



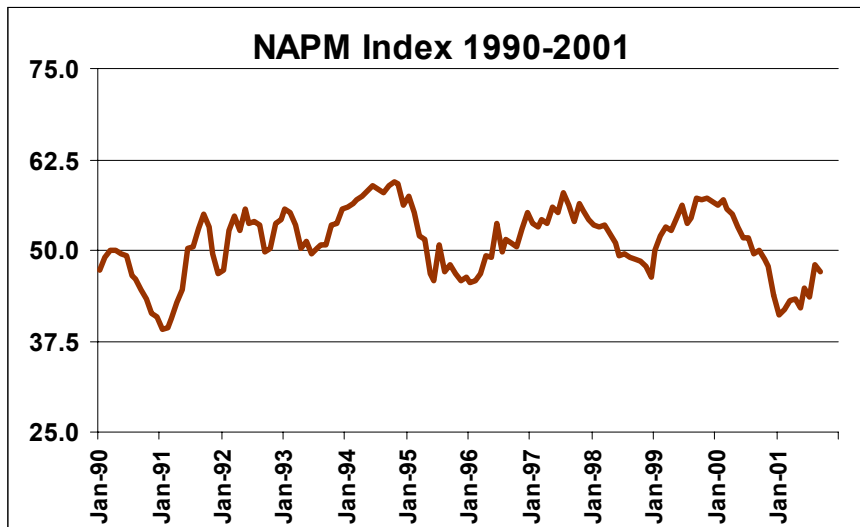
Cascade Investment Commentary

The third Quarter will always be remembered for September 11th. No other event in the lives of those who occupy Wall Street and the investment industry has ever been this traumatic. The anarchist's attempt to blow up J.P Morgan & Company on September 26, 1920 killing 38 and injuring over 300 pales by this tragedy. All of the professionals we deal with were, like ourselves, in a state of mental and physical exhaustion as the quarter came to a close. Such events only heighten the ancient and ever-present craving by mankind to somehow know the future. In the reading of the runes (the following charts), we observe the following:

The attack had the immediate effect of accelerating all of the short-term trends that were already in place. It postponed only slightly the intermediate trends, and added one new long-term trend.

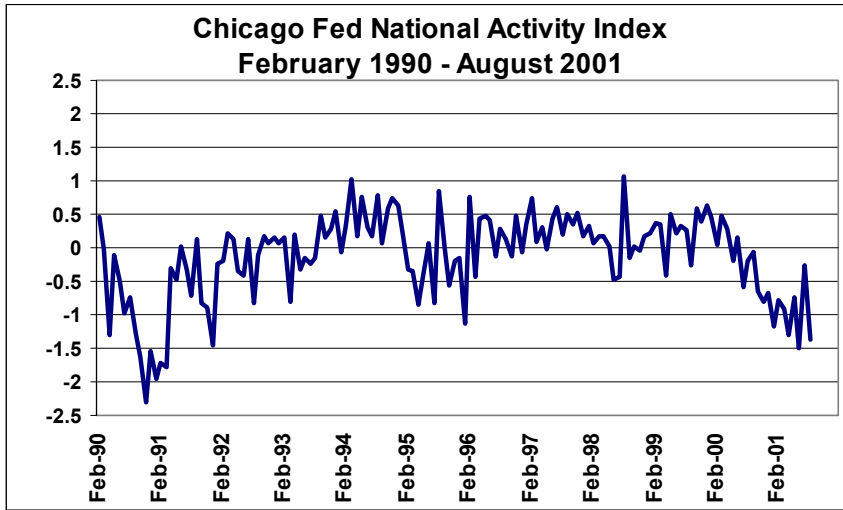
The painfully obvious first trend was the decline in progress for stock markets both here and abroad. From January 1 to September 10, the DJIA was -10.9% and the S&P 500 -17.24%, The Financial Times (of London) 100 -18.8%, the German DAX -27.9%, etc.

Gross Domestic Product has been decelerating in Europe, Japan and America since the first of the year, and there has been a clear "profit recession" in place for three quarters. In fact, the National Association of Purchasing Managers (NAPM) survey shows 14 consecutive months of decline (any reading below 50) in the manufacturing area. It is not by coincidence that the broad stock market has been declining for 17 months.

