

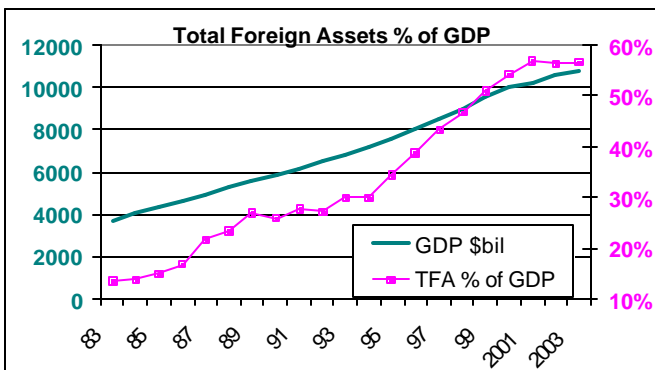


Cascade Investment Commentary

In our last Commentary, we noted that the bear market had run its course, and a bull run through the next presidential race was about to begin. We see this trend intact, but in the near future the increasing U.S. financial leverage at all levels, household, state and federal, will add increasing volatility to all financial markets. The lagging indicator of jobs creation will likely be the key to the markets next advance.

Big news broke as the 3rd Quarter started: The Federal Government is running a deficit! The Office of Management and Budget is forecasting a \$450 billion deficit this year and \$475 next year (not including the costs of Iraq). We can hear the ghost of Senator Everett Dirksen saying “a trillion here a trillion there, pretty soon you are talking about real money”.

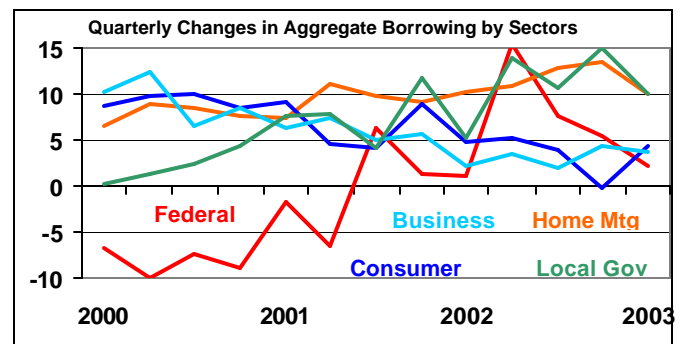
Real money it certainly is. Total U.S. non-financial debt is now above \$21 trillion. Debt of non-federal sectors is \$17.4 trillion, and the gross federal debt is \$6.2 trillion. The portion held by the U.S. public (\$3.7 trillion) is the easy part because we owe it to ourselves. The federal debt held by foreign central banks and individuals (\$1.8 trillion) and the \$4 trillion + of corporate bond and equity ownership is more problematic. It is one thing to face rising claims on ourselves; it is quite another to face claims by foreigners and their governments. Our concern is not the absolute level of claims at the moment, but in their rate of growth.



Those claims have grown in 20 years from slightly over 10% to over 56% of U.S. GDP. In May there were once again massive buyers of U.S. debt securities, Treasury/Agency and corporate: \$98 billion to be exact. This brings the net inflow to an astonishing 12 month total of \$664 billion! The Japanese invested \$40 billion in May, the Chinese have been backing their currency (Yuan) with their trade surplus \$US for years, and speculators? A good proxy for hedge fund activity is Bermuda and Dutch Antilles based organizations which purchased \$29.8 billion in May.

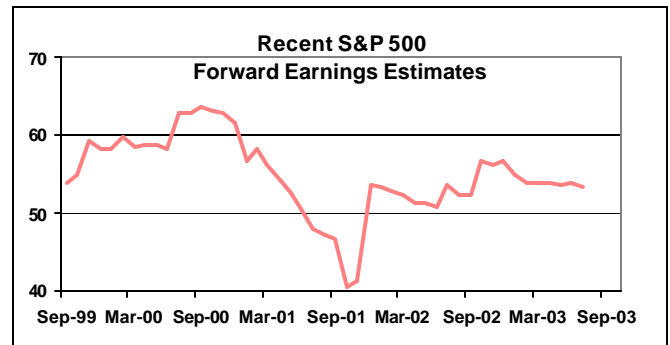
If the U.S. economy shows signs of real short term improvement, we should see currency volatility as well as bond weakness as hedge funds “unwind”. Longer term, the Chinese will be forced to adjust their terms of trade (revalue upwards). Remember when Saudi’s attempted to buy farmland in the 1970’s?

