U.S. Economic and Regulatory Outlook: Implications for Corporate Leaders

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Overview

The panelists generally have an optimistic outlook. Those from the financial sector believe that the economic outlook is positive, driven by corporate earnings, cash flow, and margins. Companies and industries with operating leverage should perform particularly well, as they translate gains in sales into even greater gains in profits. While the stock market is unlikely to match its robust returns of 2013, positive returns of around 10% are possible.

There is also optimism on the M&A front. After years of sitting on cash, corporations are feeling more bullish and are beginning to use some of that cash to do deals. Also, debt remains cheap, private equity firms have built sizeable funds, and activist hedge fund managers are pushing companies to return cash through dividends or share buybacks. These factors are influencing CEOs and boards. At the same time, there are opportunities for value investors, with particular opportunities in the energy sector due to low natural gas prices, and opportunities with companies that can flourish in a deflationary environment.

A key factor affecting all companies and all sectors is the Affordable Care Act. Implementation of the ACA to broaden access to healthcare insurance is proceeding, as are initiatives and experiments to try to constrain the growth of healthcare costs. But controlling costs is extremely difficult, fraught with political difficulties, and uncertain, and will take considerable time.

Context

Former HBSAB president Rick Williams described what has become a tradition in convening a panel of economic and regulatory experts to share their thoughts on the outlook for the year ahead. Over each of the past few years, the panelists, outlook, and discussion have been quite different.

Professor Schlesinger then led a discussion in which three leaders from the finance community (Wolfe, Lubowitz, and Horn) each shared their perspectives and highlighted a few key points. Professor Gruber summarized the key ideas underlying healthcare reform and discussed how health reform is playing out.

Rick Williams

Professor Leonard A. Schlesinger

INTRODUCTION

Rick Williams
President, The Equity Company, Inc.; Past President, Harvard Business School Association of Boston (HBSAB)

MODERATOR

Leonard A. Schlesinger
Baker Foundation Professor, Harvard Business School

DISTINGUISHED SPEAKERS

Professor Jonathan Gruber
Ford Professor of Economics, MIT; expert on healthcare and the Affordable Care Act

Bernard Horn, Jr.
President, Polaris Capital Management, LLC

Michael Lubowitz
Co-Head, New York Private Equity and Mergers & Acquisitions Dept.,Weil, Gotshal & Manges LLP

Christopher Wolfe
Chief Investment Officer, Private Banking and Investment Group, Merrill Lynch Wealth Management

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Key Themes

The trajectory for economic growth continues to improve, which could bode well for investors.

Mr. Wolfe sees a trajectory of improving economic growth through the remainder of 2014 as well as 2015. Positive economic growth is being led by the corporate sector, and specifically by the durability of profit margins. Mr. Wolfe sees generally good fundamental trends, expects profit margins to remain strong, and sees a good likelihood that companies will continue to generate good cash flow. He is particularly interested in sectors with strong operating leverage, where a positive change in sales produces an even more positive impact on the bottom line. Industries like energy and technology tend to translate a small gain in sales into a much larger gain in earnings.

He believes these positive trends—particularly durable profit margins and operating leverage—could translate into a decent year for equity investments. Mr. Wolfe forecasts potential returns for 2014 of roughly 10% for U.S. equities, with perhaps slightly higher returns outside the United States.


Christopher Wolfe

Supporting this positive outlook is that central banks will continue to inject money into the system (though less than in the past), which helps keep volatility lower than it has been. However, even with this generally positive outlook, Mr. Wolfe sees this as a time to expect more changes in the market than in the recent past, to rebalance portfolios, and to be a bit more cautious. He anticipates that stocks will perform better than bonds and commodities, though there are some bright spots in commodities, and bonds provide a "safety valve." For many investors, municipal bonds are an attractive investment, with tax-adjusted yields of 6–8%.

2014 could be a good year for M&A activity.

