

The entire Western World is suffering from three simultaneous crises: The energy crisis, the debt crisis and the now building political crisis around the death of Keynesian economics. Cascade has covered the energy crisis and the debt crisis for several years and you know how we have positioned your portfolio to avoid this pain. Politicians are behaving ever more desperate to maintain the status quo and are now a very destabilizing force. With elections coming to many Western Countries in 2012, events are likely to come to a head in the next six months.

We face circumstances not seen in living memory. The equity markets are behaving in a schizophrenic and bizarre manner. The credit markets in the Western World are functioning poorly and in several places in Europe actually broken. The US Congress is confused and has no realistic plan to deal with the economic situation; they can't even pass a budget.

Like Britain and the US, European governments have been captured politically by their major banks. Many major European banks have disguised their true leverage and have hidden bad assets off their books. In some cases they have lied about their true financial condition, but in all cases (learned from the US) they promise financial Armageddon if they are not bailed out.

In Europe the Bank/Sovereign crisis has taken on an Alice in Wonderland aura. In the graphic at right can you spot Angela "Red Queen" Merkel (Germany), Nicolas "Mad Hatter" Sarkozy (France), Tim "Alice" Geithner (US), George "Rabbit" Papandreou (Greece), Berlio "Spade" Berlusconi (Italy), Jean-Claude "Hopper" Juncker (Luxembourg) leering down on the rabbit, and of course the smiling Lloyd Blankfein (Goldman Sachs) waiting for dinner. The only thing missing from the picture is the rabbit's watch ticking down to their eventual debt default.



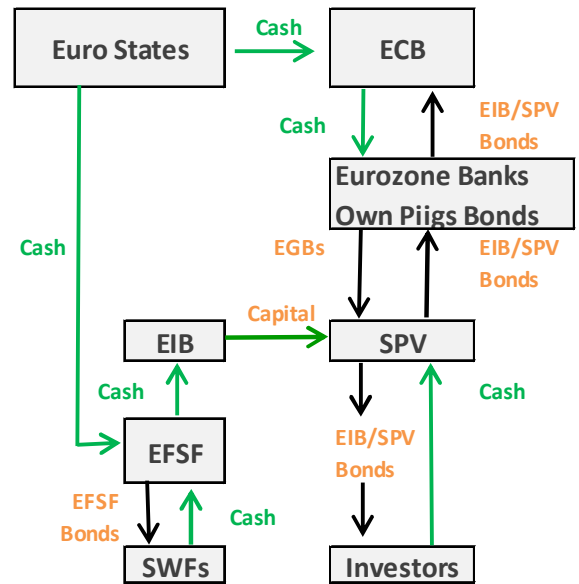
Unlike the US and Great Britain which have subcontracted their money supply management to private interests to the Federal Reserve and the Bank of England respectively, the Euro is a construct of a series of treaties setting strict rules on the behavior of governments and their ability to individually create additional monetary units. The rules state clearly that the European Central Bank (ECB) cannot directly purchase the sovereign debt of member nations. The US equivalent would be a rule that forbade the Federal Reserve from purchasing the debt of California. If California could not pay its bills they must look inward. This was the key provision for Germany's ratification of the treaty to enter the European Union.

The first Greek bailout was accomplished with the promise of capital contributions of all 17 member countries. A challenge was issued to the German Constitutional Court claiming such a bailout broke the German Basic Law. In the intervening period Greece has only received €7 billion so far in actual funds and is threatening Armageddon if not given a second bailout. On September 27th, the Constitutional Court issued its ruling: the court upheld the actions of the Merkel government on the first and the proposed second bailouts.

Andreas Vosskuhle, the Chief Justice of the Constitutional Court added in his majority ruling **“The sovereignty of the German state is inviolate and anchored in perpetuity by basic law.** It may not be abandoned by the legislature (even with its powers to amend the constitution). **There is little leeway left for giving up core powers to the EU. If one wants to go beyond this limit – which might be politically legitimate and desirable – then Germany must give itself a new constitution. A referendum would be necessary. This cannot be done without the people.”** This ruling nixed the idea of Euro area general obligation bonds that would have made Germany jointly liable for all 17 members’ sovereign debts.