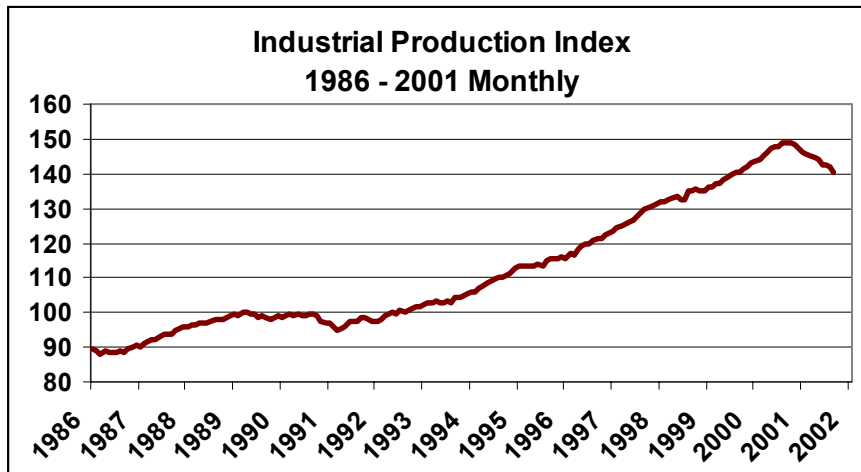


Leading up to and during the official recession of 1990, the NAPM was below 50 for a total of 25 months; during the 1982 recession, 19 months; and during the 1974 recession, a total of 12. Interestingly, we are by historic standards, closer to the end of economic contraction than the beginning.

The Chicago Federal Reserve's National Activity Index bears this out also. While the contraction has not been as severe as 1974, nor as long as 1990, it has, nonetheless been longer than people realize.



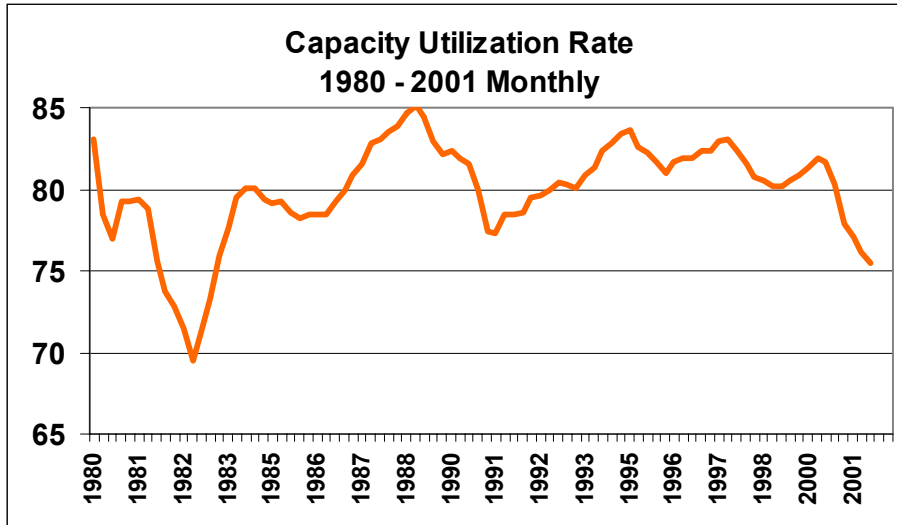
The brunt of the slowdown has been felt by the manufacturing sector. Industrial production fell in September for the 12th consecutive month, the longest string of declines since 1945.



Just how tough this has been on corporate profits was demonstrated by the report in the first week of September of the unit profit margins for the non-financial sector. They dropped a bone-crushing 24.4% below year ago levels. This deterioration is rare. In 1970 profits fell 24.7% and in 1960 profits fell 23%. By the second week of this October, earnings have dropped 26% year over year. While there is the usual beat-the-street-by-a-penny trick, only 48% of companies reporting so far have exceeded expectations versus the normal 60-65%.

