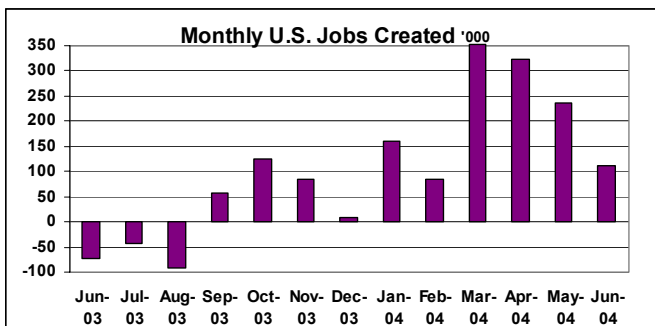




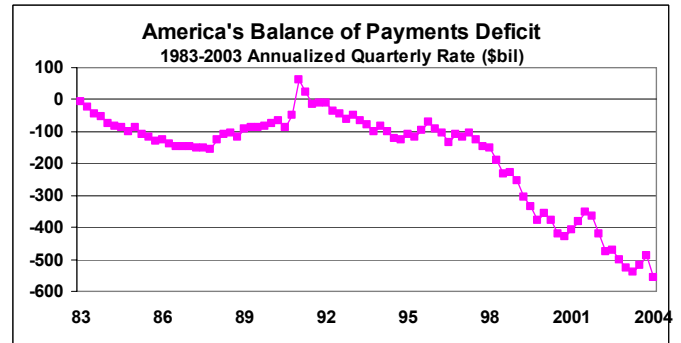
Cascade Investment Commentary

When Allan Greenspan became chair of the Federal Reserve, it was a secretive agency which kept the markets in the dark about its policy intentions and open market activities. The minutes were withheld for a considerable length of time, and traders were cautious of speculative positions before meetings. Today that position is totally reversed: the policy of the Fed is broadcast as widely as possible, and it has become a very transparent policy making agency. Why?

The short answer is that the country is now caught in a vicious circle: the current level of debt is very high and to avoid significant financial losses, employment must remain high. For employment to remain high consumers must spend increasing percentages of their disposable income, and to maintain that spending, homeowners must continue to re-finance their homes to remove rising equity values. To enable equity withdrawal, housing values must rise and mortgage interest rates must remain below the general rise in price. To keep mortgage rates low, the Fed must remain accommodative and transparent. The Treasury must exclaim a "strong dollar policy" reassuring foreign investors that they do not face major losses. To maintain the flow of even ever more dollars back into the U.S., the government must foster rising employment and lower taxes to give households the free cash flow to make payments on a rising level of debt. A break in any of these links will cause the cycle to reverse. No wonder politicians are hypersensitive to the employment data.



While exploring the current state of each of the factors in the circle is beyond the scope of this Commentary, we would like to address several salient points, starting with low interest rates.

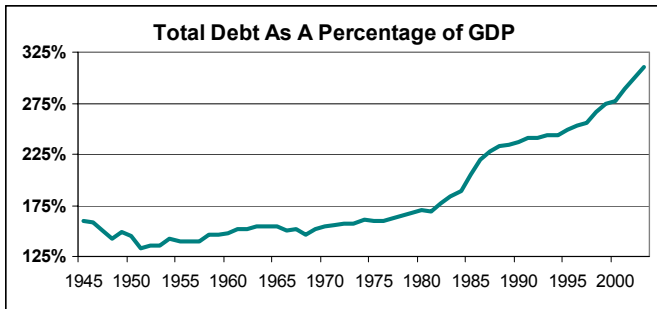


In 1971 the U.S. was no longer able to support gold at \$35 per ounce as a 25% backing for our paper currency. With the abandonment of gold, and the Breton Woods Agreement, most western nations had an inflated supply of gold that produced no income. At the same time they were installing social regimes that required large tax revenue to support health care, generous unemployment benefits etc.