Thus the unfolding drama in Euroland is now all about how to break the rules without breaking the law. Early in the summer the ECB thought that the Greek insolvency could be cured with about €200 billion and French President Sarkozy and German Chancellor Merkel were quick to strong-arm other member states to ratify such a capital commitment to the ECB notwithstanding the German lawsuit. In mid-summer that number grew again to €440 even before all of the 17 countries ratified the €200 number. By the end of the summer the real number looked more like €2.5 trillion. How then to make €440 look and act like €2.5 trillion? Our own Secretary of the Treasury Geithner had a ready solution – *leverage*. His direct comment to the International Monetary Fund (IMF) was “The threat of cascading default, bank runs, and catastrophic risk must be taken off the table, as otherwise it will undermine all other efforts, both within Europe and globally”. We think Secretary Geithner is talking his own book (think all of the Belgian and French bank paper on Wall Street’s Banks balance sheets and in their money market funds).

Below we offer a schematic of the current thinking of how to make this happen. We say current as the Red Queen’s tea party changes it almost daily. You are forgiven if you think this looks a lot like the financial plan of Enron. We do too.



Last week the Merkel government proposed a “fire ring” around the debt of Greece, Ireland and Portugal where banks would be recapitalized with tens of billions of euros, the €440 billion European Financial Stability Facility (EFSF) would be leveraged up through the ECB and Greece would default on 50% of its debt through private bondholders taking a “haircut” on Greek bonds. This legislation passed Thursday, September 29th.

Philip Swagel (Assistant Secretary for Economic Policy from 2006 to January 2009) wrote an excellent paper for the Brookings Institution titled The Financial Crisis: An Inside View. The key paragraph discloses “At Treasury, two additional lessons were learned: (1) we had better get to work on plans in case things got worse, and (2) **many people in Washington, DC did not understand the implications of non-recourse lending from the Fed. This latter lesson was somewhat fortuitous, in that it took some time before the political class realized that the Fed had not just lent JP Morgan money to buy Bear Stearns, but in effect now owned the downside of a portfolio of \$29 billion of possibly dodgy assets.** This discovery of the lack of transparency of non-recourse lending by the Fed was to figure prominently in later financial rescue plans.” Nonrecourse is not in the above Euro leverage plan.

The public in Northern Europe has seen the socialization of Wall Street losses and the Germans, the Finns and the Dutch want nothing to do with it. Their current political class however is so wedded to the Euro as the capstone of their careers that they march on despite the obvious probability of failure. They apparently will save the banks, period, no matter what the cost.

What the central bankers of the US and the UK and of Europe have in common is this: They are all academics from schools that teach only Keynesian economics and they have collectively no experience in practical banking. None has ever made a loan or foreclosed on collateral. As bureaucrats they have no chance staying ahead of those on Wall Street burning the midnight oil trying to make money. Last week Dallas Fed President Richard Fisher gave a presentation on why he dissented on Operation Twist, and began with an apt analogy. He displayed a picture of the Jan Mayen Arctic Weather Station, followed by these bullet points:

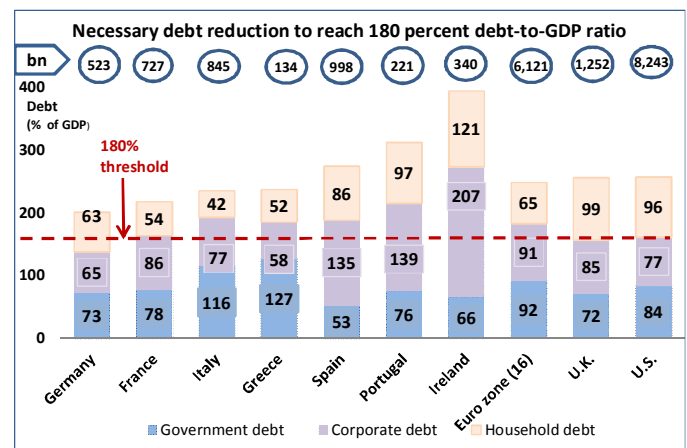


- Jan Mayen is a desolate volcanic island located about 600 miles west of Norway's North Cape. It is the home of a meteorological and communications station manned by 17 hearty members of the Norwegian Armed Forces
- My brother Mike recently visited the station on Jan Mayen. This is the sign that greeted him [Cascade has no picture].
- In norsk, it reads as follows:
- "Theory is when you understand everything, but nothing works."
- "Practice is when everything works, but nobody understands why."
- My wry brother implied that this about summed it up for monetary policy.

