



**GENERALI
INVESTMENTS**

Focal Point

US Elections: equity market implications

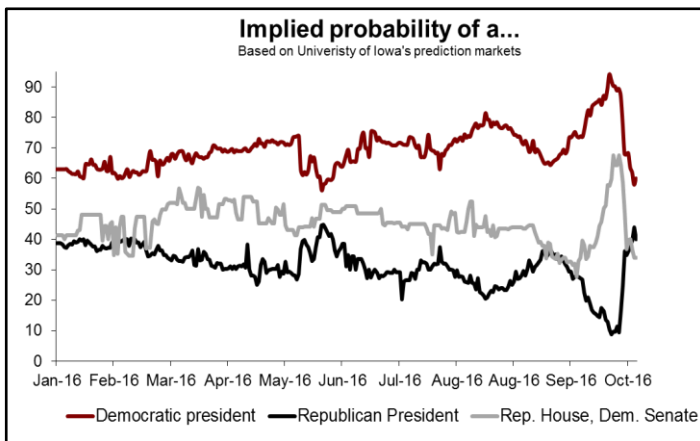
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- Four days before the elections, the race remains tight as Mrs. Clinton's lead in polls has shrunk strongly over the last week.
- A split government with Clinton as president and a Republican majority in the Congress would largely imply a continuation of current policies, except for a new emphasis on infrastructure and defense spending.
- This would be broadly neutral for markets, but record-high polarization would add to political uncertainty. While our outlook for US equity remains broadly negative, pharma and financials would suffer additional pressure short term on fears of stronger regulatory pressures. Healthcare providers and alternative energy stocks would be supported.
- If Trump wins deregulation is likely to favor Financials, Pharma and Energy stocks, while his views on trade and immigration could hurt exporters and industries reliant on outsourcing. However, the strong volatility associated with his recent gain in the polls underlines the risks of large market movements after his victory.

During the last week of electoral campaign polls have narrowed dramatically, and the outcome of the race for the next US president has become extremely open. According to polls and prediction markets, the probability of Mrs. Clinton becoming president is currently at around 65%. The bursts of volatility associated with markets' repricing the possibility of a Trump victory have highlighted the perceived risks of some of his more controversial proposals in terms of immigration and trade policies. At the same time, market attention is increasingly focused on the outcome of the races for the House of Representatives and the Senate. According to polls, the Republican would almost certainly keep their lead in the House of Representatives, while the chances of a Democratic majority in the Senate have plunged to below 50%.



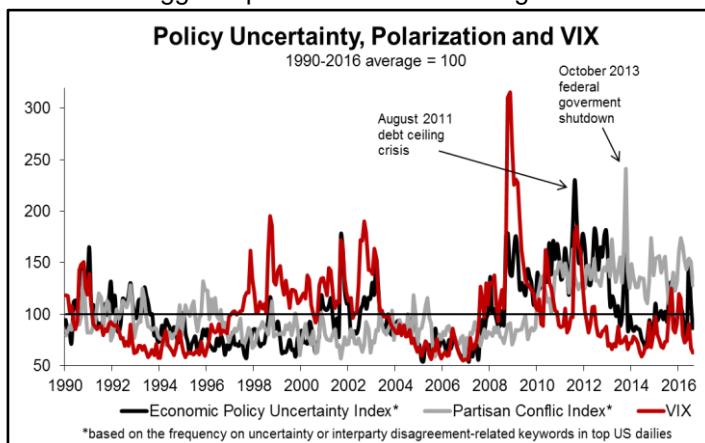
In a previous Focal Point ("US presidential elections: What is at stake?" September 6th), we have already outlined the macroeconomic implications of the elections. In a nutshell, if Mrs. Clinton is elected we expect a continuation of the current scenario of stable growth and gradually increasing inflation and interest rates. Under a Trump presidency, soaring uncertainty would weigh on risk sentiment while the impact on bond yields is not clear cut.

In what follows we provide a recap of the possible outcomes of the election in terms of fiscal and regulatory policies, with a special focus on the implications for US equities and an assessment of the extent to which markets have so far priced them.

Split government would maintain the status quo

In the slightly more likely scenario Mrs. Clinton would become President; the Democrats may gain control of the Senate but would fall short of obtaining a majority in the House of Representatives. This would basically amount to a repeat of the situation seen since the 2010 mid-term election, with a President obliged to find compromise on every piece of legislation involving tax and expenditure. The failure to agree on the debt ceiling in 2011 cost the US its AAA credit rating. Moreover in October 2013 most government routine operations were shut down as there was no legislation on how to fund them. The risk of a repeat of similar events would remain high, possibly magnified by the increased polarization between parties and the fallout of an atypically aggressive electoral campaign. Opinion surveys among voters show a degree of political polarization and distrust never seen in decades, which does not

create a favorable environment for bipartisan compromise in the Congress. Political uncertainty would be harmful for corporate actions, especially for smaller firms, which constitute the biggest spenders in investment goods.

