



# Cascade Investment Commentary

**The Third Quarter ended with a general sense of disillusion, despondency and despair. These are the psychological elements that make for major bottoms. The markets behavior in September was the worst since 1937, and at this writing many sectors (utilities) are clearly irrational. This is due to war talk, pessimistic CEO's, opaque earnings forecasts, etc. While we still are in the camp with the long term bears, the current sentiment is so negative, the crowd cannot possibly be right.**

**We** are deeply curious as to why the market is in such a panic. We have lived through several bear markets, and while they have all been different, there were some well known and common problems at the core.

**In** 1998 the dollar was weak and the fantastically leveraged Long Term Capital Management crashed in the Russian currency failure. In 1990 the Iraqi army was an unknown force (then a client state of the Soviet Union), the outcome of the war uncertain, oil was at \$40, interest rates 9% and the dollar was weak. In 1987, the dollar was weak, U.S. Treasuries yielded more than 10% and an asset allocation switch by a handful of retirement funds touched off an avalanche of leveraged selling through "portfolio insurance".

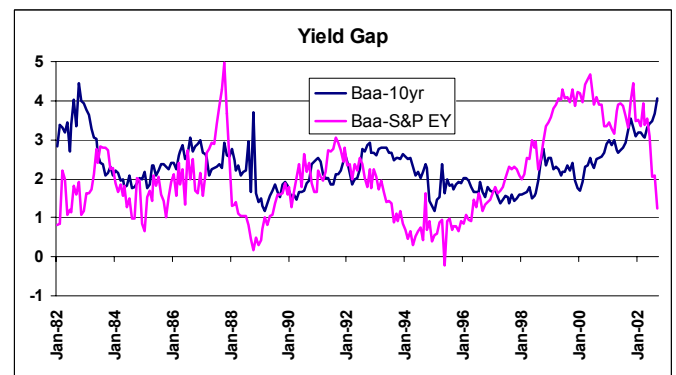
**In** 1981 oil was \$35/barrel, U.S. Treasuries paid 15%, and we had a failed administration, a failed fiscal, monetary, and foreign policy. In 1974 we were unwinding an unpopular war, the President was under siege, we faced rising interest rates, a falling dollar, and suffered with wage, price and yes, dividend controls.

**As** we head into the Fourth Quarter of *Annus Horribilis III* for the equity markets, we are suffering under \$30 oil, uncertain an outcome

with Iraq, but the dollar is strong, interest rates are under 5%, fiscal and monetary policy are both accommodative, unemployment is at tolerable levels and it is by no means sure that our foreign policy is currently a failure.

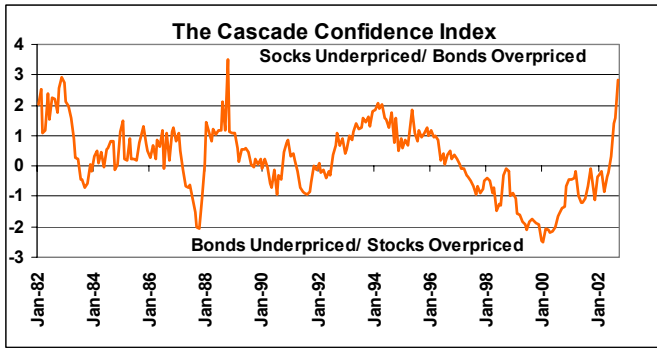
**We** can only postulate that the country has developed an extreme aversion to risk in the aftermath of the Internet/Telecom bubble. That risk aversion is causing many to discount the future earnings of well run enterprises at extreme rates due to the short-term opaqueness of future earnings.

**Back** when there were AAA Corporate bonds in sum abundance, Barron's Magazine published a "Confidence Index". It was simply the difference or "spread" between Baa industrial and AAA industrial yields. We have built the same index below using Baa industrial yields and the 10 year U.S. Treasury, which we refer to as the yield gap. Currently that gap is 4% (blue line).



**The** pink line is the Baa rate minus the expected Earnings Yield of the S&P 500 (1/PE ratio on forward earnings). This demonstrates the premium return over Baa bond returns that equity investors anticipate.

