Cascade Investment Commentary

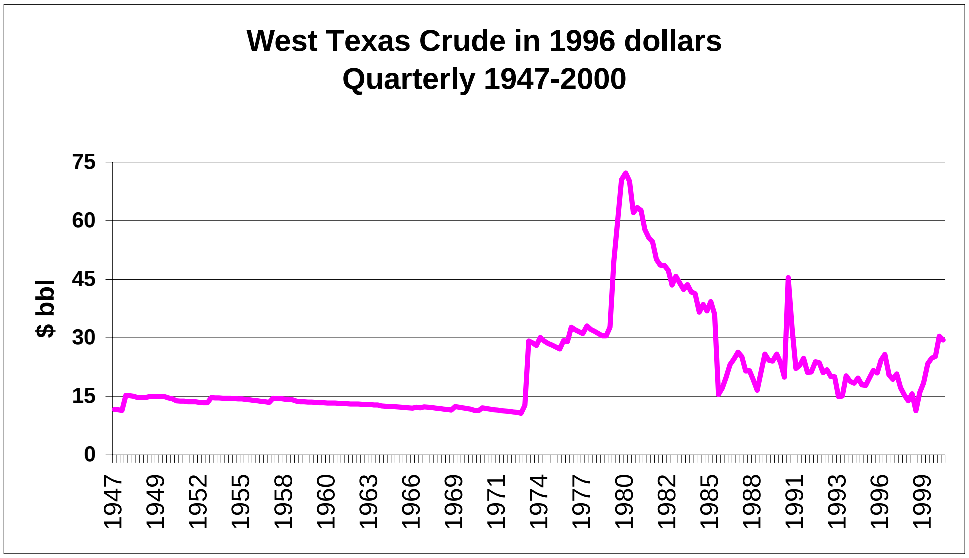
As the third quarter of 2000 ended, the financial markets were focusing on 3 E's: energy, the euro and the election. Herewith is our take on these events, and the probable E's coming up.

Energy

By now all but the dimmest bulbs have discovered that there is an energy crisis. This crisis does not resemble the 1970's "oil crisis" at all. From about 1953 until 1973 the world's largest oil companies adopted the policy to pump as much foreign oil as they possibly could. This made sense because those wells were small in number, huge in output, shallow, onshore and thus very inexpensive to service. The wells in Texas, Oklahoma, Pennsylvania and Louisiana by comparison were very expensive to operate. Because cheap oil was available from Venezuela, Nigeria and the mid-east, the oil discovery infrastructure in the U.S. subsequently withered.

Believing they were being exploited, in 1974 OPEC demanded (by restricting output) and received future compensation for their oil in the form of pricing just below the marginal cost of western production.

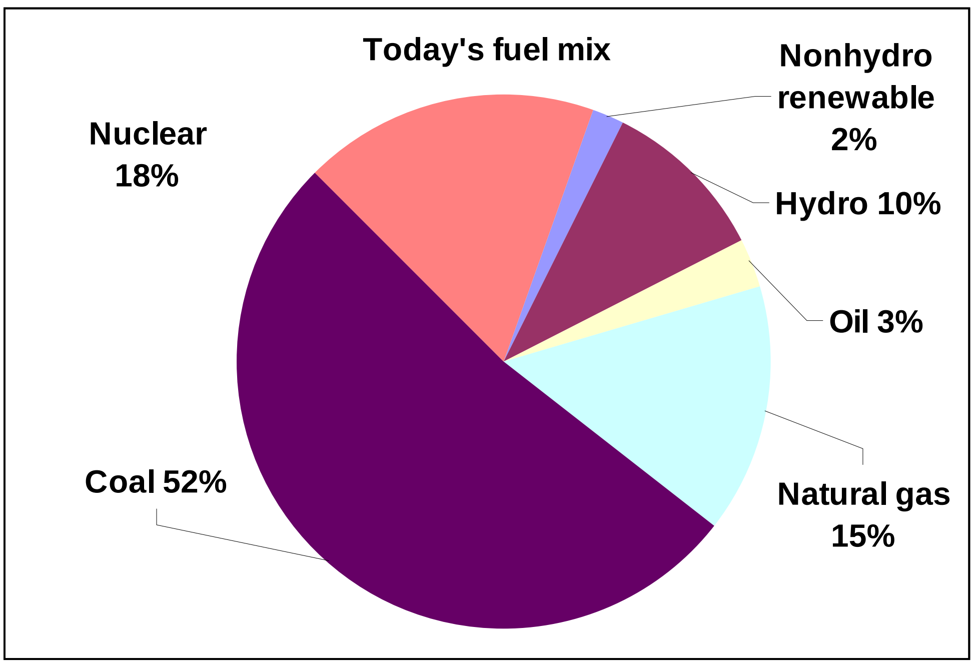
The energy crisis of the new millennium transcends oil. It is primarily an electricity crisis in the U.S., but because oil is traded in dollars, it is a currency problem (not yet crisis) for the rest of the world. Below we illustrate the price of West Texas Intermediate Crude (spot price) from 1947 to present. This illustration uses the price deflator from the Bureau of Economic Analysis, to restate the prices in 1996 constant dollars.