At some point, however, the question must be asked: Now that all sectors of the U.S are net borrowers, at what point will there be a reckoning? Where is the tipping point?



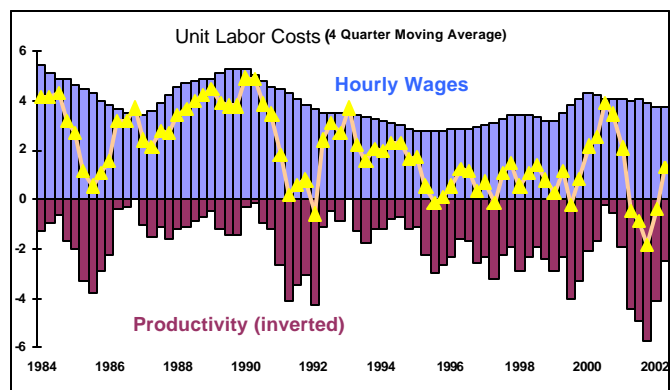
The Federal Reserve has made it abundantly clear that they will provide as much liquidity to the markets as is necessary to keep consumer spending up. But consumer spending is being fueled by home refinance and foreign lending. If foreign lending to the U.S were to just flatten out and not grow, our GDP would drop by 6%. No politician wants this on their watch.

The Fed's stated intention to maintain real (after inflation) short term interest rates at or below zero % "as long as is necessary" will require continued stimulus into the system. It is not without coincidence that the equity markets rallied in April just as the money supply soared. No one seems very upset that much of this excess money is chasing stocks and real estate.

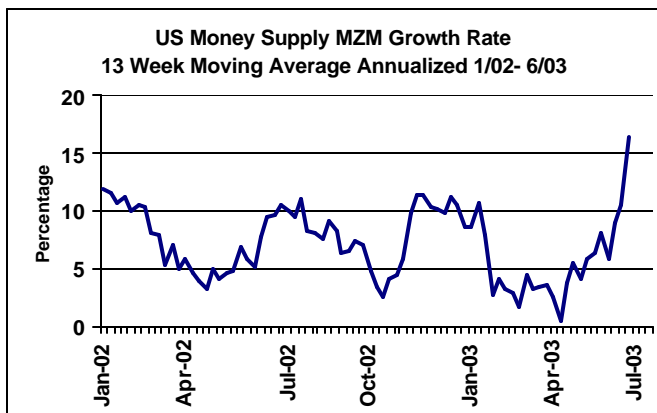


We note that earnings projections are virtually flat over the past four years. We expect that in the weeks ahead, the market will put a critical eye on the quality of corporate earnings, and on firm's ability to get "price traction". Prices in the quarter ahead could get quite volatile.

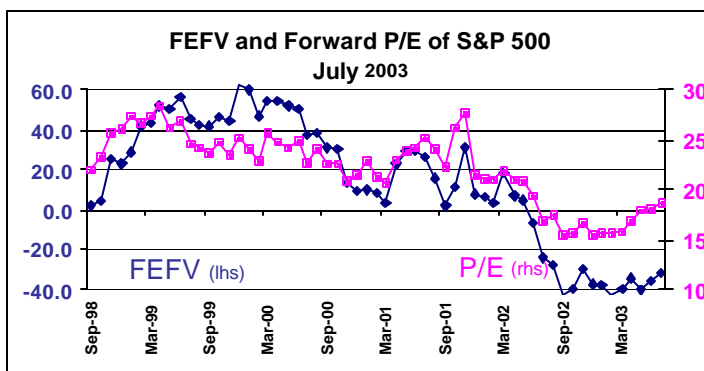
Whether you noticed it or not, 2002 was in fact a "recovery" year from the recession (as mild as it may have seemed). One pattern of economic behavior that *always* has held true is that in the first year of a cyclic recovery productivity surges and then ebbs back to a level that reflects the more marginal gains to be achieved through new rounds of technology investment, i.e. capital spending.



The red data above is the 4 quarter moving rate of productivity, the blue data the moving rate of increase in hourly wages, and the yellow data the difference or change in unit labor cost. It is the cyclical nature of the productivity data that is our greatest current interest. Productivity follows a cycle which is driven by technological innovation, capital costs and labor costs. As long as productivity grows faster than GDP, there is no reason to hire new workers. A situation we currently face.



