

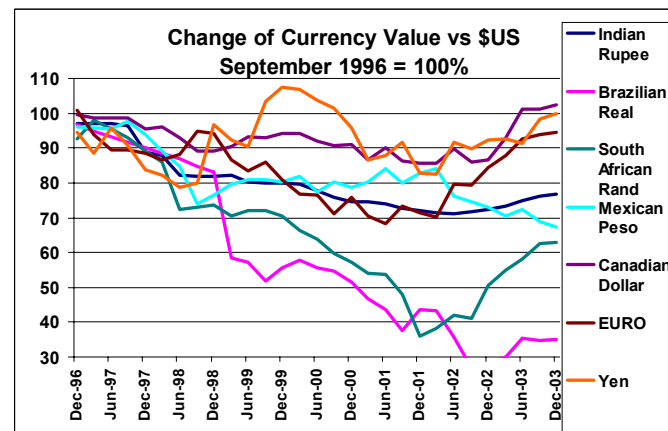


Cascade Investment Commentary

While the 3rd Quarter's news seemed obsessed by the election in California, there were several significant events that will impact the financial markets: The G7 meeting in Dubai, the WTO meeting in Cancun, and the very cool summer .

In the aftermath of the California election we should remind readers that there were several other events in the 3rd Quarter that will affect the markets in the U.S. for some time to come. Probably the most important is the decision at the G7 meeting to promote a "flexible" exchange rate system, stating that "The world trading system works best under a regime of market-based exchange rates". This is political speak for the US demanding that China let the market determine the value of the Yuan, not the Bank of China. Re-election politics aside, to us, this is playing with fire.

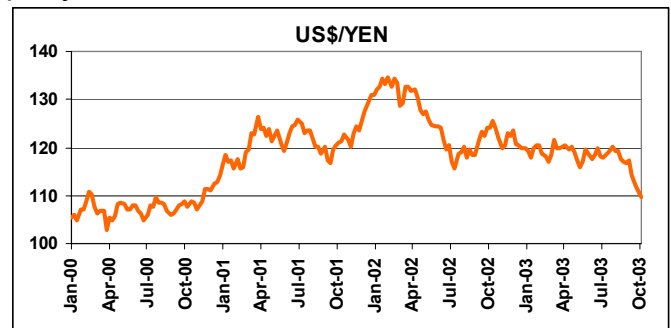
America has been losing manufacturing jobs to cheaper labor for 50 years. In the 1950's to southern US states, then to Europe. In the 1960's to Japan, in the 1980's to Taiwan, Korea, and Brazil, and now to China and India. The sudden need to cheapen the dollar to slow this trend (until election day) to prove that this administration is "doing something" about jobs will have unhappy longer term consequences.



In the chart above, we plot the relative value of several currencies to the US\$.

As can be seen in monthly terms, most of our trading partners' currencies have declined relative to the dollar since 1996. Much of this was the demand to own US equities and Treasury securities. In a "total return" world, a US\$ appreciating in value against the yen (for example) at a 3% annual rate plus a 4 1/2% coupon looked very favorable versus a 1% rate in Japan. The rising demand for US\$ to purchase stocks and bonds has been a boon to bond sales (all US borrowers).

In the mid1980's the Plaza and Louvre Accords devalued the US\$ without great disruption. But this is not 1985. Back then we were a creditor nation, i.e. we owned more assets abroad than foreigners owned here. Today our debt held by foreigners is more than \$4 trillion more than our overseas assets. It is very doubtful that thoughtful investors will purchase bonds paying 2 1/2% with the prospect of the US\$ falling 4% per year.

