

INVESTMENT STRATEGY COMMENTARY

2012 ELECTION: A SPLIT DECISION

SUMMARY

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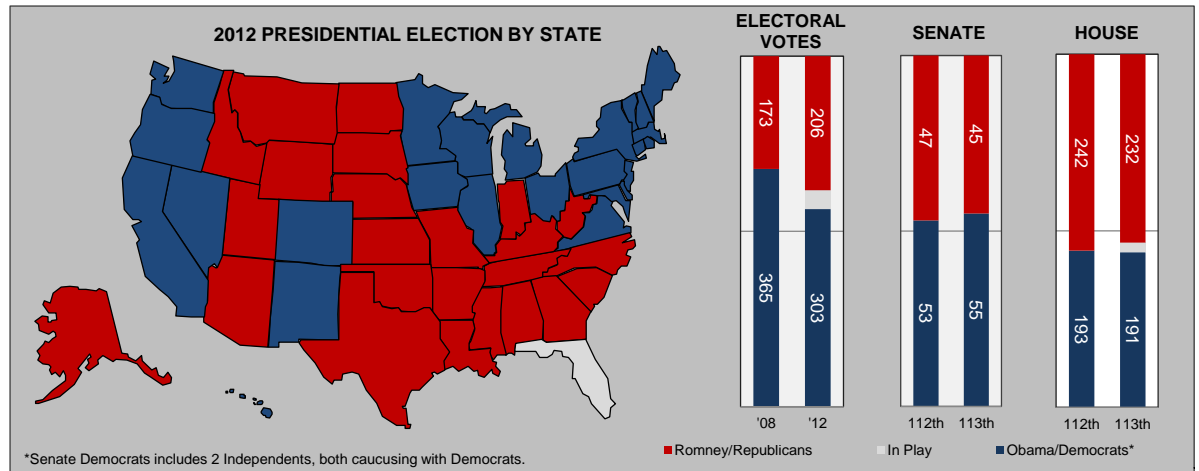
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The most expensive campaign in U.S. presidential history is finally concluded, and our base case scenario of political status quo in Washington has come to pass. President Obama won both the Electoral College and the popular vote, the Republicans kept their majority in the House of Representatives and the Democrats remain in control of the Senate. We think the impact of the election will most importantly set the stage for negotiation around the pending fiscal cliff, and will have significant policy implications on taxes and industrial regulation. We think there has been some indeterminable economic drag from uncertainty, which the conclusion of the election should help. Going forward, the most important drivers of risk taking will likely be the pace of global economic growth, the handling of the fiscal challenges in the U.S., and the European debt crisis. The impact of the election on growth may be less than people assume, as all aspects of an administration's policy must be considered. For example, a "market friendly" Republican administration might have eased regulation and lowered tax rates, but also favored a more hawkish Federal Reserve, which would tighten financial conditions. On tax policy, certain tax rates are likely to increase and tax revenue will be one part of the solution to long-term deficit reduction. On industrial policy, we think the markets have been discounting the higher regulatory environment we expect in several industries.

EXHIBIT 1: ELECTION BREAKDOWN



Source: Northern Trust, CNN.

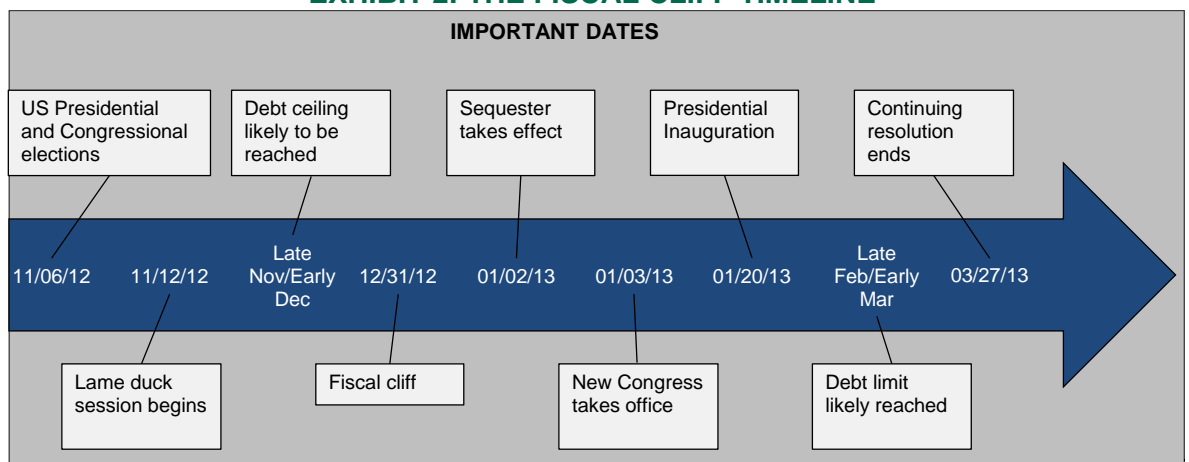
Investor interest in this year's U.S. presidential election has been feverish due to the potential impact on both fiscal and monetary policy. Progress on fiscal policy has been on hiatus ahead of the election, due to the significant policy differences between the Democrats and Republicans, resulting in the debt ceiling sequestration scheduled for early 2013. With respect to monetary policy, we would expect a more dovish Federal Reserve under an Obama administration than we would have had in a Romney administration. Chairman Bernanke's term expires in January, 2014, and it is our expectation that he is not interested in serving another term. Due to the structure of the



