

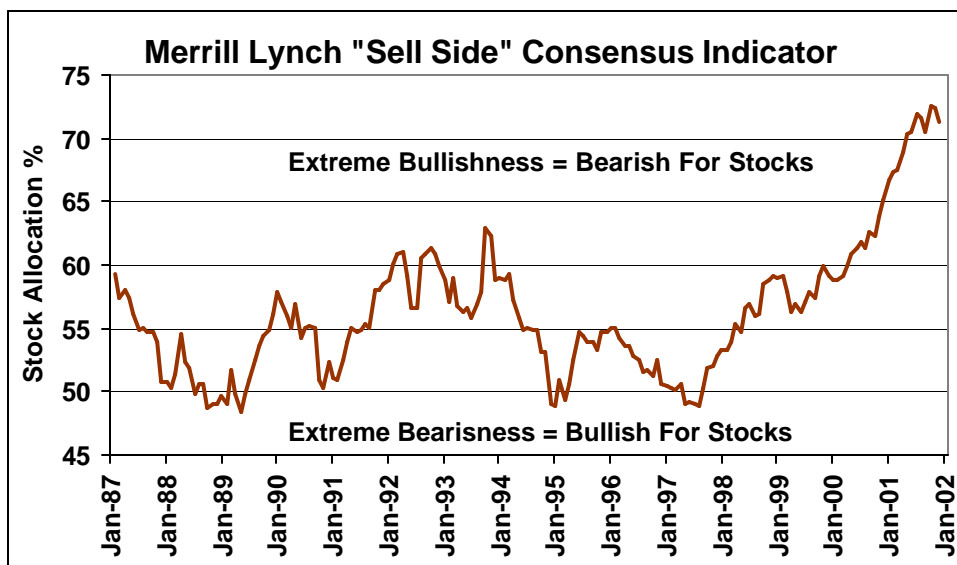


# Cascade Investment Commentary

**We have closed the books on 2001, and even before September 11, it was not a very pretty year. The Dow Jones Industrial Index and the S&P 500 both declined for a second year in a row, corporate earnings recovery was getting pushed farther into the future, the fiscal condition of most states was bad and moved to dire, and Congress has already decamped for the upcoming war in November.**

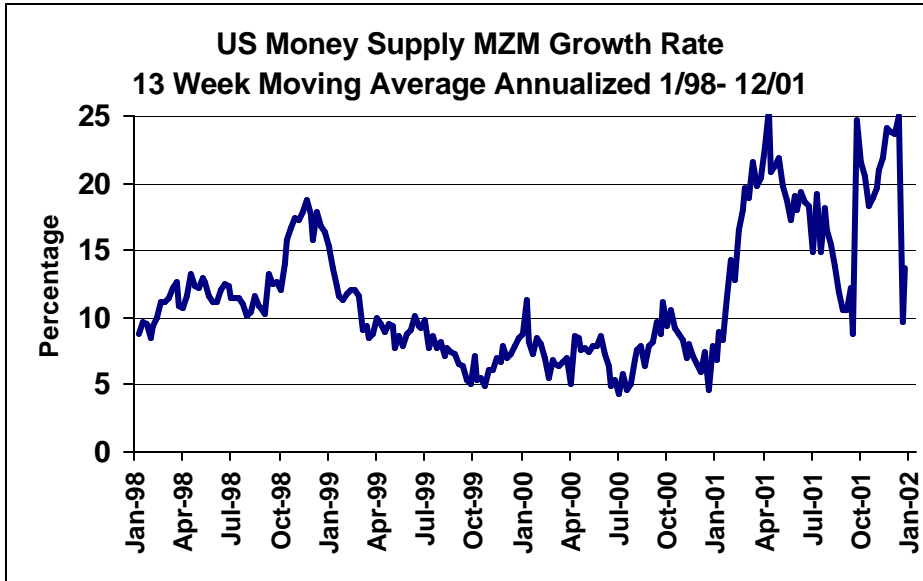
Yet as we start the New Year, everyone on Wall Street seems bullish. So bullish in fact, that the average Wall Street firm is recommending that over 70% of a "balanced" fund's assets be invested in equities. Rich Bernstein at Merrill Lynch, has built a "Sell Side" Consensus Indicator that he says is Merrill's best contra indicator of future market direction.

