An election of extremes—but a government of moderation

How long-term investors should view the 2016 election

September 9, 2016

IN BRIEF

- We are in the midst of a very unusual U.S. election campaign. But for markets, the impact of the election is likely to be more muted than the campaign hype might suggest.
- While imperfect, our system of divided government helps to ensure that no leader can implement his or her policy ideas unfettered. With our base case one of de facto divided government, markets may well be facing a largely status quo outcome.
- Historical analysis suggests that markets tend to favor incumbent candidates in the months leading up to presidential elections, likely because they represent less uncertainty to investors. However, political considerations have proven to be less of a driver for markets over longer periods.
- Regardless of who wins the election, investors should expect a recession at some point during the next four years. While long-term investors should continue to capitalize on the ongoing expansion for now, it will also be important to establish a plan for the next downturn as the cycle matures.

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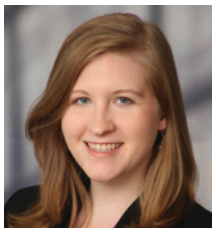

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This U.S. election cycle has been unusual from the start, most notably for the unexpected rise of non-establishment candidates Donald Trump and Senator Bernie Sanders. In the months ahead, voters will be subjected to a deluge of negativity as the candidates largely continue to make the case against each other, rather than for themselves. However, the impact of the election on markets is likely to be far more muted than the intensity of campaign rhetoric might suggest.

In this paper, we consider:

- How we got here: Why economic angst has contributed to a frustrated electorate
- Why our base case of de facto divided government is what ultimately matters most for markets
- What history tells us about market behavior before, during and after presidential elections
- Why either a President Trump or Clinton will likely face a recession in his/her first term, and how investors should think about their portfolios given where we are in the economic cycle

Not out of nowhere: The rise of populism and the legacy of the Great Recession

More than seven years after the end of the Great Recession, the fallout from the downturn continues to shape the American economic and political landscape. Despite substantial economic progress, in many ways the mood of the public is sour and distrustful. An average of polls compiled by RealClearPolitics (RCP), for example, shows that 63% of Americans believe the country is on the "wrong track," vs. less than 28% who say it is on the "right track."[1]

It is not hard to understand why. The pace of recovery has been conspicuously slow—around half that of a typical cycle—real income growth has been anemic and, while wealthy households have enjoyed a boost from rising stock and home prices, middle-income households have been disproportionately penalized by ultra-low interest rates.

Moreover, structural changes in the economy, including the ongoing shift from manufacturing to services, technological innovation and increasing globalization, have created a fertile ground for populist candidates who rail against a "broken" or "rigged" system.

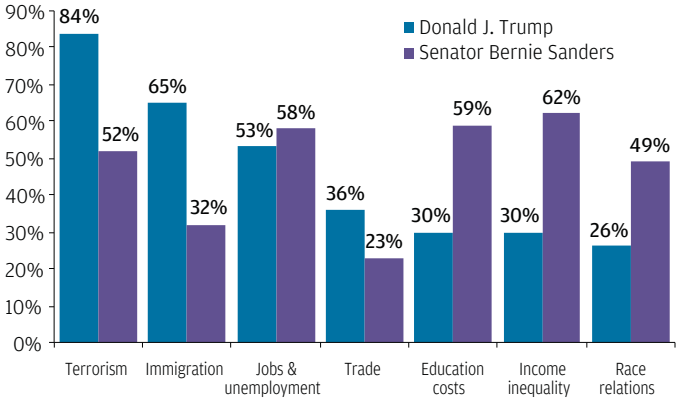
These and other frustrations have fueled the success of anti-establishment candidates. As highlighted in **Exhibit 1**, when surveyed, supporters of Donald Trump pointed to immigration as being among the most important issues to them, a sensitivity that is likely driven by economic anxiety and the fear that increased immigration represents competition for jobs. Economic issues were also important to Bernie Sanders' supporters, who cared most about income inequality, education costs and jobs.

