THE 2016 PRESIDENTIAL ELECTION AND YOUR PORTFOLIO

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WHITE PAPER
2015 November

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The 2016 Presidential election will generate the same hype and commentary that every Presidential election in our lifetimes has generated:

*"**This** is the most important election we have ever faced."*
*"**This** election will determine the make-up of the Supreme Court for a generation."*
*"If we get **this one** wrong, we will lose America as we once knew it."*
etc., etc. …

There will be no shortage of media hype, nor partisan hysteria, as concerned participants on both sides of the aisle seek to motivate and energize their respective bases around whatever issue it is that most motivates them. While all such hyperbole is often over-stated at best, and disingenuous at worst, it is, in fact, an extremely important election cycle we face.

Our interest at The Bahnsen Group is particularly in the economic implications of the election, and especially where those economic implications may speak to our investment strategy and point of view. The majority of investment managers and economists who opine on political hay do not do so without their own biases, beliefs, and ideological presuppositions. We are no different. The political climate we desire to see drives our beliefs in matters of economics in a number of ways. We are challenged to maintain a posture of objectivity when it comes to the capital markets. When a portfolio manager confuses what he or she wants to be with what it is, the consequences can be problematic.

Our analysis in this report seeks to shine a light on what we believe are the objective facts of the 2016 Presidential election, what matters of economic implication are on the line, and what we believe it means to investors in terms of asset allocation and risk-reward scenarios. Where possible, our own political preferences will be wholly irrelevant to the analysis, but we also humbly recognize the sheer impossibility of bias-free perspective. With that backdrop, let us look in more depth at the 2016 presidential election and your portfolio.

We analyze the election from five perspectives:

1) the historical testimony of partisanship in the White House and its impact on the markets;
2) what the debt picture of the United States looks like and how this election matters;
3) taxes and economic growth;
4) energy and economic growth; and finally,
5) the aspirational society.

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The Historical Testimony of Partisanship in the White House and its Impact on the Markets

It is unwise to assert a correlation between the ***political party*** in the White House and the performance of the stock market. The robust 1980's bull market took place with Republican Ronald Reagan in the White House. The robust 1990's bull market took place with Democrat Bill Clinton in the White House. The 2008 meltdown took place while George W. Bush (Republican) was in office. The Nasdaq/tech meltdown of 2000 took place while Bill Clinton (Democrat) was in office. History is rather clear that many other forces drive market activity than the mere political party in power. The stock market struggled for a time after the financial crisis, but in 2010 as the government divided (the Democrats had the White House but Republicans took the Congress), a tremendous stock market recovery ensued. The 1990's featured the aforementioned Clinton Democratic White House, but 1994 created the famous "Contract with America" and a Newt Gingrich-led Republican House of Representatives. President Reagan was firmly in control of the executive branch and his Republican party in the 1980's Bull Run, but Tip O'Neil and the Democrats ran the Congress. In other words, there is a clearer correlation between divided government and strong stock markets than there is with the party in the Oval Office.

The stronger testimony of history is that policies drive markets more than personalities or partisan affiliations. Bill Clinton was a center-left Democrat, but he favored deregulation of the Financial sector (which was then wildly bullish for stocks). He cut the capital gain tax, and most significantly for stocks and the economy, he was an avid free trader and strong dollar advocate. Those policies drove a robust market environment. President Reagan, a personal hero of this author, passed the most sweeping tax reform in American history, dramatically flattened tax rates, slashed taxes on investment, and passed extensive deregulation which helped business to prosper. Jimmy Carter, on the other hand, advocated significant regulations and controls on the economy (from wages, to prices, to rents, etc.), and the country suffered through extensive high-interest, rate-low growth malaise. Prior presidencies are not as easy to identify the policies with the political party. Richard Nixon and Gerald Ford were both Republicans, but they raised taxes, increased regulation, and dramatically weakened the U.S. dollar. Stocks suffered immensely. John F. Kennedy was a Democrat, but he slashed capital gain taxes and markets flourished.