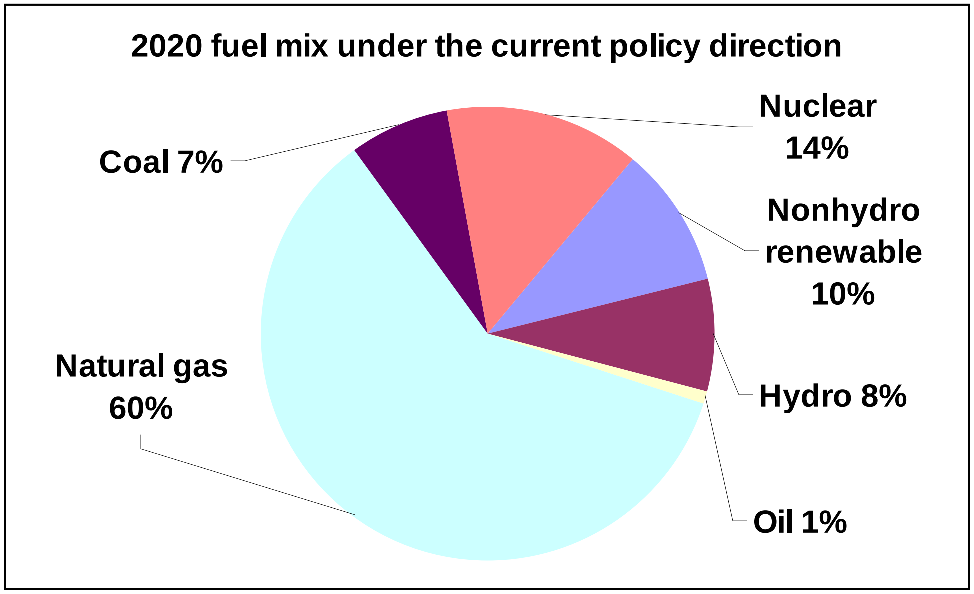
The data suggests that there was a 20 year "bust" in prices from about 1953 to 1973, followed by a six year "boom", followed by a 20 year "bust". The only interruption was the single quarter Gulf War, and that may have had more to do with commodity traders than actual supply interruption. We believe that a new "boom" started in 1999, and while we don't even presume to know how long it will last, we note that General Electric's Power Systems Division (makers of gas turbines for peaking power plants) which had a backlog of $2.7 billion in 1997 now has a $13.7 billion backlog, and is quoting new orders for 2005 delivery.

On September 30, the periodical *Hydrocarbon Processing* revealed the role of natural gas in power generation for the next 20 years. They quoted a recent study by the Electric Power Research Institute (EPRI) that indicates the consequences of U.S. air emissions policies. They claim that current and planned policies on SO_2, NO_x, and CO_2 would not allow sufficient time for developing and deploying the technologies needed to make emissions reductions efficiently.

This could lead to an "unsupportable reliance on natural gas-fired power generation over the next 20 years", says EPRI. Although renewable energy technologies are projected to expand considerably, the main CO_2 reduction strategy in the U.S. over the next 10 to 20 years depends upon the deployment of natural gas-fired power plants, with the most rapid capacity increase between now and 2010.



Under the present administration's current policy direction, the natural gas share of electricity generation would rise from today's 15% to 60% by 2020. Coal's share would drop from over 50% to less than 10%.



