

UBS Investment Research

Great Suppression II

Americas

Equity Strategy

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Revolt of the Employers

■ It's Not All About Debt: Onerous Regulation is Discouraging Hiring

What J.M. Keynes called “animal spirits—a spontaneous urge to action rather than inaction” is being suppressed by regulations ranging from the familiar (healthcare reform, financial reform) to the obscure (MACT, CSAPR). We highlight 11 regulations that cumulatively are having a negative impact on U.S. employment. It is not just small businesses that are upset; we quote six CEOs of major corporations who have spoken out against the Great Suppression.

■ Regulatory Relief Would Do Much to Revive Growth

In contrast to the early 1980s, U.S. firms are very efficient and competitive. Regulatory relief that unleashes “animal spirits” would do much to revive growth.

■ Healthcare Reform May Be Repealed...

Arguably the biggest impediment to hiring (particularly hiring of less skilled workers) is healthcare reform, which has the added drawback of straining state and Federal budgets. The Republican presidential candidates have all vowed to repeal the legislation, and they would probably follow through on that promise because healthcare reform is not particularly popular.

■ ...which Would Be Positive for Managed Care

Healthcare reform contains several provisions that are negative for managed care companies, and PE ratios are pressured by uncertainty about how the Managed Care world will look after reform is fully implemented in 2014. Over the next year leading up to the November election, the potential benefit of repeal may be factored into the valuation of Managed Care and other healthcare stocks.

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www.ubs.com/investmentresearch**Thomas M. Doerflinger, Ph.D.**Strategist
tom.doerflinger@ubs.com
+1-212-713 2540**Natalie Garner, CFA**Strategist
natalie.garner@ubs.com
+1-212-713 4915**Jonathan Golub, CFA**Strategist
jonathan.golub@ubs.com
+1-212-713 8673**Manish Bangard, CFA**Strategist
manish.bangard@ubs.com
+1-212-713 3036**Vishal Patel**Associate Strategist
vishal-a.patel@ubs.com
+1-212-713 4027

The current “jobs crisis” is not too surprising. Over two years ago, we wrote:

“Unfortunately the current “jobless recovery” is unusually severe... In addition to aggressive corporate cost-cutting, unemployment may be boosted by government policies (whether enacted or proposed) including a sharp increase in the minimum wage, higher taxes on the wealthy (aka “employers”), higher corporate taxes, healthcare reform that obliges employers to provide insurance to employees, and tougher environmental regulations. Despite that, we expect GDP and profits to recover, and stock prices to once again rise during a ‘jobless recovery’.”

Observers are gradually starting to recognize that the tax hikes and regulations emanating from Washington are frightening employers and discouraging hiring. Last November, we dubbed this phenomenon the “Great Suppression”. Rising taxes and the surge in regulation, we argued, were suppressing what J.M. Keynes called “animal spirits—a spontaneous urge to action rather than inaction.” For corporations, a spate of new regulations raises the risk of investing in the U.S., delays projects that companies **do** wish to pursue, and raises the cost of labor relative to capital. In recognition of this problem, the White House has made some effort to reduce regulation, but regulatory relief will be modest at best. Over the past two years, we have written several reports on this broad topic.

Why It Receives Too Little Attention

Although they are preoccupied with today’s employment crisis, economic observers have tended to overlook or at least underestimate the Great Suppression. There are a couple of reasons for this. For one thing, it is extremely wide-ranging, amorphous, and diffuse, involving everything from sulphur dioxide emissions to small business healthcare benefits to the size of debit card fees. Moreover it involves excruciatingly complex and arcane rules that only a handful of lawyers and accountants fully understand. Major legislation is followed by many months of rule-writing, and the new regulations are phased in gradually. Consequently the effects of the Great Suppression are nearly impossible to quantify and plug into a macroeconomic model.