The reality is that Presidents in both parties have driven market-friendly policies and Presidents in both parties have advocated policies that proved unproductive for the economy. What will drive economic growth and investment performance after the 2016 election will be the entire state of government (House, Senate, White House, individual states, etc.), and it will be the policy framework of the President – not the party affiliation. Hillary Clinton, for example, is proposing a 44% tax on capital gains. Would that proposal hurt stock prices, or is the unlikelihood of it ever passing into law the more pertinent factor? Our analysis will be on what candidates are likely to really do, not what they merely say in a campaign. Ted Cruz has proposed a 15% flat

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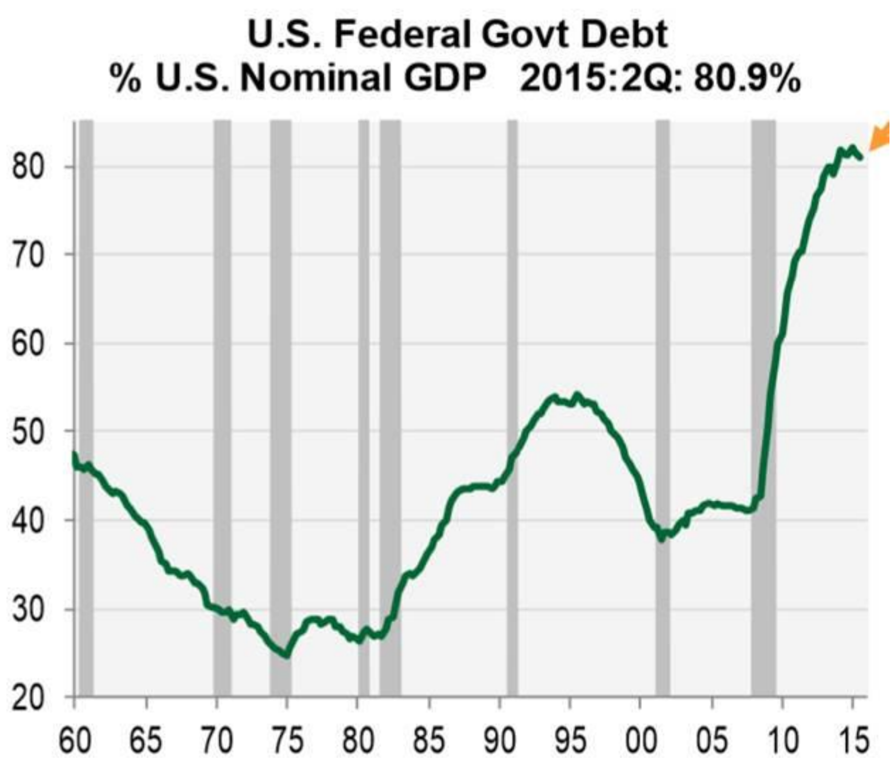
tax, for example. Would that even make it out of committee, let alone into law? The policy framework in a realistic political environment have to be understood by a diligent portfolio manager, because the intentions (whether serious or not) do not impact markets. External circumstances (the business cycle, global economic conditions, monetary policy, geopolitical climate, etc.) have always proven to trump the Oval Office in stock market results, but the policy framework a President brings to address those various matters is very important.

What the Debt Picture of the United States Looks Like and How This Election Matters

There is no question that an improved economy helps create more jobs, and helps grow wages of those who already have jobs. However, the $18 trillion national debt and large annual budget deficits mean something else in the battle for economic growth: Without it, our debt will suffocate us. The key issue when analyzing debt is always and forever the debt ***in proportion to*** the assets and the income which must service it. I have often used the analogy of someone with an $18,000/year job and $10,000 of credit card debt being far worse than someone with $100,000 of credit card debt but a $1 million/year job. Ultimately, the only way we will control our $18 trillion national debt is by reducing it in proportion to the size of our economy. Put differently, growing our economy is the number one debt management strategy we can or ever will have. The debt-to-GDP ratio as shown below is at a place we have not seen since World War II.



Source: Cornerstone Macro Research, October 30, 2015

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The level of debt is not likely to be reduced for the foreseeable future. Basic induction says that we therefore must see a larger GDP to improve this ratio. A growing economy provides the ability to service debt – even when that debt may be monstrous and perverse. Candidates putting forward debt reduction as a key piece of their platform are describing only half of the problem. Debt reduction through targeted and necessary spending cuts is admirable and pivotal, but debt reduction without GDP growth is not going to happen. The 25-year story of Japan has a society with a cost structure that made debt reduction rather untenable (keep in mind, this is without a military budget to support), and yet became a catastrophe because of a lack of nominal economic growth with which to manage and service that debt.