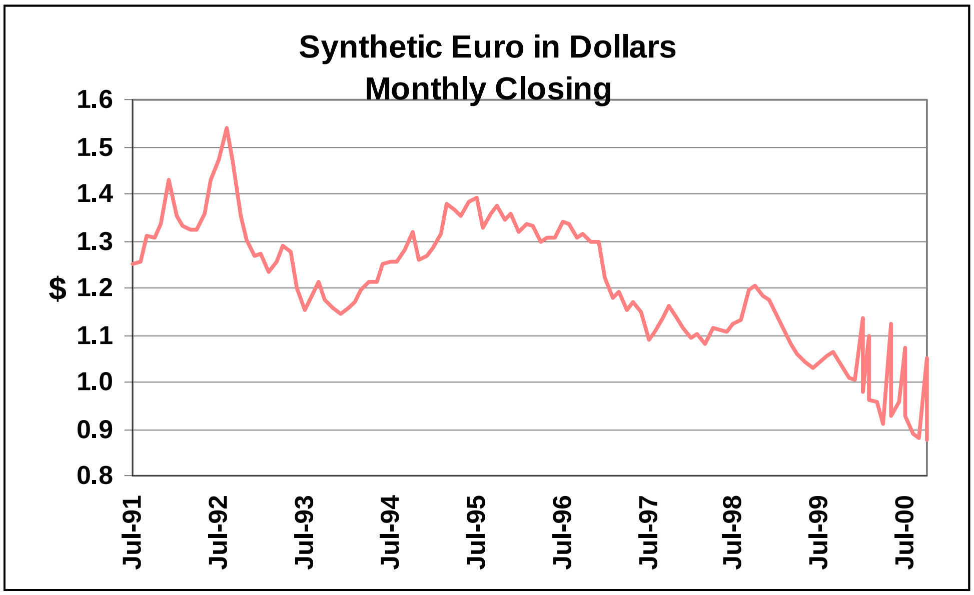
Such a rapid deployment of new natural gas-fired plants would require U.S. natural gas production to increase 50% between now and 2010 and 70% by 2020. We observe that despite the highest count of gas drilling rigs ever, and the full deployment of human resources by the gas and oil industry, the amount of gas delivered to the U.S. so far in 2000 is virtually unchanged with 1999 and 1998. We believe that while oil can (and should) trade in the mid $20 range, natural gas prices will probably never go below $2.00 again. This policy may not work.

What is different from the crisis of 1974? Politics instead of economics. Consider just the permit process. No generating capacity was built in California for over 13 years prior to deregulation. No new or "Greenfield" oil refineries have been built in the U.S. in over 25 years. There have been no major transmission lines or electrical substations built in the major East Coast metropolitan areas in decades. This is political NIMBY. No one in Queens or Brooklyn wants a new transmission line or a substation in their backyard so some Wall Street traders can leave their computers on all night. The U.S. has no coherent energy policy, and this summers actions by California Governor Gray Davis highlights the level of political denial.

Today's crisis has so many authors the credits could fill our entire report, but suffice it to say that the demonizing of nuclear power and the burning of coal by politicians coupled with the general population's insatiable desire to drive 4x4 SUV's and leave 200 million computers and their screens burning 24/7/365 are top contenders. Despite the denial of our political leadership, the effect of under-investment in all segments of energy generation and delivery are just now being realized. We believe that the electricity problem will be with us for at least four or five more years, and the solutions agonizing to politicians, but rewarding to thoughtful value investors.

The Euro

The relative terms of trade are always a political issue, and the third quarter brought this to bear with a vengeance. It started with the French on strike about fuel prices in Marseilles (what would they otherwise do in August), but surprisingly jumped channel to the Brits who discovered that 76% of the price of gasoline is taxes. Where the French offered tax relief, Mr. Blair mumbled in his hat. In any event, the euro must be converted to dollars to buy oil, and a weak euro will eventually add to the continent's inflation rate. The 25% decline in value over the past 18 months helps some and hurts others.

