



Pence Perspectives, Election Edition

Bottom Line Up Front

At the beginning of the year, we stated that we saw three substantive risks to the market – trade, interest rates, and volatility from headline news leading up to the midterm election in November. With rate hike normalization by the Federal Reserve being digested by markets and progress being made on the trade front with a new NAFTA in the form of the United States-Mexico-Canada Agreement (USMCA), focus has largely shifted to the 2018 midterms and their potential impact on economic development going forward. In one of the most divisive political climates in recent history, and with increasingly partisan media outlets taking their own, unique outlooks on the issues and the outcome, it becomes hard to separate noise from fact.

One thing is for sure, this election is going to be very difficult to call with complete accuracy. As we approach November 6, the election is looking more and more like a toss-up, and there is still plenty of room for more hot button topics to emerge in the run up – similar to Judge Kavanaugh’s immensely polarizing Supreme Court nomination. In 2016, one out of every eight voters made up their minds in the last week before the election, and both the Brexit vote and US Presidential election showed polls are no longer as accurate as they used to be. They’re functional tools, but expecting total accuracy probably is no longer realistic.

When anyone in the country has an essentially 50% chance of having completely opposite and potentially inflammatory political views with any other given person, disseminating an actual and accurate political position of likely voters becomes difficult. The great equalizer is, and likely always will be, the anonymity of the voting booth. This means it’s important to separate emotion, take a step back, and ask the big questions: What’s the landscape? What outcomes are possible or likely? And most importantly, does it really matter?

The Situation

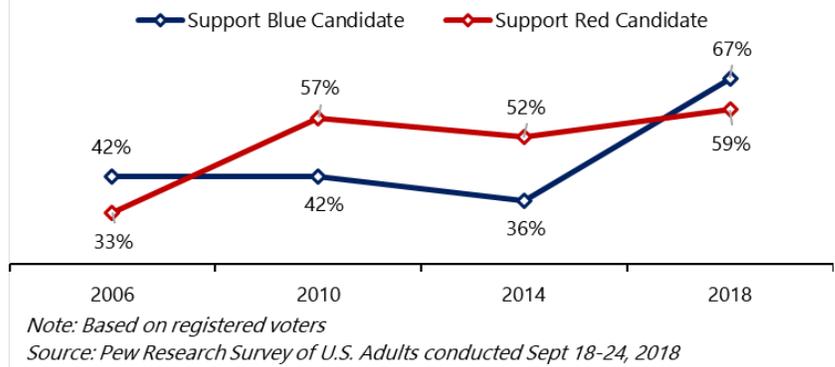
The current makeup of the Senate is 51 Republicans and 49 Democrats including the 2 Independents who caucus with the Democrats, while the composition of the House of Representatives is 240 Republicans and 195 Democrats. In November all 435 seats in the House are up for election while 35 seats in the Senate are on the ballot, including special elections in Minnesota and Mississippi due to resignations – 1 on each side of the aisle.

Historically speaking, the midterm elections tend to result in a shift away from the President’s party, as the opposing philosophy tends to be more energized due to their defeat 2 years previous. As a matter of fact, only in 1932 and 2002 did the President’s party actually gain seats in both the House and Senate. Without a Presidential nominee to galvanize, midterm turnout tends to be low.

This year that looks to be different, with both parties driven by the ideological divides that are so diametrically opposed. The 2018 primaries saw 37 million people, nearly a fifth of registered voters (19.6%), cast ballots in House primary elections, according to a Pew Research analysis of state election results. While less than 20% participation sounds low, that 37 million is a 56% increase over 2014's House primary turnout – a year which saw registered voter participation of only 13.7%. In a nation where only 61.4% of adult U.S. citizens participated in 2016's presidential election, that's a significant number.