POLITICAL POLARIZATION

Further frustrating voters, the 2016 election has unfolded amid intense political polarization. As shown in **Exhibit 2**, a study of roll call votes in the House and the Senate reveal partisanship to be at its highest in over a century. Experts point to a number of causal explanations, including increased ideological purity within major political parties[2] and years of Congressional redistricting by state legislators, which has created more "safe seats," reducing the need for politicians to compromise. Voters are unimpressed; a recent Gallup poll shows that 78% of voters disapprove of the way Congress is handling its job.[3]

Different parties have different priorities

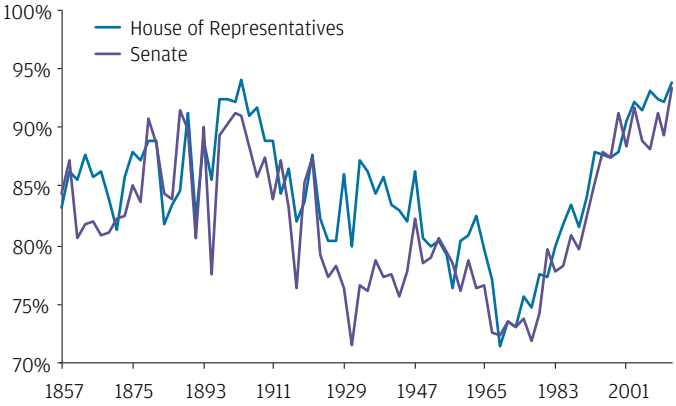
EXHIBIT 1: PERCENT OF SUPPORTERS LISTING ISSUE AS CRITICALLY IMPORTANT TO THEIR VOTE



Source: Brookings Institution, PRRI, Washington Post, J.P. Morgan Asset Management; data are as of September 9, 2016. For illustrative purposes only. Trump supporters are registered Republicans and independents who self-report as leaning Republican who put Trump as their preferred Republican nominee in a June 2016 survey. Sanders supporters were Democrats and self-identified Democratic-leaning independents who named Sanders as their top choice.

Polarization has not been this high since the turn of the 20th century

EXHIBIT 2: PERCENT OF REPRESENTATIVES VOTING WITH THE MAJORITY OF THEIR PARTY*



Source: Vote View, J.P. Morgan Asset Management; data are as of September 9, 2016. For illustrative purposes only. *In roll call votes where the majority in one party voted the opposite way to the majority in the other. Data compiled by Professors Keith T. Poole and Howard Rosenthal, available at www.voteview.com. Data on voting records are not yet available for the 114th Congress.

[1] "Direction of Country, RealClearPolitics Average." *RealClearPolitics*. RealClearPolitics Average. August 1 - September 6, 2016.

[2] Hill, Seth J., and Tausanovitch, Chris. "A Disconnect in Representation? Comparison of Trends in Congressional and Public Polarization." *The Journal of Politics* 77.4 (2015): 1058-075.

[3] Congress and the Public. "Congressional Job Approval Ratings." Gallup. August 3-7, 2016.

The presidential race—as it stands

At the time of writing, polls show Hillary Clinton with a clear lead over her Republican rival, including significant advantages in some key battleground states. According to an electoral map from RCP, Clinton has the edge in electoral votes, leading Trump 229 to 154, with 155 toss-up votes still up for grabs (270 votes are needed to win).

But it is early yet. Three presidential debates are scheduled and both Trump and Clinton struggle with dismal approval ratings (the latest RCP average finds a 54.8% unfavorable rating for Clinton vs. 58.5% for Trump).[4] Moreover, there is always the potential that a major event (terrorist attack, market shock, new hacks, unusually high or low voter turnout, an unexpectedly large result for the Libertarian or Green Party, etc.) will change the shape of the election.

TWO SCENARIOS

Acknowledging that we are not political experts, we consider two potential outcomes.

Scenario 1: Hillary Clinton as president negotiating with a Paul Ryan-led, Republican House of Representatives (with the Senate in either Republican or Democratic hands)—a very status quo outcome for markets.