What further complicates the debt picture of the United States, is the fact that entitlements are not included in the gross debt levels that are discussed, so unfunded obligations in Social Security and Medicare are not included in that economic conversation despite their profound significance.

From a political standpoint, the trend of the above chart has to be reduced if we are to avoid a debt catastrophe. We face years of slow or no growth if we get forced into an increasingly high percentage of our national economic output having to be used for mere debt service. (There is no use of funds less productive in the present than debt service.) Candidates advocating mere tax increases on the higher earners of our society face two painful realities: 1) There is likely to be little or no impact in total revenue as a percentage of the budget from such tax increases; there simply isn't that much revenue to confiscate out there in the context of the present tax base; and 2) There is a diminishing return from a more progressive tax code.

Higher marginal rates means lower productivity being taxed, so a lower revenue base being charged a higher tax rate does not exactly do what the political left wants it to do. If large tax increases are politically unlikely, but also economically dubious, what is likely to move the needle in reducing debt in our society? Once again, the answer is greater economic growth. A growing GDP means a higher tax base (across all levels of taxable income), adding revenue to the government coffers, and making possible further debt reduction as greater surpluses become possible. The "customer base" is simply too small in a +2% economy, whereas a +4% or +5% economy dramatically changes that.

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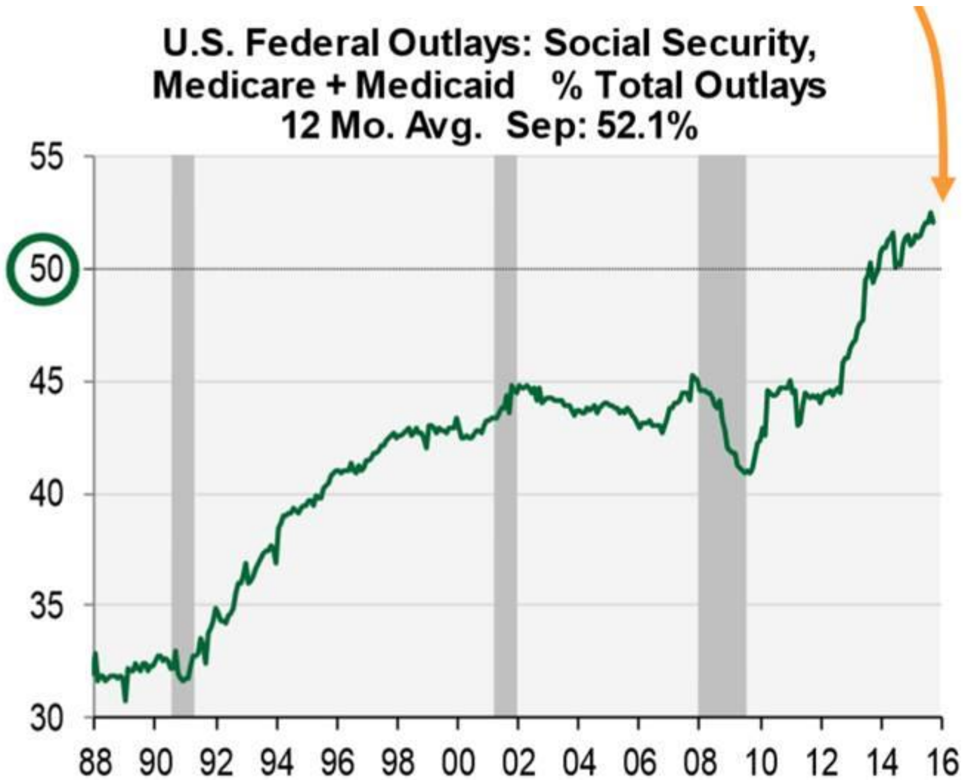

Source: Cornerstone Macro Research, October 30, 2015

Entitlements are a separate story altogether. We have seen two higher profile scenarios over the last eight years that at least provided some sneak preview as to how the political class ***could*** eventually deal with this, regardless of whether or not they ***will***. On the left, President Obama appointed the Simpson-Bowles commission to evaluate best policy prescriptions for solving the entitlement crisis we face. On the right, Congressman Paul Ryan, as Chairman of the House Ways and Means Committee, submitted a draft plan for addressing the same (years before he became the nominee for Vice President, let alone before his recent election as Speaker of the House). Neither plan had the bipartisan support to see light of day. In the case of the Obama-appointed Simpson-Bowles commission, it did not even have the support of President Obama (a significant surprise to people on both the right and the left).

