

# Least-Liked Election Unfolds Amid Unloved Bull Market

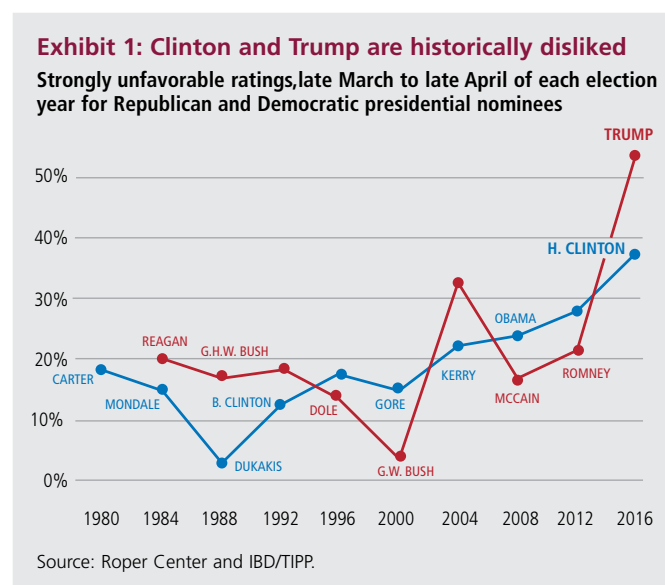
## MARKET INSIGHTS

Fourth Quarter 2016

### IN BRIEF

- While we generally don't base investment decisions on potential election outcomes, this election deserves more than the usual scrutiny.
- Anti-globalization sentiment has created an atmosphere in which politicians on both sides of the political divide feel the need to either strike out on a populist path or to trim their globalist leanings in response to a pronounced shift in the prevailing political winds.
- Congress has, over the years, ceded almost unilateral powers to the presidency to regulate the US's trade relations with other countries, which raises the stakes in this election.

While presidential politics and the US equity market are something else entirely, right now they have something in common: Few are particularly upbeat about either. Two of the most unpopular candidates for the United States presidency in the history of modern political polling are facing off this fall amid the least euphoric bull market in memory. As evidence of this market's unpopularity, retail investors have been pulling money out of US stocks for six of the last eight years, withdrawing almost \$68 billion dollars from equity funds and ETFs.<sup>1</sup> And while the headlines have clearly represented negative sentiment toward the major party nominees this election cycle, Figure 1 below serves as ample back up.



Though these are unusual times, and we are giving this election more than the usual scrutiny, we generally don't base investment decisions on potential election outcomes. We've found it best to focus on the long term, and to invest in well-managed businesses. We believe strong companies are generally able to adapt to changing political landscapes just as they adapt to the ups and downs of the business cycle. Additionally, we've noted that it is pretty hard to dramatically shift course politically in the United

States. Major change usually requires a certain level of compromise and consensus. However, the polarized political backdrop makes compromise a rare commodity in Washington these days. But as we'll see, markets tend to thrive amid political gridlock.

This election is taking place against a growing international backlash against globalization. The pushback has spread across the developed world in recent years, exemplified most notably by Brexit. Anti-globalization sentiment has created an atmosphere in which politicians on both sides of the political divide feel the need to either strike out on an unambiguously populist path or to trim their formerly globalist leanings in response to a pronounced shift in the prevailing political winds.

In 2016, we've seen Republican Donald Trump take the populist road, pushing back hard against decades of movement toward free trade. Democrat Hillary Clinton has taken a less aggressive posture, but she has abandoned support for the Trans-Pacific Partnership (TPP), the free trade pact among 12 Pacific Rim nations spearheaded by President Barack Obama, under

<sup>1</sup> Morningstar, as of 8/31/16. Combined net new money flows, ETF Open-End Fund and Non-ETF Fund.

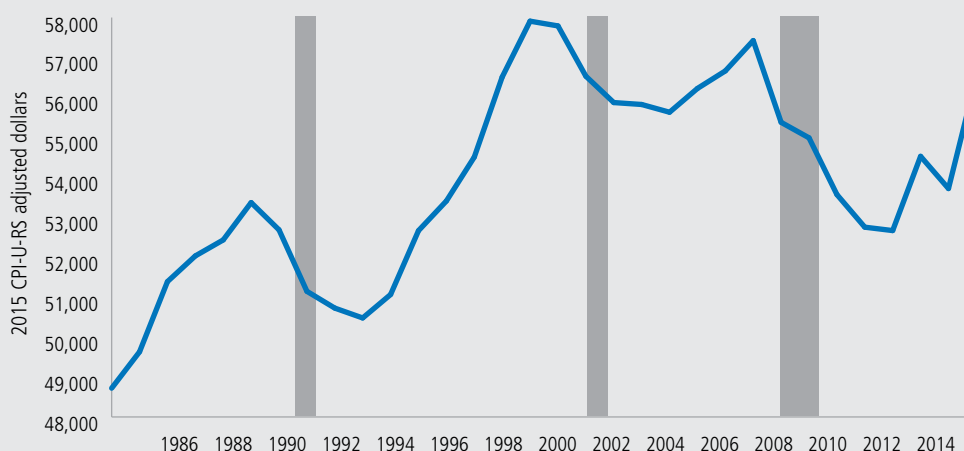
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whom Clinton served as secretary of state. While serving under Obama, Clinton referred to the TPP as “the gold standard” of trade deals. She now feels that trade deals need to include more protections for US workers.

