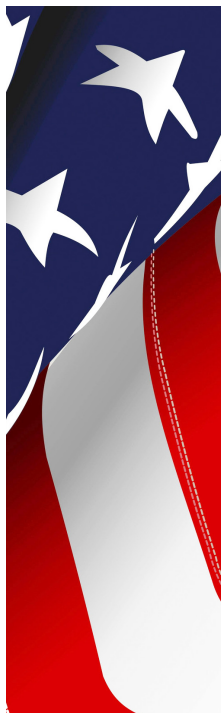


ElectionWatch

Perspectives on the 2016 US elections from UBS CIO Wealth Management Research

5 April 2016



Turning to the issues

The presidential primary races have downshifted from the frenetic pace of weekly “super” contests across multiple states during February and March to a more of a grind in April. Hillary Clinton has amassed a commanding lead over Bernie Sanders in the race for pledged delegates. She appears poised to capture the Democratic nomination despite recent victories by Senator Sanders in western states. Meanwhile, the scramble on the Republican side for “unpledged” delegates indicates that all sides see a significant chance of an open convention requiring multiple ballots. As the prospect of a splintered Republican Party has grown from a remote possibility into a likelihood, the market-implied odds of a Democratic candidate winning the White House have increased.

With a more measured primary schedule coming up between now and the July conventions, we focus the next several editions of *ElectionWatch* on specific sectors of the economy and how, if at all, they might be affected by the November election and next year’s legislative calendar.

This month’s articles drill down into policy. Both parties’ nominees have presented proposals to revise the Internal Revenue Code. The proposals vary dramatically but have not received much attention as the popular media have been more attentive to the candidates’ personalities and campaign tactics. In this edition, we review the four leading contenders’ **tax plans**, each of which would entail significant changes to both the individual and corporate tax structure.

Also in this edition, Jerry Brimeyer, our CIO WMR healthcare sector strategist, puts some

of the candidates’ rhetoric on **prescription drug prices** into context. Andy Sutphin, covering the industrials sector, provides perspective on the **US defense budget** and points out some historical patterns around elections that suggest bipartisan support for higher military spending and a tailwind for military contractors.

Time capsule

A season of incivility

The willingness of candidates in this election cycle to denigrate their opponents directly rather than through surrogates is unusual, but



personal attacks on presidential candidates are nothing new. In the 1876 presidential election, Samuel Tilden’s sup-

porters tried to discredit Rutherford B. Hayes by asserting that he had shot his own mother with a pistol in a drunken stupor. Governor Hayes, whose reputation for sobriety was unblemished, ended up winning the election through the Electoral College despite losing the popular vote.

Inset: Published in Harper’s Weekly, February 17, 1877. Wood engraving by Thomas Nast. (Photo by The New York Historical Society/Getty Images)

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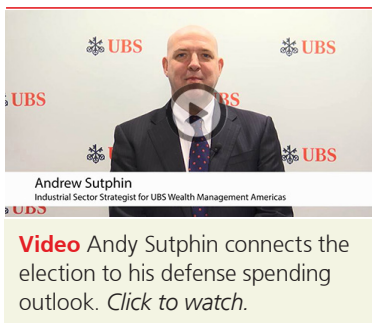
Aerospace and defense

By **Andy Sutphin**, Equity Sector Strategist

"I will make our military so big, powerful and strong that no one will mess with us." DONALD TRUMP

"As president, (I will) ensure the United States maintains the best-trained, best-equipped, and strongest military the world has ever known." HILLARY CLINTON

Campaign bravado aside, both parties' leading presidential contenders have reaffirmed their interest in a stronger military posture. While campaign rhetoric often diverges from the final appropriation bills for the Department of Defense (DoD), recent acts of terrorism in Europe and the Middle East have altered the parameters



of the debate. We believe the risks to the defense budget remain to the upside, consistent with prior election cycles.

As illustrated in Fig. 1, the returns of the US defense industry have outpaced the broader market (i.e. the S&P 500) five of the last six elections.

