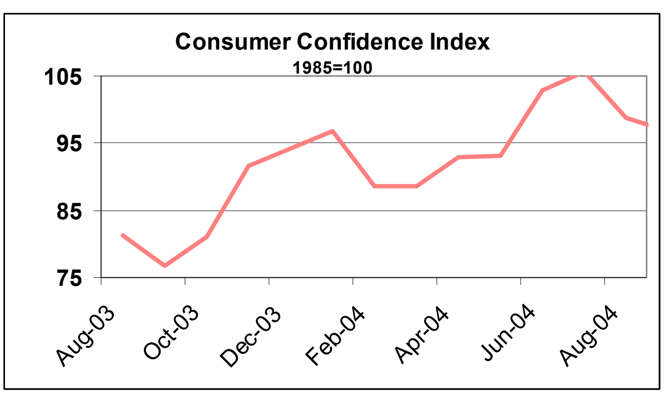
# Cascade Investment Commentary

**The Federal Reserve has now raised short term interest rates three times, and has indicated that they will continue to do so at "a measured pace". During this time the 10 year Treasury yield has fallen from 4.48% to 4.12%, which is counter-intuitive. More is involved than the effect of $50 oil.**

***A***s this note is being written, America is in the full grip of our election season. As the major news media are a zero-sum environment, much economic news has been superceded by politics. We would like to report on several issues that are important to our portfolios which have received scant attention lately.

***L***et's start with the Federal Reserve. The recently released minutes of the August FOMC meeting show a determination to raise interest rates despite recent soft economic data. In their words, "Although the pace of economic growth had moderated in the second quarter, the Committee believed that the softness would prove short lived and that the economy was poised to resume a stronger rate of expansion going forward. Given the quite low level of short term rates, especially when judged against the recent level of inflation, members noted that significant cumulative policy tightening likely would be needed to foster conditions consistent with the Committee's objectives…"

***T***his explains the rate hike of last week, and forecasts another soon ***unless*** Consumer Confidence slips further in coming months.




***W***e are not as optimistic as the Federal Reserve about the continuing strength in the economy. Real consumer spending increased only ½%, compared to the 6% pace in the quarter ending December 31. What explains the 5½% difference? Rising energy was only ¾%, but the large portion was a big swing in savings. Consumers spent 2% more than they earned in Q4 2004, but in Q2 2005 spent 1½% less than they earned. That 3½% swing was caused by the slowdown in refinancing home mortgages. As rates have stabilized, that savings withdrawal method has dried up for most home owners, and the effects are now showing as re-financings are down 70% yoy. We expect that a 2 - 2 ¼% Fed Funds rate will cause slowing in the housing sector (due to the extreme leverage of today's households with ARMs and consumer debt), and therefore interest rates will not rise as much as expected during this round of tightening.

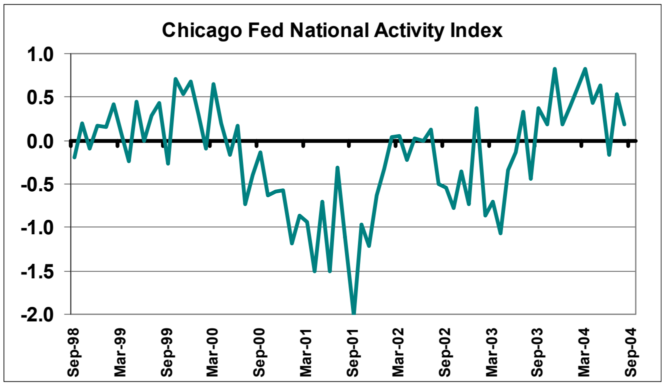
***T***he gap between GDP recovery and jobs recovery is unprecedented, as has been the gap between jobs recovery and spending. The income coming from employment recovery is not strong enough at this time to maintain consumer spending at current levels, thus we see a material slowing coming in 2005.

***l***ate in the 3rd Quarter many of the big brand names lowered their earnings guidance for 2H04 and all of 2005. Household's reaction to energy prices are also slowing other spending.