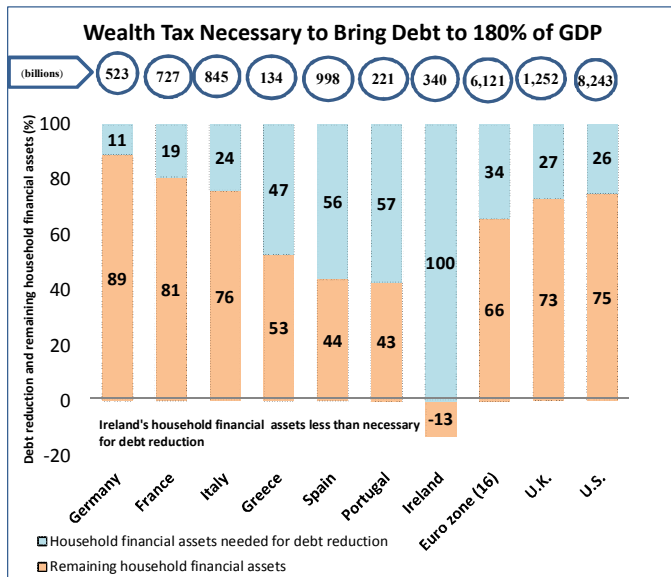
"Drawing on theory and practice, the 17 members of the Federal Open Market Committee (FOMC) have been working in the harshest economic environment to harness monetary theory and lessons learned from practice to revive the economy and job creation without forsaking our commitment to maintaining price stability. But the committee's policy has yet to show evidence of working and nobody seems to quite understand why".

This week Dexia bank, the largest in Belgium announced that it was having trouble funding itself and would need state aid. The Belgian and French Finance Ministers issued the following statement: "As part of the restructuring of Dexia, the Belgian and French, in conjunction with central banks will take all necessary measures to ensure the safety of depositors and creditors. To this end, they undertake to guarantee to bring their financing raised by Dexia." The level of state aid is supposedly €30 - €50 billion. What it will really take is unknown.

As "austerity" marches across Southern Europe the slowdown in revenue will aggravate the problem further. Academics and rating agencies have postulated that most economies can sustain debt no greater than 180% of GDP. Assuming that at some point this occurs, below we illustrate the debt reduction required to reach this in selected Western countries should interest rates rise slightly. Italy was downgraded from AA2 to A2 in large part because GDP growth for 2012 is now forecast at 0.3% while debt cost is 6%.



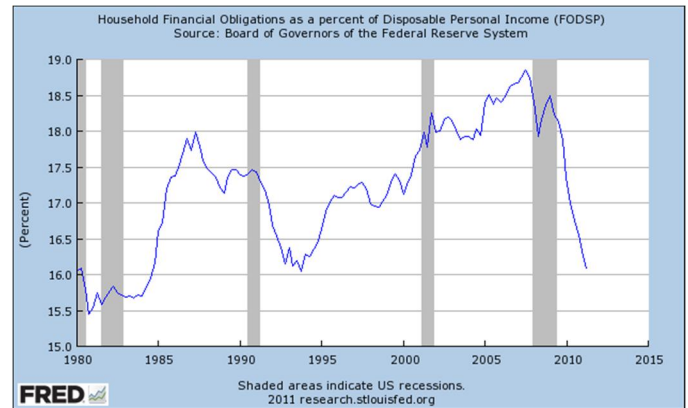
At the end of the day, many of the major banks in the Western world are insolvent. They have no real capacity to lend to their industrial clients. US banks can originate mortgages which they then move on to state owned enterprises (GSE's known as Freddy Mac, Fanny Mae, etc.), but their balance sheets are mortally impaired and they are living on a Congressional lifeline. The situation in Europe is chaotic with a new "rescue plan" being offered almost daily. As real growth cannot proceed until debts are cleared, we would not be surprised to see a future one-time wealth tax proposed.



What we are now witnessing both in Europe and the US is the rather messy death of Keynesian economics, which has become in its mutated version the "religion" of Western politicians. Our last Commentary spoke to this issue. Simply stated this religion believes that the reserve currency of the world (the US dollar) can be printed to satisfy the world's need for transaction currency at any volume. As the price of commodities based in US dollars rises, the need to provide US dollars rises also thus allowing the almost unlimited printing of US dollars. This mechanism allows future consumption to be brought forward through credit expansion. American politicians have been given a "ninth" slice of pizza for free since the end of the Bretton Woods Agreement in 1971. This is now history.

We believe that the endgame of this concept is at hand. The US consumer is now in a structural liquidity squeeze where household income cannot keep up with inflation, and where there is inadequate credit available to make up the difference. Thus consumer spending cannot show sustained expansion in real (inflation-adjusted) terms and neither can the broader economy of the US or Europe. Households continue to de-leverage.

Because the structure of the nation is dependent upon GDP growth, current theory demands that when private sector consumption is in decline the public sector must make up the difference yet private and state spending is growing less than inflation. The result is obvious but startling.



