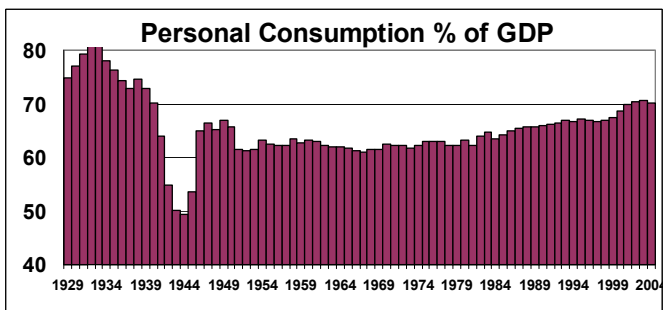




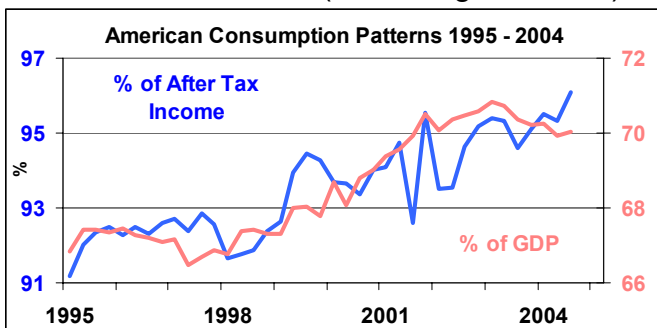
# Cascade Investment Commentary

**As we view the coming year, we find three principal reasons not to expect robust portfolio returns: Consumption has reached a point where we believe it will no longer grow faster than wages. Second, fiscal and monetary policy has been stretched to its outer limit of helping households. Last, corporate earnings are at the apex of GDP share and we now see job growth as the key to corporate profits.**

It is very hard to perceive the changing of long term trends (and often foolish to try), yet we at Cascade Investment Counsel have a strong belief that the U.S. is facing a change in some long term, very entrenched behavior patterns, and failure to adjust to those changes will be excruciating for many.



It would seem nearly impossible not to see the consumption bubble in the U.S. From WWII to 1997, consumption ran between 60% and 66% of GDP except for recession years when it was slightly higher. Personal savings ranged between 6% and 12%, and the balance went to government. After 1998 spending took off to historic levels, and was financed through the current account deficit (borrowing overseas).

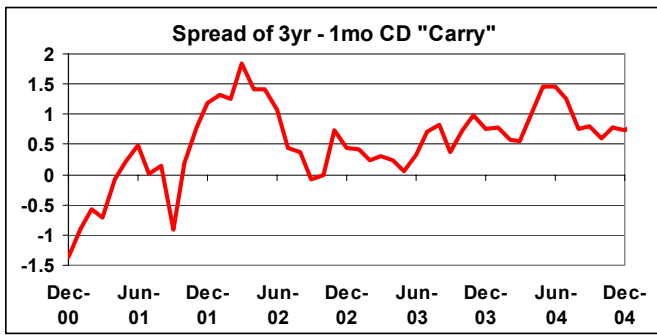


In particular, post 9/11 consumers have been on an unprecedented binge, now spending 96% of their after tax income, and 70% of GDP. Consumer spending accounted for 109% of GDP growth from 2001-2003 with consumer durables up 19%, nonresidential (business) fixed investment down 9.8%, residential investment up 14.4% and government spending up 10%. Americans continue to borrow money for consumption at the expense of building productive assets that will provide for future income. This is bad economic behavior in our opinion, and will come to an eventual end.

NIPA	Profits by Industry (\$bil)						12 mo
	1998	1999	2000	2001	2002	2003	
Corporate Profits	801.6	851.3	817.9	767.3	874.6	1021.1	1118.0
Domestic industries	635.5	655.3	613.6	549.5	599.0	683.4	706.3
Financial	165.4	194.3	200.2	227.6	276.2	299.8	237.6
Durable goods	83.4	72.3	60.0	-25.4	-8.3	-3.5	29.8
Nondurable goods	73.6	78.3	84.3	78.0	58.9	70.7	75.2
Wholesale trade	53.2	55.5	59.7	52.1	51.0	47.9	61.1
Retail trade	66.4	65.2	59.6	71.0	78.1	77.7	64.7
Transportation	21.0	16.1	14.9	1.3	-1.3	10.5	7.3
Information	20.1	10.5	-17.6	-25.6	-11.2	-0.7	21.6

In 1998, manufacturing profits (yellow highlight) were \$83 billion as measured by the National Income and Product Accounts. By 2003 manufacturing profits had fallen to a \$3.5 billion loss. Even with the sharp drop in the \$US during this period manufacturing profits have only returned to slightly over 1/3 their 1998 level. It is striking that since 1998 110% of the growth in corporate taxable earnings has come from financial institutions or the financial subsidiaries of industrial corporations (green highlight above). This has come in from re-financing fees, the “carry trade” by both financial and non-financial corporations to augment their normal operating earnings.

