Key Insights

→ The Republican Party added to its majority in the House of Representatives, regained control of the Senate and padded their majority in the Governor’s races.

→ With a Republican Congress and a Democratic Executive branch, we envision three paths of political implications going forward: Gridlock & Parallel Policymaking, Mix of Gridlock and Compromise and Compromise. While the path is not clear-cut, we believe concerns over the President’s legacy may well force him to follow the bumpy middle path of a mix of compromise with gridlock in dealing with Congress.

→ In our view, the potential exists for both Republicans and Democrats to come together on some key reforms for the US economy (the Keystone pipeline, corporate tax reform, trade agreements and energy policy liberalization) but it will not come smoothly. There are likely to be some serious negotiations and we would not be totally surprised if a few of these policies gets derailed.

→ As medium-to-long term investment implications, any move to pass trade agreements, reform corporate taxes, reduce regulation and take measures to boost growth are likely to push equity prices higher and to strengthen the US dollar. On US Fixed Income, they may be negative: they could weigh on rate hike expectations and, more importantly, pull forward the tightening cycle.

Another Wave Election

The churning of the American electorate continues yet again experiencing an unprecedented fourth Wave Election in the last 10 years – 2006, 2008, 2010 and now 2014. The Republicans (the Grand Old Party (GOP)) added to its majority in the House of Representatives, regained control of the Senate and padded their majority in the Governor’s races. Though some races are still too tight to call or being recounted, the GOP could gain as much as 16 seats in the House to take a 250-185 (currently 245 – 184, with 6 undecided). 250 would be the largest GOP majority since 1929. The GOP will take control of the Senate, currently leading 52 – 44, with 2 races undecided. Finally, in the Governor’s races, the GOP is expected to pick up 2 seats for a 31-19 lead over the Democrats.
Uphill Environment
Since the beginning of the year, it was obvious the Democrats were going to face major headwinds in the mid-term elections for the following reasons:
1. President Obama’s approval ratings have been averaging in the low-to-mid 40’s all year long – an important threshold for potential wave election
2. An overwhelming majority of Americans continued to believe the country was heading in the “wrong direction” with 64.9% believing the country is on the “wrong track” compared with only 26.4% who believe it is on the “right track”, according to the Huffington Post Pollster Trend. This had been building from years of negative real income growth, renewed US involvement in the Middle East, and other factors.
3. Democrats were defending 21 Senate seats versus only 15 for the GOP and most of them in Red States where GOP nominee Romney won by wide margins in 2012.

Political Implications for the 2016 Presidential Elections
No Coat Tails? - With Obama’s poor approval ratings, the Clintons were in demand to campaign across the country. Given the results, it is evident the Clintons have little or no coat tails.
Demographics Time Bomb for GOP? - There is a belief the GOP suffers from a demographic issue as the US becomes more diverse. However, the exit polls showed that there were more Latinos voting for the GOP compared to 2012. Interestingly, the GOP showed its biggest improvement among Asians, the fastest growing community in the US, where they split nearly 50-50 – a swing of 9% for the GOP. These improvements, if they continue, could help GOP prospects to regain the White House in 2016.
Early Edge for Democratic Candidate? - A recent research reveals that in the Senate, the mid-term election in the second presidential term is actually negatively correlated with the presidential election result two years later (i.e. greater Republican gains this year would be associated with a greater vote for the Democratic presidential candidate in 2016).

The Mid-term Election in the Second Presidential Term Seems Actually Negatively Correlated With the Presidential Election Result Two Years Later

Source: Goldman Sachs. data as of 7 November 2014.
Three Possible Paths

With a Republican Congress and a Democratic Executive branch, we envision three paths going forward.

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Source: Pioneer Investments, as at November 7, 2014.

President Obama did not follow the path of compromise during the first two years of his first term in office. He enjoyed a Democratic Congress and was able to pass major legislative priorities such as Obamacare and the American Recovery and Reinvestment Act of 2009. Following the GOP wave of 2010, President Obama has had frosty relations with GOP leaders in Congress and therefore Gridlock & Parallel Policymaking was the norm. As a result, very little of substantive legislation was passed during the last 4 years.

As the Obama presidency veers towards the final two years of his term, a period known as the Lame Duck stage, he will increasingly begin to think about his legacy. While the path is not clear cut, we believe concerns over his legacy may well force Obama to follow the bumpy middle path of a mix of compromise with gridlock.

Policy Agenda for 2015

We look at potential policy agenda for 2015 and the probabilities that they become law.

