Investment Management Division

An Update on the Presidential and Congressional Race and Investment Implications

October 14, 2016

Investment Strategy Group

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Today’s Discussion

I. Presidential and Congressional Race Update

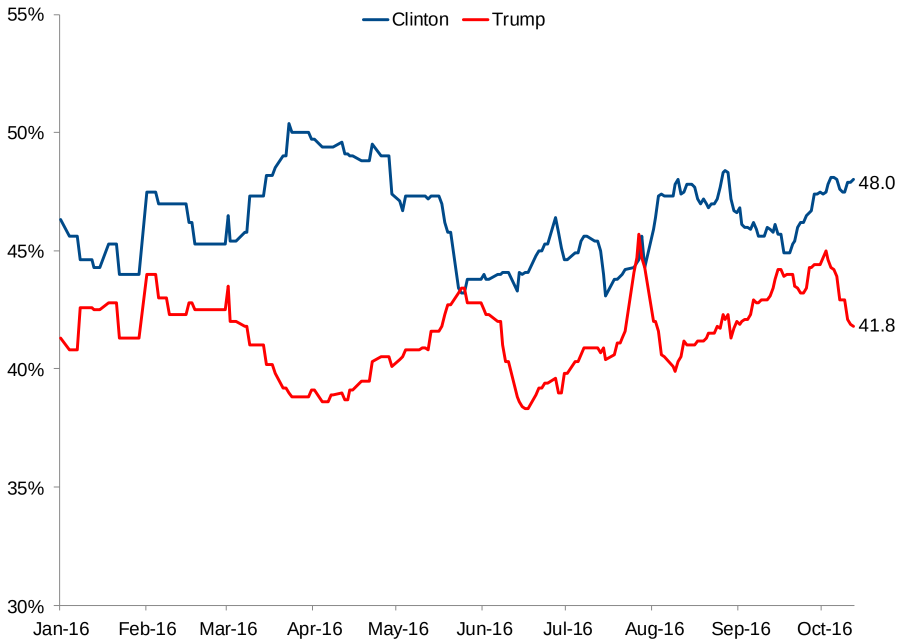
II. Direct and Indirect Economic Impact

III. Investment Implications

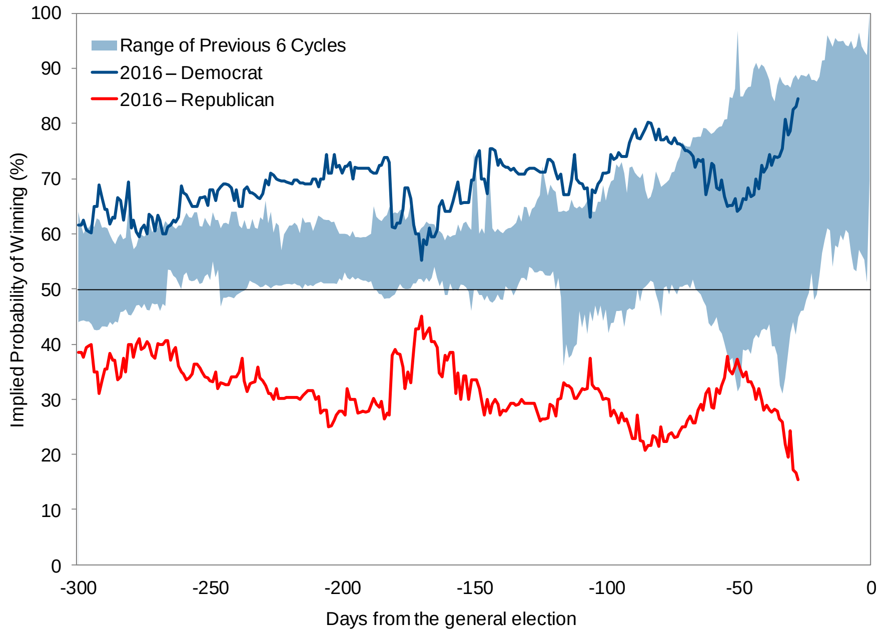
Source: Investment Strategy Group.

State of the Race

1. Trump vs. Clinton Average Polling by Real Clear Politics



2. Implied Probability for Eventual Winning Party Since 1992

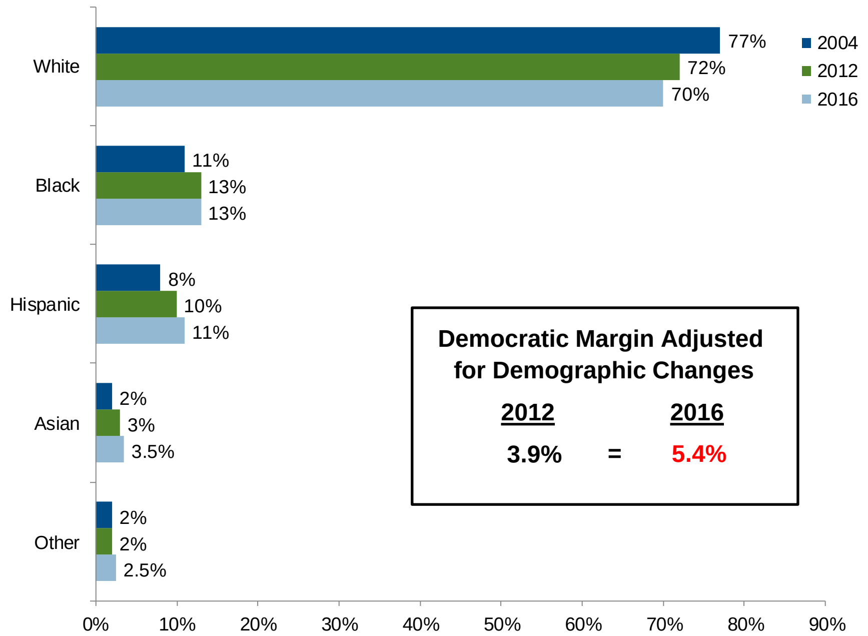


- Hillary Clinton has regained her post-convention lead after the first two presidential debates.
- The Iowa Electronic Markets imply an 80%+ chance of a Democratic victory, near the top of the historical range at this point of the election cycle going back to 1992.
- According to Nate Silver, author of *The Signal and the Noise*, "While a Trump comeback is still mathematically feasible … it wouldn't really have any good precedent in recent American presidential elections."[1]