sequestration (the spending cuts are automatically scheduled) and expiration of the Bush-era tax cuts, inaction by Washington carries considerable risk. The total impact of the fiscal cliff, if unaltered, represents approximately 4.4% of GDP. Financial markets have given the U.S. breathing room, so far, to deal with the recurring fiscal deficits. It is our expectation that market volatility will increase over the next several months as policymakers deal with the fiscal cliff, and we show the timeline of the key dates in Exhibit 2.

The Congressional Budget Office (CBO) has estimated that not addressing the fiscal cliff would push the U.S. economy into a recession, with a 2.9% contraction in first half growth followed by 1.9% growth in the second half. The unemployment rate in this scenario would be projected to rise to 9% by the end of 2013. (The deficit, however, would be estimated to fall by \$500 billion due to the higher tax receipts.) As we believe neither party wants to be labeled as the intransigents that pushed the economy into recession, we expect some sort of deal to address the fiscal cliff. To address fiscal-hawk and market concerns, the optimal policy will address the fiscal cliff along with longer-term deficit reduction action. While the confluence of these dates is onerous, they also could provide the necessary catalyst for action.

EXHIBIT 2: THE FISCAL CLIFF TIMELINE



Source: Northern Trust.

The U.S. is projected to reach its debt ceiling in late November/early December, with the Treasury able to extend financing through late February/early March when the debt limit is reached. The Republican-controlled House is unlikely to approve another extension of the debt ceiling without legislation to cut the deficit. Similarly, we believe it is politically unpalatable to both parties to simply extend the sequestration cuts without commensurate action on deficit reduction. Finally, the ratings agencies are likely to take a dim view of further delay of fiscal repair, raising the threat of further ratings downgrades of U.S. Treasury debt.

The record of significant legislative work during the lame duck session is sparse, and this year may stay true to form despite the fiscal cliff catalyst. President Obama and the Democrats may decide that their bargaining position is strengthened by the expiration of the Bush-era tax cuts and the implementation of the defense industry spending cuts. This could also make life a little easier for Republican votes on tax rates, as the starting point for any legislation would be the higher legacy tax rates. And recall the CBO's projected \$500 billion deficit reduction in the wake of the fiscal cliff –

this may assuage the ratings agencies and keep any ratings downgrades at bay. So expect increased volatility as Washington works through the fiscal cliff – especially if the Democrats decide it is to their advantage to start serious negotiations only after the fiscal cliff has already been hit in the new year. Our base case scenario calls for incremental progress on the fiscal cliff and deficit issues over the next year, with a “grand bargain” leading to serious long-term deficit reduction less likely.

THE OUTLOOK FOR TAXES

The outcome of the election will clearly shape tax policy going forward, and we now know that we have a Democratic President for four more years, the Democrats have kept control of the Senate and the Republicans have kept control of the House of Representatives. These results are the culmination of an electoral season with an inordinate level of conversation on the topic of taxes. What do the results foretell for tax legislation? What types of “tax patches” are anticipated, and when? What about tax reform?

EXHIBIT 3: TAXES UP, BUT BY HOW MUCH?

TAX POLICY OUTLOOK			
	2012 LAW	SCHEDULED 2013 LAW	POTENTIAL 2013 OUTCOMES
Ordinary Income Tax Rates	10%, 15%, 25%, 28%, 33%, 35%	15%, 28%, 31%, 36%, 39.6%	10% to 15% - lowest rate; 35% to 39.6% - highest rate
Medicare Tax on Net Investment Income	Not applicable	3.8% on net investment income above applicable threshold	0% to 3.8% - Medicare surtax
Long-Term Capital Gains	0% - lower income taxpayers; 15% - higher income taxpayers	10% - lower income taxpayers; 20% - higher income taxpayers	0% to 10% - lower income taxpayers; 15% to 20% plus Medicare surtax - higher income taxpayers
Qualified Dividends	0% - lower income taxpayers; 15% - higher income taxpayers	Ordinary income tax rates	0% - lower income taxpayers; 15% to 39.6% plus Medicare surtax - higher income taxpayers
Alternative Minimum Tax Threshold	\$45,000 - married filing jointly; \$22,500 - married filing separately; \$33,750 - single/head of household	Same as 2012	Range of outcomes includes: complete repeal, indexed threshold, and low unadjusted threshold

Source: Northern Trust

The long awaited election results present no immediately apparent mandate that will break the impasse in Washington over tax legislation, but there has already been much discussion of the need to move forward. In the absence of a clear mandate, tax negotiations will continue, with limited interim tax “patch” legislation expected, although no substantive income tax legislation is anticipated before the end of November. Reaching agreement by mid-December would be optimistic, with late December being more likely. Clarity regarding 2013 gift, estate and generation-skipping transfer taxes prior to year-end is not a certainty.

