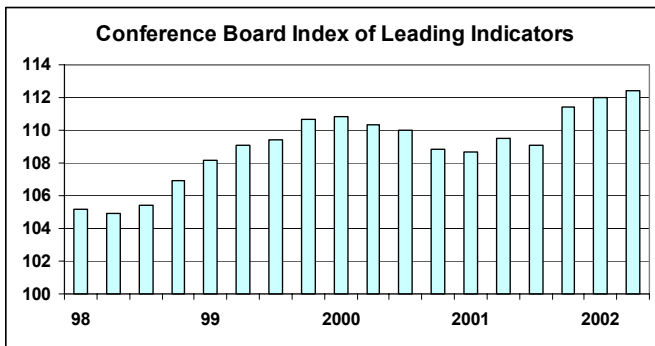
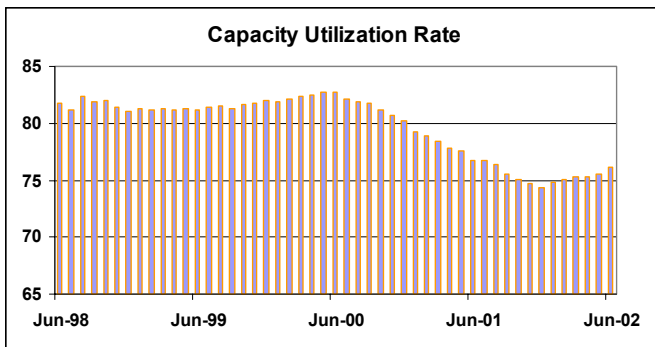


New orders for manufactured goods have temporarily peaked in March as inventories were re-stocked from very depressed levels last summer. The decline in the \$US versus the Euro should give this sector some added lift as the year continues.

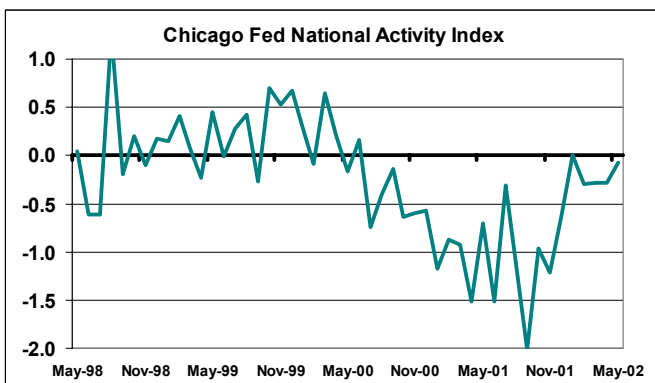


Tellingly, the prices being paid by the manufacturing sector seem to be rising quickly. This price rise is currently below the radar screen of most investors, but those are the areas where profit leverage is being earned.

Capacity utilization does not currently fit with the Prices Paid Index. This leads us to speculate that capacity utilization would look very different if telecom and airline capacity were taken out.



Despite the current bear market in equities, a declining wealth effect has not yet appeared in either the leading indicators or the Chicago Fed Activity Index. This too is good news.



All this good economic news is laid out before you to remind you of our lessons learned since 1962, to wit: **Dividends matter**. Dividends are paid out of free cash flow, and as the economy strengthens, well run business models will generate increasing levels of free cash flow.

We have observed that when stock prices rise, many boards of directors are reluctant to raise dividends. Conversely so in declining markets.

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We are currently able to purchase companies with extremely strong balance sheets whose secure dividend payments yield exceed the yield of 5 and 10 year US Treasury rates. The last time investors were able to enjoy this, Eisenhower was president.

To conclude: At the fundamental heart of American capitalism is trustworthiness. This is the cardinal virtue which, when accompanied by the sanctity of contracts makes the whole system work. While we applaud greater disclosure of pay and incentives, and cheer loudly the requirement that shareholders approve **all** stock option grants, we have reservations that the addition of a chronic fear in the hearts of American CEO's that a slight misinterpretation of data or missed forecast will earn them 10 to 20 years of jail time. We fear that this may be more harmful than not. This unknown political risk will affect long term investing, just as the new rule FD has.

In 1961 President Kennedy publicly threatened Roger Blount, the CEO of U.S. Steel that if he did not rescind a 4% increase in steel prices, the FBI would stalk him and the IRS would audit all of his past tax returns. This frightened the markets considerably, and turned a cyclic downturn into a prolonged a terrible bear market.

Richard Nixon imposed wage and price controls in 1973 (including a freeze on dividend hikes) as a panic measure to deal with 4.5% inflation. He closed the gold window signaling that the US no longer had a fiscal discipline in place. His actions greatly impacted the bear market, and the future inflation that ensued.

This bear market will take time and good earnings to turn. In the mean time, we hope that what started as a reasonable attack on the froth and bubble of the NASDAQ does not become a politically driven armed assault on the majority of American firms.

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