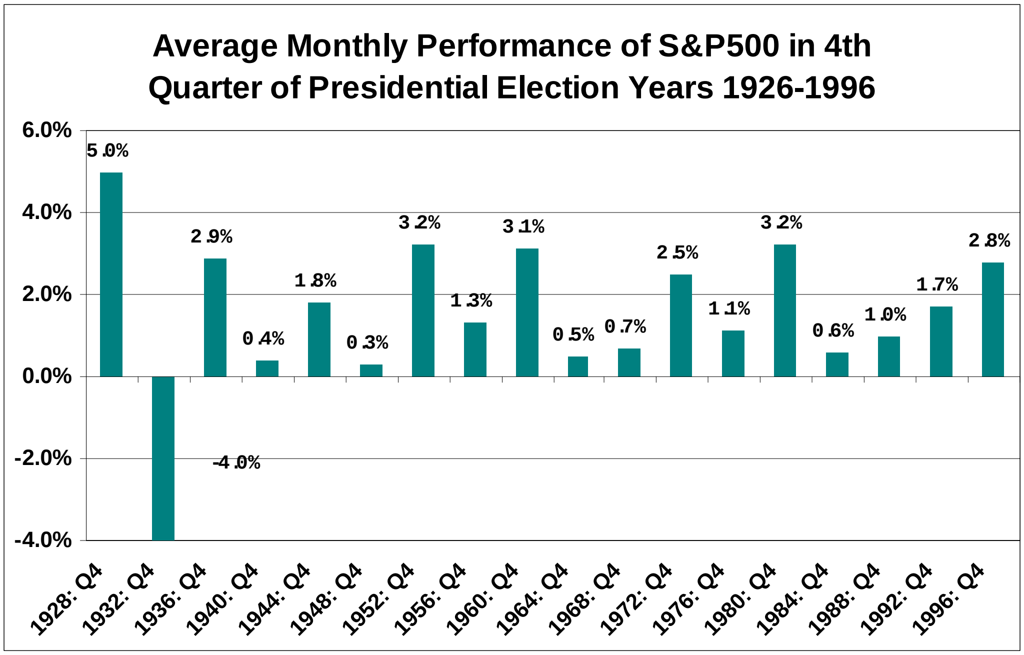


The European Central Banks are intervening. In mid-September the G7 central banks sold over $10 billion to purchase euros at $.87. This gave an immediate pop to $.91. Will this work? While $10 billion is a big number, it is dwarfed by the trade and capital flows driving currencies. $10 billion is only a moderate sized U.S. acquisition by a European firm. The Merger & Acquisition flow out of Europe is now equivalent to 7% of European GDP. If flows of that magnitude continue nothing will stop the euro's fall. On the other hand, should it slow (maybe for lack of acquisition candidates), with the Americans selling over $400 billion per year (our net current account deficit), the dollar must fall. It is only a question of time.

While the euro is the focus of Wall Street conversation, we at Cascade are more concerned with Asia and the Pacific Rim. All are heavily dependent upon imported energy, and the export-based economies like Korea and Hong Kong are very susceptible to a slow down in American retail consumption. The recent weakness in the Asian stock markets is shouting that there is trouble ahead.

The Election

On an upbeat note, we comment upon the election. As usual, none of the issues being argued late at night at Cascade Investment Counsel are being addressed by the candidates, but we thought we would bring you the immediate investment results of elections past.



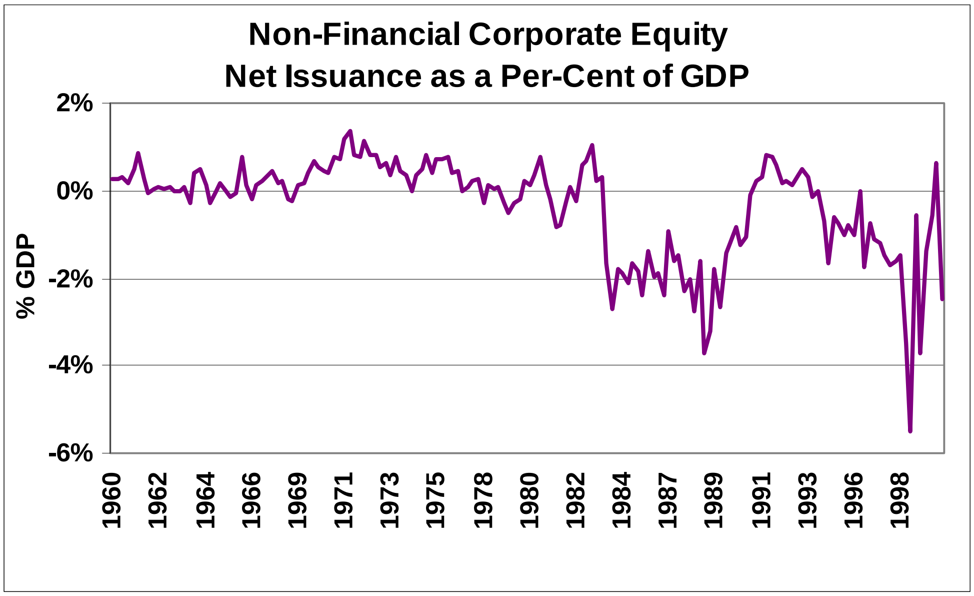
This graphic reminds us that the stock market generally likes elections. The only time the S&P 500 (425 before 1955) did not behave well in the final three months of a presidential election year was 1932. The rally into that election became known as the "great suckers rally".