So Much to Do and So Little Time

The challenge remains achieving the consensus required for the actual passage of tax legislation in the face of pressing time constraints. The publicly reported Congressional schedule for the lame duck session is remarkably abbreviated. In addition, there will be new leadership elections in both the House and the Senate which may not be completed until the end of November. Consequently, any real legislative activity likely will not occur until December. There is much work to be done and it is possible that the lame duck session could extend to near year-end.



The House and Senate are both slated to meet Tuesday, November 13. Beyond that, the House is presently scheduled to be in session through November 16, break for the week of Thanksgiving, and then be in session a total of 12 days for the remainder of the term, ending December 14. Although the last in-session day on the calendar is presently mid-December, it is in fact not certain at this time when the “official” last day for Congress will be. December 21 is the end of the week prior to the Christmas holiday week, December 28 is the end of the holiday week, and December 31 is a Monday.

Recall that the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 was approved by the Senate (by a vote of 81 in favor to 19 against) on December 15, 2010; the House approved the measure on December 16 (by a vote of 277 in favor to 148 against); and President Obama signed the bill into law on December 17, 2010. By contrast, December 17 may seem early as we follow the 2012 lame duck session. Just as “temporary” was a key characteristic of the 2010 year-end tax legislation, we anticipate that temporary will again be the character of any 2012 lame duck session tax legislation. The Joint Committee on Taxation has identified 60 categories of tax provisions that expired at the end of 2011 and in excess of 40 more that will expire by the end of this year (Joint Committee on Taxation, “List of Expiring Federal Tax Provisions 2011-2022,” (JCX-1-12), January 6, 2012).

Income tax “patches” at least dealing with certain of the broadly applicable individual income tax provisions that expired at the end of last year, such as the Alternative Minimum Tax (AMT) threshold (which has otherwise dropped from \$74,450 for a married couple filing a joint return in 2011 to \$45,000 in 2012), are expected in the lame duck session. As a matter of basic tax administration, final determination of the 2012 tax rules such as the AMT threshold is necessary in order for the production of individual tax forms and instructions for the 2012 tax year. The Internal Revenue Service has already stated that the production of some 2012 forms will be delayed.

As to individual income tax provisions effective for 2013, a negotiated short-term patch with at least some level of continuation of the current favorable individual income tax rates is expected, but high income taxpayers remain at risk. It is a definite possibility that legislation for 2013 gift, estate and generation-skipping transfer taxes will be delayed until the new Congress convenes in 2013 and that the window of opportunity to make large lifetime gifts with the \$5,120,000 gift tax exclusion amount will close December 31st.

Temporarily Deferring Elements of the Budget Quandary

Congress has bought some time on certain pending budget issues. In September, both houses of Congress passed H.J.Res. 117 - Continuing Appropriations Resolution. The Resolution makes continuing appropriations for FY 2013 for operations, projects and activities which were conducted in FY 2012 and for which appropriations, funds, or other authority were made available in a wide range of areas including agriculture, commerce, defense, energy, homeland security, transportation, disaster relief and others. The Resolution increases by 0.612% the rate for operations under various acts. The extension provided under the Resolution is for the period ending March 27, 2013, so there is additional time for some aspects of the budget. However, certain discretionary spending remains subject to the limitations of the Budget Control Act of 2011 taking effect January 1, 2013. Once again, the general theme is “temporary.”



The Essential Elements of Tax Legislation

The tax patches and any broader tax reform under consideration arise in the context of a fragile economic recovery, and a budget deficit of historic magnitude. There is broad consensus that the impact taxes have on the economy and budget, employment in particular, is critical. While these concerns are expected to continue to frame the ongoing tax conversations and any resulting legislation, the Democratic and Republican approaches remain distinct and the election results do not provide a singular tax mandate.

The Democratic approach is to maintain the current individual income tax rates for low and middle income taxpayers, but not high income taxpayers, and similarly to continue the low capital gain and dividend tax rates for low and middle income taxpayers, but not high income taxpayers. More specifically, for high income taxpayers the maximum marginal tax rate on ordinary income would increase to 39.6%, with dividends potentially taxed as ordinary income, and the capital gain tax rate would increase from 15% to 20% for high income taxpayers. However, there has been some discussion of continuing the current tying of the qualified dividend tax rate to the capital gain tax rate. The Medicare taxes under the Affordable Care Act of 2010, including the new 3.8% Medicare contribution tax on net investment income, would remain in place for 2013 and subsequent years. For the gift, estate and generation-skipping transfer taxes, the 2009 rates, exclusion and exemption levels would be the starting point. That means a 45% tax rate, \$1,000,000 gift tax exclusion, and \$3,500,000 estate tax exclusion and generation-skipping transfer tax exemption. The corporate tax rate would be lowered to 28%.