The reality is that the American tendency is to wait until something becomes a crisis to actually act. There is little reason for optimism about a short-term reform solution in the unfunded entitlement situation. However, both the Simpson-Bowles plan and the Paul Ryan plan show the feasibility of ***some*** plan constructed around at least a framework of their work. Some combination of a change in the key variables (retirement age, benefit formula, etc.) can dramatically improve the health and outlook of the American entitlement system. The political danger in demonstrating courage around these issues is palpable. We would expect that the winner of the 2016 Presidential election will have a ***second term*** opportunity (post-2020) to address this topic in a generationally-significant way. We do not expect long-term reform will be achieved in a meaningful way. Substantial "meat on the bone" in

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2016 entitlement policy is likely to be hard to find. Where it is found, is likely to be politically toxic.

The old Keynesian debate about how adding to national debt to smooth out periods of economic distress is not going to fly during this election cycle. President Obama got to oversee the explosion of national debt that he did because he inherited the 2008 financial crisis and because the American people were willing to try old Keynesian policy prescriptions about spending our way into more jobs and higher wages. The results have been underwhelming and no candidate is likely to suggest that greater debt and greater deficits are a big part of their platform. (Though, Paul Krugman and the academic Keynesian left would certainly like to see this!)

A future President can ignore the national debt picture to the peril of our own country, or they can address it only in the context of spending reductions (all of which are easier to talk about than actually enact). But the policy approach which will most substantively lower debt and benefit the markets is one which focuses on growth as the tried-and-true American way. Real economic growth is a magic potion to curing debt just as a raise or a bonus are a splendid formula towards reducing personal debt. The great question for those following American debt levels after the 2016 election is: "Which candidate will be most likely to promote and achieve dramatic economic growth?" That candidate will be the one most likely to improve the debt profile of our country.

Taxes & Economic Growth

Few issues represent lower hanging fruit for economic growth, jobs growth, and earnings growth, than corporate tax reform. The chart below shows the delta between the statutory rate U.S. corporations pay (including family businesses set-up as "C" corporations) and the rest of the world. The significant advantage countries like Ireland (12.5%), England (20%) and Israel (17%) have has nothing to do with the advantage companies in those countries may have. Rather, it has to do with the incentives companies in America have to do more and more business offshore (and keep those profits offshore free of U.S. corporate tax levels).

Currently, U.S. businesses with multi-national sources of revenue (nearly all of the S&P 500) pay a 35% corporate tax rate at the federal level on the profits earned here in America. They only pay the foreign rate on profits earned in a foreign domicile. If those profits are brought back to America, the difference between the U.S. statutory rate of 35% and whatever foreign rate was already paid must be levied. This provides huge incentive to not bring profits back to the United States where they could be invested in jobs, capital expenditures, infrastructure, and growth initiatives.

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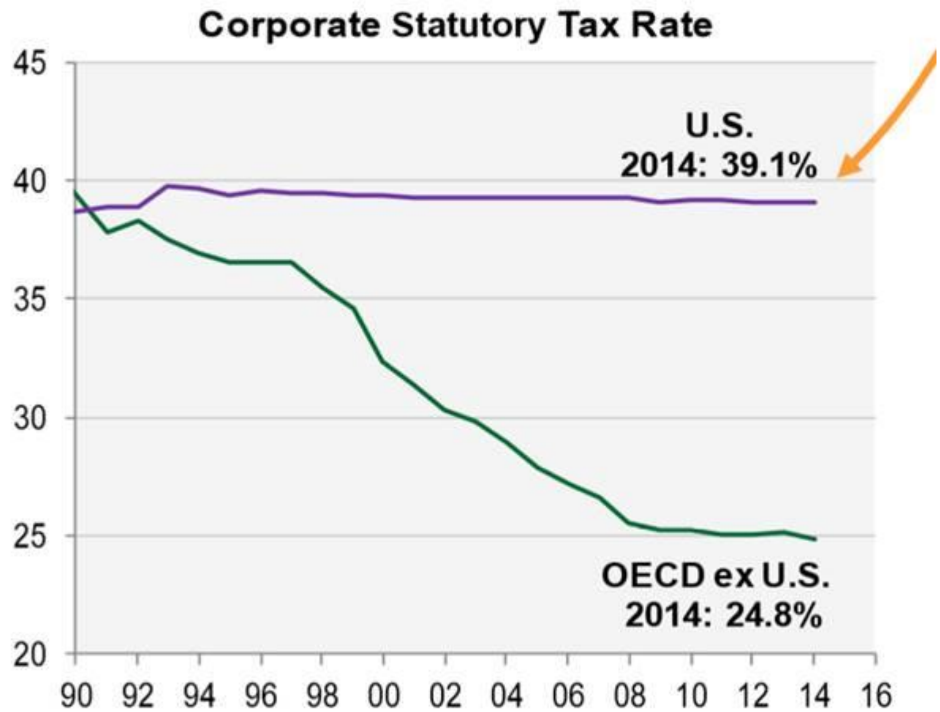

