David Hay

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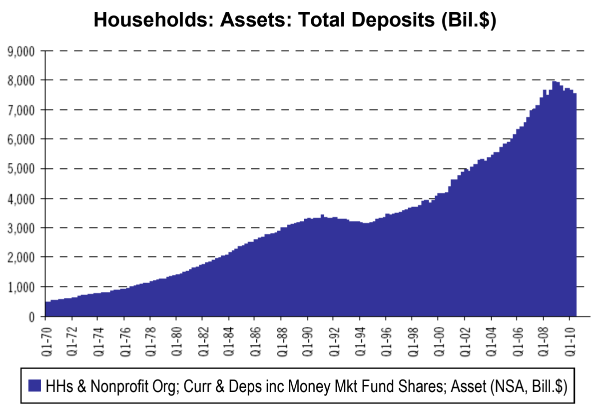
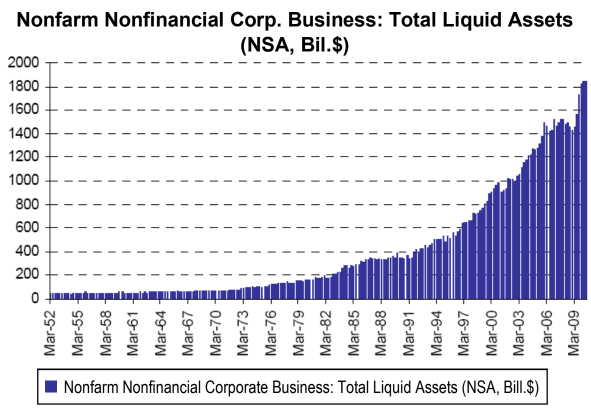
"Debt and deficits are not inventions of ideology. They are facts of arithmetic."

Paul Martin, Canada's finance minister at the start of the country's "Redemptive Decade"

Points to Ponder

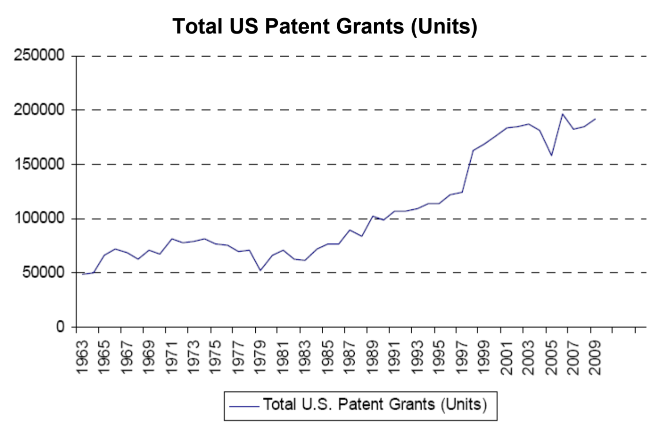
1. Despite the massive sums that have flowed into income vehicles over the last year, there remains roughly $8 trillion in bank deposits yielding next to nothing. Corporations also hold unprecedented quantities of cash.



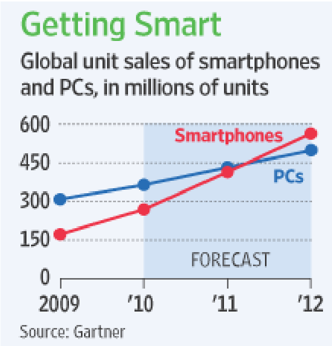


2. An intriguing aspect of the torrent of cash moving into bond funds is that nearly all of it is flooding into short-term vehicles. According to the Wall Street Journal, less than 1% of recent in-flows have gone into longer term funds.

3. Contradicting fears that America is losing its competitive edge, US patent grants to domestic entities have doubled over the last two decades. US and Japanese companies are essentially in a dead-heat for most patent awards, with all other countries trailing far behind.



4. In another illustration of how cheap stocks are relative to interest rates, the S&P 500 now has an earnings yield higher than that of junk bonds for the first time since Merrill Lynch created its index of lower rated corporate debt in 1987.