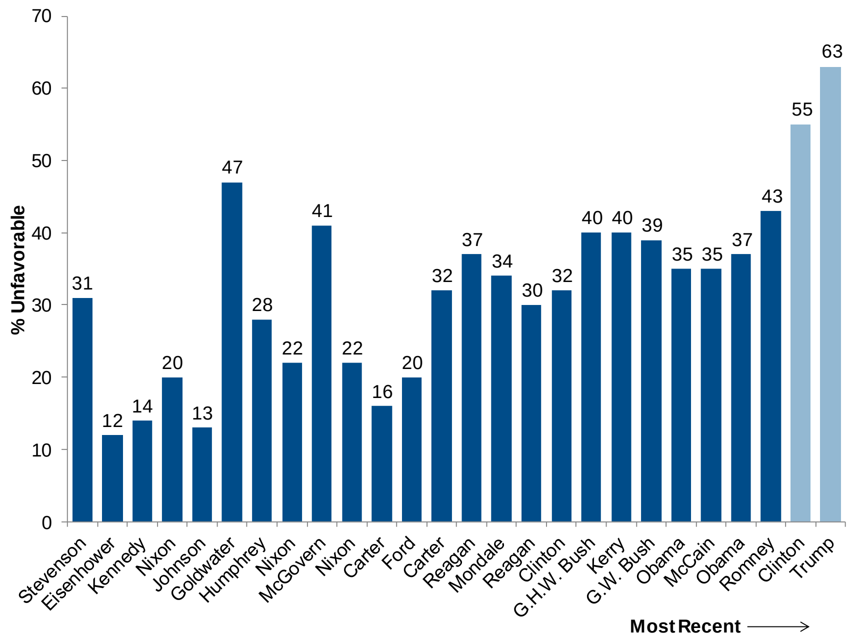
(1) Nate Silver, "Election Update: Post-Debate Polls Show Trump Still In Big Trouble," FiveThirtyEight.com, October 12, 2016.
Source: Investment Strategy Group, Real Clear Politics, Iowa Electronic Markets, FiveThirtyEight.com. As of October 12, 2016.

The Structural Drivers of the Election Are Mixed

1. Demographics of US Electorate: 2004, 2012, 2016



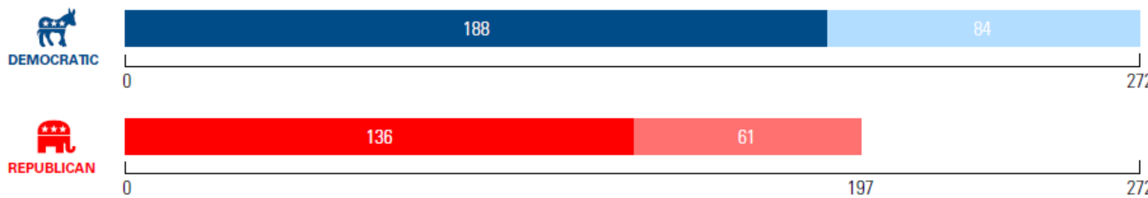
2. Unfavorable Ratings of Major Party Presidential Nominees: 1956-2016[1]



- Demographic trends favor the Democrats.
- Both candidates face historically high unfavorable ratings.
- The “Keys to the White House” model, which has accurately predicted every presidential election since 1981, favors a Trump victory (see page 22 in the Appendix).
  - Amy Walter of the Cook Political Report: “I normally do put a lot of weight in these models but these candidates are so unique that the traditional historical patterns become less important.”

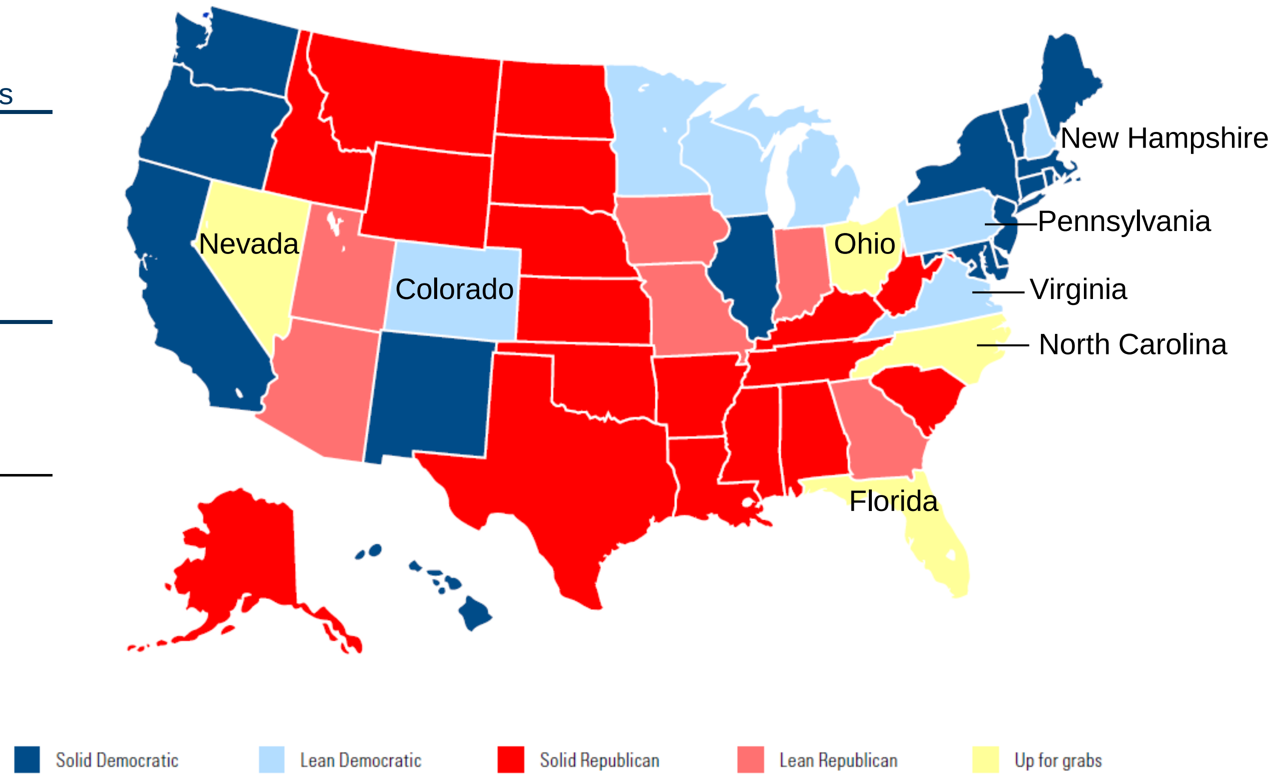
(1) Dates for all years except 2016 are final pre-election; No data for 1988, 1996 and 2000.
Source: Investment Strategy Group, Gallup, Professor Allan Lichtman, Washington Post, Cook Political Report.

Electoral College: Clinton Has an Easier Path to 270



Toss-Up States	Votes
Florida	29
Ohio	18
North Carolina	15
Nevada	6

Other Key States	
Pennsylvania	20
Virginia	13
Colorado	9
New Hampshire	4

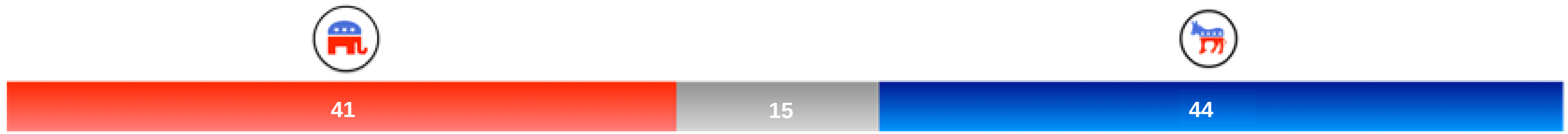


- There are 19 states that Democrats have won in every election since 1992, representing 242 Electoral College votes.