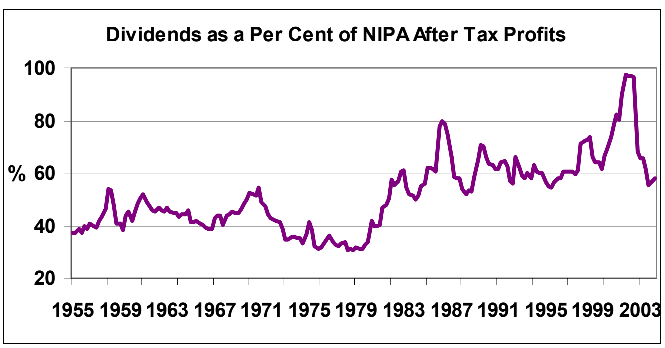
**S&P 500 2004 Sector Earnings Forcasts**

| | Jan-04 | Sep-04 | % Diff |
|---|---|---|---|
| Consumer cyclicals | 17 | 15 | -2 |
| Consumer Staples | 12 | 11 | -1 |
| Energy | -7 | 34 | 41 |
| Financials | 11 | 13 | 2 |
| Health care | 18 | 15 | -3 |
| Industrials | 11 | 15 | 4 |
| Materials | 49 | 73 | 24 |
| Technology | 26 | 16 | -10 |
| Telecom | 13 | -7 | -20 |
| Utilities | 14 | 4 | -10 |
| S&P 500 | 14.2 | 15.5 | 1.3 |

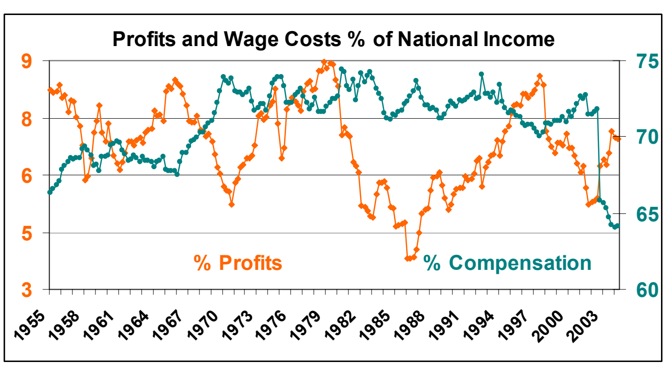
The big question is how much this general slowing will affect earnings into 2005. We see a clear deceleration of profits except for the energy sector where we remain over-weighted.




Despite the rosy forecast for corporate profits, we noted last year that actual corporate earnings (National Income Product Accounts, or NIPA) would not support much dividend growth. The earnings recovery of the past 18 months has changed this picture somewhat, so that we should see some increases in 2005.




We should be mindful that wage costs as a percent of national income is at a 50 year low, and not likely to keep falling indefinitely. There could be considerable wage cost pressure in 2005 and 2006, as household's pay winter heating bills and higher transportation costs.




America currently spends significantly more than it earns (leading to deficits that have to be financed overseas), and conversely, the rest of the world is spending less than it earns, leading to savings that must be invested. Two sides of the same coin, so to speak. This equilibrium has existed for several years, but America cannot sustain this borrowing forever.

Since the Federal Reserve's first tightening, the 10 year U.S. Treasury has actually gone up in price, down in yield from 4.48% to 4.12%. This yield "flattening" trend is signaling that consumer spending is slowing, the savings rate is rising, and GDP growth will moderate going forward. As we know that Asian central banks are purchasing more than half of new U.S. Treasury debt, it signals the continuing unwillingness of Asian banks to face the reality of their undervalued currencies. They are purchasing capital losses on our bonds to maintain trade advantages in the short term.

Asian purchases have been the surprising source of the recent $US strength. The dollar is 4 ½% above its February low despite our recent "soft patch". While it has been widely anticipated that the dollar will drop over the next few years under the crushing weight of the twin US Federal deficit and US foreign account deficit, Asian intervention is keeping our rates artificially low, postponing the inevitable slowdown in housing, and the inevitable rise in value of Chinese and Japanese currency.

