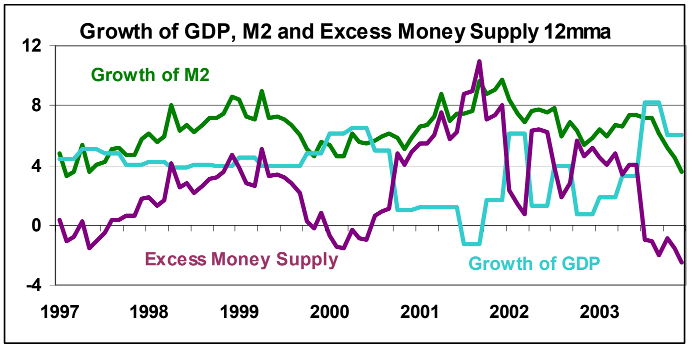
Cascade Investment Commentary

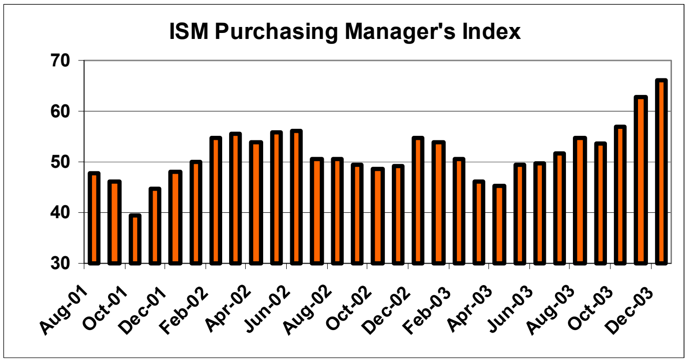
In the 4th Quarter, the success of the Federal Reserve's policy of injecting mass liquidity into the credit markets became abundantly clear. Stocks rallied, the $US fell and GDP quickened all over the world. The economic recovery will give rise to two critical issues in the year to come: First, the need for an intelligent energy policy in the US; second, a rational policy towards China's role in our growing trade/debt load.

Money has energy. It is not the same as electricity or gasoline, but when money is spent it stimulates actions and reactions. With massive stimuli in the form of tax and interest rate cuts in 2003, America has been robustly energized.



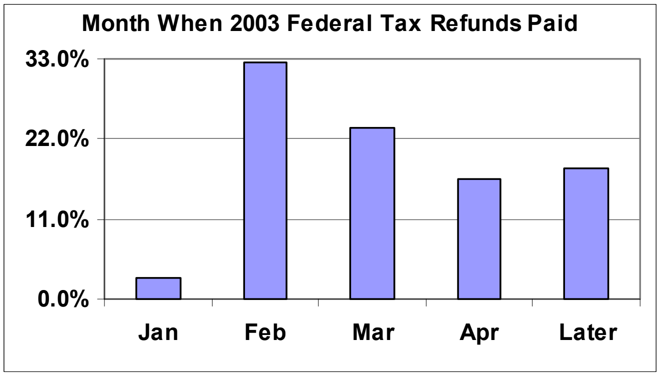
In the above chart observe that the money supply M2 (green line) grew from a 4% annual rate in 1997 to over 8% in 1999 in response to the Asian meltdown of 1997. Excess money i.e. growth of GDP minus growth of M2 (purple line) peaked with the top of the "old economy" stocks, and declined until the recession started in January 2001. The Fed then started a policy of easy money which brought excess money supply to a growth rate of over 10% in mid 2001. It has been this excess that has fueled a major turn in stock and bond prices. In the last 90 days of 2003, M2 and excess money are both shrinking as the economy booms (we are guessing a 6% growth in GDP for the 4th Quarter). With excess money now shrinking, the price of borrowing should rise in the next several months as the Fed takes its foot ever so slightly off the monetary pedal.

The full extent of the recovery can be seen in the Institute for Supply Management (ISM) data. The ISM Purchasing Managers Index is widely followed because of its accuracy (above 50 is expansion, below is contraction)



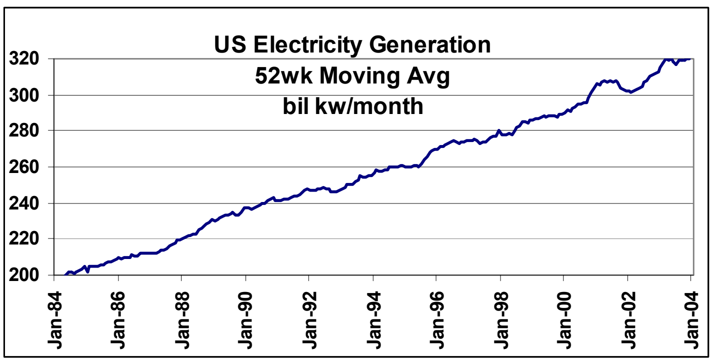
This shows that the economy has picked up steam since July. The last time this number was above 60 was 1987. The ISM Employment Index rose to 51 in November and 55.5 in December after remaining below 50 for 38 consecutive months. This recovery has "legs".