Those nations have since been steady sellers of gold and purchasers of U.S. Treasuries (now over 50% of new issues). Further our trading partners, particularly the Japanese and Chinese, have extended us vast quantities of credit as can be seen by our balance of payments deficit. The interest rates on this debt are currently at a 40 year lows, and it has been a painless substitute for domestic saving which is in reality deferred consumption (postponed pleasure). Multi-national corporations have been increasingly eager to own corporate debt, and more recently household and sub-prime consumer debt.

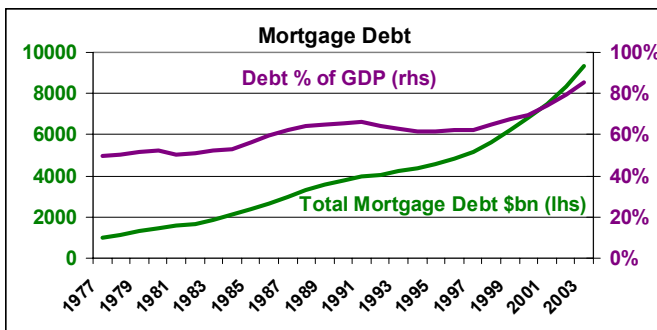
Households, corporations and governments have all used the worldwide demand to own \$US denominated assets to leverage up their balance sheets. At some unknowable point major changes in interest rates will probably have the consequence of causing a disruption of or even worse, reversing the circle.

There is nothing wrong with debt as long as it can be easily serviced. The oft used standard for sovereign lending is when total debt grows to more than 100% of GDP, the interest cost of service reduces government's ability to function correctly, and no further loans should be made. Argentina and Brazil are cases in point. Total US Treasury debt is \$4 trillion or about 40% of GDP.



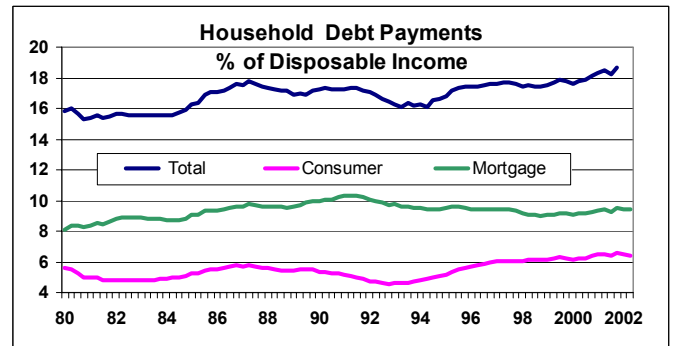
The nation as a whole has become very leveraged. At year end, there was total debt of \$34 trillion outstanding. With interest rates at a 40 year low, the servicing of this debt is not yet seen as an unbearable burden.

The major growth area of debt has been in home mortgages, both first and second. In the past 25 years, mortgage debt has climbed from \$1 trillion to \$9 trillion, and that debt is now almost 90% of GDP.

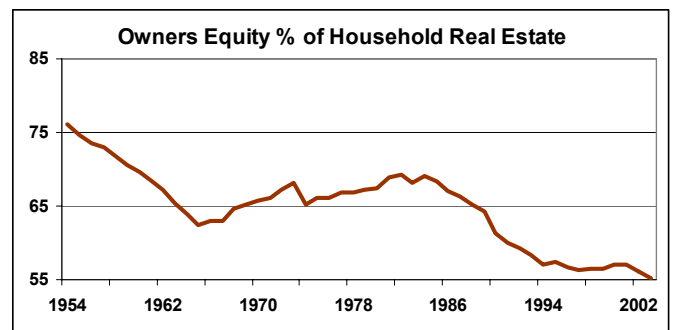


The amount of disposable income used to service household debt has held in a range of 15% to 18% for a considerable time. What is not fully appreciated (in our view) is that as interest rates have trended lower, 18% of disposable income now supports a much higher absolute level, and should interest rates rise significantly, debt service will be a burden.

