



## PRIVATE CAPITAL MANAGEMENT

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### “In politics, absurdity is not a handicap.”

- Napoleon Bonaparte

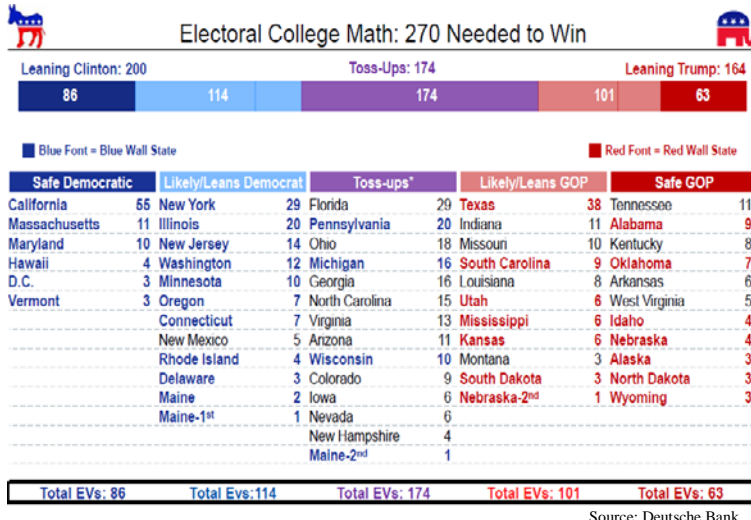
With the next U.S. Presidential and Congressional Elections just weeks away, we have decided to dedicate this quarter’s commentary to information about the elections and markets.

#### Can the stock market predict the next Presidential Election?

A recent analysis created by S&P Global Market Intelligence, spanning from 1945 to 2012, showed that 82% of the time when the S&P 500 was up from July 31<sup>st</sup> – Oct 31<sup>st</sup> during Presidential Election years, the incumbent political party was reelected.<sup>1</sup> Alternatively, in 86% of the Presidential Election years when the S&P 500 was down from July 31<sup>st</sup> – Oct 31<sup>st</sup> the incumbent political party was replaced.<sup>1</sup> While past performance is no guarantee of future results, the market has done a decent job of predicting which party will win the Presidential Election. From July 31<sup>st</sup> through September 30<sup>st</sup> of this election year, the S&P 500 was down 0.25% (excluding dividends). So, it will be interesting to see what the stock market does during the month of October, and how the elections unfold on November 8<sup>th</sup>.

#### Electoral College Math

The U.S. Constitution assigns electoral votes to each state and Washington D.C. equal to the number of its members in Congress. The table below from Deutsche Bank breaks down their estimate of the 270 Electoral Votes needed to win the Presidential Election. At this point, the electoral math seems to favor Clinton over Trump. This race is far from over.



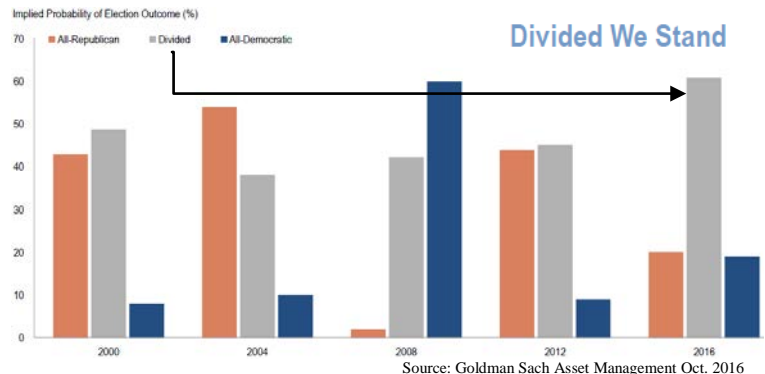
#### Who will control the Senate after the elections?

