THE

Envestnet Edge

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Waiting on Washington? Invest "As If"…

Markets surged after the election of Donald Trump, based on expectations for healthcare overhaul, tax reform, infrastructure spending, and deregulation, yet Washington continues to be ensnared in its soap opera and legislative morass. This month, we suggest that investors may benefit from disregarding these expectations, and, instead, make investments that are aligned with fundamentals. If, by chance, policy changes do occur, investors may reap rewards.

We are now a hundred and something days into the Trump Administration, and the Washington soap opera is in no immediate danger of cancellation. Aside, however, from a brief sell-off on May 17, markets have been chugging along on a different track, largely shrugging off political drama.

That said, there remains an underlying thesis that this year's market behavior is a response to expected policy outcomes from a Trump presidency combined with a Republican-controlled Congress. Hence the phrase "Trump rally" that has entered common parlance since the end of last year. That rally was predicated on the widespread expectation that 2017 would bring a slew of major policy shifts, especially in healthcare, tax reform, infrastructure spending, and deregulation. As of mid-spring 2017, all seem in doubt, with the possible exception of deregulation.

As a result, we recommend that investors going forward invest "as if," acting as if none of those expected policy shifts will happen in 2017 or even 2018. That means investing as if there will be no substantial healthcare reform, no repeal

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and replace of Obamacare, no major tax overhaul, and no significant uptick in federal infrastructure spending.

How to invest "as if"

The advantage of investing "as if" is that investors gain the potential advantage of positioning according to current fundamentals, without being vulnerable to policy outcomes that are uncertain at best. In addition, if there is positive movement on healthcare, tax reform, or infrastructure, then the "as if" portfolio reaps the rewards. The base case is that the positioning yields benefits regardless of Washington policy; the bear case is that the portfolio lags because of fundamentals but not because of policy outcomes; and the bull case is that the portfolio does even better when there is movement on policy. In that sense, investing "as if" creates a portfolio that does well on its own merits and even better if Washington gets its act together, but does not suffer if, as seems increasingly likely, Washington generates lots of sound and fury signaling nothing.

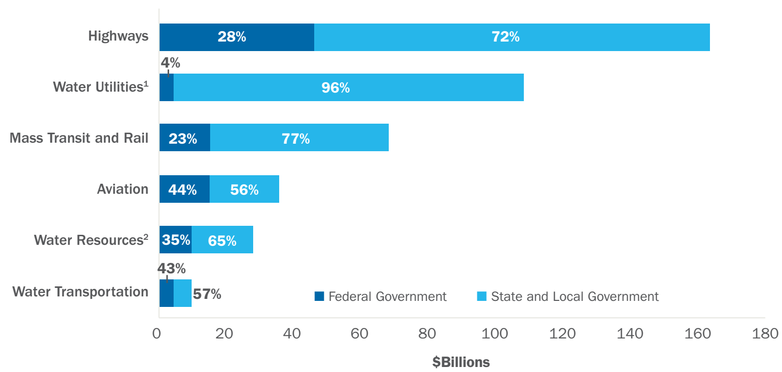
Take infrastructure spending. In the fall of 2016 and into early this year, a fair number of construction-related and commodity companies experienced surging equities on anticipation of a massive $1 trillion in federal infrastructure spending. As of May, even though there is a several $100 billion dollar infrastructure proposal buried in the White House budget proposal just released, that proposal is spread over years and suggests incentives rather than direct financing. And, of course, it appears highly improbable that any part of the current budget will survive Congress.

If last fall investors had structured a bond and equity portfolio predicated on a massive infrastructure plan, that portfolio would be in jeopardy now. Bond yields on some names were low and have now moved a bit higher, whereas the equity names have lagged the market since that dramatic run. Nonetheless, there continues to be a chronic need for infrastructure spending at the state and local level, and federal spending on roads and bridges to the tune of about $50 billion a year is already allocated in prior budgets, even if the Trump plan goes nowhere. States have been underinvesting, as have municipalities (Figure 1), and they will be forced to spend more. No local or state government can defray bridge and tunnel spending indefinitely, given that people tend to become justifiably upset when one of those collapses.

There is, therefore, an attractive and viable path for infrastructure investing regardless of whether Washington does anything more than spend the tens of billions that it does annually. We are not saying investors should avoid investing in infrastructure, but rather, if this is an area of interest, it's better to invest in it "as if."

Tax reform has been lauded, along with deregulation, as a reason to invest in the financial sector. Financial stocks also rallied strongly early in the year, in part based on anticipation of fiscal and regulatory policy changes. But the Trump tax

Figure 1:
U.S. Federal, State, and Local Government Spending on Infrastructure, 2014 (Billions)



Source: Congressional Budget Office based on data from the Office of Management and Budget and the Census Bureau.
[1] Includes water supply and wastewater treatment facilities.
[2] Includes water containment systems (dams, levees, reservoirs, and watersheds) and source of freshwater (lakes and rivers).

Figure 2:
Tax Rates and Stock Market Returns

	Average Top Marginal Tax Rate		Stock Market Returns
	Individual	Corporate	(S&P 500 Returns)
1930s	61.8%	14.7%	-0.9%
1940s	86.3%	36.7%	8.5%
1950s	90.5%	50.9%	19.5%
1960s	80.3%	50.8%	7.7%
1970s	70.2%	47.9%	5.9%
1980s	48.4%	43.0%	17.3%
1990s	36.7%	34.7%	18.0%
2000s	36.2%	35.0%	-1.0%
2010s	37.6%	35.0%	12.7%

Source: Bloomberg View, April 26, 2017.

