CASCADE
INVESTMENT COUNSEL, LLC

Quarterly Commentary

4th Quarter 2011

*T*here were three events in the final Quarter of 2011 that impacted your portfolio:
* Continuing solvency problems of Euro area banks and their respective governments
* Theft of customer funds at MF Global
* Japanese/Chinese agreements to swap bonds and facilitate currency transactions outside of US$.

Europe is becoming increasingly paralyzed by its debt crisis and the ever building political crisis around the death of Keynesian economic theory. It is rapidly dawning on investors that liquidity is different than solvency, and the solvency issue in Europe cannot be fixed by a new treaty that has already been vetoed by Britain. In the table below, view the official Moody's rating of government debt and the implied (real world) rating via the cost of their respective Credit Default Swaps (CDS).

Country	Moody's Rating	CDS Implied Rating	Rating Difference
Austria	Aaa/Stable	Baa3	Nine
Belgium	Aa3/ ↓12/15	Ba2	Ten
Cyprus	Baa3/Negative	B3	Six
Finland	Aaa/Stable	Aa3	Three
France	Aaa/Stable	Baa3	Nine
Germany	Aaa/Stable	A2	Five
Greece	Ca	C	One
Ireland	Ba1/Negative	B2	Four
Italy	A2/Negative	Ba2	Seven
Netherlands	Aa/Stable	A3	Six
Portugal	Ba2/Negative	B3	Four
Slovakia	A1/Stable	Ba1	Six
Slovenia	Aa3/Negative	Ba2	Eight
Spain	A1/Negative	Ba2	Seven

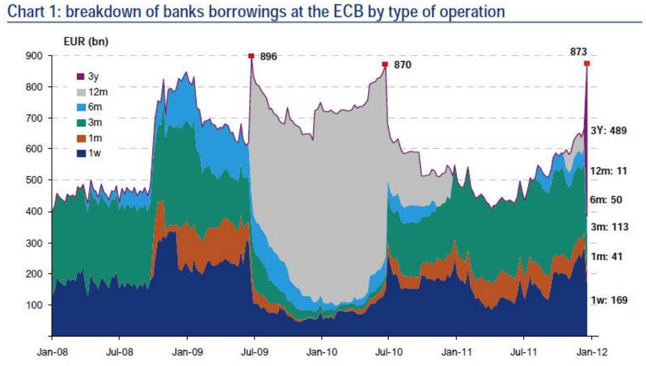
Belgium was downgraded by Moody's 2 notches from Aa1 to Aa3 on December 15th. Moody's cited three reasons for the Belgian downgrade: "First the fragility of the entire Euro Sovereign debt, second the overall weakness in the Belgian economy and third, the ultimate cost of the nationalization of Dexia Bank (local) and the debt that will add at the sovereign level."

The importance of financial events in Europe can hardly be overstated; euro banks alone need to re-finance €82b of debt in January, €234b in Q1 and a total of €740b in 2012. Bank debt is 80% of all non-sovereign European debt (in the US it is 22%). A substantial amount of that bank debt is lent in the peripheral states in Europe and also to US borrowers. The funding crisis in Europe will certainly affect lending in the US.

The size of the non-sovereign US debt held by these banks is unknown but it is large enough that the Fed not so secretly bailed out one or more Euro banks in December via the mechanism of "swap" lines of credit that were opened by the Fed, the Bank of England, the Swiss National Authority and the Ministry of Finance in Japan. Called a "Long Term Repo Operation" (LTRO) 523 Euro banks immediately borrowed €489 b or $645 for a 3 year period at 1.00%.

This represents more than 50% of the money needed to get the major European banks through 2012. Where did the money go? €411 b on deposit with the European Central Bank (ECB) earning 0.50%. Guaranteed loss of ½% can only signal desperation. Cascade wonders where in the Federal Reserve charter it is authorized to commit the American public to bailing out foreign banks and/or their governments?

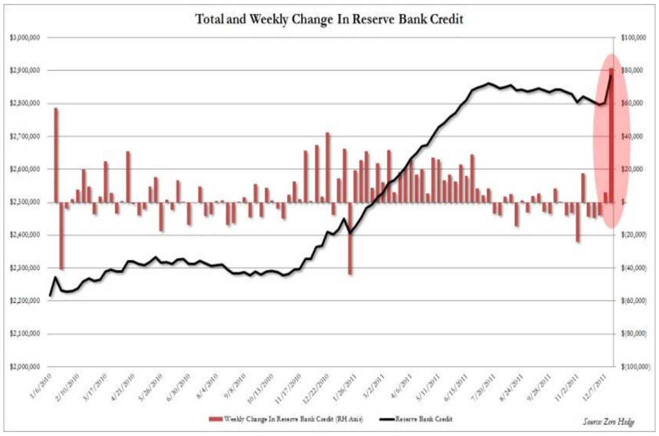
Chart 1: breakdown of banks borrowings at the ECB by type of operation



Source: BofA Merrill Lynch

In another desperate act the Greek and Italian governments are selling "preferred" bonds to the banks who are posting them as collateral for ECB loans.