Below is the US Treasury debt summary for Monday October 3rd. In the first three days of the fiscal year the US debt increased by \$162 billion. That puts the budget deficit on track to be \$1,971,000,000 for fiscal 2012.

TABLE III-C—Debt Subject to Limit

Balance Transactions	Closing balance today	Opening balance		
		Today	This month	Fiscal year
Debt Held by the Public,.....	\$ 10,124,774	\$ 10,124,030	\$ 10,127,031	\$ 10,127,031
Intragovernmental Holdings,.....	4,732,085	4,713,069	4,663,309	4,663,309
Total Public Debt				
Outstanding,.....	14,856,859	14,837,099	14,790,340	14,790,340
Less: Debt Not Subject to Limit:				
Other Debt,.....	487	487	487	487
Unamortized Discount,.....	34,337	34,347	34,376	34,376
Federal Financing Bank,.....	8,441	8,441	8,441	8,441
Hope Bonds,.....	493	493	493	493
Plus: Other Debt Subject to Limit				
Guaranteed Debt of Government Agencies,.....	10	10	10	10
Total Public Debt Subject to Limit	\$ 14,813,111	\$ 14,793,341	\$ 14,746,553	\$ 14,746,553
Statutory Debt Limit,.....	\$ 15,194,000	\$ 15,194,000	\$ 15,194,000	\$ 15,194,000

Act of 8/2/11, operated to permanently increase the statutory debt limit to \$15,194 billion after 9/21/11.

Unamortized Discount represents the discount adjustment on Treasury bills and zero-coupon bonds (amortization is calculated daily).

In September, the European Central Bank in coordination with the Federal Reserve, the Bank of England, the Swiss National Bank and the Bank of Japan opened a swap line of credit which offered \$US in unlimited quantities against "collateral" of un-named creditworthiness to the major European banks. Into this "TARP like" process all equity markets rallied. But this belies the real problem of western financial institutions: there is plenty of liquidity but not solvency!

While few in Washington seem to know what to do about this, certain Asian central bankers (all of whom have reportedly worked in commercial lending and securities trading in Western Commercial and Investment banks) seem to have a plan. The Financial Times (of London) reported in September that a key rate setter for China's central bank let slip that Beijing aims to run down its portfolio of US debt as soon as safely possible. "The incremental parts of our foreign reserve holdings should be invested in physical assets" said Li Daokui at the World Economic Forum..."We would like to buy stakes in Boeing, Intel and Apple and maybe we should invest in these types of companies in a proactive way."..."Once the U.S. Treasury market stabilizes we can liquidate more of our holdings of Treasuries" he said.

What does this mean for your portfolio?

1. Nominal interest rates are near zero and real interest rates across the entire spectrum are negative. In our opinion interest rate risk is the greatest investment risk at this time. Negative real interest rates have always been good for gold.

2. With a (mostly) insolvent banking system, corporations which do not have independent access directly into the money market system are at risk for reasonable cost funding. Credit spreads for Prime 2 and Prime 3 (BBB and lower) are widening and will continue to do so. Rising credit spreads favor large cap companies vs. small cap.

3. In an environment where real credit is scarce the rationing process will either be by market force or political force.

Either way, we believe that the "national champion" companies like GM, Chrysler and Wall Street Banks will be helped first.

4. With the debt "saturation" of households the risk of repudiation remains high and the prospect of real GDP growth remains low. Low risk investment opportunities are very limited and therefore broad industry diversification in your portfolio is counter-productive.

5. Today's employment report demonstrates that business is shy to hire because of anti-business signals from Washington. The "good news" was that government employment decreased 34,000 and that overall employment rose 103,000. Of the 103,000 new jobs, 45,000 were striking workers returning to their old jobs. The bad news was that year/year wage gains were 1.9% versus the stated CPI rise of 3.8%

We at Cascade believe that the US dollar will continue to be the world's major transaction currency for many years but due to the stated policy of the Federal Reserve to debase the currency through deliberate inflation has ceased to be a long term store house of wealth. Precious metals, strategic materials, life necessities and long duration productive assets will be the real store house of wealth until there is a new world monetary regime. Such a regime will only be enacted in the aftermath of a crisis so its future date is unknown but reform is coming.

In the near future we expect greater volatility, greater protectionism, continued deflation in wages and real estate despite monetary inflation and greater political intervention. Cash will prove to be a poor asset choice as every major government on earth is debasing its currency to maintain unsustainable export markets. Large cap, low levered, politically favored companies with free cash flow and rising dividends will be the best asset class until the world-wide debt crisis is resolved and real growth can begin anew.

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