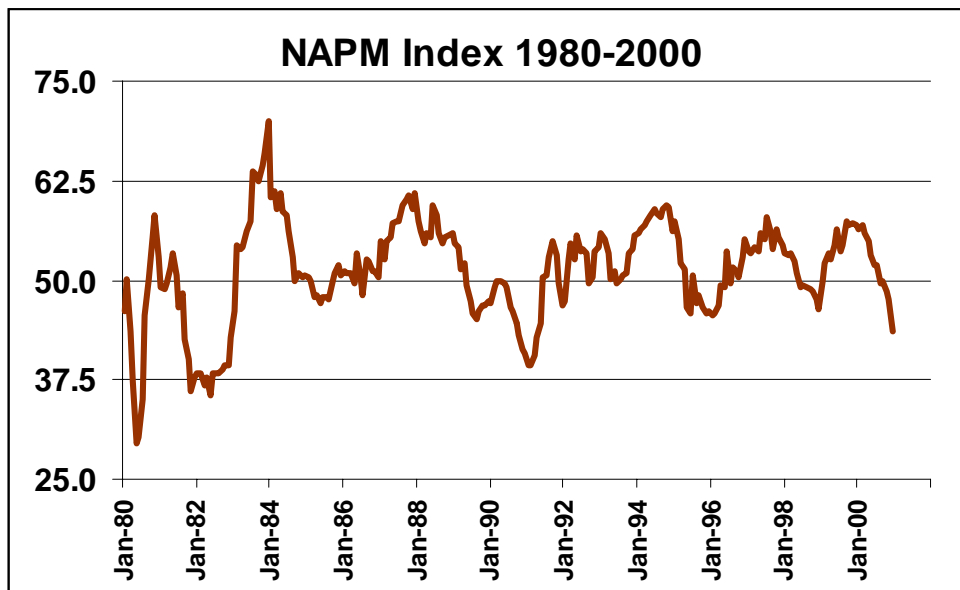




Cascade Investment Commentary

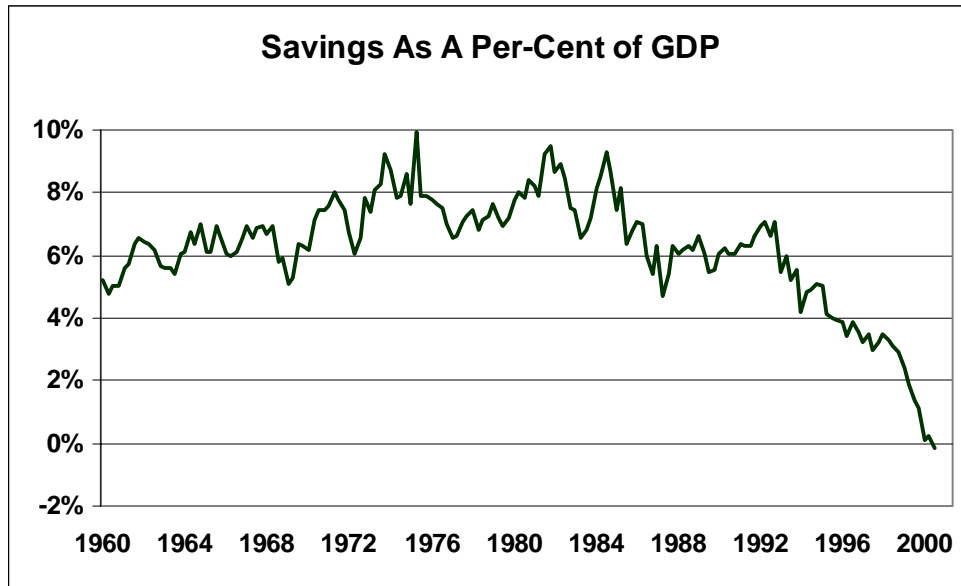
The final quarter of 2000 was dominated by the political struggle to set the national agenda. The markets faced the turbulent process of determining the change in national policies, and discounting their probable financial impact. We doubt that the social agenda of the new administration will have any economic consequence, but the financial agenda surely will. Bush II should be friendlier to business as a whole, and we believe to the “old economy” in particular.

