# Investing During Political Change

America voted on November 8th to elect a new President of the United States. Defying most pre-election day polls and political experts, Donald Trump upset the expected winner Hillary Clinton by taking key battleground states such as Florida and flipping traditionally Democratic states such as Wisconsin and Michigan. In January, we will have a new President who is likely to impact three main areas – politics, the global economy, and the financial markets.

On the political front, Trump's successful campaign came to fruition as many Americans voted their displeasure with the current state of the US government. As a political outsider, he appealed to voters who feel he could bring a different voice to Washington. Based on the election results, the Republican Party now holds both the executive and legislative branches in Washington. With New Hampshire still too close to call, Republicans now have 52-53 seats in the Senate. In the House, Republicans have an approximate 20-seat majority. While this suggests legislative changes may be passed quickly, in reality, policy changes can be slow as they get bogged down by special committees and debates. Both Trump and Congress will likely focus their attention on comprehensive tax reform, while repeals of the Affordable Care Act, the North American Free Trade Agreement (NAFTA), the Trans-Pacific Partnership (TPP), Obama's immigration efforts and clean energy policies are clearly in their crosshairs. But again, despite best efforts by Trump and a Republican-controlled Congress, these potential legislative changes will take some time. Looking forward, Republicans will not only remain the majority party, but appear to be heading into the 2018 mid-term elections with a possible a filibuster-proof, 60-seat senate supermajority outcome.

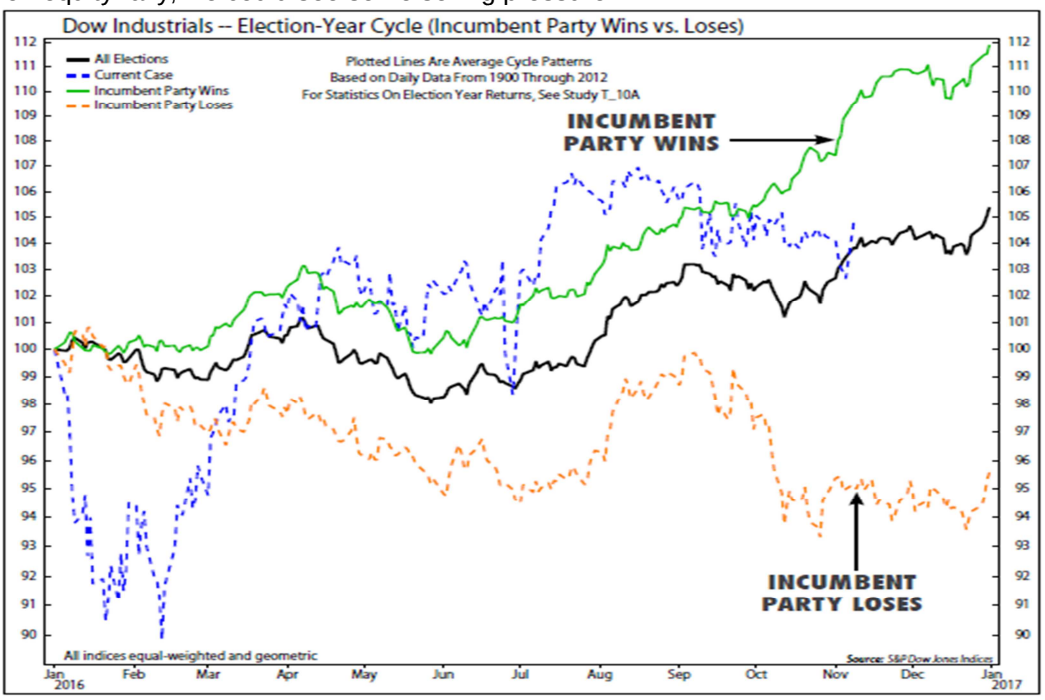
One potential change likely to occur sooner rather than later is a conservative addition to the Supreme Court. Article Two of the Constitution requires the President to nominate Supreme Court justices, while Senate confirmation is needed for them to be appointed. Throughout his election campaign, Trump pledged to appoint ultra-conservative justices to fill vacancies in the Supreme Court. If he is successful, and it seems likely given the Republican-controlled Senate, more conservative policies may take hold, possibly altering policies on abortion and gay marriage, while upholding gun rights.