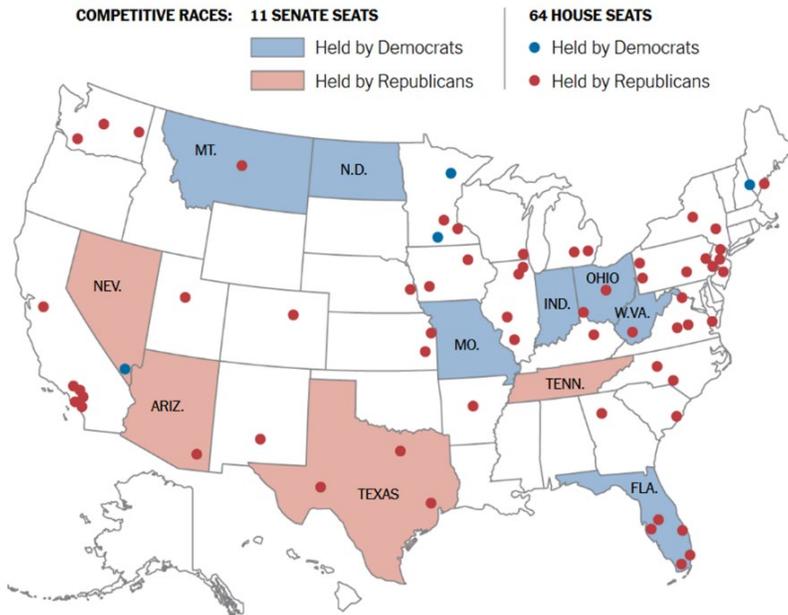
Voter enthusiasm rises - especially among Democrats

% of registered voters who say they are more enthusiastic than usual about voting...



What makes this such a difficult race to call is that both cohorts are at multi-year highs in terms of enthusiasm, both parties see the other as more ideological as their own, and each are on opposite sides of key issues such as healthcare, immigration, trade, and economic systems. Both sides are motivated primarily by the other, and emotion is a hard variable to quantify.

The Map



By The New York Times | Source: Cook Political Report

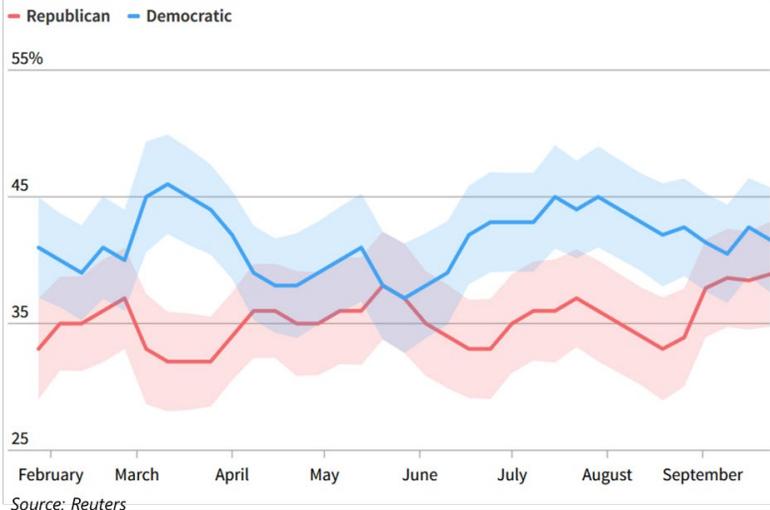
The House is allocated based on population – which means that more seats are concentrated in higher density areas that typically lean left on most issues and are a fairly reliable electorate. For a majority in the House, the Democrats need a net gain of 23 seats and political consultancies consider anywhere between 40 and 55 seats toss ups with 38 to 51, respectively, of those seats currently being Republican.

The Senate seats up for grabs are overwhelmingly on the Democrat side, with the party defending 26 seats compared to only 9 Republican seats holding elections. The Cook Political Report considers 11 of 35 races competitive, 4 races are held by Republican Senators and 7 with the Democrats. In order for a majority in the Senate, the Democratic Party needs a net gain of 2 seats – a 50-50 result would still be considered a Republican Senate due to the tie breaking vote that lies in the hands of Vice President Mike Pence.

The House of Representatives has all 435 seats holding elections, and for a variety of reasons this is viewed as the best chance for a Democratic majority. Unlike the Senate, the

WHO WOULD YOU VOTE FOR?

