

ElectionWatch

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

6 May 2016



It's only the beginning

Donald Trump's victory in Tuesday's Indiana primary caps a remarkable campaign to seize the GOP nomination for the presidency. By capturing 57 of the state's delegates to the Republican National Convention, he forced Senator Ted Cruz and Governor John Kasich to acknowledge the fact that a brokered convention was now far less likely. Both candidates suspended their campaigns after the votes were tallied. Mr. Trump is now the Republican Party's presumptive nominee. Senator Bernie Sanders notched another narrow primary win by capturing approximately 52.5% of the popular vote in the Democratic primary in Indiana. While he remains popular among younger and more liberal voters, his path to the nomination is rapidly closing. Secretary Clinton is now the Democratic Party's presumptive nominee.

Looking ahead, we expect to see a general election campaign that will test the tolerance of American voters for negative advertising. Both presumptive nominees have poor net favorability ratings, which suggests that they may encounter challenges in garnering support from uncommitted independent voters. In the face of the withering criticism that each candidate will likely direct toward the other, we believe voter turnout will dictate the outcome. Mr. Trump must convince working-class Americans that his appeal to nationalism offers hope for an economic renaissance and better employment prospects. Secretary Clinton must strike a delicate balance between convincing Bernie Sanders' fervent supporters to support her candidacy while persuading more conservative voters that she shares their concerns regarding political gridlock in Washington and is prepared to abandon politics as usual.

In this month's edition of *ElectionWatch*, equity sector strategist Jon Woloshin offers an

assessment of the US housing and commercial real estate markets. Both candidates are likely to express their support for tax reform legislation in the next Congress; as the US real estate market is exposed to any substantive change to the Internal Revenue Code, these developments in Congress bear watching.

Next, in our sector report on financial services, equity sector strategist Brad Ball reviews the regulatory environment within which banks must operate. He concludes the risks are moderating for most financial institutions. We close this edition with a review of the political prediction markets and the degree to which policy uncertainty affects investor behavior.



Tom McLoughlin discusses this edition of *ElectionWatch* in a [short video](#). Click the photo to watch.

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Avoiding another housing crisis

By **Jonathan Woloshin**, CFA, Equity Sector Strategist



Given the importance of the real estate market to our national economy, it is rather surprising how little attention both housing and commercial real estate have received from the remaining presidential candidates. Interestingly, with the exception of Senator Sanders who recently outlined his vision for the US housing market, the resounding silence from the balance of the field has been deafening.

Housing

Irrespective of party affiliation, we believe the next president must 1) address the structure and role of the federal government in the mortgage market, and 2) examine alternatives to encourage responsible lending to a broader cross section of potential borrowers. Despite myriad proposals from both Republicans and Democrats to wean government-sponsored enterprises (GSEs) from the mortgage market, Fannie Mae and Freddie Mac remain under the conservatorship of the Federal Housing Finance Agency (the FHFA).

The role of government-sponsored enterprises in the housing market has proven to be a bone of contention in Washington. Both political parties have expressed a desire for more private capital investment in the mortgage market, but uncertainty regarding regulatory oversight has dissuaded some investors from greater participation. In the wake of the last financial crisis, banks and other private mortgage industry participants have paid more than USD 160 billion in fines and penalties (both hard and soft dollars). More stringent underwriting criteria, adopted in response to new federal regulations, have restrained growth in private lending. The rules surrounding Disparate Impact (DI) and the potential legal risks associated with DI claims also pose an obstacle to further private capital investment.