The Republican approach for the near term continues to be to maintain the current individual income tax rates for all taxpayers (with a top marginal rate of 35%) and the favored lower rates for capital gains and dividends (not greater than 15%), and to extend the historic low gift, estate and generation-skipping transfer tax rates (35%) and the historic high exclusion and exemption levels (\$5,000,000, with an inflation adjustment) – all on a temporary basis. Longer-term tax policy considerations articulated during the campaign include additional individual ordinary income tax rate reductions by as much as 20%, further reductions in taxes on savings and investments (*e.g.*, capital gains, dividends and interest) for the middle class, limitations on itemized deductions, repeal of the alternative minimum tax, elimination of the additional Medicare taxes under the Affordable Care Act of 2010 (including the new 3.8% Medicare contribution tax on net investment income), elimination of the estate tax, and ultimately a simpler and more efficient individual tax system. On the corporate side, a reduction of the corporate income tax rate from 35% to 25% is suggested, with additional structural changes to encourage inbound investment by U.S. corporations. However, with the results of the elections, Republican compromise “at the edges” will be necessary in order for even temporary tax patch legislation to move ahead.

Tax Reform

The last major reformation of the Internal Revenue Code occurred in 1986. The Tax Reform Act of 1986 had broad bipartisan support – 97 of 100 U.S. Senators voted in favor of that legislation. Meaningful tax reform in 2013 will require bipartisan cooperation and compromise, notwithstanding the election results. Any meaningful reform will be an amalgamation of thoughtful policy-driven principles refined by the realities of what is technically possible and politically feasible. If history is any indicator, meaningful and lasting tax reform will be very challenging to accomplish.



Navigating Continuing Uncertainty

This leads us once again to a number of core principles. In evaluating the ongoing tax debate, consider the assumptions being made and the accuracy of those assumptions. In comparing tax proposals, evaluate the constituent elements and gather the information to make meaningful comparisons. Is a proposal related to an item with a significant tax cost such as the AMT threshold for one year (only 2012) or two years (2012 and 2013)? In assessing individual alternatives regarding investments, the tax treatment of accounts in which assets are held (*e.g.*, currently taxable or tax deferred), charitable giving and wealth transfer, first identify goals and objectives, and then add the tax overlay. What is the range of possible outcomes and what outcomes are you comfortable with? All in all, 2012 remains a “good tax time” when taking rates, deductions, exclusions and exemptions into consideration, and we do not anticipate an immediate long-term resolution to the uncertainty we continue to face regarding 2013. Year-end is fast approaching. Informed decision-making based upon what one considers probable after thoughtful consideration of possible outcomes remains the best available course.

THE ELECTION IMPACT ON SECTORS

In addition to a top-down perspective on the election outcome, we also take a bottoms-up approach. There are many sector and industry level implications of the election, with the most notable areas including financial services, health care services, defense, and energy. The table below briefly summarizes our perspective on the key issues for each sector, which we expand on in the text that follows.

EXHIBIT 4: MORE LOSERS THAN WINNERS

ELECTION OUTCOME'S EFFECT ON EQUITIES			
	HEALTH CARE	TECH/TELECOM	INDUSTRIALS/MATERIALS
	Overall Mixed	Overall Modestly Negative	Overall Modestly Negative
Help	• HC Providers/Managed Care: an additional 35 million people to receive health insurance coverage	• Tech: renewal of R&D tax credits (also supported by Republicans)	• Energy: discouragement of natural gas exports reduces input costs, somewhat offset by regulation
Hurt	• Medicare Health plans: less favorable reimbursement environment • Medical Device co.'s/Commercial Health plans: higher taxes and structural uncertainty from health exchanges	• Tech: unlikelihood of tax holiday or any increase in visas for foreign workers, and more restrictions relating to M&A • Telecom: may become less attractive if dividend tax increases	• Broad Industry: environment/regulatory hurdles to hinder growth • Defense: Obama budget less favorable
	CONSUMER	ENERGY/UTILITIES	FINANCIALS
	Overall Negative	Overall Negative	Overall Negative
Help	• Dollar stores: continued unemployment assistance • Drugstores: expanded healthcare coverage	• Alternative/Renewable Energy: likely to receive subsidies and benefit at the expense of traditional energy	• Financials: Fed's accommodative attitude toward financial instruments to remain intact
Hurt	• Restaurants: higher employment costs related to mandated insurance coverage • High-end Retail/Travel: possible tax hikes	• Oil and Gas: continuation of restrictive environment (hydraulic fracking scrutiny) • Coal Plants: carbon reduction plans	• Banks: Dodd-Frank Act expected to be fully implemented, mildly offset by support for residential mortgage markets and lending