Tax cuts have had a big role. In 2003, $190 billion was returned to households in the form of lower withholding from paychecks. In 2004 it will be even larger, as households will receive refunds from the first six months of withholding from 2003 plus the new lower rates. This money will probably infuse itself into the economy through a familiar pattern. This will temporarily offset the effect of slowing mortgage re-financings, but after the end of 2004 there will be no more fiscal stimulus for households for a long, long time.



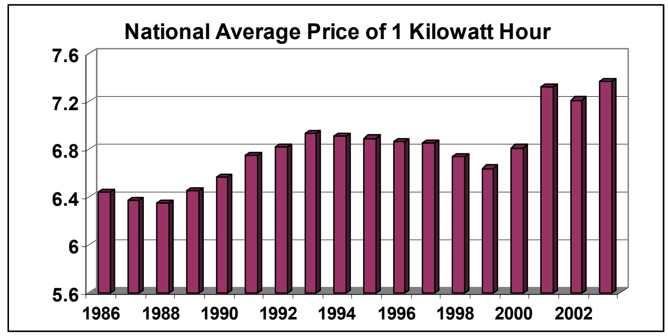
The hope in Washington is, of course, that this stimulus will carry a happy electorate all the way to the November election; and it is our opinion that it will. While we are concerned about the hangover from this orgy, that awaits the arrival of 2005, a long time from now.

We have argued for more than two years that when the worldwide recovery really gets going, there will be greater problems than just rising interest rates. The greatest problem is insufficient infrastructure in industries with political difficulties or where the internal returns have been too low to afford spare capacity. The poster child for this issue is the electric industry.

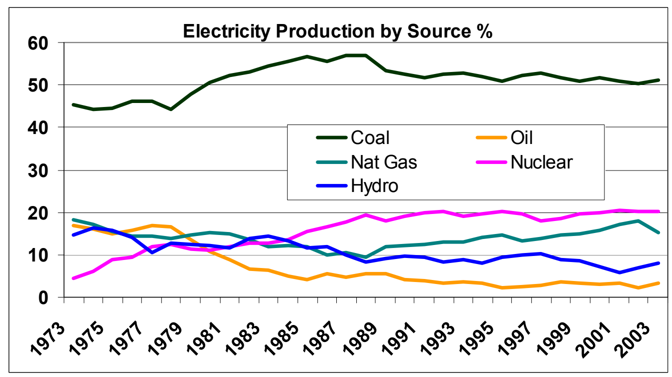


The 9/11 impact on our economy coupled with the mild winter of 2001 brought the only significant decline in electricity demand since 1982. We are much more heat efficient than before the OPEC oil embargo, and the electricity demand per unit of GDP is way down (as industrial jobs move out of the US), but electricity is still a growth business. It is a business with some deeper problems than the California experience exposed. The US lacks adequate transmission infrastructure, and an adequate return on new investments.

Without political resolution to the issue of equal access to public (hydro) power rates we can expect continued fighting between states with cheap power (Idaho, Oregon, Washington and Tennessee) and states with expensive power (New York, Illinois and California). The FERC cannot order utilities into money losing investments. Without a comprehensive nationwide energy policy we expect more blackouts in upcoming summers.



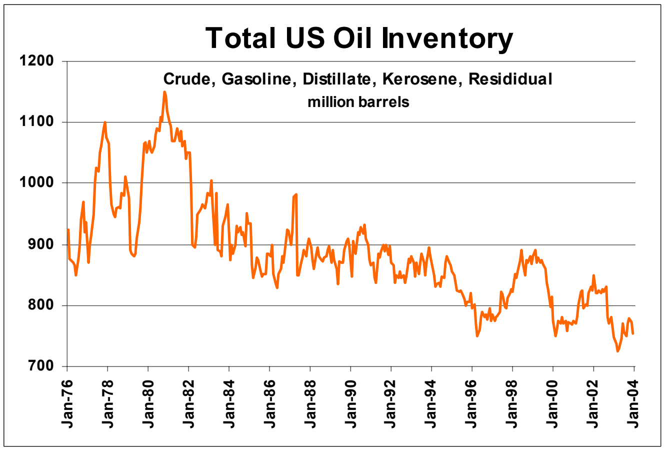
Very long term contracts for both coal and nuclear fuel have held down electric production costs in the Mid-West and East. These conditions will continue because coal supply will easily meet demand for hundreds of years.