Over the past 15 years the average recommendation was 55% equities, 45% fixed income. Rich's research leads them to issue a "sell signal" when the indicator is above 60.3% and a "buy signal" at or below 50%.



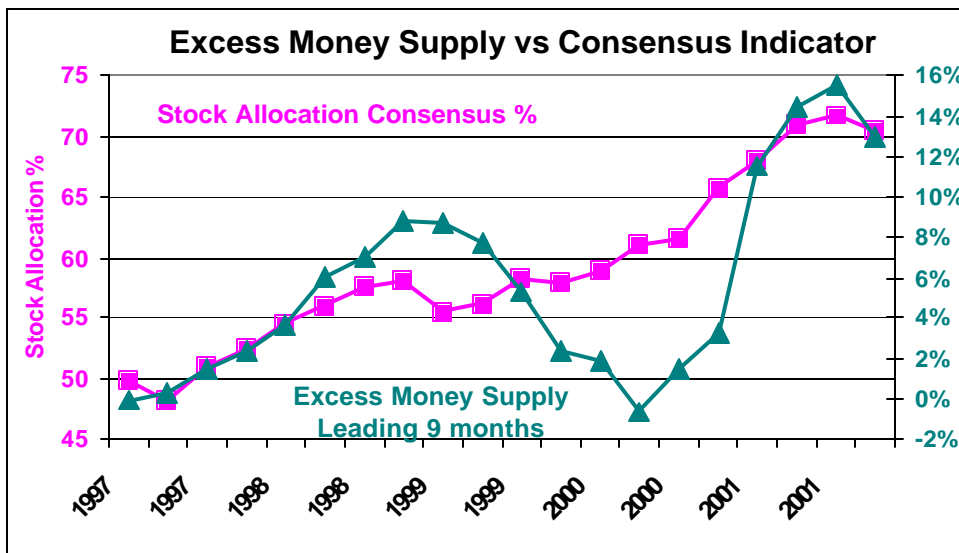
We are mystified by the willingness of the public to continue to acquire more risk in their portfolios, and by the wild bullishness of the investment professional community. This is probably driven by a number of factors.

Firstly, there is the money supply, with which one purchases securities: Stocks, bonds commodities and real estate. During 2001 the Federal Reserve Bank flooded the system with money and made one heck of a lot of those purchases possible. It took eleven rate cuts to keep up with the demand for Treasury issues. The Fed actually followed interest rates down as the overnight rates were below the fixed rate almost all year.