While political experts will discuss for a long time how Trump surprised many with his victory, one potential premise for any candidate winning an election is how voters feel the economy is doing. Generally speaking, if the economy has been doing well, people do not seek out political change, as they tend to be content with those in power. Conversely, if the economy is not providing the jobs and opportunities that people expect, they tend to vote for a change in government. With the economy muddling along since the Great Recession, the people voted for change and got it. Looking ahead, if we focus on statements he made during his campaign, we anticipate Trump driving economic stimulus via increased infrastructure spending, along with an uptick in defense spending. Other parts of his agenda include personal and corporate tax cuts and more flexibility in the repatriation of offshore funds by U.S. corporations. Tax cuts can have a huge positive effect on economic growth, while repatriated funds could offer U.S. corporations more flexibility in investing in domestic growth opportunities or even returning cash to shareholders. At this time, it remains unclear how high we will allow debt levels or budget deficits to rise to pay for these stimulus programs and ideas. Regardless, one clear ramification is a higher-than-expected rise in inflation. In the bond market, investors have already begun to price in this expectation as the yield on the 10-year Treasury jumped 11 basis points to almost 2 percent.

With economic stimulus on the agenda and potential of higher inflation, one uncertainty is how the Federal Reserve will react. Heading into the election, the probability of a December Fed rate hike was about 70%. Given the global market volatility that ensued, this probability dropped to about

50%, but later reversed and moved higher to 75%. Despite this volatility in the probability levels, we still believe the Fed will raise rates in December as strong economic data persists, especially in the labor and housing markets, while manufacturing and service data continues to be solid. Looking out to next year, based on the previously mentioned Trump stimulus agenda and accompanying potential inflation, we do believe the Fed will continue to raise rates, possibly even faster than the markets anticipate.

Throughout this year, financial markets have demonstrated resiliency. We have seen concerns about a potential recession (January and February) and Brexit (June). As the financial markets demonstrated after results became conclusive, we believe Trump's election will likely have the same effect. We do believe market volatility will rise. Case in point, once it became clear Trump would win the election, global markets sold off dramatically overnight. For the most part, these losses reversed as Trump gave a surprisingly low-key acceptance speech, despite his historic win. Similar to what transpired after Brexit, we expect sharp market swings to be common as investors react to political and economic ramifications of this government change. Regarding broad market returns, we still believe other factors continue to suggest muted, range-bound returns for the major domestic equity indices. These factors include the length of the current bull market, valuations, still slow economic growth, recent weakness in corporate earnings, and the Fed raising rates. From a historic perspective, according to Ned Davis Research, the Dow Jones Industrial Average has rallied by a median gain of +2.7% in the 10 days after the election when the incumbent party has won versus -0.9% when the incumbent party has lost (see chart below). So despite the post-election equity rally, we could see some selling pressure.