Source: Northern Trust

While we touch on factors that are unique to particular industries, there are also potential impacts of the election which apply to much larger groups of stocks, including higher dividend payers (modestly hurt by the prospect of higher dividend taxation) and companies with considerable overseas operations. Importantly, we believe the market had been discounting a re-election of President Obama (his re-election odds were at or above 50% all year), and therefore many of the “negatives” have likely been largely discounted into current stock prices.



Health Care

The recent elections were a critical factor in determining whether the recently passed healthcare law, more formally known as the Patient Protection and Affordable Care Act (ACA), would be implemented quickly or materially changed. While the Supreme Court recently upheld the healthcare law in late June, we viewed the Presidential election as the more pivotal event. Since President Obama was re-elected and Congress remains split, we believe the law will largely be implemented in 2014. The ACA will be the largest expansion in healthcare coverage since the government created Medicare and Medicaid in 1965. More than 35 million people are expected to gain health insurance coverage through the existing Medicaid program, subsidies for commercial health insurance on exchanges, or independently as a result of the individual mandate.

As a result of the healthcare coverage expansion, we believe healthcare providers benefit the most after more than 15 years of margin contraction from treating the uninsured. We also believe Medicaid Managed Care plans will benefit from the healthcare coverage expansion as states will look for low cost solutions to cover the new Medicaid as a result of the higher income thresholds. While Medicare Advantage plans will continue to grow from the aging of the baby boomers into Medicare, the reimbursement environment under President Obama may be less favorable for these health plans and may hinder growth to some degree. For Drug and Biotechnology companies, we do not expect a significant change under President Obama. These companies have already paid the price in terms of excise taxes, subsidizing the "donut hole," and other ways. It is unclear if these companies will see a net benefit from the expansion after factoring in higher costs and taxes. We believe healthcare stocks were largely reflecting a win by President Obama as the polls led to some material stock moves ahead of the elections.

After President Obama begins his second term, there will be several events converging that could lead to additional healthcare pressures. These include the debt ceiling, the expiration of tax cuts, the undoing of sequestration, and the doctor fix. We believe Medicare providers may face new headwinds from additional reimbursement cuts as deficit reduction and balanced budgets become central issues for the President and Congress.

Energy

We view the re-election of President Obama as a negative for the prospects for the Oil and Gas Industry. U.S. government budget concerns will force President Obama to consider (1) reducing tax incentives going to the industry and (2) ways to increase taxes on the oil and gas producing companies (given federal budget concerns, Governor Romney may have had to consider the same choices should he have won). Beyond the U.S. budget issues, we believe President Obama will be more restrictive toward the industry than a Republican administration would have been, and is likely to continue to promote and subsidize alternative/renewable energy sources such as wind and solar. During the President's first term, the Oil and Gas Industry faced a number of hurdles including (1) increasing regulations on public lands and leased offshore activities, (2) cancellations of possible offshore bid rounds in a number of areas off both the West and East coasts, (3) a proposal by the Interior Department to make 50% of the National Petroleum Reserve, Alaska (the NPRA – not ANWR, the Alaska National Wildlife Refuge) off limits to oil and gas drilling, (4) the delay or possible cancellation of the Keystone XL crude oil pipeline and (5) risks that the Environmental Protection Agency (EPA) will place onerous future regulatory burdens on the industry related to water pollution, air emissions, climate change and the safety of chemical additives used in fracturing



fluids. During a second term, we believe it is unlikely the President will shift meaningfully from these views, leaving a more restrictive environment in place.

Industrials/Defense/Materials

We believe that the broader industrial sector will see only a modest impact due to the election. The bigger issue looming is the fiscal cliff and its impact on near term capital spending plans, as we do believe concerns over the fiscal cliff are restraining capital spending currently. It remains to be seen if merely removing the uncertainty regarding the election will bring back capital spending, or more likely, if companies will wait for certainty around the fiscal cliff before increasing investment. In general, we do not see President Obama's administration lowering environmental/regulatory hurdles (and the associated costs) in order to facilitate the growth of manufacturing in the US.

President Obama's victory will be viewed negatively for the defense industry. Comments from Governor Romney regarding defense spending were quite favorable for the defense industry, including a view that defense spending should run at 4% of GDP. This lost opportunity could be viewed as a "lack of a positive" as the current administration's plans are unlikely to change in a second term. The near-term issue is regarding sequestration, and whether the administration and Congress can reach a consensus to water down the cuts due to take effect next year. During the debates, President Obama indicated that he did not want to see sequestration play out, but in the very divisive Congress, there are no guarantees of changing course.