5. The only thing that might be more frustrating to Seattleites than our continually hapless sports teams is the performance of Microsoft's stock price. It remains stuck in the mid-20s, notwithstanding robust earnings. This may be a function of the flattening growth of PCs versus smart phones and Microsoft's lagging presence in the latter space.

EVAlauting the Environment

Arrivaderci, Italia; Yo, Canada. It's ok—you can be honest with me. Many of you on the receiving end of this newsletter were probably wondering if I had developed some kind of Italian infatuation, sort of like the young cyclist in that fun movie from the late 1970s, *Breaking Away.*

You can rest easy. Although I readily concede it is a breathtakingly beautiful country (save for Naples which we discovered is the Tijuana of Italy), my wife and I were thrilled to be back in the US of A, where the first thing I did was order a cheeseburger.

Certainly, the Italian locals were consistently friendly and extremely gracious even as we mangled their lovely language. However, as they opened up to us, it became clear how fearful they are about their country's economic future. Like so many southern European nations, Italy's debt levels have soared to grotesque levels, even compared to our own current state of fiscal debauchery.

Therefore, it was somewhat ironic that one of the two books I read while over there was about Canada and, specifically, the extraordinary financial turnaround that country has made over the last 15 years. Remarkably, if you were to roll the clock back to 1995, Canada was actually deeper in debt than Italy.

In those days, the Canadian dollar was derisively known as either the Loonie (after the bird on Canada's $1 coins) or the Northern Peso. The situation was so dire that the Wall Street Journal ran what turned out to be a pivotal article in which the authors asserted that Canada had become "an honorary member of the Third World in the unmanageability of its debt problem."

This editorial set off shock waves around the world and, of course, within Canada itself. To its credit, Canada's political establishment got fiscal responsibility religion in a hurry; it was almost like they went from being atheists to Southern Baptists overnight. And, get this: For the most part, it was the equivalent of Canada's Democratic Party that assumed the yoke of pulling the country back toward the high ground of financial solvency.

Do you think that perchance we could learn a thing or two from Canada's experience?

Canada High and Dry. It's been a consistent theme of mine for a year or more that Americans are not going to passively accept the disastrous fiscal path on which our brilliant political parties have put us. It has also been my belief that politicians from both sides of the aisle would get the message.

At this time last year, there weren't many who agreed with me (in fact, when I put forth this theory to the CEO of a huge financial firm 13 months ago he looked at me like I was suggesting the Mariners' front office knew how to run a baseball team). But the public backlash against unsafe and insane fiscal policies is now unmistakable, and it's very much a bipartisan movement.

Politicians, being the generally feckless creatures they are, have scrupulously (or should that be un-) avoided putting forth much in the way of tangible solutions prior to the critical mid-term elections, now just a month away. Yes, I know, the GOP came up with the Pledge to America and it's a start—of sorts—but it strikes me as woefully unequal to the massive task.

A far more rational way to approach the problem (I realize that rationality and politicians rarely converge) would be to make the book I just finished—*The Canadian Century, Moving Out of America's Shadow*—required reading for all incoming members of Congress. It would be nice to demand this from incumbents as well, but let's face it: Most of them don't even bother to read the legislation they put into law.

Many of you also know that I've brought up the remarkable Canadian renaissance more than a few times. Thus, I was truly excited to read the aforementioned book after seeing a review of it earlier this year. Though I was aware of the happy outcome, I really had no idea how Canada pulled off moving from "basket case to world beater," in the writers' own words.

And there's no exaggeration in that statement; Canada then was in far worse shape than even we are now in our headlong rush to fiscal perdition. For example, in the mid-1990s, one-third of all government revenues were being devoured by interest costs on Canada's rapidly escalating debt. Illustrating how bad that was, in the US today interest expenses consume just 10% of tax revenues, excluding the non-cash interest accrual on Treasury debt held by the social security trust fund (more on that later).

By the 1990s, Canada had also become one of the developed world's most socialized economies, with the government accounting for 53% of the country's GDP. Economic growth was stagnating while debt levels were inexorably and dangerously mounting.