Below we can observe the jump in bank credit extended by the Fed to the LTRO program in Europe. At $81 billion the December 14th injection was the highest since the May 2009 QE1 damage control.



Not that we wish to throw stones at the Europeans. Our fiscal house is not in order; in truth, our (US) numbers are simply stunning.

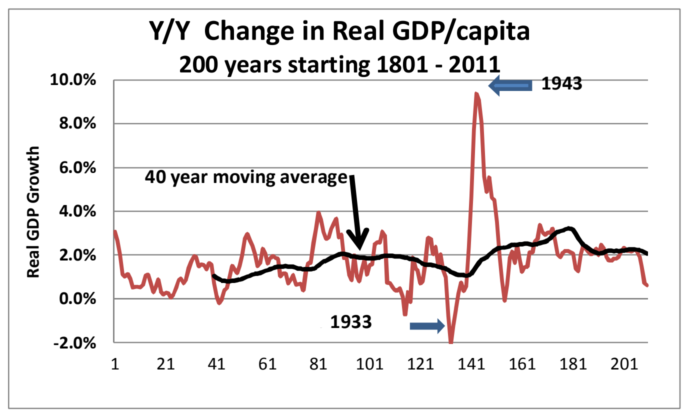
- 2011 US Tax revenue: $2,170,000,000,000
- US Budget $3,820,000,000,000
- 2011 New debt $1,650,000,000,000.

Now let's take off 8 zeros like we were Zimbabwe, Argentina or Yugoslavia and put this into household numbers:

- Median US family income: $21,700
- Median US family spending $38,200
- Net 2011 new household debt: $16,500
- Outstanding household balance on credit cards (Sept 2011) $142,710

This uses the government reported debt levels of $15 trillion, but if you include the "off books" debt (GSE, Social Security, etc.) approaching $100 Trillion. This equates to a debt level for each person of over $470,000. While this is now being funded at rates close to zero, what will happen if rates rise? At a 6% average cost of borrowing the US would now pay ½ of tax revenue on interest alone. At $15 Trillion the US has a debt to GDP ratio of over 100% which has traditionally been the danger zone. The "budget crisis" compromise cut was only $385 per family.

The Maastricht Treaty that created the Euro 10 years ago set a limit on the budget deficits of member countries to 3% of GDP for a very good reason: historical evidence of peace-time economies show that GDP growth can be sustained at that level. When debt is equal to GDP and interest rates rise above growth rates a country falls into a debt trap. Greece, Ireland, Spain are now hopelessly trapped as is Japan with debt to GDP over 200%. Austerity may be popular with the Germans, but hundreds of millions of people in the developed world have been promised benefits that mathematically cannot be paid and there is no political will to speak the truth in public. At the end of the day it is really an unsolvable math problem. Austerity actually lowers revenue in societies with poorly directed investments. Greece had until March to convince the northern savers to part with their savings to "save the Euro" or the unwinding begins. Yesterday that was been shifted to June as Europe really does not have the money to give to Greece.



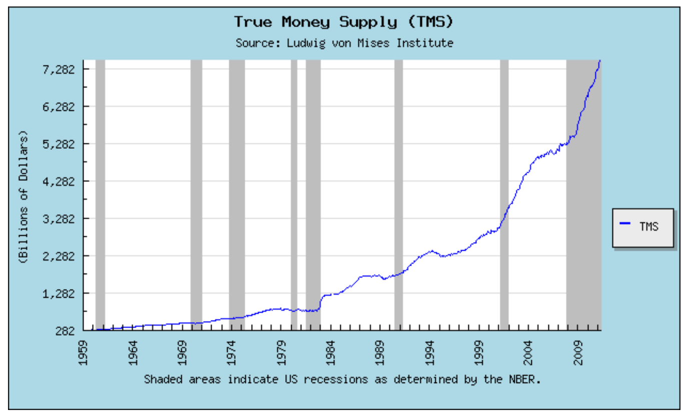
Above we look at a 200 year record of American productivity. With all of the inventions including the entirety of the hydrocarbon, electrical and internet ages productivity has grown annually at about 2% on a generational basis. Thus real (after inflation) interest rates above 2% represents a net transfer of wealth from borrower to lender. Looking at this picture can anyone condone the government promising a 30 year inflation protected retirement benefit of 8% annually to retirees (Oregon), or promise anything over 2%? Something major will give, and very probably before 2014.