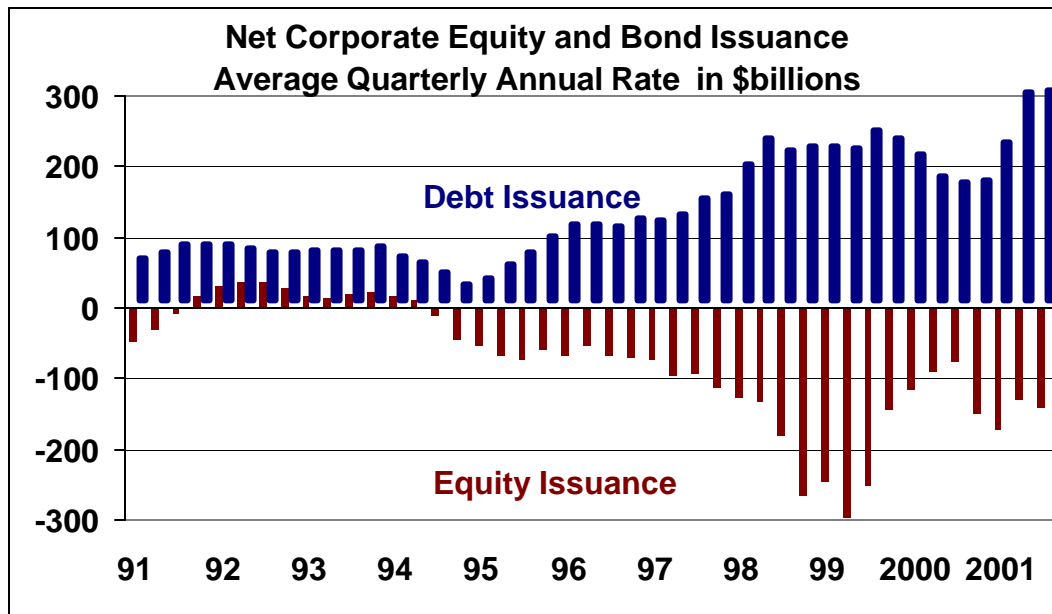
The system was flooded with much more liquidity than a slowing U.S. economy needed, or the slowing economy of the rest of the world needed, or even Argentine bank depositors needed. In response to the marked down cost of borrowing, households by the thousands refinanced and re-liquefied their balance sheets. Corporations issued a record amount of debt to cover the shortfall of cash that resulted from the collapse in 2001 profits (see below).

We have mentioned before that when money is created faster than is needed by domestic growth needs or foreign demand a condition of “excess liquidity” results. We have pointed out that that is a good indicator of very short-term future common stock prices. We are now postulating that sustained conditions of excess liquidity may very well influence the long-term outlook of investment professionals. Why else would thoughtful analysts who have counseled balanced portfolios to be between roughly 50% and 60% common stocks go in almost a straight line from extremely bearish to all time bullish?



Following our suspicion that that these two data series are somehow linked, we took the excess money supply growth, gave it a 9-month lead-time and plotted it against the Merrill Consensus Indicator just to see. As brokerage firms cannot get much more bullish, we wonder if the S&P 500 has a third poor or negative year in a row, will they learn to love bonds more?

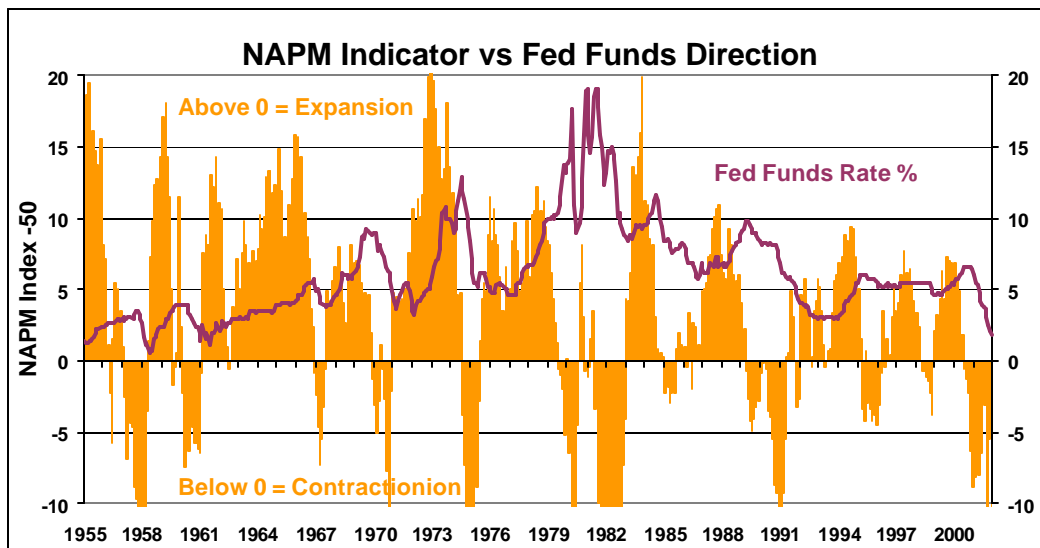
Secondly, it is possible that the analysts have an aversion to bonds more than they love stocks at these prices, or are they simply being influenced by the behavior of their largest investment banking clients, the Fortune 1000 firms that continue to issue bonds and retire stock.



