Can Congress (or anyone) fix the health care industry?

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John Adams complained in *1776*, "One useless man is called a disgrace; two are called a law firm; and three or more become a Congress.…We piddle, twiddle and resolve, but not one damn thing do we solve." That attitude makes it awfully tempting to blame Congress for its inability in the past decade to craft a bipartisan reform of our health care system. Yet as fractured and dysfunctional as Congress has been throughout our nation's history, our legislative branch hasn't been the real problem here; the flaws are deeply embedded in the industry's structure.

Consumers and buyers are different entities. As a result, the entire health care system has come unmoored from basic economic principles of supply and demand, cost and price. We consumers don't know how much anything actually costs, so we cannot judge for ourselves whether we are spending our money wisely; nor can we comparison shop for the best price. Purchasers (insurance companies and government) can't judge how a free market might set prices, so they simply accept the prices demanded by providers. And fifty years of regulation have created a hopelessly complex and expensive bureaucracy that adds no value to the actual care provided.

The cost to society of this system is staggering. As the chart nearby shows, per-capita expenditures on health care have soared while spending on everything else has barely budged. Health care now consumes 22% of our total personal spending, up from 6% in 1959; it has crowded out nearly all growth in consumer spending on anything else.

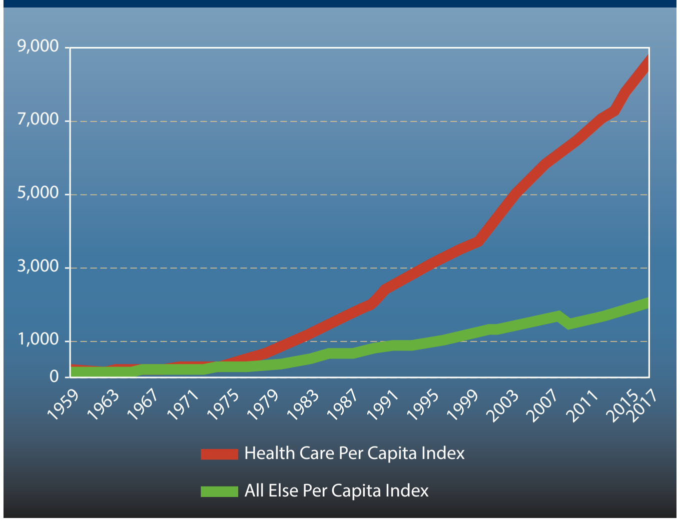
The recent Republican bills aimed to reduce federal spending through sharp cutbacks to Medicaid, which may have been partially offset by higher state-level funding. Medicaid constitutes only 26% of federal entitlement spending; Medicare and Social Security are larger, and are likely to grow faster as more baby boomers hit retirement age. Consequently, the Republican bills would have shifted the dollars around (and imperiled access to care for millions) but did nothing to address the root causes of runaway health care costs.

Fixing the problem requires that consumers regain direct knowledge of the true costs of health care products or services, and that we gain the ability to shop around for better prices. A free and open market can enforce price discipline on service providers, drug makers, equipment suppliers, and other participants. Medicare has been successful keeping per-capita costs down in large part because it exerts pricing power over the entire health care system. Insurers should do the same, but their economic incentive is perverse: they earn higher profits by simply passing higher costs through to consumers.

It's no surprise that health care stocks have been market leaders for decades, through bull and bear markets alike. They have generated monopoly-like profits and paid robust dividends, unimpeded by marketplace discipline. If a different regime had been in place over the past half-century, health care stocks might not have performed so well, but the immense savings to consumers would have been manifest in better performance in a host of other industries.

If Congress had the bipartisan backbone today to stand up to the many special interests in health care, it might be able to drive costs down by eliminating bureaucracy and by reducing the monopoly rents. That would have far greater beneficial effect than simply targeting Medicaid, because it would reduce cost without reducing access to care. Alas, it's probably too much to ask, as John Adams knew when he pleaded with the Almighty: "If you don't want the voice of sanity forever still, then God, Sir, get thee to it — for Congress never will!"