Scenario 2: Donald Trump as president with GOP majorities in the House and Senate.

We note that it is unlikely that the Democrats would gain the 32 seats necessary for House control if Trump wins the national vote, and while possible, it is also unlikely that a Clinton win would be enough for the Republicans to lose the House.[5]

IF HILLARY CLINTON WINS

If Clinton wins, and assuming a GOP-controlled House, there would likely be little change in the direction of macro-economic policy; the House of Representatives would be unlikely to support expansionary fiscal policy (other than the possibility of some infrastructure spending), big tax increases on the rich or significantly more restrictive financial regulations. We do see the potential for one significant policy change: If Republicans felt that Trump's anti-immigration rhetoric helped them lose the White House, they might want to enact some version of immigration reform. We might also see some corporate tax reform if Clinton and Speaker Ryan can find common ground encompassing lower rates but fewer loopholes.

In **Exhibit 3** we consider a range of sectors and industries in the context of Ms. Clinton's proposals.

EXHIBIT 3: CLINTON'S PROPOSALS AND MARKET IMPLICATIONS

SECTOR	IMPLICATION
Trade	Current agreements remain in place; potential for action on new version of Trans Pacific Partnership (TPP), but anti-trade wing of the Democratic party will stall any TPP action
Health care	Congress will keep ACA subsidies in place, benefiting hospitals, Medicaid HMOs; pharmaceutical companies will face pricing pressure and drug costs will be targeted
Infrastructure	Infrastructure spending is likely to rise, increasing demand for raw goods and construction expertise; any infrastructure deal is likely to contain a large boost for information infrastructure, potentially benefiting some technology companies
Energy	Increased regulation of fossil fuels, especially on fracking; possible increase in federal spending on alternative energy development
Consumer	Expanded earned income tax credit and maintained safety net programs to boost spending by low income households; a federal minimum wage hike could increase consumer spending but would also hurt retailers and restaurants
Agriculture	Immigration reform could increase supply of, and bring certainty to the legal status of, temporary laborers

Source: Cornerstone Macro, Strategas Research Partners, Washington Analysis, J.P. Morgan Asset Management; data are as of September 9, 2016. Comments reflect the candidate's policy stance and proposals and do not consider the likelihood of enactment of these proposals. For illustrative purposes only.

IF DONALD TRUMP WINS

A Trump victory would bring greater uncertainty both because of uncertainty about his final policy proposals and because of the difficulty he might have in moving these proposals through an "establishment" Congress, albeit a Republican one.

As president, Trump would have executive authority to arrest and deport undocumented immigrants. However, he might well hesitate to do so immediately because of the economic disruption that would inevitably cause. He could also ask the Treasury department to label China a "currency manipulator" and use that ruling to impose countervailing duties on specific industries. However, it is possible that he would threaten to do so as an opening bid in an attempt to negotiate certain trade issues with China.

[4] "Clinton & Trump: Favorability Ratings, RealClearPolitics Average." *RealClearPolitics*. RealClearPolitics Average. August 24 - September 6, 2016.
[5] 32-seat gain assumes 186 seats currently held by Democrats, 246 seats held by Republicans and 3 vacancies, with 218 needed for a majority (as of September 7, 2016).

In one of the signature proposals of his campaign, Trump has vowed to exit and renegotiate the 1994 North American Free Trade Agreement (NAFTA)—a stance that he has now softened somewhat. As investors digest these and other proposals, it is important to recognize that trade deals are often written into existing law after the agreements are signed, suggesting that significant changes to the provisions of a trade agreement could well require an act of Congress. Some market participants also worry that the threat of economic disruption from mass deportations or a trade war could have ramifications for markets.

Of course, a president also wields significant power in the realm of foreign policy. Some worry that a more forceful approach to foreign policy under a Trump presidency could also act to unnerve markets.