Thirdly, in its December release, the National Association of Purchasing Managers Index, NAPM (now known as ISM) showed a slight up tick in manufacturing activity, and a draw down on business inventories. This suggests that the cycle low in the manufacturing sector is probably behind us. Trend watchers and momentum players have eagerly embraced this as a chance to purchase stocks. The economic cycle low appears to be September, and some earnings recovery should ensue.

Fourthly, everyone has bet on the consumer. Paul Volker, in a recent interview, acknowledged that the consumer was buoyed in 2001 by tax cuts, lower interest rates, lower gas prices, lower interest rates, mortgage refinancings, and recent stock market recovery, added that economists “shouldn’t underestimate the short-term ability of the American consumer to spend all of his income”.

The final element is optimism over future short-term interest rates. Below we offer a complicated graphic that tries to tell the story of how the trend of Federal Funds rates relates to the NAPM headline number. A NAPM reading of 50 or higher denotes industrial expansion and a reading below 50, contraction. On our chart we have displayed in gold the monthly NAPM value *minus* 50 so that the zero line separates expansion from contraction. Thus on the scale, a reading of 5 is modest expansion. We have used this device to display the Federal Funds rate.



With the exception of the extraordinary period of the 1979-80 inflation, it would appear that when the NAPM Index rises above 55 there is an almost certain reaction by the Fed to raise interest rates. Likewise, when the index drops below 50 the *trend* of Fed funds declines.

Thus we speculate that the Fed will probably not raise interest rates until after the NAPM reaches 55. The logical question to ask then is how soon this is likely to happen. Those who counsel an unprecedented equity exposure must surely think it is coming soon. As the longer-term readers of our Commentary are likely to suspect, we are less sanguine.

While we share the widely held view that the economy will improve in 2002, we believe that there is less good news than meets the eye in corporate profits, and many large firms will find that 2002 brings them a "profitless prosperity".

Our principle concern is unemployment. Unemployed people tend to not spend frivolously to begin with, and so far in this economic cycle the majority of the unemployment pain has been suffered in the telecom and high tech industries. The workers at the lowest end of wages have not been severely affected so far. For many who are not unemployed, 2002 will start off with non-bonuses. This means that the actual income of many households will decline in 2002.

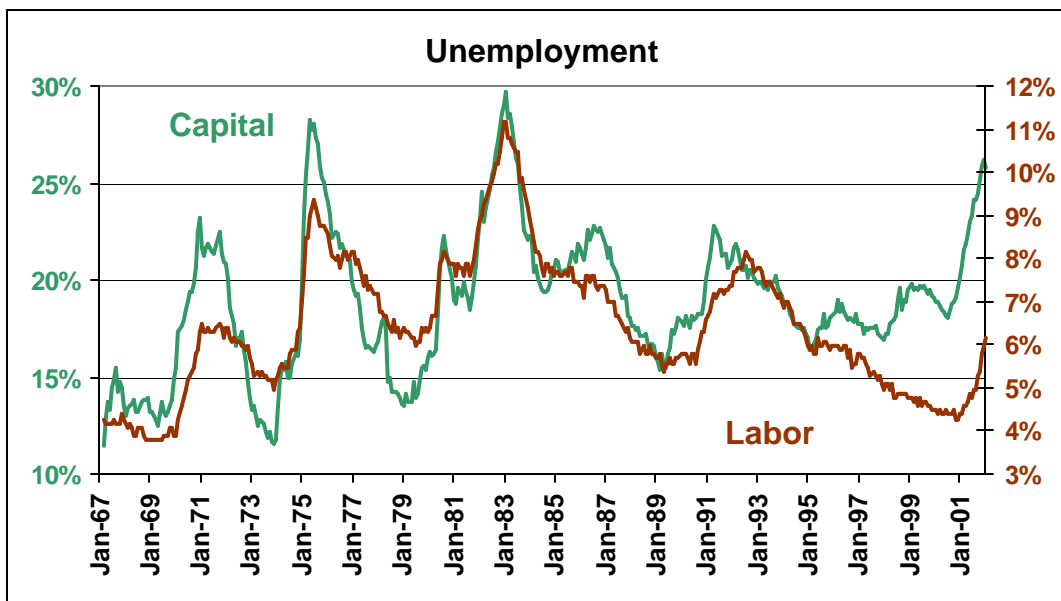
We remind readers that the old economy peaked in 1998 and the new economy literally fell apart in December 2000 as the Fortune 1000 companies stopped their purchase of high tech machinery almost simultaneously. It will take a powerful rebound to induce capital expenditures, and there is no clear evidence of this yet.