At Cascade we have never officially subscribed to "politically correct" investing, but we have had a philosophy that companies engaged in activities that were harmful to human beings were probably not good long term investments. Your portfolio has never owned tobacco, alcohol or arms related companies. But we have had a big moral issue with slavery. We believe that we are living in an era of debt slavery that will end, probably within 5 years and, in our opinion, rather badly. We have not been invested in the banking system for a number of years (to your benefit) because banking has morphed into a system of control over our lives that is without recent historical precedent. It has become a 26% burden upon the productive sector of society and frankly unsustainable, unaffordable and politically protected from reform.

We say recent because there is a long history in the course of human affairs of debt slavery. In Book V of Aristotle's *Politics* he describes the eternal transition of democracy into aristocracy, into oligarchy, into revolution, into tyranny then back to democracy, endlessly. In ancient Greece a tyrant was a popular figure leading a revolt. Debt has always been the fundamental driving force of this cycle; both in its creation and destruction. Aristocrats always try to make their own wealth hereditary, and they always try to defend their privilege from competition. In the absence of innovation and productivity the aristocracy must live on rents and rising debts by someone.

Hammurabi's laws (c. 1750 BC) required that all agrarian debts be cancelled in the first year of a new regime. He recognized that debt slaves make poor soldiers in time of war. Egyptian pharaoh's had similar rules. Leviticus 25 speaks of the Jubilee year. Greece and Rome had debt cycles always with bloody results. Julius Caesar was possibly murdered because he sought to cancel the debts of tens of thousands of Roman debt slaves. By the second century AD about 25% of Romans were in debt bondage and this is one of the main reasons the empire collapsed.

The US Congress abdicated control in 1913 over the money supply to the Federal Reserve Bank which is a privately owned, Congressional regulated corporation that has as its principal goal the support the commercial banking system in America. From a practical standpoint its job is to create enough new money each year that the interest on the total nation' debt load can be paid. It has the unlimited license to create that currency, and they have been very effective. The consequence is inflation and since 1913 the purchasing power of the $US has decreased by 98%. That debasement continues as stated Obama Administration policy. The graphic below illustrates that True Money Supply growth is accelerating.



The Fed has been totally ineffective fulfilling the wish of Congress to provide both stable prices and full employment, but has been extremely effective in its support of the "too big to fail" banks. So effective that it has transferred trillions of dollars from the taxpaying public to the 13 oligarch banks without much commotion save the Occupy Wall Street movement.

This brings us to the theft of the customer funds at MF Global. MF Global was captured by John Corzine, the former co-CEO of Goldman Sachs, former Senator, former Governor, self- made aristocrat and a member of the Wall Street banking oligarchy. With a straight face he told Congress that he had "no knowledge" where the $billions lost investing in the sovereign debt of Greece, Spain, Italy and Portugal with the use of client funds were. Apparently he did not care that this is simply not credible.

Mr. Corzine must be supremely confident that his deceit would go unpunished by Congress or the Commodity Futures Trading Commission (CFTC). While those investors who had signed margin contracts with Lind-Waldock and MF Global could have their margin money comingled with the MF Global money was disclosed in the contract, the removal of cash balances in accounts without margin requirements was outright theft. We expect litigation to take years.

With the bankruptcy filing on October 31, J.P. Morgan in London (different set of rules than the US) seized all of the cash assets of MF Global and probably knowing that the assets had been transferred to London from the US without permission asked for a hold harmless letter stating they were only MF Global assets. We know of no such letter. What happened next is the big problem; all of the US accounts of MF Global were transferred to other brokerage firms who froze the accounts in place not allowing any trading until new money had been deposited. This is regulatory breakdown.

The Chicago Mercantile Exchange was formed as a mutual (member owned) company like the Chicago Board of Trade, the New York Stock Exchange, etc. to set rules for trading, rules for behavior and to stand in and protect customers from the fraudulent behavior of a member. In recent years the drive by the largest investment banks to earn more profits have led these exchanges to become for profit corporations where the customer's protection has become less clear. The unwillingness of the CME to come to the aid of Lind-Waldock clients threatens the entire farming, milling, mining, ranching communities and a substantial portion of our food chain.