Expectations

A person, sitting under a tree in A.D. 1000, decided to put $1 into a bank. At that time, 5% was the going interest rate, and the conservative depositor accepted the terms. If that single dollar had remained untouched and allowed to compound, today it would be worth $1,546,300,000,000,000,000,000 or $1.55 billion trillion dollars. The current annual income would be $77.3 million trillion. While this case seems absurd, it points out the fact that current expectations of earnings growth by the general public of high tech firms are not sustainable in the long term. Likewise many value investors should be content with stable, conservative and well financed companies earning a mere 10% and selling for less than replacement cost.

Earnings

Much has been made worldwide of the enormous and sustained performance of the U.S. economy. What is not frequently commented upon is the divergence between reported earnings and their underlying earnings. Reported earnings per share have averaged almost 20% per year for the past ten years, yet the actual earnings growth in dollars has been almost half of that. This is a result of stock repurchase programs.

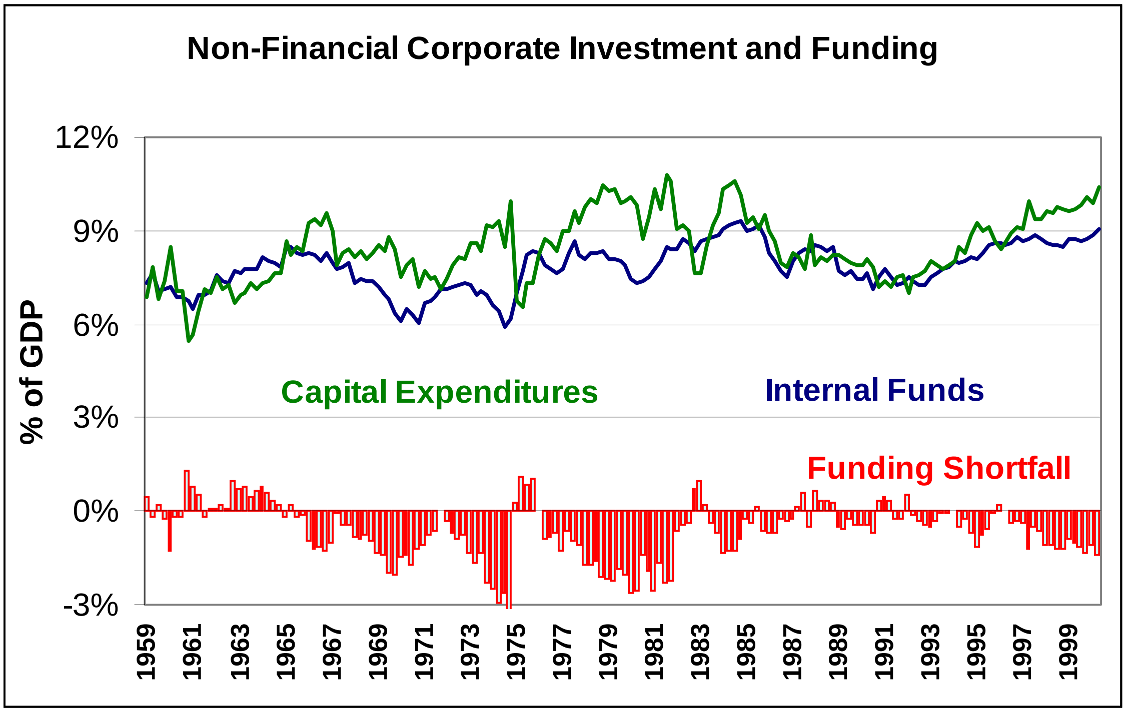


The incentive to perform has never been more powerful on key executives. Look no further than the option packages offered. Long ago companies were prized on their ability to build a game plan that could raise the dividend each year. With so many option packages now in effect, the currently prized companies are those who are diverting their free cash flow into their share repurchase program. Many, however are using borrowed money to buy their stock back.