There is also pain in the non-manufacturing area. The employees in service jobs have compensation that is rising faster than inflation, although the rates have been decelerating somewhat. Some year/year examples ending 3<sup>rd</sup> quarter:

Private Compensation	3.9
White Collar	4.0
Blue Collar	3.8
Goods - Producing Industry Workers	3.4
Service - Producing Industry Workers	4.2
Benefit Costs – Civilian Workers	5.0
Benefit Costs – Private Industry	4.9
Goods - Producing Industry Workers	3.3
Service - Producing Industry Workers	5.8

The year/year change in the All Urban Consumer Price Index ending September 30 was 2.6%. This is a major squeeze on corporate profits that will not improve in 2002.

The other unemployment rate is capital. To the extent that plant and equipment is idle, it too is unemployed. If we take 100 minus the capital utilization rate, we can compare unemployed capital with unemployed labor. Since the beginning of 2001, the unemployed capital rate has jumped over 4%, leaving intense price pressure on manufactured goods. Worldwide over-capacity in autos, aluminum, steel, and literally all basic commodities will require much attention before returning to profitability.

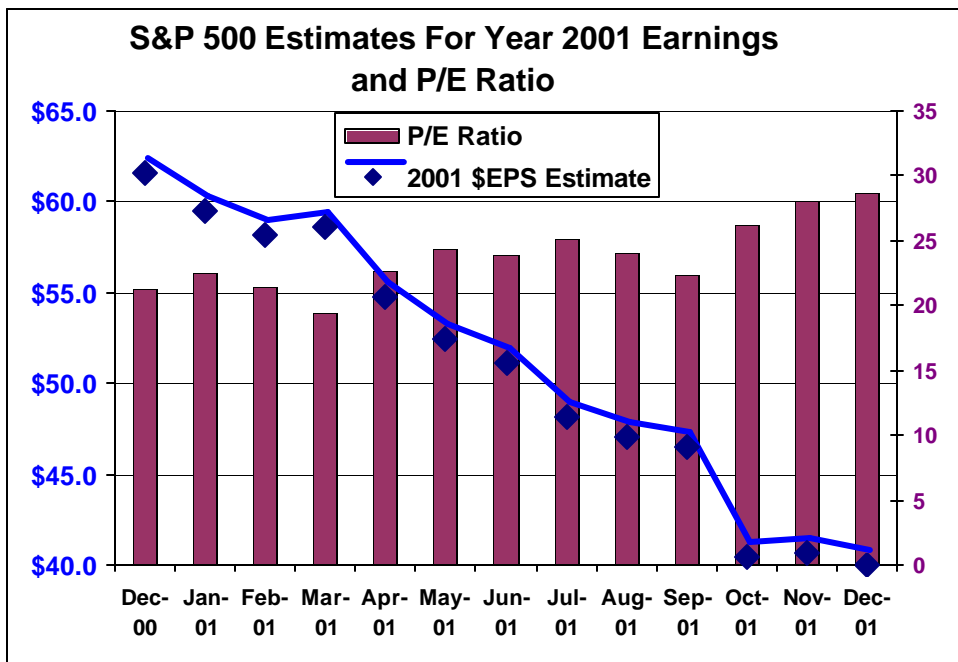


We now see a very wide spread in the two unemployment rates, and while this is good for consumer prices of durable goods and petroleum, it does not bode well for the very strong rebound expected by the super bullish case on Wall Street.

One of our current concerns is that there are now a variety of ways to calculate earnings, leading to a wide range of estimates. In December Bloomberg news reported that the S&P 500 was selling on a trailing P/E of 46, and at the same time Datastream said 31, First Call 23 and Standard & Poor's 28. By implication, First Call was projecting earnings growth of 12.4% while Standard & Poor's was predicting 34%, all from the same guidance from corporations. How can that be?

The root cause is that there is no commonly agreed upon methodology for reporting forecast earnings. The new 2002 rules of goodwill accounting do not help. It simply makes the corporate earnings comparisons over last year look better. If this was not confusing enough, companies are increasingly moving the goal posts, moving away from Generally Accepted Accounting Practice (GAAP) based estimates to varying measures of operational earnings. This means that a 2002 forecast may differ significantly from a forecast given several years ago.

Thoughtful analysts have been therefore taking their knife to earnings projections all year. The results can be seen below. We would note that in December 1997 year forward estimates were for earnings of \$51.80, December 1998 \$47.01, December 1999 \$58.27 and now December 2001 estimates for 2002 earnings are starting at \$53.59. If this repeats itself again for the fourth year in a row, the S&P 500 would appear to be historically expensive.



