CONWAY• JARVIS LLC
Investment Outlook

Volume 27 Issue 2 June 27, 2017

Can Congress Deliver on What the Market is Promising?

In our April letter to clients we stated the obvious: Government is anything but nimble in formulating policy. We shared that in the context of tempering our expectations for what might be accomplished in Washington this year. So far, our very modest expectations have not been exceeded. The crafting of a new Healthcare Initiative and Tax Reform Bill are essential to the budget process. Despite the flurry of late night, optimistic tweets emanating from the White House, those charged with actually conducting the legislative process have found it difficult to get off the starting line. We aren't surprised and, thankfully, the stock market has taken it in stride. It seems to be focused on things other than the theater starring the Russians that's being presented in Washington these days. Things like improving earnings, lesser regulation, and an approach to tax reform that puts the economy first. So far, that's been enough to reward investors. However, that's unlikely to continue if results don't match the rhetoric. 2018 might prove to be a different year for the markets.

The Market Prices in Great, or at Least Good, Expectations

The Global stock market has, at the end of May, logged a return that would satisfy most investors for an entire year, led by the Developed and Emerging Foreign markets (+14% and+17% respectively). It's about time. Foreign markets have seen a revitalization of their economies and stock markets that had underperformed those of the US since 2010. US stocks have lagged this year, perhaps due to the sobering thought that 3% GDP growth may be beyond our reach in spite of Washington's best efforts. At this time, the US stock markets are awash in complacency as indicated by the record low level of volatility. That's all good but while stocks have been pointing to a brighter economic future, the bond market is leaning in the opposite direction.

Despite a fourth increase in key rates since 2015, the 10-year treasury yield is essentially at the same level it was when the Fed began to tighten. So, while the stock market and the Fed price in an improving economy and a return of moderate inflation, the bond market is pricing in deflationary pressures. What gives? One might explain this as being the result of instability in global markets that has triggered a flood of foreign investment in US treasuries. While that may have been true several years ago, that instability has moderated, as evidenced by both foreign stock and bond markets. We're left asking whether the bond market is sending investors a warning about the next cyclical slowdown, better known as Recession, or just reflecting serious doubts that the extent to which the Republican agenda will be realized. We choose door #2.

As of now, we discount the prospect of Recession because of data pointing to a renaissance of the US Production Sector (Manufacturing and Services) accompanied by a return to full employment. What does give us pause is the absence of wage pressure that usually accompanies full employment. Add to that the unimpressive set of data flowing from the Consumption sector. Consumers, benefitting from the Fed's accommodative monetary policy, shouldered the burden of moving the economy forward from 2010 on while the Production sector dithered over the absence of a stimulative fiscal policy during the Obama years. We're still without one, but the promise of one is on the current agenda. That leaves businesses increasingly confident about the future and more willing to invest and expand. That's essential to push GDP growth back to the 3% level and is contingent on Congress reaching the finish line on several initiatives by this time next year.

Moving the Agenda Forward in Washington

The cost to government for a Healthcare initiative has to be folded into the budget equation before there's any discussion of tax reform and it's effect on the deficit. We see this as *the* major hurdle to crafting a *lasting* fiscal policy that steepens the growth trajectory of the US economy. Back in 2008, the White House and the party in control of Congress at the time designed and passed a healthcare plan that was unsustainable and could never deliver what was promised to the American public. Now, Republicans promise to repeal and replace the ACA with a better plan. It might be different but whether it's *better* depends on the terms by which you measure it.

The ACA promised healthcare coverage for virtually everyone, lower premiums, and no change in coverage. That proved to be little more than well-intended, wishful thinking. The ACA did increase the number of those covered but it was built like a time bomb that would go off after its namesake had long departed the White House. The financial reality? It's proved to be structurally unsustainable and headed for collapse under the weight of consumer preferences and market forces. Comprehensive care for all at a lower cost is an unrealistic goal. So too, is the expectation that all providers will remain in-network and all insurers in the marketplace. In our view, the ACA promised us a unicorn. Today, the ruling party is touting the benefits of its plan, one that does reflect the hard truths and financial realities of a government-engineered, comprehensive healthcare plan. We see it as merely a second iteration of Obamacare, whereby fewer people will be covered and premiums will increase. In the end, it's just another unicorn of a different color.

Our two cents? We think both parties are on a path to nowhere with their respective plans. It's unlikely that anything short of a government-sponsored, single-payer *option* constructed as a safety net will solve the problem. The idea of using that *option* as part of a two-tier, public/private plan has not gained traction on the federal level. A few states are intent on constructing a Medicare-like plan for all. We think it's a first step in the right direction, but we'll be watching with great interest to see how it's funded. The second step is accepting the fact that one size cannot fit all when it comes to healthcare and that a for-pay private option has to be part of the overall plan for those who can afford it. We don't want to replicate the Canadian experience. Ask anyone on a waiting list up there. Meanwhile back in Washington, we expect to see a compromise among Republicans that will result in a bill being passed. Our guess is their version of the ACA will simply kick the can down the road once again. Regardless, that box will be checked and everyone can move on to tax reform.

There, we'll get an up-close look at the class war being waged in D.C.. The subtext will focus on the capitalist agenda vs. the progressive. Isn't *progressive* just another name for socialist when it comes to economics? The media will present it as a struggle between good and evil, the Fat Cat vs. the Little Guy. We see it as more of a battle over priorities: What's best for the country as a whole or what's best for a particular constituency? The opposing views are evident in each party's agenda. It would appear the stock market clearly favors the capitalist agenda. It's the nature of the beast and why we remain somewhat complacent in our bullish outlook. That will continue unless any current distractions become so great as to obstruct the completion of the Republican agenda between now and the mid-term elections. Should that happen, we could see current optimism for the economy wane and the market reverse course. We'll keep you posted.

Conway ● Jarvis LLC