Source: Cornerstone Macro Research, October 30, 2015

The economic critique of a high corporate tax rate is that, ultimately, corporations don't actually pay it – the customers of those corporations do. The employees of those corporations do (via lower wages and benefits). The stockholders of those corporations do (via lower retained profits and dividends). Great Britain's corporate tax rate is nearly 50% lower than the rate here in the United States, and their economic growth has been much faster than ours post-2008, and triple that of their high-tax counterparts throughout Europe. The non-partisan Tax Foundation found that an elimination of the corporate tax rate would increase GDP by 6%, increase investments by 20%, and perhaps most significantly, increase hours worked by 1%, the key driver of productivity (*Tax Foundation, March 12, 2013, No. 208).*

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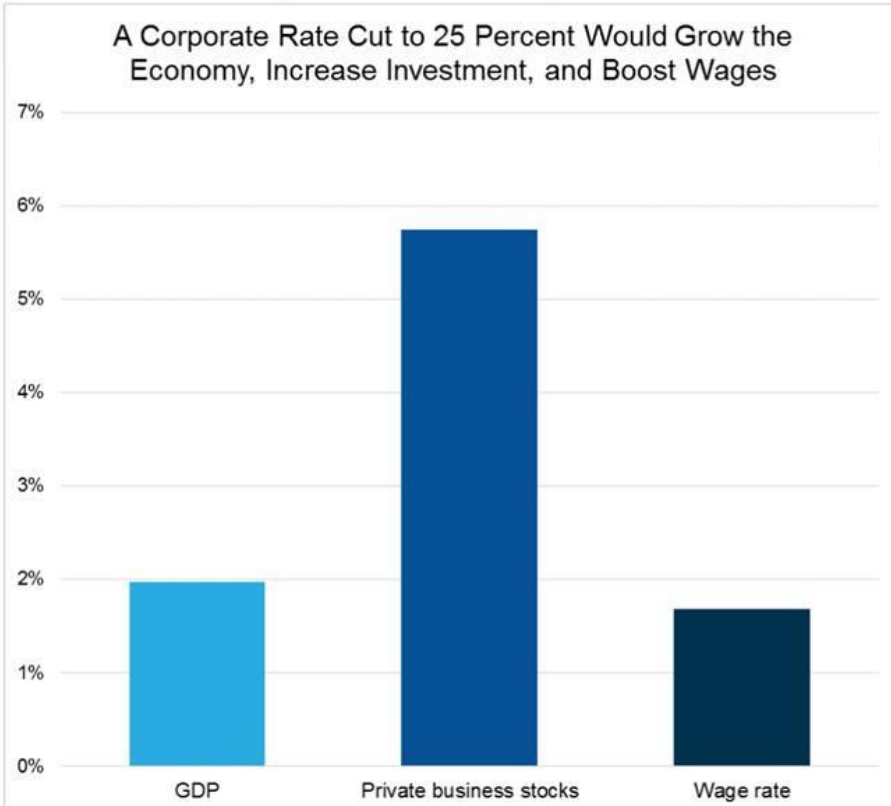

Source: Tax Foundation's Taxes and Growth Model, March 12, 2013, No. 208

Realistically, a total elimination of the corporate tax rate is not likely to happen in the next four years, but large reductions in the rate itself – accompanied with an elimination of various loopholes, deductions, and offsets – is quite politically viable. Any proposal hoping to survive Congress would have to create a corporate tax rate reduction that is revenue neutral, or near neutral, so as to not blow out the deficit. It is on this front, that we will also see substantive differences amongst the candidates. When it comes to the actual earnings of companies in an investment portfolio (the fundamental driver of stock prices), we believe corporate tax reform and a policy for repatriation of foreign profits will be highly stimulative. Businesses would have more incentive and certainty to drive hiring decisions and a framework to rationalize even greater hiring here in the United States.