Probably the most accurate leading index of the most sensitive part of our economy is the survey of the National Association of Purchasing Managers. 300 manufacturers are surveyed monthly on their forward view of new orders, production, supplier deliveries, inventories and employment. These indices are then aggregated into a composite index, and released near the end of each month. We believe that the events of the end of December (lowered earnings expectations, market sell-off, etc.) and of the entire first quarter (Fed lowering interest rates, Congress cutting taxes, etc.) are and will be related to the markets perception of the NAPM, employment rates and the other indices that measure similar data.



As can clearly be seen, business conditions deteriorated rapidly in the 4th quarter, falling from a strong reading of 57.1 in December 1999 to a reading of 43.7 in December 2000. The low point reading of the 1990-1991 recession was 39.2 in January 1991. It is primarily this series that is cited by many who believe the recession has already started.

We believe that this rapid deterioration was inevitable, and was the cause of the Federal Reserve action taken the first week of January 2001. Why was this deterioration inevitable? We have mentioned it before, and it bears repeating: The American spending and savings habits are simply at unsustainable levels, and must change.



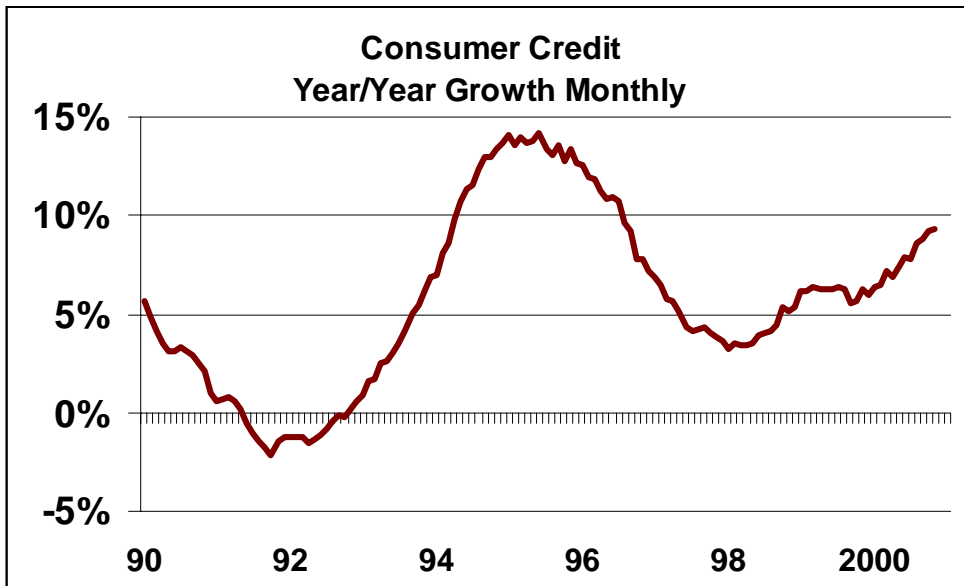
The chart above is not a pretty picture. While the clients of Cascade Investment Counsel may be saving money in their 401(k) plans, in aggregate, the country is not. Corporations should have been saving during this incredible business cycle, but in aggregate, they are not either. Only the government sector has been saving (through federal and state surpluses). The difference between what we now save and what we now need to save to keep the wheels of industry moving (depreciation, depletion, research and innovation) is being made up entirely by the importation of foreign savings.

Increasingly foreigners are purchasing stocks and entire businesses rather than their historical purchase of U.S. Treasury securities. While we still have a lot of businesses to sell, this trend cannot last forever. While the Fed may aggressively lower interest rates in the near future (itself a disincentive to save), this will work only with a time lag to stimulate growth. That time lag may be getting longer as the Fed has little control over the foreigners who are doing the lending. How quickly American households build back their savings will determine whether we will have a “soft” or “hard” landing. If the savings pool is replenished slowly over the course of several years, we will not overly suffer.

