Investment Update

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WEALTH MANAGEMENT

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Position for the Expected, but Plan for the Unexpected

When I was a kid, I was taught to think of my trunk as the "just-in-case" space in my car. My over-protective Italian mother had me load it full of winter clothes, blankets and jumper cables just in case of the unexpected. Needless to say I was prepared to be stranded by a winter storm, even when it was 75 degrees and sunny outside.

As an investment strategist, I have to weigh that cautious thinking with where we believe the global markets and economy are headed. Today, we have positioned portfolios for a late-stage bull market of modest equity returns, lower-for-longer yields and a pickup in volatility. Yet, we constantly monitor for new information that may influence how we are positioned. This may include developments around the timing and pace of the Federal Reserve's (Fed) next tightening move, clarity around the future state of the Eurozone following Brexit and of course, the U.S. presidential election. And, as Election Day nears, investors are wondering whether their portfolios are properly positioned for the outcome.

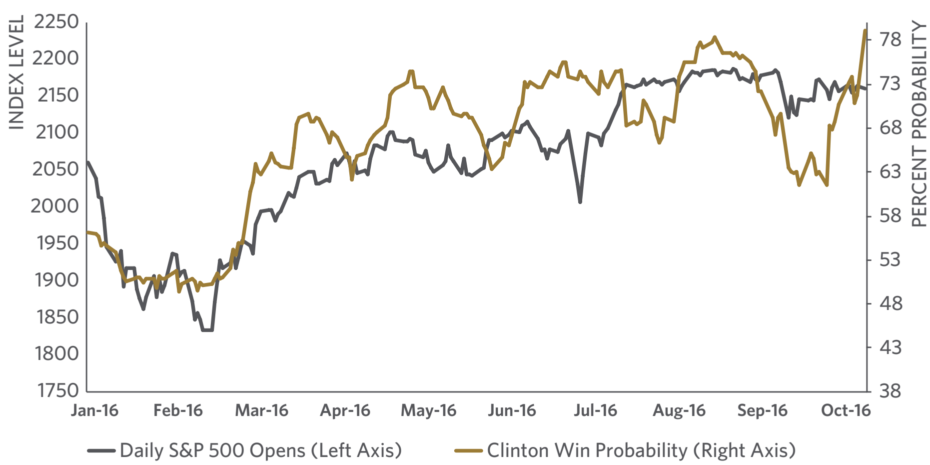
Elections and Markets

Since the creation of the Fed in 1913, there have been 26 presidential elections: 14 were won by Democrats, and 12 by Republicans. As I have highlighted in earlier *Updates*, history tells us that the outcome won't have a significant impact on stock market performance because other economic and market factors are far more important. But while elections don't seem to predict stock market returns, the stock market seems to be a fairly good predictor of who will win the election. The general rule states that if the S&P 500 is positive in the three months leading up to the election, the incumbent party wins the White House. If returns are negative, a change in presidential party leadership is foreshadowed. This time around, the S&P 500 has so far been nearly flat, so we will have to watch how October plays out to see if this relationship holds.

Another relationship that is on our radar compares the odds of a Clinton win against S&P 500 performance (Figure 1). The recent ticks higher in performance correspond to the market's view that Clinton won both the first and second debates, supporting the interpretation that the market is getting comfortable with a Clinton victory. Given the fact that markets view a Clinton administration as a continuation of current policy, rather than the uncertainty posed by a Trump presidency, we were not surprised by the advance.

Figure 1—Election Betting Odds Post-Debate

S&P 500 vs. Probability of Hillary Clinton Winning U.S. Presidential Election



As of 10/10/16. Source: StrategasRP

Although the market is expecting Clinton to win, there are unique aspects of this election cycle that could influence voters and result in a surprise outcome. Isolationism fueled by nationalist and populist rhetoric has been sweeping the globe, paving the way for events such as Brexit, Grexit, the Scottish Independence Movement, the rise of Podemos (Spain) and the recent German elections, where Merkel finished third. Trump is playing into this general theme by calling for stricter immigration, greater defense spending and a dismantling of current trade policies. A Trump victory would be attributed to the strength of this global trend.

Positioning Portfolios

Will the election impact your portfolio? Probably not as much as some investors might think. More important than the election outcome are the ultimate policy landscape and implications of those policies for the business, economic, and stock market cycles. These relationships, rather than who sits in the Oval office, have a more direct impact on corporate earnings and business and consumer confidence.

Recent history illustrates this point well. Former President Ronald Reagan and President Barack Obama were both handed economic and market troughs near the beginning of their presidencies. Both pursued very different policies, yet each president went on to preside over very strong equity markets during their tenure. This strong empirical evidence illustrates that the combination of policies and market cycles may matter significantly more than who is president.

We have not yet made any asset allocation changes in anticipation of the election outcome, but we are prepared should a surprise happen on Election Day, realizing that what becomes law is usually very different (and watered down) from what is proposed on the stump. The following provides some perspective on the types of changes we may consider making in the event of an unexpected Trump win.

Small Cap vs. Large Cap: Our portfolios slightly favor large cap equity over small; however Trump's isolationist trade policy may damage earnings of large multi-nationals and we may increase exposure to small cap stocks, due to their more domestic focus.

Domestic vs. International: Uncertainty surrounding trade policy under a Trump administration could have an impact on currency as well as the potential for trade barriers. The dollar may strengthen, due to its safe haven tendencies, which would reduce the earnings of international companies when translated back to dollars, but also hurt domestic large companies by further hindering their exports. This result may cause us to invest more in the international small company asset class, as these firms generally sell only to their local population and would be more insulated from trade barriers and tariffs.

Emerging Markets: Protectionist trade policies may diminish growth for many export-driven, emerging market economies. Countries most dependent on exports, including Canada and Mexico (both with about 70-80% of exports to the U.S.) may be substantially hurt, while other emerging markets with fewer exports to the U.S., such as Russia (<5%) and China (20%), might do quite well in comparison. Look for us to remain significantly underweight this asset class if Trump gets elected.

Taxable vs. Tax-exempt Bonds: Marginal tax brackets have been discussed by both candidates. Higher marginal tax brackets, advocated by Clinton, would make municipal bonds more attractive as this would increase the tax-equivalent yield. Lower marginal rates, as proposed by Trump would make the same municipal bonds less attractive than their taxable counterparts.

Exposure to Diversifiers: We are currently overweight diversifiers, which are designed to help buffer swings in the market. A Trump victory could certainly increase market volatility, at least in the short run, so we may recommend increasing exposure to this asset class, especially to strategies that benefit from increased volatility.

Waiting and Watching

Over the next several weeks there will be much to contemplate. In the market's view, the most likely outcome is a Democratic president and a Republican or divided Congress, similar to the current political backdrop. We believe investors are well-positioned for a long, but slow global expansion, low inflation and accommodative monetary policy. In the event of a surprise outcome, markets may become more volatile. We would look to potentially recommend a change in portfolio positioning, making allocations shifts depending on a host of variables including whether the election's outcome changes our outlook on the economy and markets.

By the way, I never did need to use the items in my trunk when I was a young driver. While the markets seem to think we won't need them this time around either, I've learned through the years it's always best to be prepared.

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