Trump's tax proposals are generally estimated to be pro-growth, but they would greatly increase the deficit because of the massive cost of lost tax revenue. On health care, Trump might get a bill through Congress that repeals parts of the Affordable Care Act, but we point out that the removal of individual and company insurance mandates would necessitate the abandonment of widely popular coverage for pre-existing conditions, which would present a political challenge.

A president also exerts power through executive appointments. Over a four-year term, either candidate could name several new Supreme Court justices, potentially moving the court in a significantly more partisan direction. The president could also appoint Federal Reserve governors, with two vacant positions to be filled currently. However, he or she would not be able to replace or reappoint Fed Chair Janet Yellen until her term expires in February 2018. Moreover, a choice for Secretary of Energy, Treasury Secretary or even the creation of new posts has the ability to shape the country for far longer than one presidential term.

In **Exhibit 4** we consider a range of sectors and industries in the context of Mr. Trump's proposals.

In short, the immediate aftermath of a Trump win and full Republican control of Congress could generate considerably more uncertainty—at least initially—than a Clinton victory, primarily owing to the potential for more radical policy changes.

It should be emphasized that a Trump-GOP sweep would be different from past electoral sweeps: After all, the "establishment" GOP and its presidential nominee have not exactly seen eye to eye on many important issues, and markets should appreciate that a Paul Ryan-led House would ultimately act to dilute a fair bit of a President Trump's boldest proposals. This could make a Trump victory much more of a de facto status quo than people perceive today.

EXHIBIT 4: TRUMP'S PROPOSALS AND MARKET IMPLICATIONS

SECTOR	IMPLICATION
Trade	Companies with international supply and assembly chains may have to rethink locations; prices of consumer goods and business inputs likely to rise; internationally exposed large companies likely to be hurt the most
Health care	ACA repeal likely to hurt hospitals and HMOs as they lose subsidies; pharmaceutical companies are likely to benefit as pressure to lower drug prices is diminished
Infrastructure	Significant disagreement between Republican factions; highway restoration bill likely and would benefit industrial firms
Energy	Less regulation of energy extraction could open up new areas for energy exploration; energy transporters likely to benefit as Keystone and other similar projects are likely to be approved
Consumer	Simplified consumer tax code could increase consumer spending; firms paying minimum wage likely safe from a mandated wage increase
Financial markets	Lower corporate tax rates could boost earnings for corporations; increases in federal debt could push interest rates higher
Security	Private security firms and prisons would likely be called in to assist with immigration policy changes
Banks	Regulatory relief likely for small and community banks; tax increases on certain activities likely
Gold	Heightened global risks and higher federal deficits likely to make gold more attractive as a safe asset

Source: Cornerstone Macro, Strategas Research Partners, Washington Analysis, J.P. Morgan Asset Management; data are as of September 9, 2016. Comments reflect the candidate's policy stance and proposals and do not consider the likelihood of enactment of these proposals. For illustrative purposes only.

But there is more to the upcoming election than a new president; a third of Senate seats and all House seats will be decided on Election Day. And as we will soon see, Congress matters a lot for markets.

The importance of Congress

Winston Churchill famously quipped, "Democracy is the worst form of government, except for all the others." And while voters may be rightfully frustrated, in a sense, our system's shortcomings also constitute its strength. The Founding Fathers created a political system defined by separation of powers (executive, legislative and judicial) held in balance by a structure of checks and balances. These checks ensure (among other things) that no individual leader or party can wield unfettered power. In this context, Congress has often proven to be a useful buffer between the president's aspirations and the economy.