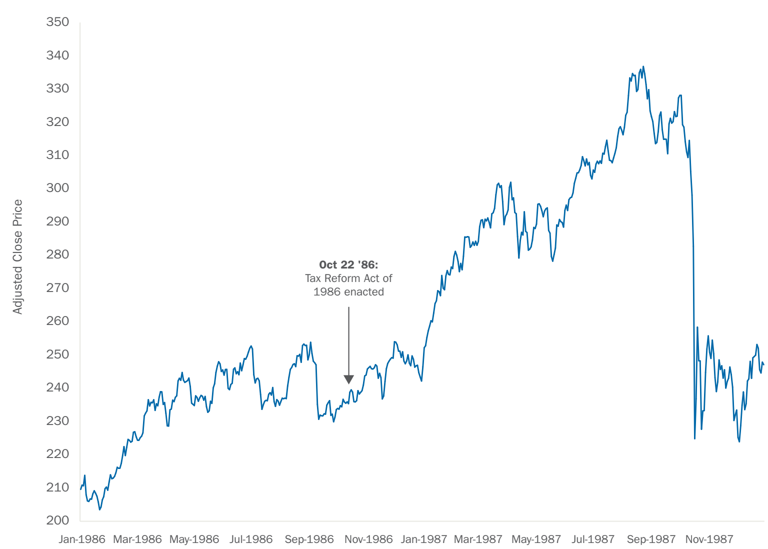
proposals face very steep hurdles in Congress, not just from Democrats but also from Congressional Republicans who have divergent views on tax cuts. Tax reform is also partly dependent on healthcare reform, which itself is very much in jeopardy.

Yet financial stocks and related instruments, such as preferred and convertible bonds, have rallied this year for reasons other than policy hopes. The Federal Reserve is ending years of ultra-accommodative policy, and modestly rising rates should be good for many financial institutions' profit outlook. Market performance has been strong, which was long overdue, as financial companies had lagged for some time. As a result, there have been and continue to be fundamental reasons to be invested in the financials sector. If there is meaningful tax or regulatory reform, even better, but such movements are not essential to this investing thesis.

Investors also should remember that tax reform is not always beneficial for the financials sector, or indeed markets in general. Actual reform may have mixed results for companies and capital. The behavior of stocks the last time Washington debated and then passed major tax legislation is instructive. In 1986, there were wild swings as different elements of policy leaked out or were discussed, but by the time the Tax Reform Act passed, stocks were largely back to where they were when the debate began (Figure 3). Had investors rode that wave, it would have been bumpy and discomfiting; it likely would have led to reactive trading and positioning; and at the end, they would have been back to where they started.

Finally, there is healthcare. Clearly, the 2010 Affordable Care Act, a.k.a Obamacare, needs change. It is likely that at some point before the mid-term elections of 2018, Congress will address some of the issues. But even though the House of Representatives has passed a new healthcare bill, the path through the Senate and then back to the House for an actual law does not yet appear to exist. Investing "as if" there will be more noise and uncertainty, rather than actual legislation, leaves investors in the position of investing based on the fundamental changes now sweeping across the healthcare landscape. These changes include the shifts in drug development and research care of the vast computing power now being deployed on the genome and drug discovery; the digitization of patient information; the movement from hospitals to smaller care centers; the role robotics plays in surgery; and the burgeoning elderly population, with its demands for care. None of these trends depend on government action, and indeed, as Figure 4 shows, healthcare equities have been rising steadily along with the market overall, rather than trading on Washington healthcare policy per se.

Figure 3:
S&P 500 performance around Tax Reform Act of 1986



Source: S&P 500 represented by adjusted close prices for GSPC. Jan 1986 to Dec 1987 data from Yahoo Finance.

Figure 4:
Healthcare Stocks Performance (S&P 500 Healthcare Index), 2008-present

Sources: (1) S&P Dow Jones Indices for S&P 500 Healthcare Sector TR index data between Jan 2009 to May 2017, (2) Affordablehealthca.com for timeline of the Affordable Care Act.

And so

It may be that Washington suddenly becomes a well-oiled legislative and policy machine. It may be that this fall brings a slew of meaningful bills that address needed issues in healthcare, tax reform, and infrastructure. If that occurs, each of these investing areas will benefit, and any positioning that stemmed from "as if" investing will see a decent boost. But if that does not happen, an investor's "as if" portfolio will be aligned with the long-term fundamentals that drive those investments. That may not inoculate against equity downturns or bond volatility, but it may protect against the vagaries of a political climate that seems more likely to do nothing than to do something.

May Takeaway:

Markets are chugging along. While the equity rally was originally propelled by expectations for overhauling healthcare, enacting tax reform, investing in infrastructure, and deregulation, all but the latter appear to be bogged down by Washington's dramatics and business-as-usual mode. Although it's possible that these reforms could come to fruition, the path may be rocky. Positioning portfolios "as if" these policy shifts will not occur may be a better approach. If it turns out that the touted changes come about, investors' portfolios may get a boost, and if not, they should benefit from the fundamentals that drive their investments, regardless of government policy.

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