Weekly Market Commentary

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The "Wall Street" Election Poll

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Highlights

The biggest event for investors over the next six months is likely to be the November elections in the United States. The outcome of the elections will define the political context and leadership for the policies that address the looming fiscal imbalances coming to a head in early 2013.

Based on the relative performance of legislation-sensitive industries that may react more favorably to one party, we have created two indexes to help us track the markets' implied forecast of the election outcome reflected in the performance of these industries.

While there are other factors that may influence the relative performance of these indexes, as time goes on the election consequences may become paramount as investors increasingly vote with their money.

The biggest event for investors over the next six months is likely to be the November elections in the United States. The outcome of the elections will define the political context and leadership for policies that address the looming fiscal imbalances coming to a head in early 2013. We have explored this budget bombshell in prior commentaries and what it could mean for the markets and economy. This week we will take a look at what the market is pricing in regarding the election outcome.

As we explore the issue of what the market is pricing in when it comes to the outcomes of the November elections, it is important to be aware of the shortcomings of overly simplistic election analysis. An illustration of this can be seen in Figure 1, where we plot the odds of President Obama's re-election (measured by contracts traded on Intrade.com) and the movements in the stock market, measured by the S&P 500 Index. Is the stock market going up because of the rise in Obama's re-election odds, or are Obama's re-election odds going up because the stock market is rising—or, more likely, are both tied to something else?

1 Odds of Obama Re-election and S&P 500

Source: LPL Financial, Intrade.com 05/04/12

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

Attempting to draw simple conclusions about what the market is saying about the election is fraught with the potential for misinterpretation. Instead, there is a better, more analytical way for investors to attempt this kind of potentially rewarding analysis. Analyzing the market by the industries most impacted one way or another by the election outcome can provide more precise insight into what the market is pricing in regarding the election.

For example, the components of the 10 stock market sectors are impacted in different ways by election outcomes:

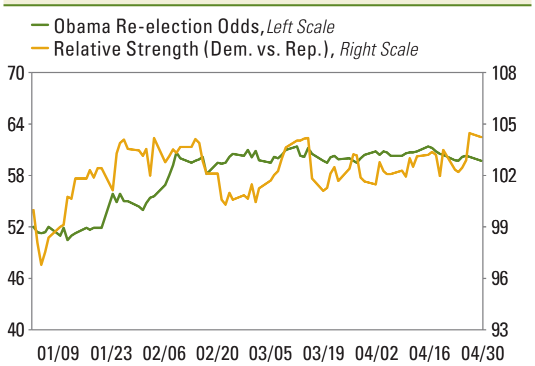
- Health Care is the biggest driver of the long-term budget problems at the Federal level. States are already cutting Medicaid to balance their budgets. A sweeping win for the GOP holds the most promise for Managed Care providers as risks decline and investors increase the odds for a repeal of all or part of the Affordable Care Act. Diagnostic labs, generic drug makers, hospitals, and nursing homes may benefit if the Act is upheld and from Democrats' leadership, given expanded health care coverage and an emphasis on preventative care and legislation to speed up the introduction of generic drugs to market.
- We may see a relief rally among the banks in the legislation-sensitive Financial sector. If the GOP takes the Senate it will result in the change of chairmanships of key committees. While major changes to the financial reform law, Dodd-Frank, are unlikely, an all GOP Congress might influence regulations implementing the law. On the other hand, Republicans would likely look to address Fannie Mae and Freddie Mac conspicuously left out of the Democrat-led financial reform law, which could have negative ramifications on home loan originators. Democrats may also provide more housing support programs benefitting home builders and construction materials providers.
- As previously mentioned, the potential extension of Bush tax cuts would mean the dividend tax rate may remain closer to 15% instead of going to 43.4%, a plus for companies with lots of cash to distribute. High dividend-paying sectors such as Telecommunications Services, Consumer Staples, and Utilities may benefit. Cash-rich companies in other sectors may also benefit as they introduce or substantially increase their dividend payout as they look to attract a new class of investor seeking yield. Alternatively, some food and staples retailers may benefit from potential for a further extension of unemployment benefits.
- Companies in the Energy sector may be impacted by a strong election for the GOP in a number of ways. Regulations on drilling would be more favorable as would EPA regulations. We could see lower regulatory costs for producers in the Materials sector and users of coal such as Utilities. Gas may benefit from stricter coal regulations under the Democrats. On the other hand, alternative energy companies would face a less supportive outlook for subsidies under a GOP outcome.