US defense budgets are cyclical

We have witnessed three cycles of Defense Department spending levels over a span of more than 50 years, from the Johnson Administration through the current Obama Administration. Following the cycle peak in 1968 during the Johnson Administration, the US defense budget fell 32% over the next seven years to trough in 1975 under President Ford. Ten years later, the US defense budget peaked again under President Reagan. Similar to the prior budget cycle, the

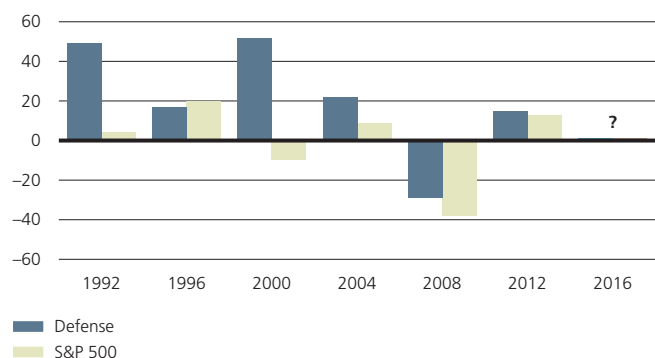
next thirteen years saw the US defense budget decline by 35%, bottoming in 1998 during the Clinton Administration. The next upcycle lasted ten years through 2008, coinciding with the final year of President George W. Bush's tenure. During the eight years of the Obama Administration, the US defense budget has declined by 30%. In our view, the US DoD spending cycles coincide with the global threat environment faced by the US.

What matters most – the investment accounts

From 2013 to 2015, the defense budget hovered around \$495bn in nominal dollars due to the Budget Control Act, better known as the "sequester." This year's proposal reflects the two-year budget agreement covering FY16-17 and includes a plan for the base budget to grow at a 3% CAGR from FY17 through FY21. While the total fiscal 2016 Department of Defense base budget will grow 5%, the investment accounts

Fig. 1: Defense stocks' outperformance during election years

Change in price, in %



Source: UBS, Thomson Reuters Eikon, as of 30 March 2016

Aerospace and defense

which procure military hardware increased by 14%. The effects of the increased fiscal 2016 budget have begun to flow to the US prime defense contractors as the year-over-year increase in modernization outlays began with the current calendar year.

US defense budget set to resume growth

President Obama's fiscal 2017 budget request for the Department of Defense was largely in step with the recently passed Bipartisan Budget Act of 2015. The total DoD budget request for fiscal 2017 is virtually unchanged compared with the fiscal 2016 DoD budget, but the modernization fell modestly, 3%, compared with the prior fiscal year's "out-sized" increase. The current fiscal 2017 DoD budget request emphasizes a "full spectrum" of readiness for threats from superpowers (China, Russia), rogue nations (Iran, North Korea) and terrorist organizations (ISIS). Both sides of the political aisle appear to agree the sequester-level funding is too constraining. We believe any request for a further increase in the defense budget is likely to meet with less resistance.

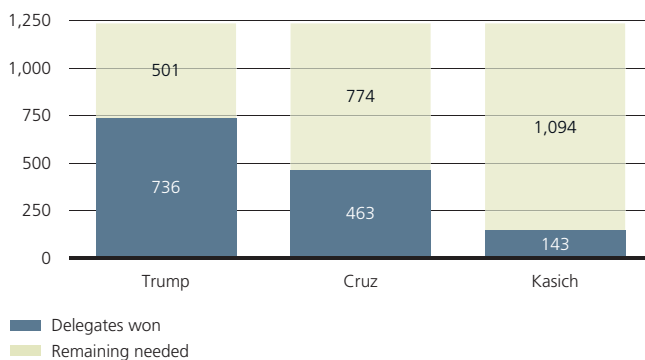
Investment takeaways

- Historically, the cycles of Department of Defense budgets have been correlated with the global threat environment faced by the US.
- Hardware produced by US defense contractors is funded through the DoD's investment accounts, which appear poised to resume growth after a cyclical decline.
- We recommend that clients increase their exposure to the US aerospace & defense subsector to take advantage of these funding dynamics.
- By contrast, the machinery subsector is likely to perform less well due to its exposure to depressed natural resource prices.
- For specific guidance, please refer to our *Equity Preference List* dated 23 March 2016.