It very well may be that this elastic is getting stretched about as thin as it can get. There is a point at which this device reaches diminishing returns, especially in a rising interest rate environment. Thus, we believe that share buybacks may be much muted over the next year or so compared with the last five years due to declining free cash flows. What we might see is a return to the leveraged management buyouts of the late 1980's of basic industry and "value" stocks due to ridiculously low market levels.

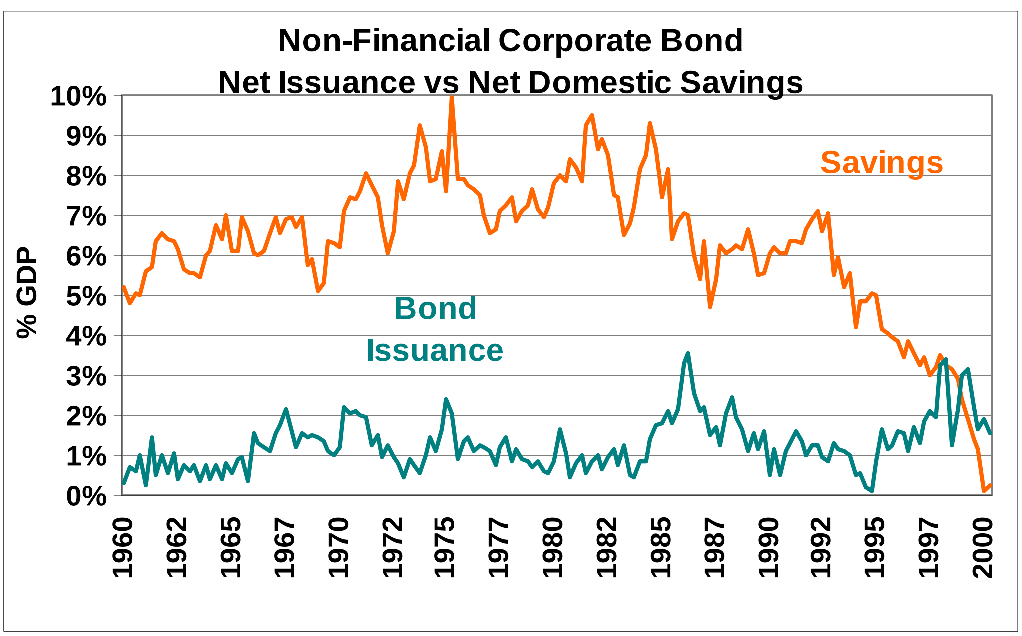
The August 2000 Fed survey of senior loan officers showed that 33.9% of them said they had tightened standards on Commercial & Industrial loans in the past three months. 0% said that they had eased. This point spread (i.e. 33.9%-0.0%) is close to the peak of 1998 (before the Long Term Capital Management crisis) of 36.4%. For reference, the spread was just over 50% during the 1990 recession.

The Federal Reserve released its quarterly flow of funds report in September, and it shows that business investment is near an all time high relative to GDP. While most of this investment is funded from internal cash flow, there is a persistent short fall.



Investment usually rises through an economic expansion cycle, and corporations' internal funds usually rise also, with some lag. As a result, net funding requirements are often contra-cyclical: falling as growth rises and rising as growth falls.

While our graphic shows that funding shortfalls are not new, what is new this time is the absence of savings on the part of Americans to fill the breach. Our funding shortfall is being entirely imported form the rest of the world, and Europe in particular.