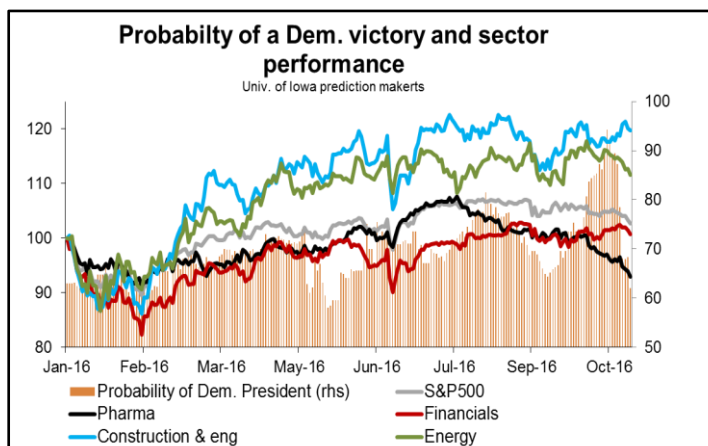


In terms of policies, we would expect a prosecution of the current status quo, entailing a mildly expansionary fiscal stance. A bipartisan agreement on higher defense and infrastructure expenditure would lead to more fiscal stimulus, but the size proposed by Mrs. Clinton would likely be severely curtailed by the Congress. Moreover, some sort of agreement is likely to be found on the repatriation of the cash US multinationals keep abroad, while the stated proposal to tighten regulation on banks and pharmaceuticals' prices, as well as to increase tax rates for the wealthiest households would be vetoed. However, the price of drugs is a very sensitive political issue and the next President will have some power to intensify moral suasion, toughened by the possibility to ask the Department of Justice to start an investigation on producers' pricing strategies. This would most likely lead the industry to some form of self-policing.

Finally, the relatively critical approach to free trade recently embraced by Mrs. Clinton matches the Republican Party's attitude. A trade war looks unlikely, but a less favorable view on trade deals – meaning the freezing on the TPP deal with Asian countries and a significant slowdown in the talks with the EU on the TTIP agreement – looks likely. This would burden more internationally exposed firms.

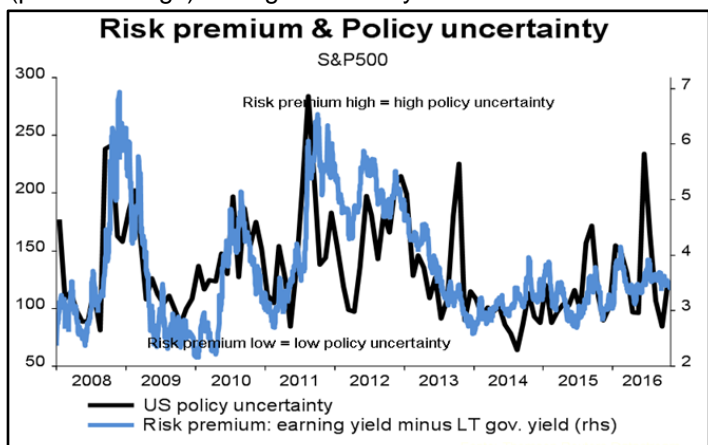
Status quo broadly neutral for equities

Investors seem to have started appreciating the risks of a Trump presidency only over the last couple of weeks. Previously the S&P500 appeared to be rather insensitive to swings in the polls.



The uncertainty caused by the political gridlock emanating from a split government adds to the concerns over accelerating wages and subdued productivity in shaping our rather cautious view of US equities. While our S&P500 earnings growth estimate for 2016 is close to the consensus, we have a much lower growth forecast for 2017: 2.5% vs. 13%. This picture represents a risky one for the index given the current high PE multiples (16.5X, 12-month forward): we forecast a negative low-digit total return over a one-year horizon.

After 2009, political uncertainty has had a non-negligible impact on risk aversion. We calculate that a one-standard deviation increase in the Economic Policy Uncertainty Index causes a nearly 50 bps rise in the ex-ante equity risk premium (defined as the equity earning yield minus the 10-year Treasury bond yield). Therefore, persistently higher political instability would lead to lower market multiples (price-earnings) for a given bond yield.



Turning to specific sectors, in the case of a split government, pharma and financials would still suffer short term as regulatory pressures may intensify. However, in the medium term prices may go back in line with valuations and earnings development.

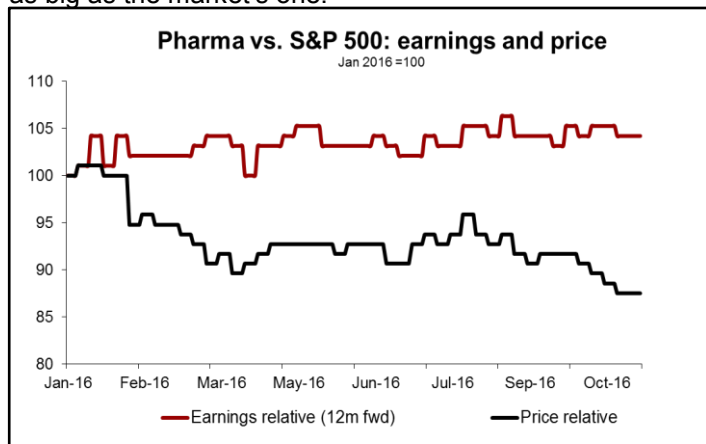
In order to estimate the upside potential we combine several metrics, such as:

- valuation relative to its history and to the S&P500 index),
- performance vis- à-vis Europe at the sector level.
- sector earnings dispersion (standard deviation of earnings forecast by analysts) compared to the S&P500 one
- current sector price performance year-to-date (YTD) relative to the average historical performance during election years
- relative earnings revisions vs. the S&P500 (net positive 12-month earnings revisions divided by total revisions) vs. relative price trend.