Another reason why the Great Suppression is underappreciated is that it falls outside the bounds of the “Great Debates” of the economics profession: Does Keynesian fiscal stimulus actually work? Must the U.S. endure years of slow growth as it “deleverages?” Are structural factors such as a skills miss-match or under-water mortgages keeping unemployment high? (Another to consider: Amazon, Google, et al. are crushing some labor-intensive services, such as main street retailers and the U.S. postal service.)

Elements of the Great Suppression

Tax Hikes on High-Income Individuals

An Administration priority is ending the Bush tax cuts for “millionaires and billionaires” capaciously defined as individuals earning over \$200,000 and households earning over \$250,000. Under current law, the Bush tax cuts end at the start of 2013. At the same time, the healthcare reform law raises the Medicare payroll tax on wages and salaries of high earners from 2.9% to 3.8%, as well as imposing a new 2.9% tax on their investment income. Affluent Americans face a major tax hike 15 months from now.

High Corporate Tax Rate

The U.S. corporate tax rate is about the highest in the world, and no effort has been made in recent years to bring it in line with other countries. Washington shows little interest in a tax holiday for repatriation of foreign profits; this would bring capital back to the U.S. at little cost to the US Treasury while boosting the morale and financial flexibility of companies.

MACT and CSAPR Rules for Electric Utility Boilers

The Environmental Protection Agency's new maximum achievable control technology (MACT) standards and cross-state air pollution rule (CSAPR) affect many utility plants. Designed to cut emissions of sulphur dioxide and nitrous oxide emissions, the rules will force many older coal-fired plants to be shut down. The resulting rise in electricity prices will make some energy-intensive industries less competitive.

MACT Rules for Industrial Boilers

This will force owners of industrial boilers to spend heavily to reduce toxic emissions. The paper industry alone estimates it will cost \$5-7 billion. The impact is wide-ranging, affecting not only heavy industry but services such as hospitals and schools.

Ozone Rules

The Administration was planning to cut the acceptable level of ozone (which causes smog), which would have put most densely populated counties in "non-attainment" status. This would have limited expansion of factories in affected areas, raising costs by \$25 billion annually, according to the EPA. Following the dismal August jobs report, the White House shelved the new rule, but reconsideration of this decision is possible in 2013. Therefore, tougher ozone rules may continue to factor into investment decisions.

Financial Reform

Financial reform creates dozens of complex new rules as well as a Consumer Financial Protection Bureau that "supervises banks, credit unions, and other financial companies." To varying degrees, banks will be forced to redesign their business models to conform to the new regulations. Speaking at an investor conference, the CEO of J.P. Morgan's investment bank noted, "...it is an enormous amount of new regulation to deal with. And the sheer administration from a legal, compliance, risk, auditing function, managing a large, complex financial institution now in terms of just the data flow is an enormous challenge." For the largest banks, another burden is the Basel III capital rules; JP Morgan CEO James Dimon called them "blatantly anti-American" in an interview with the *Financial Times*.

Government Litigation of Banks

The Federal Housing Finance Agency sued 17 major banks for selling defective mortgage securities to Fannie Mae and Freddie Mac. State attorneys general have also sued banks. The financial risks created by litigation will encourage banks to lend more cautiously and pare payrolls to protect profit margins. For example, Bank of America plans to lay off 30,000 workers by year-end 2013.

Tougher Regulation of Fossil Fuels

Washington has promoted “green jobs” while showing little enthusiasm for expanded production of fossil fuels, which account for 78% of U.S. energy production today and an estimated 74% in 2035, according to the Energy Information Agency. Fossil fuels are abundant in the U.S. and demand is rising rapidly in emerging markets. Thus this sector is **not** caught in the debt-driven undertow that afflicts some other parts of the economy. It can create many new high-paying jobs over the next decade if permitted to so. Regulatory issues facing the industry include:

- No oil drilling in ANWR (Alaska National Wildlife Reserve).
- The moratorium on deepwater drilling in the Gulf of Mexico slowed activity there, although it is finally back to pre-crisis levels.
- Lengthy delays on the Keystone XL pipeline taking oil from Canada’s oil sands to the U.S. Midwest.
- The Federal Government refused to extend an ExxonMobil lease on its lucrative Julia field in the Gulf of Mexico on a legal technicality. The company is suing.
- Threatened tax hikes on oil and gas companies, which actually have a higher effective tax rate (around 45%) than the overall S&P 500 (30-35%, depending on the year).
- Tougher regulation of coal mining.