The economic realities surrounding the government's participation in the mortgage market will make it very challenging to extricate the GSEs (and by extension the Federal Housing

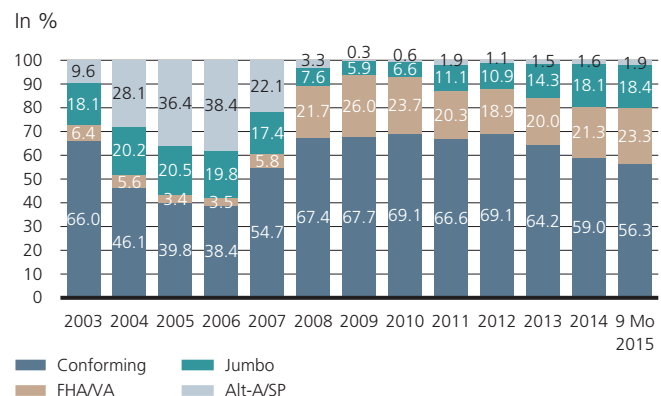
Administration) from an integral role in the housing industry in an expeditious manner. As the data in Fig. 1 indicate, the GSEs and FHA account for some 80% of the mortgages issued in the US. In addition, the GSEs and the FHA combined own and/or guarantee almost USD 8 trillion of the estimated USD 10 trillion in outstanding 1-4 family mortgages.

Commercial real estate

Although the candidates have refrained from offering specific proposals on the commercial real estate (CRE) market, the need for comprehensive tax reform has been a recurring theme throughout the campaign. Our colleagues in the UBS US Office of Public Policy have reiterated their view that substantive tax reform is highly unlikely this year. However, we do believe that both presidential candidates will express their support for some reform in the run-up to the general election.

Former Chairman of the House Ways & Means Committee Dave Camp released a tax reform proposal in February 2014. Mr. Camp's plan, which was admittedly a rough outline, eliminated section 1031 of the Internal Revenue Code, where it has resided since 1921.¹ Although the bill failed to generate enough interest among members of Congress, and Congressman Camp has since retired, the pressure

Fig. 1: Composition of US mortgage market over time



Sources: FHFA, Inside Mortgage Finance, UBS, as of April 2015

Avoiding another housing crisis

to repeal and/or reduce the benefits of 1031 exchanges remains in the forefront of the tax reform discussions. According to the Joint Committee on Taxation, the elimination of Section 1031 would generate more than USD 40 billion between 2014 and 2023 making it an attractive target for members of Congress eager to offset the revenue losses associated with lower marginal tax rates.

Recent industry surveys have uncovered evidence that upwards of 60% of 1031 exchanges involve properties worth less than USD 1 million and more than 30% are worth less than USD 500,000. As for larger players (those transactions valued over USD 5 million) the stakes get even larger. As can be seen in Fig. 2, there were more than USD 540 billion in CRE transactions in 2015 and the transaction volume has averaged more than USD 275 billion since 2001. Although not all of these transactions utilized 1031 protections, we believe it is reasonable to conclude that the ability to employ a 1031 structure helped facilitate the robust transaction market.

At this point, we do not have sufficient information to accurately handicap the odds of an elimination or curtailment of 1031 exchanges. That said, we are obliged to note the frequency with which it is discussed on both sides of the political aisle. Real estate investors are well-advised to remain vigilant in monitoring the progress of any tax reform discussions as it relates to this crucial provision of the tax code. Commercial

real estate values were adversely affected when the Tax Reform Act of 1986 was implemented and, while history doesn't repeat itself, it often rhymes, as Mark Twain reputedly said.

- The combination of solid operating fundamentals, access to attractively priced capital, rising dividends, a favorable regulatory backdrop and the upcoming formation of a standalone economic sector positions REITs for continued out-performance vs. the S&P.
- Investors in private CRE should focus on multi-family, industrial and self-storage in strong secondary and tertiary markets that have solid job and population growth, more reasonable valuations vs. their coastal peers and more attractive risk-adjusted reward profiles. The continued measured recovery of the housing market coupled with the increasing level of cash-out refinancings and home equity lines of credit should provide a positive backdrop for select larger national builders and home improvement retailers and suppliers.
- For stock selections, please refer to our Equity Preference Lists for US REITs, 3 May 2016 and for US Consumer Discretionary, 3 May 2016.