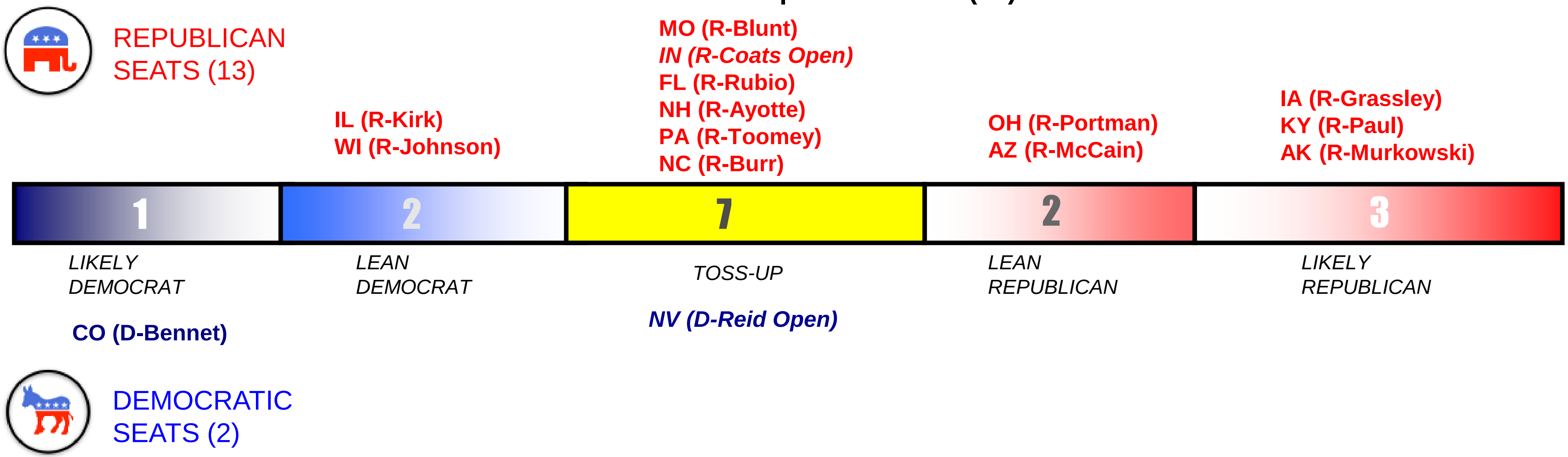
Source: Investment Strategy Group, Cook Political Report. As of September 29, 2016. Polling in Nebraska's congressional district (1 vote) points to a toss up. Maine's second district (1 vote) leans Republican.

US Senate Landscape – Does it Favor the Democrats?

Republicans can lose 3 of the 15 competitive seats and still maintain control of the Senate*



Breakdown of Competitive Races (13)

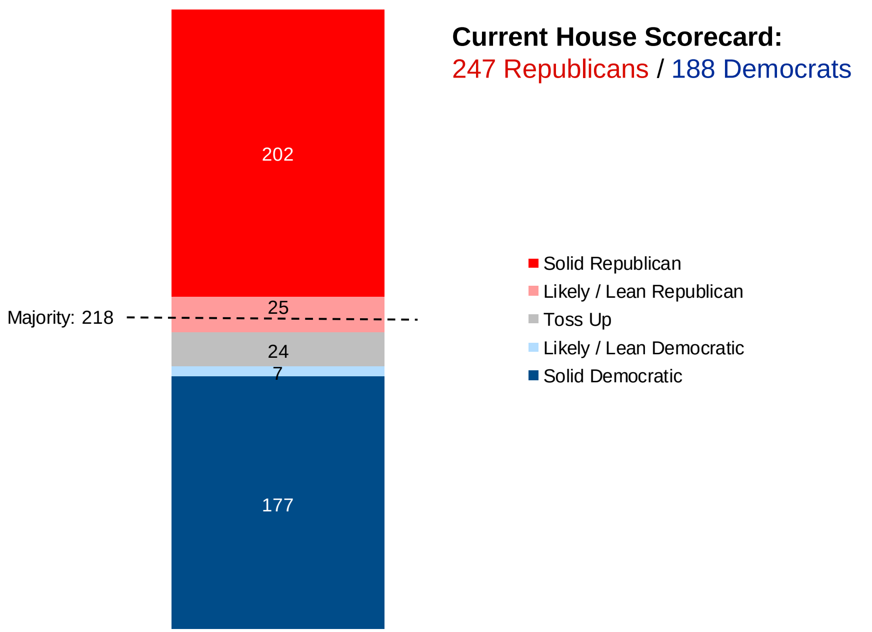


- Republicans control 54 out of 100 seats in the Senate. Thirty-four seats are up for election in 2016.
- Republicans are defending seats in seven states that President Obama won in 2012, including five that he won by margins ranging from 5.2% to 16.2%. Democrats are only defending states that Obama won by at least 4.7%.

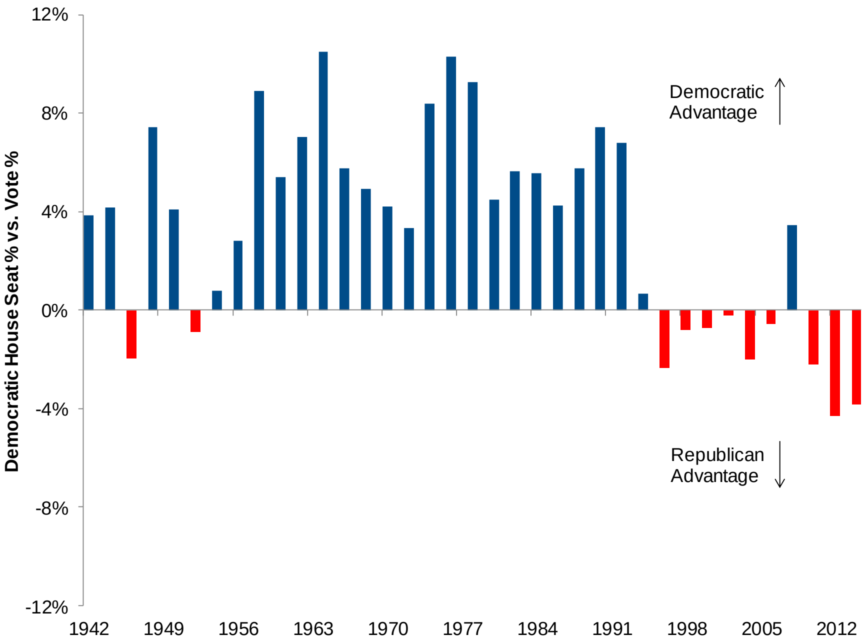
*In the case of a Democratic victory in the presidential elections.
Source: Investment Strategy Group, CNN 2012 Election Results, Cook Political Report. As of September 30, 2016.

US House Landscape – Is the Republican House at Risk?