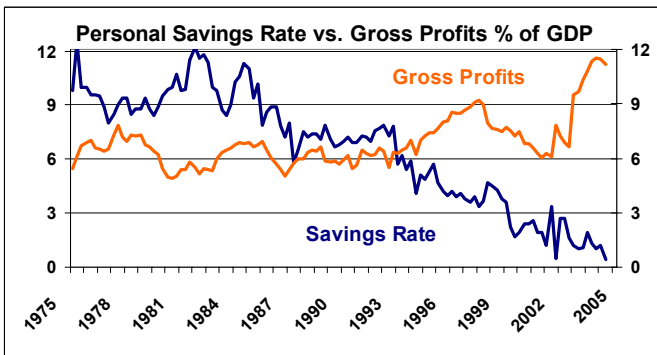
With imports now 53% higher than exports and so many manufacturing jobs “outsourced” overseas, we do not believe that it is possible that the \$US can fall far enough to overcome a \$550+ billion trade deficit expected in 2005. A chronic lack of investment insures that this condition cannot be overcome for some time.



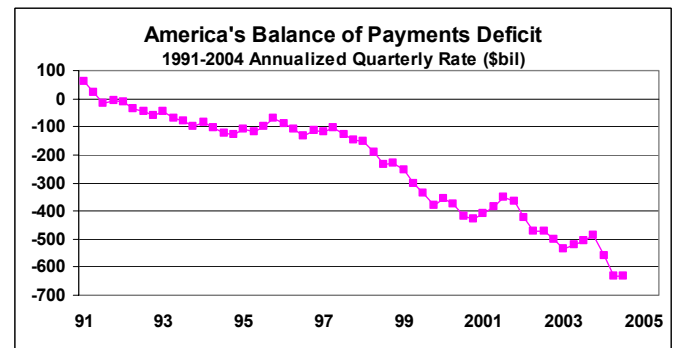
After 9/11 when the Fed flooded the US financial system with liquidity, the rate differential between the 30 day commercial paper cost and the 3 year US Treasury yield became almost 2 %. It has been in positive territory ever since. This source of income is not, in our opinion, sustainable over the intermediate term because the short term cost of borrowing is going up (as the Fed raises short term rates), and the longer end of the yield curve is (surprisingly) staying flat.

The lack of both fiscal and monetary flexibility to induce consumers to spend any more than the mere growth in wages will, in our opinion, define the economic landscape for the next several years, and we expect GDP growth to reflect the reality of this new situation. With personal consumption well past the outer limits for a healthy economy, the matrix of our investment outlook for the next 18 months has three key elements: interest rates, debt burden and jobs.

Like everything else interest rates are set by supply and demand. On the supply side, American savings were \$35 billion in the 3<sup>rd</sup> Quarter of 2004. That's right! Only \$140 billion annualized out of \$11,800 billion of economic activity. On the demand side, American consumption (trade deficit) is now borrowing at the rate of \$650 billion/year, the Federal government borrowed \$412.3 billion in its 2004 fiscal year, and states borrowed \$228 billion.



The trend to use financial leverage to augment earnings will, in our opinion, disappear in 2005. The chart above illustrates that corporate gross profits are now at the highest point in recent history as a percent of GDP. We believe that gross profit margins have peaked for this cycle. First, because savings have drifted below 1% and (as we argue throughout this report) must rise at some point soon. Second, the long fall in the savings rate has been a strong wind at the back of those businesses *economically leveraged* to the long term trend of consumers spending an ever increasing percentage of all available income sources. Third, wages are only 55% of household income, and we see no new government aid going to households in the form of tax reduction, child credits etc. any time soon.

