PRUDENTIAL FIXED INCOME

U.S. ELECTION PERSPECTIVES

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While the 2016 U.S. presidential election has been unprecedented in its rancor and series of surprising developments, it is also part of a global political theme where an anti-establishment candidate—in this case Republican Nominee Donald Trump—faces off against a politically entrenched opponent—in this case Democratic Nominee Hillary Clinton. The deep division between the candidates not only underscores the political polarization that has increasingly defined the country, but it also reflects the rise in public frustration with slow economic growth (which is widespread throughout developed economies) and broad income inequality.

As we consider the political scenarios that might unfold on November 8th, the following provides some perspective on some of the potential policy shifts, their economic impact, and subsequent effect on certain corporate sectors and markets. The caveat, however, is that the presidential election has become increasingly close, and the number of potential scenarios raises the difficulty of forecasting market reactions. Furthermore, polling in some recent noteworthy votes (e.g. Brexit) has proven to be unreliable, which has been underscored by the ongoing fluidity in the numerous polls tracking the upcoming U.S. elections.

A Broad View of the Presidential and Congressional Races

Overall, we believe Hillary Clinton’s position has appeared steady, as she has the potential to win even if many of the undecided voters side with Donald Trump. That said, an electoral college win in either direction is unlikely to be a landslide, unlike Ronald Reagan’s victory in 1984. We believe Trump could win up to 45% of the popular vote. The ultimate outcome of the presidential election will likely depend on opinion trends in the final days of the campaign and the turnout of various voting segments of the population, which the polls may not have accurately tracked.

We believe the most likely outcome in the House of Representatives is that Republicans lose 15-20 seats, but maintain a narrow 232-230 seat majority. The polarization that has recently characterized the U.S. political landscape is quite evident from the composition of the House. Pew research shows very few counties are still in play—only about 300 counties nationally—and the rest are either Red or Blue by more than 5%. This number is down from 600 counties a few years ago. Despite reports of widespread gerrymandering, it is not an issue for 90+% of the seats; it is rather that the country has an extreme level of geographic partisanship.

In the Senate, we view the most likely outcome as a 51-49 seat majority in favor of Democrats (and an independent), but it’s not out of the question for Republicans to maintain control.

Modest fiscal stimulus/infrastructure spending seems likely in most of the election outcome scenarios, and therefore, may already be priced into the interest-rate, spread and currency markets. Aggressive fiscal stimulus that manages to take growth significantly higher, however, would likely push the yield curve and the dollar higher with credit spreads eventually tightening as well. A disjunction
in trade policy—especially an aggressive protectionist agenda—is a difficult policy reaction function to gauge, since a range of possible geopolitical scenarios could follow.

At any rate, a serious trade war would in all likelihood prove negative for risk markets, taking spreads wider. While a risk-off event would typically push Treasury yields lower—and that would be the base case here—there is also the possibility that a Treasury “foreign buyers strike” could alternatively push Treasury yields higher. Similarly, while prior to the 2008 crisis flight-to-quality periods typically resulted in a weaker dollar, more recent flight-to-quality periods have seen the dollar strengthen as a safety currency. So while a “two-handed” outlook is certainly in order here, the more likely course would seem to be a stronger dollar, perhaps ironically given the negative likely overall economic impact of a trade war on the U.S., as well its related trade partners.

With that potential backdrop, there is a reasonably good likelihood of some bipartisan policy progress, but gridlock cannot be ruled out. If there is progress, the agenda could consist of the following:

- tax reform—geared more towards corporate than individual
- infrastructure investment
- trade with Asia and U.K.
- data security—regulations for retailers
- criminal justice
- student loans

So in short, probabilistic views are slightly skewed towards: 1) a Clinton presidency, 2) a House that will likely remain Republican, and 3) a probability that the Senate swings to the Democrats.

**Election Impact on Policy and Programs**

*Federal Reserve Policy:* We don’t expect the election itself to have much influence on the Fed, and still expect, as a base case, that it will likely follow through on a 25 bp rate hike in December 2016. This year’s rebound in energy prices and waning effects of past U.S. dollar appreciation are expected to lift headline inflation temporarily to over 2% in 2017, keeping additional Fed rate hikes on the table for next year. That said, we think risks are tilted towards Fed policy undershooting the median projection of Fed officials (as of September 2016) for two more 25 bp rate hikes next year. Unless energy prices rise further, the impact of their increase to date on headline inflation should prove temporary. In the meantime, household purchasing power is expected to be constrained by rising energy and medical costs, limiting the pace of household spending in other areas and thus the need for aggressive Fed rate hikes. This base case is predicated on fiscal policy remaining mildly expansionary, as we expect would be the case if control of congress and the presidency remains split across political parties. If fiscal policy turns significantly more expansionary, however—which we think would be more likely in a “sweep” scenario in which one party gains control of the presidency and both chambers of congress—the probability increases that the Fed will hike rates next year by more than the one to two 25 bp increases we currently expect.