At its scariest zenith, Canadian federal and provincial government debt amounted to 120% of GDP, with roughly 70% at the national level and an outrageously bloated 50% owed by the provinces. Again, to put that in perspective, despite our debt binge over the last decade, US government debt is around 60% of GDP while state debt is nearly 17% of GDP, or 77% overall (this is based on net, not gross, debt and excludes the social security trust fund holdings as well as intergovernmental liabilities).

Moreover, unlike our present situation, Canada's interest rates were rising due to worries about the nation's solvency. Its coveted AAA credit rating was yanked and the market was treating it as an increasingly unreliable borrower. In other words, it was much like the situation a number of European countries find themselves in today—except that Canada didn't have Germany to bail it out.

As you can readily see, there's simply no question that Canada was in some very deep do-do. Which begs the multi-trillion dollar question for us: How the heck did it get out of that jam?

Northern Composure. As I've given various speeches over the last year, it has become clear to me that very few Americans are aware of the extraordinary recovery Canada has achieved since the mid-1990s. When I bring it up, most people seem surprised that Canada could have gone from laughing stock to the envy of the developed world in just a decade. But, actually, 10 years wasn't the true recovery phase. And that was my big surprise from reading *The Canadian Century*.

The reality is that Canada achieved stunning progress in a mere *three years*. Further, this time frame was consistent at both the federal and provincial levels. In case you think I'm exaggerating the speed and magnitude of the rehabilitation, let me provide some specificity:

- Paul Martin, the finance minister for the national Liberal Party, unveiled a budget in early 1995 that shocked all the cynics accustomed to smoke-and-mirrors accounting. It *reduced* program spending by 8.8% over two years (and our politicos quiver over a mere hint of spending freezes).
- As part of this radical spending rationalization, federal government employment was reduced by 14%.
- Federal grants to the provinces were reduced by 14% as well, but the trade-off was that they were allowed to control how the money was spent. Provincial governments also needed to provide half of all funding (i.e., put skin in the game).
- While some taxes were raised (and, according to the authors, these worked against the recovery), spending cuts were 4 ½ times tax hikes.
- Canada's welfare system was dramatically modified. Rather than just providing a blank check to the provinces (which administered the welfare programs), Ottawa incentivized them to put the funds to better use. Benefits were cut for single, employable individuals and aggressive efforts were made to get them back in the work force.

- Despite accusations from the far left that the poor would suffer due to these changes, the percentage of welfare recipients fell in just a few short years from 10.7% of the population to 6.8% by 2000. From 1997 to 2007, the percentage of Canadians classified as low income plunged by over 30%.
- The tax structure was dramatically redesigned. Corporate tax rates were cut by nearly a third, taxes on corporate capital were abolished, and personal income and capital gains taxes were reduced.
- The General Services Tax (basically a consumption tax or VAT) was instituted to pay for the tax cuts described above. While initially very unpopular, it was a key part of the rehab plan.
- The Canada Pension Plan (CPP), the country's version of social security, also underwent major surgery. Instead of payroll taxes gradually rising to 14%, the increases were pulled forward but capped at under 10%. This produced immediate surpluses that were invested in higher returning corporate securities. (As noted in past EVAs, this is a huge defect with our social security system; its many trillions are tied up in low-yielding US government bonds that simply add to our overall national indebtedness.) The CPP today's well funded and actuarially sound.
- As a result of these actions, and many others I've left out, the federal budget was balanced *within three years.* After achieving this remarkable feat, Canada went on to produce 11 straight budget surpluses. This allowed our northern neighbors to reduce their federal debt from 80% of GDP to 45%.

Further demonstrating how quickly good policy can turn things around, the provinces enacted similar measures. Most of them also moved to balanced budgets or surpluses within just three years, though in the case of Ontario it took five years. However, that was still one year ahead of schedule (pronounced "shh-edule", of course). By contrast, even Congressman Paul Ryan's allegedly bold goal to balance the US budget will take decades to attain.

One of the recurring themes from *The Canadian Century* is the concept that not all taxes are created equal. Some have a much more negative impact on economic activity than others. This totally resonates with me and it's why I believe estate taxes should be our version of the VAT. However, I would concede that possibly a combination of the two might be necessary and desirable. Most of all, I have tremendous respect for what has worked in the real world and within a country so similar to our own.