> 50% Probability of Passing and becoming Law

Approval of Keystone XL Pipeline – This is a project that aims to build a pipeline carrying Canadian tar sands oil from Alberta, Canada to the Gulf Coast of Texas. This project was opposed by Democratic Senate leadership and President Obama. Mr. Obama wanted to wait until the State Department finished its review of the pipeline.

Corporate Tax Reform – This is a perennial issue that could garner bi-partisan support. Both President Obama and the both sides of Congress agree the current corporate tax system is deeply flawed with big loopholes, high statutory tax, incentives to keep profits/proceeds abroad, to name a few. According to Citibank research, the general outline of corporate tax reform has broad agreement: Cut the corporate tax rate from 35% to between 20-27%, taxing profits earned overseas at between 5 and 20% and finally eliminate loopholes and depreciation allowances that favor capital intensive firms/industries but leave many non-capital intensive firms paying much higher effective taxes.
Trade Promotion Authority (TPA) – TPA allows fast track consideration of trade agreements which is critical to approving the Trans-Pacific Partnership (TPP). Obama supports this bill but has not come to a vote due to opposition by Senate Majority Leader Reid.

Energy Exports – Viewed as a strategic asset, oil exports have been banned since the 1970’s. Now that US oil production at 8.64mbpd (million barrels per day) is at its highest level since the 1980’s, there has been bi-partisan talk of liberalizing the law that would lead to a resumption of domestically produced US oil exports.

Comprehensive Immigration Reform – This bill would reform the nation’s immigration system by providing a path to legal citizenship for the country’s 11 million illegal aliens.

Obamacare – The GOP is looking to repeal parts of the Affordable Health Care Act, such as the medical device tax. The Supreme Court has agreed to hear a case concerning subsidies for poorer Americans that boils down to the legality of taxes in light of the way that the law is currently written, which could be a major setback.

Fiscal Policy – There could be room for an agreement on fiscal policy. The Republicans would like to ease restrictions on the payment scheme for higher defense spending. The Democrats would like to increase domestic spending on infrastructure, such as roads or raise the minimum wage.

Foreign Policy – The GOP could try to have a bigger impact or influence foreign policy. They could pass symbolic legislation to escalate sanctions on Russia. They could authorize further US involvement against ISIS or another Middle East conflict.

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We believe the potential exists for both sides to come together on the Keystone pipeline, corporate tax reform, trade agreements and energy policy liberalization, but it will not come smoothly. There are likely to be some contentious negotiations and we would not be totally surprised if a few of these policies get derailed. For the other bucket, it is unlikely both sides will come to any meaningful compromise. On immigration reform, the newly elected GOP will view their election as a mandate for a more conservative approach than the White House has proposed. The President may try to use Executive Authority to by pass Congress and implement a watered down immigration reform. Any changes to Obamacare are likely to be vetoed by the President so any GOP move will only be symbolic. Finally, if there is a stronger possibility of passage, it will come from some sort of Fiscal agreement or on Foreign policy.

Long Term Investment Implications

US Equity Market - Positive
A recent analysis by Goldman Sachs has shown that the post-mid-term trend in the S&P performance has substantially and fairly consistently exceeded average performance, and this was regardless of party. They found no one factor driving this outperformance.
Qualitatively, any move to pass trade agreements, reform corporate taxes, reduce regulation and take measures to boost growth i.e. Keystone are likely to push equity prices higher.

**Foreign Exchange – US dollar Positive**
From a top down perspective, any effort at passing legislation aimed at boosting growth is USD positive. In addition, liberalizing energy exports will help reduce the trade and current account deficit that is likely to be even more favorable to the USD. From a micro perspective, there has been speculation that tax reform might include repatriation of corporate earnings held overseas. There are more than $2.25tn unrepatriated earnings held abroad. If there is a tax reform that provides incentives for corporations to repatriate a portion of its overseas earnings this could lead to a stronger USD similar to the Homeland Investment Act of 2005 (HIA). HIA led to a repatriation of approximately $100bn in Q4 2005 that led the USD index to appreciate 7%.

**US Fixed Income - Negative**
Passage of any of these measures will be seen as pro-growth and should push Treasury yields incrementally higher. Also, it could weigh on rate hike expectations and more importantly pull forward the tightening cycle. We expect the yield curve will continue to flatten as short end yields climb on rate hike expectations while current benign inflation/inflation expectations will work as a stabilizer at the long end and attempt to temper higher yields.

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