The 2012 election carried great significance around personal tax policy because the income tax rates for every single American taxpayer were set to rise just seven weeks after the election, as were the rates on investment income (capital gains and dividends). Both parties wanted to wait until after the election to deal with this so as to potentially drive a more favorable outcome if their party prevailed in the election.

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On January 1, 2013, a bill was passed which kept all the income rates where they had been besides the top income rate (which rose from 35% to 39.6%). It kept the investment rates where they were (at 15%), until income had surpassed $250,000 for a single and $450,000 for a married couple (at which point the rate went to 20%). Absent this arrangement, the top dividend rate would have gone to 39.6%. No such "expiration" is set to happen in this cycle, as present tax rates are the law of the land both before and after this election, absent an act of Congress. While this takes the pressure off of the President and the legislature to act with urgency (as opposed to the 2012 cycle), virtually every candidate has some form of tax change as a part of their campaign platform.

A "flat tax" in which all Americans are paying the same rate of taxation, but the deductions that disproportionately help larger taxpayers are phased out, is popular in some Republican circles. Steve Forbes made it famous in his 1996 campaign for President. Ted Cruz, Rand Paul, and Ben Carson are all running on different flat tax proposal platforms in this cycle. Criticisms or concerns of a flat income tax rate generally center around fears that it would be inadequately progressive, or that it would not tax high earners enough. Other candidate proposals from the right may not involve a "flat tax", but they do involve a "flatter tax", where there are less brackets (usually three rates instead of five), and the rates are lower across the board.

The economic argument for lower rates at the high end were made popular by Ronald Reagan, Jack Kemp, and Art Laffer in the 1980's. It basically centers around incentive for productivity being higher when both the worker and the entrepreneur know he or she will be keeping more of what they earn on the margin. Our analysis indicates that tax simplification, and a flattening of tax rates, has bipartisan appeal. The tax proposals put forth by Jeb Bush, Marco Rubio, and John Kasich, all have strong similarities in them, and the likely economic effect of increasing productivity, thereby growing GDP. Investors are more likely to be impacted by the investment tax rates. While most Republican candidates call for an elimination of these rates, the political viability of such is not known at this time. No candidate in the Republican Party is calling for an increase in investment income tax rates. Hillary Clinton's proposal calls for capital gain rates to be raised dramatically, with the rate only staying at the present 20% if an investment is held six years or longer. It stands to reason that investors would be most served by lower rates on investment income, and that it would incentivize further investment.

We would also point out that the tax rate on dividend income has a dramatic impact on less affluent investors as well, including senior citizens who often most rely on that income. Once again, tax policy from a revenue standpoint has to be reconciled with deficit impact from a debt standpoint. While we would not endorse one particular policy over another, we can safely point out to investors that a dramatic reduction in investment income tax rates would be most positively stimulative, and a dramatic increase would be most problematic.

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Economic growth is never purely about tax rates, and political candidates have erred in the past by suggesting that a tax policy makes a sufficient economic policy. However, tax rates matter, and many elected officials – and their constituents on both sides of the aisle – believe some form of tax code simplification is in order.

In summary, we believe corporate tax rate reform, a repatriation of foreign profits to encourage domestic investment, a simplification of personal tax rates (that involves some form of flattening), and an avoidance of higher investment income tax rates are the four elements of tax policy most likely to impact an investor's portfolio from the 2016 election.

Energy & Economic Growth

While tackling entitlements, reducing the national debt, and creating tax policy suitable to compete globally and drive productivity are all noble and desired ends in this election cycle, one industry, in particular, has the potential to unleash significant economic growth across the U.S. economy. The Energy sector (unlike Technology and Consumer Staples, for example) contains significant policy implications that effect its health and vibrancy.