"If the election for U.S. Congress were held today, would you vote for the Democratic candidate or the Republican candidate in your district where you live?" (Data reflects competitive districts only)



In a Reuters analysis of those competitive districts, however, they've found that the general ballot gap between Democrat and Republican likely voters has narrowed significantly. What was at several points an over 12-point lead for Democratic candidates, the last month has seen that diminish to a simple margin of error. The mid-September confirmation process for Judge Brett Kavanaugh has resulted in a major lift in expected Republican participation. Swings like this have happened at numerous times over the course of this year, and there is plenty of room for more as the election draws closer. Currently the markets seem to be expecting a Democrat-

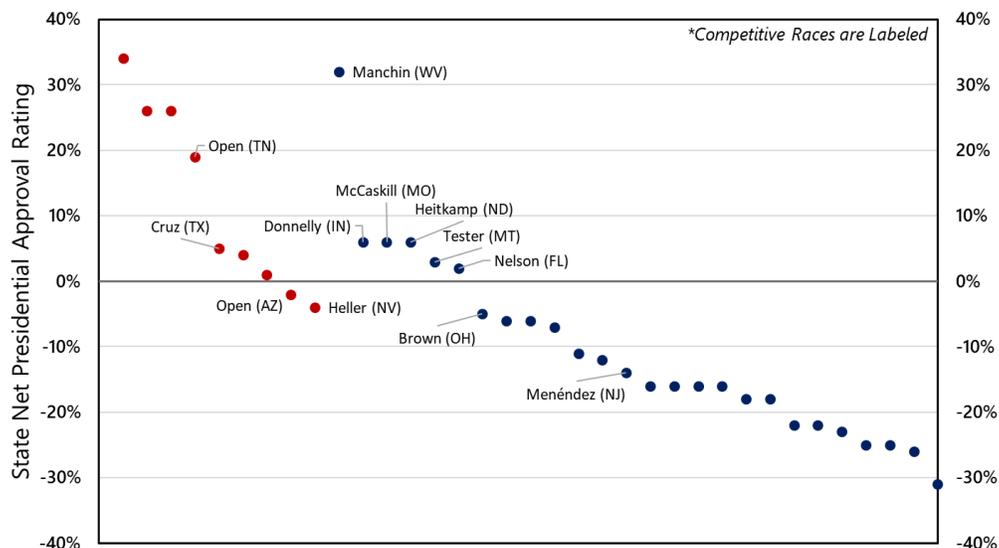
majority House after November, however it is important to note that – just like the Presidential election in 2016 – anything can happen. We need to be prepared for different outcomes.

Our bicameral legislature means that control in both chambers of Congress is needed in order to pass substantive legislation, so even if the House looks likely to flip the Senate would have to as well. As the Senate is not population based – each state gets 2 seats – the visibility on a potential result is a bit better as the demographics are on a larger aggregate level. The very nature of a midterm election is that it tends to be a referendum on the sitting President and this year is no different with surveys showing that 60% of the electorate views their vote as an expression of either opposition or support of Donald Trump. This suggests that there is a certain level of predictability when looking at state demographics and electorate history to chart out the path forward.

Simply put, when looking at the map of Senate seats versus that State's net Presidential approval rating (Approval – Disapproval), the Democrats have a pretty bleak outlook. Only two Republican seats are up in a net-negative Trump state, while 6 Democrat seats are up in net-positive Trump states. Of those seats, only 1 of them – Joe Manchin (D) (W.V) – is considered a "Lean D" likelihood by The Cook Political Report, Real Clear Politics, and CNN.

The Senate Election Map Largely Favors the Republicans

(US Senate Seat by State Presidential Approval Rating)



Source: Morning Consult, Goldman Sachs Global Investment Research, Pence Wealth Management

The rest are toss ups or "Lean/Likely R" in Pro-Trump states with an electorate history of voting red.

Arizona and Nevada are the best shot the Democrats have at flipping seats, with an outside chance of Beto O'Rourke defeating Texas's Ted Cruz (R) in a race that has become a riveting look at two completely opposite ideologies in a state without a Democratic Senator in 25 years. On the flip side, Missouri, North Dakota, and Florida all have very good chances of changing sides, and Menendez's New Jersey seat has emerged as a possible flip as the campaign has focused on his spotty history with corruption and scandal throughout his tenure. Senate Primary turnout was also higher for Republicans than it was for Democrats, giving the GOP an edge that they don't have in the race for the House.

The Democratic path to a Senate majority lies through Texas, Arizona, or Nevada. Currently Republicans have leads in polling in these states. If the Democrats can flip one, their opening for a Senate majority increases dramatically – but if the votes go the other way in these states the likelihood of a Democratic Senate essentially becomes zero given the difficulty of their map elsewhere.