PER CAPITA EXPENDITURES (INDEX: 1959=100)



>> FOCUS ON EQUITIES

Newton's Laws of Motion drive stocks to new highs

By Rose Grant-Brooks
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Many professional investment managers were well educated at the finest schools, with training in sophisticated research protocols and valuation methodologies. Yet often they make important decisions based mainly on simple market aphorisms: "The trend is your friend" or "Sell in May and go away," for example. The expression "Don't fight the tape" suggests not to trade against the trend in equity markets; if stocks are moving up, the saying goes, they are more likely to continue their ascent. Call this Newton's First Law of Market Motion. The adage has held true this year, as stocks have gradually and consistently crept upward; the S&P 500 posted an 8.2% gain by the halfway point. The external forces envisioned by Newton's Second Law of Market Motion have largely canceled each other out, resulting in the lowest volatility in a half-century and no major downdrafts.

Equity markets are riding improving corporate fundamentals. Double-digit earnings growth is the strongest we've seen in five years. Beyond our borders, economic growth has improved and monetary policy remains accommodative, which is providing better prospects for U.S. companies operating internationally. These trends are sustainable and could result in steady positive results for the equity markets.

When markets rallied after President Trump's election, they were carried by the belief that tax cuts, infrastructure spending, and deregulation would swiftly follow. That has not occurred; instead of legislation, the news from Washington has been about political turmoil and delays in enactment of any form of fiscal stimulus. This comes at a time when the Federal Reserve has increased the federal funds rate four times and plans to reduce its $4.5 trillion balance sheet; as the Fed withdraws monetary stimulus, economic growth may increasingly depend on Congress to implement the policies heralded on Election Day.

In the near term, equities can be supported by higher earnings and a growing economy. A correction, always a lingering possibility, would not necessarily represent an end to the current bull market. Still, sustained earnings growth and stock price appreciation may depend on legislative action. In the meantime, "Don't fight the tape" competes with the more bearish "Don't fight the Fed" as the dominant equity investment theme of the moment.

>> PERSPECTIVES ON FIXED INCOME

Central banks shift their perspectives and their strategies

By Tom Bussone
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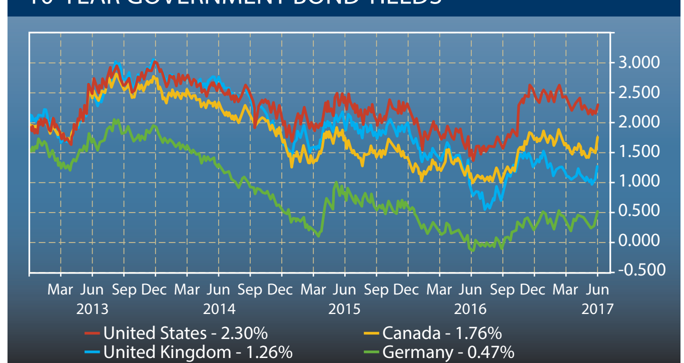
Since the Great Recession, central banks around the globe have been operating under extraordinarily easy monetary policies in efforts to cut interest rates, raise asset values, stoke inflation, and stimulate what has been an anemic economic expansion. That era now appears to have ended; several central banks have changed course and are now determined to normalize their policies despite inflation lingering below their target goals.

The Federal Reserve has been leading this increasingly hawkish stance, having raised the federal funds rate twice this year to 1.25%. The Fed is also prepared to start trimming its balance sheet by year-end. (Rolling off long-term securities sucks money out of the financial system, effectively tightening monetary conditions.) The Bank of England and Bank of Canada have also signaled that they will likely follow the Fed's path. Surprisingly, even European Central Bank President Mario Draghi has acknowledged that the European economy could withstand a pullback of unconventional monetary policies, such as the tapering of bond purchases.

The shift in central bank rhetoric has sent sovereign debt yields higher. Yet despite the sell-off, yields of U.S., U.K., Canadian, and German 10-year debt are all still within one percentage point of their lows set during the credit crisis. With global growth picking up steam, we think the central banks will continue to be less accommodating; yields will slowly grind higher. Even so, the upside in yields is likely limited until global growth accelerates along with increased inflationary pressures.

10-YEAR GOVERNMENT BOND YIELDS



Interest rates on government bonds have finally begun to rebound.