1. House of Representatives Polling by Party



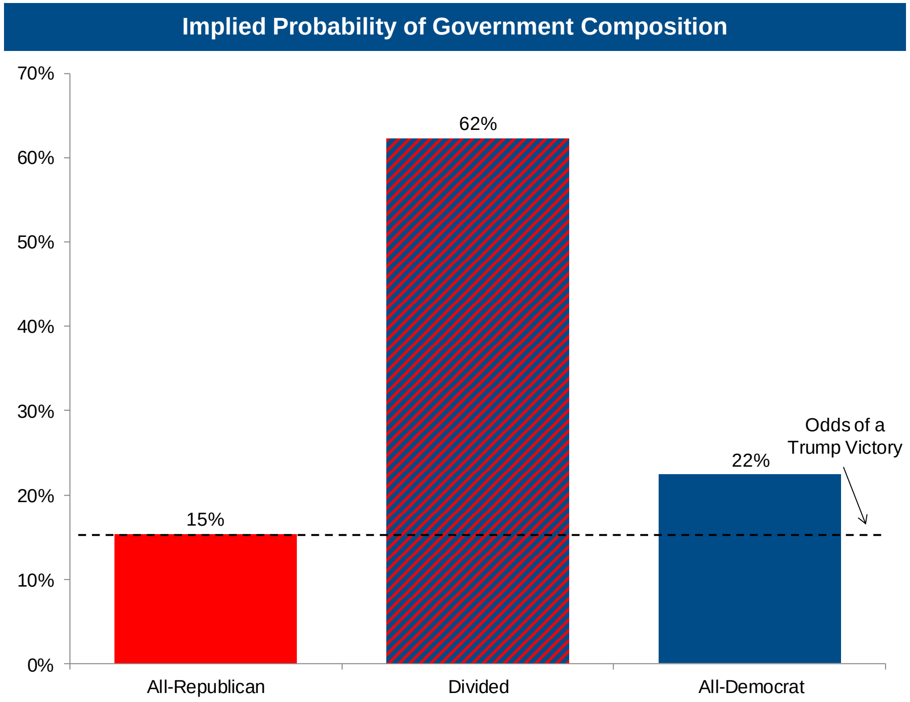
2. Democratic House Seat vs. Vote Advantage – 1942-2014



- Republicans currently preside over a 30-seat majority, their largest majority since prior to the Great Depression.
- In the two congressional elections since the last redistricting, Democrats received around 4% fewer seats than votes.

Source: Investment Strategy Group, Cook Political Report. As of October 4, 2016.

Divided Government is the Most Likely Outcome

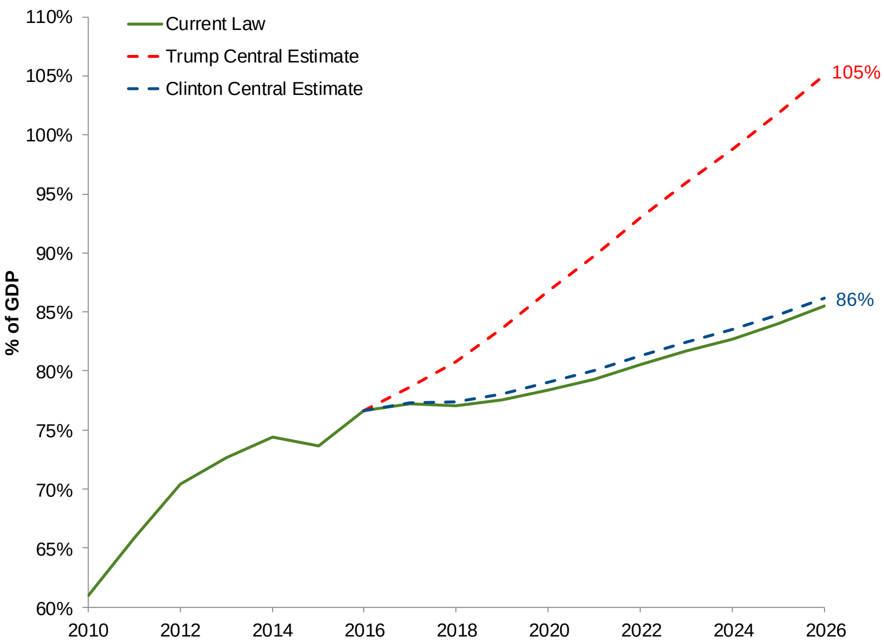


- According to betting markets, the most likely election result is a divided government with different parties controlling the White House and one or both houses of Congress.
- The US has faced divided government roughly 40% of the time since Washington's presidency and 60% of the time in the post-WWII period.

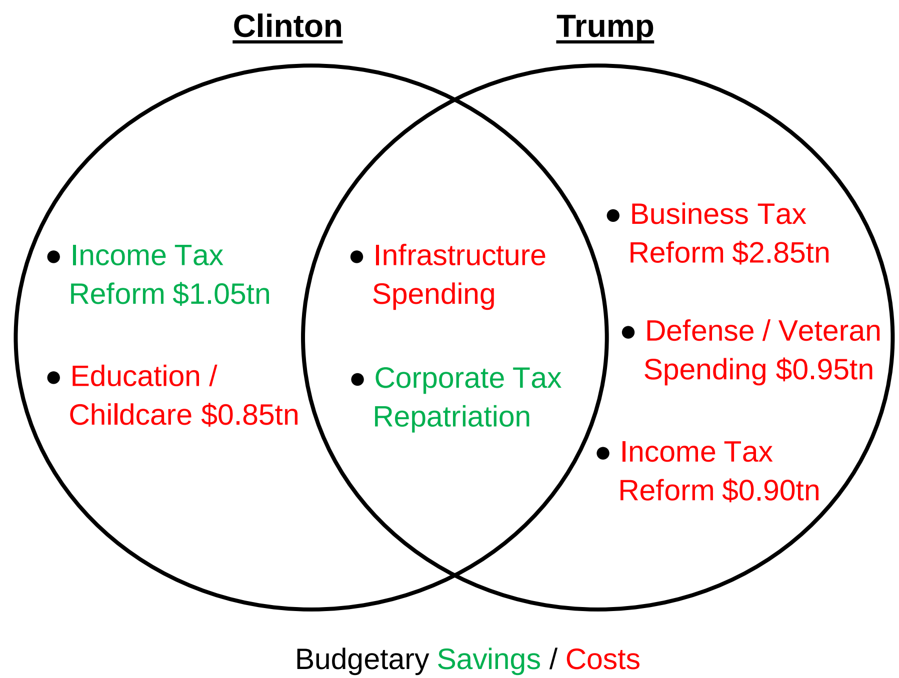
Source: Investment Strategy Group, Iowa Electronic Markets. As of October 12, 2016.

Fiscal Policy Outlook Based on Candidates' Proposals

1. Estimated US Debt-to-GDP Under Candidates' Proposals – Through 2026



2. Major Policy Proposals and 10-Year Budgetary Impact (Trillion $)



- According to the CRFB, Clinton's proposals would result in a net budgetary impact of $200 billion in additional expenditures over ten years. Trump's current proposals would:
  - Cost roughly $5.3 trillion.
  - Lead to an increase in the federal debt of nearly 30% of GDP through 2026.
- Both candidates appear to be in favor of infrastructure development, which Clinton has proposed paying for by using proceeds from business tax reform.

Source: Investment Strategy Group, Committee for a Responsible Federal Budget (CRFB), Tax Policy Center. Estimates as of September 22, 2016.

What Can Realistically Be Achieved?