Source: Ned Davis Research; 11/9/2016

However, despite this historical data, one positive is that when we have a Republican controlled Congress and a Republican President, as we will have, the Dow Jones Industrial Average has posted above-average gains.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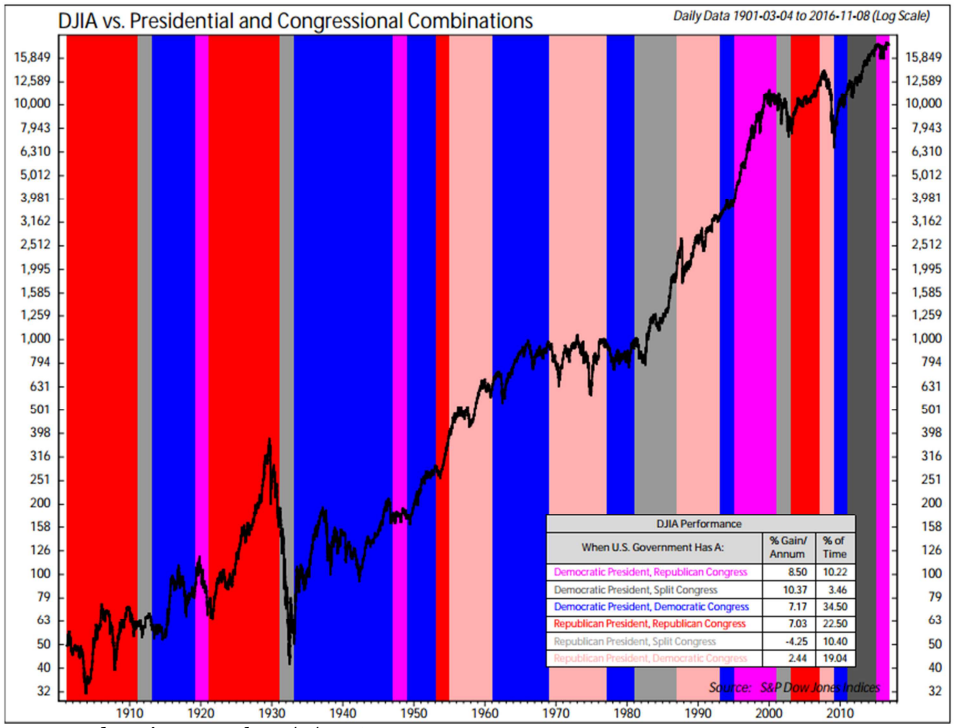

Source: Ned Davis Research; 11/9/2016

Within the broad equity markets, we feel there are some potential sector opportunities. Overall, we feel that companies with high current effective tax rates will benefit from expected corporate tax cuts. Based on the Trump's economic plans, speeches, and our historical interpretations, we believe the following sectors will most likely be positively impacted.

| Sector/Sub Industries | Good or Great | Rationale |
|---|---|---|
| **Energy and Materials** – building materials, oil companies, E&P<br><br>**Industrials** - engineering & construction | Good | Trump pledges a national infrastructure build out. Approval of a south border security wall would give Trump an added spending dynamic. Possible repeal of clean energy acts and possible more drilling. Stronger dollar could act as a headwind to commodity prices. |
| **Industrials** - aerospace & defense | Great | Trump favors a Reagan-like restoration of the nation's military. |
| **Industrials -** small-caps<br>**Consumer Discretionary** - small-caps | Good | Trump's "America first" views and pledge to bring foreign-outsourced manufacturing back to the U.S. should benefit these areas and small cap stocks tend to be more domestically focused vs. large cap that have greater international exposures. |
| **Consumer Discretionary** – autos, luxury retailers | Good | Tax cuts and economic stimulus will benefit. |


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| **Healthcare** - Pharma/biotech, life sciences, managed care | Great | Trump seeks to repeal Obamacare |
| **Technology** | Great | Wall Street analysts' identified software, services and semiconductors as potentially benefiting more under Trump.<br>Cut in corporate taxes could help technology spending. |
| **Financials** - large cap banks, insurance, brokers, asset managers, life insurance, and exchanges<br><br>**Real Estate -** REITs<br><br>**Utilities**<br><br>**Telecom** | Good | Trump is viewed as less challenging from a regulatory perspective. |

From a broad perspective, we continue to maintain our portfolio biases. We continue to favor domestic equities over international, with a slight bias toward value over growth-oriented companies. However, we do recommend retaining global exposures with an emphasis toward emerging market equities. With that said, we will be watching the impact of potential tariffs or repeals of trade agreements on foreign equities. Within fixed income, we believe Trump's stimulus plans could increase inflation and pressure bond prices. As such, we recommend below-benchmark durations and an allocation to spread product, such as corporate bonds.

With the growing uncertainties surrounding global central bank effectiveness and a likely elevated level of market volatility as Trump proceeds with his agenda, we continue to recommend staying fully diversified to limit outsized concentrations in a single asset class and to incorporate alternative investments to help mitigate against fluctuations.

Ultimately, we believe investors will welcome the clarity and relief from contention that the final vote brought with it. Putting all historical perspectives aside, remember that your portfolio should reflect your individual investment objectives, goals, and risk tolerances. It is imperative to remain disciplined and therefore work closely with your investment advisor during these interesting times.

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*The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.*


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