Candidate delegate count update

Republican delegate count

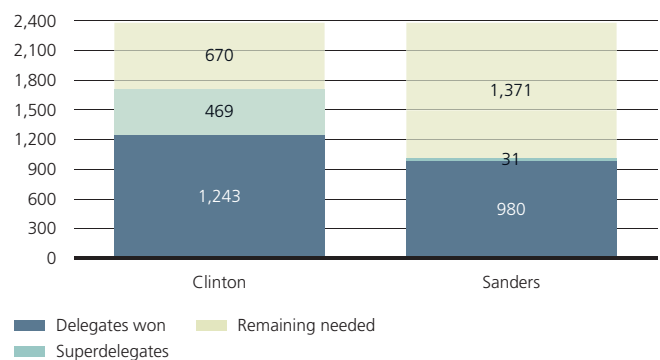
1,237 needed to win on the first ballot



Source: [Real Clear Politics](http://www.realclearpolitics.com/epolls/2016/president/republican_delegate_count.html) (http://www.realclearpolitics.com/epolls/2016/president/republican_delegate_count.html) as of 31 March 2016

Democrat delegate count

2,382 needed to win on the first ballot



Source: [Real Clear Politics](http://www.realclearpolitics.com/epolls/2016/president/democratic_delegate_count.html) (http://www.realclearpolitics.com/epolls/2016/president/democratic_delegate_count.html) as of 31 March 2016

Healthcare on the defensive

By **Jerry Brimeyer**, Equity Sector Strategist



While healthcare is a frequent topic of heated debate on the presidential campaign trail, prospects for meaningful execution of campaign rhetoric into viable legislation appears unlikely. Absent a supportive Congress, few healthcare policies are likely to change and the rhetoric targeting drug prices and the Affordable Care Act (aka ACA or “Obamacare”) is likely to diminish after November regardless of who is elected.

While it is possible that the GOP could win the White House and maintain control of both houses of Congress, calls to repeal Obamacare (a frequent Republican refrain) could be an uphill battle without a larger GOP majority in the Senate (although it is technically possible, through budget reconciliation, to repeal some facets of the law with only 51 votes in the Senate). We believe little will

change in Washington over the near-to-intermediate term to meaningfully affect healthcare policy, although political uncertainty will continue to weigh heavily on healthcare stocks until the outcome of the election is clear.

The political divide in Washington regarding healthcare policy remains wide and not easily bridged. Republican presidential candidates and many Congressional Republicans in Washington (as well as those likely to be heading there after the 2016 election) are determined to repeal and replace Obamacare. It remains to be seen if the GOP can devise a plan to cover the more than 17 million previously uninsured Americans who currently receive healthcare coverage due to the ACA (either through Medicaid expansion or state health insurance exchanges).

Select healthcare proposals from presidential front-runners

	Clinton	Trump
ACA (Obamacare) and related	<ul style="list-style-type: none"> Expand ACA partly through expansion of Medicaid and state health insurance exchanges Lower out-of-pocket healthcare costs Lower prescription drug prices 	<ul style="list-style-type: none"> Repeal ACA Deduct health insurance premiums from tax returns Allow sale of health insurance across state lines Encourage wider use of health savings accounts (HSAs)
Taxes relating to healthcare	<ul style="list-style-type: none"> Tax credits up to \$5000 / family to offset out-of-pocket and premium costs up to 5% of income 	<ul style="list-style-type: none"> Allow deduction of health insurance premiums from taxes Repeal all tax implications of ACA
Medicaid	<ul style="list-style-type: none"> Encourage more states to expand Medicaid programs 	<ul style="list-style-type: none"> Have federal government issue block grants to states for Medicaid
Drug pricing	<ul style="list-style-type: none"> Reduce prescription drug prices Permit Medicare to negotiate drug prices 	<ul style="list-style-type: none"> Permit government to negotiate directly with drug companies Allow consumers to access imported drugs

Source: UBS

Healthcare on the defensive

The Republican front-runner, Donald Trump, has proposed tax deductions for health insurance premiums, the sale of healthcare insurance across state lines, and incentives for wider use of health savings accounts (HSAs). As popular as these proposals may be, they are likely to be insufficient to compensate for the aggregate loss of coverage if the ACA were repealed. Conversely, both of the leading Democratic candidates want to expand Obamacare, partly by encouraging more states to expand Medicaid and partly by aiding health-care exchanges. This would appear to be a feat equally as challenging as the repeal of Obamacare. Moreover, our colleagues in the UBS US Office of Public Policy believe the GOP will retain control of the House of Representatives, making further expansion of the ACA highly unlikely.