1. Eurasia Group: Outlook for US Fiscal Reform Under New President

Likelihood	Election Outcome Scenario: President	Election Outcome Scenario: Congress	Fiscal Reform Scenario: Outcome	Fiscal Reform Scenario: Probability of Success within Each Scenario
Most Likely	Clinton	Split	Infrastructure bill / international tax reform	25%
	Clinton	All-Republican	Infrastructure bill / international tax reform	35%
	Clinton	All-Democratic	Spending increases paid for with tax hikes	60%
	Trump	All-Republican	Spending cuts / comprehensive tax reform	15%
Least Likely	Trump	Split	Spending flat / international tax reform	40%

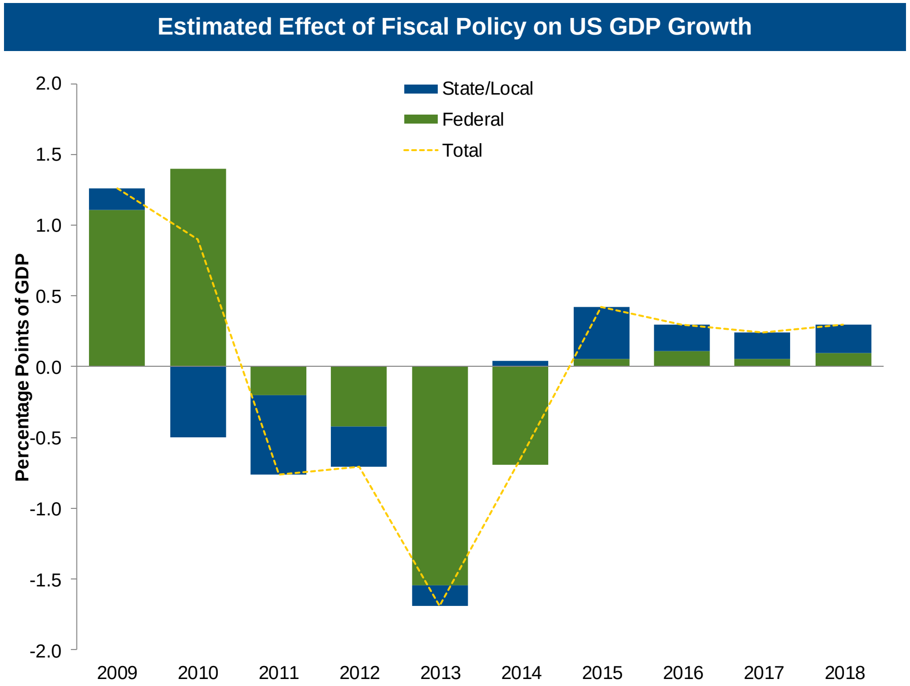
2. Federal Tax Proposals of Each Candidate

	Current	Clinton	Trump
Income (Top Tier)	39.6%	43.6%	33.0%
Long-Term Capital Gains	20.0%	20.0% to 39.6%*	20.0%
– ACA-Related	3.8%	3.8%	0.0%
Corporate	35.0%	N/A	15.0%

- How likely is it that we will see a compromise around business tax reform/repatriation of foreign savings and infrastructure spending in the event of divided government?
- Clinton has proposed raising tax rates while Trump's proposals would cut them.

* Clinton's proposed capital gains tax rates vary depending on the length of the holding period.
Source: Investment Strategy Group, Eurasia Group, Tax Foundation, Tax Policy Center.

Fiscal Policy Impact on US Growth



- If a fiscal compromise were achieved, its impact would likely be modest. Goldman Sachs Global Investment Research (GIR) estimates that:
  - Fiscal policies could boost GDP growth by 0.2% in 2017 and 0.3% in 2018 under divided government.
  - If Congress were to enact a major infrastructure or tax reform package—possibly under single-party control—“there would be upside to these numbers.”

Source: Investment Strategy Group, Goldman Sachs Global Investment Research.

Trade Policy – Positions of each Candidate

1. Hillary Clinton Trade Positions

- Opposes Trans-Pacific Partnership
- Would create "trade prosecutor" position, emphasize enforcement of existing agreements
- Opposes "market-economy status" for China
- Supports countervailing duties against exchange-rate manipulators

2. Donald Trump Trade Positions

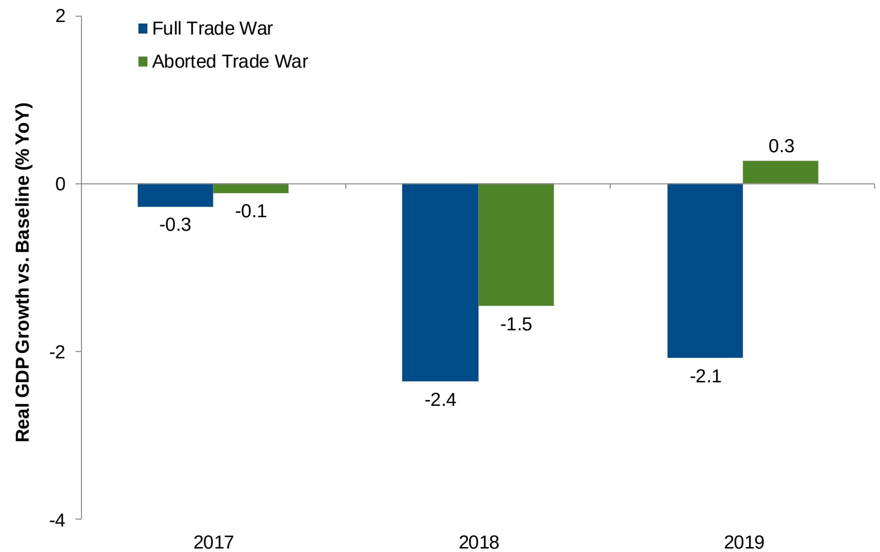
- Opposes Trans-Pacific Partnership
- Would declare China a currency manipulator
- Supports tariffs (possibly firm-specific) on China and Mexico
- Renegotiate and possibly abrogate existing free trade agreements
- Possibly withdraw from WTO
- Threats and bargaining

- The president has ample authority to restrict free trade (see page 23 in the Appendix).
- According to an analysis from the Peterson Institute (PIIE),[1] both candidates' trade policies are suboptimal:
  - Clinton is likely to maintain the status quo, with potential benefits from TPP foregone.
  - Trump, on the other hand, has taken positions that could result in trade wars.

(1) Marcus Noland, Gary Clyde Hufbauer, Sherman Robinson, and Tyler Moran, "Assessing Trade Agendas in the US Presidential Campaign," Peterson Institute for International Economics, September 2016.
Source: Investment Strategy Group, PIIE.

