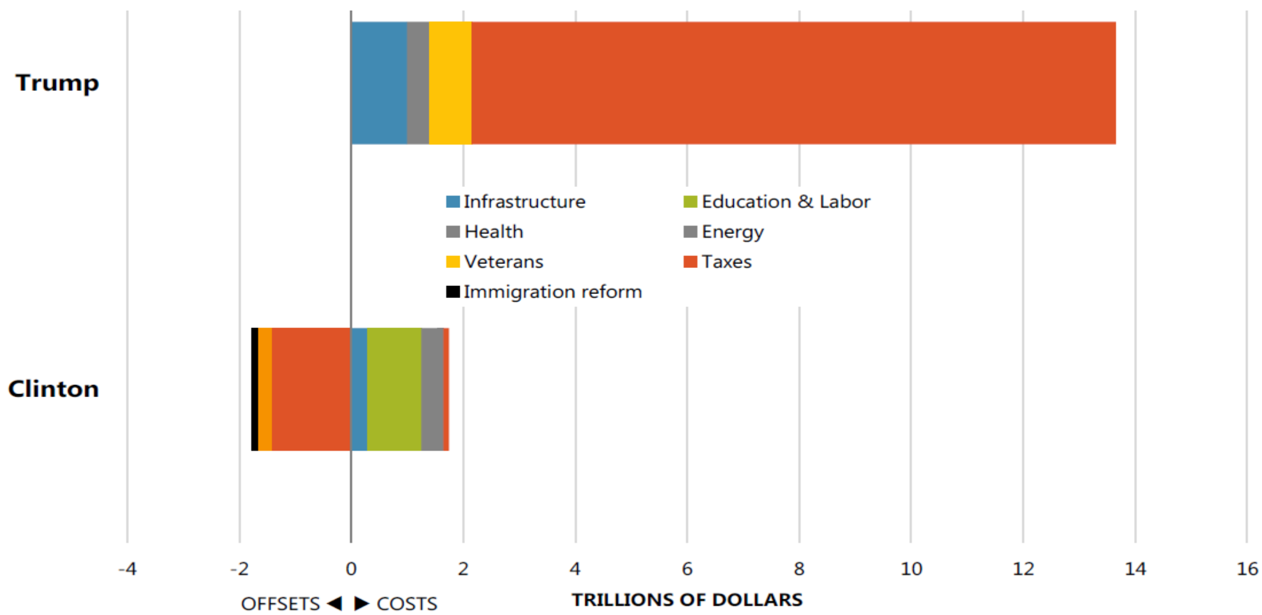
Election 2016: Policy Implications and Scenario Analysis

With the 2016 U.S. election approaching, we wanted to review the major policies of each candidate as well as the likelihood of those policies being implemented. We will also examine the potential outcomes in both the House of Representatives and the Senate. Control of the Senate is likely to be a close race while taking a majority in the House will be a tougher task for Democrats. Historically, divided government is beneficial for equity markets since policy changes tend to be slower. Current polls suggest the odds of a Clinton victory are around 80%, but as we have seen in recent months, significant swings can occur in a short period of time. In addition, the swing States of Ohio, Florida, Pennsylvania, and Virginia, which will ultimately decide the election, have moved in Clinton's favor.

Surprisingly, the candidates do agree on some issues. First, they both are in favor of significant fiscal stimulus with a focus on infrastructure spending. They both oppose the Trans-Pacific Partnership (TPP) trade proposal, but Trump also wants to renegotiate the North American Free Trade Agreement (NAFTA) and potentially exit the World Trade Organization (WTO). Next, the only individual tax issue they agree on is raising the carried interest tax to ordinary income rates. Finally, they each want to prevent additional corporate inversions but in different ways. Clinton would implement exit taxes on corporations that reincorporate outside the U.S. while Trump would provide a one-time repatriation holiday taxed at 10%.

As for the differences, none are larger than their views on taxes both at the individual and corporate levels. In general, Clinton proposes to raise taxes on individuals with incomes over $1 million per year and reduce taxes for low income workers. Trump favors much lower taxes across the board. These tax cuts would need to drive substantial income growth or the country would begin to run large deficits. As the chart below displays, Clinton's plan would increase overall taxes by roughly $1.3 trillion over a 10-year period and Trump's plan would decrease taxes by approximately $11.5 trillion.

