Cascade Investment Commentary

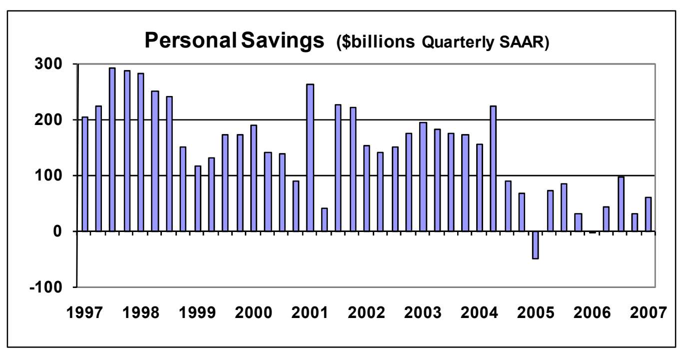
At the end of the year the European Central Bank and the Fed took the extraordinary step of directly auctioning funds to the banking system. The ECB injected over $500 billion in one fell swoop and the Fed is offering $20 billion every other week with no official end in sight. Why are the monetary authorities taking such radical steps and what does it really mean to your portfolio?

For many years fiscal and monetary policy has been driven by the short term goals set by the needs of the next election. These policies have promoted consumption over savings, wanton federal spending over fiscal rectitude, and enabling speculative bubbles with artificially low interest rates. In the second half of 2007 the long term results of bad policy became manifest: frozen credit markets and rapidly rising inflation. Our long time overweighting in energy and now into gold producers is paying us handsomely.

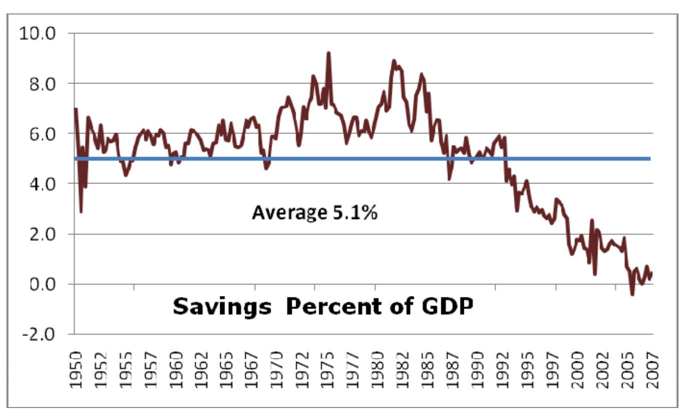
By now everyone should know that there is a "liquidity crisis" somehow connected to the "sub-prime" lending market. We will start with our partial view of how this crisis developed, where it is now and what might possibly be ahead. We at Cascade are firmly in the Austrian school of economic thought, and agree with Frederick von Hayek, Ludwig von Mises and Karl Richebacher. We all reject the Keynesian notion that most long term economic problems can be solved by government meddling.

The late Dr. Kurt Richebacher explained… "Available liquidity is, of course, most important. Nevertheless, we find it most important to distinguish, first of all, between two different sources of liquidity: borrowed and earned liquidity. Present excess liquidity in the United States and several other countries is of a peculiar kind. It does not come, as would be normal, from unspent current income – in other words, from saving. In the absence of any new savings, all the liquidity creation occurring in the United States is borrowed liquidity. Generally borrowing against rising asset prices is in diametric contrast to earned liquidity from savings out of current income. By definition, this is liquidity from credit inflation. One thing is certain about borrowed liquidity: it depends on rising asset prices. Once asset prices stop rising (see current U.S. housing prices) this liquidity suddenly evaporates. Moreover, ever larger credit injections are needed to keep asset inflation—like any other inflation—rising. Nevertheless, there inevitably comes a point in which asset prices, for one reason or another, refuse to rise further and the big selling without buyers begins. Never before in history has there been an exception from this disastrous end of asset inflation."