All things considered, the likely outcome is that we end with a Blue House and a Red Senate. The Republicans look likely to retain or add 1-2 seats to their majority in the Senate, and there is a very good chance the Democrats take the

Outcome	RR	DR	DD	RD
House of Representatives				
United States Senate				
Likelihood	11%	67%	19%	3%

Source: FiveThirtyEight, Pence Wealth Management

Date Retrieved: October 22

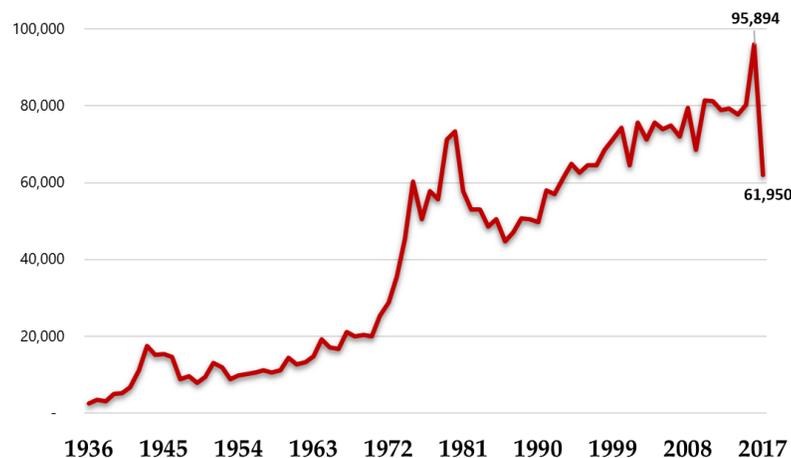
House as 21 seats are looking like flips already based on a FiveThirtyEight running analysis of polling data. In the end, rather than a blue wave it may be more of a ripple, and that may not even occur.

The Power of 67

Given this, the question then shifts to whether a change matters and if it's going to derail what has occurred over the last two years - which have unquestionably been very good for the markets. Two things are the predominant drivers of this economy right now, the Tax Cuts and Jobs Act (TCJA), and President Trump's long-standing policy towards Federal Regulation.

Pages in the Federal Register

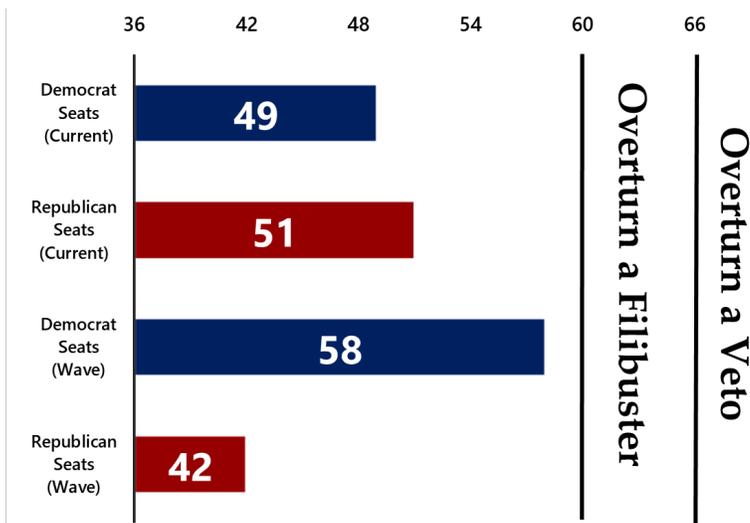
(Total Pages, Excluding Skips)



Source: Federal Register, Pence Wealth Management

The Federal Register contains all government agency rules, proposed rules, and public notices – essentially, it's a giant book that is directly correlated with the size of the Federal Government. Donald Trump ripped out almost 34,000 pages from the Federal Register in his first year, more than Reagan did in his entire presidency. At the end of 2017 that book was 35% smaller than before he took office, and it has shown with record levels of business and consumer confidence, record unemployment, and essentially 3% wage growth for the first time since 2009.

The likelihood any of this changes in a meaningful way comes down to two numbers: 60 and 67. Let's assume for a moment that we get a Blue House and Senate, and that the Democrats overperform wildly and take every seat available to them in November – all 435 House seats and all 35 Senatorial seats. What changes?