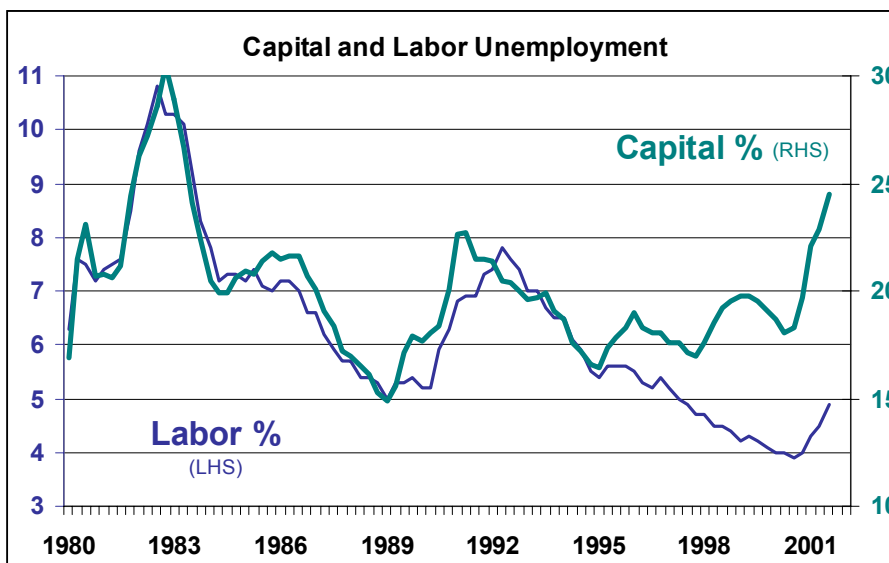
The problem is brutally simple: Excess capacity and weakening worldwide demand for industrial goods. This is an echo from the enormous buildup of capacity in years 1995-2000 in technology, media and telephony (TMT). There is now more excess capacity than ever before in TMT. For the rest of manufacturing, the slowdown has led to capacity

utilization rates not seen since the recession of the 1980's. Furthermore, with a pickup in general activity not expected until mid-2002, this could get worse before it gets better. Now we face the prospect of the revaluation of post-bubble assets running into a genuine slowdown of core earnings.

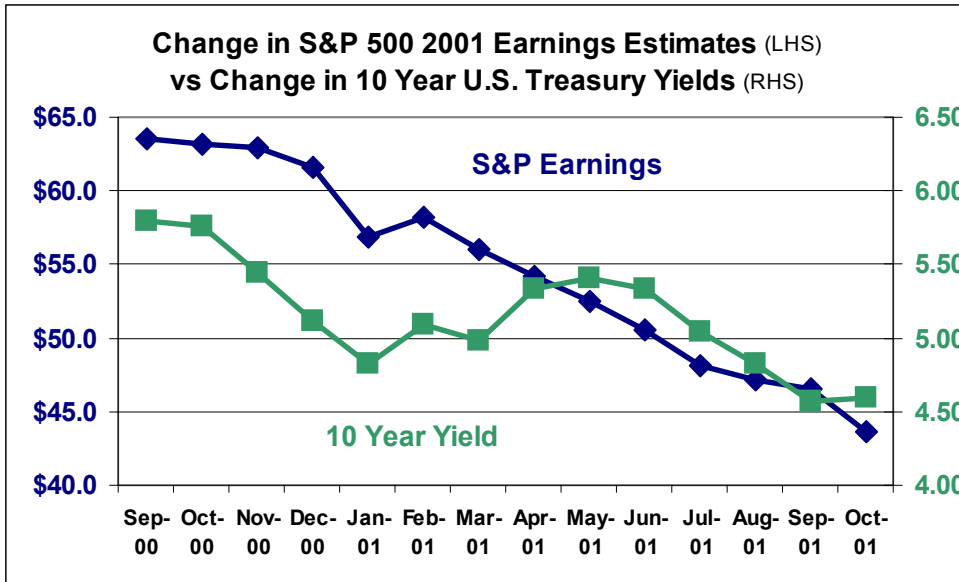


In the U.S. there is a further complicating factor: there is far more excess capital capacity than excess labor capacity. This means that wage rates are still rising in real (after inflation) terms. Although wage growth will probably slow in the coming months due to corporate layoffs, the rising wage scales are putting enormous pressure on gross profit margins.