The campaign rhetoric from Secretary Hillary Clinton and Senator Bernie Sanders regarding drug prices has obscured the larger issue that Democratic proposals actually tend to be more favorable for healthcare companies largely due to insurance coverage expansion. That is to say, in general, healthcare companies (and by extension, healthcare stocks) should perform better when more Americans are covered by health insurance. And while Democratic



presidential contenders have been more critical of pharmaceutical companies, proposals to regulate drug prices will likely meet stiff opposition in Congress.

Investment takeaways

- The current weakness in healthcare stocks presents an opportunity for patient investors who are willing to maintain their investment positions past the November elections.
- Among healthcare stocks, biotechnology and pharmaceutical shares have been most affected by negative political rhetoric, yet many large-cap companies in these areas have fairly predictable and defensive earnings growth.
- For this reason, biotech and pharma stocks, in our opinion, are most likely to be outperformers post-election.



Taxes: A study in contrasts

By **Tom McLoughlin**, Co-head of Fundamental Research



Almost 30 years ago, on a sunny morning in October 1986, President Ronald Reagan put his pen to paper and enacted the single largest tax reform measure in American history. The Tax Reform Act of 1986 was the product of two years of painstaking negotiations in Congress and required the active engagement of a president popular within his own party and the public at large. The legislation reduced marginal tax rates, shifted a larger share of the tax burden of taxation from individuals to corporations, and reduced the number of available deductions. Republicans and Democrats on Capitol Hill sparred over the details but eventually managed to settle their differences and close the policy gap. The GOP was rewarded with lower tax rates, while Democrats were reassured by the elimination of various loopholes.

As our colleagues in the UBS US Public Policy Office often remind us, the environment in Washington is different today. Bipartisan compromises on major legislation are rare. And as we discussed in the last edition of *Election-Watch*, the rise of the independent voter has paradoxically undermined the ability of both political parties to find common ground. So it is within this context that we examine the four leading candidates' tax proposals.

Follow the money

The two GOP front-runners rely on the economic stimulus generated by lower taxation to reduce the size of the operating deficit. The Democratic candidates, on the other hand, are focused on reducing income disparity through the application of fiscal policy. As we illustrate on the next page, the policy prescriptions are so different as to make a political compromise very difficult indeed. Senator Sanders' preference for radically higher tax rates, for example, is likely to fall on deaf ears in Congress. Senator Cruz' proposal to eliminate the Internal Revenue Service, while holding some appeal for many taxpayers every April, is equally unlikely to be adopted.

The tax policy differences between the two parties are dramatic and there is no better way to assess that disparity than by focusing on the prospective standard-bearers' tax proposals. Senators Hillary Clinton and Bernie Sanders would both increase the marginal tax rate on wage earners with the highest incomes, but Clinton's plan is more limited in scope. According to the nonpartisan Tax Foundation, most of the revenue raised from her proposals would be derived from a cap on itemized deductions and a four percent surtax on individuals reporting the highest income.

The tax policy differences between the two parties are dramatic.

Her opponent for the Democratic nomination, Senator Bernie Sanders, would go much further. He favors adding four new marginal tax rates, ranging from 37% to 52%, instituting a new payroll tax, and raising the estate tax rate. The revenue derived from these taxes, among others, would be used to fund universal healthcare and more generous social welfare programs.

On the Republican side of the aisle, Senator Ted Cruz supports the repeal of both the corporate income tax and the estate tax. He favors a 10% flat tax rate on individual income and the elimination of most tax deductions. A business transfer tax, akin to a value added tax, would be levied at the rate of 16%. He would also expand the child tax credit. Donald Trump would reduce the marginal income tax rate for individuals and increase the value of standard deductions. He favors a reduction on the corporate tax rate to 15% and would treat carried interest as ordinary income.

Regardless of who is elected, we expect a reduction in the scope of the tax proposals. Politics is, after all, the art of the possible.