By the way, in case you think that Canadians universally supported these rational reforms as they were first enacted, consider how similar our northern friends are to us. In other words, they are every bit as fractious as we are. There was a cacophonous chorus of extreme Keynesians (those who believe government spending should never be cut) who predicted Canada's grand experiment would be an abject failure.

Yet, despite all those who were sure that downsizing government would do the same to their growth rate, Canada's economy grew at 3.3% per year versus the developed world average of 2.7%. Notwithstanding Canada's undeniable success, should we decide to follow in its footsteps, be prepared for folks like NY Times columnist Paul Krugman to wax apocalyptic. Come to think of it, given his forecasting track record, that would be a good thing.

Quite an amazing story, eh? Unquestionably, and it's interesting that today, without giving Canada credit (probably due to its legendary pride, bordering on arrogance), most of Europe is essentially following the same game plan. Yet there is one immensely important difference.

The crucial currency tailwind. The aforementioned Wall Street Journal article from early 1995 that strongly suggested Canada was careening toward bankruptcy not only served as a national wake-up call, it also tanked the Canadian currency. While this collapse was highly embarrassing to its citizenry, it sowed powerful seeds for recovery.

Canadian goods became very inexpensive on world markets, thereby stoking demand. And Canada's real estate became irresistibly attractive to both American and Asian investors, drawing in massive amounts of hard currency.

As mentioned in numerous past EVAs, this is the vital missing link for countries like Italy. The stunning rise in the euro from the depths early this summer is the worst thing that could be happening to the Continent, especially for the weaker countries—almost all of them except Germany.

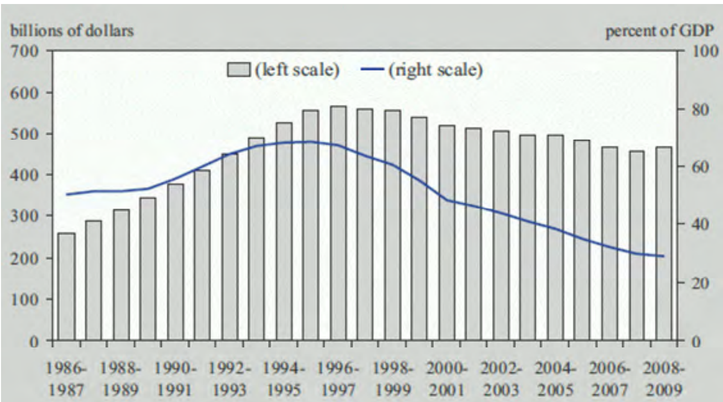
Fortunately for us, our situation is much more like Canada's was in the 1990s. The buck is once again seriously undervalued not only against the euro but versus the yen as well (the dollar recently touched 15-year lows against Japan's currency). This will greatly aid our exporters, who are already prospering.

Sadly, though, our political leaders seem absolutely oblivious to the miracle that happened right across our border and in very recent times. Perhaps I've missed it, but I haven't heard a single representative from either party bring up the notion of emulating Canada. Both parties seem to be infected with, among other maladies, an acute case of Not Invented Here-itis.

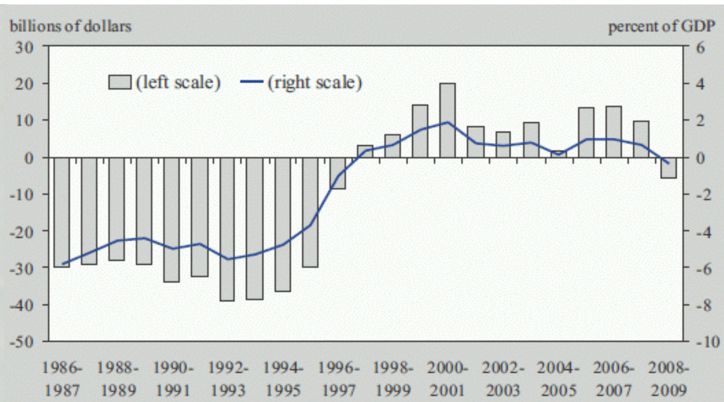
Maybe it's time for all of us who are deeply concerned about our country's financial future to harness the power of the internet to influence the many fresh faces that will soon be moving to the other Washington. The good news is that this incoming class promises to be far less indoctrinated by their respective parties' failed ideologies and much more open to innovative concepts.