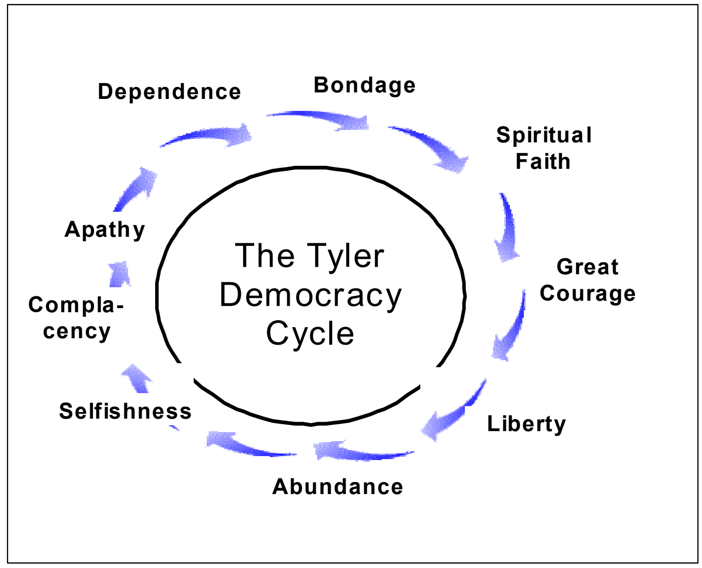
In the next few years the best economic environment would be a gradual moderation in American spending and borrowing just as the rest of the world begins to grow more, reserving a growing portion of their savings for internal growth. In this environment there is reasonable financially stability worldwide.

There are two other possibilities: The first possibility is that America keeps demanding the lion's share of the world's capital savings, while the rest of the world becomes less willing to lend. This would lead to a rapidly falling $US and rapidly rising interest rates in the U.S. We see this as a low probability event.

The second possibility is that the American appetite to borrow could moderate and the rest of the world could have their growth slowed by higher energy costs, reducing demand for their own savings. As we enter the 4th Quarter, this may well be the case. Japanese 3 year rates, for example have fallen from .53% to .25% in their "soft patch". The consumer sentiment Indexes for Europe as well as Japan continue to plummet. The Chinese are deliberately trying to slow their economy (although we don't know their success), and Korea and Taiwan are very sensitive to oil prices. The possibility of a synchronized slowing for world growth clouds our equity outlook in 2005.

The last under reported story is the new prescription drug benefit. The "true believers" in the Republican party genuinely believe that "deficits don't matter" as long as the debt service costs are "manageable" and the overall debt load is less than some ill defined per-cent of GDP. While this may be true in the abstract, the continuous leveraging of our financial system has long term consequences that are harsh indeed. The Democrats seem bound as ever to send us down the road to serfdom faster than the Republicans.

We would like to begin this story with a canard from the last presidential election. Following the 2000 election, the following quote, attributed to a certain Alexander Tyler, supposedly an 18th century historian, was widely distributed on the Internet. "A democracy cannot exist as a permanent form of government. It can only exist until the voters discover that they can vote themselves money from the public treasure. From that moment on the majority always votes for the candidates promising the most money from the public treasury, with the result that a democracy always collapses over loose fiscal policy followed by a dictatorship. The average age of the world's great civilizations has been two hundred years. These nations have progressed through the following sequence: from bondage to spiritual faith, from spiritual faith to great courage, from courage to liberty, from liberty to abundance, from abundance to selfishness, from selfishness to complacency, from complacency to apathy, from apathy to dependency and from dependency back to bondage."



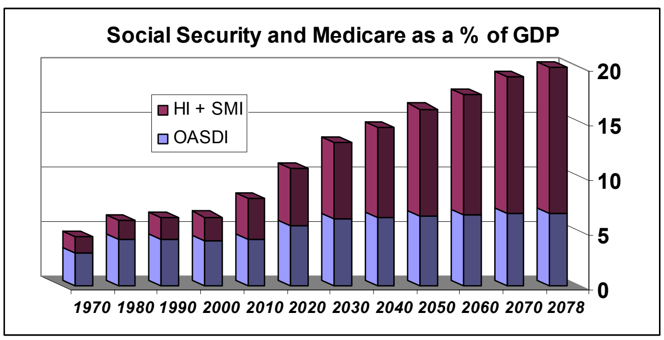

Notwithstanding the fact that no Alexander Tyler can be found (but a Scottish historian named Lord Woodhouselee, Alexander Fraser Tytler did write several books on economics and history at the turn of the 19th century), the authors of this fictitious quote certainly wished to focus on the level of dependency in America at this time, and the serious consequence that this dependency foretells.