National Labor Relations Board

Large corporations are alarmed by the NLRB’s complaint against Boeing for building a factory in South Carolina that would employ 5,000 people. South Carolina is an “open shop” state and the NLRB alleged Boeing was retaliating against the labor union in Washington State, even though Boeing continued to operate its factory in Washington.

Immigration Policy

Washington policy-makers, including Republicans in Congress, are not pursuing a pro-growth immigration policy, which would make it easier for 1) high-tech firms to hire foreign-born scientists and engineers, many of whom are trained at U.S. universities; and 2) farms to employ immigrant labor. These policies actually hurt U.S. employment by making it harder for entrepreneurs and farmers to create and expand enterprises.

Healthcare Reform

The new law requires most businesses to provide a generous “essential” package of benefits, which is beyond what many small businesses provide today. It subjects businesses to highly complex rules that increase the cost, risk, and “hassle factor” of adding to payrolls. Companies that do offer insurance can be fined if low-income employees take a government-subsidized plan. All firms with more than 50 workers must provide benefits, which creates an incentive for smaller firms to stay “under the limit” by expanding overseas, outsourcing, or dividing into two companies.

A new tax on Managed Care companies, which will be passed on to small businesses that do not self-insure (as opposed to large corporations that do self-insure), will increase the healthcare costs of small business; the National Federation of Independent Businesses has bitterly protested this part of the law. By raising the cost of labor, healthcare reform systematically discourages hiring, especially of low-wage workers whose mandated benefits are high relative to their wages. The legislation is sufficiently onerous that roughly 1500 temporary waivers have been extended by the Health and Human Services Administration to companies and organizations.

Revolt of the Employers—What CEOs Say

How the Great Suppression affects employment depends on the perceptions and behavior of business people who decide whether to hire and invest in the U.S. Quite a few CEOs have spoken out against the Great Suppression.

Steve Wynn, CEO of Wynn Resorts

In the second quarter 2011 conference call, Steve Wynn said,

“I’m saying it bluntly that this administration is the greatest wet blanket to business and progress and job creation in my lifetime. And I can prove it and I could spend the next three hours giving you examples of all of us in this marketplace that are frightened to death by all the new regulations, our healthcare costs escalate, regulations come from left and right, a President that seems, you know – that keeps using this word redistribution.”

Wynn also excoriated Congress for not working with the Administration to handle the debt ceiling issue properly.

David Far, CEO of Emerson Electric

On Emerson’s June 2011 quarter conference call, David Far said,

“I think the biggest issue that I’m watching right now is they’re not really, either in the U.S. or Europe, really addressing the gut issues. I mean the U.S. has enormous regulations coming at us right now. The incentive to invest in the United States is negative. And from my perspective, people talk about ‘we want clarity.’ I’ve got all the clarity I need. They’re spending, they’re regulating us, the tax rates they’re talking about raising the tax rates.

....And then we have a company like Boeing, you’re talking about one of the iconic U.S. companies, gets sued by the federal government. If that doesn’t get your attention, nothing will. They get sued for investing \$2 billion in South Carolina. Last time I saw South Carolina was a part of the United States of America, and you get sued for that?”

Paul Otellini, CEO of Intel

In August 2010 Otellini said, “I think this group does not understand what it takes to create jobs. And I think they’re flummoxed by their experiment in Keynesian economics not working.”

James Tisch, CEO of Loews Corp.