Mr. Lubowitz, who is intimately familiar with the world of M&A, described 2013 as an "up and down year" which started slowly but picked up during the year, with a very strong fourth quarter. Overall, deal counts in the U.S. were up and 2013 was highlighted by several very large deals, such as Verizon's $130 billion acquisition of Vodafone's interest in Verizon Wireless. The momentum from the last part of 2013 has continued into 2014. Mr. Lubowitz sees the following drivers of increasing M&A activity:

- **The low cost of debt.** Debt remains cheap and the terms are good.
- **An abundance of cash on balance sheets.** Corporations are sitting on record amounts of cash and private equity firms have raised huge funds. For several years post-crash, CEOs were extremely risk averse, lacked confidence in acquisitions, and were content to sit on their cash instead of taking a flier on an acquisition. But CEO confidence is changing. Many CEOs believe we have now emerged from the crash, are seeing attractive values, and are engaging in M&A.


Michael Lubowitz

- **A rise in shareholder activism.** Many hedge funds have become activist shareholders. Activism has increased, and those funds taking an activist approach have dramatically outperformed the industry average. In general, activist shareholders are pushing to have cash returned—either through share repurchases or dividends—and are also pushing for

> "There's still some pretty good fundamental trends . . . not just in the U.S., but there are improvements in Europe, and to a lesser extent Japan, that give us a lot of confidence that we'll have a reasonably good year in equity markets."
> Christopher Wolfe

> "The cash on the balance sheet of corporations is at all-time highs. For a number of years post-crash, companies were not interested in using cash to do deals . . . but CEO confidence is changing. When CEO confidence is high, deals happen."
> Michael Lubowitz

strategic acquisitions and dispositions. These activities are having an effect on CEOs and in board rooms.

Attractive opportunities exist for value investors with unique, somewhat contrarian philosophies.

As a value investor, Mr. Horn and his firm look at the world a bit differently. He touched on three subjects that play an important role in his firm's investment strategy:

- **The future of energy.** Due to shale gas and fracking, the supply of natural gas—much of it in the U.S.—has increased and the cost has fallen. At the same time, oil prices have remained high. This is creating an arbitrage situation where natural gas is far more cost-effective than oil. This is helping economic activity in the U.S. as companies invest in new facilities to take advantage of low natural gas prices.

Bernie Horn, Jr.

- **The impact of deflation.** Emerging economies have inflation while the developed world has persistent deflation, seen through real wages in the U.S. that are largely unchanged over the past 30 years. Conventional wisdom is that deflation is problematic and risky. But Mr. Horn doesn't see it that way. In fact, his firm is in favor of deflation. They believe that the Fed's inflation target should be -2%. He argued that technology is deflationary in that it lowers costs, and companies such as WalMart are deflationary in that they provide products at lower prices. In these situations, the result of deflation is positive, not negative. Also, deflation would mean lower costs for consumers and corporations, which would make housing and labor more affordable, and would help create more jobs.

  Note: One of the other panelists argued that while pockets of deflation, like technology, can be beneficial, systemic deflation is bad for economies, which has been proven.

- **Identifying deflation beaters.** In a deflationary environment, some companies can succeed by managing their costs extremely well and can lower the costs for their customers. Mr. Horn's company has had success by making deflation beaters an important investment theme.

Efforts to reform the U.S. healthcare system aren't new.

Politicians going back about 100 years have talked about trying to reform the U.S. healthcare system, with serious attempts to do so roughly every 20 years. (To learn more, read *Remedy and Reaction* by Paul Starr.) Efforts to reform healthcare have always fluctuated between two extremes:

- **The left.** The extreme left has favored a single payer health system which would solve the problem of the uninsured by providing everyone insurance from birth. Costs could be addressed by regulating costs. This position has had no political chance of succeeding, because most Americans have had access to healthcare and most Americans have been fairly happy with the system. So, instead of major reforms the country put an employer-sponsored health insurance system in place, with tax breaks for employers, and enacted Medicare and Medicaid.

- **The right.** Those on the extreme right see the current system as working, don't want to change it, and favor simply giving tax credits to help everyone afford care. The problem with this perspective is that it ignores the reality that a substantial minority (currently, about 50 million people representing 18% of the population) lack coverage. And, if a person is not insured by their employer or the government, they are essentially uninsured.