A good starting point for review is to look at the current level of domestic savings. Out of $14 trillion (tn) in GDP Americans saved only $60 billion (bn) in the year ended 9/30/07.



Since a 1% rise in savings will cost $140 bn in lost consumption, getting even to 2% will hurt discretionary spending. With food and energy costs rising, retail remains in trouble.



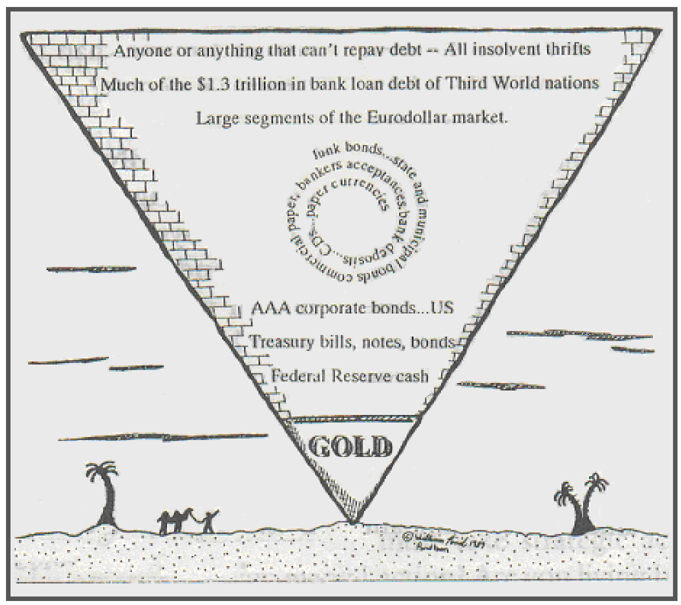
The crux of the problem is well known. We save too little and have depended for years on importing the economic savings of others. We have passed the point where asset prices are still rising, and Dr. Richebacher's words now haunt the markets. Financial panic arrived in August and like all panics it was short and brutal. The panic brought a complete turn by the Fed. From fighting inflation and rewarding savings (through higher interest rates) they now attempt to rescue those who lent and borrowed foolishly to purchase perceived rising assets.

We have now entered the crisis phase which is likely to be a long and slow torture. Bill Gross of the giant PIMCO funds wrote in December "…what we are witnessing is essentially the breakdown of our modern day banking system, a complex of leveraged lending so hard to understand the Fed Chairman Ben Bernanke required a face-to-face refresher course from hedge fund managers in mid-August…. as the commercial paper market shrinks by hundreds of billions a month, central bankers worldwide are facing a giant stress test of the modern-day shadow banking system. The publicized and photographed overnight 'runs' on Countrywide and the UK's Northern Rock in mid-August were nothing compared with what's taking place in the shadows of the real banking system. Credit contraction, with its inevitable companion of asset destruction, is spreading with the speed of an infectious bacterial disease. "

The virtual breakdown of inter-bank lending (LIBOR) is the most visible symptom. The major banks started playing a giant game of "Old Maid" and as we approached year end no one wanted to trade cards (make an inter-bank loan) for fear that the dreaded Old Maid card would appear on their year end balance sheet. The real need to protect capital has certainly been highlighted by Citibank borrowing $5 billion at 11% from a Dubai investor, Morgan Stanley paying 9% and giving a 9.9% position to the Chinese national bank, Merrill Lynch offering $6.2 billion at a 15% discount, UBS needing $11.5 bn; not typical behavior for the self proclaimed "Masters of the Universe".