In August 2010 James Tisch said, “The thing that business people don’t like is uncertainty. Part of the problem is that business has very little confidence in what’s been going on and very little visibility.” Tisch, whose company owns half of Diamond Offshore Drilling, said the rough treatment of BP during the Mocondo oil spill “sends a strong message to American industry that if your industry gets in trouble, there’s a possibility you won’t get a fair shake.”

George Buckley, CEO of 3M

In February 2011 George Buckley said, “There is a sense among companies that this is a difficult place to do business. It is about regulation, taxation, seemingly anti-business policies in Washington, attitudes towards science.”

Mortimer Zuckerman, CEO of Boston Properties

In an editorial Zuckerman wrote,

“Meanwhile, everyone in the business world is pleading for some kind of adult supervision to build a national platform for sustained growth that includes a long-term fiscal plan that addresses our ballooning deficit. They are desperate for strong leadership and feel that all we are getting out of Washington is a lot of noise as Democrats and Republicans blame one another.”

These remarks underscore that rising regulation is by no means just an issue for “small business”. The Great Suppression gives large, cash-rich companies ample incentive to make their new investments outside the U.S.—which exacerbates a long-standing problem. Our study of 28 large multinationals found that from 2002 to 2008, their domestic assets barely grew while their foreign assets grew at a 9.9% annual rate. Meanwhile, small businesses are pessimistic and cautious. The NFIB small business optimism index is just 88 versus a normal mid-cycle level of about 100. Prior to 2009, the index had been lower than 88 only during the 1980 recession.

Why Investors Should Care

For a couple of reasons:

Regulatory Relief Would Boost Growth

If we are correct that the Great Suppression has reduced employment, then a decisive shift in a more business-friendly direction could boost economic growth fairly quickly—much as deregulation did in the late 1970s and early 1980s. Obviously, this would not solve all the structural problems vexing the U.S.; heavy debt loads would continue to burden households and governments.

But keep in mind that, in contrast to the early 1980s (with which the current period is frequently compared), U.S. corporations are well-managed and globally competitive. Productivity growth is strong by historical standards. If disincentives to domestic investment were reduced, GDP growth would likely re-accelerate. Because 9% unemployment is politically problematic, such a change may well occur. Investors should not extrapolate very far into the future the current rate of employment and GDP growth.

In a recent *New York Times* article (Sept. 11, 2011), N. Gregory Mankiew invoked Keynes' "animal spirits" insight and noted that business investment – which tends to be one of the major drivers of economic expansions – has been unusually weak in this cycle. Although Keynesian economists attribute this to "lack of demand", this diagnosis is at best incomplete because corporate profits have been much stronger than analysts or economists of the "New Normal" school expected. On a four-quarter basis, and adjusting for the BAC write-downs in Q2 2011, S&P 500 earnings have climbed 84% from the 2009 trough. From trough to peak, stock prices have doubled. Resource-based domestic industries such as agriculture, energy, and mining are quite prosperous. If business were more confident about the regulatory environment, domestic capital investment would be stronger and the denominator of the debt / GDP ratio would be growing faster.

Potential Repeal of Healthcare Reform

There is a reasonable chance that healthcare reform will be repealed within the next couple of years, before it is fully implemented in 2014. We think that possibility will be factored into investor expectations and stock market valuations over the next year, as we head toward the pivotal November 2012 elections. The 2012 Presidential election is likely to be close, and all the leading Republican candidates have vowed to repeal healthcare reform. Even if Republicans ultimately lose in 2012, the potential that they could win and repeal healthcare reform will be priced into stocks.

Why is healthcare reform vulnerable? It is important to have health insurance, but it is much more important to have a job. As discussed earlier, healthcare reform impedes employment by systematically raising the price of labor, by making it much more complicated for small companies to increase payrolls, and by encouraging companies to stay "under the limit" of 50 employees. The law will particularly hinder employment of lower-income and entry-level workers, making a bad situation worse. Today, the unemployment rate is 4.3% for college graduates but 14.3% for those without a high school diploma. It is 8% for whites, 11.3% for Hispanics, and 16.7% for African Americans. Influential groups such as the Congressional Black Caucus are complaining bitterly about the high rate of unemployment.