We estimate that pharma is currently 1.6% overvalued (against 10% for the index as a whole), whereas Financials are undervalued by around 3.5%. More importantly, Pharma stocks were, year-to-date, 15% below their average performance during election years. This is true, to a lesser extent also for Financials.

These results can be compared with the over-performance of the Construction & Engineering sector, as the increase in demand brought about by the next government's fiscal stance has already been priced in by investors, at least to some extent. However, according to our metrics, valua-

tions are still at 12% discount. The sector could then be an interesting idea, keeping in mind that its volatility is twice as big as the market's one.



Some of Mrs. Clinton proposals on energy and the extension of Obamacare would be beneficial for alternative energy producers and healthcare providers. However the upside potential for their stock prices would be strongly linked to the extent to which these proposals are turned into law.

Finally, the large swings in the VIX and the prices of safe assets like gold following the dramatic narrowing in the polls at the end of October highlights market worries about the consequences of the implementation of some of his extreme views on trade and immigration. Therefore, some degree of market turmoil is to be expected should the Republican candidate win, continuing until his policy proposals are spelled out in details.

Conclusion

The high likelihood of a split government preventing any significant fiscal boost or structural reform has translated into a very mild impact of US political developments on the S&P 500 during much of the political campaign. Uncertainty will be a recurring theme and, is one of the factor behind our below consensus outlook for US equities.

Markets have started to reprice the possibility of a Trump victory only during the last two weeks. The ensuing increase in volatility and the implications his extreme (and in the end economically harmful) views on trade and immigration would weigh on equities, despite some short term buying opportunities for specific sectors like Financials and Energy which would benefit from deregulation.

Markets	weight	Price / Earnings *		Price / Book *		Price/ Cash Flow *		Dividend Yield *		Avg. Discount
		current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.	
USA	100.0%	16.9	15.5	2.6	2.3	11.1	9.6	2.2	2.2	8.9
Cons Discr.	13.1%	18.0	18.7	4.2	2.8	11.1	10.3	1.7	1.5	9.2
Cons. Staples	9.6%	19.4	17.5	5.1	3.9	14.7	12.4	2.8	2.7	14.4
Energy	7.2%	36.2	16.6	2.0	2.0	9.7	7.2	2.7	2.1	30.2
Financials	13.0%	12.1	12.8	1.1	1.3	8.6	8.8	2.3	2.6	-3.7
Health Care	14.2%	14.8	18.0	3.2	3.0	12.7	12.1	1.8	2.0	1.6
Industrials	9.2%	17.0	16.3	3.6	2.7	11.8	10.6	2.5	2.3	10.2
IT	21.7%	17.0	21.0	3.9	3.3	12.7	11.9	1.5	1.2	-5.6
Materials	3.0%	16.0	15.5	3.0	2.5	9.9	8.7	2.3	2.2	9.0
TLC	2.7%	13.8	16.9	2.7	2.2	5.9	5.3	4.5	4.5	3.1
Utilities	3.3%	16.8	13.8	1.7	1.6	7.2	6.8	3.7	3.9	9.1

Note: Multiples are based on 12m forward estimates; PEs are since 1995, the rest is since 2003.
 Discount in % to historical average: blue and negative numbers = undervaluation. Red and positive numbers = overvaluation.
 Source: Thomson Reuters Datastream, IBES estimates.

Trump good for Pharma, uncertainty on the rise

In his program, Mr. Trump has pledged sizeable cuts in corporate taxation and a tax holiday for cash held abroad. Moreover he plans to increase expenditure in infrastructure and defense, without reducing any other budget item. Therefore, notwithstanding the channeling environment for equities there might be a temporary uptick in equity prices for some specific sectors. Energy producers could benefit from a much looser environmental regulation; however, earnings are likely to be capped by the expected higher shale production and its negative impact on prices. The upside is further limited by the fact that since January, the US energy sector has already outperformed the European one by nearly 25% and currently valuations are appreciably higher than historical average.

Financials could also gain from deregulation (and historically have benefited from a Republican government). However, reputational risk looms large (as shown by the ongoing Wells Fargo scandal), and therefore far reaching deregulation is unlikely, at least in the short term. Moreover, Trump's aim to repeal Obamacare would be beneficial for Pharmaceuticals and negative for Healthcare providers. On the contrary, his fierce anti-trade stance would harm firms more exposed to the global market, like exporters (e.g. Machinery) and those industries that have outsourced to foreign countries a large part of their production process, like for example Electronics. Industries employing largely immigrants, like construction and agriculture, could face labor shortages and higher costs.

Imprint

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