Rational business managers do not borrow money to expand manufacturing facilities where no buyers exist for the end product, no matter how low interest rates go. Another way to view this is to think of idle capacity as the unemployment rate for capital. We define that rate as 100 minus the capacity utilization rate.

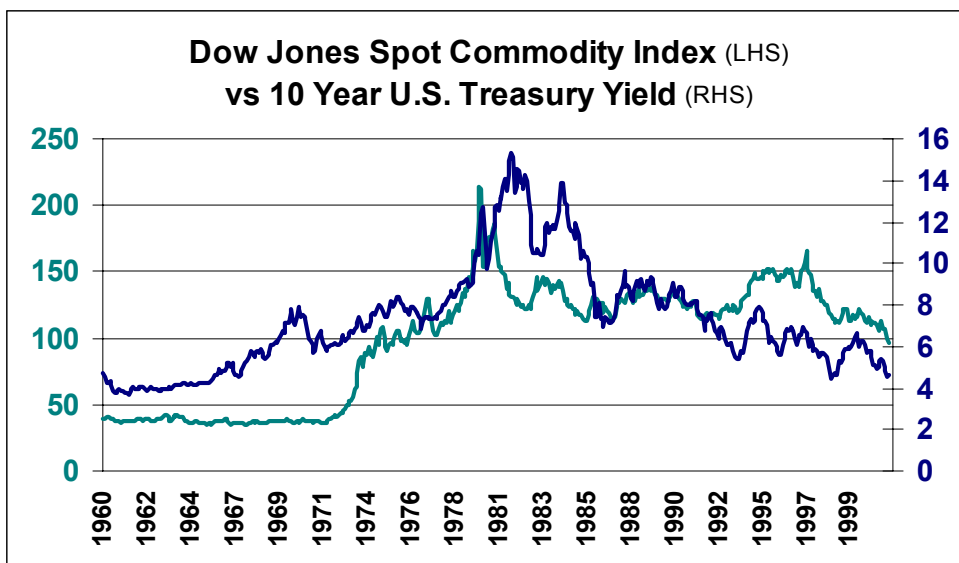


Productivity is not the current problem. Labor productivity rose by 2.1% at an annual rate in September, and is still up 1.5% above year ago levels. The key problem is that hourly wage payments are now running more than 4% above year ago levels. This coupled with soaring health care costs has led to a 4.9% rise in unit labor costs at a time when selling prices have risen a mere 1.9% over the year. While the meager price rise has cheered those whose job is price stability, it has led to a dramatic fall in corporate profits.



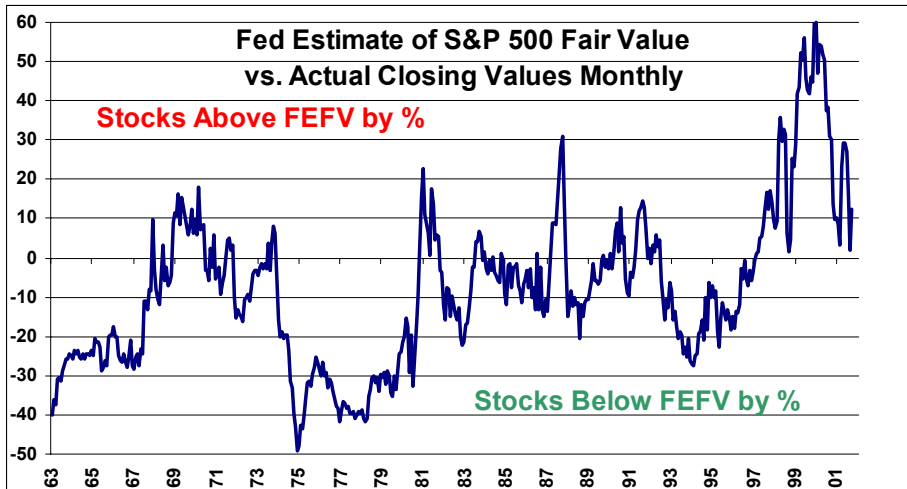
The third trend that has been in place since 2000 is that interest rates have been falling. The 30-year U.S. Treasury yield fell from 6.49% in January 2000 to 5.38% on September 10th. The 90-day Treasury Bill fell (rather was pushed) from 5.71% in October 2000 to 3.19% on September 10th. This also reflects the slowing of the economy that has been in place for 14 months.