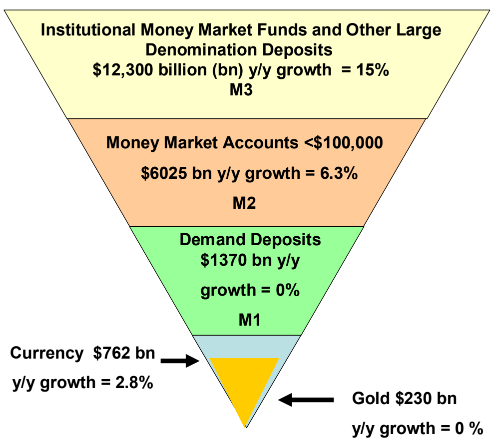
The aforementioned are in Singapore, Dubai, Beijing (countries with earned savings) precisely because the Americans have no earned savings to lend. That the Fed will bail out the major banks we have no doubt; that is their main job, inflation be damned. Our concern is the probability that the overall leveraged lending crisis is far from over and will spill over into the greater economy of the US and the world. The wildly inflationary actions of the monetary authorities here and in Europe gave us no comfort and joy during the holidays. Try as they might, they cannot convince Americans that now is a good time to buy a new house and what goes into it.

In the early 1960's John Exter (head of NY Fed's gold department and later head of Citibank's gold department) proposed a liquidity pyramid that became very famous in the late 1980's when the long term effect of leaving the fractional gold standard in August 1971 became apparent. We believe that in times of financial crisis people try to scramble down the pyramid to safer assets.



In John's pyramid there was a big line above gold signifying that everything above it represented debt. Indeed, the essential argument of the "gold bugs" is in fact all paper money represents is someone else's debt and therefore gold is the only "real" money. If we fill John's pyramid with some (but not all) of the modern assets we get a very good perspective of how the crisis may unfold in 2008.

First let us look at money and near money. Currency in circulation is the base building block, and contrary to popular opinion about "helicopter Ben" the Fed cannot create coins and paper money without some backing (yes the official US gold hoard of $230 billion is still an indirect backing for our currency). The demand for cash does not grow much any more since the introduction of the Euro, and as of Sept 30 stood at $762 bn. Money supply M1 consists of cash plus checking accounts and it also is growing slowly. M2 consists of M1 plus savings accounts and retail money market funds, and has been rising at twice the growth rate of GDP for some time, reflective of real inflation.

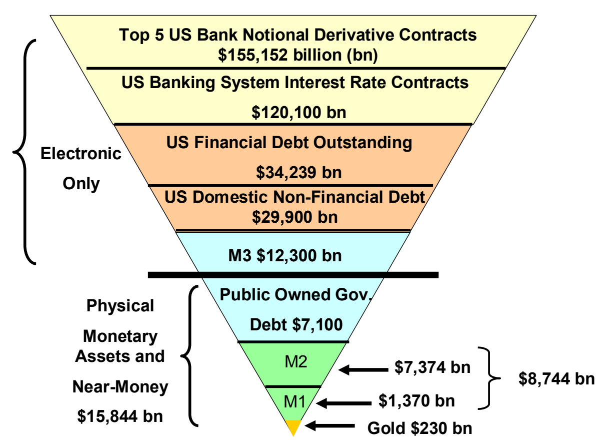


M3 is comprised of M2 plus the large denominated money market fund shares and Institutional money market funds. M3 levels can not be controlled by the Fed. In our opinion, they chose to stop publishing the number in March 2006 because they don't want responsibility for its inflation.

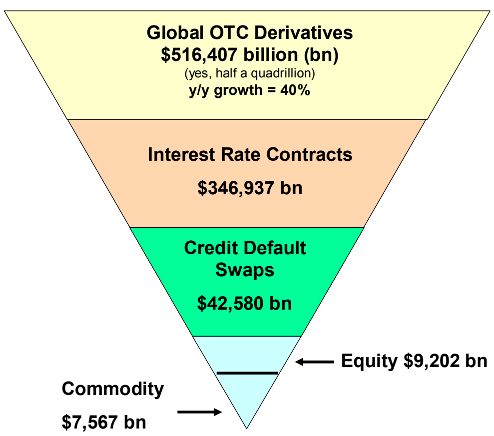
The Fed was certainly prescient. The 25%+ growth rate of Institutional money market accounts (a part of M3) has a large component of Asset-Backed Commercial Paper (ABCP) which was issued to float long term tranches of supposedly prime rated Collateralized Mortgage Obligations, or buckets of many mortgages. It was discovered that many of the home loans made in 2006 and 2007 contained at least one element of fraud. Perhaps the Fed saw this coming. They are not saying.