With President Obama holding office, we would expect the government's stance regarding environmental/EPA regulations to remain intact. We would view this as a net neutral as we have already seen the negative impact on coal production from the increased costs associated with labor safety and environmental regulations. We do not expect the EPA to change its stance regarding the permitting of new coal-fired power plants (no new plants on docket post-2014), and do not expect a watering-down of MATs and as such, expect coal-fired power plant retirements to continue as had been planned through 2015. Should subsidies remain in place for renewable forms of energy (solar, wind) we would expect this to hinder demand for more cost-effective electricity production (and thereby demand for natural gas and coal). Given that the Democrats failed to implement a cap-and-trade program in 2009 we do not see this as a significant risk with President Obama remaining in the White House.

We believe one of the ways to capitalize on the arbitrage between U.S. and global gas prices will be through the construction of chemical plants which will allow for the export of refined products (chemicals). We believe President Obama will discourage the export of U.S. natural gas (LNG). One could argue that this may be a net benefit to the U.S. economy as America thereby exports 'upgraded' (higher-value-add) products including chemicals and fertilizers. In addition, by keeping natural gas "stranded" in the U.S., the government will keep input costs low for the U.S. manufacturing base, thereby giving the U.S. a longer-term competitive advantage. By preventing free-trade (export of natural gas), President Obama may give the U.S. a long-term competitive advantage.

Financials

We believe that the financial sector has the greatest sensitivity to the outcome of the election given the perception of vast differences under different administrations. While there is a small basket of beneficiaries from President Obama's re-election, it is largely a negative for the sector overall, and



most notably, the banks. Importantly, the negative is just the preservation of the status quo – the positive case was the belief that a Romney administration would have led to significant regulatory relief. Under a second term for President Obama, we expect the full implementation of the Dodd-Frank Act to move forward. We expect non-bank SIFIs (systemically important financial institutions) to be named either later this year or early in 2013, with the guidelines being drafted after that for stress tests for the non-banks which would be implemented in either 2013 or 2014. Banks will continue with their Comprehensive Capital Analysis and Review (CCAR) stress tests early each year, determining how much capital they will be allowed to distribute in the form of share buybacks and dividends. The Volcker Rule, which outlines which risk activities banks will be allowed to continue, should move forward toward finalization, which is expected to weigh on earnings from capital markets-related businesses. We also would expect lawsuits related to the financial services crisis to continue against certain financial services companies, weighing on sentiment, and to a lesser extent, capital.

In terms of positives, we would expect the administration to continue efforts to bolster the residential mortgage market, which could increase the opportunities for banks to lend, and potentially reduce losses from legacy mortgage exposure. Additionally, the futures exchanges actually benefit under Dodd-Frank as more volumes are pushed to their platforms as a way to reduce systemic risks.

Technology

Repatriation of foreign profits has been an issue for several years as tech companies have an increasing amount of cash sitting offshore. Several large companies have been very outspoken in favor of bringing cash back at a lower tax rate. Industry expert, ISI, believes the chances of this happening are just ~33%, given that President Obama ran his campaign four years ago on closing corporate tax loopholes and Senator Baucus is opposed to the idea of a tax holiday (it would run through his committee). The Democratic Party as a whole views it as a giveaway to corporations. The last time there was a tax holiday was in 2005 and companies that benefited the most from the holiday actually cut jobs and used the majority of the proceeds for share buyback.

With the re-election of President Obama, the chance for an increase in work visas and/or outsourcing is likely smaller, because Democrats are concerned with keeping jobs within the U.S. This issue is the largest for Indian outsourcers and IT services firms, but was a larger issue during the boom. After the 2008 recession, not all of the visas were actually used, so it is not as big of a deal anymore.

The Democrats are typically tougher on Justice Department investigations for anti-trust behavior than Republicans, so with President Obama's re-election, we predict greater regulation. The most common litigation currently is between Google and a coalition of its competitors (MSFT, Expedia, Foundem, etc.), with the main point of contention being whether Google's search engine favors other Google products or deliberately harms Google competitors. This is not an easy issue as there are multiple issues (antitrust and privacy), multiple past cases, and multiple geographies involved (US and EU) – we do not believe this issue will be resolved quickly.

The currently expired R&D tax credit will likely be renewed, as both sides are in favor of it. Congress is in favor of keeping it as an annual renewal (as opposed to making it permanent), because it has less impact on the budget each year when it stands as a renewal. We believe there is a



75-80% chance the R&D tax credit is renewed and a 55-60% chance the renewal is retroactive (which would boost tech companies earnings from prior years), with the software companies benefitting the most.

Telecom

We view the re-election of President Obama as a slight negative for the telecom sector due to prospects for higher dividend taxes (yield has been a strong attraction to the group this year) and ending prospects for bonus depreciation, as well as continuation of a restrictive FCC with regard to spectrum allocation and possible application of the "universal service" policy to broadband. The Department of Justice (DOJ) is also likely to be modestly more restrictive on M&A.