We must express a concern about Enron and the new culture of corporate earnings reporting. We have mentioned before our distaste for the new economy (Yahoo!) style that reports “pro-forma” results (i.e. remove all of the special losses that seem to reoccur each quarter). These “pro forma” may show a profit, but often the 10Q and 10K filings with the federal authorities show actual losses.

In 1973 Equity Funding, an insurance company based in Century City California, admitted to a fraud almost the size (in relative terms) as Enron. It was a computer-based fraud, hidden easily from their auditors. Computers were new to corporate culture, and because auditors were abandoning the long rolls of adding machine tape, investors became frightened that almost anyone could hide misdeeds in the invisible markings on computer tapes. This fear cast a long pall on the entire market for more than a year as investors’ lost confidence in honest reporting just as the country faced the recession at the end of the Vietnam War.

Arthur Anderson has now given the market much to be afraid of. We have been trapped by management’s untruthful words more than once, but the auditors are the bulwarks of shareholder’s confidence. In retaliation for their perfidy, we will seek to know if Anderson has a consulting contract with management before we ever vote to retain them as auditor. If they are acting as both, we will vote no.

To finish on an up beat note, we believe that there will be great opportunity in the coming year. Companies that have investor’s confidence of honest disclosure will command a premium price. Companies with “free cash flow” (the profit before dividends and non-essential capital expenditures) that are able to raise dividends, buy distressed assets or retire company shares will become highly regarded. As this Commentary is being written, the pieces of Enron are being sold on the cheap to such companies. Industries that have not invested in over-capacity, industries with modestly rising personnel costs, and industries that are consolidating to bring price discipline will all reward patient investors.

The aftermath of September 11 will be felt long after the Taliban is gone, and in our opinion America’s foreign policy will ultimately change towards all regimes that are not democratic. This will ultimately affect the geo-politics of the entire Persian Gulf region. Whether these countries can join the world’s brotherhood of democracies without bloodshed is not yet knowable. However, we continue to believe that the most under priced assets are those hydrocarbon assets located in the safety of North America.

Jeff Cutler

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