Trade Wars Could Have a Significant Impact on US Growth

Trade War Scenarios – GDP Growth Impact vs. Baseline Through 2019[1]



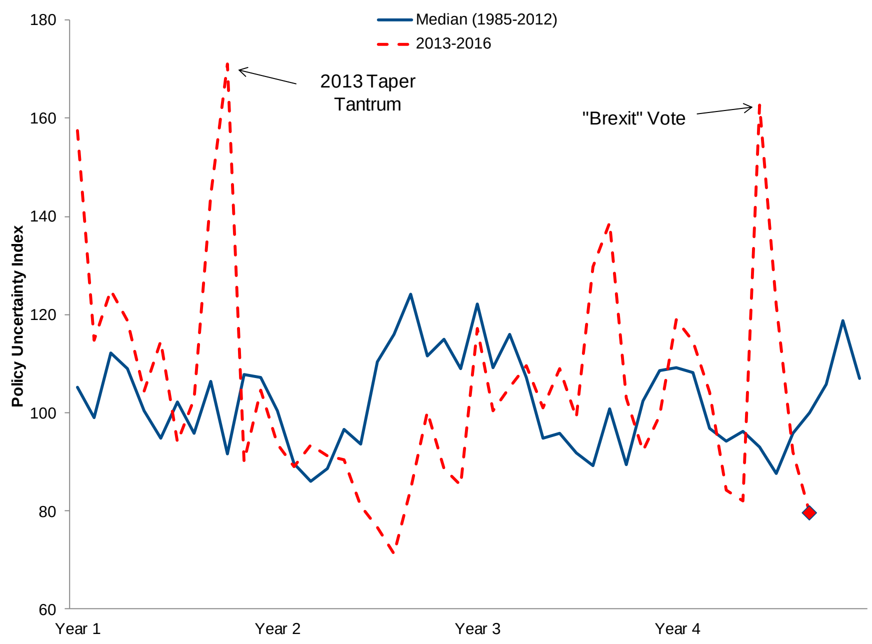
Full Trade War: Permanent imposition of 35% tariff on Mexico, 45% tariff on China; they respond symmetrically.
Aborted Trade War: Tariffs removed after one year.

- According to PIIE, a "full trade war" could detract over 2 percentage points from baseline annual GDP growth in both 2018 and 2019, leading to a recession.

(1) Marcus Noland, Gary Clyde Hufbauer, Sherman Robinson, and Tyler Moran, "Assessing Trade Agendas in the US Presidential Campaign," Peterson Institute for International Economics, September 2016.
Source: Investment Strategy Group, PIIE.

Economic Policy Uncertainty Rises Ahead of Elections

US Economic Policy Uncertainty Index Over the 4-year US Political Cycle



- As measured by the Economic Policy Uncertainty index, the typical increase in uncertainty from September to November in election years could reduce employment by about 60 thousand and capital goods orders by 0.3%.[1]
- At the extreme, if uncertainty rises by 90 points—as much as it rose in the global financial crisis—fixed investment in the US could decline by 7% within two quarters of that increase (-1.1% impact on GDP).

(1) Relative to the baseline. Allison Nathan and Marina Grushin, "Top of Mind: Political Uncertainty," Goldman Sachs Global Investment Research, June 23, 2016.
Source: Investment Strategy Group, Goldman Sachs Global Investment Research, Scott R. Baker, Nicholas Bloom and Steven J. Davis, "Measuring Economic Uncertainty," As of September 30, 2016.

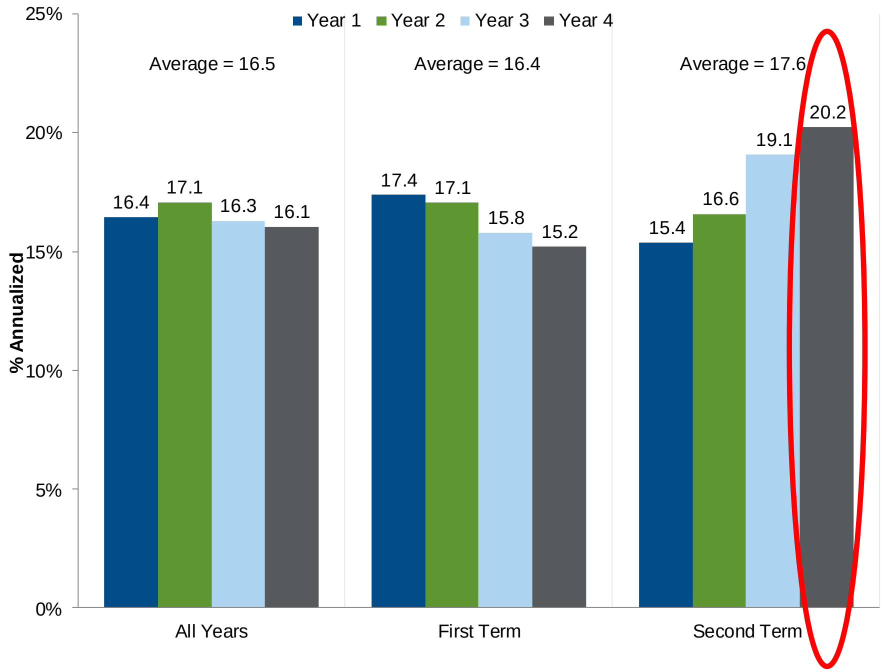
Foreign Policy – Geopolitical Hotspots

- Foreign policy and immigration are other areas where the president can act unilaterally without congressional approval.
- How would each candidate approach US relations with:
  - Mexico
  - Russia
  - China
  - The Middle East

Source: Investment Strategy Group.

Equity Market Volatility Around US Elections

S&P 500 Volatility Based on US Presidential Cycle

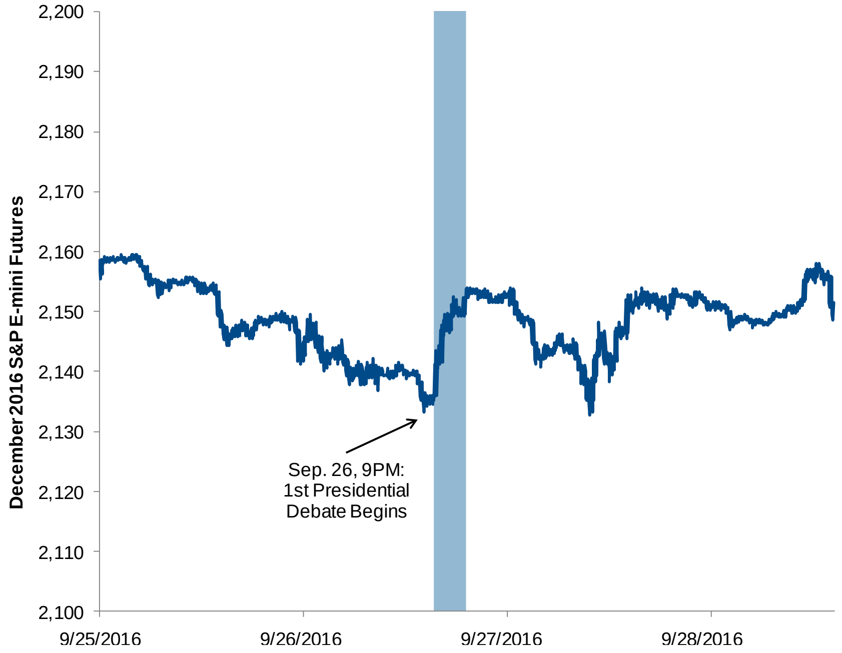


- While limited available data preclude drawing conclusive market implications from past elections, market volatility has generally been higher in the fourth year of the second term of a presidential cycle.

