Commentary from Jim McDonald, Chief Investment Strategist

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This past week President Obama signed into law the Patient Protection and Affordable Care Act, increasing healthcare coverage from around 83% of the population to 94%, increasing restrictions on health insurance companies and implementing new taxes to help pay for the program. The Senate also passed the reconciliation bill which was the final piece of legislation tied to the healthcare expansion and reform effort. With the legislative effort on life support a month ago, the Obama administration has scored a political victory by doubling down and they have avoided a humiliating defeat. What does this victory mean for the administration, the economy and the financial markets?

The Obama administration made a calculated (or principled) thrust to pass a bill about which the American people had very mixed feelings. Confirming other national polls, a March 20-22 poll by YouGov® (from *The Economist*) showed a slight plurality of Americans believed the House of Representatives should vote against the bill. The most notable reason for this view, cited by one-third of respondents, was a belief that healthcare costs would increase "a lot" under this legislation. But the surge to pass the bill may pay dividends for President Obama, as a *Washington Post* poll released today indicates a five-point increase in approval of his handling of the healthcare issue (although to just 48%). The president has certainly sought to capitalize on this momentum, with his 15 recess appointments, Russian nuclear arms control agreement and visit to Afghanistan. Will this embolden the administration to advance additional planks of the Democratic platform, including climate change, labor and taxation? While we think the uncertainty of the mid-term elections will provide some limiting effect, we do think the administration will be bolder than if the healthcare legislation had failed. So our theme of extraordinary government involvement in the economy and financial markets stays intact and continues to warrant extra focus.

With respect to the impact of the legislation on the economy, the risks seem tilted to the downside. The increase in coverage of about 25 million Americans is the largest component of this expansion, which the Congressional Budget Office estimates at around $900 billion (including $433 billion toward Medicaid and $358 billion toward subsidies). Analysis conducted by the independent RAND Corporation forecasts a 2% increase in overall health spending by 2020 from the new legislation, compared with our current system. While citing clear benefits from improving health care for the previously uninsured, those same people who avoided routine care in the past will now seek it and increase overall costs. But it is the reliance on tax hikes to pay for half of the cost that tells the true financial impact of the plan – an expected $517 billion over 10 years. On a cyclical basis, the impact is not large – this increase in taxes of less than 0.5% of gross domestic product

(GDP) seems unlikely to derail the cyclical recovery. On a long-term basis, we seem to have done little to address our structural problem and we will likely be back at the legislative table several years from now, when an increase in U.S. interest rates from bond market vigilantes may be needed to force Congress to finally fix our long-term cost problem.

HEALTH CARE PLAN ANALYSIS		
LINE ITEM	**WHAT IT COSTS ($BIL)**	**HOW ITS BEING PAID ($BIL)**
TOTAL COSTS	**898**	
Extra Medicaid & CHIP Costs	434	
Health Insurance Exchanges	358	
Other Costs	106	
TOTAL SPENDING CUTS		**524**
Medicaid/Medicare & CHIP Spending Cuts		455
Other Spending Cuts		69
TOTAL NEW TAXES/FEES		**517**
Taxes on High-Income Earners		210
Fees on Manufacturers & Insurers		107
"Cadillac" Plan Tax & Uninsured Penalty		105
Other Revenue Generation		95
EST. SURPLUS OVER 10-YR PERIOD	**143**	

Source: Congressional Budget Office, Joint Committee on Taxation, Northern Trust

So what are the investment implications of the healthcare legislation? The stock market has had a long time to digest this possibility and the reaction has been muted. Healthcare stocks modestly underperformed the broad market, falling 1.0% compared with a 0.6% rise in the Standard & Poor's 500. We think the passage of the bill is a minor positive for the healthcare stocks – increased patients seeking care (volume) will offset reduced reimbursement levels (price), plus the removal of this legislative uncertainty is a plus. The U.S. dollar actually strengthened 1% on a trade-weighted basis on the week, a reminder that as bearish as you may want to get on the prospects for the United States, you need to spend an equal amount of time analyzing the dollar's competition. In this instance, concerns about the European support plan for Greece overshadowed our issues. Finally, the bond market did see some selling pressure, with the 2-year yield rising six basis points to 1.04% and the 10-year climbing 16 bps to 3.85%. While I think an improved growth outlook was the principle cause of the rise, concern about increased supply cannot be dismissed.

The current global economic backdrop remains constructive. On top of economic strength led by the emerging markets and followed by the United States, we got some better news out of Europe last week. The Markit Flash Eurozone Composite Output Index rose to 55.5 in March, which is consistent with 2.5% GDP growth. While we have had some short-term pressure in interest rates over the last month, we do not expect either growth or inflationary pressures to lead to a jump in interest rates this year. Our key wildcards remain either a mishandling of monetary policy in China, leading to a dramatic slowdown in growth, or a political policy error in the United States leading to disappointing growth. While the healthcare debate has engaged many Americans in a heated discussion over the last year, it doesn't look like its impact will be large enough to derail the cyclical economic recovery and the attendant increase in risk-taking that have driven financial markets off their lows of last March.