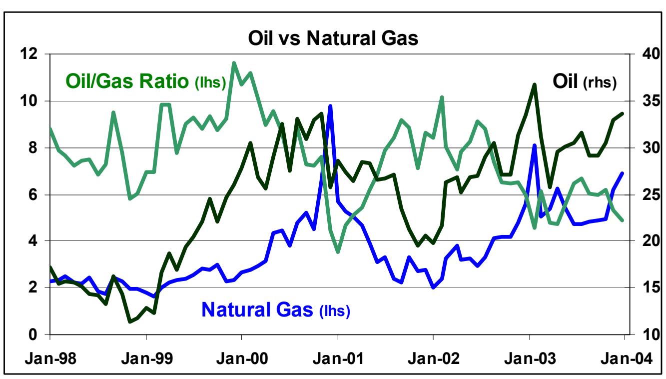
But coal which carries 50% of the base load of the US electric supply will not be a source of future growth without some spectacular new and as yet unknown emission technologies. It is remotely possible that a nuclear permit will be issued someday, but not in time for a cold winter in 2004 or even 2010. Hydro electric is weather dependent and no more major dams are planned.

Oil has its own new problems beginning this month. Gasoline must now contain less sulfur, and most refining processes only move sulfur from one product to another. As we consume more gasoline, the product absorbing sulfur has been diesel.

In January 2006, however, ultra low sulfur diesel is mandated, and many refiners have yet to commit to the capital cost of producing this fuel, especially non-US producers. As a result we expect shortages of gasoline in the next two years, perhaps as early as this summer.

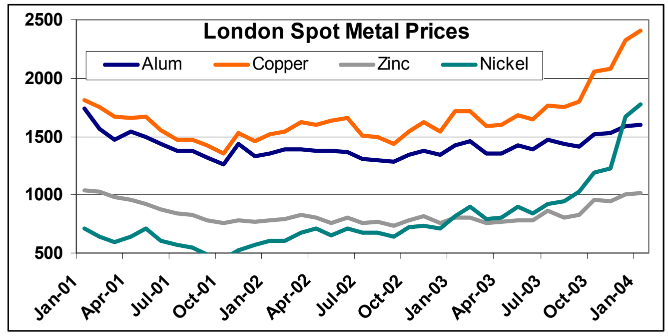


*T*he total inventory of oil and it's distillates above ground continues to shrink. Part of this downtrend is due to energy efficiencies, part due to the lessening of industrial demand (loss of manufacturing jobs) and part due to the consolidation of small retail gas stations into fewer but bigger outlets. At some point, however we must face the infrastructure problem: No new refineries have been built in over 25 years, and none are even planned. The industry is running a full capacity, and while in the past we could rely on Dutch or Caribbean gasoline to fill in during tight supplies, after the new rules this year it will be increasingly difficult. Rising GDP brings a rising energy demand. Most of the pressure is coming to bear on natural gas.

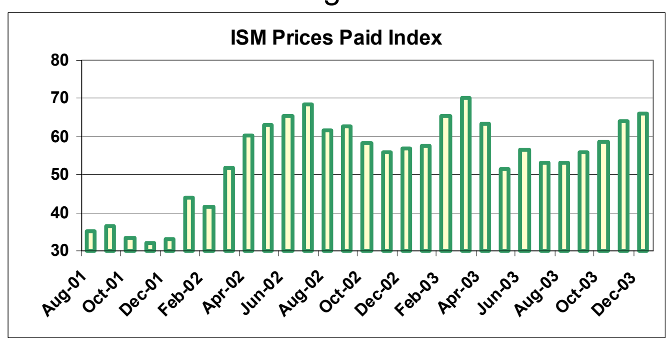


*A*s the chart illustrates, the oil/gas ratio (left hand scale) was between 8 and 10 times more valuable than gas (for decades) until 2000. As we approach the crunch of the heating season that ratio has fallen to 4.9. The winter has been mild so far, but a cold spell could bring gas prices to levels high enough to even capture the attention of Congress.

*W*ith its many comparative labor advantages, China has become not only a great exporter to the US, but also a great importer of raw materials. Metals are a prime example.



*A*s the American economy recovers and our imports rise, China is bidding up the cost of the materials to manufacture their exports with. That bidding is increasing the cost of our domestic manufacturing. This adds to inflation.



*C*hina has become an $80 billion/year player in the greatest vendor-financed-purchase scheme in history. The world lends us money, and we use it to buy their goods. We need a total debt management policy before the world looses its confidence in the $US. The Fed reported that foreigners bought $40 bn of US debt in October, for a total of $690 bn in 12 months. The current account deficit is at the rate of $542 bn. This is a large stakes game. We need a rational policy towards our debt before the scheme starts to unravel. The crisis in Asia in 1997 was a result of insufficient funds coming into countries with high internal debt and external trade deficits. A substantially lower $US and higher interest rates will be our first clues.

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