The Energy industry is heavily beholden to national energy policy due to the foreign policy implications and heavy environmental impact. The vast majority of jobs created during the Obama administration were created in the Energy industry, as the fracking revolution created new technologies and new opportunities which essentially birthed an entirely new business. With that said, federal lands have not been opened up to exploration, and various pipelines which would facilitate North American oil production and transportation have not been approved (most famously, the Keystone pipeline).

The reality is that both before the oil price collapse of late 2014 and afterwards, significant economic potential is embedded in the American Energy infrastructure. Producers and explorers of both oil and gas have created a literal renaissance around horizontal drilling and fractionation techniques (fracking). This increased production capability has changed the discussion in profound ways about the exporting of oil and gas. Indeed, while decades-old bans of exporting crude oil were originally intended to protect the U.S. reserves of oil because of our limited capacity for production, we now have flipped that on its head, and have the ability to become an exporter of oil and gas, with tremendous national security and economic benefits.

Liquefied natural gas is an entirely U.S.-created phenomena, the exports of which carry huge economic leverage because this much more expensive natural gas is in other parts of the world than it is here (giving producers huge incentives around

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profit margins to sell worldwide). It is Pollyannaish to suggest that merely lifting the ban on exporting crude oil would solve all of our problems. Indeed, the producers would not be able to realize profits on such an opportunity yet because there is no 21st-century infrastructure in place to transport and store such increased volumes and prepare them for external shipment. It is that infrastructure need which represents the opportunity for economic growth in this cycle. Funded entirely by the private sector (almost all discussion of "infrastructure investment" involves public funding; not this one), there is likely to be a major decision around U.S. energy policy in the aftermath of this election. The degree of savvy the candidates offer in this space may speak a lot to their understanding of economic growth and the needs and opportunities in this present context.

We would not ignore the implications for economic growth out of other sectors either. Drug stocks face particular headwinds as debate rages on about whether or not the government should fix prices in Pharmaceuticals. Medicare reimbursement rates are a pivotal topic for hospitals, care providers, and drug companies. The Financial sector continues to be impacted by the manner in which Dodd-Frank legislation is enacted. Monetary policy effects housing, construction, the net interest margin at banks, and mortgage rates. The Industrials space is effected by the tax treatment of large purchases. (Several pro-growth policy proposals have called for immediate write-off of large capital expenditures, a move that would dramatically boost business investment.) At the end of the day, all of these sectors (and others) will be impacted by the 2016 election, but we do not believe any will be more impacted than the Energy sector.

There are environmental impacts on each element of energy policy. This matters both for the political viability of what is proposed but also for the stewardship of our environment. A greater use of natural gas for power generation in our society means less greenhouse emissions and reduced risk in transportation. Politicians have talked for 50 years about a national energy policy, and the motivations have generally been around national security (reducing our dependence on Middle East oil). For the first time in these 50 years, the next President will actually have a chance to do just that – reduce domestic dependency on Middle East oil, and create more opportunity around U.S. energy. The natural gas and natural gas liquids story is a catalyst for the GDP growth our country needs to solve its long-term debt issue, to create jobs in the middle class, and to adopt to the challenges of a 21st-century global economy.

The Aspirational Society

The final area we highlight where the 2016 Presidential election carries profound significance for investors is that of the "aspirational society". This speaks to the DNA of the American people, and our foundational bedrock as a productive society, a leading economy, and a community that believes in the hopes and dreams of a free market. The last 10 years have not been kind to the aspirational society.