In the 2004 report by the Social Security and Medicare Boards of Trustees, a frightening financial scenario is drawn. We have converted the numbers into percentages of the GDP because it is easier to visualize. To start with, the average "take" of the Federal Government of the GDP on a cash basis has been 10.89% over the past 50 years. We will use this as a baseline for the future, i.e. assume that it will stay constant.

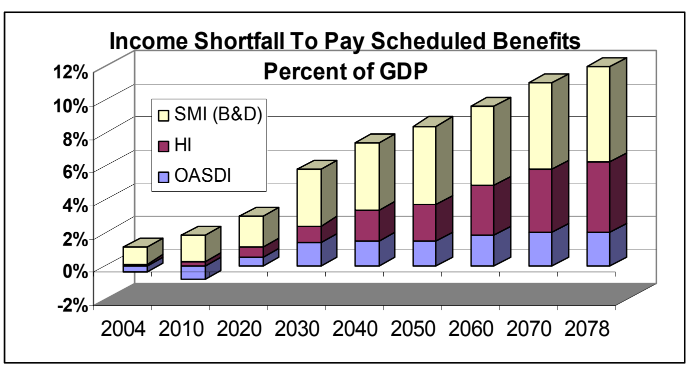
There are four Trust Funds: The Old-Age and Survivors Insurance (OASI) pays retirement and survivorship benefits. The Disability Trust Fund (DI) pays disability benefits, and combined they are referred to as OASDI. Medicare is composed of The Hospital Insurance Trust Fund (HI), which pays for inpatient and hospital care, and the Supplementary Medical Insurance Trust (SMI).

**P**art B of this fund pays for physician and outpatient services (at discounted rates), and Part D which, effective this year, pays for a new prescription drug benefit starting in 2006. The purpose of our recounting is to shed light on the financial impact of this starting in 2005.

**T**he Medicare Prescription Drug, Improvement, and Modernization Act of 2003 is the most sweeping entitlement program since the Great Society of Lyndon Johnson's years. The annual cost of Social Security benefits represents 4.3% of GDP today and will rise to 6.6% in 2078 according to the actuaries. That is the good news as this is manageable. The bad news is Medicare. It is now 2.7% of GDP and will rise to almost 14% by 2078. Adding the two entitlements together paints a somber picture. On a combined basis these transfer payments will be twice the size of the historic annual average of GDP paid in Federal taxes over the past 50 years. At today's tax rates it will consume everything!




**H**owever "compassionate" this entitlement program seemed to the Republicans in 2003, it was anything but "conservative". Obviously tax rates will rise substantially for nearly everyone.




**S**tarting in 2006 SMI Part D payments will be 75% made from general revenue and 25% from additional payroll taxes. This drain on general revenue will eventually reach crisis proportions, as the cost of Social Security is already set to grow from the present 11% of payroll to 19.3%. Within 15 years 25% of the general revenue must be transferred to support Medicare programs, and by 2040 they will consume all federal revenue at today's rates.

**Key Dates For The Trust Funds**

| | OASI | DI | HI |
|---|---|---|---|
| First Year Outgo exceeds income excluding interest | 2018 | 2008 | 2004 |
| First Year Outgo exceeds income including interest | 2029 | 2017 | 2010 |
| Year Trust Fund is exhausted | 2044 | 2029 | 2019 |

**W**ith millions of people dependent upon the government for their old age medical care, our government will aggressively and ruthlessly pursue the collection of taxes. As the corporation is the creature of government, it is the essential tax collector. Companies with very large payrolls in relation to profits will suffer disproportionate collection costs. It is hard to see this as a "pro jobs" environment.

**A**t the end of 2003, 39.4 million people were receiving OASI benefits, 7.6 million were receiving DI benefits and 41 million were covered under Medicare. As these numbers swell in the baby boomer retirement years, how far will this dependence be from bondage?

**W**ith the chilling prospect of a runaway drug benefit (SMI part D) in 2006, coupled with higher energy prices (see First Quarter 04 Commentary), what can we divine about the coming year? We expect the new Congress to pass an energy bill, and look to find ways to reduce the cost of the now promised prescription drug entitlement.

October 1, 2004


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