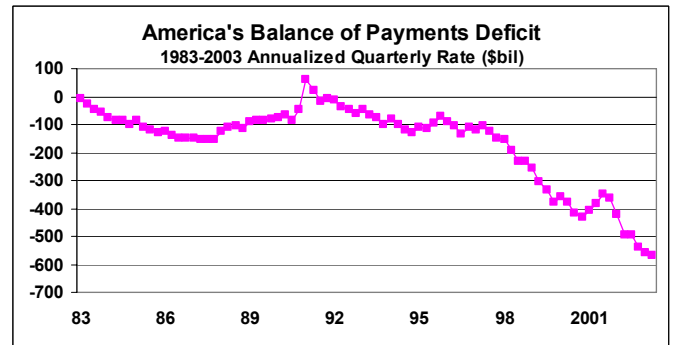
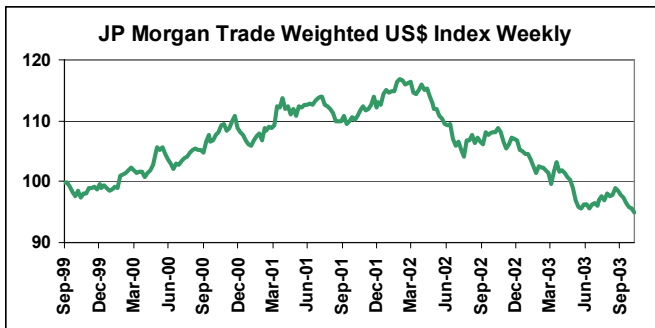


Consider the Japanese purchaser of a 5 year US Treasury note in May. The buyer paid 120 Yen to buy \$1 worth of a 2.625% note. The note has declined in value by 1.5% and the currency loss has been more than 9%. 88% of the total gain expected in five years has already been wiped out.

With current rates at 3.15% and the implicit promise from Treasury Secretary Snow that the US\$ will continue to fall versus the Yen, what will the appetite of that same investor when we go back to borrow again?

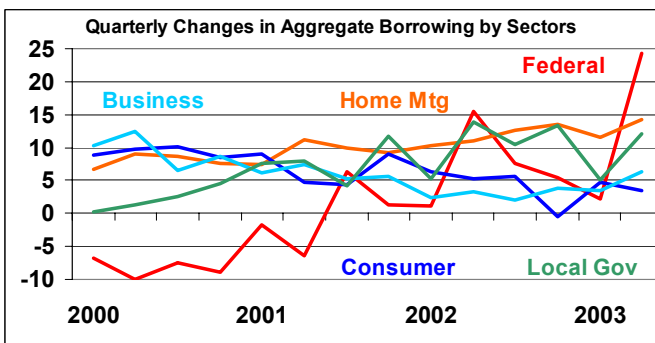
Thus far in 2003 the Japanese government has spent (to our thinking, squandered) more than \$85 billion defending their currency from rising in value. Is it any wonder that gold traded at 7 year highs during the 3rd Quarter.

One reason is the sheer size of the debt flows. The US borrowed \$676 billion from the rest of the world in the 12 months ending July, with a large portion (39%) coming from Japan.



Why all our concern about the value of the US\$? Should we care if someone is holding a depreciating asset? It is all about the upcoming issuing of debt. Our economy's industrial base has been weakening despite strong consumer demand for "stuff" (much of which is made in the Far East). Consumer spending has been rising faster than income for some time, and the difference has been made up by borrowing, primarily through mortgage refinancing. As we have reported in the past, this was fine when governments were reporting surpluses. Now, however, everyone is borrowing all at once.

The *Economist* reported in July that Japanese household savings fell from 23% of disposable income in 1975, to 14% in 1990, and then to 6.9% in 2001. They believe that the rate may have fallen to 4% last year, and to 2% in the 1st Quarter of 2003. If this is so, than the Japanese household savings rate is now below that of the Americans for the first time in 50 years! Where is the next \$ trillion we need to borrow to maintain our lifestyles coming from?



We believe that fiscal stimulus is now almost exhausted. The Fed has pushed short rates to 1%, and while they may remain there for some time, the yield curve has turned positive with rising demand for loans. Home mortgage rates are flat on the last 12 months, and with a declining number of re-financings possible, and with probable increased winter fuel bills (see below), consumer spending will grow in 2004 at a rate below most people's expectations.

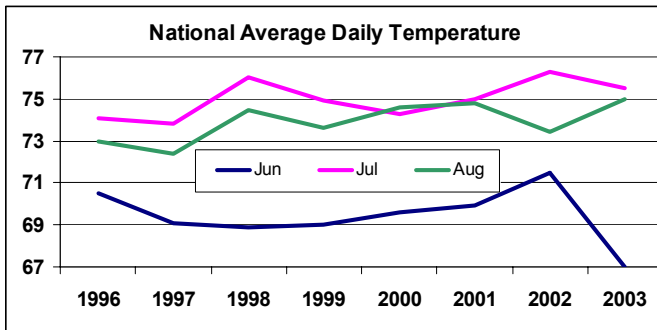
Total borrowing in the US is running at a 12% year over year increase, with the Federal Government leading the way at an astounding 25% rise. State and Local governments are borrowing 12% more and home mortgage financing is almost 15%. Clearly this cannot last forever.