The world wide economic slowing is also reflected in spot commodity prices.



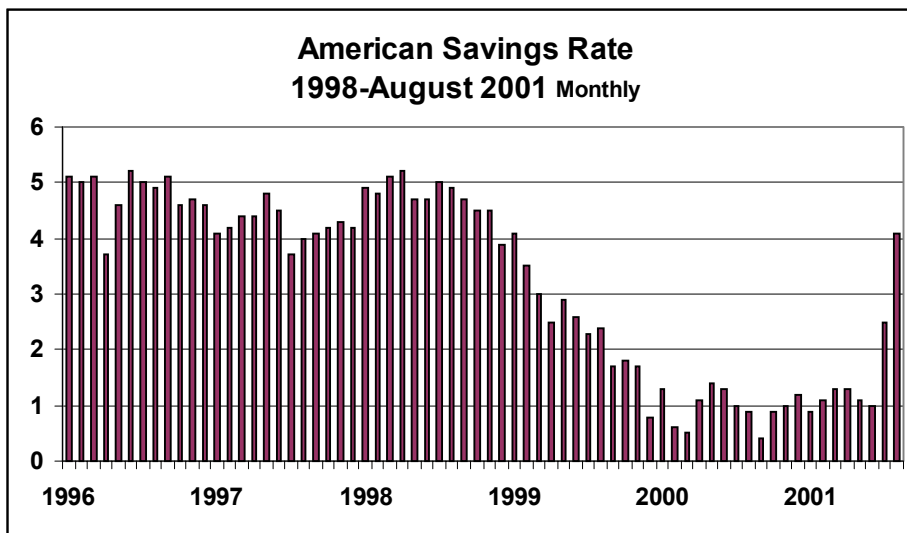
The Dow Jones Spot Commodity Index has fallen from 130 in January 1998 to 96.87 at mid month October. That 25% fall has brought prices to levels last seen in the recession of 1974. Responding to lower perceived inflation, the 10 Year U.S. Treasury yield has fallen.

Has the 10-year yield fallen far enough to make stocks the preferred investment? The Fed's model of fair value indicates reasonable pricing at the September 21st low.

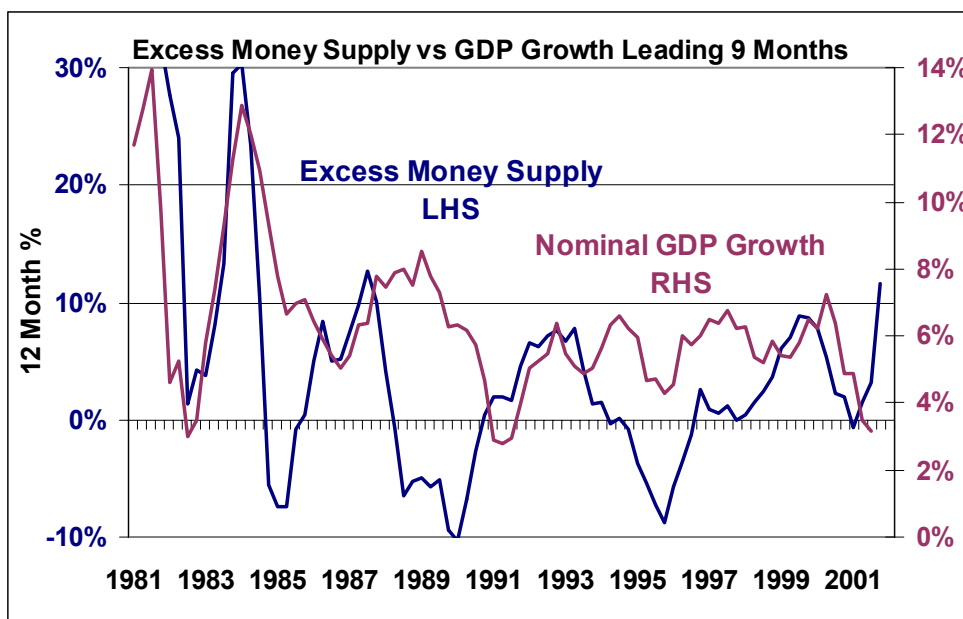


To many observers, equity prices have declined to such an extent that they appear to be great bargains. We note several risks to be concerned with.