Consumer Discretionary/Staples

President Obama's re-election should be most favorable for the dollar stores (as a Romney White House may have sought to reduce unemployment assistance and SNAP benefits) and the drugstores, since the ACA expands healthcare coverage, which in turn drives prescription volumes. A second term should be viewed as unfavorable for restaurants (since the ACA will likely lead to higher benefit costs for the hourly employee base) and some areas within specialty retail (*i.e.* hikes to the dividend/capital gain tax rates could dampen the wealth-effect, which would weigh on high-ticket discretionary categories like jewelry). Within media, the DOJ has made some noise about investigating the content/distribution ecosystem, and some agreements could be deemed uncompetitive. Content is probably better positioned in this regard than cable/satellite. We do not see the election as particularly meaningful to the consumer staples stocks, other than possible dividend tax rate considerations for higher yielding stocks, such as tobacco.

Utilities

In the utilities sector, the Obama administration has openly pledged its support for alternative energy. It is much more likely that tax incentives for wind and solar will continue. Despite significant blowback after the Solyndra bankruptcy, Department of Energy grants and loan guarantees for new alternative energy technologies are also likely to continue, though with minimal immediate impact on the utilities. The EPA will likely continue to put coal generation under pressure. Recall that we expect many retirements in 2015 as various rules from the EPA are implemented. President Obama is likely to support a carbon reduction scheme, which would place further upward pressure on coal plants' marginal costs, and potentially lead to even more retirements, depending on the details of the rules. This would further accelerate demand for natural gas generation which has benefitted from the recent low natural gas price environment. We do expect hydraulic fracking to continue to receive scrutiny from the EPA but that will not offset the impact on coal from these other rules. The Department of Energy expects natural gas and renewables to dominate newbuild activity over the next 10 years under the current rules, with only a smattering of hydro and nuclear uprates. An Obama administration will likely continue policies that support that outlook: more coal retirements, replaced with gas, wind and solar additions, but limited new nuclear (President Obama openly supports nuclear but has not put forward a plan to safely store the spent fuel, effectively raising the costs and risks of adding to the nuclear fleet). We would note that because utilities tend to be higher dividend payers, higher tax rates could negatively impact the stocks' relative attractiveness on an after-tax basis.

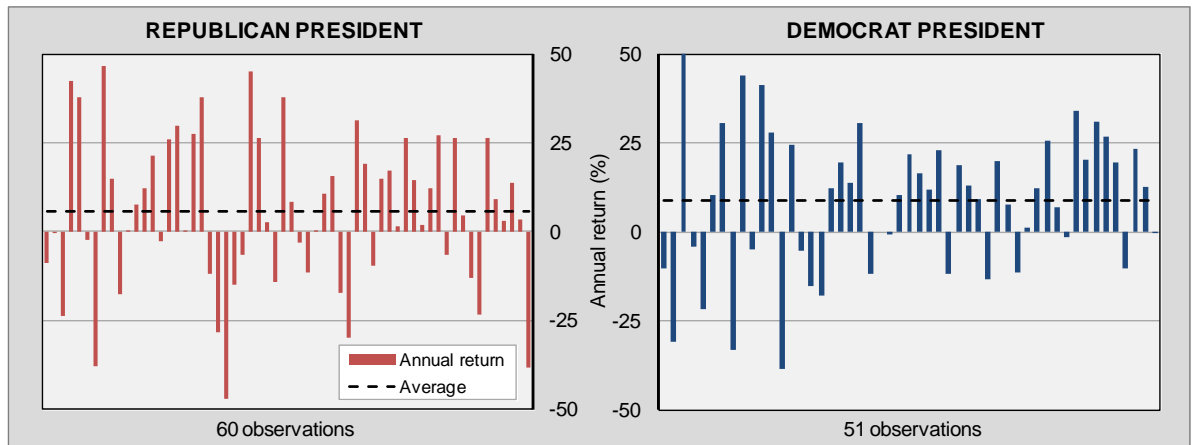


THE HISTORICAL IMPACT OF ELECTIONS ON THE STOCK MARKET

Turning to the effect of the election on the overall stock market, there is considerable interest in the effect of the election outcome on market returns. We thought it would be interesting to put the historical data under some statistical scrutiny. Exhibit 5 displays annual U.S. stock market returns from 1901 to 2011 based upon which political party controls the presidency. The market has performed better historically when a Democrat is in the White House, with a 9.0% annual return, as compared to a 5.6% return during Republican presidencies. Looking at the data since 1950 reveals the same relationship with Democrats averaging a 5.5% greater annual return than their Republican counterparts.