*Fiscal policy:* Fiscal policy has already turned modestly stimulative over the past year, given a loosening of government spending caps in recent years. We think fiscal policy is likely to be loosened further under either a Trump or Clinton presidency, although perhaps a bit more so in the case of Trump. Clinton has tended to advocate for more federal spending on social programs as well as
infrastructure and other investments—offset to a degree by higher taxes. Trump has indicated that he would also likely pursue infrastructure and other government investments and would also likely boost military spending. In contrast to Clinton, he is calling for tax cuts and in general is advocating for more regulatory restraint. We think the scale of a fiscal expansion under either presidential candidate depends on whether the winning candidate’s own party also controls the Senate and has at least significant control of the House after the election. In the case of a “sweep” election by either party, we expect fiscal policy to be looser than otherwise.

Importantly, the federal budget will be on the front burner right after the election with the current stop-gap appropriation measures due to expire on December 9, 2016, thus requiring either an extension or budget deal by a lame duck Congress and President. The federal debt ceiling becomes binding again on March 15, 2017.

**Tax policy:** There has been bipartisan support for corporate tax reform for years. Some of the sticking points to implementing reform thus far has been whether to tie a corporate tax rate reduction to changes in the personal income tax structure, or more generally, what offsets should be implemented if any.

**Trade policy:** We anticipate more general uncertainty in this area in the case of a Trump presidency, with an increased likelihood of tensions in existing trade deals. Although both candidates have stated some opposition to the TPP, passage of that pact and the T-TIP¹ would appear remote under Trump. In a Clinton presidency, a divided or a Republican congress would also make passage of large trade deals less likely.

**Affordable Care Act:** Industry experts note a likelihood that the economics of the ACA will need to be addressed, very possibly within the next year. Clinton emphasizes increased government subsidies and cost controls, while Trump advocates a heavier reliance on private sector competition. A divided congress would perhaps increase the likelihood of only minor changes to the current system. A “sweep” in favor of Democrats would more likely result in increased government spending on healthcare, with the overall program left largely intact. A “sweep” in favor of Republicans would likely result in wholesale changes to the program and more limited government spending in this area.

**Infrastructure Spending:** Both candidates support infrastructure spending. Over the past year, there’s been a pullback in fixed investments by state and local governments given their budget constraints. This component of general government expenditures is expected to increase somewhat over the next several years regardless of the election outcome.

**Sector Specific Impacts**

**Healthcare:** This sector could be directly impacted by the outcome of the presidential and congressional elections. Generally, gridlock may be good for Healthcare in that little is likely to get passed from a legislative perspective that would materially impact the sector.

**Healthcare Facility-Based Providers:** A Trump win and Republican majority in Congress could have an outsized negative impact on providers given the rhetoric around repealing and potentially replacing the Affordable Care Act—that could result in adverse volume, mix, and/or reimbursement impacts—as well as other potential entitlement reforms and/or reductions in entitlement spending.

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¹ The TPP is the Trans-Pacific Partnership and the T-TIP is the Transatlantic Trade and Investment Partnership.
Pharmaceuticals: Drug pricing has become a hot-button topic over the last year as some companies have come under scrutiny for aggressive price increases. Both candidates have talked about the issue, although Clinton has laid out a more specific set of policies she would use to curb the impact of drug costs. These include relatively minor proposals regarding the sector, such as putting a stop to direct-to-consumer advertising, or limiting the out-of-pocket costs for drugs allowed under health plans. However, they also include some policies that could have a larger impact, such as switching patients that qualify for both Medicare and Medicaid to cheaper Medicaid drug pricing, or allowing Medicare to negotiate directly with pharmaceutical companies for discounts and rebates. Although the industry might not be totally insulated from some legislative action under Trump, it seems less likely. Republicans would likely be able to moderate many of Clinton’s plans if they maintain some congressional control.

With that said, the Independent Payment Advisory Board (“IPAB”, which was created under the Affordable Care Act) bears watching, as it provides the potential for significant executive powers regardless of congressional control. The IPAB could potentially put pharmaceutical companies at risk, as drug pricing remains a political hot topic on both sides of the aisle. There have been continued efforts—on behalf of the administration, Congress, and regulators—to highlight, as well as potentially address drug pricing issues, including value-based pricing models, new efforts toward greater pricing transparency, and bipartisan support for speeding up the approval process for generic drug applications.

Technology: The biggest impact to this sector would be the potential for corporate income tax reform, particularly any changes to taxes on foreign earnings/repatriated earnings—either in a one-time situation or in a permanent arrangement. The likelihood for corporate tax reform is greater under a Trump victory, however there have been recent media reports that Clinton could support a one-time tax break on repatriated earnings in order to fund infrastructure spending.

Building Materials/Construction: We would expect an increase in spending on infrastructure projects, which would benefit the Building Material credits in the concrete/aggregates space, in the event of a Democratic sweep and under a Trump Presidency where Republicans maintain control of at least one chamber of Congress.

Energy: A democratic sweep would have negative consequences for the energy sector as Clinton has a stated goal of generating 50% of U.S. electricity from renewables by the end of her first term. Natural gas is currently about 33% of U.S. electricity generation and this percentage is steadily increasing. Displacing 50% of aggregate demand in favor of renewables would severely affect pricing, as well as demand for pipeline capacity and gas processing services, while also having a very negative effect on both the upstream and midstream energy sectors. It’s hard to fathom that 50% of the U.S. electricity grid can move to renewable without significantly higher utility bills or massive government subsidies, however, it has been stated.