¹ Section 1031 of the U.S. Internal Revenue Service Code allows investors to defer capital gains taxes on any exchange of like-kind properties for business or investment purposes. Taxes on capital gains are not charged on the sale of a property if the money is used to purchase another property. The payment of tax is deferred until the property is sold with no reinvestment.

Fig. 2: US government owns or guarantees nearly 80% of mortgages issued in the US

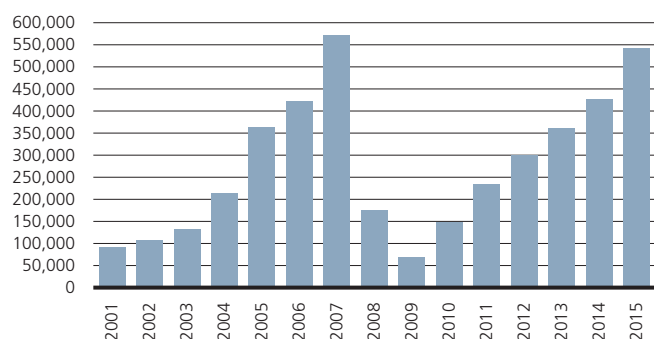
In USD bn

	USD bn	% outstanding
1-4 family mortgages outstanding	\$9,986	100.0%
Fannie Mae	\$3,102	31.1%
Freddie Mac	\$1,947	19.5%
FHA	\$2,796	28.0%
Subtotal US government	\$7,845	78.6%
Other	\$2,141	21.4%

Source: FHFA, HUD, FRB, UBS, as of April 2016

Fig. 3: Commercial real estate transaction volume over time

In USD mn



Source: Real Capital Analytics, UBS, as of April 2016

A taxing task

By **Brad Ball**, Financial Services Sector Strategist

"Wall Street engaged in financial crimes and no one should be too big to jail."

Hillary Clinton

"I'm not going to let Wall Street get away with murder."

Donald Trump

 The rhetoric surrounding the US financial sector during this election cycle has been decidedly negative. Criticism of banks and other large financial institutions has been a bipartisan exercise among candidates seeking our nation's highest office. Nevertheless, we retain a slightly more positive outlook for the sector – or perhaps a slightly less negative one – regardless of the election outcome in November. Our more sanguine view is based on the assumption that the new president will not replicate the current administration's penchant for draconian rules, regulations, and oversight authorities.

The new financial sector regulations imposed since the Great Recession limit banks' products and practices, raise their cost of compliance, and dampen their profitability through higher capital requirements. As these rules take shape and effect in the years ahead, we expect less ambiguity in the regulatory environment. So while we acknowledge that the sector has the propensity to generate headlines in an election cycle, we believe the political backdrop will take a turn for the better after the dust settles in November.

Framing the risks for financials

The incendiary rhetoric has certainly captured the headlines. The Democratic candidates have promoted the breakup of the largest banks into smaller pieces and called for the prosecution of executives at failed institutions. The presumptive GOP nominee has shown less overt hostility but echoes some of the same criticism. Although their extreme positions could heighten the rancor toward big banks leading up to November, we

believe the actual risks post-election will be limited. The two most likely candidates, Hillary Clinton and Donald Trump, do not strike us as being as ideologically driven as is the current administration.

In our view, the regulatory environment will be the most important factor for financial services companies in the years ahead. For some time now, the sector has battled the headwinds of the development, implementation, and enforcement of rules under the Dodd-Frank Wall Street Reform and Con-

Criticism of banks and other large financial institutions has been a bipartisan exercise among candidates.

sumer Protection Act of 2010. Six years since it was signed into law, financial regulation has significantly progressed. Nearly 90% of the act's roughly 400 rules have either been proposed or finalized; they now mandate certain minimum liquidity and capital levels and constrain capital return through dividends and buybacks.