Ten year costs and savings from major campaign proposals



Source: ISI

Tax proposals are polar opposites

<u>Clinton</u>:

- Boost ordinary income taxes on individuals earning over $5 million per year by 4%
- Itemized deductions would be capped at 28%
- A 30% Alternative Minimum Tax (AMT) for individuals with income over $1 million
- Increase the holding period necessary to qualify for long-term capital gains from 1 year to 2-6 years with declining rates each year
- Raise the Estate Tax top rate to 45% and reduce the exclusion to $3.5 million from $5 million
- Carried interest taxed at ordinary income rates from capital gains rate
- Municipal bonds tax exemption of 28% (so investors with a 39.6% tax rate would pay 11.6%), compared to no taxes currently

- Implement a tax penalty for U.S. companies that choose to reincorporate outside the U.S.
- Provide up to a $1,200 tax credit for caregivers

Trump:

- Decrease the number of tax brackets to 3 (12%, 25%, and 33%) from 7 – this would raise the lowest bracket and reduce the highest
- Eliminate the AMT and the Estate Tax
- Carried interest taxed at ordinary income rates from capital gains rate
- Allow childcare expenses to be tax deductible
- Reduce the top corporate tax rate to 15% from 35%
- Provide a one-time repatriation holiday taxed at 10%
- Change the business depreciation rate to 100% from 50%

Since taxes play a significant role in our decision making, changes in tax rates could have meaningful implications for asset allocation and planning advice. For example, a narrowing of the tax rate between income and capital gains could favor owning more bonds relative to stocks. On the other hand, a new tax on municipal bonds would somewhat reduce the attractiveness of this asset class. Furthermore, changes in the Estate Tax could alter the long-term planning strategies we recommend for our clients.

Winners and losers based on other potential policies

Aside from taxes, many companies and industries could be impacted by other potential policy change. Trump wants to repeal the Affordable Care Act (ACA). This would negatively impact Healthcare companies such as hospitals that benefit from additional volume. On the other hand, Pharmaceutical stocks could have a relief rally because Clinton has talked openly about cracking down on drug pricing. The Energy sector would clearly favor a Trump victory, as he has proposed reducing regulation, lifting the moratorium for drilling on Federal lands, and approving the Keystone XL pipeline. Pipeline companies have faced a challenging regulatory environment the last few years with many projects being denied. Many more pipeline projects would be approved under a Trump administration. Financial services companies would face less regulation as Trump has suggested scaling back many of the measures implemented under Dodd-Frank. Finally, defense contractors should benefit as the defense budget would be increased.

Trump		Clinton	
Winners	**Losers**	**Winners**	**Losers**
Financial Services	Hospitals	Hospitals	Financial Services
Oil/Gas/Coal Producers	Managed Care	Managed Care	Oil/Gas/Coal Producers
Pipelines	Alternative Energy	Alternative Energy	Pipelines
Defense Contractors		Defense Contractors	Pharma/Biotech
Infrastructure		Infrastructure	
Pharma/Biotech			

Under Clinton, businesses would generally face more regulation especially in the Financial Services and Energy industries. Her plan would be more of a continuation of the current administration's policies. On the positive side, renewable energy companies would benefit from Clinton's plan for tax incentives and grants for solar and wind. Clinton will also push to expand the ACA and that would benefit hospitals and managed care. Infrastructure and defense companies are both likely to benefit under either candidate.

Now that we've reviewed some the major proposals, it's time to ponder the likelihood of proposals actually becoming law. Under the most likely outcome (Clinton win, Republican House, Close Senate margin either way), the potential for higher taxes is very low in our opinion. Even in the remote chance of a democratic sweep, Democrats would still not have the 60 vote majority in the Senate to push through major reforms. The same is true with a Republican sweep. The bottom line is that bi-partisan support is still going to be necessary to pass any major legislation and therefore substantial policy changes seem to be a low probability in our opinion. Based on the current polls, we estimate the probabilities are as follows:

- Clinton win with a Republican controlled Senate and House 40%
- Clinton win with a Democratic Senate and a Republican House 35%
- Clinton win with Democratic control of the House and Senate 5%
- Trump win with Republican control of the House and Senate 18%
- Trump win with divided Congress 2%

We believe the market is now pricing in and expecting a Clinton victory. We also think the market performs better, at least through the remainder of 2016, with a Clinton win. While a Trump victory could likely lead to a better economic outlook, uncertainty on trade and foreign policies pose risks. Plus, the Executive branch has much more power when it comes to trade/foreign policy and could make significant changes without the approval of Congress. In addition, a Trump win could potentially lead to a more hawkish stance from the Federal Reserve, making it more likely that interest rates rise. Clinton is expected to reappoint Janet Yellen, which would provide more consistent monetary policy.

In conclusion, we think divided government is the most likely outcome and that most of the proposals championed by each candidate will not become law. Historically, divided government has coincided with the best stock market performance. However, should major policy changes occur, we will be prepared to make asset allocation changes appropriate for different environments.

At MAI, we value the confidence you have placed in us. We are always available to discuss the markets and your portfolio in more detail, so please do not hesitate to reach out to us. Finally, please remember to contact us if there are any changes in your financial situation or investment objectives.