However, after running a regression analysis, no statistically significant relationship was apparent. This is not surprising given the extreme variability in returns from year to year regardless of who is in office; the market has a standard deviation of over 21% for both parties. To provide some perspective, less than 40% of the total observations are within 10% of the average.

EXHIBIT 5: NO RELIABLE PARTY ADVANTAGE



Source: Northern Trust, Bloomberg. Data series 1901-2011.

Note: Market return based on Dow Jones Index prior to 1928 and on S&P 500 thereafter.

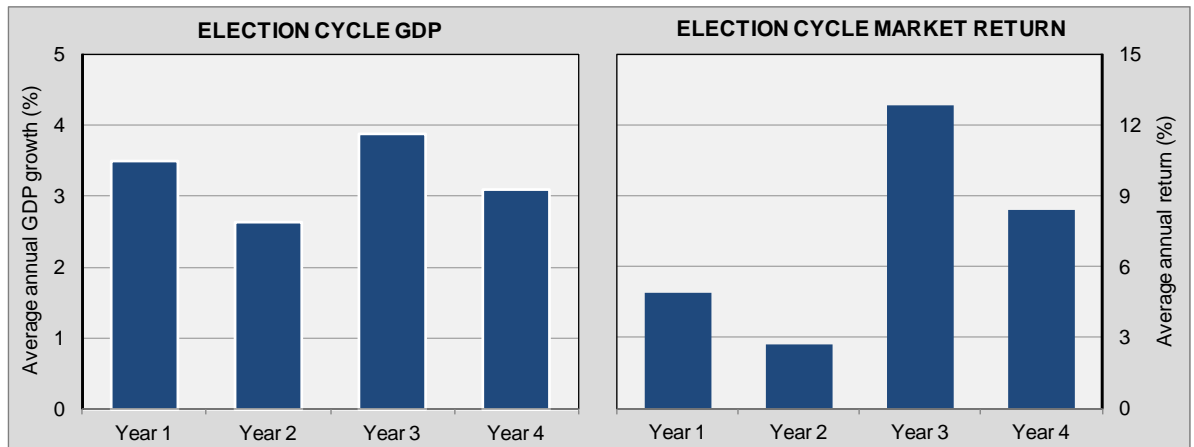
Over the long term the market is influenced by changes in expectations for economic growth, which is in part driven by policy out of Washington – but it is difficult to discern whether a sitting President is merely benefitting from (or suffering from) policies of his predecessors. Also, demographics (such as labor force growth) and productivity (such as technological innovations) are at play and, for the most part, out of the government’s short-term control. One branch of market research analyzes how government regulation can either be a market headwind or tailwind based on the amount of new regulation passed. Bianco Research has analyzed the economic record of the two-year Congressional Sessions from 1937-2011, and while their data likely has the same statistical vulnerability of the data in Exhibit 5, it shows some interesting trends. Growth in regulation (as measured by the length of the Federal Register) is much slower during periods of divided government. During periods of single-party control, regulation has grown at a 3.9% annual pace, while it has grown at just a 1.3% pace with divided government. The bond market has performed much better during periods of divided government (with the long-bond returning 10.6%) than unified government (long-bond return of just 2.6%). The relatively poor performance of bonds



during unified government could be explained by the increased cost of doing business, and the potentially inflationary result. The stock market seems more indifferent to governmental unity, with unified government returns of 18.5% modestly outperforming divided government returns of 16.6% during the study period.

In Exhibit 6 we look at another bit of market lore - the four-year presidential cycle and its impact on growth and equity returns. For the 28 periods we analyzed, average GDP growth and market returns follow a similar trajectory throughout the cycle, bottoming in year two and peaking in year three.

EXHIBIT 6: GOOSING THE SECOND HALF?



Source: Northern Trust, Bloomberg, usgovernmentspending.com. Data series 1901 – 2011. Note: Market return based on Dow Jones Index prior to 1928 and on S&P 500 thereafter.

Considering data from 1950 forward, year one averages the lowest return (4.8%) while year two exhibits the second highest average return (6.4%). This is possibly due to markets becoming more efficient at pricing-in the year two slowdown and the year three re-acceleration. While the basis for this cyclical relationship is not entirely clear, a reasonable theory is that the incumbent President tries to boost fiscal spending during the latter two years of the cycle to increase his party’s chances for re-election. So how much can one rely on the election cycle to forecast economic growth and market returns?

Once again we cannot draw a firm conclusion because the relationship does not show any statistical significance – the dispersion of the data points is too high and the number of data points represents too small of a sample. Diving deeper into the issue of dispersion reveals how significantly the average returns can mask the individual cycle experience. For instance, year two actually had the highest GDP growth during eight of the cycles while year three was the leader for only four of the cycles. Further, the market had its worst single-year decline in the third year of the election cycle, falling 47% in 1931. So while the four-year Presidential cycle holds some intuitive appeal, it is only one of many factors that should be considered when analyzing the prospects for the equity markets.

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