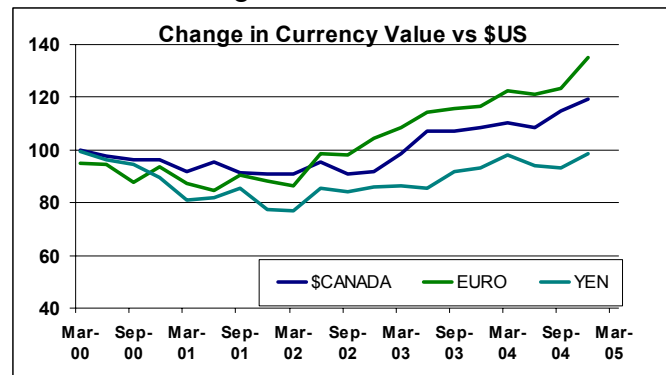


Who is on the lending side of these transactions? According to the Federal Reserve, our primary lenders are now foreign central banks, increasingly in Asia. Our guess is that most central bankers are now on the horns of a terrible dilemma: defending their own domestic manufacturing jobs and continuing to export goods to the US, or face being paid in new loans in a depreciating \$US. Someday they will take action. Maybe 2005?

In the week before Thanksgiving, Alan Greenspan fired a loud shot across the bow of Congress from the G8 meeting in Berlin to reassure our European and Asian creditors despite a 40% erosion in value since 2002.

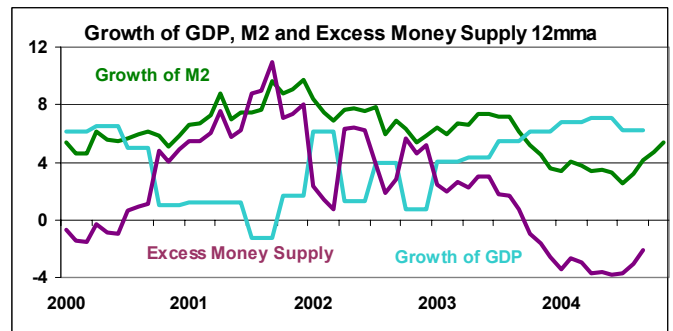
*In Dr. Greenspan's words "Given the size of the US current account deficit, a diminished appetite for adding to dollar balances must occur at some point. International investors will eventually adjust their accumulation of dollar assets or, alternatively, seek higher returns to offset concentration risk, elevating the cost of financing the US current account deficit and rendering it increasingly less tenable." It was a clear admission that the Federal Reserve is aware that the limit of the world's appetite to acquire more than \$633 billion per year of a diminishing asset is somewhere in sight. Until this (historic pronouncement), the standard position in Washington was the denial that America had a savings problem, and an insistence that the rest of the world had a growth problem.*

*Dr. Greenspan has changed the tone of the debate stating "reducing the federal budget deficit, or preferably moving it to surplus appears to be the most effective action that could be taken to augment domestic saving. Significantly increasing private saving in the United States – more particularly, finding policies that would elevate the personal saving rate from its current extraordinary low level – of course would be helpful." With such a man giving such a statement to creditors who now possess over \$10 trillion in US assets, it is inconceivable to us that he will bless a Congress that wishes to stimulate further consumption demand. The Maestro has tacitly promised change in our savings trend and the behavior of Congress.*



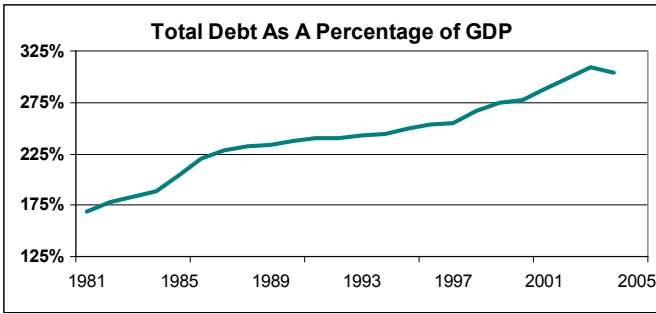
**That testimony seems to be mollifying the G8 nations for the moment. As this Commentary is being composed the \$US is rising against most major trading currencies. But for how long?**

**Each time the Fed Funds rate is raised, the profit from financial leverage diminishes, and with it corporate profits, particularly those of financial institutions. The "flattening" of the yield curve has another effect: it changes the demand for different types of money supply i.e. savings, checking and money market funds. To the extent that the Fed supplies an excess of money (purple line below) it creates financial inflation (or financial deflation).**