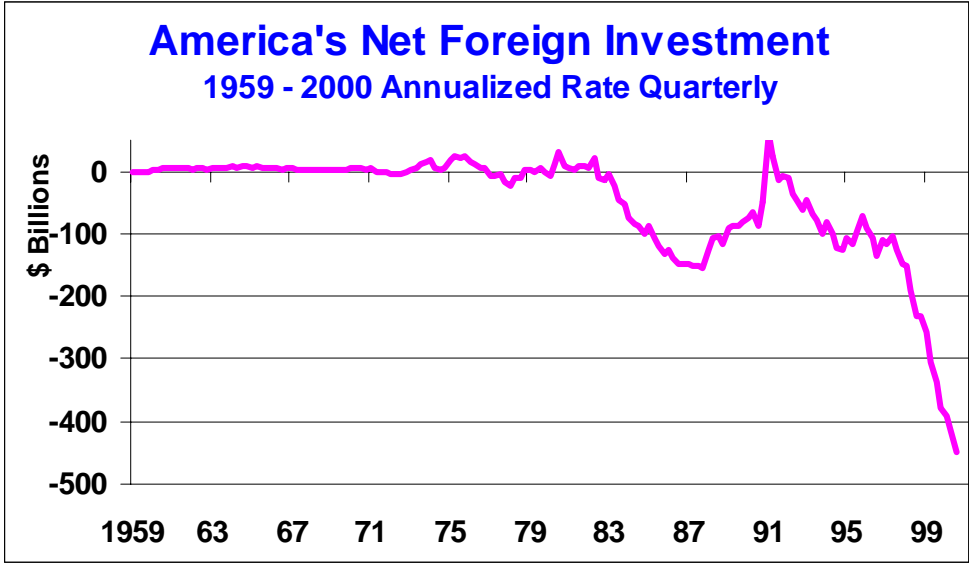
This lack of willingness to save on the part of Americans is often attributed to the stock markets “wealth effect”, but we see other forces at work also. In the past decade, we have become the consumers of first resort for much of the world’s goods, and advertising plus easy financing terms have force fed us like a Christmas goose. To put the decade in perspective we show the 4 quarter rate of change in real (after inflation) disposable personal income and the 4 quarter rate of change for real personal consumption. The two were reasonably correlated until mid 1998 when spending grew despite several quarters of falling income growth. Since consumer spending is 70% of our Domestic National Product, any change in patterns has large ripples worldwide. . Should the consumer abruptly stop spending, there will be more than a profits recession.



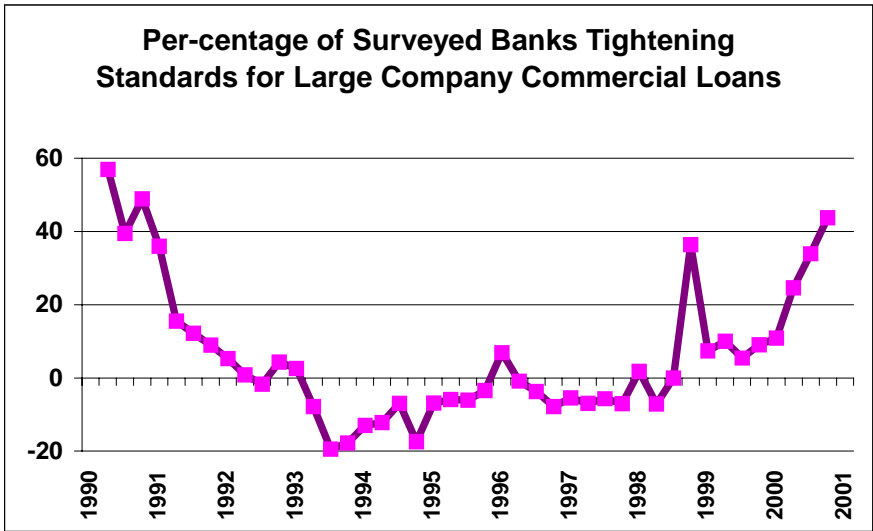
Proof that consumers are yet to change their lifestyles to reflect economic reality is the continued rise of household debt to finance purchases. In the last recession, there was not only slowdown, but also a net pay down of household debt.