Since October over 10 North American banks and fund managers have had to inject their own money to keep their funds from "breaking the buck" or not dropping below $1.00 per share as promised to investors. As institutions shun ABCP where does it go? We believe that it is going into retail money market funds sponsored by the investment banks that wrote it. As millions of ARM rollovers come due in 2008 we expect much more of this, and several months ago we moved all of the money market accounts we could to US Government only funds. The losses on subprime paper in such funds can only be made up out of income, so in reality US Government yields are trading at a premium to asset backed equivalents.

Soon people seeking higher quality assets will find nowhere to go down the pyramid. There are "only" $7100 bn of publically traded Government debt (the huge sums held in the Social Security "lockbox" are simply large non-tradable pieces of paper). If bond fund managers wanted to exit the debt of financial institutions such as Citicorp etc., how could $34,000 bn be crammed into the safer pyramid blocks below? It cannot be done, and the Fed cannot create real assets, only electronic ones. In short, monetary policy itself has become the problem. Congressman Ron Paul (running for President) asked Ben Bernanke in his last testimony how the problem caused by creating too much money could be solved by creating yet more money. There was no reply from Mr. Bernanke.



In the worldwide derivative market, for example, according to the Bank for International Settlements there are about $7567 bn in outstanding contracts to deliver future commodities (typically a single years' crop but sometimes several years in the case of oil and minerals). Complex puts and calls on equities are about $9200 bn (June 30). These are derivatives on tangible or revenue generating assets. Once we leave this area we go into the Ethernet: private contracts with nothing more to back them than the ability of each side to deliver. The massive growth of this business has yet to be stressed tested since most of it has blossomed since Long Term Capital Management blew up in 1998. The growth in derivatives is stunning: Foreign Exchange contracts up $46 tr or 20% in six months, interest rate contracts up $55 tr or 19% in six months.



"***C***harlie (Munger) and I are of one mind in how we feel about derivatives and the trading activities that go with them: we view them as time bombs, both for the parties that deal in them and the economic system."

"...The derivative genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear…"

"…In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."

Warren Buffet, February 21, 2003

The recent actions of the monetary authorities, in our opinion, are based upon the fear that if the "Old Maid" appears in public there might be a rush to unwind Credit Swaps and Interest Rate Contracts. This presents what we believe is the principle fear of all monetary authorities: counterparty failure.

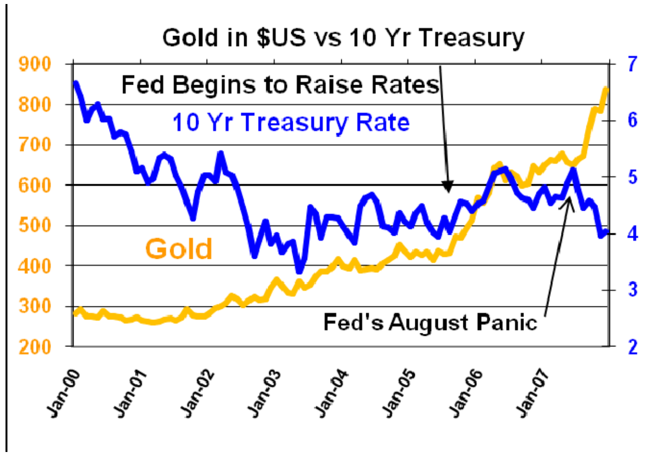
Simply stated, counter party failure means that in a private financial contract one side cannot meet the terms of the agreement. It is impossible to value private derivative contracts accurately so computer models are widely used. We find it very troubling that in a world where there are contracts worth half a quadrillion $US (essentially bets on the weather, bets on GM bonds, bets on interest rate movements, etc) both sides price these bets at 100 cents on the dollar. The fact that 97% of derivative contracts in the US are written by seven supervised institutions and 100% are with only 25 gives no comfort to us. The last time a major contract had a counterparty failure one side was Orange County California and the other was an obscure German business called Metallgelen.