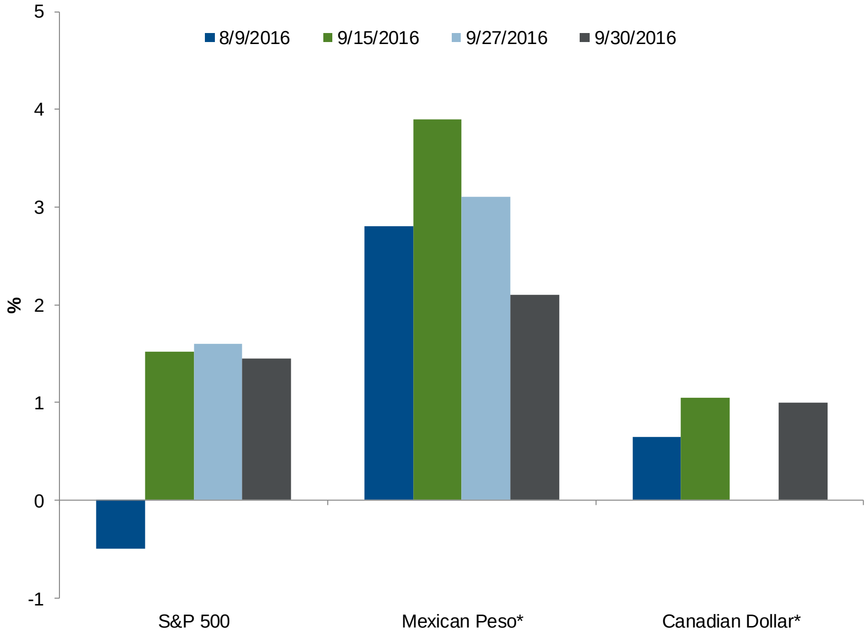
Source: Investment Strategy Group, Bloomberg, Robert Shiller.

Market Reaction to Potential Election Outcomes in 2016

1. S&P 500 Futures During 1st Presidential Debate



2. Move in Asset Price Implied by 10pp Increase in Clinton Probability[1]



- As the odds of a Clinton victory increased by approximately 5% during the first presidential debate on September 26th, S&P 500 futures rose by approximately 0.8%. Futures were roughly flat around the second debate on October 9th.
- Large shifts in election outcome probabilities to date have implied that the S&P 500, Mexican peso and Canadian dollar would have a favorable short-term reaction to a Clinton victory with divided government.

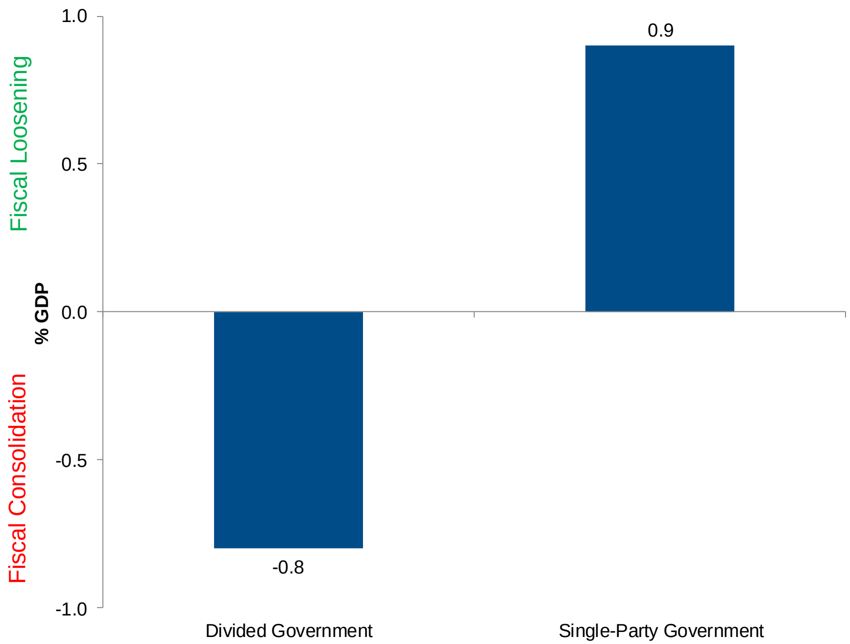
(1) Dates chosen based on large, isolated changes in probabilities. * Positive change implies appreciation against the dollar.
Source: Investment Strategy Group, Bloomberg, Predictwise, Goldman Sachs Global Investment Research.

Bond Market Performance Around US Elections

1. Annual Bond Returns and Political Gridlock: 1969 - 2014[1]

Overall (Number of months = 552)	7.5%
Divided Government (n = 408)	8.8%
Undivided Government (n = 144)	3.7%
Divided Minus Undivided	
Mean	5.1%
Significance	> 99%

2. Average Fiscal Impact – 1st Year of New Administration Since 1961

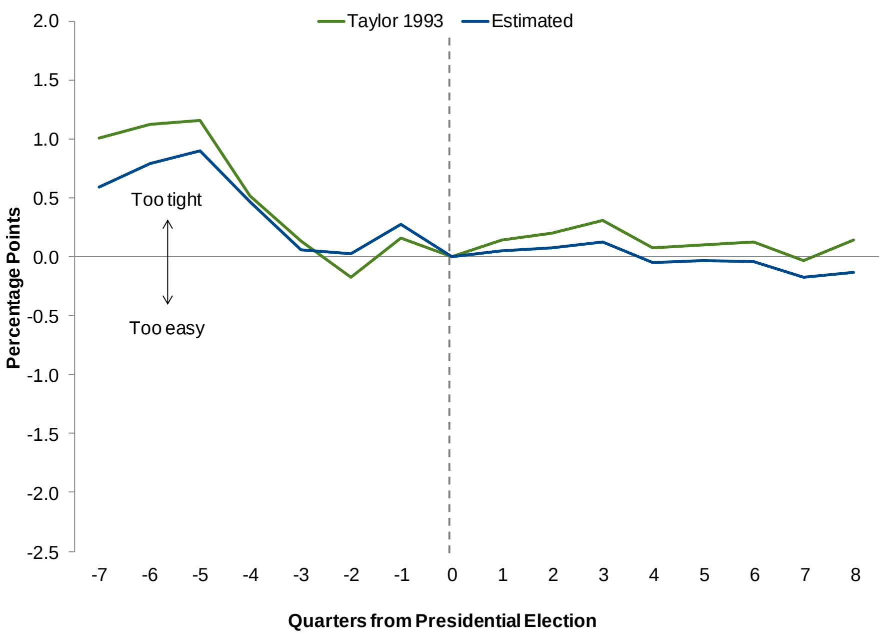


- Since 1969, average bond returns have been 5.1 percentage points higher in the face of divided government.
- This could be because divided government has been associated with fiscal tightening of 0.8% of GDP in the first year of a new administration based on data since 1961, while single-party control has coincided with 0.9% of GDP loosening.
- A modest fiscal stimulus and rising interest rates could pose headwinds to bond prices in 2017.

(1) Barclays US Aggregate Bond Index.
Source: Investment Strategy Group, Bloomberg, Goldman Sachs Global Investment Research.

How Could the Election Impact Fed Action?