At the end of the decade the U.S. GDP accounted for almost 30% of world output up from 26% at the beginning. U.S. companies now make up almost half of all world corporate profits, a 33% increase from 1990. The entire world follows our stock market and our spending habits. As our stock markets become more rational, the deficit between consumer spending and earnings will be highlighted. That gap has been recently made up through our balance of payments deficit, as foreign manufacturers finance our consumption, and investors worldwide send money to Wall Street to buy shares. To keep the party going, America imported over \$1 billion each day last year. After a while it builds up. That total is approaching \$500 billion.



Simple economics indicates that if there is less of something relative to demand, the price will change. Prices at the margin always change first. In the 4th Quarter the price of borrowing by lesser credits went up considerably. While the headlines focused on the decline in U.S. Treasury interest rates and the Federal Budget surplus, from an economic standpoint the price that the U.S. Treasury pays now to borrow is of less consequence because it is paying down loans not accumulating new ones. Small business, the telecoms and the manufacturing sectors all saw a different picture.

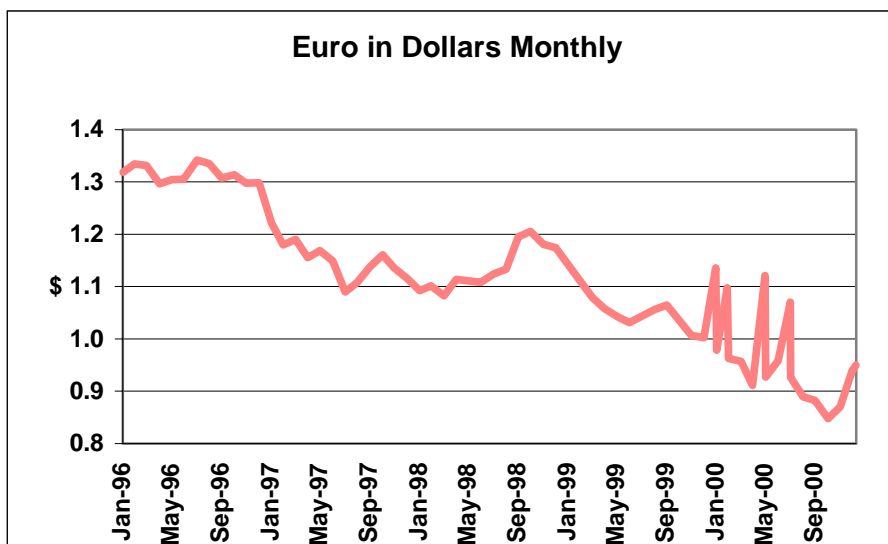


Notwithstanding online information and bill paying over the Internet, banks and bankers have not changed much in the past 500 years. They are still basically ruled by greed and fear. They still have the habit of loaning money at the highest price they can get until they get scared and refuse to loan money at any price.

The Federal Reserve surveys a group of lending officers at major banks monthly to determine whether their lending standards are loosening or tightening. As can be seen by the chart above, during the 4th quarter they became scared.