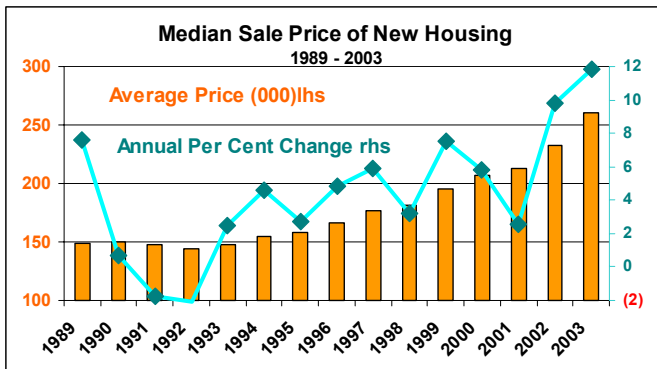
It has become a cultural norm to remove equity from one's home to finance consumption. In the last recession, most households did not have to reduce lifestyles because of unemployment. For the first time ever in a recession, home borrowing went up to maintain lifestyles.



In the recession of 1981 and again in 1991 households reduced consumer debt and let their mortgage payments pay down total debt as they have in each recession in modern times. That was not the behavior of the last recession due in our opinion to very low interest rates coupled with the intense competition in the mortgage lending industry. The elderly, who used to look forward to being debt free are now borrowing, and reverse mortgages are becoming popular.

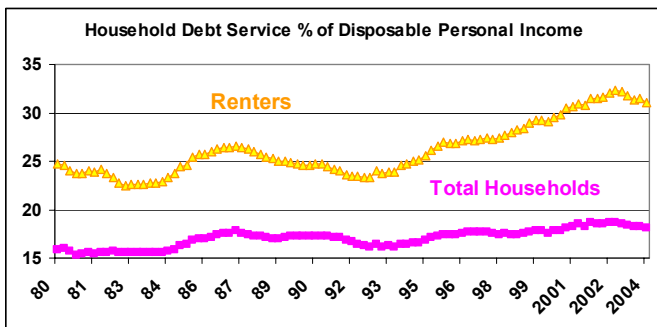


The mortgage interest rate is now the most important rate in the U.S. because it a big part of the cycle. The margin of safety required by lenders is low by historic standards precisely because of the current Fed transparency. As long as the rate of change in home prices exceeds the mortgage re-finance rate, people are induced to spend. As long as they spend, state and federal revenues will flow, and policy makers and mortgage lenders will be sanguine.



Residential values have risen at a pace considerably above mortgage interest rates for four of the past five years, and we expect that this will remain so for several more. It is unlikely that any major housing price contraction will be tolerated by any lending constituency, nor Congress itself (Bush I ran for re-election when the economy was picking up, but housing was still falling in price). With the current leverage in the financial system, it is unlikely that any policy that would affect housing prices will be implemented. **Any policy that would reduce inflation would also reduce housing values, so we do not see any action to curb housing inflation other than rhetoric. Interest rates will not rise as much as the market fears.**

Post 9/11 fiscal policy has stimulated consumption at a pace that cannot be sustained. The tax cuts, child credits and tax refunds meant to re-elect Bush II are not likely to be repeated soon. That has left home construction as the major economic locomotive engine. With home ownership at an all time high, new home sales are increasingly to current renters who are already extended.



Many low income people are chronically over-extended in debt, and the planned rise in short term rates will affect their credit card borrowing in the coming months. Lower quintile income families have had a tough time in the 2nd Quarter of 2004, and should face a more difficult 2005.

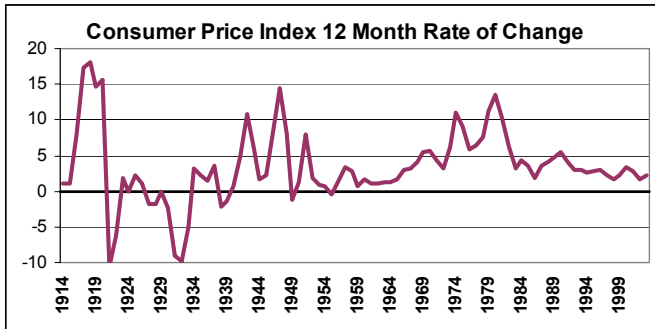
So the Fed faces a dilemma. Rising rates will slow the economy, generate increasing deficits and risks damage to a leveraged financial sector. A return to the 1998 level of interest rates will almost certainly trigger another recession acerbating fiscal problems. On the other hand, a policy that allows home prices to hold up through modest inflation postpones the day of reckoning for an indeterminate period. **Therefore, we believe that negative real rates will be seen for some time to come, and negative real rates are good for housing but also inherently inflationary.**

In our last Commentary we discussed our outlook for energy in great detail (available on our website www.cascadeinvestment.com). Energy is a unique and immediate input to modern society's health and welfare. For reasons discussed below, it is probably now the unexpected variable that will eventually upset the treadmill outlined above.