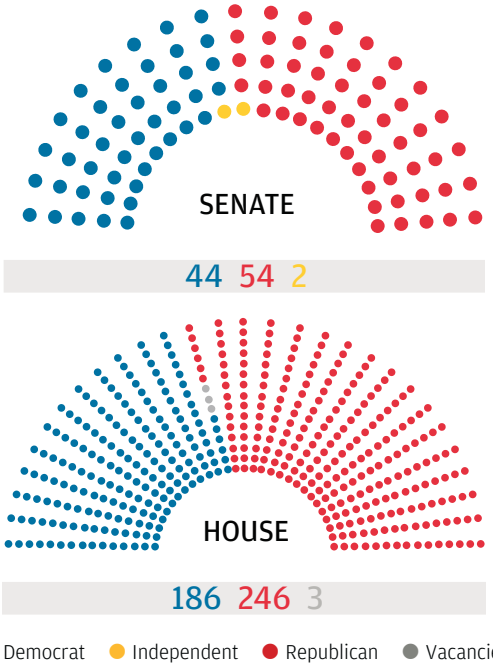
Anecdotal evidence of this is easy enough to come by; a quick Google search for the phrase "Congress watered down" reveals a battery of purportedly "watered-down" bills on taxes, privacy, foreign policy, financial regulation, tax reform, immigration and, for that matter, health care. In other words, investors shouldn't measure market prospects based on the raw proposals they hear during the campaign season.

Our base case: Continued divided government

Currently, both the Senate (54 Republicans, 46 Democrats) and the House (246 Republicans, 186 Democrats, 3 vacancies) are under Republican control (**Exhibit 5**).

The Democrats would need to win 32 seats—a high hurdle—to take control of the House

EXHIBIT 5: CONGRESSIONAL CHAMBER CONTROL



Source: U.S. House of Representatives, U.S. Senate, J.P. Morgan Asset Management; data are as of September 9, 2016. For illustrative purposes only.

Democratic control of the Senate is well within the realm of possibility. Democrats need a four-seat pick-up to gain a majority (assuming Clinton wins the White House, as the vice president casts tie-breaking votes). If Clinton does prevail, we see a higher than 50% probability of a Democratic-controlled Senate.

The House of Representatives is a different story. There, Democrats would need to win 32 seats—a high hurdle. It may be manageable in a "wave election" in which a landslide Clinton victory cascades down ballot.

[6] For more on debt, see Market Insights bulletins, *Living on borrowed time* and *5 government debt myths*.

The federal debt—a growing problem

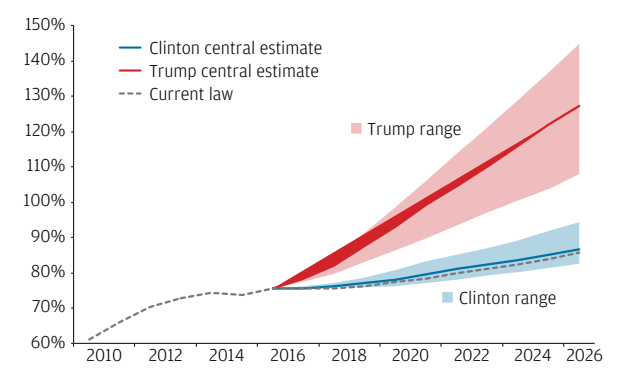
What happens to federal debt in the next administration? It's a serious issue. An improving economy and budget agreements like the Budget Control Act and American Taxpayer Relief Act have had a positive fiscal effect that is starting to fade. Despite a dramatic reduction in the federal deficit from 9.8% of GDP in 2009 to 2.5% of GDP today, the federal debt held by the public currently amounts to just over 76% of GDP—up from 39% before the financial crisis. By 2026, the Congressional Budget Office (CBO) estimates the ratio will reach 86%, before ultimately exceeding the post-World War II peak of 107% by the 2040s. These trends are exacerbated by an aging population and rising interest costs.

At first glance, the policy proposals of both candidates would likely exacerbate the fiscal deficit. Clinton's increased expenditures, partially offset by higher tax revenues, would moderately increase the deficit above the current CBO baseline estimate. As we have noted, most estimates—including those from the Committee on a Responsible Federal Budget—suggest that Trump's proposals would exacerbate this; while his proposed tax cuts might stimulate growth, the effects would likely be overwhelmed by the massive cost of lost tax revenue.