The second big story of the 3rd Quarter was productivity. Productivity growth is a two edged sword. Over time, it is the key to lifting living standards. At cycle turning points, however it dampens the most important mechanism that generates a self-sustaining expansion: the link between rising production and rising employment. The recession of 1991 was followed by a "jobless recovery" that cost George Bush Sr. his job despite a very accommodative Fed policy.

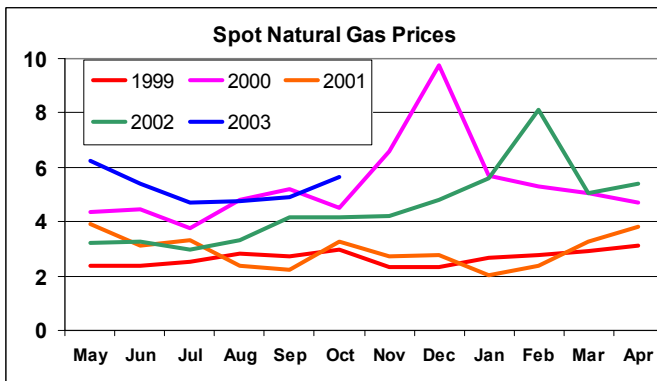
The 1st Quarter of 2003 saw productivity gains of 2.1% and 2nd Quarter gains of 6.8%, but in the first five of these months employment fell. The political echo of 1991 could be heard loud and clear in Cancun where the US was unwilling to give on any trade topic that would cause job losses before November 2004.

The short term upside for the corporate sector is that stronger productivity growth and weaker employment growth implies very low unit labor cost increases, hence strong earnings. Those earnings being reflected in the market now.

Cooler than normal plus rainy weather in June gave the natural gas industry the ability to reach record level injection rates for eleven weeks this summer.



The net effect was that cooling degrees were 11% below normal. This summer's Hurricane Isabel disrupted the demand for gasoline and natural gas further allowing inventories to build. Despite this rest in demand, natural gas prices are significantly above past "shoulder" months.

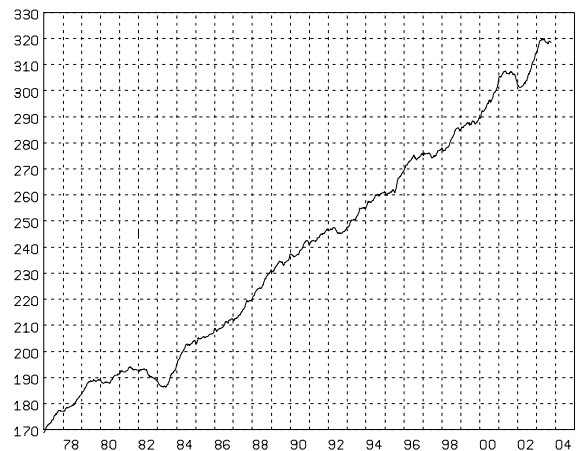


Last year, working gas inventory switched from record high levels to record low levels during what turned out to be a normal winter. In April 2003 gas in storage hit an all time low of 623 Bcf, 74 Bcf lower than the prior low in 1996. Last October there were 3,074 Bcf in storage for the winter, and there is currently 211 Bcf less than last year.

Today's closing spot price of \$5.65 is ominous (blue line on above chart). This price signal indicates that all of the gas in storage is spoken for by an end user that actually plans to use it. If anyone wishes more for industrial reasons, i.e. glass for homes or auto's, steel, aluminum, etc., they are going to have to pay a price so high that someone else will forgo the profit on their end product.

Should the nation experience a cooler than normal winter, we will close factories first as usual, but we may also have to close some schools and government offices. The cooler than normal summer still produced the nation's largest and deepest blackout. In the chart below note the growth from the recession in 2001. This summer it was clearly at capacity even with bringing the merchant gas fired emergency capacity into play.

Monthly Output of Electricity (millions of kilowatts)
52 wk moving average



We expect that all of this will heighten the demand for Congress to pass a rational national energy policy next year.

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