Since August, almost $1000 bn has been injected in an effort to keep credit markets from freezing up. The problem is that all of this "money" is in the form of electronic credits which only boosts the top of the pyramid. The acute shortage is earned savings at the bottom, and the attempt to douse insolvency with liquidity is, in our opinion, doomed to fail. The simple fact is that there are millions of households in America that are essentially insolvent. They have declining equity in their home and they have no equity whatsoever in their automobile. Their incomes are not rising as fast as their monthly payments. $690 bn of "interest only" ARM's are due for an interest rate hike between now and July 2008 (out of a total of $1400 bn) and the administration's only idea of how to help is to try to somehow untangle the woven mess of who owes what to whom and who among the subprime liars is most to blame for the defaults in payments. Rewrite how many contracts?

We see several adverse consequences to the Fed's efforts. If they once again artificially suppress the rental value of savings by holding interest rates too low we will again face the "tyranny of low interest rates", whereby the burden of future defined payments becomes harder to earn and it takes greater capital to assure a measured outcome. Low interest rates exacerbate problems funding all future liabilities such as defined benefit pensions, Social Security, Medicare, life insurance contracts etc., and raises the economic cost of servicing debts incurred at higher fixed rates. Second, it lowers the value of capital investments that were purchased with higher cost debt. It is a problem for labor also as the value of older US capital assets fall relative to new foreign assets and US labor costs rise vis-a-vis low cost countries. High wages cannot be earned in obsolete factories.

So how does all of this directly this affect your portfolio? We have fully scrambled down the pyramid: we continue to hold energy and energy infrastructure. Second, we continue to avoid those industries that are now a classic "value trap". Many firms look attractively valued on trailing earnings, but we believe that earnings in 2008 will be of poor quality for financials and consumer discretionary. We own no retail firms outside of gasoline stations. Cascade has not owned any major lending companies for more than two years although we hope to re-enter the finance field in 2008 after the "public hanging" of someone or some firm connected to the subprime crisis. In truth we cannot run our country without a healthy banking system so the problem will eventually be solved. It won't be solved soon. It has taken Japan over 20 years.

We have purchased of gold mining shares for the first time in our entire career. There are several key factors that make the industry very attractive to us. Barrick Gold claims that world gold production has peaked. They suggest that we might expect a 10 to 15% drop in overall mine supply of gold within the next five to seven years.



The free cash flow of the major gold producers is already set to soar. This comes at a time when "Sovereign Funds" are seeking to diversify out of holding $US 6 tr.

Cascade Approved List
Gold Producers

Company	Proven & Probable Reserve M oz	Cash Costs $/oz 2007E	Net Asset Value $M	Market Cap $M	Mkt Cap to Reserve Ratio @ $800/oz
Yamana	N/A	$254	$7,745	$4,699	**0.61**
Newmont	93.9	$388	$30,262	$22,071	**0.73**
Barrick	123	$370	$41,325	$35,605	**0.86**
Goldcorp	39.8	$140	$24,475	$23,780	**0.97**

The $US decline is causing the UK and Europe into painful adjustments, while the dollar bloc is faced with strong inflationary pressures from falling US interest rates. We expect some currency pegs to break in 2008. **In short, we could experience major *deflation* at the top of the pyramid and major *inflation* at the bottom**.

"The national budget must be balanced. The public debt must be reduced; the arrogance of the authorities must be moderated and controlled. Payments to foreign governments must be reduced if the nation doesn't want to go bankrupt. People must again learn to work instead of living on public assistance." (Cicero, 55 BC).

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