**Taking issue with trade**

Why are voters focused on trade? And why is trade more important to investors than many other issues this year? It has become a prime focus largely because of stagnant US household incomes. Though real, inflation-adjusted incomes rose notably last year, median incomes remain below their 1999 and 2007 peaks. For more than 15 years, real median incomes have essentially flat-lined. It is easy to understand why many voters are frustrated. Globalization gets much of the blame for stagnant incomes, some of which is deserved. It also takes the blame for rising income inequality, in which the benefits of globalization accrue to those in the top earnings brackets, leaving behind those in the middle and at the bottom of the distribution.

**Exhibit 2: Real Median Household Income in the United States, 2015 CPI-U-RS\* Adjusted Dollars, Annual, Not Seasonally Adjusted**



Source: U.S. Bureau of the Census. Shaded areas indicate US recessions.  
\*Consumer Price Index Research Series Using Current Methods.

**Fewer checks and balances**

Despite the US political system’s myriad checks and balances, foreign trade is an area in which Congress has delegated much of its constitutional authority to the executive branch, by statute. Presidents have been granted sweeping powers to regulate trade, powers that exceed those in most other areas of their authority, with the possible exception of foreign policy, in which the president is granted wide latitude by the Constitution. Foreign policy can directly affect the conduct of foreign trade and vice versa, enhancing the president’s powers in the foreign trade arena.

But if Congress can grant the president such trade authority, can’t it reclaim those powers? Indeed it can, but any effort to do so would certainly be vetoed by the sitting president, and a two-thirds majority in both the House of Representatives and Senate is required to override any veto. That’s a fairly high hurdle.

Often times, campaign rhetoric and the realities of governing clash. Upon taking office, presidents sometimes find the promises they made on the campaign trail are unworkable in practice, given the institutional constraints surrounding the presidency. However, given Trump's platform, the risk that if elected he could pursue trade policies which substantially impact the market is not insignificant.

## Trump on trade

Trump has campaigned for renegotiating or withdrawing from the North American Free Trade Agreement (NAFTA), which since its implementation over two decades ago has all but eliminated tariffs among the US, Canada and Mexico. NAFTA, like most other trade deals, contains an escape clause that allows any of the parties to withdraw with just six months' notice. If he chose to, a President Trump could scuttle NAFTA by mid-2017. Other trade deals contain similar clauses, as does the US's membership in the World Trade Organization (WTO). Abandoning the WTO could set off a trade war, with the US raising tariffs and our trading partners retaliating in kind. In a low-growth, low-inflation world, large scale trade disruptions would likely tip the global economy back into recession. Corporate earnings could take a significant hit. For perspective, 40% of the earnings of the companies that make up the S&P 500 index are generated outside the US. A re-imposition of trade barriers could result in a lower-for-even-longer global interest rate environment which could necessitate further monetary policy accommodation.

## Clinton's call

During her US Senate tenure, Hillary Clinton generally supported free trade, voting in favor of seven bilateral trade deals, while opposing one multilateral deal, the Central American Free Trade Agreement, which she said lacked robust protections for foreign workers. Her recent shift to oppose the TPP would leave in place the status quo. Clinton has called for the creation of a trade prosecutor to report directly to the president to stop unfair practices by US trading partners. During her 2008 presidential campaign, Clinton called for the renegotiation of NAFTA, but apparently does not maintain that position today.

In general, it's fair to say that investors view Mr. Trump as somewhat rash and Secretary Clinton as more predictable — and more likely to take an incremental approach to policymaking. Markets hate uncertainty and therefore appear more comfortable with the idea of a Clinton presidency. As evidence, US equities responded favorably to a sub-par performance by Trump in the first televised presidential debate, which hurt his electoral chances, while the Mexican peso rallied as Trump's prospects dimmed.

## Investors love gridlock

While voters might find Washington gridlock frustrating, investors tend to welcome divided government. History shows some of the best periods of returns come when one party controls the White House and the other party controls at least one house of Congress. The US has experienced many such periods of divided government in recent decades. It is during such periods — when one party controls both the White House and both houses of Congress — that sweeping legislative initiatives, such as the Affordable Care Act, are enacted. Divided government tends to produce more incremental change, which has a tendency to create less uncertainty. That's often viewed as a plus for the market.

## Sector implications

Clearly, regardless of sentiment toward the major candidates, one of them will win. So it's important to consider some sector implications based on the rhetoric from the campaign trail.