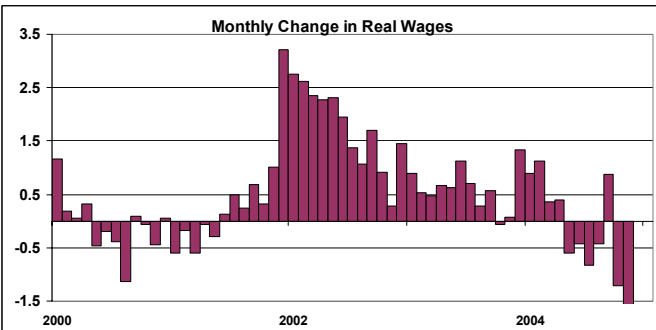
**At the time of 9/11 the nation was already in a recession and the Fed was providing excess money supply to stimulate activity. After the attacks, the economy faced what might have been a much worse fate if the Federal Reserve hadn't flooded the system with liquidity (purple line above). This excess money supply went first into the "carry trade" by big banks, brokers and industrial corporations. Next it chased stocks and then real estate. As can be seen by the purple line, as the Fed has tightened ever so slowly, the excess money is coming out of the system and is currently negative. **We view this as a negative sign for asset inflation in the immediate future.****

**At the moment we are unsure on whether the US will have a hard or a soft landing from a pricking of the credit bubble created in the aftermath of 9/11. We are certain, however, that the consumer will be hard pressed to "pay up" much further for real estate or consumer goods purchased on credit. Today it was announced that in November, consumer credit fell unexpectedly by \$8.7 billion, or a 5% annual rate. This was the largest dollar decline on record. Revolving (credit card) debt led the decline, falling 11%. While this number may be revised, we should take note nonetheless.**



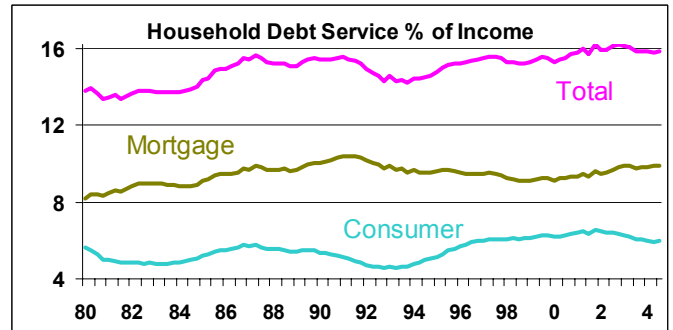
It has been a very long time since debt as a per-cent of GDP fell and it did so in the 3<sup>rd</sup> Quarter, and all of this was due to recent corporate debt pay down. The CFOs and the CEOs of America’s major corporations should be highly regarded for their financial judgment and they are de-leveraging their balance sheets through the accumulation of cash. What is done with this money becomes critical to the economic direction for the next 18 months. Will this money go into mergers, dividends, new technology or jobs?

Prior to 9/11 real wages or the average hourly wage change of non-agricultural workers minus the rate of inflation, had been declining. Fiscal stimulus gave a shot in the arm to households, their real wages rose as inflation fell and a flood of cheap imports kept official inflation in check. Since that time real wages have been falling just as costs for the capital items (stocks and real estate) have been rising.



To the extent that consumers save more, or demand higher wages to offset rising household costs, corporate profit as a per-cent of GDP is bound to slow and therefore disappoint those on Wall Street hoping for big gains in corporate profits. We see wage pressure gaining importance in the 3<sup>rd</sup> year of an economic recovery.

The Cascade outlook makes four assumptions about 2005. Consumer spending will grow no faster than wage earnings. Real estate will not appreciate much further in the intermediate term and the mortgage re-finance run is mostly spent. There will be no new Federal handouts to households. Finally to mollify our creditors, Congress will make good on Dr. Greenspan’s pledge of “... **finding policies that would elevate the personal savings rate from its current extraordinary low level...**”, and the savings rate will rise.



While household debt service is historically high, it is not at unmanageable levels. Going forward however, it is unlikely that the ratios will rise further. Thus we conclude that the key economic matrix element of 2005-2006 will be job growth. While the goal of the Bush Administration has been the creation of 200,000 new jobs per month (150,000 is what is needed to absorb new entrants into the labor force), the US achieved only slightly over 145,000 per month in 2004. We currently estimate that 150,000 per month is the most realistic outlook for 2005.

Below we construct a matrix illustrating the GDP effect of wage increases (vertical axis), and monthly payroll growth (horizontal). Turn your attention to the change in hourly wages (vertical scale).