Regulatory pendulum has swung

We expect the remaining 10–15% of the rules to be implemented over the next few years, supplementing the tougher standards already in place. All of this is likely to sustain



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Brad Ball discusses this article of *ElectionWatch* in a [short video](#). Click the photo to watch.

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the higher cost of doing business for financial firms and impair their earnings power and profitability. The upshot? The uncertainty regarding regulation will further diminish, paving the way for a more stable operating environment for financial services companies.

What's more, the legal and regulatory charges banks have faced related to pre-crisis activity, in areas such as mortgages and trading, have been declining. The largest financial institutions have paid their fines and remediated their issues, though the smaller ones will remain subject to substantial oversight for a while longer. And although some regulatory and legal aspects remain to be finalized, most of the unknowns – outside of the election-related noise – are now in the past.

To be sure, there are lingering exceptions. The impact of the Federal Reserve Board's comprehensive capital analysis and review regulations is still uncertain. The Fed's "living wills" test recently found five of the nine so-called global systemically important financial institutions wanting, which suggests that oversight will be a recurring hurdle for the major banks. Meanwhile, the new regulatory agency, the Consumer Financial Protection Bureau, is likely eager to sharpen its claws against unfair and deceptive practices in the industry.

Investment recommendations vis-à-vis the election cycle

Regulatory regime change since Dodd-Frank and the ensuing challenges for financial services companies have not been all bad for investors and markets. In fact, we believe the health of US banks relative to peers in other developed markets – whose capital adequacy and leverage ratios are lagging – has not only helped increase market confidence and stabilized global markets, but also elevated the stature of US financial regulators.

As headlines continue to paint US banks in good light, regulators in the country will likely enjoy somewhat of a reprieve from public criticism. The perception that the Fed

is tough on the key measures of financial strength – asset quality, capital adequacy, management, and liquidity – should confirm the effectiveness of the oversight regime, and could minimize the need for any significant new crackdown on financial firms. We therefore find it unlikely that whoever wins the White House in November will squander these gains.

The largest financial institutions have paid their fines, though the smaller ones will remain subject to oversight for a while longer.

- We prefer financial companies that have paid the bulk of their fines, adjusted their business models, and stockpiled capital to comply with new regulations.
- Although capital return remains closely regulated, we do not expect a material easing of capital requirements. We continue to view increasing dividends and share repurchases as positive near-term catalysts for equity investors.
- From a credit standpoint, we are comfortable with the big banks' fundamentals, including regulatory capital and leverage levels, especially in the context of ongoing balance sheet downsizing and de-risking.
- While we see some potential for an easing of Dodd-Frank regulations in the event of a GOP victory in November, we are not overly concerned about the likely status quo regulatory risks in case of a Democratic win.
- Please refer to our US Financials: Equity Preference List, 28 March 2016, for stock selections.

The uncertainty principle

By **Brian Nick**, CAIA, Head of Tactical Asset Allocation US, and **Tom McLoughlin**, Co-head of Fundamental Research



In the March edition of *ElectionWatch*, Chief US Equity Strategist Jeremy Zirin highlighted the role of political uncertainty in driving equity markets. While not a perfect proxy for electoral outcomes, the economic policy uncertainty index developed by social scientists at the University of Chicago and Stanford University has been correlated with equity market volatility (see Fig. 4) over time. Fundamental factors such as industry profitability and macroeconomic policies dictate long-term performance, but politics can certainly influence financial markets over shorter time horizons.

One might expect the current election season, with its bombastic rhetoric and unconventional campaign tactics, to impact markets. Yet, despite the histrionics, at only one point in the past 12 months has a candidate's political platform appreciably moved markets. Secretary Clinton's tweet regarding prescription drug prices on 21 September 2015 alarmed enough investors to trigger a correction in the prices of pharmaceutical stocks.

"Price gouging like this in the specialty drug market is outrageous. Tomorrow I'll lay out a plan to take it on."