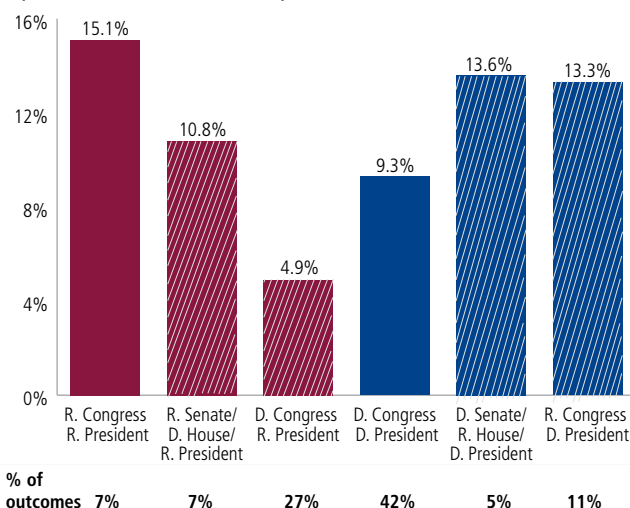
While neither a Democratic or Republican sweep is expected during this cycle, sweeps tend to create the most uncertainty, since in their wake a president can rely on support from both houses, which makes passing major, potentially disruptive legislation easier. It's worth exploring a few sectors which could be impacted in the event that a sweep occurs.

If the Democrats sweep, a few sectors look particularly vulnerable. The health care sector could be impacted, with the potential introduction of price controls on pharmaceuticals and perhaps medical devices. The Affordable Care Act could be expanded to include a public option, perhaps curtailing or eliminating the role of private insurers. The consumer discretionary sector might be disadvantaged as well, since higher income taxes and capital

gains on the wealthy could hurt consumption. An increased minimum wage could be a negative for retailers and restaurants.

In the case of a Republican sweep, the anticipated repeal of the Affordable Care Act could drive increased uncertainty. Proposed tax cuts, if enacted, could boost consumer spending, while cuts in capital gains and dividend taxes would tend to make equities more attractive.

**Exhibit 3: Partisan control, avg. annual S&P performance (1933–2015, excl. 2001–2002)**



Source: Strategas, through 2015 (latest available). Six of eight possible combinations are shown. The two combinations not shown are (1) Democratic President, Democratic House and Republican Senate and (2) Republican President, Republican House and Democratic Senate. The 2000 election resulted in an 50/50 senate. Then Vice President Cheney (R) acted a tie breaker, so officially the Republicans controlled congress through early June 2001. Senator Jim Jeffords changed his party from Republican to Democrat in June 2001. This resulted in a Republican president, Democratic Senate and Republican House through the end of 2002. This combination of partisan control had never happened before and 1.5 years of history is not a robust enough sample to use.

Past performance is no guarantee of future results.

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### Perspective over politics

Whether the 2016 election result is considered a blessing or curse for investors remains to be seen. Like most elections, it will probably be a little of both. But what is clear, both in Europe and in the US, is that anti-globalization has become and could remain a potent force, regardless of the outcome on 8 November. A December referendum in Italy, as well as national elections in France and Germany, among other European countries in 2017, will all be impacted to varying degrees by the backlash against globalization. Charged issues like free trade and immigration will continue to dominate the debate in much of the developed world with impacts potentially extending to the emerging world if trade patterns shift.

It's important to keep all of this in perspective, however. One thing investors learned from Brexit is that even unexpected outcomes don't always lead to expected results. Most observers would have expected markets in the United Kingdom to react very poorly to the vote to leave the European Union. Instead, in the wake of the referendum and after a few days of volatility, the UK has been among the world's best performing equity markets and, so far, the economy has held up much better than feared. Investors who reacted rashly to the negative headlines missed the boat. By focusing on company fundamentals rather than headlines, investors can take advantage of investment opportunities that could become available as a result of volatility. As always, it is important to be prepared and have a well-thought out plan of action, regardless of what the pundits say and how the politics shakes out.

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Joined MFS in 1985

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Chief Investment Officer, Global Fixed Income  
Joined MFS in 1997

**Kevin Beatty**

Chief Investment Officer, Global Equity  
Joined MFS in 2002

**Robert M. Almeida, Jr.**

Institutional Equity Portfolio Manager  
Joined MFS in 1999

**Robert M. Hall, Jr.**

Institutional Fixed Income Portfolio Manager  
Joined MFS in 1994

**Ben Kottler, CFA**

Institutional Equity Portfolio Manager  
Joined MFS in 2005

**Benjamin R. Nastou, CFA**

Quantitative Portfolio Manager  
Joined MFS in 2001

**Sanjay Natarajan**

Institutional Equity Portfolio Manager  
Joined MFS in 2007

**Robert Spector, CFA**

Institutional Fixed Income Portfolio Manager  
Joined MFS in 2005

**Erik S. Weisman, Ph.D.**

Chief Economist, Fixed Income Portfolio Manager  
Joined MFS in 2002

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