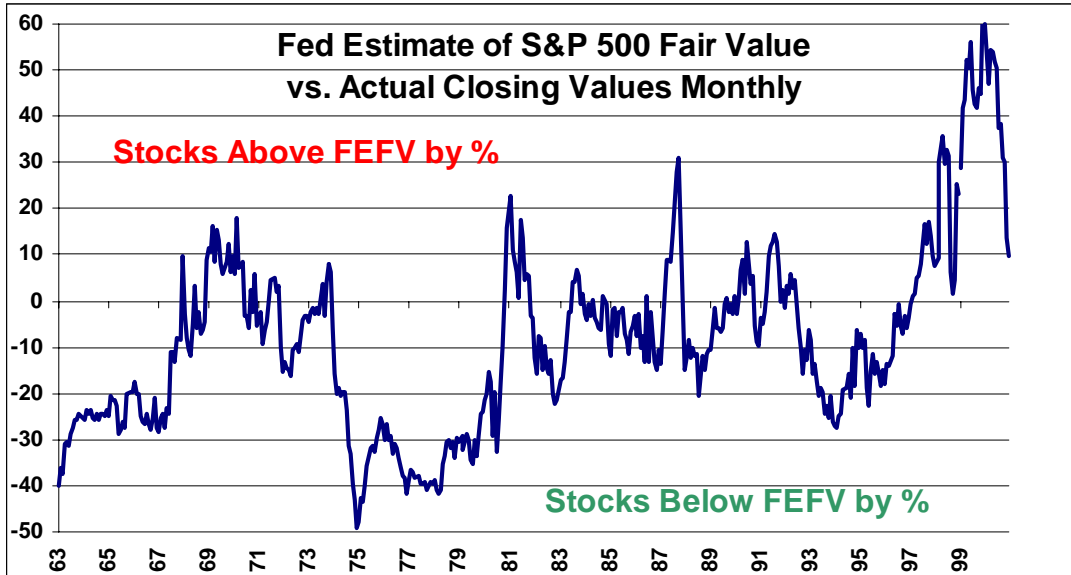
In only two quarters of the 1990 recession were lending standards tighter than now (the series only dates from June 1990). In the old economy this was known as a credit squeeze. While the recent 50 basis point move by the Fed to add some liquidity to the system will definitely help, it is hard not to vision that a “soft landing” by the economy will not bring a “hard landing” to many corporate bottom lines. At this writing, the forward markets anticipate further Fed easing.

Our concern is that the Fed faces a major dilemma. Having convinced the world that it stands for stable and virtually inflation free money, it faces a credibility problem should it inject too much into the system to compensate for bankers’ flight to quality. The Fed can print money but it cannot create personal savings. Creating money for its own sake is the purest form of inflation. The other horn of the dilemma is the very large swing in the Euro caused by European and Asian investors chasing the American technology bubble.



We believe that the surest short term measure of how the world savers view sending more of their own saved productivity to the U.S. is the value of the currency in forthcoming months. Should the dollar decline significantly against the euro because our interest rates have declined below the competitive world rate, the nation will probably have to face a cycle of slowing sales, slowing profits, and rising real interest rates. Being forced to raise real interest rates to fight inflation during an economic slowdown is the worst nightmare of the Fed and the equity markets.

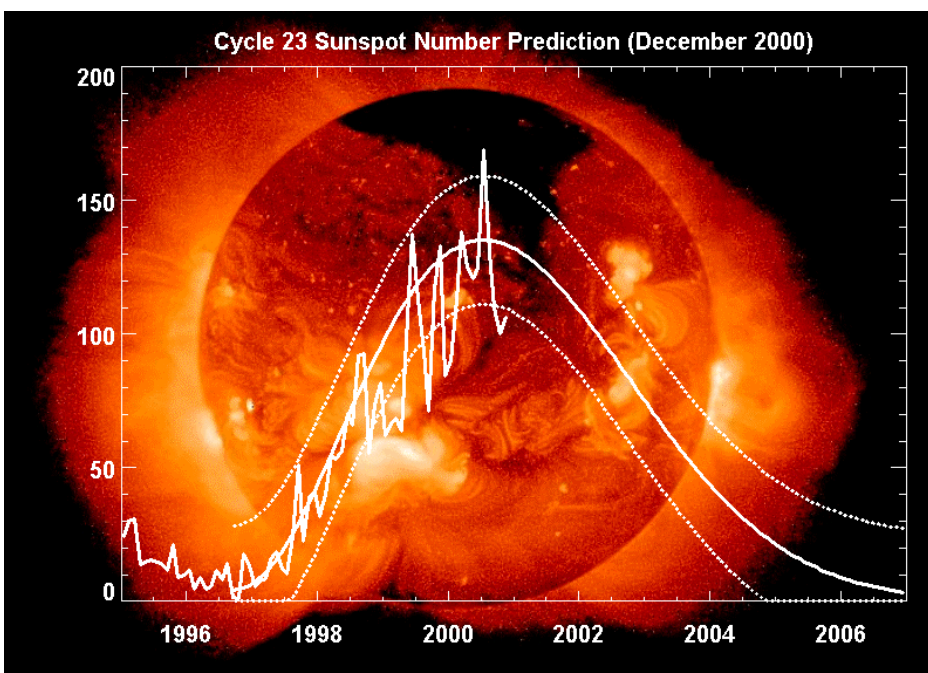
The considerable decline in the popular averages would seem to already discounted most of this, and the talking heads on business programs are pleading for an end to the bear market. With the major decline in the yield of the 10-year Treasury note we now visit the Federal Reserve Board’s model of fair value for the S&P 500. It is based upon the forward earnings of the index, multiplied by the reciprocal of the 10-year note.