Comparison of candidate tax policies

	<i>Individual provisions</i>	<i>Business provisions</i>
Hillary Clinton	<ul style="list-style-type: none"> Introduces a 4% “surcharge” on high-income taxpayers earning over \$5mn Implements the “Buffet Rule” which establishes a 30% minimum tax on adjusted gross income over \$1mn Caps all itemized deductions at a 28% tax value Adjusts the schedule for long-term capital gains by raising rates on medium-term capital gains Limits the total value of tax-deferred and tax-free retirement accounts Taxes “carried interest” at ordinary income rates 	<ul style="list-style-type: none"> Eliminates the deductibility of reinsurance premiums paid by corporations to foreign subsidiaries and provides an exclusion from income for reinsurance recovered for any arrangement where the deduction was disallowed Establishes business tax credits for profit-sharing and apprenticeships Taxes high-frequency trading
Bernie Sanders	<ul style="list-style-type: none"> Adds four new income tax brackets for high-income households with rates of 37, 43, 48, and 52% Taxes capital gains and dividends at ordinary income rates for households with income over \$250,000 Creates a new 2.2% “income-based health care premium paid by households” Eliminates the Alternative Minimum Tax, the personal exemption phase-out (PEP), and the Pease limitation on itemized deductions Creates a new 6.2% employer-side payroll tax Applies the Social Security payroll tax to earnings over \$250,000 Decreases the estate tax exclusion to \$3.5mn and raises the estate tax rate to between 45–65% 	<ul style="list-style-type: none"> Eliminates several business tax provisions involving oil, gas, and coal companies Ends the deferral of income from controlled foreign subsidiaries Changes several international tax rules to curb corporate inversions and limit use of the foreign tax credit Creates a financial transactions tax on the value of stocks, bonds, derivatives, and other financial assets traded by US persons Limits like-kind exchanges of property to \$1mn per taxpayer per year and prohibits the use of like-kind exchanges for art and collectibles
Ted Cruz	<ul style="list-style-type: none"> All personal income is taxed at 10% Increases the standard deduction to \$10,000 per filer Eliminates all credits except for the child tax credit and the Earned Income Tax Credit Expands the Earned Income Tax Credit by 20% Creates tax-free savings accounts for up to \$25,000 of savings a year Eliminates all itemized deductions except for the charitable and home mortgage interest deduction Eliminates the payroll tax Eliminates the Alternative Minimum Tax, the Net Investment Income Tax, the Medicare Surtax, and Estate Tax 	<ul style="list-style-type: none"> Eliminates the corporate income tax Creates new “business transfer tax” or value-added tax of 16%, levied on all business profits, rents, royalties, and payroll Enacts a one-time deemed repatriation tax of 10% on all foreign profits currently deferred
Donald Trump	<ul style="list-style-type: none"> Creates 10, 20, and 25% income tax brackets Increases the standard deduction to \$25,000 (\$50,000 for married filers) Steepens the curve of the personal exemption phase-out and the Pease limitation on itemized deductions Eliminates the Alternative Minimum Tax, the Net Investment Income Tax, and the Estate Tax “Carried interest” taxed as ordinary income 	<ul style="list-style-type: none"> Reduces the corporate income tax rate to 15% Caps the tax rate on pass-through business income at 15% Ends tax deferral on overseas corporate income Enacts a one-time repatriation tax of 10% on all foreign deferred profits Eliminates all other corporate tax expenditures Eliminates corporate Alternative Minimum Tax Caps the deductibility of interest expenses

Source: UBS, TaxFoundation.org, as of 31 March 2016

COMING SOON?



The Democratic National Convention, held in the New Merchant's Exchange in St. Louis, June 27–29, 1876. The chairman, General McClelland, announcing the nomination of New York governor Samuel J. Tilden, as presidential candidate. (Cornell University Library)

PRIMARY CALENDAR

Date	State	Democratic delegates	Republican delegates
Tuesday, April 5	Wisconsin	96	42
Friday, April 8	Colorado Conventions (Rep)*		37
Saturday, April 9	Wyoming caucus (Dem)**	18	
Tuesday, April 19	New York	291	95
Tuesday, April 26 (Super Tuesday)	Connecticut	70	28
	Delaware	31	16
	Maryland	118	38
	Pennsylvania	210	71
	Rhode Island	33	19
Tuesday, May 3	Indiana	92	57

Note: Only states with primaries through the next edition of *ElectionWatch* are shown. All dates are primaries unless otherwise noted. Primaries, conventions, and caucuses which are only held by one party on that date are noted as (Dem) or (Rep). The delegate counts represent the total delegates from that state for each respective party. *Colorado Democratic caucus was held March 1. **Wyoming Republican caucus was held March 1.

Source: New York Times, UBS, as of 4 April 2016

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Leading the ElectionWatch team this year are Tom McLoughlin, Co-head of Fundamental Research, and Brian Nick, Head of Tactical Asset Allocation US

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