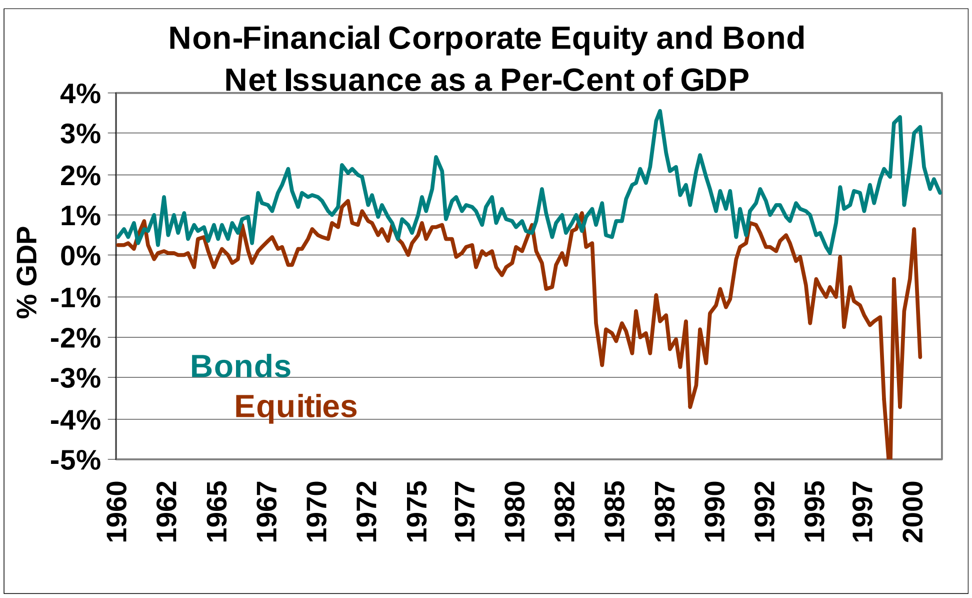


Standard & Poor's recently reported that the S&P 500 earnings growth had slowed to 28% year over year in the second quarter down from a peak of 33% (year over year) in March 2000. They forecast the third quarter to be up 11%, and they are currently expecting a 9% gain for all of 2001. Why worry?

It is significant to us that since 1970 whenever the profit cycle for the S&P 500 has peaked, it has subsequently decelerated for at least five additional quarters. A trend reversal after one or two quarters has not occurred. By implication, the market may have to wait until the end of 2001 for good news to discount.

Equipment

Telecoms have been central players in the new economy, and they have been huge spenders. They have thrown lavish sums buying licenses, capital goods and each other. The latter has been critical to the capital flows into the U.S., and their capital goods rush has led to the spectacular growth of many technology firms such as Nortel, Lucent, Cisco and JDS Uniphase. It is estimated that 40% of the direct investment flows into the U.S. over the past three years have been to purchase telecoms, with the $54 billion takeover of Voicestream by Deutsche Telecom being the largest single transaction.



It is the related spending on capital equipment that is important here. As is well known, business investment has led this business cycle since 1994. Business Week estimates that American telecoms made 16% of all investment by S&P500 companies in 1999. Spending has increased over 25% per year since 1996 to $82 billion while the sector's revenues have increased by only 10.5%. Returns on telecom assets have dropped from 12.5% in 1996 to 8.5% this year. As corporate borrowing has increased recently the cost of borrowing has risen above 8.5% for many. The mind boggling fees to be paid next year for spectrum licenses (some say $170 billion will be spent) may be a problem. As the economics of investing in new telecom assets deteriorate, and the safety margin between purchasing new capacity and the earnings capability of those assets narrows, we believe that the logical consequence is a slowing of capital equipment purchases. This may be the big tech story of 2001.

If we are correct, there will be several ramifications: First, the super P/E MEGA Cap information technology infrastructure companies will report slower top line sales, and many investors hoping that their $1 will grow at 40% compounded into infinity will be brought to reality. Second, because the stock prices in the tech area (at the margin) are being driven partially by foreign (particularly German) purchases, their incremental buying pressure is likely to abate. When the buying pressure on tech stocks slows, the dollar will fall versus the euro due to the reduced demand to convert euros to dollars. Third, the reduced flow of new money into the U.S. to buy tech stocks will accentuate the savings shortfall in the U.S., causing real interest rates to remain high during a slowing period. Corporate retirement of equity shares may well dry up.

The relevance to the value investor of the above recitals is clear. As a nation we have been over-allocating our resources to "growth" and "high tech" industries by tilting equity portfolios dramatically away from slower growing industries. It is commonly said of today's marketplace "that there is tech and everything else". That allocation decision has caused a dramatic under-investment in gas and oil production, refining, electricity generation and other basic industries. This allocation has already begun to right itself, and while our portfolios have already profited handsomely this year, we see several very good years ahead.

October 4, 2000