2 S&P 500 Industries Likely to React More Favorably to One Party

Republicans	Democrats
S&P 500 Coal & Consumable Fuels	S&P 500 Health Care Facilities
S&P 500 Diversified Financial Services	S&P 500 Food & Staples Retailing
S&P 500 Oil & Gas Exploration & Production	S&P 500 Gas Utilities
S&P 500 Oil & Gas Drilling	S&P 500 Health Care Services
S&P 500 Managed Health Care	S&P 500 Life Sciences Tools & Services
S&P 500 Electric Utilities	S&P 500 Construction Materials
S&P 500 Specialty Retail	S&P 500 Homebuilding

Source: LPL Financial 05/07/12

3 LPL Financial Research "Wall Street" Election Poll: Relative Strength of Democrat vs. Republican Indexes Reflect Election Odds



Source: LPL Financial, Intrade.com, FactSet Research Systems 05/07/12

- Sectors highly sensitive to trade, including **Technology,** may benefit from a strong showing by the GOP. The **Consumer Discretionary** sector could also benefit from the diminished risk of China trade protectionism—a plus for retailers dependent on low-cost imports and U.S. exporters of capital equipment fearing Chinese retaliation.
- The election could hold positives and negatives for companies in the **Industrial** sector. At 20% of the budget, defense spending will likely see cuts next year, but would likely see a more shallow trimming under the GOP than Democrats. On the other hand, transportation funding will likely be smaller under GOP leadership, resulting in fewer government dollars for engineering and construction companies.

While there are many "man on the street" polls, what matters most to investors is what is priced in on Wall Street rather than what people are saying on Main Street. A stock market based "election poll" is useful in that it highlights what the market is pricing in about the outcome of the election that is more refined than merely looking at the overall market.

Based upon these legislation-sensitive industries, we have created two indexes to help us track the markets' implied forecast of the election outcome reflected in the performance of these industries. Each index is composed of an equal weighting among seven industries that combined total about 100 S&P 500 stocks.

To track what the market has priced in for the Democrats' odds of retaining the White House and Senate we have taken the Democrats index and divided it by the Republicans index. An upward sloping line suggests the market may be pricing in a rising likelihood of the Democrats retaining the White House and their majority in the Senate, while a downward sloping line suggests improving prospects for the Republicans. While other factors may influence the relative performance of these indexes, as time goes on the election consequences may become paramount as investors increasingly vote with their money. As you can see in Figure 3, already this year Obama's re-election odds on Intrade.com are generally tracking the relative strength of our Democrat vs. Republican indexes.

If you elect to follow our "Wall Street" election poll index, we pledge to continue to keep you informed as to how these issues are likely to affect the markets. We will update this index frequently as the election becomes an increasingly important driver of the markets over the coming six months. ■

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Consumer Discretionary Sector: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services and education services.

Consumer Staples Sector: Companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.

Energy Sector: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Financials Sector: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

Health Care Sector: Companies are in two main industry groups — Health Care equipment and supplies or companies that provide health care-related services, including distributors of health care products, providers of basic health care services, and owners and operators of health care facilities and organizations. Companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

Industrials Sector: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Manufacturing Sector: Companies engaged in chemical, mechanical, or physical transformation of materials, substances, or components into consumer or industrial goods.

Materials Sector: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

Information Technology: Companies include those that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

Telecommunications Services Sector: Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth and/or fiber-optic cable network.

Utilities Sector: Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

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