> "We're trying to find lots of ways to invest in companies that are trying to make this arbitrage very profitable."
> Bernie Horn, Jr.

That's because in the individual insurance market, a person who has been sick will either be denied coverage or will have to pay exorbitant prices. The solution from the right hasn't worked.

The model for a pragmatic solution came from Massachusetts and Mitt Romney.

As governor of Massachusetts, Mitt Romney developed a solution termed by Professor Gruber as "Incremental Universalism." The idea of "incremental" borrowed from the right, in building on what works and leaving alone those with coverage. The idea of "universalism" borrowed from the left in working to get to universal coverage.

Romney's solution had three elements:

Jonathan Gruber

1. **Fix insurance markets so that insurers could no longer discriminate against the sick.** This meant requiring insurers to provide coverage to everyone, regardless of their health status, at fair price levels. This had previously been through "community rating" where insurers could not deny insurance to anyone and priced based on the rating of a community. The problem was that when this was the only policy enacted, sick individuals signed up and healthy individuals did not.
2. **An individual mandate.** In order for the insurance market to work, everyone has to participate, meaning both the sick and the healthy. In exchange for insurers having to cover everyone, everyone has to be mandated to sign up for insurance. This mandate is what makes the system sustainable.
3. **Subsidies.** Since all people are mandated to purchase insurance, subsidies are needed to make insurance affordable for lower-income individuals.

This solution was implemented in Massachusetts in 2006, and has largely been successful. Two-thirds of those in the state who lacked insurance are now insured, and the uninsured rate in the state is 3%, compared with 18% nationally. The price of health insurance in Massachusetts has risen at the same rate that insurance prices have risen nationally.

The Affordable Care Act borrows heavily from Massachusetts, though the ACA has an added focus on controlling costs.

The approach in Massachusetts became the model for the Affordable Care Act, even though as a candidate, President Obama opposed this plan. The approach of fixing the insurance market through guaranteed coverage and community rating, an individual mandate, and subsidies (done through the expansion of Medicaid) forms the core of the ACA.

But reforming healthcare nationally is much harder. The federal government helped cover the uninsured in Massachusetts, but needed other funding sources to pay for health reform nationally. So, reductions were made in Medicare spending and new taxes were enacted (on medical devices, on Cadillac health plans, and on families earning more than $250,000).

Also, unlike in Massachusetts, where cost control was not a legislative goal, it was part of the ACA. The problem is that controlling healthcare costs is extremely difficult. One perspective is that costs have increased tremendously—but it has largely been worth it, as people now live longer, healthier lives. The true issue in controlling costs is political, as there are vocal opponents who will fight any changes in reimbursement, even in the face of overwhelming scientific data.

> "We left people alone who liked what they had . . . prices are rising at the national trend, and we have fixed the system for people for whom it wasn't working."
> Professor Jonathan Gruber

That said, there are several actions within ACA that attempt to control cost growth. These include:

- **The Cadillac tax on health plans.** This essentially imposes a cap on the tax break for health insurance. Cash income is taxed but health benefits are not. This essentially imposes a tax on some portion of health benefits, which could reduce the excessive amounts of healthcare that people purchase.
- **Health insurance exchanges.** These exchanges create competitive marketplaces where consumers shop for insurance.
- **The Independent Payment Advisory Board (IPAB).** This board is going to play a key role in attempting to move the country from a fee-for-service payment system to a value-based payment system.
- **Comparative effectiveness.** Previously, drugs would get approved by the FDA based on whether they were safe and worked. But there was no data regarding cost effectiveness. For example, two drugs might work equally well, with one being 10 times more expensive. The ACA puts $3 billion into researching what works.

In addition, there are dozens of experiments about alternative ways to deliver care and reimburse providers, such as Accountable Care Organizations (ACOs). Progress is already taking place in expanding insurance coverage, but controlling costs will take years. What matters is not reducing current cost levels, but simply constraining the degree of cost growth. Patience is needed in this long journey.

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