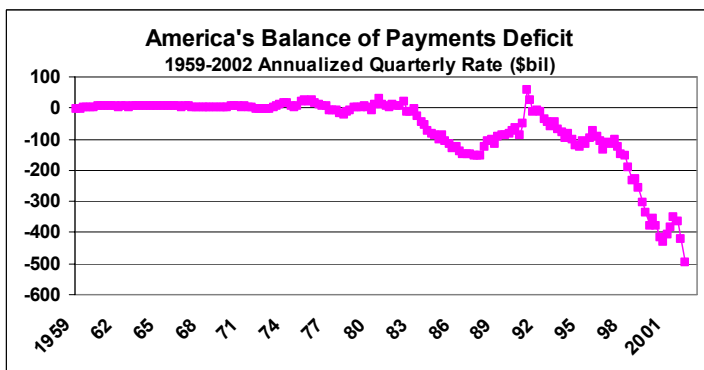
**We** have subtracted one from another to give us a relative confidence index, (modestly) referred to as the Cascade Confidence Index.



We view this index thus: When the index is at zero, investors have the same expectation of return owning Baa bonds as owning the S&P 500. When the index falls below -2 investors increasingly prefer the risk of stocks. When the index rises above +2 investors show an extreme preference not just for bonds, but Treasuries. By this measure stock prices appear to substantially under-valued.

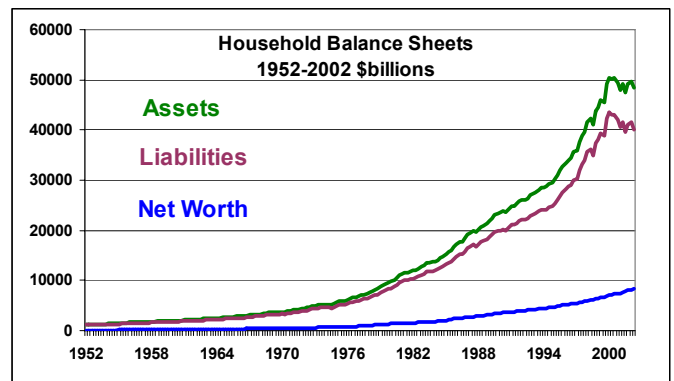
If the business conditions in the country are not as difficult as 1974 or 1981, we at Cascade submit that the 10 year Treasury is as overpriced now as stocks were overpriced in January 2000.

One major concern is the general level of debt, and consumer debt in particular. We have spoken often about this subject, but it bears repeating. First, there is the general level of indebtedness to the rest of the world, as viewed through the balance of payments deficit. This has been growing exponentially in recent years as Americans import almost everything except services. The main culprit is oil, which should come down after the war. Furthermore the world likes to own dollars.

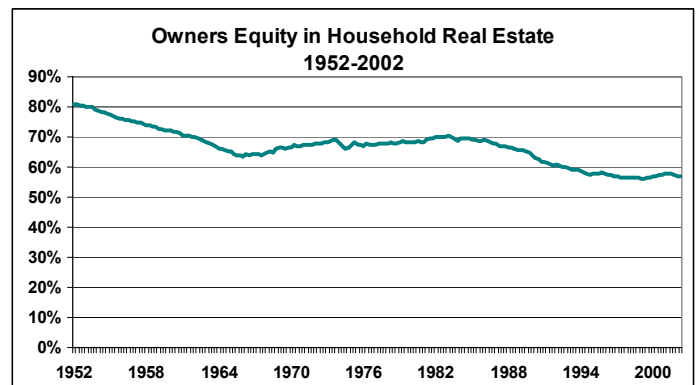


It is popular to characterize the American consumer as over fed, under dressed, in a pool of personal debt rising above the shoulders, being force fed ever more toys, trucks, SUV's, and an endless array of "stuff" largely manufactured overseas. We have complained on these pages about this consumption before, and how it might come to a bad ending if the global flows of money into the U.S. suddenly stopped. We will know in advance, because the dollar would become visibly weak, and domestic interest rates rise rapidly.

To put another large perspective on this consider the total net worth of households. Despite the deflation of stock market assets, household net worth continues to rise.



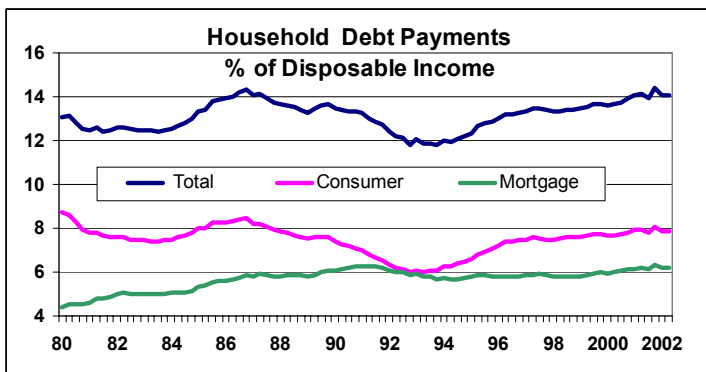
While concerned that Americans continue to consume the rising equity value of their homes through re-financings, and the net equity owned in homes as a percentage has dropped, it does not yet seem terribly out of line with long historical trends.