If they are, it's not a stretch to believe that our finances can begin to track the Canadian path, as illustrated below.

Accumulated Deficit



Annual Surplus/Deficit



Role reversal time? *The Canadian Century* was clearly written for domestic consumption. As such, there is a fair amount of chest-puffing over Canada's accomplishments as well as some thinly veiled savoring of our current predicament (the Germans have a perfect word for this: schandenfreude). Yet the authors also concede a few chinks in Canada's armor.

For one thing, they note that there is some serious backsliding going on when it comes to adhering to the fiscal reformation creed. A certain amount of this is attributable to combating the ravages of the Great Recession, even though Canada was not nearly as hard hit as was the US. But beyond this, the authors are seeing clear evidence that the resolve to restrain spending seems to be waning.

Alas, this does seem to be the natural cycle of democracies: Governments spend recklessly until the situation is so bleak there is no choice but to drastically cut back. Once financial health is restored, there then seems to ensue a long, almost imperceptible erosion of fortitude until a crisis hits and debt levels rise so terrifyingly that corrective action becomes unavoidable. Often, as in Canada, it's the more putatively liberal party that administers the tough but necessary medicine.

The book is also quite candid in its admission that Canada's healthcare system is largely as dysfunctional as our own. The authors point out the immense challenge that lies ahead for both countries in bringing the wealth-devouring beast of healthcare under control. It's hard to disagree with their belief that both the US and Canadian healthcare systems need a healthy injection of incentive-based economics, competition, and behavioral modification. Thus far, neither country has made much progress in that regard.

For me, though, the key message of this book was that the future does not have to be a depressing choice between accepting sub-par growth or committing fiscal suicide. Canada's experience emphatically demonstrates that replacing bad policies with good ones leads to dramatic and rapid improvement, with the shift to financial soundness restoring confidence and actually boosting long-term growth.

Some forty years ago, then US President Richard Nixon famously remarked: "We're all Keynesians now." To fully channel his inner Keynes, Nixon needed to take us off the gold standard, which he did in 1971. The keys to the perpetual printing press had been found. Soon thereafter a new economic term was coined: stagflation.

These days, at least when it comes to fiscal policy, a far wiser statement would be: "We're all Canadians now." If we want to right our nation's financial ship, we might be well-advised to swallow our pride, and follow the lead of a country that has long been in our shadow. This is likely to be far more effective than further pursuing failed economic policies from our distant past.

David Hay | Chief Investment Officer | Evergreen Capital Management, LLC

Our Current Likes & Dislikes

We Like	*We're Neutral On*	*We Don't Like*
Intermediate municipal bonds *with strong credit ratings*	Publicly-traded pipeline partnerships *yielding 6-7%*	Real Estate Investment Trusts (REITs)
High quality preferred stocks *yielding 7%*	Investment grade corporate bonds	Most cyclical resource based stocks
BB-rated corporate bonds *(i.e., high quality, high yield)*	International developed markets	Intermediate Treasury notes
3-year to 5-year FDIC CDs	Long-term municipal bonds *with strong credit ratings*	Longer-term Treasury bonds
Blue chip oil stocks	High quality preferred stocks *yielding 7%**	Small Cap Value
Large Cap Growth	Emerging stock markets	
Large Cap Value	Emerging bond markets	
Mid Cap Growth	High yield (junk) bonds	
	Gold-mining stocks	
	Small Cap Growth	
	Mid Cap Value	
	Cash	
	Gold	

**High quality preferred stocks yielding 7% were moved from We Like to We're Neutral On this week.*

EVERGREEN CAPITAL MANAGEMENT
10500 NE 8th Street, Suite 950
Bellevue, WA 98004
425.467.4600 | 800-755-1359
www.evergreencapital.net

For information regarding sources referred to and used in this article, please contact Kim Harlan at: kharlan@evergreencapital.net