Exhibit 6 depicts the possible trajectories for the federal debt, based on each candidate's published budget proposals. While we do not believe either candidate is likely to see his/her policies implemented unfettered (and so the chart probably exaggerates the impact), investors should recognize the costs associated with a worsening debt environment, including slower growth, higher taxes and potentially higher interest rates.

Debt likely to grow under either candidate

EXHIBIT 6: DEBT AS A PERCENT OF GDP, EACH CANDIDATES' PUBLISHED PROPOSALS



Source: Committee for a Responsible Federal Budget, J.P. Morgan Asset Management; data are as of September 9, 2016. For illustrative purposes only.

What history does (and does not) tells us about market behavior around elections

It's human nature to look for patterns, be they in the clouds or in historical market and economic data. But when it comes to historical market returns and politics, we caution investors not to believe everything they see in the numbers… it all depends on how you slice the data.

For example, a simple analysis of past market returns (looking at S&P 500 data back to 1925) suggests that the *worst* combination for markets has been "R-D-R," or a Republican president with a Democratic Senate and a GOP-led House. But a closer look shows that this is entirely owing to two years, 2001 and 2002, during which time markets were dominated by the fallout from the bursting of the Tech Bubble in 2000 and the terrorist attacks on September 11, 2001.

Another example: The *best* combination for markets, based on a study of returns since 1933, has been an across-the-board GOP government, which saw average annual returns of 15.6%. But by simply extending that historical period by one more presidential term back to 1928, the "R-R-R" combination return falls to 6.2%, and fourth place, behind "D-D-R," "D-R-R" and "D-D-D."

Rather quickly, then, it becomes clear that averages like these tell us less about the impact of elections on the markets and more about the circumstantial timing and impact of major world events on those same averages.

HOW ABOUT SOMETHING USEFUL?

Can market data tell us anything useful about elections? Perhaps surprisingly, they can. Looking over the last 22 election cycles (since 1928), in the three months leading up to the election, a rising stock market accurately predicted a victory by the incumbent party's candidate, while a down market predicted a victory by the challenger party—in 86% of all observations. The data is in **Exhibit 7**.

Heading into November, it would not surprise us to see a higher market eventually predict a Clinton victory, or a lower market forecast a Trump win. We caution that this pattern is less a market vote on the long-term impact of policy proposals than a referendum on uncertainty vs. status quo. Again—markets dislike uncertainty.

TREES DO NOT GROW TO THE SKY

The next president will likely preside over a recession during his/her first term. In their recent publication, "Recession Risks," our Chief Global Strategist, Dr. David Kelly, along with colleagues Ainsley Woolridge and Hannah Anderson, argues that the cumulative probability of a recession beginning in any given quarter rises over time, starting at around 20% in the next 12 months, but growing to over 50% by year three.

Exhibit 8, which shows a comparison of the length of past expansions since 1900, emphasizes this point. No past expansion has lasted more than 10 years; for the current expansion to outlast the first term of our next president, it would need to do exactly that—making it the longest expansion on record. While anything is possible, it does not seem likely to us.

Market "votes" can be seen as a referendum on uncertainty vs. status quo

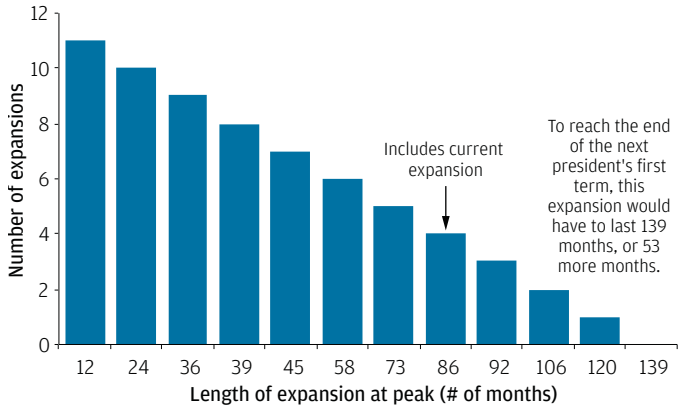
EXHIBIT 7: MARKETS AND ELECTION OUTCOMES