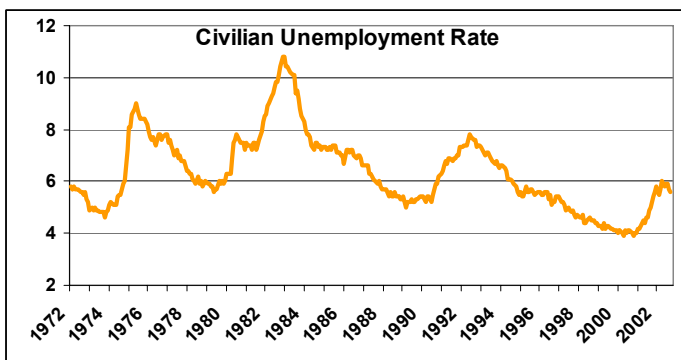
Of particular interest is the larger pattern during long bull and bear markets:

**Note** that in the bull markets of the 50's, net equity declined as a per-cent of market value. Likewise in the long bear market of 1974-1982 people allowed their home equity to become a greater portion of their portfolio. This leads us to believe that real estate is not yet in a bubble.

The more salient question is can households pay their bills on a timely manner. The area that the market fears the most seems to be the universal knowledge that the consumer must slow down. While not presently at dangerously high levels, very low interest rates have clearly made the consumers buying binge affordable, but rapidly rising rates might invoke a similar response to past recessions.

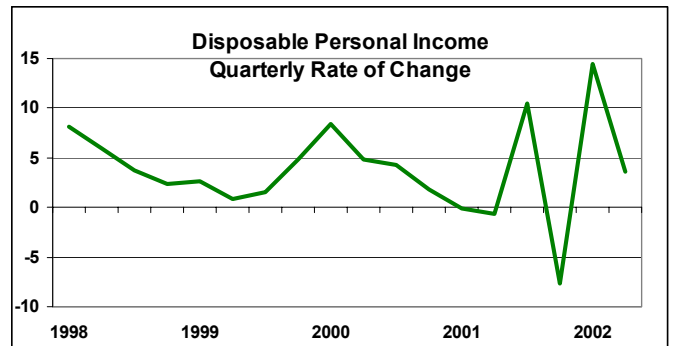


The key going forward is going to be employment growth. Unemployment has been remarkably low considering the slowing economy of early 2001 and the trauma of 9/11. Recent employment news is encouraging.

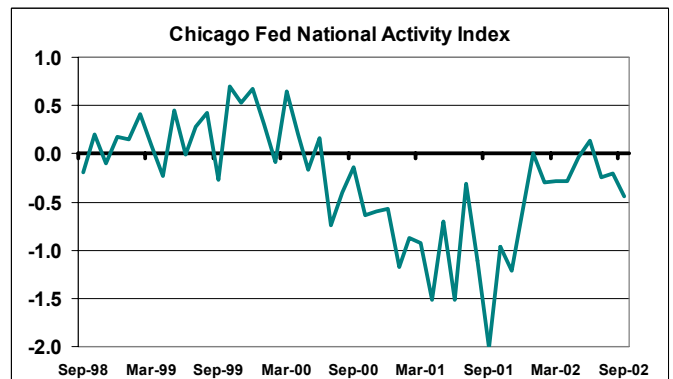


Surprisingly, the growth of real disposable income has held up despite more than a million layoffs since 9/11. This is due to several factors: First, wage income amounts to only 55-60% of total household income. Rents, dividends, pensions and other transfer

payments account for the rest. While wage income has not been robust in the past year, the other transfers have been. In the past 12 months, pre-tax income has risen 3.0%, while after tax income has risen by 5.2%. The Bush tax cuts and the rebate checks have had a major effect. This will get us past the election, but possibly not much further. It is the not much further that has led the market, in our opinion to the depths of despair. We fear not.



While the markets have been driven to unrealistic lows by short sellers and frightened amateurs selling 401(k) funds, valuations are now out of proportion to the economic reality.



Reality is probable slow growth going forward, with modest profit growth, not the collapse being discounted in today's market. Last, we would remind readers that the bear markets of 1946, 1957, 1960, 1962, 1966, 1974, 1987, 1990 and 1998 all ended in the month of October.

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