In *The Great Wave*, the history of inflation from the thirteenth century to the present, Mr. David Fisher describes the trends in England as follows: "The price of manufacturers also rose at a slower pace than those of food and fuel. Throughout Europe, the slowest rates of increase were for industrial goods which could be produced most easily in large quantity. In England, the price of food and fuel rose by a factor of six or eight, while industrial commodities merely trebled". "That pattern of price relatives has appeared in every great wave."

Eight hundred years of evidence suggests that when energy prices rise faster than general economic activity, substantial inflation ensues. While this does not mean that history will repeat in this current cycle, our analytic antennae are full up and receptive.

In the 20th Century, there were three periods of significant inflation: World War I, World War II, and the period from the mid 1970's to the early 1980's. Everyone understands the inflationary nature of wartime shortages, and it needs no further comment. But the 1970's and 1980's Inflation experience was in peacetime, and should be revisited here for relevance.



For reasons related to increased spending in the Kennedy Administration, the gradual failure of the Breton Woods Agreement to fix the price of gold in \$US terms, the rising costs of the Great Society, the cold war and the Vietnam War, the price of oil began rising faster than GDP starting in 1973. The recession of 1973-1975 (along with the collapse of the stock market) didn't slow the price rise.

It was the official line of OPEC that they started the first oil embargo as a protest to our support for Israel in the 1969 war. Our belief is that it was a concern that Richard Nixon was pursuing a policy of cheapening dollars to promote GDP growth and offset the real cost of oil. In either case, energy costs continued to rise. Purchasing oil from a non-US source acts as a tax that cannot be controlled by government. The oil "tax" became so high in the Carter Administration that people clamored for tax relief.

Jimmy Carter's Federal Reserve Chairman was G. William Miller, the former chairman of Textron. While President Carter's answer to the energy crisis was to tell us to turn down the thermostat and wear a sweater, Mr. Miller's answer was to inflate the money supply and attempt to pay OPEC in devalued dollars.

It was a catastrophic policy. The U.S. began a treadmill of rising prices, rising interest rates

and declining currency that threatened economic ruin. It required the extreme inflation crusade of Paul Volker to bring about the generation-long downtrend in interest rates and commodity prices. Those trends are reversing.

What the oil embargo experience made clear was that once energy prices started to rise, it was almost impossible to stop the pervasive infiltration of cost shift into all segments of the economy. In the early 1970's energy represented about 7% of GDP. By the late 1970's it had risen to 10%. In 2003 the best guess was that energy was about 7% of GDP (despite the major loss of manufacturing jobs), and we face the same shift now that oil has risen from the low \$20's to over \$40. 3% of \$11 trillion is a big tax bite. This time this is not a voluntary shut off of oil, but a lack of supply to meet current world needs, and because the nation is now so highly leveraged, no Fed Chairman can repeat Paul Volker's turning of real interest rates so highly positive.

We view policy makers as cowboys trying to move hundreds of millions of slow moving cattle without their being stampeded by an oil or interest rate shock. In the 2nd Quarter, stock and commodity markets reacted to China's effort to slow its economic growth. We see greater economic (and market) volatility in coming years as the world deals with "Peak Oil" and rising inflation.

To maintain financial stability, jobs and economic growth are the basic political goals of both parties. The next president will have an economic agenda very close to the current one. Growth is putting price pressure on oil, natural gas and interest rates. The problem is that with the policy options available, the cattle are slowly moving into a box canyon where at some future date there will simply be no good policy options.

July, 2004

Cascade Investment Counsel, LLC
 827 Alder Creek, Suite B
 Medford, Oregon 97504
 541.857.8551 541.857.8553 fax