In addition, Clinton has proposed cutting oil and gas subsidies— basically eliminating deductions for dry holes and some drilling costs—that would slightly raise the cost structures for the upstream energy sector. She would also repeal the foreign tax credit for integrated oil companies operating in foreign countries, subjecting them to double taxation. Clinton has not expressly objected to hydraulic fracturing (“fracking”), but has hinted at closer scrutiny of the techniques involved. She has also mentioned that she is opposed to the Keystone XL pipeline. This has as a modest negative effect on Canadian producers and some slight positive effects for Midwest U.S. oil refiners.
In a Clinton Presidency where Republicans control at least one Congressional chamber, it seems highly unlikely that Clinton’s ambitious plans would come to fruition, since the Congressional delegations from powerful states such as Texas would probably block these plans. If the Democrats sweep the Presidency and congress as well, all bets are off.

In the event Trump wins, the status quo would likely prevail, although he has promised to approve Keystone XL. We don’t see much policy change from a Trump victory.

**Oil & Gas:** The big impact to the sector would be considerable incremental restrictions on hydraulic fracturing that would be in-play if the Democrats controlled the executive branch and the Senate. Yet, even in such a scenario, there is a very low probability of industry-altering legislation. We believe coal remains the scapegoat for now, and plans to wean off fossil fuels largely serving as rhetoric in the short-run.

**Electric Utilities:** The candidates’ views on environmental issues, renewable energy, climate change, fracking policies, and energy efficiency standards are very different. Picking winners and losers, however, at this point is difficult without having more policy detail. For example, new anti-coal regulations could help Exelon’s merchant nuclear plants—by encouraging coal generation to shut down and pushing electric market prices higher. However, if aggressive renewables targets are also adopted, these could offset the anti-coal benefits by increasing the amount low marginal cost renewables and further displacing higher cost nuclear power.

In general, a Democratic sweep could materially help issuers with large renewables businesses—such as NextEra and Southern Power—and hurt issuers with significant merchant coal generation—such as FirstEnergy. We believe a Trump presidency where Republicans control at least one Congressional chamber would reverse the winners and losers. A split between the executive branch and Congress would likely result in gridlock, and thus have limited impact on investment-grade utilities.

While the results of this Presidential election will have an impact on the high yield merchant power generation sector, there are just too many unknowns and avenues either a Trump or Clinton victory could take to make a decisive claim at this point in time.

Neither candidate has laid out a clear road map, with the exception of Clinton wanting to "do away" with coal generation, and Trump wanting to "bring it back." The best scenario—and one that brings more stability—would be a mixed result with either a Trump or Clinton victory with Congress being controlled by the other party. The EPA administrator needs to be approved by Congress, which could help dampen radical change. That said, a Clinton victory will likely be a better outcome for the power space at first. There are many existing rules on the books that will force additional coal plant closures, therefore tightening up the power market and increasing capacity value for existing generators. That said, coal heavy generators would likely prefer a Trump victory to try and extend the option value of their plants for a couple more years; however it is unclear how/if Trump would actually implement an extension. Longer term, a Clinton victory could be detrimental to merchant power names if she pushes through legislation that incentivizes uneconomic renewable power generation with government subsidies. Again, it is not clear how this would actually work without creating instability in the power grid and adversely affecting power markets with uneconomic renewable generation.
Municipal Bonds: Key areas of focus for the municipal market as it relates to the Presidential election are tax reform and infrastructure spending. Congressional outcomes will be a driver of what the next administration can accomplish. In addition, any significant fiscal stimulus that leads to higher rates will have a negative impact on the broad municipal market, as higher yields and negative returns will likely lead to outflows for municipal bond mutual funds.

A Clinton victory would lead to higher marginal tax rates for top wage earners and the potential for a cap on the tax-exempt interest deduction. While higher tax rates should result in increased demand for tax-exempt bonds, any proposal to cap the tax-exemption will have a negative impact on tax-exempt bonds. A Trump victory that leads to tax cuts and a potential cap on the tax-exempt interest deduction would be negative for tax-exempt bonds.

There is bi-partisan support for infrastructure investments, with both candidates having called for increased infrastructure spending. The key question is how does this get financed? Reports indicate that Clinton’s $275 billion infrastructure plan will be financed through corporate tax reform. Despite the success of the taxable municipal Build America Bond (BAB) program that ended in 2010, we do not anticipate a similar program under a Clinton or Trump administration. There have been several efforts over the past few years to introduce legislation that would create a BAB-like program, however legislation has failed to advance in Congress.

Recent reports indicate that voters in 26 states will be asked to vote on $250 billion for 375 local and regional transportation projects and initiatives. In California, voters will be asked to vote on Proposition 55, a measure that would extend the temporary income tax hikes in effect since 2012 for another 12 years. If passed, the taxes are estimated to generate between $4 billion and $9 billion annually through 2030.
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