1. Federal Funds Rate, Average Gap vs. Taylor Rule - 1983-2013



2. Candidates' Comments on the Federal Reserve

"This Janet Yellen of the Fed is doing political things by keeping interest rates at this level … when they raise interest rates, you are going to see some very bad things happen because the Fed is not doing their job."

– Donald Trump, September 26, 2016

"Secretary Clinton believes that the Fed needs to be more representative of America as a whole and that commonsense reforms—like getting bankers off the boards of regional Federal Reserve banks—are long overdue."

– Clinton Campaign, May 12, 2016

- There is no evidence that monetary policy has been too loose in the run-up to elections since 1983.
- While neither candidate has advocated major changes to monetary policy, Trump is in favor of a bill to audit the Fed.
- Wholesale leadership change at the Federal Reserve is unlikely: the terms of 11 of 12 Bank presidents and five governors extend at least until 2020, although the roles of Chair and Vice Chair will be up for reappointment in 2018.

Source: Federal Reserve, Goldman Sachs Global Investment Research, Real Clear Politics, *Washington Post*.

Key Takeaways

- The election is likely to lead to divided government.
- In that scenario, the economic and fiscal impact of the elections should be modest.
- A rise in uncertainty due to worsening trade friction or foreign policy missteps could pose downside risk.
- Large shifts in election outcome probabilities to date have implied that US equities would have a favorable short-term reaction to a Clinton victory with divided government.
- We recommend that clients stay invested in US equities and maintain a modest underweight in bonds.

Source: Investment Strategy Group.

Appendix

“The Keys to the White House”

The 13 Keys to the White House from Professor Allan Lichtman (>8 True => Incumbent Will Win Reelection)

Key	Definition	Hillary Clinton[1]
Party Mandate	Incumbent party holds more seats after midterm elections than after previous midterm elections	FALSE
Contest	No serious contest for incumbent party nomination	TRUE
Incumbency	The incumbent party's candidate is the sitting president	FALSE
Third Party	There is no significant third-party or independent campaign	FALSE
Short-Term Economy	The economy is not in recession during the election campaign	TRUE
Long-Term Economy	Real per-capita economic growth during the term equals or exceeds mean growth during the previous two terms	TRUE
Policy Change	The incumbent administration effects major changes in policy	FALSE
Social Unrest	There is no sustained social unrest during the term	TRUE
Scandal	The incumbent administration is untainted by scandal	TRUE
Foreign/Military Failure	The incumbent administration suffers no major failure in foreign or military affairs	TRUE
Foreign/Military Success	The incumbent administration achieves a major success in foreign or military affairs	FALSE
Incumbent Charisma	The incumbent is charismatic or a national hero	FALSE
Challenger Charisma	The challenger is not charismatic or a national hero	TRUE
Score	**Number of Questions Answered "True" Out of 13**	**7/13**

- The “Keys to the White House” model, which has accurately predicted every presidential election since 1981, favors a Trump victory as Clinton’s “count” falls below the eight-key threshold for an incumbent party to win.[1]

(1) Scores determined by Professor Allan Lichtman.
Source: Investment Strategy Group, *Washington Post*.

The President Has Ample Authority to Restrict Trade

Statutes Available for Presidential Control of Foreign Commerce[1]

Name of statute	Authorization trigger	Presidential powers
Trade agreements		
NAFTA Implementation Act of 1993	Proclamation of tariffs	Proclaim return to MFN tariffs on imports from Canada and Mexico
	Maintain reciprocal concessions with Mexico and Canada	Proclaim additional duties following consultations with Congress
Limited statutes		
Trade Expansion Act of 1962	Finding of an adverse impact on national security from imports	Impose tariffs or quotas as needed to offset the adverse impact
Trade Act of 1974	Large and serious US balance-of-payments deficit	Tariffs up to 15 percent, quantitative restrictions, or both for up to 150 days
Trade Act of 1974	Foreign country denies the United States its FTA rights or carries out practices that are unjustifiable	Retaliatory actions, at presidential discretion, including tariffs and quotas
Almost unlimited statutes		
Trading with the Enemy Act of 1917	During time of war	All international commerce, plus the power to freeze and seize foreign-owned assets
International Emergency Economic Powers Act of 1977	National emergency	All international commerce, plus the power to freeze foreign-owned assets

- Congress has at times delegated the power to restrict or liberalize foreign commerce to the president based on Article I of the Constitution; neither courts nor Congress can deter a president from carrying out trade threats.
- Trump's threats to raise tariffs and withdraw from NAFTA and other trade agreements are amply supported by existing statutes. If threats turn into actual restrictions, the US can expect legal battles in the WTO.

(1) FTA = free trade agreement; MFN = most favored nation; NAFTA = North American Free Trade Agreement. Marcus Noland, Gary Clyde Hufbauer, Sherman Robinson, and Tyler Moran, "Assessing Trade Agendas in the US Presidential Campaign," Peterson Institute for International Economics, September 2016.
Source: Investment Strategy Group, PIIE.

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- ***Emerging Markets and Growth Markets.*** Investing in the securities of issuers in emerging markets and growth markets involves certain considerations, including: political and economic conditions, the potential difficulty of repatriating funds or enforcing contractual or other legal rights, and the small size of the securities markets in such countries coupled with a low volume of trading, resulting in potential lack of liquidity and in price volatility.
- ***Equity Investments.*** Equity investments are subject to market risk, which means that the value of the securities may go up or down in respect to the prospects of individual companies, particular industry sectors and/or general economic conditions. The securities of small and mid-capitalization companies involve greater risks than those associated with larger, more established companies and may be subject to more abrupt or erratic price movements.
- ***Fixed Income.*** Investments in fixed income securities are subject to the risks associated with debt securities generally, including credit/default, liquidity and interest rate risk. Any guarantee on an investment grade bond of a given country applies only if held to maturity.
- ***Non-US Securities.*** Investing in non-US securities involve the risk of loss as a result of more or less non-US government regulation, less public information, less liquidity and greater volatility in the countries of domicile of the issuers of the securities and/or the jurisdiction in which these securities are traded. In addition, investors in securities such as ADRs/GDRs, whose values are influenced by foreign currencies, effectively assume currency risk.
- ***Real Estate.*** Investments in real estate involve additional risks not typically associated with other asset classes, such as sensitivities to temporary or permanent reductions in property values for the geographic region(s) represented. Real estate investments (both through public and private markets) are also subject to changes in broader macroeconomic conditions, such as interest rates.
- ***Structured Investments.*** Structured investments are complex, involve risk and are not suitable for all investors. Investors in structured investments assume the credit risk of the issuer or guarantor. If the issuer or guarantor defaults, you may lose your entire investment, even if you hold the product to maturity. Structured investments often perform differently from the asset(s) they reference. Credit ratings may pertain to the credit rating of the issuer and are not indicative of the market risk associated with the structured investment or the reference asset. Each structured investment is different, and for each investment you should consider 1) the possibility that at expiration you may be forced to own the reference asset at a depressed price; 2) limits on the ability to share in upside appreciation; 3) the potential for increased losses if the reference asset declines; and 4) potential inability to sell given the lack of a public trading market.

Important Information

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