Former Secretary of State Hillary Clinton on Twitter, 21 September 2015

The S&P 500 Pharmaceutical Biotech and Life Sciences industry group fell 2.2% that day and a further 8.2% over the next five trading sessions after Clinton released the details of her plan. In last month's edition of *ElectionWatch*, equity sector strategist Jerry Brimeyer explained that the chances of major drug price controls passing in the next Congress are relatively low. Even so, the market reaction to Clinton's initial tweet and subsequent statements suggests that her candidacy is viewed

as having a higher probability of success than that of her opponent. Policy statements from other candidates have had little to no impact on equity prices. For example, while presumptive Republican nominee Donald Trump has outlined major policy changes on issues ranging from trade to taxes, his statements thus far have not had a discernible impact on the value of the US dollar or US Treasury yields. The market reaction to Secretary Clinton's statement may reflect a higher degree of confidence in her electoral prospects.

One might expect the current election season, with its bombastic rhetoric and unconventional campaign tactics, to impact markets.

The market impact of policy proposals is often limited

Many presidential candidates champion policies that would mark significant deviations from the status quo. But only a handful of those policy proposals ever stand a realistic shot at implementation. A recalcitrant Congress often serves as a bulwark against an unfettered executive, notwithstanding the enactment of the Affordable Care Act. When weighing the potential market impact of a candidate's policy proposals, investors must sort through these layers of conditional probability. This makes the likelihood of any single outcome, especially a disruptive one, relatively low most of the time. This is precisely what we see in the current primary season.

According to various political prediction markets, like PredictIt (see Fig. 5) and the University of Iowa Political Markets, the outcome of the 2016 presidential election is modestly certain, more certain, in fact, than in any prior election dating back to 1992. The Democratic

The uncertainty principle

Party, likely to be represented by Hillary Clinton, was given a 65-75% chance of winning the White House as measured during the month of April. To put this in context, the University of Iowa Political Markets priced President Obama's odds of reelection at only 60% in April 2012. And they were under 55% at the same point in 2008.

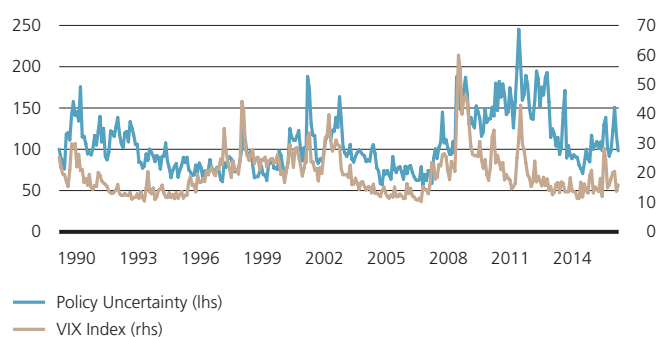
We are obliged to remind readers that the recent tranquility of global equity markets does not reflect a market preference for one political party over another. But markets do abhor uncertainty. When one candidate has a commanding lead over another, market participants may adjust their expectations and behavior accordingly. Telling business owners or investors the outcome of the November election in advance removes a "known unknown" from their decision-making process and likely gives them greater confidence, on the margin, to take risk.

The gap is likely to narrow

It would be naïve to assume that the current certainty that academic prediction markets ascribe to the election outcome can persist without incident through