This creation of excess liquidity coupled with sluggish world-wide demand due to excess capacity, has driven down rates (the rental price) far out into the yield curve. That in turn has changed the discount mechanism for valuing all financial assets *and* liabilities, such as equities and pension funding requirements.

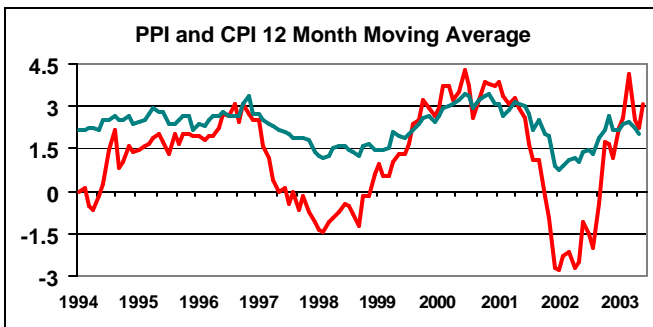


In early 2003 the Fed's Estimate of Fair Value for the S&P 500 was almost 40% below its current selling price. In the rally that started in April the S&P 500 has advanced over 20% despite falling earnings projections. Yet it still appears to be below fair value, giving us confidence that after a correction (coming soon), the bull run has more to go.

Notice that in the first year after a recession productivity surges even while nominal wage costs may still be declining. The net difference (yellow triangles) is the net unit labor cost. This past cycle was no exception, and productivity reached an astounding 5.7% in the 12 months ending September 2002.

This drop in nominal unit labor cost was the greatest in 50 years, and should have dropped directly to the bottom line of manufacturing firms. It should be remembered that at the bottom of a cycle, firm's have the least extra manpower, and slight increases in sales yield big returns. It is ominous that GM had profits drop by 94% in this period. Until the issue of a "profitless recovery" is settled, "old economy stocks" will not make much further progress.

Clarity of future profits remains elusive. The trend of declining marginal productivity gains has already started (red data above), and employment costs remain steady at about 4%.

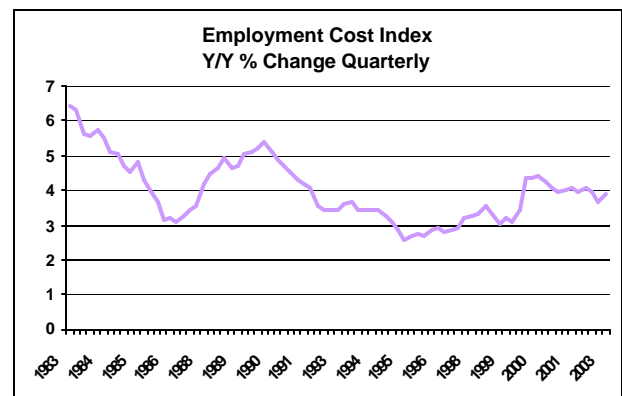


Viewed in the aggregate, consumer prices (CPI in green) are currently not rising as fast as costs (PPI in red), hence the current squeeze on industrial profit margins. Recent Labor Department reports show that inflation is now strongest at the initial stages of production and weakest in the final stage, squeezing profits. In June, prices of unprocessed goods rose 4.5%, the fastest rate in three months. Prices of semi-processed goods rose only 0.5% (pushing the red line above the green).

What we see in the quarter ahead is this temporary squeeze on profit margins due to rising labor costs and lack of current pricing power. With recovery in sight workers have little incentive to accept further cuts in wages,

so manufacturers are muddling through awaiting the ability to raise prices. We think that general optimism in the 4th Quarter generated by tax cuts and child credit checks will lead to modest price traction and better earnings. Not for the auto's, but for drugs, health care, technology, telecom, and those few raw material industries that have already rationalized, i.e. aluminum, forest products, energy and mining.

What still faces most fabricating industries is chronic worldwide over-capacity creating a deflationary spiral in many industrial goods (automobiles in particular). This will not change until these industries are more fully rationalized.



Fortunately the U.S. is increasingly a service economy, and most services are not overly cyclical. Lacking a new "must have" technology, service businesses seldom invest in labor saving technology until the costs "pencil out". When they do, techs really move.

Thus employment levels should be viewed as a lagging indicator. When the unemployment rate starts to drop, businesses will then get the confidence to ramp up their capital expenditure spending, giving a new lift to the equity markets. Our best guess is that this is a Q4 '03 or a Q1 '04 occurrence.

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