MF Global and John Corzine illuminate the problem with the bank oligarchy in the U.S. The moral character of Congress and the effectiveness of the Federal Agencies they supervise has been entirely corrupted by campaign contributions. The neglected whistleblower laying Bernie Madoff's Ponzi open to the SEC to the President's Working Group on Markets almost daily intervention in whatever market they choose, the markets are seeing growing evidence of manipulation and malfeasance going unpunished. The ultimate consequence is a rising risk premium to do business in these markets both in the price of the paper asset itself, a risk premium for the risk of the exchange not performing and ultimately a risk premium for dealing in the sovereign currency of the regulating authority.

Two consequences of this already affect your portfolio: First, in the last few years have you noticed that about 90% of the time when the monthly jobs report comes out on the first Friday of each month that if the number is "bad" gold mysteriously falls on the second London Fix? We have.

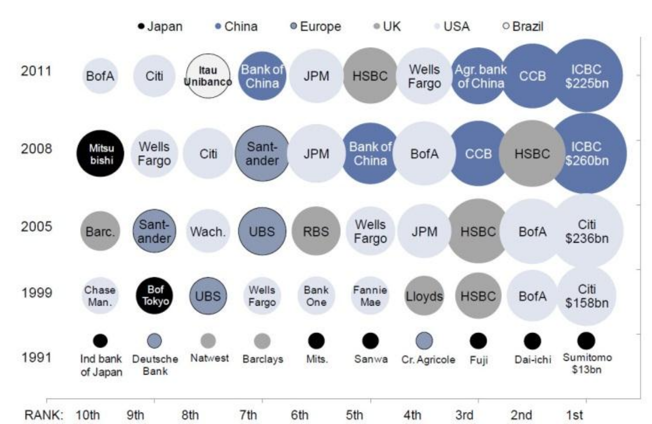
Second is the growing disconnect between the paper price of gold and silver set on the COMEX Exchange and the price demanded by physical bullion dealers. In the big takedown of paper gold prices last November, which directly and negatively affected the gold mining share prices in your portfolio, the prices asked for gold coins and silver bars declined only slightly. Dealers were unwilling to sell their inventory anywhere near the paper price.

Does this chart look like a bear market?

Richard Russell a famous market newsletter writer (still working in his 80's) noted that gold has been up 11 years in a row, and to his knowledge no commodity has done that in history. During the past 11 years we have been told that gold was in a "bubble" with increasing frequency. We have done no selling in any of the corrections since 2006.

***L**ast week it was quietly announced that China would purchase a modest amount of Japanese debt with some of their foreign exchange reserves (selling $US in the process), and the Japanese would do likewise. Further both nations have started a mechanism in Shanghai and Tokyo to settle trade transactions in Yuan and Yen. This will accelerate. This is a clear signal that major nations are seeking diversification from a depreciating asset, i.e. the $US and that the risk premium in doing business in dollars is rising. While this probably a natural move on the part of the Chinese, they have complained loudly in recent years about the erosion of the purchasing power of their $US reserves. The growing loss of confidence in the integrity of our Exchanges may very well be giving them cause to accelerate their movement to diversify out of $US denominated assets.

Top-10 banks by market cap and region



Source: Datastream.

***T**he rise of China as a major purchaser of bullion is important in another way. Many stories have been floated about the solvency of the major Chinese banks due to loans made to state mandated projects (like building completely empty cities), and facilities that have little long term usefulness and no long term ability to repay. No Communist government allowed its citizens to own gold until China legalized it several years ago. China now actively promotes it's citizenry to own physical gold, and in our opinion should stories of bank insolvency prove to be true the amount of money that would flee the banking system into physical metal would be astonishing. Consider the graphic on the other side of the page showing the importance of Chinese banks versus only a few years ago. All of the Central Bank selling under the Washington Agreement on Gold (WAG) has ceased for three years and the Brazilian, Chinese and Indian general populations remain relentless buyers of physical gold. China imported 85.7 tonnes of gold in October from Hong Kong up 50% from September and 40 times the amount of last year.

***T**he Sharp Charts graphic above plots the large cap gold mining stock index ($HUI) against the spot price of gold ($GOLD). Cascade first entered the mining sector in 2006 and mining company prices have been underperforming gold since then and in some cases dramatically. In the 2001 low spot gold prices were substantially below the marginal cost of production, but not so the corrections of 2008 and 2011.

We believe that the mining sector, while likely to fall at first in a general market correction will de-couple and produce very good results in 2012.

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