The current make-up of the U.S. Senate is 44 Democrats and 54 Republicans. 34 seats are up for reelection this year. Of those 34 seats, 24 are GOP and 10 are Democratic. In order for the Democrats to gain a majority, they must gain 5 seats (4 if they retain the White House). Deutsche Bank’s Head of Government Affairs - Americas, Frank Kelly, notes that the states to watch are New Hampshire, Pennsylvania, Ohio, North Carolina, Illinois, Indiana and Wisconsin.<sup>2</sup> However, he notes that in 2018 the Democrats will have to defend 25 of 33 Senate seats.<sup>2</sup> So, it is likely that if the Republicans do not retain control this year, they may regain control in 2018. Of course, there are no guarantees.

#### What about the House of Representatives?

To hold a majority in the House, either party must have at least 218 seats. Currently, there are 239 Republicans and 187 Democrats, but only 16 seats appear to be a “toss up” in this year’s elections. In other words, it seems the Republicans will retain control of the House.

Goldman Sachs Asset Management recently released the chart below showing that the current market-implied probability of a divided government is above any of the last four cycles. They believe a divided government reduces the chance of seismic public policy shifts, but note that short-term politically induced market volatility remains their base case.<sup>3</sup>



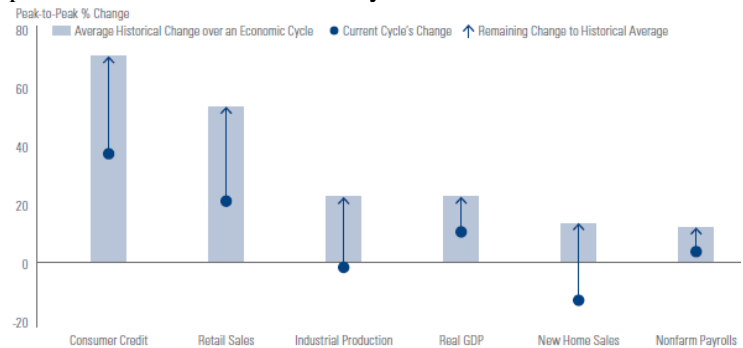
Both Presidential candidates have proposed fiscal plans to stimulate economic growth. Their proposals have substantial differences, but whoever wins in November will have to get their plans approved by Congress. Economic research firm Capital Economics believes not only will neither candidate’s proposals ever make it into law in their current form, there is also no guarantee either candidate will be able to enact their

proposals.<sup>4</sup> We are cautiously optimistic, however, that the new Senate Leaders will be more capable and willing to negotiate on important matters like new fiscal policies.

### Resiliency in the Face of Uncertainty

As we discussed in last quarter's commentary, the S&P 500 index did not make meaningful new highs from December 2014 until July of this year, or for about 19 months. From January 1<sup>st</sup> through June 30<sup>th</sup> the S&P 500 price-only index (which excludes dividends) was up only 2.7%. However, in July this index finally moved into new high territory advancing 10%. Surprisingly, this rally came just after the BREXIT vote, and in the face of continued anemic U.S. economic growth and uncertainty about the elections. We believe this resiliency reflects investors focus on economic data, which continues to be respectable, and the fact that corporate earnings may resume growing again.

The current economic expansion is the slowest since World War II, but it is now the fourth longest in 116 years.<sup>5</sup> In the chart below, Goldman Sachs Asset Management shows why they believe that the slow U.S. recovery leaves room for continued economic expansion. None of the six economic measures below (blue dots) have reached their average historical changes (blue bars) as measured from all of the post-World War II economic cycles.



Source: Haver and GSAM as of August 2016. The chart shows the current economic expansion based on several economic variables relative to their averages across all historical cycles since the post-WWII period. The economic cycle is defined as the peak-to-peak period for the overall economy, capturing both the downturn and subsequent upswing. The analysis employs the NBER (National Bureau of Economic Research) recession specified periods. GDP refers to Gross Domestic Product.