		Household Income Growth Matrix							
		Payroll Growth Per Month '000							
		-50	0	50	100	150	200	250	300
Hourly	0.05%	0.1%	0.6%	1.1%	1.5%	2.0%	2.4%	2.9%	3.3%
Earnings	0.10%	0.8%	1.2%	1.7%	2.1%	2.6%	3.0%	3.5%	3.9%
Growth	0.15%	1.4%	1.8%	2.3%	2.7%	3.2%	3.6%	4.1%	4.6%
Per	0.20%	2.0%	2.4%	2.9%	3.3%	3.8%	4.3%	4.7%	5.2%
Month	0.25%	2.6%	3.0%	3.5%	4.0%	4.4%	4.9%	5.3%	5.8%
%	0.30%	3.2%	3.7%	4.1%	4.6%	5.0%	5.5%	5.9%	6.4%
	0.35%	3.8%	4.3%	4.7%	5.2%	5.6%	6.1%	6.6%	7.0%
	0.40%	4.5%	4.9%	5.4%	5.8%	6.3%	6.7%	7.2%	7.6%

Assumes no changes in hours worked per worker

The wage growth in 2004 was 2.38% or 0.2% per month. We have boxed the intersection of 2004 wage gains and job gains and it highlights growth in household income of 3.8%. The December 2004 income growth was announced today to be 0.12%, which if continued throughout 2005 would lead to household income gains of only 2.6% before inflation. Such a condition would have severe consequences for state and Federal finances.

Next, we have built a matrix for household consumption. The PCE deflator is the inflation rate for households. The PCE ran about 2.5% in 2004 but could rise to 3% with a weaker \$US and thus higher energy and other import prices. We have boxed recent quarterly experiences. If the savings rate rose only back to +2%, we would see real consumption growth of near zero, or possibly a slight decline, were the level of inflation to remain at present levels.

		PCE Deflator							
		0.0%	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%
Savings	-3%	8.0%	7.4%	6.9%	6.4%	5.9%	5.3%	4.8%	4.3%
Rate	-2%	6.9%	6.4%	5.9%	5.3%	4.8%	4.3%	3.8%	3.3%
Change	-1%	5.9%	5.3%	4.8%	4.3%	3.8%	3.3%	2.8%	2.3%
Per	0%	4.8%	4.3%	3.8%	3.3%	2.7%	2.2%	1.7%	1.3%
Month	1%	3.7%	3.2%	2.7%	2.2%	1.7%	1.2%	0.7%	0.2%
%	2%	2.7%	2.2%	1.7%	1.2%	0.7%	0.2%	-0.3%	-0.8%
	3%	1.6%	1.1%	0.6%	0.1%	-0.4%	-0.8%	-1.3%	-1.8%
	4%	0.6%	0.1%	-0.4%	-0.9%	-1.4%	-1.9%	-2.4%	-2.8%

Assumes gross income of 4.8% and average tax rate unchanged

Were inflation to rise only slightly from 2004 levels, and the savings rate to rise only slightly, we will definitely experience an economic slowdown. This would probably resemble the “stagflation” from the late 70’s and early 80’s.

The Fed indirectly claims that it is committed to defending the world’s reserve currency, although the Congress of the United States acts like it is not. Our Administration claims to stand for solid money yet has appointed a railroad executive with no experience in finance to represent us to our \$10 trillion creditors. When we are called on to honor our pledge to maintain sound money (read a stable \$US), the investment climate could change very quickly.

US Treasury interest rates do not currently carry a noticeable risk premium for currency fluctuation. If one were added to compensate for a falling \$US, there would be immediate pain. The sub-prime borrower with an adjustable mortgage and lots of credit card debt, in particular, would start to experience financial stress. Firms that lend and do business with those households would face a difficult earnings environment. Whenever a nation or an industry starts to de-leverage due to rising interest rates, or rising credit standards, there is always someone who cannot unwind their financial entanglements soon enough. Such an occurrence will only be forestalled if real wages rise faster than interest costs to households, and the next Congress makes good on fiscal restraint.

History tells us that the only mechanism that has actually slowed import growth and with it the balance of payment deficit in the US is outright recession. Prior to the abandonment of the gold standard in 1973, the US had never experienced a negative yield curve, or short term rates higher than long term rates. A positive sloped yield curve (short rates lower than long term) is a sign of bullish investor and business sentiment, and a flat or negative curve is the opposite. The only reliable indication of ensuing recession since 1973 has been a negative yield curve, and while that is unlikely in 2005 or 2006, the sheer size of the trade deficit and the Federal borrowing requirements cannot rule this out entirely.

The economic consequence of the several hundred \$billion lost in the dot.com bubble has not fully dissipated from our economic landscape. It represents a shortfall of savings that must be made up. Until it is, and until a trend to balance our trade deficit is in place, we will face an increasingly hostile investment environment.

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