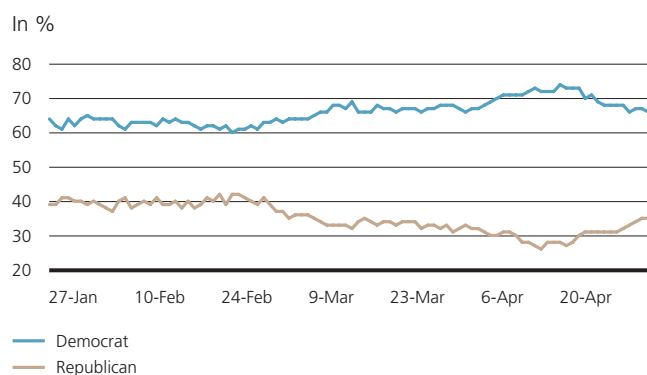
November. In fact, over the last few days, the Democratic Party's odds have narrowed slightly as the Republican presidential candidate race has consolidated. A slipup at a debate, a geopolitical shock, or an economic downturn could all change a possible runaway election into a nail biter. As few as 50 days before the 2000 election, George W. Bush was seen as having only about a one-in-three chance of winning. In that sense, investors are well advised not to expect calm sailing straight through the next six months. At the same time, we believe that investing (or not investing) purely on the expected electoral outcome could be an unwise strategy, given all the other factors impacting markets on a regular basis.

Fig. 4: Correlation between policy uncertainty and market volatility over time



Sources: Bloomberg, policyuncertainty.com, UBS, as of 29 April 2016

Fig. 5: Market-implied likelihood of a Democrat vs. Republican president in the 2016 election



Source: Predictit.org, as of 2 May 2016

The American electorate is clearly frustrated with political gridlock in Washington and skeptical that legislators understand their concerns. Donald Trump and Bernie Sanders both appear to have tapped into a vein of discontent among the young and among individuals holding blue collar jobs whose economic prospects have diminished over time. Trump will leverage that frustration into a party nomination for president, but his success in the GOP primaries may be difficult to replicate in a general election.

Both parties' presumptive nominees, Hillary Clinton and Donald Trump, will fight an uphill battle to counter negative perceptions among the general electorate. As the chart below illustrates, one recent poll suggests that Mr. Trump has the highest disapproval rating among any presidential candidate in recent memory. Hillary Clinton fares marginally better but only by comparison with her Republican rival. Each candidate must overcome entrenched perceptions among prospective voters dissatisfied with politics as usual.

Donald Trump and Hillary Clinton are viewed unfavorably by majority, in %

Year	Candidate	Favorable	Unfavorable	Net Rating
March 2016	Trump	24%	57%	-33%
March 2016	H. Clinton	31%	52%	-21%
March 2012	Romney	30%	37%	-7%
March 2012	Obama	41%	41%	0%
March 2008	McCain	38%	31%	7%
March 2008	Obama	44%	28%	16%
March 2004	G.W. Bush	43%	39%	4%
March 2004	Kerry	28%	29%	-1%
March 2000	G.W. Bush	42%	32%	10%
March 2000	Gore	34%	40%	-6%
March 1996	B. Clinton	50%	38%	12%
March 1996	Dole	36%	36%	0%

Source: CBS News/New York Times (<http://www.cbsnews.com/news/donald-trump-and-hillary-clinton-viewed-unfavorably-by-majority-cbsnyt-poll/>), UBS, as of April 2016

PRIMARY CALENDAR

Date	State	Democratic delegates	Republican delegates
Saturday, May 7	Guam caucus (Dem) ¹	12	
Tuesday, May 10	Nebraska (Rep) ²		36
	West Virginia	37	34
Tuesday, May 17	Kentucky (Dem) ³	61	
	Oregon	74	28
Tuesday, May 24	Washington (Rep) ⁴		44
Saturday, June 4	Virgin Islands caucus (Dem) ⁵	12	
Sunday, June 5	Puerto Rico caucus (Dem) ⁶	67	

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. ¹Guam Republican caucus was March 12. ²Nebraska Democratic caucus was March 5. ³Kentucky Democratic caucus was March 5. ⁴Washington republican caucus was held on Feb. 20, but will allocate delegates through the May 24 primary. Democratic caucus was March 26 ⁵Virgin Islands Republican caucus was March 10 ⁶Puerto Rico Republican primary was March 6. Source: New York Times, UBS, as of 4 May 2016

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