We would like to remind readers that reaction to the mean is a concept rarely seen in pure form. Markets are not efficient in our view, and have a well documented history of pushing extremes. While we believe that we could see a considerable bounce in the early part of the year, stocks are a long way from undervalued.

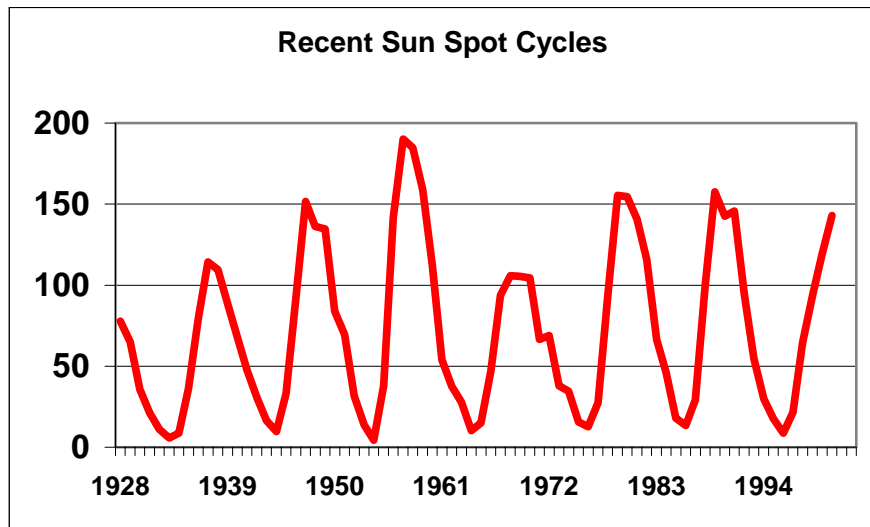
We cannot leave the year behind without mentioning the most obvious story. Gretchen Morgenson writing in the December 31st New York Times rhetorically asked about Wall Street analysts covering the dot.com companies “How can so many (analysts) who are paid so much to scrutinize companies have blown it so spectacularly for their investor customers?”

We offer not entirely in jest, the following explanation:



Yes, sunspots. At this writing the Sunspot Index Data Center (<http://sidc.oma.be/index.php3>) reports 104 active sunspots, down from 170 in July (which is a very high number). This sunspot cycle has certainly influenced the weather as all of Cascade's clients (heavily laden with natural gas stocks) can attest.

In the 1950's a sunspot theory became popular which postulated that people got a little crazy at cycle peaks (every 11.2 years). Recent cycles are shown below, and one can certainly find some interesting points: The century's big mania in the late 1920's was all about technology, especially radio.



Right after WWII there was an aviation stock boom, which later crashed in 1949. In 1960-61 it was bowling and transistor radios. In 1967-68 it was "the great garbage market" of stocks ending in "onics", and of course the famous "Nifty Fifty". This was followed by the first biotechnology stock mania, and then in 1989 by the Great Japanese Bubble. It is probably only an interesting coincidence, but the Cycle 23 Prediction at the top of the page sure looks like the NASDAQ 100.

January 8, 2001