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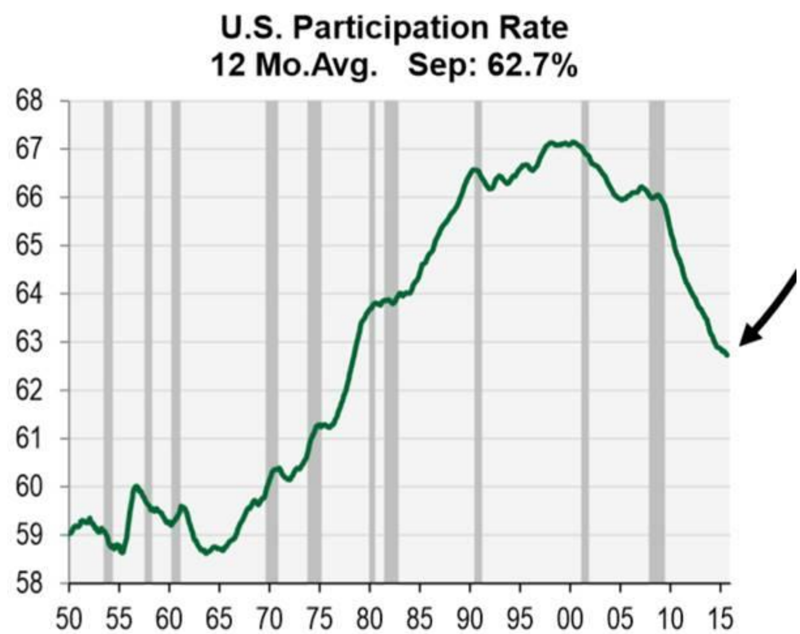
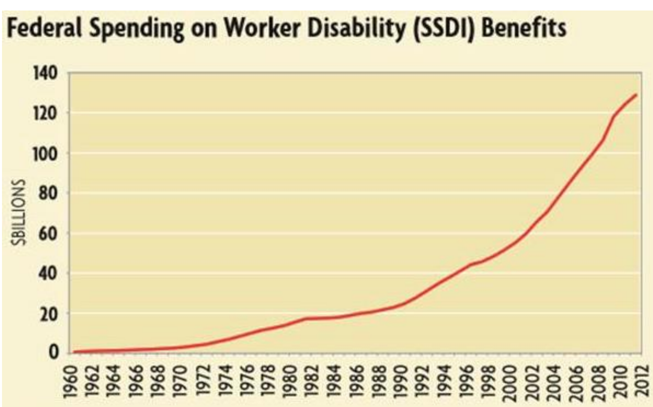
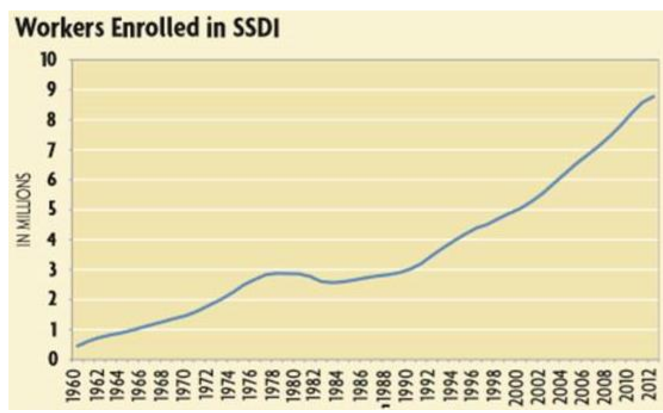
Participation in the labor force has fallen precipitously since 2010. The number of those on Food Stamps has risen over 43%.



Source: Cornerstone Macro Research, October 30, 2015

There has been a 49.7% increase in those making disability claims with social security. Most interestingly, this comes as physical demands in most jobs have decreased and overall health has increased.





Source: Social Security Administration, 2013; Note: 2012 figure through August.

The new President has a chance to set a tone for a truly aspirational society, where a more even playing field can exist, and where the American tradition of hard work, opportunity, and incentives not only exist, but flourish. The higher education system in America has grown exponentially over the last several decades, but that increase has led to higher tuition rates and higher student debt, but not necessarily higher incomes for young adults.

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Globalization has changed much of the dynamic for an American work force, and our economy requires innovative restructuring in how we approach education, technology, training, and engagement. The jobs that will be created in the next decade will not look exactly like the jobs created in the last decade, and certainly not like the ones created in the five preceding decades.

What will carry the biggest impact on the economy out of this election will be the tone and policy spectrum around the society we want to be. The American model has been one of free markets, the overcoming of obstacles, and the profit motive since the birth of America. Will our new direction be one of less aspiration, less innovation, and less opportunity? Or, will it be one that supports business, supports the entrepreneur, supports the profit motive, and ultimately, supports the aspirational society? The answer to these questions will determine much for investors and economic actors in the years to come.

The Presidential election of 2016 will not answer it entirely, but the tone and demeanor set from the bully pulpit matters. A society of people with jobs requires a society of job creators. The 21st-century economy can flourish in America despite global competitiveness, despite excessive indebtedness, and despite the steps backward in the American psyche around work. That flourishing will come from free market forces, functioning within a framework that encourages risk and reward. I see this element at the heart of what will matter to investors in the Presidential election of 2016.

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