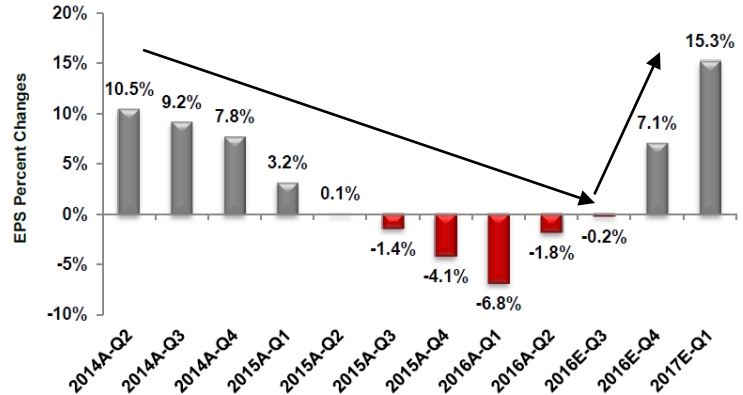
Below are three recent economic data points that we believe show continued resiliency in the U.S. economy:

- The ISM non-manufacturing (services) index surged to an 11-month high of 57.1 in September, signaling expansion.
- Initial jobless claims fell by 5,000 to 249,000 in the week ended Oct. 1<sup>st</sup>, marking the second lowest level since 1973.
- A record number of job openings helped add 156,000 jobs in September, following a gain of 167,000 jobs in August.

As the following bar chart from S&P Global shows, the collective earnings of the companies in the S&P 500 have been declining on a year-over-year basis since the third quarter of 2015. This is largely attributed to the steep decline in the earnings from companies in the energy sector, and a stronger U.S. Dollar. Looking forward, S&P Global expects that earnings may bottom in the 3Q16 and begin to rise again. Rising earnings are generally good for stock prices. And, with

the S&P 500 currently trading at about 16.6x estimated earnings, rising earnings will be an important factor in the stock market's ability to move higher.

### Year-Over-Year Changes in S&P 500 Operating EPS Actuals/Estimates



Source: S&P Global Market Intelligence. Chart is provided for illustrative purposes. Data as of 9/2/2016.

### Thank you

During this most unusual election year, we sincerely appreciate the opportunity to serve as your trusted advisor.

–The PCM Team

### By the numbers...

Index	Close	3 <sup>rd</sup> Quarter	Year-to-Date
S&P 500	2168	+3.9%	+7.8%
Dow Jones Industrial Average	18,308	+2.8%	+7.2%
Russell 2000	3110	+9.1%	+11.5%
MSCI EAFE	1701	+6.4%	+1.7%
MSCI Emerging Markets	903	+9.0%	+16.0%
Barclay's US Aggregate Bond	-	+0.5%	+5.8%
Bloomberg Commodity	85	-3.9%	+8.9%

Data provided by Morningstar as of 9/30/2016

1 Stovall, Sam. "Investment Outlook: Elections and the Markets." Uncharted Territory: Navigating Global Uncertainty. Cherry Hills Country Club, Cherry Hills Village, CO. 13 Sept. 2016. Speech.

2 Kelly, Francis J. "The 2016 US Elections: Making Sense of This Most Unusual Election Cycle." Uncharted Territory: Navigating Global Uncertainty. Cherry Hills Country Club, Cherry Hills Village. 13 Sept. 2016. Speech.

3 Goldman Sachs Asset Management. "Market Pulse." *Perspectives from GSAM Strategic Advisory Solutions* (Oct. 2016): 1. Print.

4 Ashworth, Paul, ed. "Election Unlikely to Cause Major Shift in Fiscal Policy." *US Economics Weekly* (10 Oct. 2016): 2. Print.

5 Kelly, David P., Ph.D., CFA. "Quarterly Perspectives." *Market Insights* (30 Sept. 2016): 3. Print.

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based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The Bloomberg Commodity Index is an index composed of the futures contracts on 19 physical commodities. Additional information is available upon request. Dated: 10/7/2016