Election year	1928	1932	1936	1940	1944	1948	1952	1956	1960	1964	1968	1972	1976	1980	1984	1988	1992	1996	2000	2004	2008	2012	2016
S&P 500 (% change 3 months leading up to election)	14.9%	-2.6%	7.9%	8.6%	2.3%	5.4%	-3.3%	-2.6%	-0.7%	2.6%	6.5%	6.9%	-0.1%	6.7%	4.8%	1.9%	-1.2%	8.2%	-3.2%	2.2%	-19.5%	2.5%	6.7% (YTD)
Incumbent	Won	Lost	Won	Won	Won	Won	Lost	Won	Lost	Won	Lost	Won	Lost	Lost	Won	Won	Lost	Won	Lost	Won	Lost	Won	?
Match?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	?

Source: Office of the President, Standard & Poor's, Strategas Research Partners, J.P. Morgan Asset Management; data are as of September 9, 2016. For illustrative purposes only.

It would be unprecedented for this expansion to last through the next president's term

EXHIBIT 8: NUMBER OF EXPANSIONS LASTING EACH NUMBER OF MONTHS



Source: NBER, J.P. Morgan Asset Management; data are as of September 9, 2016. For illustrative purposes only.

Conclusion

Markets dislike uncertainty, as investors well know. In this election cycle, the prospect of a Trump victory represents the more uncertain outcome for markets. But investors should also remember that Congress—even under GOP control—will probably act to muffle the impact of either president's proposals, as de facto divided government is the most likely outcome.

We also conclude that fundamentals—not elections—will be the more important drivers of asset prices in the coming years. Investors should focus on valuations, the health of corporate balance sheets, the level of interest rates, the path for the U.S. dollar and the economic cycle, all of which will have a greater influence on portfolios.

Currently, the U.S. economy appears set for stronger growth and a lift in corporate profits. Consumer balance sheets are strong, and with only a slow rise in inflation and an even milder increase in interest rates expected, a recession is anything but imminent. Investors should continue to take advantage of the good weather while it lasts.

But trees do not grow to the sky, and eventually the next recession will come. Today, we see the expansion as being closer to the seventh inning than the second, and it is only prudent for investors to consider positioning more cautiously by reducing large risk overweights that might define an early or mid-cycle portfolio.

Relative to a long-term strategic allocation, our Multi-Asset Solutions team has gradually shifted from a significant equity overweight toward a neutral stock-bond allocation, favoring the U.S. for its status as a high-quality, safe harbor market. We believe that investors should also consider the inclusion of defensive equity strategies with attractive downside capture ratios or lower betas—although here we point out that valuations present something of a challenge for certain defensive stocks and sectors given the ongoing hunt for yield.

With respect to fixed income, the anatomy of the next recession will play an important role in determining the right approach, requiring investors to be somewhat flexible. For example, in a labor supply-constrained economy, such as the U.S., it is possible that any upward demand shock could result in an overheating scenario, catching the Fed—and bond markets—off guard. This could push interest rates higher, hurting fixed income investors with too much duration exposure.

On the other hand, a slow-growth economy that gradually coasts to softer growth might favor high-quality duration. In other words, investors will have to be more nimble—there is no simple formula this time around.

To be clear, prudence is not to be confused with panic. Neither the prospects for a recession in the coming years, nor the impact of the upcoming election, justify drastic action. Instead, investors should take a disciplined, balanced approach that enables them to stay invested so that they can participate in any upside offered in the late stages of the expansion, while feeling more confident that a market downturn won't upend their retirement plans.

As always, we look to help long-term investors keep emotion out of their financial decisions. In the final months of the presidential campaign, it is easy to become distracted by heated rhetoric and gyrating polls. As needed, we will provide market updates—and repeat our call for calm.

NEXT STEPS

For more information about the Market Insights program, contact your J.P. Morgan representative.

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