Source: Pence Wealth Management

The short answer is: Very Little. Our two-house legislature means that both sections of Congress have to agree and pass legislation and then send it to the Executive to be signed into law. A 100% Democratic House can pass all the bills they want, but it does not matter if the Senate won't vote on it or the President won't sign it.

The Democrats getting a +9 result in November wouldn't even get them the 60 seats they need to stop a filibuster, and given how aligned both parties have been over the last 2 years in their refusal to work with the

other, the likelihood of much Republican support to defeat anything is extremely low. If Congress does pass a bill, there is always the Executive Branch's power to veto any legislation, which takes 67 votes in the Senate to overturn – and is even more unlikely. To this point, only 7.1% of the more than 1,500 Presidential Vetoes since 1791 have been overturned. Realistically, we are looking at 2 years of gridlock and the Executive driving political action.

This is no real change from any Congress in the last 10 years, there's a very good reason why Congress has averaged an 18% approval rating since August 2008 in a Gallup/Newsweek poll. This wouldn't even really be a change from last year's Congress either, as last year was the 4th least productive first year of a session of Congress going back 30 years. In fact, 5 of the 10 least productive Congressional sessions have been in the last 10 years. Objectively speaking, there isn't much to derail.

A positive that could result from a split legislature is that the two chambers would have to work together to get anything passed, and it would result in less power in the hands of fringe members of our government. The House Freedom Caucus, far and away considered the most far-right members of the GOP, currently hold 33 seats, making up 73% of the Republican majority right now and as a result have a huge voice in legislation shuttering several bills in the process. Losing their vote meant narrow margins on a majority in the House, and what did pass stood a very high chance of Democrat filibuster in the Senate or the loss of more moderate Republican Senators. Key examples of this were last year's attempts at Healthcare and this year's attempt at immigration reform.

A split Congress wouldn't have this problem to such an extent, there would be no point writing legislation that the other chamber would not consider – meaning less action but hopefully done better. One party would need to craft proposals the other could possibly vote for, and that's a positive. We believe that a split Congress has a very good chance at an Infrastructure bill next year, predominantly because both parties can take credit for it and the Democrats wouldn't seemingly be handing a victory to Trump and his Republican-controlled Congress. That in itself would be a significant boost to markets.

The parties are on the fringes, but America is in the middle. There is a reason why independents are the largest voting bloc in the United States. The partisan circus that is Congress is keeping us from moving forward on key issues that need addressing. A Pew Research Center survey found that while Democrats and Republicans are on ideologically opposite sides of key debates – healthcare, international relations, the openness of our borders, the right to choose, and government regulation – on every single one of those issues the general public is in the middle. An all Republican Congress might be better for the markets, but a split Congress might be better for compromise.

Conclusion

A lot of noise will be made between now and November 6. Realistically, we are looking at a Blue House and a Red Senate that picks up 1 or 2 seats. If we get a Blue House and a Blue Senate, markets will react – likely heavily – because that’s what they do. Markets like to panic. We urge a clear head.

The reality is our democracy was founded on the principles of three branches of government – the Legislative, Executive, and Judicial – to work together and provide oversight for each other. The proceeding years have seen the Legislative cede more and more of its constitutional authority to Executives from their party. No significant action can be undertaken without a 67-vote consensus in the Senate to override a Presidential Veto, the tax cuts won’t be going anywhere anytime soon, and federal regulation tends to come from government agencies – which all have Trump’s picks at the helm. Additionally, if there’s one thing the two parties are bipartisan on, it’s defense spending.

Part of what has made this country and its institutions so lasting is it’s designed to move slow on purpose. “Rapid Change” and “Congress” are practically antonyms. Think on how hard it has been for this Congress to repeal bad policy in the past, much less remove policy that is actually additive and provably functional. This means that the United States economy gets to do the talking, and that’s a pretty compelling story.

The most likely outcome of a Blue House and Red Senate will cause market volatility that could be significant. However, as corporate earnings and consumer spending are improving any down draft to the market should be recovered in the following months. In the end, earnings win.

If the Republicans retain control of the House we see the markets improving and recovering more rapidly from volatility than a split government. In either situation, we are still confident in the economy for the next year. In the end it is the actions of consumers that outweigh those of politicians – regardless of party.

We appreciate your trust and the opportunity to be of service.

All the best,

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