A second problem with healthcare reform is that it is broadly negative for U.S. economic performance and is a "budget buster" for states and the Federal government. The fundamental problem with U.S. healthcare is that it consumes 17% of GDP but produces medical outcomes similar to other countries where healthcare consumes only ~10% of GDP. So the system is extraordinarily inefficient. Unfortunately, healthcare "reform" did nothing to address that. On the contrary, it made the system bigger by mandating a more generous "essential" coverage package and then extending that coverage to the uninsured. Consequently, healthcare will claim an even bigger share of GDP in the future. The Centres for Medicare and Medicaid forecast that it will claim nearly 20% of GDP by 2020.

Surveys by consultants such as McKinsey and Towers Watson find that many employers, possibly as many as 50%, are considering dropping coverage because it is cheaper to pay the \$2,000 per employee annual fine. Lower-income

workers who lose coverage from their employer would enter Medicaid; this would tax already strained state and Federal budgets. Tax hikes could cover some of the extra cost, but ballooning Medicaid costs will crowd out spending on infrastructure, education, research, etc. This makes the U.S. less competitive, further boosting unemployment.

Clearly, a healthcare program that discourages hiring, threatens state and Federal budgets, and expands an already over-large segment of the U.S. economy is problematic. The Republican presidential candidates who have promised to repeal it would likely keep that pledge because repeal is a quick, decisive way to improve the regulatory environment and attempt to get the U.S. economy back on track. Although certainly controversial, repeal would not be extremely difficult politically. Unlike Medicare and Social Security, healthcare reform has not developed a strong base of support. A Sept. 5, 2011 Rasmussen poll found that 57% of likely U.S. voters favored repeal of the Health Care Law, and 54% say repeal is likely.

One change we are not likely to see is just partial repeal of the healthcare reform scheme because it is an integrated system. On the other hand, in our view, the U.S. probably would not just revert to the *status quo ante*; the Republican mantra is “repeal and replace”. Their new reform scheme would likely contain such elements as:

- A national market for health insurance, which would be more price-competitive and offer more low-cost options.
- Promotion of high-deductible plans coupled with health savings accounts that allow families to buy healthcare with pretax dollars.
- Personal income taxes on fancy “Cadillac” healthcare plans offered by companies. This would reduce demand for healthcare by cutting the tax subsidy for healthcare spending.
- Expansion of Medicare Advantage, a popular Medicare option administered by private companies. As many as 23 million people have been enrolled in Medicare Advantage.

Repeal Would Be Bullish for Managed Care

Healthcare Reform expanded the number of people to be covered by Managed Care insurers, which was a clear positive for the industry. However, the legislation also embedded key provisions that represent an adverse headwind for the Managed Care plans. These include:

- Minimum medical loss ratio requirements—i.e. requiring a minimum amount of premium revenue to be spent on medical care.
- Medicare Advantage reimbursement pressure—i.e. the amount the government pays companies to provide healthcare services to seniors is under pressure.
- Guaranteed issuance, effectively removing medical underwriting, so anyone can enter a plan.

- Once state-based exchanges start up in 2014, price transparency and competition will increase, which could put pressure on profit margins.

In addition, there is great uncertainty in terms of how the Managed Care world will look after the 2014 healthcare reform provisions kick in. This uncertainty probably pressures PE ratios. Repeal of Healthcare Reform would diminish that uncertainty. Any legislation that replaced Healthcare Reform probably would not have all of the onerous provisions of the current plan, but it would attempt to expand access by facilitating participation in a managed care program.

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Sell	Sell	7%	14%
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Buy	Buy	less than 1%	33%
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