First, the consumer was ramping down spending even before September 11th. That is reflected in weekly retail sales data. More tellingly is the disposition of the \$300 Federal rebate check. According to Chairman Greenspan's recent testimony, only about one quarter of that money has been spent.



With consumer spending being approximately two thirds of GDP, consumer confidence is critical to corporate profits. The popular measures of consumer sentiment will become critical to near term fiscal and monetary policy. As to monetary policy, it has been very stimulative all year. The growth of the broad money supply (M2) has exceeded the growth rate of the U.S. all year. We chart the difference between the need for money (GDP growth) and the supply of new money (M2), calling any surplus excess money supply. Excess money supply has been traditionally bullish for stocks, and this time should be no exception. Below we illustrate these two with a 9-month lead-time.



We believe that another trend is about to unfold in the wake of September 11th. That is cost-push inflation.

While inflation as we currently observe it is all but dead (see above chart on commodity prices), commodity prices save for energy are becoming less important in the overall scheme of American commerce. As we increasingly become a service-based economy, we rely more on computers, software, telephones and electronic transactions. In the 1990's the price of computing and telecommunications collapsed. Long distance phone calls dropped more than 95%. At 3.5 cents per minute of long distance there is little downside left. Likewise the cost of computing has collapsed as computers and silicon chips are in chronic worldwide overcapacity.

Counteracting this commodity and high tech deflation is the rising cost of service sector salaries, medical costs, and now because of September 11th, property and casualty insurance. Few firms are capable at this time of absorbing these rising costs out of their current profit margins. We believe that these new costs will be a very heavy burden on small and mid-sized corporations, and the rising risk premium demanded as result of September 11th will hasten both merger activity and industry consolidations.

In the past few years there has been a remarkable consolidation in natural resource companies. In past cycles, marginal producers would sell products below the marginal

cost of production most often to repay debt. With the world's natural resources being accumulated by very strong hands, this may not be the case for long. We find it noteworthy that recent paper, mining, and energy mergers all resulted in the shutdown of excess capacity. We believe that the future belongs to the lowest-cost producer.

The 1990's brought just-in-time management systems that dramatically lowered inventory costs using computers to follow goods. Those same systems replaced redundant human tasks, and slowly removed most of what was known as "middle management". The aftermath of September 11th is a new layer of risk management affecting all major enterprises, the cost of which has not yet been priced into finished goods and services. Decentralizing corporate assets and personnel, hiring sky marshals, installing metal detecting devices in buildings, posting guards at plants, dams and bridges diminishes overall productivity, which in turn, fosters inflation.

After September 11th, the Administration and Congress abandoned fiscal discipline as they should have. All members of Congress and the Administration are in a mood to spend freely. For the time being, the slowdown in corporate borrowing due to a flagging economy will offset the new borrowing demands of the Federal Government. If all of the monetary and fiscal stimulus now being applied has the desired effect, we should be looking a higher interest costs and lower bond prices a year hence. Perhaps sensing this, mortgage refinancing has taken off like a rocket in the past month.

A last word on the tragedy. When Princess Diana died, all of Great Britain was stunned. People stayed home for a week watching the "telly". In the second week they were absorbed by the actions of the Royal Family. The third week ended with a magnificent funeral that was broadcast worldwide. Only then did they discover that they were all out of toothpaste, soap and groceries. One year later U.K. GDP was hitting new highs along with the FTSE 100.

While our circumstances are far removed, and England did not mobilize for war, Americans have already started to get on with business, and our magic runes predict economic recovery sooner than most. The question before the house is to what level of profit this return to prosperity will bring.

We at Cascade Investment Counsel are value managers, and we have found under priced assets all during this period. Our annual returns ending September 30th are all in positive territory. We believe that the current turmoil in the markets offers excellent investment opportunity to the disciplined, value minded investor.

October 15, 2001

Cascade Investment Counsel, LLC
1109 Siskiyou Blvd. Suite B
Ashland, Oregon 97520
541.552.0636 541.552.0638 fax
info@cic-llc.com